

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

ROCHESTER GAS AND ELECTRIC CORPORATION : DECISION

for Revision of Determinations or for Refund of Sales and :
Use Taxes under Articles 28 and 29 of the Tax Law for the :
Period December 1, 1979 through November 30, 1985. :

Petitioner Rochester Gas and Electric Corporation, 89 East Avenue, Rochester, New York 14649 and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on December 21, 1989 with respect to petitioner's petition for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1979 through November 30, 1985 (File Nos. 800909 and 803875). Petitioner appeared by Nixon, Hargrave, Devans and Doyle (John R. McQueen, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

Both parties filed briefs on exception. Oral argument, at the request of both parties, was heard on July 13, 1990.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether payments made by petitioner to a non-profit research and development organization are taxable under section 1105(c)(1) of the Tax Law as purchases of information services.

II. Whether payments made by petitioner to consultants for the service of studying problems discovered in certain nuclear power plants and providing written analyses of the results of the

studies constituted purchases of information services taxable under section 1105(c)(1) of the Tax Law.

III. Whether the service of refueling at the Ginna nuclear power plant, when purchased in conjunction with the nuclear fuel, constituted the maintenance, service or repair of real property subject to sales tax under section 1105(c)(3) of the Tax Law.

IV. Whether petitioner established that it had reasonable cause for its failure to report and pay over local sales tax due on its purchase of services to repair equipment used primarily in production.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "12" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

On November 4, 1983, the Division of Taxation ("Division") issued to petitioner, Rochester Gas and Electric Corporation ("RG&E"), a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period December 1, 1979 through November 30, 1982, assessing tax due of \$670,457.43 plus interest.

On June 20, 1986, the Division issued to RG&E two notices of determination and demands for payment of sales and use taxes due for the period December 1, 1982 through November 30, 1985. The first notice assessed tax due of \$801,444.51 plus interest, and the second notice assessed a penalty of \$61,116.12 plus interest.

For both of the periods in issue here, RG&E executed consent forms extending the period of limitation for the assessment of sales and use taxes, and as a consequence the statutory notices described were timely issued.

RG&E is a gas, electric and steam utility. It is in the business of generating and distributing electricity and steam and distributing natural gas. The energy it needs to generate

electricity and steam is derived from water power, fossil fuels and nuclear fuels. During the audit periods, RG&E operated the Ginna nuclear power plant and several conventional power plants.

The notices which are the subject of this proceeding were issued as a result of two separate field audits of RG&E's business operations. The first audit was conducted in 1983 for the period December 1, 1979 through November 30, 1982. The second audit was conducted in 1986 for the period December 1, 1982 through November 30, 1985.

The 1983 Audit

The Division did not conduct an audit of RG&E's sales. Since two prior audits revealed that RG&E properly collected and paid over all sales taxes due on its sales of utility services and RG&E continued to employ the same accounting methods for collecting tax, an audit in this area was considered unnecessary. An audit was conducted of RG&E's own purchases of services and property.

Virtually all of RG&E's purchases were made under its direct payment permit; therefore, it paid no sales tax at the time of purchase and maintained accrual accounts for sales tax owed on purchases. A clerical staff person in the corporation's tax department reviewed each voucher to determine whether the transaction was taxable. Each voucher was then coded to ensure that tax was accrued at the proper state and local rate on each taxable transaction.

The auditor conducted a two-step examination of petitioner's purchase records. A statistical sampling was made of all vouchers totalling less than \$20,000.00. A detailed audit was made of all vouchers totalling \$20,000.00 or more. The auditor also reviewed all capital expenditures. This method resulted in additional tax due of \$1,225,937.47. Of this amount, RG&E conceded tax due of \$554,980.04, It disputed the remainder of \$670,957.43.

Of the disputed portion of the audit, \$66,481.44 represents a projection of the results of the statistical sample, and the remaining \$604,475.99 represents a detailed audit of vouchers over \$20,000.00. RG&E did not object to the audit methods employed including the projection of the

statistical sample over the entire audit period. It disagreed with the Division's determination that the following transactions were subject to sales tax:

1. Payments to the Electric Power Research Institute ("EPRI") and the Empire State Electric Energy Research Corporation ("ESEERCO");
2. Payments to Westinghouse Electric Company and other consultants for services described by RG&E as "analysis services";
3. Payments to the Nuclear Regulatory Commission ("NRC") for government inspections;
4. Fly ash transportation services;
5. Nuclear refueling services; and
6. Payments to consultants to perform maintenance tests and inspection services.

