

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition :  
of :  
**COSTCO WHOLESALE CORPORATION** : DETERMINATION  
DTA NO. 825882

for Revision of a Determination or for Refund of Sales and :  
Use Taxes under Articles 28 and 29 of the Tax Law for :  
the Period September 1, 2005 through February 28, 2009. :

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Petitioner, Costco Wholesale Corporation, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 2005 through February 28, 2009.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, in New York, New York, at 10:30 A.M., on November 21, 2014, with all briefs submitted by March 25, 2015, which date began the six-month period for the issuance of this determination. Petitioner appeared by Alan Ziperstein, CPA. The Division of Taxation appeared by Amanda Hiller, Esq. (David Gannon, Esq., of counsel).

### ***ISSUE***

Whether petitioner is entitled to an exemption from sales tax for utilities consumed by its commercial pan washers.

### ***FINDINGS OF FACT***

1. During the period in issue, September 1, 2005 through February 28, 2009 (audit period), Costco Wholesale Corporation (Costco) was a corporation headquartered in Issaquah, Washington, that provided retail and wholesale distribution of consumer goods and services,

together with meat and bakery products, pharmacies, photograph processing and automotive tires and services. Costco had 13 locations or warehouses within New York State, including 2 gas stations located in Nanuet and Staten Island.

2. A sales and use tax audit was performed by the Division of Taxation (Division) for the audit period between April 2009 and June 2012. The audit inspected sales transactions, recurring expense purchases and capital purchases. A refund application, not in issue here, was granted for tax paid on what were determined to be exempt purchases of utilities used in production and for the purchases of equipment used predominantly in production in the bakery and meat departments. The exemption that gave rise to the refund was for 21.65% of the electricity used in the production facilities and 32.26% of the gas consumed. These figures were determined after an exhaustive analysis of equipment at four stores in New York State and thorough consideration of the equipment manufacturers' specifications. The Division worked with petitioner, the equipment manufacturers and technical manuals to arrive at an acceptable ratio of utilities consumed.

3. At the conclusion of the audit, petitioner was found to owe additional sales and use taxes for the audit period of \$3,271,472.93 plus interest. After the refund was applied, petitioner made payment in full and the audit was completed. Petitioner was notified of the completion by letter dated June 6, 2012.

4. A second refund application was filed by petitioner on June 15, 2012 that sought a refund of taxes paid presumably on utilities and equipment used directly in the production of tangible personal property for sale in the amount of \$125,013.31, plus interest. Specifically, the claim sought a refund of taxes on the utilities used to power the pan, pot and kettle washers (pan washers). Petitioner never contended that these washers qualified for an exemption from tax as equipment used directly and predominantly in the production of a product for sale. The pan

washers were used before the production process to clean and sanitize the pans for use in the production process at a later time. The pan washers, of necessity, must be clean and sanitized prior to the raw materials being introduced into the production process.

5. By letter of July 25, 2012, the Division denied the claim in full, stating:

“Refund requested was denied because purchases of tools used in the general maintenance, repair, or servicing of production machinery and equipment is subject to tax. The pan-washer was not qualified production equipment but a tool used to clean production equipment and utensils before or after production process; and the utilities it consumed was [sic] not exempt from tax during audit period.”

6. According to the company that fabricates the pan washers, LVO Manufacturing Inc., the pan and rack washers were designed to wash and sanitize pots, bun/sheet pans, cake pans, racks, steam table pans, totes, bins, buckets, and other items commonly found in the bakery, meat, poultry, candy and food service industries. The items were loaded into the racks that are specially designed to hold them for the most effective cleaning. Recirculating water is pumped through high velocity, stainless steel V-jet wash nozzles. The machines were fully automatic, with adjustable wash, rest and rinse timers. LVO pan and rack washers were NSF (National Sanitation Foundation) approved for hot water sanitation (180 F-195F) to kill bacteria and other contaminants.

7. Petitioner used its LVO pan washer in its bakeries to wash, rinse and sanitize bakery equipment in order to comply with the federal Food and Drug Administration’s (FDA) requirements specified in the FDA Food Code 2009 part 4-501.112 et seq.

#### ***SUMMARY OF THE PARTIES’ POSITIONS***

8. Although not used directly and predominantly in the production process, petitioner argues that the utilities consumed by the pan washers qualify for the exemption from sales tax

because they are used to create conditions necessary to complete the production process by sanitizing the pots, pans, kettles and utensils used in the production process.

9. The Division contends that since the pan washers were not a part of the production process they were not entitled to an exemption and the utilities consumed by them were likewise not entitled. The Division argues that the utilities were not consumed by machinery and equipment directly and predominantly in the production process and, therefore, do not qualify for the exemption.

### ***CONCLUSIONS OF LAW***

A. Tax Law § 1115(c)(1) provides for an exemption from the sales and use taxes imposed under Tax Law §§ 1105 and 1110 as follows:

“Fuel, gas, electricity, refrigeration and steam, and gas, electric, refrigeration and steam service of whatever nature for use or consumption directly and exclusively in the production of tangible personal property, gas, electricity, refrigeration or steam, for sale, by manufacturing, processing, assembling, generating, refining, mining or extracting shall be exempt from the taxes imposed under subdivisions (a) and (b) of section eleven hundred five and the compensating use tax imposed under section eleven hundred ten of this article.”

