New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-87 (14) C
Corporation Tax
May 29, 1987

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION PETITION NO. C861215B

On December 15, 1986, a Petition for Advisory Opinion was received from Protocom Devices, Inc., 1666 Bathgate Avenue, Bronx, New York 10457.

The issue raised is whether Petitioner, an Article 9-A taxpayer, is allowed an investment tax credit, pursuant to section 210.12 of the Tax Law, and an employment incentive credit, pursuant to section 210.12-A of the Tax Law, with respect to manufacturing equipment used in the production of computer hardware and software which is used in a data communications environment. Also, since Petitioner has not earned any profits to date, can the investment tax credit be allowed in the current taxable year, as a refund, rather than carrying the credit to future years.

Petitioner was incorporated in February 1983, and is engaged in the design, development and manufacture of high performance communications processors that interface electronic data processing equipment (both synchronous and asynchronous) to state of the art X.25 packet switched networks. (X.25 is an international standard that defines the operation of a packet switched network). Without such highly sophisticated products, vendor specific electronic data processing equipment could not connect to nor communicate over packet switched networks. Among Petitioner's developed products are packet assembler/disassemblers that support the broadest variety of vendor specific synchronous equipment.

Petitioner designs, develops and manufactures software packages that provide network management and permit network access to personal computers. Petitioner has expertise in network design and consulting, as well as the production of customized interface products that satisfy unique requirements dictated by non-standard operating environments or desired by customers.

Petitioner also designs, develops and manufactures hardware products that contain the software products developed by Petitioner and function as the physical connective points between vendor specific equipment and X.25 packet switched networks.

The equipment used in Petitioner's manufacturing process is depreciable and was acquired since February 1983. The equipment consists of:

Fluke micro trouble shooter - used as circuit tester for repair of PCB's
Ungar desoldering system - used to repair damage electronic components
AMP harness tool - used in manufacturing of cable assemblies
Fluke meter - used for continuity tests of electronic circuits
Tektronic oscilloscope - used to measure signals on electronic circuits
Portable gang programmer - used for reproduction of software; EPROM's
Kayro 10 computer - used for software reproduction
IBM Computer - used for hardware design; schematics
Bernoulli 20 + 20 - used for software storage; all products
Apple Macintosh P.C.s - used for project management; data processing, etc.
Precision electric drill - used for assembly modifications.

Section 210.12 of the Tax Law allows an investment credit against the tax imposed under Article 9-A of the Tax Law equal to six percent of the cost or other basis of equipment which:

(1) is acquired, constructed, reconstructed or erected after June 30, 1982;

(2) is depreciable pursuant to section 167 of the Internal Revenue Code or recovery property with respect to which a deduction is allowable under section 168 of the Internal Revenue Code;

(3) has a useful life of four years or more;

(4) is acquired by purchase as defined in section 179(d) of the Internal Revenue Code;

(5) has a situs in New York State; and

(6) is principally used by the taxpayer in the production of goods by manufacturing, processing, and other specified activities.

"Manufacturing" means the process of working raw materials into wares suitable for use or which gives new shapes, new quality or new combinations to matter which already has gone through some artificial process by the use of machinery, tools, appliances and other similar equipment.

Section 5-2.4(b) of the Business Corporation Franchise Tax regulations (hereinafter Article 9-A regulations) provides, in pertinent part, that the term "property used in the production of goods" includes machinery, equipment or other tangible property which is principally used in the repair and service of other machinery, equipment or other tangible property used principally in the production of goods.

Section 5-2.4(c) of the Article 9-A regulations provides that the term "principally used" means more than 50 percent.

The investment tax credit is not allowed for any property which is leased by the taxpayer to any other person or corporation.

A similar investment tax credit is provided for in section 606 of the Tax Law with respect to personal income tax. Section 606(a)(2) which requires that the property claimed as the basis for the credit be "principally used by the taxpayer in the production of goods by manufacturing, processing..." follows verbatim the terms of section 210.12(b)(2). In applying section 606(a)(2), the Tax Commission has ruled that equipment used in the production of video tapes constitutes equipment used in the production of goods by manufacturing so as to satisfy the production pre-requisite for the investment tax credit. Richard H. Roberts, State Tax Commission Advisory Opinion, TSB-H-81(57)I. The same conclusion is also appropriate with respect to the tax imposed under Article 9-A of the Tax Law. In fact, the Tax Commission has made a similar ruling in Unitel Video Services, Inc., State Tax Commission Advisory Opinion, TSB-A-85(5)C.