The 1986 Audit

The 1986 audit was conducted as the 1983 audit had been. Total additional tax due, after application of a credit due of \$382,823.96, was determined to be \$1,127,017.76. RG&E conceded tax due of \$325,573.25, leaving an amount in dispute of \$801,444.51. The disputed amount represents tax due on these transactions: payments to EPRI and ESEERCO, fly ash transportation, and nuclear refueling services.

Included in the tax conceded by RG&E was \$270,714.05, representing local sales taxes imposed on RG&E's purchase of contractual services for the maintenance and repair of equipment used in production (referred to in the record as "contract labor"). The Division had found tax due on such purchases on the 1983 audit as well. While RG&E conceded the tax due, it protested the Division's imposition of penalty and interest above the minimum for RG&E's failure to pay the tax due on these transactions.

By the time of hearing, some of the disagreed portions of both audits had been conceded or settled. The only items presently disputed are (1) the payments to ESEERCO, (2) payment to

Westinghouse and other consultants for analysis services, (3) nuclear refueling services, and (4) the imposition of penalty.

Payments to ESEERCO

RG&E is a member of two research and development consortiums, EPRI and ESEERCO. On audit, the Division treated all payments made by RG&E to EPRI and ESEERCO as the purchase of information services taxable under section 1105(c)(1) of the Tax Law. At hearing, RG&E established that EPRI is a not-for-profit corporation exempt from Federal taxation under section 501(c)(3) of the Internal Revenue Code. As a consequence, the Division conceded after the hearing that any purchases RG&E made from EPRI were exempt from sales tax under section 1116(a)(4) of the Tax Law. It continues to assert that payments made to ESEERCO are taxable as purchases of an information service.

RG&E is a regulated public utility subject to the jurisdiction of the New York State Public Service Commission ("PSC"). Through its ratemaking procedures, the PSC encourages RG&E to expend approximately one percent of its revenues on research and development. Its budget is reviewed by the PSC staff to ensure that monies allocated for research and development are properly expended. Many of the internal company research projects undertaken by RG&E address short-term considerations and the research findings which result can be implemented quickly. RG&E's internal projects also provide support for basic research. Other research problems encountered by RG&E are long-term or large-scale in nature. To address these problems, RG&E pools its resources with a number of other organizations. During the years at issue, RG&E, with the approval of the PSC, expended approximately 51 percent of its research and development budget on internal company programs, 22 percent on contributions to EPRI, 20 percent on contributions to ESEERCO and 7 percent on contributions to the New York State Energy Research and Development Authority.

Although payments to EPRI are no longer in issue, some discussion of EPRI's history and purposes will aid in understanding the parties' positions as they relate to ESEERCO. EPRI was founded in 1972 as a not-for-profit corporation. Its purposes, as set forth in greater detail in its articles of incorporation and by-laws, are to promote and conduct research and development in the area of electric power generation, to create through study and research the methods and means to provide electric power which is both economically efficient and environmentally safe, to provide a medium for the exchange of information among organizations and individuals concerned with electric power research and development, and to disseminate information about research and development activities in the field of electric power.

EPRI membership is open to individuals and organizations who have evinced an intention to support a national program for research and development in the production, transmission, distribution and utilization of electric power. The membership is divided into five classes: (1) agencies of the Federal government; (2) cooperative corporations engaged in the production and transmission of electric power; (3) electric utilities operated by state and local governments; (4) investor owned utility companies; and (5) non-voting members, consisting of any other individuals or organizations eligible for membership. EPRI had approximately 500 members during the audit periods, and RG&E has been a member since EPRI's inception.

EPRI is funded by member contributions. After the board of directors approves the annual program plan and budget, the necessary revenues are raised through assessment of the membership. During the audit periods, EPRI's operating budget was approximately \$300 million per year. The annual amount of each member's contribution was calculated by a formula based on two factors, gross revenues derived from electric power sold and number of kilowatt hours sold to ultimate customers. RG&E contributed about \$1.1 million per year to EPRI which amounted to approximately .04 percent of EPRI's annual budget.

