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Taxpayer Services Division
Technical Services Bureau

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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO: Z870223A

On February 23, 1987, a Petition for Advisory Opinion was received from Sigma Sound Studios, 1697 Broadway, New York, New York 10019.

The issues raised are (1) whether for purposes of Article 9-A of the Tax Law Petitioner qualifies for the investment tax credit provided in section 210.12 of the Tax Law; (2) whether for purposes of Article 9-A of the Tax Law Petitioner qualifies for the employment incentive tax credit provided in section 210.12-A of the Tax Law; and (3) whether certain exemptions from the sales and use tax imposed under Articles 28 and 29 of the Tax Law apply to purchases of equipment, material and services used by the Petitioner in providing space and equipment for the recording of audio performances on magnetic tape.

Facts

Petitioner is an audio recording and mixing facility with offices in New York City and Philadelphia. The New York City facility employs 24 people and has three studios that are designed and equipped to "store" audio performances on magnetic tape. Each studio includes a room in which the performance to be recorded takes place and a "control room" in which the recording equipment and ancillary paraphernalia is placed and technical functions such as "mixing" are undertaken. These two sections of a studio are adjacent to each other, separated by a wall with a double soundproof glass window, thus permitting visual communication in either direction between producer, engineer, artist and musicians.

The sections of the studios that are of main interest to the mixing process are the control rooms. The control rooms vary in size depending on the amount of equipment in it and its ultimate functions. Great care was devoted to the acoustics of each control room, since vital decisions which will affect the final sound of the recording are made based on the sound generated by the studio monitors as perceived by the producer in the control room.

In the control room, the console is the nucleus that controls the entire recording and mixing chain. During the recording and mixing processes, various effects utilizing inboard as well as outboard equipment (outboard equipment is interfaced through the console's patch bay) can be introduced: equalizing, panning, reverb, digital delays, flanging, phasing, noise reduction, compressing, limiting, filtering sound. Many mixing consoles are computer-automated so that all adjustments made during the preliminary mixes are "remembered" and made automatically. The monitor speakers are placed on either side of the console or above (different types and makes of speakers) so that comparisons can be made before a decision is reached on the proper mix or mixes.

Mixing is the process of combining the recorded tracks of a multitrack master tape to a more condensed format such as 2 tracks for stereo. The process of mixing allows the mix engineer (mixer) to enhance the sound of each separate track by using special effects such as equalization, reverberation, and echo delay, to achieve a final recording having the desired overall sound.

A mix can be a complex and time consuming process, depending upon the personal tastes of the mixer and producer and the degree to which they feel it necessary to ensure that the intrinsic octave-to-octave/beat-to-beat, balance in the musical performances are emphasized or deemphasized.

Mixing is done after the recording process is complete (i.e., after all the tracks have been "laid down"). After recording, there is a tape containing 24, or whatever number of tracks have been used. The term "track" refers to a channel of a multi-track recording. It is necessary to transfer the sound on all of these separate tracks onto a "master-mix" tape - usually a half-track stereo half-inch tape - to be used in its final form. At this point, the mixing process is complete and the editing process commences.

In all three studios, sound architects have been called upon to design and create, from the use of undulating wall surfaces (to generate reflection of sound waves) through the alternating of areas on the walls that are reflective and absorptive (to prevent "hardness" and impart a "warmth" and vice-versa) to varying room dimensions via sloping ceilings and angled walls, a series of control rooms endowed with desired acoustics.

Of Petitioner's three studios, Studio 5 is used 70 percent in the process of mixing, Studio 7 is used 50 percent in the process of mixing and Studio 8 is used 95 percent in the process of mixing. More than 50 percent of the mixing process conducted in all studios is engineered or produced by persons who are not employees of Petitioner. Rather, the producers and engineers are in the employ of the record companies which are the customers of Petitioner. Petitioner rents its studios to such record companies on a per hour basis.

The assets at issue for each studio consist of the following:

Technical Equipment - used in the mixing process.

Tools and Parts - used in repair of technical equipment.

Supplies - used in the mixing process such as magnetic tape and floppy discs and used for labeling such as pens and labels.

Renovation and Construction: control room only.

Design/Construction/Materials - architectural fees, labor,
building materials: dry wall, wood, doors, etc.

Finishing/Materials - trim strips, locksets, paints, etc (facades).

Acoustic Treatment/Materials - flooring, tiles, fabric, polyhedral diffusion arcs of sound,
insulation, sound proofing glass, etc.

Heating, Ventilation, Air Conditioning - air ducts, vents, air cooling unit, heating unit.