The term "processing," while not defined in the statutory provision or regulation here at issue, is defined at 20 NYCRR 527.4(d) (a sales and use tax regulation) as "the performance of any service on tangible personal property for the owner which effects a change in the nature, shape or form of the property." In Continental Terminals, Decision of the State Tax Commission, TSB-H-82(4)C, the Tax Commission held such definition to be applicable to determinations made under Article 9-A. It appears clear from such definition that the transmutation of raw film to usable video tapes and films, and blank tapes to usable radio tapes, constitutes "processing" within the meaning of section 210.12(b) of the Tax Law. The conversion of raw film or tape into a form suitable for transmission is, in effect, a form of imprinting. Such procedure has itself been held by the Tax Commission to constitute processing, defined by the Commission as "an operation whereby raw material is subjected to some special treatment, by artificial or natural means, which transforms or alters its form, state or condition." Matter of Multimode, Inc., Decision of the State Tax Commission, May 20, 1983, TSB-H-83(23)C. See also Matter of Epic Chemicals, Decision of the State Tax Commission, October 30, 1981, TSB-H-81(59)C. The view represented herein is given further support by a consideration of the examples given in connection with 20 NYCRR 527.4(d). Thus, it is there held that the term "processing" applies to (1) the development of film by a photographic laboratory, (2) cutting, editing, sound dubbing and the addition of titles to convert exposed and developed film footage into a completed film and (3) changing existing computer programs by rearranging, adding or removing metal pins, for the metal bar type or altering the imprint on tape for the imprinted electronic tape type. The creation of television films and video tapes, as well as radio tapes and the changing of existing computer programs, similarly effects changes in the nature and qualities of film, tape, metal bar programs and imprinted tape programs and thus falls under the rubric of "processing".

In two distinguishing Tax Commission decisions, Matter of Super Data Systems, Inc., State Tax Commission, June 1, 1984, TSB-H-84(26)C and Matter of Quantum Computer Services, Inc., State Tax Commission, September 9, 1983, TSB-H-83(42)C, it was determined that the conduct of data processing services does not constitute the using of property in the production of goods or wares. In such instances, the taxpayer received data, such as payroll records, from customers. Taxpayer's employees using keypunch machines transfer the data onto tape or disk and either the computer reorganizes the data and prints documents such as a payroll check or statement to be returned to the customer or the tape or disk itself is returned to the customer for its use.

In the instant case, Petitioner produces, for sale to its customers, the hardware and software products it has developed. When producing the software products, Petitioner's activities are in the nature of taking a raw material and subjecting it to treatment that transforms or alters its form, state or condition, i.e, the taking of a blank tape or disk and substantially changing it by imprinting it to create a software program. Such process is similar to taking a blank video tape and imprinting a commercial on it to create a master video tape. Therefore, Petitioner's activities of producing the software products for sale to its customers constitutes "manufacturing" and "processing" as determined in Richard H. Roberts, supra; Unitel Video Services, Inc., supra; Continental Terminals, supra; Matter of Multimode Inc. supra; and Matter of Epic Chemicals, supra.

Since Petitioner's activities cannot be characterized as the mere taking of data from a customer and packaging it in a different form and giving that same information back to the customer, Petitioner's activities do not constitute data processing services as determined in Matter of Super Data Systems, Inc., supra; and Matter of Quantum Computer Services Inc., supra.

The production of Petitioner's hardware products, the physical connective points between vendor specific equipment and X.25 packet switched networks, clearly constitutes manufacturing as defined in section 210.12 of the Tax Law.

Accordingly, it is determined that all of Petitioner's equipment listed above, except the Apple Macintosh P.C.s, that is used in producing the hardware and software products is used in the production of goods by manufacturing and processing within the meaning and intent of section 210.12(b) of the Tax Law. This includes the equipment used in the repair of equipment used in the manufacturing process. The Apple Macintosh P.C's that are used for project management and data processing, do not constitute part of the manufacturing process. Matter of Epic Chemical, Inc., supra. Therefore, such computers do not qualify for the investment tax credit.

If Petitioner's equipment used in the production of goods meets the "principally used" test and also meets the other requirements of section 210.12 of the Tax Law, such equipment will qualify for the investment tax credit.

Section 210.12-A of the Tax Law allows an employment incentive tax credit against the tax imposed under Article 9-A of the Tax Law in each of the three years succeeding the taxable year for which an investment tax credit has been allowed under section 210.12 of the Tax Law. The amount of the credit allowed in each of the three years is fifty percent of the investment tax credit allowed. However, the credit is allowed only in taxable years when the average number of employees during each such year is at least 101 percent of the average number of employees during the taxable year immediately preceding the taxable year for which the investment tax credit is allowed.