Virtually all of EPRI's budget was spent on research and development activities. As of 1985, EPRI had started approximately 2,500 research projects and completed approximately

1,500 of these. The primary activities associated with the conduct of a project were performed by outside contractors. Approximately 80 percent of EPRI's budget was used to fund these contracts, and the remaining 20 percent was used to manage and oversee the contracts, to disseminate information and to pay EPRI's operational expenses.

We modify finding of fact "12" of the Administrative Law Judge's determination to read as follows:

An example of a project undertaken by EPRI during the audit years is the gasification-combined cycle plant built at Southern California Edison Company's Cool Water generating station. The plant was built through a partnership of EPRI, industrial suppliers, contractors, process developers, and domestic and foreign utilities. The technology developed on this project chemically converts coal to gas which is cooled, cleaned of pollutants, and then fired in a combustion turbine to produce electricity. It is generally regarded as a demonstration of the most advanced methods of turning coal into electric power with the least impact on the environment. The total cost of the project was more than \$300 million.

Two other projects carried out by EPRI and ESEERCO concerned "crevice-flushing" and "solvent decontamination". Because the Ginna Nuclear Plant owned by petitioner generates more than 50% of petitioner's total electric power, petitioner is very interested in any research and development affecting nuclear electric generation. The crevice-flushing project dealt with the problem of the corrosion of tubes through which reactor water passed during the steam generation process at nuclear facilities. An EPRI research project found a solution to the corrosion problem by flushing the crevices in the tubes (Tr., pp. 112-113). Petitioner was the first utility to demonstrate the viability of this solution.

The solvent decontamination project was funded by ESEERCO and dealt with the buildup of radioactive material in the steam generators in a nuclear plant. Petitioner was the first utility to demonstrate that the results of the research could be applied by the use of a dilute solvent which gets rid of the radioactive material with minimum worker exposure to radiation (Tr., pp. 113-114). This method of reducing the radioactive material during

maintenance lessened the annual radiation exposure of workers by 20%.¹

An important part of EPRI's program is the transfer of technology to its members. This is done through seminars and conferences and the loan of EPRI employees, among others. One of the most important ways of transmitting information is through the publication of technical reports. A contractor working for EPRI typically prepares a technical report summarizing the results of its work. EPRI edits these reports, formats them in accordance with EPRI's publishing standards and makes them available to its members. Members receive reports in several ways. Members are asked to list research areas or projects in which they are specifically interested; EPRI then forwards automatically any report within the utility's listed areas of interest. EPRI also publishes periodic guides to published reports, and members may order reports at any time. EPRI does not charge members for reports provided to them. These same reports are available to the public at a nominal cost.

RG&E is also a member of ESEERCO, a New York research and development consortium similar in many ways to EPRI. ESEERCO was founded in 1960 as the Empire State Atomic and Development Associates ("ESADA") to conduct research and development in the field of nuclear energy. In 1973, the organization was reconstituted as ESEERCO and its activities were expanded to include all fields of electric energy research and development. ESEERCO supports a research and development program directed to the particular needs of its members which are the major investor-owned New York State electric utilities.

ESEERCO employs a staff of 12 individuals, 8 of whom are scientists, engineers or administrators specializing in the field of electric power generation. The staff supports the work of five technical committees which are composed of employees of ESEERCO's member utilities.

¹ We modified finding of fact "12" of the Administrative Law Judge's determination by adding two paragraphs describing "crevice-flushing" and "solvent decontamination" to more fully reflect the record concerning the types of projects carried out by EPRI and ESEERCO.

The committees meet six to eight times per year to identify common problems, to develop projects in a research area, and to monitor on-going projects. When necessary, subcommittees and task forces are formed, reporting to the main committees. In carrying out its work, ESEERCO makes use of the personnel and facilities of its member utilities. ESEERCO staff members testify before regulatory agencies and participate in conferences, seminars and symposiums with other research organizations, on behalf of its member utilities. As is the case with EPRI, the primary activities associated with the conduct of a research project are performed by outside contractors.

