

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

TSB-A-99(52)S
Sales Tax
TSB-A-99(29)C
Corporation Tax
November 23, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. Z991007A

On October 7, 1999, the Department of Taxation and Finance received a Petition for Advisory Opinion from CHEP USA, 500 Airport Drive, Wappinger Falls, NY. Petitioner, CHEP USA, provided additional information pertaining to the Petition on October 8, 1999.

The issues raised by Petitioner are:

- (1) Whether equipment used in the remanufacture of its industry standard pallets qualifies for exemption from sales and compensating use tax under Section 1115(a)(12) of the Tax Law.
- (2) Whether its plant and operations, as described below, are eligible for the investment tax credit under Section 210.12 of the Tax Law.

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

Petitioner is a Florida/New York corporation whose main business is the purchase and subsequent provision, pooling and "remanufacture" of 48" X 40" industry standard pallets which cycle between Petitioner's "depot," its customers who manufacture grocery products (e.g., Procter & Gamble, Kraft, Dole, Campbell's, etc.) and the retailers who distribute the customers' products. (The original manufacturing of new pallets does not take place at Petitioner's facility). Upon issuance of a pallet to a customer, Petitioner charges a fee comprised of 1) a transportation charge, which covers Petitioner's operating and transportation costs, 2) rent, which covers such expenses as depreciation and interest for the time the pallet is in the customer's facility and 3) a transfer charge, which covers the time the pallet spends at the distributor (retailer) level.

Petitioner is scheduled to open a fully integrated manufacturing plant in Wappinger Falls, New York in October 1999, where pallets issued to customers will be commingled and remanufactured through an automated inspection, repair/rebuild and painting/stenciling process as described below. After pick-up from its customers' retail distributors, the pallets will be unloaded from trailers and fed into Petitioner's system where the following steps will take place:

Step 1: Inspection System

Each stack of up to 21 pallets will be loaded onto the sortation infeed. Tippers will be used to present single pallets for the sortation operator and to feed the two Automatic Digital Inspection

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(ADI) systems. Tipplers have the capacity to operate at a machine speed of 580 pallets per hour. The tipper operator's function is to prepare the pallet for ADI and to determine those pallets not suitable for the ADI system. "Other" pallets, trash and loose lumber will be removed prior to the pallet being fed into the (ADI) system.

Step 2: Automatic Digital Inspection (ADI)

ADI will inspect the top, bottom and vertical faces of each pallet using high definition digital cameras. The system will analyze the integrity of each component of the pallet separately and will be able to report on all damaged elements, in electronic format. Each of the two ADI systems is capable of operating at 900 pallets per hour.

A bar-code or similar label for use within the depot will be automatically applied prior to ADI to avoid the need to "track" pallets through the inspection, rebuild and repair process.

Step 3: Stringer and Block Rebuild, Repair Lines and Grinder

The Stringer Rebuild/Repair Line will consist of two lines, the minor repair line and the major rebuild line. The major rebuild line consists of a lead board and stringer removal station and secondary stringer removal station. Eight rebuild/repair tables will be linked via a powered two-strand chain conveyor for pallet delivery, and a lower powered two-strand chain conveyor to return rebuilt/repared pallets to a system of stackers.

Each self-sufficient rebuild/repair table will be equipped with a nail gun, grinder, crow bar, hammer and brush. Single pallets will be delivered to rebuild/repair lines with pallets stacked or dispensed from accumulation stackers as required. Pallets will be flipped automatically and presented to the repairers upside down.

The two Block Rebuild/Repair Lines operate in a similar fashion.

For all lines and individual tables, the control system will automatically monitor productivity and lumber usage and feed this information to a digital display and the central operations computer.

A lumber grinder will process waste lumber for resale (e.g., wood chips).