Section 5-3.2(a) of the Article 9-A regulations provides:

The average number of employees in a taxable year as used in this Subpart is computed as follows:

(1) ascertain the number of employees within New York State, except general executive officers, employed by the taxpayer on March 31st, June 30th, September 30th, and December 31st in the taxable year;

(2) add together the number of employees ascertained on each of such dates; and

(3) divide the sum by the number of such dates occurring within the taxable year. 20 NYCRR 5-3.2.

Where a taxpayer qualifies for an investment tax credit with respect to eligible property, the taxpayer may also qualify for an employment incentive tax credit for each of the three years next succeeding the taxable year for which the taxpayer qualified for the investment tax credit. The taxpayer will qualify for the credit in each of the years in which the average number of taxpayer's employees is at least 101 percent of the average number of employees during the taxable year immediately preceding the taxable year for which the investment was allowable (the base year). Each year's qualification is determined separately. If a taxpayer fails to have a sufficient number of employees in one or two of the three years, it will nevertheless qualify for the credit in the year or years in which is has a sufficient number of employees.

Accordingly, if the Petitioner qualifies for the investment tax credit, it will also qualify for the employment incentive tax credit in each of the next succeeding three years if the number of its employees is at least 101 percent of the number of its employees in the base year. The amount of Petitioner's credit in each of the three years will equal one-half of Petitioner's investment tax credit (i.e. one-half of six percent) for a total of nine percent if Petitioner qualifies in all three years. This amount is in addition to the six percent credit allowed for the investment tax credit. If Petitioner does not claim the investment tax credit, Petitioner may not claim the employment incentive tax credit pursuant to section 210.12-A of the Tax Law for the appropriate taxable years.

A taxpayer must claim the investment tax credit for the first taxable year in which the property becomes eligible property. Section 210.12(e) of the Tax Law provides that the investment tax credit allowed for any taxable year shall not reduce the tax due below the fixed minimum tax and that when a taxpayer has an excess amount it may be carried over to the following year or years and may be deducted from the taxpayer's tax for such succeeding year or years. In lieu of such carryover, a taxpayer which qualifies as a new business may elect to treat the amount of such carryover as an overpayment of tax to be refunded.

Pursuant to section 210.12(j) of the Tax Law, a "new business" includes any corporation, except a corporation which:

(1) over 50 percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by a taxpayer subject to tax under Article 9-A; section 183, 184, 185 or 186 of Article 9; Article 32 or Article 33 of the Tax Law; or

(2) is substantially similar in operation and in ownership to a business entity (or entities) taxable, or previously taxable, under Article 9-A; section 183, 184, 185 or 186 of Article 9; Article 32 or Article 33 of the Tax Law; Article 23 of the Tax Law or which would have been subject to tax under such Article 23 (as such article was in effect on January 1, 1980) or the income (or losses) of which is (or was) includable under Article 22 of the Tax Law whereby the intent and purpose of paragraph (j) and (e) of subdivision 12 of section 210 of the Tax Law with respect to refunding of credit to new business would be evaded; or

(3) has been subject to tax under Article 9-A for more than four taxable years (excluding short taxable years) prior to the taxable year during which the taxpayer first becomes eligible for the investment tax credit.

Accordingly, Petitioner may elect to treat any allowable investment tax credit carryover as an overpayment to be refunded for the taxable years that Petitioner qualifies as a new business pursuant to section 210.12(j) of the Tax Law. The employment incentive tax credit is not refundable.

If a taxpayer fails to claim the investment tax credit or employment incentive tax credit for the taxable year in which it first qualifies for the credit, it may not claim the credit in a subsequent year. However, in such a case, the taxpayer may file amended returns for the taxable years in which the credits should have been claimed (as long as the period for filing such amended returns has not expired) and thereby claim the credit.

Section 1087(a) of the Tax Law provides that a claim for credit or refund of an overpayment of tax must be filed by a taxpayer within three years from the date the return was filed or two years from the date the tax was paid, whichever of such periods expires later. If a taxpayer files such an amended return, it may claim a refund of taxes previously paid (subject to the limitations set forth in sections 210.12(e) and 210.12-A(c) or it may carry over the credits to the following year or years and apply the credits against taxes for such year or years.

DATED: May 29, 1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.