Each ESEERCO member appoints two representatives to the ESEERCO Board of Directors each year. The board is ultimately responsible for approving all research and development projects undertaken by ESEERCO. Research projects are divided into two classes, minor projects with an anticipated cost over the term of the project of less than \$250,000.00 and major projects with an anticipated cost over the term of the project of more than \$250,000.00. ESEERCO's Administrative Committee has the power to approve minor projects within certain limitations established by the board. Major projects require a unanimous vote of the board, voting at a meeting at which a quorum is present.

Each year ESEERCO puts out a call for funds to pay the operating expenses of ESEERCO and to pay the costs to be incurred by ESEERCO as a result of ESEERCO's entering into contracts to implement research and development projects. Budget expenses are allocated to members using a formula based on the member's reported annual energy requirements, essentially kilowatt hours of electricity generated. Thus, the greater a member's electric generation, the larger its contributions will be relative to other members. Upon request by the treasurer, each ESEERCO member pays its allocated share of three major expenses: (1) the operating expenses of ESEERCO; (2) costs incurred by ESEERCO as a result of its entering into contracts for minor projects; and (3) costs incurred by ESEERCO as a result of its entering into contracts for major projects. A member is obligated to pay costs in the third category only if it

had a representative present when the unanimous vote of the board was taken or if it later agreed to bear its allocated share of the board approved project. An individual member may opt out of a particular project by dissenting from a board vote approving a major project or, if not present at the time the vote is taken, refusing to share the cost of the project. If the board decides to go forward with the project despite the lack of unanimity, the remaining members then bear the cost of the project. Once a member votes to approve a project, its obligation to fund that project continues even if it later terminates its membership in ESEERCO. This has occurred in the case of Long Island Lighting Company which was forced to drop its ESEERCO membership because of financial hardship. ESEERCO has never undertaken a major project which did not have the unanimous approval of its members.

In 1982, ESEERCO's budget was somewhat over \$16 million, of which about \$1 million was budgeted for operating expenses, and the remainder was budgeted for contracts entered into for research and development projects. During the audit periods, RG&E contributed slightly less than \$1 million per year to ESEERCO.

ESEERCO is primarily concerned with short-term and mid-term projects designed to improve electric service. Approximately 30% of the projects entered into by ESEERCO have been co-sponsored with EPRI. For example, ESEERCO contributed approximately \$7.5 million to the coal-gasification combined cycle plant described above. ESEERCO has also undertaken projects addressing issues of special concern to New York State. To address problems caused by acid rain, ESEERCO has entered into a long-range research project in cooperation with the New York State Department of Environmental Conservation. Essentially, this project entails gathering information on over 1,200 lakes and ponds in the Adirondacks in order to determine the acidic content and presence of fish and wildlife in those bodies of water. RG&E's witness described it as taking a snapshot of the Adirondacks in order to have a point of comparison. As of December 1985, ESEERCO had completed approximately 250 research projects and was in the process of conducting an additional 150 projects.

All research conducted by ESEERCO is contracted out to organizations with the expertise to actually carry out the research activities. Each contractor is required to submit a report summarizing its findings. These technical reports are published under ESEERCO's name. Its members automatically receive copies of all such reports. The reports are available to the public at no charge if extra copies are available, and if they are not, copies are provided for the cost of reproducing the report.

By letter dated May 17, 1961, the Internal Revenue Service found that contributions made by a member to ESADA (ESEERCO's former name) constituted research and experimental expenditures within the meaning of section 174 of the Internal Revenue Code.

RG&E treated its contributions to ESEERCO as research and development expenses for all relevant purposes, including internal accounting, Federal and State taxation and ratemaking proceedings before the PSC.

Analysis Services

During the first audit period, a number of nuclear generating facilities throughout the nation experienced problems associated with equipment or procedures common to many nuclear plants. When such problems arise, the Nuclear Regulatory Commission ("NRC") requires utilities to undertake a study for the purpose of determining the problem's cause and suggesting ways of correcting it. All affected utilities are required to make such studies, but in the interests of efficiency, the utilities often form owners groups which will engage a manufacturer or consultant to conduct the required tests at one of the plants and to share its findings and recommendations with the NRC and all affected utilities. RG&E belonged to three such owners groups during the first audit period. The first was the reactor vessel motion group, a group of eight utilities addressing the issue of reactor vessel motion following an accident involving loss of coolant. The second was the Three Mile Island Group, a group of 26 utilities which joined together to address a range of problems arising from the nuclear accident at Three Mile Island.