- Power Distribution/Materials - cost of bringing power from service entrance of building to breaker point and to control room.
- Lighting - lighting fixtures, dimmer switches, etc.
- Grounding - ground wire, etc.
- Design of Signal and Control Cabling/Materials and Installation - electricity and power needed to operate studio consisting of cables, labor, etc.
- Repair Services - air conditioning service contract.

The editing post-production process is conducted in a room equipped with tape recorders in various formats, some outboard equipment (i.e., equalizers and compressors), and a monitoring system. Editing is the post-production function in which the original master tape is "arranged" into a satisfactory performance format via "splicing" together sections of performances to achieve a correct and cohesive musical sequence. The editing function comprises cutting, rearranging, and reassembling the original master-mix tape into a different sequence, as well as removal of unwanted performances or portions of performances. Once the master tape is mixed, edited, sequenced, timed, head and tail leadered, containing test tones, it is sent to a Mastering Lab for lacquer or subsequent tape mastering.

The edit room is used 100 percent in the mixing process and its assets at issue consist of the following:

- Technical Equipment - used for editing.
- Tools and Parts - used for repair of the technical equipment.
- Supplies - such as magnetic tape, tape labels, pens, etc.
- Repair Services - air conditioning service contract.

A technical shop, manned by an in-house technical support team, offers service and spare parts to all studio facilities. The shop room is used for maintaining, testing, evaluating and enhancing the mixing and recording equipment and machinery.

The technical shop, used 75 percent to test, service, modify, and improve mixing equipment work, is conducted by in-house technical staff. The assets at issue consist of the following:

- Technical Equipment
- Tools and Parts
- Supplies - such as cables, wire, lubricants, cleaning agents, etc.

Issue 1

For taxable years beginning prior to January 1, 1987, section 210.12 of the Tax Law allows an investment tax credit against the tax imposed under Article 9-A of the Tax Law equal to six percent of the cost or other basis for federal income tax purposes of tangible personal property and other tangible property, including buildings and structural components of buildings which:

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

- (2) are 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) have a useful life of four years or more;
- (4) are acquired by purchase as defined in section 179(d) of the Internal Revenue Code;
- (5) have a situs in New York State; and
- (6) are principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing.

For taxable years beginning in 1987, 1988 and 1989, section 210.12(a) of the Tax Law allows an investment tax credit against the tax imposed under Article 9-A with respect to qualified tangible personal property and other tangible property, including buildings and structural components of buildings, at the rate of five percent with respect to the first \$500,000,000 of the investment credit base and four percent with respect to the excess, except that in the case of research and development property at the option of the taxpayer the rate is nine percent. The investment credit base is the cost or other basis for federal income tax purposes of qualified tangible personal property and other tangible property, including buildings and structural components of buildings, less the amount of the nonqualified nonrecourse financing with respect to such property to the extent such financing would be excludible from the credit base pursuant to section 46(c)(8) of the Internal Revenue Code. Tangible personal property and other tangible property, including buildings and structural components of buildings, is qualified if it:

- (1) is acquired, constructed, reconstructed or erected during taxable years beginning in 1987, 1988 or 1989;
- (2) is depreciable pursuant to section 167 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 (a) principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing,
 - (b) industrial waste treatment facilities or air pollution control facilities, used in the taxpayer's trade or business, or
 - (c) research and development property.

"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. Property used in production includes all facilities used in the production operation, including storage of material to be used in production and of the products that are produced.

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

The investment tax credit allowed is based on the cost or other basis for federal income tax purposes or, for taxable years beginning in 1987, 1988 and 1989, the investment credit base of tangible personal property that is principally used by the taxpayer in the production of goods by manufacturing, processing, etc. The equipment used in the mixing process, whereby a master tape is created, is considered to be used in the production of goods by manufacturing. Richard H. Roberts, State Tax Commission Advisory Opinion, April 7, 1981, TSB-H-81(57)I. However, in the instant case, more than 50 percent of the actual mixing process is engineered or produced by persons who are not employees of Petitioner. Since Petitioner's employees are not performing the actual mixing process, Petitioner is not principally engaged in the production of goods, but, in essence, is principally engaged in providing a service, namely the renting of the studio and/or the control room, whereby the master tape is created. Therefore, Petitioner's principal business activities do not constitute the production of goods by manufacturing as contemplated by the statute. Accordingly, Petitioner may not claim an investment tax credit based on the tangible personal property contained in Studio 5, Studio 7, Studio 8, the Edit Room or the Technical Shop.

