

New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-05(25)S
Sales Tax
June 22, 2005

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S041221A

On December 21, 2004, the Department of Taxation and Finance received a Petition for Advisory Opinion from David E. Werth, CPA, Tronconi Segarra & Associates LLP, 6390 Main Street, Suite 200, Williamsville, New York, 14221.

The issues raised by Petitioner, David E. Werth, CPA, are:

1. Whether Petitioner's client is a person engaged in the production for sale of tangible personal property for purposes of section 1115(a)(12) of the Tax Law.
2. Whether Petitioner's client's purchases of machinery, equipment, tools, supplies and utilities used to apply coatings to its customers' property, as described below, qualify for exemption from sales and use tax pursuant to section 1115(a)(12) of the Tax Law

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner's client (XYZ) applies coatings that improve the performance of tools and precision components. The coatings are extremely thin, harder than steel and reduce friction and wear. XYZ develops the coatings and coating processes, markets systems and equipment to produce the coatings and provides a contract coating service in a network of coating centers that includes a facility in New York State.

XYZ's customers are typically manufacturers of tools and precision components. XYZ applies these coatings to its customers' tools or components (hereinafter "tangible personal property"). The typical process at a coating center begins with inspection of incoming tangible personal property to be coated. Upon receipt by XYZ, the tangible personal property to be coated is counted and inspected for material composition and surface condition. The tangible personal property is then cleaned using various specialized techniques which prepare the property's surfaces for application of the specific coating desired by the customer. Some additional pre-treatment may be required for certain applications. Then, using various methods, the coatings are applied to the customer's tangible personal property.

Once the coatings have been applied to the customer's tangible personal property, the coatings are inspected to ensure their proper application. In many cases, XYZ carries out a post-treatment where, for example, the coated tangible personal property is demagnetized. The coated tangible personal property is usually returned to the customer in the packaging in which it was delivered.

Applicable law and regulations

Section 1101 (b)(4) of the Tax Law provides, in part:

Retail sale. (i) A sale of tangible personal property to any person for any purpose, other than (A) for resale as such or as a physical component part of tangible personal property, or (B) for use by that person in performing the services subject to tax under paragraphs (1), (2), (3), (5), (7) and (8) of subdivision (c) of section eleven hundred five where the property so sold becomes a physical component part of the property upon which the services are performed or where the property so sold is later actually transferred to the purchaser of the service in conjunction with the performance of the service subject to tax. . . .

Section 1105 of the Tax Law provides, in part:

Imposition of sales tax On and after June first, nineteen hundred seventy-one, there is hereby imposed and there shall be paid a tax . . . upon:

(a) The receipts from every retail sale of tangible personal property, except as otherwise provided in this article.

* * *

(c) The receipts from every sale, except for resale, of the following services:

* * *

(2) Producing, fabricating, processing, printing or imprinting tangible personal property, performed for a person who directly or indirectly furnishes the tangible personal property, not purchased by him for resale, upon which services are performed.

Section 1105-B of the Tax Law provides:

(a) Receipts from the retail sales of parts with a useful life of one year or less, tools and supplies for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale by manufacturing, processing, generating, assembling, refining, mining or extracting shall be exempt from the tax imposed by subdivision (a) of section eleven hundred five of this article.

(b) Receipts from every sale of the services of installing, repairing, maintaining or servicing the tangible personal property described in paragraph twelve of subdivision (a) of section eleven hundred fifteen of this article, including the parts with a useful life of

one year or less, tools and supplies described in subdivision (a) of this section, to the extent subject to such tax, shall be exempt from the tax on sales imposed under subdivision (c) of section eleven hundred five of this article.

(c) Parts with a useful life of one year or less, tools and supplies described in subdivision (a) of this section and services described in subdivision (b) of this section shall be exempt from the compensating use tax imposed by section eleven hundred ten of this article.