B. The regulation promulgated pursuant to Tax Law § 1115 (c), 20 NYCRR 528.22 (c), provides the following:

“(c) Directly and exclusively. (1) Directly means the fuel, gas, electricity, refrigeration and steam and like services, and must during the production phase of a process, either:

- (i) operate exempt production machinery or equipment; or
- (ii) create conditions necessary for production; or
- (iii) perform an actual part of the production process.

(2) Usage in activities collateral to the actual production process is not deemed to be use directly in production.

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(3) (c) Exclusively means that the fuel, gas, electricity, refrigeration and steam and like services are used in total (100%) in the production process.

(ii) Because fuel, gas, electricity, refrigeration and steam when purchased by the user are normally received in bulk or in a continuous flow and a portion thereof is used for purposes which would make the exemption inapplicable to such purchases, the user may claim a refund or credit for the tax paid only on that portion used or consumed directly and exclusively in production.”

C. Based on these statutory sections and the regulation, it is concluded that the Division properly denied the exemption from sales tax with respect to the electricity consumed by the pan washers.

Petitioner argues that because the pan washers are creating conditions necessary for production to occur, the utilities consumed by them are being used directly and exclusively in the production process and thus qualify for the exemption provided for in Tax Law § 1115(c)(1). Petitioner readily concedes the pan washers themselves do not qualify for any production exemption, but contend that the standard is different for the utilities consumed by them as set forth in the regulation at 20 NYCRR 528.22 (c). Further, petitioner points out that the same information is restated in the Division’s Publication 852, “Sales Tax Information For: Manufacturers, Processors, Generators, Assemblers, Refiners, Miners and Extractors [and] Other Producers of Goods and Merchandise.”

Petitioner’s interpretation of the statute and, in particular, the regulation, ignores a critical phrase in the regulatory definition of “directly and exclusively,” which limits any exemption for utilities consumed to those consumed “during the production phase of a process” to create conditions necessary for production. (*See Matter of Klein’s Bailey Foods*, Tax Appeals Tribunal, August 4, 1988.) Although petitioner would like to ignore the other provisions of Tax Law § 1115, the section provides the context that guides the interpretation of subsection (c) and the regulation promulgated thereunder. Tax Law § 1115(a)(12) provides an exemption for machinery

or equipment used or consumed directly and predominantly in the production of tangible personal property for sale. Petitioner discarded this standard for utilities because it does not seek an exemption for the pan washers, admitting they are not used directly and predominantly in the production process. Instead, petitioner carefully crafted its argument using the regulatory definition of “directly and exclusively” to lay claim to the exemption for utilities consumed in the production process. The flaw in the argument is that the use of the utilities must create the conditions necessary for production *during the production phase of the process*. Clearly, the record demonstrates that the pan washers were not used during the production phase herein. They were used to clean and sanitize equipment before it ever came into contact with raw materials in the production process. Petitioner has not introduced any evidence that the pan washers were part of the production process and readily admits they do not qualify for a production exemption. (Tax Law § 1115[a][12].)

The regulation at 20 NYCRR 528.13, promulgated pursuant to Tax Law § 1115(a)(12), carefully defines the administration, production and distribution phases of production. Production “includes the production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished and packaged for sale.” (20 NYCRR 528.13[b][1].) The regulation notes also that the exemption only applies to machinery and equipment directly and predominantly used in production, not the other phases. (20 NYCRR 528.13[b][2].) The pan washers do not qualify for the exemption because their place in the process was clearly not in the production phase, indicating that the utilities consumed by them were likewise not consumed in the production phase, and were, therefore, not used directly and exclusively in the production of the tangible personal property. (20 NYCRR 528.22 [c].)

Similarly, the Division's own Publication 852 comes to the same conclusion with regard to the exemption for utilities, consistent with the analysis above.

Petitioner's reliance on the TSB-A-96(51)S was in error by extension of the same reasoning. There, heating, ventilating and air conditioning systems (HVAC) were determined to be necessary to maintain specific environmental conditions within the motor control centers that housed electrical components of the manufacturing production line equipment for the production of paper. The Division determined that the motor control centers, which were directly wired to the production equipment, assumed the identity of the machinery and equipment and were therefore entitled to the same exemption afforded the machinery and equipment. The utilities consumed by the HVAC system were likewise extended the exemption because of its place in the production process, in contrast to the pan washers, which were not used during the production phase.

D. As the instant matter presents the issue of whether petitioner is entitled to an exemption from sales tax, it must be noted that statutes and regulations authorizing exemptions from taxation are to be strictly and narrowly construed (*see Matter of International Bar Assn. v. Tax Appeals Tribunal*, 210 AD2d 819 [1994], *lv denied* 85 NY2d 806 [1995]; *Matter of Lever v. New York State Tax Commn.*, 144 AD2d 751 [1988]). In order to qualify for the exemption, petitioner bears the burden of clearly proving its entitlement to the exemption sought (*see Matter of Grace v. New York State Tax Commn.*, 37 NY2d 193 [1975], *lv denied* 37 NY2d 816 [1975]). Based upon the discussion above, it is concluded that petitioner has not met its burden.

E. The petition of Costco Wholesale Corporation is denied, and the Division's denial of petitioner's application for refund, dated July 25, 2012, is sustained.

DATED: Albany, New York  
August 27, 2015

/s/ Joseph W. Pinto, Jr.  
ADMINISTRATIVE LAW JUDGE