The third was a group of 10 utilities addressing the problem of feed water cracking tubes. The experiences of the third group were described with some detail by RG&E.

In May 1979, wall cracks were detected in the pipe elbows of a steam generator operating in a nuclear power plant in the Mid-West and manufactured by Westinghouse Electric Corporation. On June 25, 1979, the NRC issued a directive to all pressurized water reactor facilities with similar generators ordering the inspection of all their feedwater lines. This resulted in the other plants detecting cracks in the same general areas. In order to provide a uniform and systematic approach to the assessment of this problem, a utilities Feedwater Line Cracking Owners Group was formed with Westinghouse as its technical agent. At this time, the factors causing the cracking were suspected but not positively identified. The owners group identified eight tasks necessary to evaluate the thermal, hydraulic, structural and environmental conditions which could individually or collectively contribute to cracking of feedwater lines. As the program progressed, revisions and additions were made to the program. In sum, the objective of the overall program was to provide an approach for all utilities in evaluating the cause of feedwater line cracking, and to identify modification options available to minimize or eliminate its continuance. Westinghouse's total charge for its services was \$538,534.50. Approximately \$400,000.00 of this was for engineering services, and \$140,000.00 was for computer services. Westinghouse produced a final report which was delivered to each member of the Owners Group and the NRC. It included the results of its studies and recommendations regarding options available to the utilities in addressing the feedwater cracking problem in their individual plants. The complete report was not made available to the public.

On audit, the Division determined that payments made to consultants such as Westinghouse for their services and final reports were subject to sales tax as the purchase of an information service

Nuclear Refueling

The nuclear fuel system at the Ginna station consists of fuel assemblies. Each assembly is made up of pencil-thin rods containing uranium pellets. RG&E replaces approximately one-third of the assemblies each year. Because the fuel is radioactive, the refueling process is complex and requires a high level of knowledge and skill to accomplish. The spent fuel rods are removed from the reactor core, transferred to an adjacent building and deposited in the spent fuel pool. New fuel assemblies are placed in the core, and all of the fuel assemblies are rearranged to achieve the optimal mix of new and old assemblies. The entire procedure is carried out under 40 feet of water. The nuclear power plant is placed out of service while the refueling occurs.

The Division determined that the nuclear refueling constituted the taxable service of maintaining, servicing or repairing real property under section 1105(c)(5) of the Tax Law. RG&E contests the imposition of tax on these charges only for the years 1984 and 1985.

During the years 1979 through 1983, the refueling service was performed by specialists other than the suppliers of the fuel. Beginning in 1984, RG&E contracted with Westinghouse to supply both the nuclear fuel and refueling services. RG&E entered into a contract with Westinghouse which covered "the fabrication of nuclear fuel and associated services". RG&E purchase orders show separate billing for the fabrication of the nuclear fuel and the refueling services. One invoice dated January 27, 1984 shows the price for "full-scope refueling services" for one outage period to be \$228,230.00.

Penalty

The Division assessed a penalty for the period December 1, 1982 through November 30, 1985 under Tax Law § 1145(a) on that portion of audited tax due relating to contract labor. RG&E conceded the underlying tax but contests the penalty.

RG&E hires outside contractors to repair and maintain its generating facilities. These services are exempt from State sales and use taxes under Tax Law § 1105-B(b), but subject to local sales and use taxes. On the 1983 field audit, the Division found that RG&E had failed to

accrue and pay tax due on these contract labor transactions. Following that audit, RG&E did not change its accounting procedures to capture the local tax; consequently, tax was found due on the same transactions on the 1986 audit.

During both audit periods, all RG&E vouchers were routed through one individual who was responsible for determining whether sales and use taxes were due. This individual followed written guidelines and had in-house tax experts available for advice as needed. Approximately 200 vouchers per day were reviewed and coded for tax purposes. The coding is a complex task because RG&E operates in 10 different taxing jurisdictions and its purchase transactions are subject to a wide range of sales tax provisions some of which are complex and subject to varying interpretations.