Issue 2

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 with respect to property, the acquisition, construction, reconstruction or erection of which commenced on or after January 1, 1976 and prior to January 1, 1987. The amount of the credit allowed in each of the three years is fifty percent of the investment tax credit allowed.

Section 210.12-D 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 two years succeeding the taxable year for which an investment tax credit, other than at the optional rate applicable to research and development property, has been allowed under section 210.12 of the Tax Law with respect to property, the acquisition, construction, reconstruction or erection of which commenced on or after January 1, 1987. Where the investment tax credit was allowed for taxable years beginning in 1987, 1988 or 1989 the amount of the employment incentive tax credit allowed in each of the two succeeding years is the sum of two percent of the first \$500,000,000 of the investment credit base and two and one-half percent of the excess.

Since Petitioner does not qualify for the investment tax credit, Petitioner does not qualify for the employment incentive tax credit.

Issue 3

A. Purchases of equipment

Petitioner's studios and sound processing equipment are generally used by producers for artists' recording sessions and subsequent sound mixing and editing of the magnetic tape. Although one of Petitioner's employees is usually present at a recording session, the equipment is mainly operated by employees or sound engineers engaged by the producer. Thus, since Petitioner's client has the right to direct the use of the equipment, Petitioner is deemed to be renting tangible personal property to its customers rather than providing a service or producing tangible personal property. 20 NYCRR 526.7(e)(6).

The Tax Law (1105[a]) imposes tax on every retail sale of tangible personal property, except as otherwise provided; the term "sale, selling or purchase" is deemed to include rentals, leases, and the license to use tangible property (1101[b][5]). The term retail sale is deemed to exclude sales of tangible personal property for resale as such (including rental of such property) or as a physical component part of tangible personal property. (1101(b)(4)). However, to qualify as a purchase for resale, a purchase must be exclusively for resale. The use of rental equipment by its owner defeats the qualification of such equipment as equipment purchased exclusively for resale. (Matter of Micheli Contracting Corporation v. New York State Tax Commission, 109 AD2d 957).

The final version of a tape recorded at Petitioner's studio is intended to become the source of the master record, tape or compact disc produced by a mastering laboratory. This "master" then is used for reproduction by the manufacturer of the marketable recordings. The source tape, therefore, is itself "equipment" used and consumed in a continuous manufacturing process.

Section 1115(a)(12) of the Tax Law exempts from State and local (but not New York City) sales taxes the receipts from sales of "[m]achinery or equipment for use or consumption directly and predominantly in the production of tangible personal property . . . for sale by manufacturing, processing"

The Sales and Use Tax Regulations define the term "directly" to mean the machinery and equipment must, during the production 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. Machinery or equipment used in activities collateral to the production process is not deemed to be used directly in production.

Machinery or equipment is used "predominantly" in the production of tangible personal property if it is so employed over 50% of the time. Machinery or equipment used to produce other machinery or equipment for self use in production is considered to be used directly in production. 20 NYCRR 528.13(c).

Accordingly, purchases of studio and editing equipment listed above are exempt from state tax only to the extent that such equipment is used by Petitioner directly and predominantly in production. If such equipment does not qualify as equipment used directly and predominantly in production by Petitioner, it will nevertheless be exempt from State and New York City sales tax if it is purchased by Petitioner exclusively for resale. If the equipment is neither used by Petitioner directly and predominantly in production nor purchased by Petitioner exclusively for resale, then such equipment is subject to sales tax when purchased by Petitioner.

Furthermore, whenever Petitioner rents one of its recording studios to a producer the portion of the charge applicable to rental of production equipment will not be subject to sales tax (except for New York City local tax) upon receipt of an Exempt Use Certificate (Form ST-121) in proper form from the producer. However, tax exempt use may be claimed only by the person producing tangible property for sale. The exemption does not extend to Petitioner's purchases of such equipment when furnishing a studio for rental. The tax status of a piece of machinery or equipment also applies to purchases of replacement parts and electric power to operate such property.

Notwithstanding the Regulations provision (20 NYCRR 528.13[c], supra) exempting from tax machinery used to produce other machinery, testing apparatus and tools used for repair and maintenance in the technical shop and by technical support personnel are not considered to be used directly in production. Such equipment is subject to State and local sales taxes, as is electrical power consumed by shop operations. 20 NYCRR 528.13(e). However, Petitioner may apply for a refund or credit of tax paid on spare parts or supplies purchased for shop inventory which are subsequently used to maintain and operate equipment qualifying for the production exemption. 20 NYCRR 534.2.

Charges arising from a service contract for Petitioner's air conditioning system are taxable at the combined State and local rate.