Step 4: Paint Processing

Two paint lines will be installed to receive pallets and process them as follows:

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- The 40" ends of the pallets are painted as the pallet passes through the first of the two paint booths.
- The pallet is transferred through 90 degrees, in order for it to pass through the second paint booth where the 48" sides are painted.
- The pallet then passes through a radiant heat drying tunnel which is designed to dry a .001" coating of paint so that it is dry to the touch.
- The pallet is then squared on the conveyor in preparation for stenciling.
- The automatic rotary stencil then detects if the pallet is a Mk III or Mk 55 and stencils the pallet with the appropriate logo and ownership statement.
- The pallets are then diverted to the block or stringer pallet stacker as required.

Pallets are sorted and stacked by pallet type, then shipped to customers.

Applicable Authority

Issue 1

Section 1105(a) of the Tax Law imposes a tax on “[t]he receipts from every retail sale of tangible personal property, except as otherwise provided in this article.

Section 1115(a)(12) of the Tax Law exempts from the sales tax imposed by Section 1105(a) and from the compensating use tax imposed under Section 1110 of the Tax Law:

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 . . . but not including parts with a useful life of one year or less or tools or supplies used in connection with such machinery, equipment or apparatus. . . .

Section 1105-B of the Tax Law provides for the elimination of the sales tax on receipts from sales of parts with a useful life of one year or less, as well as tools and supplies, for use or consumption directly and predominantly in the production of tangible personal property for sale.

Section 527.4(b) of the Sales and Use Tax Regulations defines “producing” as “the manufacture of a product from raw materials and any process in which raw materials loses its identity when the production process is completed.”

Section 527.5(3) of the Sales and Use Tax Regulations provides, in part:

Maintaining, servicing and repairing are terms used to cover all activities that relate to keeping tangible personal property in a condition of fitness, efficiency, readiness or safety or restoring it to such condition. (Emphasis added)

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

(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 . . . by manufacturing, processing, generating, assembling, refining, mining or extracting. . . .

* * *

(b)(1)(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.

* * *

(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.

* * *

(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 13: A company purchases a machine to produce new paper machine rolls and to recondition old paper machine rolls for its customers. The machine is to be used for production 70 percent of the time and for reconditioning 30 percent of the time. Reconditioning is a repair service to tangible personal property, and machinery used for that purpose is not in production. However, as the machine in this example will be used directly in production over 50 percent of the time, it qualifies for exemption. (Emphasis added)

Issue 2

Section 210.12 of the Tax Law allows an investment tax credit against the tax imposed under Article 9-A of the Tax Law. For taxable years beginning after 1990, Section 210.12 allows an investment tax credit equal to five percent with respect to the first \$350 million of the investment credit base and four percent with respect to the investment credit base in excess of \$350 million. 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.

Under Section 210.12(b) of the Tax Law and Section 5-2.2 of the Business Corporation Franchise Tax Regulations ("Article 9-A Regulations"), the term "qualified property" means tangible personal property and other tangible property, including buildings and structural components of buildings, which:

- (1) is acquired, constructed, reconstructed or erected by the taxpayer after December 31, 1968;
- (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 the taxpayer by purchase as defined in Section 179(d) of the Internal Revenue Code;
- (5) has a situs in New York State; and

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- (6) is 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.

Section 210.12(b)(ii)(A) of the Tax Law provides that the term "manufacturing" shall mean "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(c) of the Business Corporation Franchise Tax Regulations ("Article 9-A Regulations") provides that the term "principally used" means more than 50 percent.

In the Matter of J. H. Wattles, Inc., Dec St Tax Commn, October 30, 1981, TSB-H-81(58)C, the petitioner was engaged in the wholesale egg business. The petitioner was denied investment tax credit on its equipment because the operations the petitioner performed on the farm-run eggs did not constitute manufacturing or processing within the meaning of section 210.12(b) of the Tax Law, since the end result was not so significantly different from the raw material. It purchased eggs directly from producer farms in farm-run condition, and prepared them for distribution to supermarkets in accordance with applicable state and federal statutes. The eggs were received in a refrigerated condition and the petitioner held the eggs in coolers. The petitioner transported the eggs by conveyor through a mechanized washing system, and then to a candling station where employees selected out any undesirable eggs. Next, the quality eggs were weighed and transported, by weight, to the packing station and mechanically dropped into dozen cartons. The cartons were then packed into cases and taken by pallet to coolers to await distribution. In its conclusions, the Tax Commission cited Gressel Produce Co. v Kosydar, 297NE2d 532 (Ohio, 1973) wherein the court examined an operation like J. H. Wattles and the court stated:

The operation described herein evidences no change in the state or form of the eggs regardless of the fact that they may have been enhanced in value. Those eggs which were unfit for consumption when received from the producer remained unfit for consumption; and those eggs which were fit for consumption when delivered to the retailer were fit for consumption at the time they were received. Id. At 536.

In the Matter of Dobbin & Ramage, Inc., Dec St Tax Commn, July 20, 1987, TSB-H-87(21)C, the petitioner was engaged in the production of apple juice and the packaging and marketing of whole apples. The petitioner's activities in grading, assembling, storing and cleaning apples to be sold as fresh did not constitute the production of goods by processing within the meaning of Section 210.12(b) of the Tax Law, and the petitioner was denied investment tax credit on its grading and assembling rooms. The petitioner purchased apples or received them on

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consignment from growers in tree-run condition. The petitioner assembled and graded the apples according to size and quality, disposing of poor quality apples. The apples were then placed in atmosphere-controlled, sealed storage rooms which served to retard their spoilage, thereby lengthening the life of the apples. When needed, the petitioner removed the apples from the storage rooms and cleaned them. The higher graded apples were then bagged for sale. The apples sold were not significantly different than the tree-run apples received by the petitioner.

In K. Van Bourgondien & Sons, Inc., Adv Op Comm T&F, September 26, 1995, TSB-A-95(17)C, the petitioner imported live flower bulbs in bar root condition. Petitioner sorted the bulbs to discard non-live bulbs and repacked the rest in point of sale display packages or flower pots to be sold to wholesalers. The package was placed in a special horticulture medium to ensure retail shelf life of the bulbs and were stored in cold storage units until shipped. It was held that the petitioner's packaging and storage activities did not constitute the production of goods by processing or assembling within the meaning of Section 210.12 of the Tax Law.

Opinion

Issue 1

Petitioner purchases and provides 48" X 40" industry standard pallets used to ship goods to its customers who are manufacturers of grocery products. Petitioner provides its customers with the benefit of its pallet pooling system, in which commingled industry standard pallets are cycled from Petitioner's "depot" to its customers, to the customers' distributors for product distribution, and back to Petitioner's depot for inspection, repair/rebuilding (where necessary) and painting.

The original manufacturing of new pallets does not occur at Petitioner's facility. Rather, defective pallets are repaired/rebuilt by Petitioner for the purpose of being rented as a "remanufactured" unit. To be eligible for the production exemption, machinery and equipment used in this process must be used directly and predominantly (more than 50% of the time) in the production of tangible personal property for sale. The production operations eligible for the exemption are those that produce goods for sale by manufacturing, processing, generating, assembling, refining, mining or extracting. See Section 1115(a)(12) of the Tax Law. "Producing" means the manufacture of a product from raw materials and any process in which raw materials lose their identity when the production process is completed. See Section 527.4(b) of the Sales and Use Tax Regulations. "Manufacturing" generally results in the creation of a product that is substantially different in form, character, composition, and usefulness from its components. See New York State Department of Taxation and Finance Publication 852 (12/97), Sales Tax Information for Manufacturers, Processors, Generators, Assemblers, Refiners, Miners and Extractors, and Other Producers of Goods and Merchandise, at page 2.