In order to code the contract labor vouchers and accurately capture the local tax on each individual transaction, RG&E would have had to substantially change its existing accounting and computer systems. At the time the audits were being conducted, RG&E was in the process of evaluating and redesigning these systems; therefore, it delayed making any immediate changes and instead addressed the tax on contract labor within the context of a major redesign of the accounting and computer systems. As of mid-June 1986, the necessary changes were implemented.

Stipulation

Following the administrative hearing, RG&E and the Division entered into a stipulation which is adopted here as the following findings of fact.

During the period December 1, 1979 through November 30, 1982, petitioner paid to the State Department of Taxation and Finance the amount of \$286,784.91 in use taxes for the use of its own electricity and gas.

Use taxes for the self-use of petitioner's electricity and gas were paid in the period December 1, 1979 through November 30, 1982, based upon representations made to petitioner by

auditors from the Department of Taxation and Finance. Those auditors stated that petitioner was required to pay use tax on its use of its own electricity and gas.

In a subsequent audit, representatives of the Department of Taxation and Finance stated that the New York Tax Law does not impose any use tax on self-use of utility services. Accordingly, credit was allowed for all such use taxes paid in the period from December 1, 1982 through November 30, 1985.

The company has not yet been refunded any of the use taxes for self-use of utility services paid in the period December 1, 1979 through November 30, 1982.

The company was not required to pay use tax on the self-use of utility services.

The \$286,784.91 in taxes incorrectly paid in the audit period December 1, 1979 through November 30, 1982 may be and will be applied and set off against any amounts of unpaid or underpaid taxes found to be owing in the instant matter for the audit period December 1, 1979 through November 30, 1982.

Opinion

The Administrative Law Judge determined that ESEERCO's business was to conduct research and development, not to provide an information service within the purview of Tax Law § 1105(c)(1) and that petitioner's payments to ESEERCO were contributions for research and development and not for the purchase of an information service within the purview of section 1105(c)(1).

The Administrative Law Judge also determined that the payments by petitioner for "analysis services" were for engineering and other professional services and were not subject to sales tax as the purchase of information services under section 1105(c)(1).

Relying on Matter of Rochester Gas & Electric Corp. v. New York State Tax Commn. (128 AD2d 238, 516 NYS2d 341, affd 71 NY2d 931, 528 NYS2d 810), the Administrative Law Judge determined that the installation of nuclear fuel was a separate transaction from the

purchase of nuclear fuel and that the installation was subject to sales tax as a maintenance service to real property under Tax Law § 1105(c)(5).

Finally, the Administrative Law Judge determined that petitioner failed to show reasonable cause for waiver of penalty for its failure to report tax due on contract labor charges for the 1982 through 1985 audit period.

In its exception, the Division asserts 1) that ESEERCO is not engaged in research and development; 2) that ESEERCO is an information service and that its primary function is to generate the information requested by petitioner and other utilities; 3) that ESEERCO's reports are the focal point of its activities; 4) that in exchange for their payments to ESEERCO, petitioner and other utilities obtained the right to select the topics examined by ESEERCO and as a consequence, the reports generated by ESEERCO; and 5) that there is no exclusion in section 1105(c)(1) for production of information used by customers for new products. Accordingly, the Division asserts that petitioner's payments to ESEERCO are for the purchase of an information service provided by ESEERCO and are subject to tax pursuant to section 1105(c)(1).

In reply to the Division's exception, petitioner asserts that the Administrative Law Judge correctly determined that ESEERCO is engaged in research and development; that the contributions by petitioner to ESEERCO were for research and development; that research and development is not the providing of an information service; and that research and development is not one of the enumerated services subject to tax under section 1105(c).

In its exception, petitioner asserts that the Administrative Law Judge erred in concluding that the installation of nuclear fuel is separate from the purchase of nuclear fuel and subject to tax as the purchase of a maintenance service to real property. Petitioner asserts that for the years 1984 and 1985 the facts are different from those in Matter of Rochester Gas & Electric Corp. v. New York State Tax Commn. (*supra*) relied upon by the Administrative Law Judge because for these years the fuel was purchased from and installed by a single vendor. Petitioner also asserts

that it proved reasonable cause for the waiver of the penalty for its failure to report tax due on contract labor charges for the 1982 through 1985 audit period. Petitioner asserts that its substantial compliance with the law is reasonable cause citing the Division's regulations at 20 NYCRR 536.5.