B. Construction and repairs

Services to real property are generally classified as either capital improvements or taxable repair, maintenance or installation services, depending on the end result of the service. If the end result of the services is repair or maintenance of real property, such services are taxable. If the end result of the same service is a capital improvement to the real property, such services are not taxable. [20 NYCRR 527.7(b)(4)]; Matter of Building Contractors Association, Inc. v. Tully, 87 A.D.2d 909.

Section 1101(b)(9) of the Tax Law defines "capital improvement" as any addition or alteration to real property which meets ALL THREE of the following requirements:

1. It substantially adds to the value of real property or appreciably prolongs the useful life of real property, AND

2. It becomes part of real property or is permanently affixed to real property so that removal would cause material damage to the property or article itself, AND
3. It is intended to become a permanent installation.

Services which keep real property in a condition of efficiency and safety or restore it to such condition are considered taxable repair and maintenance services. 20 NYCRR 527.7(a)(1). Nevertheless, a series of services to real property which, when viewed as a whole, constitute a major renovation may qualify as a capital improvement. Matter of Frazer Jones Co., Decision of the State Tax Commission, July 16, 1985, TSB-H-85(195)S.

Petitioner inquires about such studio construction costs as dry wall, insulation, doors, windows, floor tiles, nonportable air conditioning and heating units and in-the-wall hot or cold air ducts and electrical wiring. It is clear that such installations meet the criteria for capital improvement quoted under 1 and 2 above. But, since Petitioner conducts its business in rented premises, it is presumed that tenant-installed improvements are not made with an intention to enhance the permanent or lasting value of the property and thus do not qualify as capital improvements pursuant to Tax Law section 1101(b)(9). (People ex rel. 100 Park Ave., Inc. v. Boyland, 144 NYS2d 88, mod on other grounds, 284 App Div 1033, revd on other grounds, 309 NY 685; see Tiffit v. Horton, 53 NY 377.) However, the facts may serve to rebut such presumption (Matter of Flah's of Syracuse, Inc. v. Tully, 89 AD2d 729).

Accordingly, the third criterion for qualification under Tax Law 1101(b)(9), supra, will be met only if Petitioner does not hold or reserve the right to remove the improvement at any time after construction and the title thereto passes to the owner of the premises upon construction or the conclusion of Petitioner's lease.

The imposition of sales tax applies to capital improvements as follows: Building materials are subject to all State and local taxes when purchased (with certain exemptions not here applicable). When the property owner buys material for installation by employees or by outside labor it must pay tax to the supplier; no tax is due on labor charges. If material and labor is provided by a contractor, the property owner pays no tax, but the contractor must pay tax to the supplier on materials and supplies. For details see Department of Taxation and Finance Publication 862 (2/81), Classifications of Improvements and Repairs to Real Property.

Petitioner's studios are designed to achieve the proper acoustics through the installation of angled or undulating panels or other reflective or absorptive materials on ceilings, walls and floors. This room treatment, necessary for the purpose of Petitioner's business, is not for the benefit of the landlord. Such installations are comparable to trade fixtures which are not considered capital improvements because they are removable by the tenant without substantial injury to the real property and therefore fail to satisfy the requirement of intended permanence. People v. Boyland, supra; Antonowsky v. State of New York, 14 Misc. 2d 689.

Thus, charges to the Petitioner, both for the purchase of the tangible personal and the installation service are subject to all applicable State and local sales taxes; similarly, charges for outside labor and for electrical supplies to hook up sound recording and editing equipment to the electrical sources are taxable. 20 NYCRR 527.5.

A service contract for repair and maintenance of air conditioning is taxable pursuant to Tax Law 1105(c)5. See also 20 NYCRR 527.7(b)(1), (3).

Fees charged by a sound architect for design services, which result in the preparation of blueprints as the only tangible product of a design contract, are not taxable.

C. Studio rental

It should be noted that when Petitioner charges for studio time and receives no Exempt Use Certificate it must collect the applicable State and local sales taxes.

However, since real estate is not considered tangible personal property for purposes of the sales tax, its rental is not taxable. 20 NYCRR 526.8(c). Furthermore, the wages of an equipment operator may be excluded from the taxable receipt for equipment rental. 20 NYCRR 526.7(e)(6).

Consequently, Petitioner's charges for the portion of studio rental amounts representing operator's wages and rent for the rooms (if reasonable in relation to prevailing wage and rent rates) are not subject to tax, if shown separately from the taxable charge on the billing rendered.

If the invoice lacks sufficient detail for determining taxable and exempt charges, the total amount billed will be subject to tax.

DATED: October 1, 1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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