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While Petitioner terms its services “remanufacturing,” an analysis of its activities finds that Petitioner’s activities do not fall within the meaning of production as defined under Section 528.13(b)(1)(ii) of the Sales and Use Tax Regulations nor within the meaning of producing as defined under Section 527.4(b) of the Sales and Use Tax Regulations. Petitioner’s activities are not an extension of the pallet manufacturer’s production process, nor do they involve the creation of pallets from raw materials. Rather, Petitioner is simply engaged in the repairing or reconditioning of previously manufactured pallets, which were sold at retail and will again be sold at retail upon such repair and reconditioning. Repair, rebuilding and reconditioning are not production but occur after the completion of the production process (see Matter of Sandy Hill Corporation v. State Tax Commission, 61 AD2d 550; Professional Transmission & Truck Service, Adv Op Comm T&F, February 4, 1993, TSB-A-93(11)S; United Radio, Inc., Adv Op Comm T&F, January 17, 1989, TSB-A-89(2)S). Moreover, Petitioner’s activities do not fall within the meaning of processing as defined under Section 527.4(d) of the Sales and Use Tax Regulations, as they do not effect a change in the nature, shape or form of the pallets. Accordingly, as Petitioner is not considered to be engaged in the production of tangible personal property for sale, but rather, the maintaining, servicing or repairing of tangible personal property, Petitioner’s purchases of equipment for such use do not qualify for the exemption provided under Section 1115(a)(12) of the Tax Law and are subject to state and local sales or compensating use tax (see Professional Transmission & Truck Service, *supra*; United Radio, Inc., *supra*).

It is noted that a person engaged in the processing of scrap material for sale is engaged in “processing” within the meaning of Section 1115(a)(12) of the Tax Law and Section 527.4(d) of the Sales and Use Tax Regulations (see Vigliotti Recycling Corp., Adv Op Comm T&F, December 24, 1990, TSB-A-90(58)S; Lindemann Recycling Equipment, Inc., Adv Op Comm T&F, January 31, 1989, TSB-A-89(3)S). Accordingly, if Petitioner’s lumber grinder is used directly and predominantly (more than 50%) to process waste lumber into wood chips which will be sold, such equipment qualifies for exemption under Section 1115(a)(12) of the Tax Law (see Vigliotti Recycling Corp., *supra*).

Issue 2

In determining whether Petitioner's activities in "remanufacturing" pallets that will be rented to its customers constitutes "manufacturing, processing, assembling ..." under Section 210.12 of the Tax Law, consideration must be given to the extensiveness of the activities performed on the pallets and whether the end products will be equivalent in usefulness and treated as freshly and newly produced pallets. The court in United States v J. Leslie Morris Co. Inc., 124 F2d 371 (9th Cir 1941), with respect to the federal manufacturers excise tax, observed: "[t]he question whether the process is essentially one of production or merely of repair is to be resolved by an over-all view of taxpayer's activities, beginning with its acquisition of discarded parts and ending when a useful article of commerce emerges ..."

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While Petitioner terms its services "remanufacturing," an analysis of Petitioner's activities as considered in Morris, supra, finds that Petitioner's activities, with the exception of the processing of waste lumber for resale as wood chips, will not constitute "the production of goods by manufacturing, processing, assembling ..." as contemplated under Section 210.12 of the Tax Law. As in Wattles, supra, Dobbin, supra and Van Bourgondien, supra, Petitioner's automated inspection, repair/rebuild and painting/stenciling process activities, will not constitute the manufacture of new pallets from raw materials, and they will not effect a change in the nature, shape or form of the pallets. Rather, Petitioner will simply be engaged in the repairing or reconditioning of previously manufactured pallets, which were rented to a customer and will again be rented to a customer upon such repair and reconditioning, with the exception of the processing of the waste lumber for resale as wood chips. Accordingly, Petitioner's equipment used in its "remanufacturing" process does not qualify for the investment tax credit under section 210.12 of the Tax Law, except that if Petitioner's lumber grinder is principally used (more than 50%) to process waste lumber into wood chips, such grinder would qualify for the investment tax credit if it meets all of the other requirements of section 210.12(b) of the Tax Law.

DATED: November 23, 1999

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

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