Section 1115 of the Tax Law provides, in part:

(a) Receipts from the following shall be exempt from the tax on retail sales imposed under subdivision (a) of section eleven hundred five and the compensating use tax imposed under section eleven hundred ten:

* * *

(12) Machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale, by manufacturing, processing, generating, assembling, refining, mining or extracting. . . .

* * *

(c)(1) 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.

Section 527.4 of the Sales and Use Tax Regulations provides, in part:

Sale of services of producing, fabricating, processing, printing or imprinting.

(a) Imposition. (1) Section 1105(c)(2) of the Tax Law imposes a tax on the receipts from services of producing, fabricating, processing, printing or imprinting tangible personal property, performed for a person who directly or indirectly furnishes the property.

(2) The enumerated services are not taxable when:

(i) purchased for resale; or

(ii) performed on property intended for resale.

* * *

(d) Processing. Processing is 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.

* * *

(f) Resale. (1) When the services enumerated in this section are rendered on property held for resale, the services are not taxable.

Example 1: A manufacturer of home appliances has certain of the component appliance parts galvanized by a plating firm. The service of galvanizing is not taxable since it is being performed on a product which will be sold by the manufacturer.

(2) Where a person performing a service subject to tax purchases tangible personal property, which becomes a part of the property on which the services are performed or which is later transferred to the purchaser of the service in conjunction with the service performed, the purchase of the property is for resale and is not subject to the sales tax.

Example 2: A plating company purchases zinc for galvanizing steel which is furnished by its customer. The zinc becomes part of the steel. The purchase of the zinc by the plating company is a purchase for resale which is not subject to tax.

Section 528.13 of the Sales and Use Tax Regulations provides, in part:

Machinery and equipment used in production; telephone and telegraph equipment; parts, tools and supplies.

(a) Exemption. (1) Exemption from statewide tax. An exemption is allowed from the tax imposed under subdivisions (a) and (c) of section 1105 of the Tax Law, and from the compensating use tax imposed under section 1110 of the Tax Law, for receipts from sales of the following:

(i) Machinery or equipment (including parts with a useful life of more than one year) used or consumed directly and predominantly in the production for sale of tangible

personal property, gas, electricity, refrigeration or steam, by manufacturing, processing, generating, assembling, refining, mining or extracting. . . .

* * *

(iii) (a) Parts with a useful life of one year or less, tools or supplies for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale by manufacturing, processing, generating, assembling, refining, mining or extracting.

* * *

(iv) The services of installing, repairing, maintaining or servicing the exempt machinery, equipment, apparatus, parts, tools or supplies identified in subparagraph (i), (ii) or (iii) of this paragraph.

* * *

(b) Production. (1) The activities listed in paragraph (a)(1) of this section are classified as administration, production or distribution.

(i) *Administration* includes activities such as sales promotion, general office work, credit and collection, purchasing, maintenance, transporting, receiving and testing of raw materials and clerical work in production such as preparation of work, production and time records.

(ii) *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.

(iii) *Distribution* includes all operations subsequent to production, such as storing, displaying, selling, loading and shipping finished products.

(2) The exemption applies only to machinery and equipment used directly and predominantly in the production phase. Machinery and equipment partly used in the administration and distribution phases does not qualify for the exemption, unless it is used directly and predominantly in the production phase.

(3) The determination of when production begins is dependent upon the procedure used in a plant. If on receiving raw materials, the purchaser weighs, inspects, measures or tests the material prior to placement into storage, production begins with placement into storage, and the prior activities are administrative. If the materials are unloaded and

placed in storage for production without such activities, the unloading is the beginning of production.

Example 1: A crane is used to unload raw materials, which are immediately placed in storage at a plant. From the storage site, the material is placed on an assembly line without testing. The crane is being used in production.

* * *

(4) Production ends when the product is ready to be sold.

* * *

(c) Directly and predominantly. (1) *Directly* means the machinery or equipment must, during the production phase of a process:

(i) act upon or effect a change in material to form the product to be sold,
or

(ii) have an active causal relationship in the production of the product to be sold, or

(iii) be used in the handling, storage, or conveyance of materials or the product to be sold, or

(iv) be used to place the product to be sold in the package in which it will enter the stream of commerce.

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

* * *

(4) Machinery or equipment is used *predominantly* in production, if over 50 percent of its use is directly in the production phase of a process.

Example 11: A fork lift is used 60 percent of the time on an assembly line and 40 percent of the time for loading finished products onto railroad cars for delivery. The fork lift is used predominantly in production.

Opinion

XYZ is engaged in the processing of its customers' tangible personal property by applying specialized coatings to its customers' tangible personal property. This application creates tangible personal property which is superior to the original tangible personal property by virtue of its increased hardness, increased resistance to wear and reduced friction. XYZ's customers then either sell the processed tangible personal property to others or use it themselves. Since XYZ sells a service performed on its customers' tangible personal property rather than making direct sales of tangible personal property to its customers, a threshold question in this case is whether XYZ is a person engaged in the production of tangible personal property for sale by manufacturing, processing, generating, assembling, refining, mining or extracting for purposes of section 1115(a)(12) of the Tax Law.

Publication 852, entitled *Sales Tax Information For: Manufacturers, Processors, Generators, Assemblers, Refiners, Miners and Extractors, and Other Producers of Goods and Merchandise* (12/97) provides that "The purchase of machinery and equipment used by a subcontractor to perform part of a production process may also be entitled to exemption as production machinery and equipment."

XYZ's application of its coatings to its customers' tangible personal property effects a change in the nature of the tangible personal property by increasing its hardness and resistance to wear, and reducing its friction coefficient. XYZ's services to its customers' tangible personal property clearly fall within the meaning of *processing* as provided under section 1105(c)(2) of the Tax Law. See section 527.4(d) of the Sales and Use Tax Regulations.

Sections 1105-B and 1115(a)(12) of the Tax Law provide exemptions for machinery, equipment, parts, tools and supplies used or consumed directly and predominantly in the production for sale of tangible personal property by processing. If XYZ's customer is a manufacturer of tangible personal property for sale and XYZ's finished product (i.e., the coated tangible personal property) is, or becomes a component of, the tangible personal property manufactured for sale by XYZ's customer, then XYZ is performing a part of a production process for its customer. In such cases, XYZ's services are, in effect, performed as an extension of its customer's manufacturing process. See *Burn Brite Metals Company, Inc.*, Adv Op Comm T&F, February 29, 1988, TSB-A-88(17)S; *O. W. Hubbell & Sons, Inc.*, Adv Op Comm T&F, September 2, 2004, TSB-A-04(22)S. Accordingly, XYZ's purchases of machinery, equipment, parts, tools and supplies qualify for exemption from sales and use tax pursuant to sections 1105-B and 1115(a)(12) of the Tax Law to the extent that XYZ's machinery, equipment, parts, tools and supplies are used directly and predominantly (more than 50% of their use) to process tangible personal property which is, or becomes a component of, tangible personal property manufactured for sale by XYZ's customers. XYZ must maintain records documenting that such exempt machinery, equipment, parts, tools and supplies are used directly and predominantly in the production of tangible personal property for sale.

XYZ must be able to substantiate that its processing activities are a part of its customers' production of tangible personal property for sale. XYZ should obtain a written statement or information from its customer that the property upon which XYZ's services are performed is, or becomes a component part of, tangible personal property manufactured, processed or assembled for sale by the customer. A properly completed *Resale Certificate* (Form ST-120) obtained by XYZ from its customers in substantiation of the customer's purchases of XYZ's services without payment of tax may be additional evidence that XYZ's services are performed on property for sale by XYZ's customer.

Machinery, equipment, parts, tools and supplies used by XYZ to process a customer's tangible personal property are not used in the production of tangible personal property for sale when the property upon which XYZ performs its services is not manufactured, processed or assembled for sale by such customer or, when the property does not become a component part of property manufactured, processed or assembled for sale by such customer.

Section 528.13(b)(3) of the Sales and Use Tax Regulations provides that the determination of when production begins is dependent upon the procedure used in a plant. If, upon receiving raw materials, XYZ weighs, inspects, measures or tests the material prior to placement into storage or the production line, production begins with placement into storage or onto the production line. In such instance, the activities prior to placement into storage or onto the production line, such as unloading raw materials, are administrative. Petitioner states that upon receipt, the tangible personal property to be processed is counted and inspected for material composition and surface condition. The activity of counting incoming materials, by itself, does not ascend to the level of handling required by section 528.13(b)(3) of the Sales and Use Tax Regulations to make unloading raw materials an administrative activity. See *Henry & Henry Inc.*, Adv Op Comm T & F, June 26, 2002, TSB-A-02(17)S. However, the inspection and testing of incoming tangible personal property to determine material composition and surface condition are administrative activities as contemplated by section 528.13(b)(3) of the Sales and Use Tax Regulations. Accordingly, machinery, equipment, parts, tools and supplies used by XYZ to unload and count incoming tangible personal property and to inspect and test such materials for composition and surface condition are used in the administrative phase and not directly in the production process. The purchase of such machinery, equipment, parts, tools and supplies by XYZ is, therefore, subject to the sales or use tax imposed by section 1105(a) of the Tax Law unless such machinery, equipment, parts, tools and supplies are also used directly and predominantly in the production process.

XYZ's production line ends once the tangible personal property is packaged and ready to be returned to its customer. Any use of XYZ's machinery, equipment, parts, tools and supplies subsequent to the packaging of the tangible personal property is a use in the distribution phase. See sections 528.13(b)(1)(iii) and 528.13(b)(4) of the Sales and Use Tax Regulations. Machinery, equipment, parts, tools and supplies used 50% or more in distribution activities are not exempt from sales or use tax under section 1105-B or 1115(a)(12) of the Tax Law.

Accordingly, in order to determine whether machinery, equipment, parts, tools or supplies qualify for exemption from sales tax pursuant to sections 1105-B and 1115(a)(12) of the Tax Law, XYZ must be able to document that 1) the machinery, equipment, parts, tools or supplies are used directly in the production process as contemplated under section 528.13(c)(1) of the Sales and Use Tax Regulations; and 2) more than 50% of the use of the machinery, equipment, parts, tools or supplies is in the production of tangible personal property which is, or becomes a component of, tangible personal property manufactured for sale by XYZ's customers (See section 528.13(b) of the Sales and Use Tax Regulations). It is noted that XYZ's purchases of the services of installing, repairing, maintaining or servicing machinery, equipment, parts, tools or supplies which qualify for exemption from sales tax under section 1115(a)(12) of the Tax Law are also exempt from sales or use tax under section 1105-B(b) of the Tax Law.

Section 1115(c) of the Tax Law provides an exemption from the sales and use tax for 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 for sale by manufacturing, processing, assembling, generating, refining, mining or extracting. Provided that XYZ maintains records showing the amount of utilities used directly and *exclusively* in applying coatings to tangible personal property which is, or becomes a component of, tangible personal property manufactured for sale by XYZ's customers, XYZ may purchase such utilities exempt from sales and use taxes. See Technical Services Bureau Memorandum, entitled *Determining Electricity Used in the Production of Tangible Personal Property for Sale*, September 7, 1982, TSB-M-82(25)S for additional information pertaining to calculating the amount of utilities used directly and exclusively in the production of tangible personal property for sale by manufacturing.

It is noted that XYZ also markets systems and equipment to produce the coatings. If XYZ manufactures these systems and equipment for sale, the purchase by XYZ of machinery, equipment, parts, tools or supplies used directly and predominantly (more than 50% of their use) to produce these systems and equipment for sale will also qualify for exemption from sales and use tax under sections 1105-B and 1115(a)(12) of the Tax Law. Utilities used directly and exclusively in such production will also qualify for exemption under section 1115(c) of the Tax Law.

DATED: June 22, 2005

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