We affirm the determination of the Administrative Law Judge in its entirety.

We think it helpful at the outset to briefly review the provisions of the Tax Law relevant to the taxation of sales of tangible personal property and services.

As a general matter, all retail sales of tangible personal property are taxable unless specifically exempted (Tax Law § 1105[a]). We note that tangible personal property purchased for use or consumption in research and development in the experimental or laboratory sense, as well as gas and electricity consumed or used for the same activity, are exempt from sales tax (Tax Law §§ 1115[a][10] and 1115[b][ii], respectively).

Generally speaking, sales of services are not taxable unless specifically enumerated as taxable (Tax Law § 1105[c]).

Research and development is not enumerated as a service subject to tax. The sale of an information service is subject to tax. More particularly, Tax Law § 1105(c)(1) imposes a tax upon:

"The receipts from every sale, except for resale, of the following services:

(1) The furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons . . ." (emphasis added).

We deal first with the Division's assertion that ESEERCO is not engaged in research and development, but that its activities were the selling of an information service.

We cannot agree.

There is no definition of the term research and development in the Tax Law. However, the Division's regulations define the term for purposes of sections 1115(a)(10) and 1115(b)(ii) and provide guidance as to its meaning. The regulation provides:

"Research and development. (1) Research and development, in the experimental or laboratory sense, means research which has as its ultimate goal:

- (i) basic research in a scientific or technical field of endeavor;
- (ii) advancing the technology in a scientific or technical field of endeavor;
- (iii) the development of new products;
- (iv) the improvement of existing products; and
- (v) the development of new uses for existing products" (20 NYCRR 528.11[b]).

Using this definition as guidance, the record here is crystal clear that ESEERCO was created for, and engaged in, research and development activities in the experimental or laboratory sense. The documentary evidence submitted by petitioner, which includes: the certificate of incorporation of ESEERCO (Petitioner's Exhibit 11); the petitioner's report to the State Public Service Commission (PSC) (Petitioner's Exhibit 18); the excerpts from the PSC Annual Report (Petitioner's Exhibit 19); and the Internal Revenue Service Ruling on Research and Development Treatment of Payments to ESEERCO (Petitioner's Exhibit 15), makes it clear that ESEERCO was created for and engaged in research and development.

The testimony of petitioner's witnesses, describing specific projects undertaken by ESEERCO, indicates the projects were research and development in the context of the regulatory definition. We refer here to the Southern California Edison Cool Water Project, a six year project to research efficient ways to burn coal in generating electricity; the Acid Rain Project, a

multi-year project carried out by ESEERCO and the New York State Department of Environmental Conservation to determine the connection between the burning of coal in power plants and acid rain; the "crevice-flushing" project which found a solution to corrosion of tubes through which reactor water passed by flushing the crevices in the tubes; and the "solvent decontamination" project which found a way to get rid of radioactive buildup in the steam generators in a nuclear plant through the use of a dilute solvent and lessened the annual radiation exposure of workers by 20%.

In short, we conclude that, contrary to the Division's assertion, ESEERCO was engaged in research and development activities.

The next issue we address is whether, as asserted by the Division, written reports produced as a result of ESEERCO's research and development activities make such activities taxable as an information service under section 1105(c)(1).

We cannot agree with the Division's assertion.

Research and development is a separate, identifiable activity (see, Tax Law §§ 1115[a][10] and 1115[b][ii]; 20 NYCRR 528.11[b]) and where provided by one entity to another, as here, is a separate, identifiable service. Research and development is not one of the services enumerated under section 1105(c) as taxable. The mere fact that a written report is rendered indicating the status of a research and development project does not, in our opinion, transform the research and development into an information service.

The essence of the relationship and transaction between petitioner and ESEERCO is research and development. Petitioner's purpose in funding the Cool Water, the "crevice flushing" and the "solvent decontamination" projects was the technology produced by the research and development underlying such projects: the technology through which coal is chemically converted to gas, is cleaned of pollutants, and then fired in a combustion turbine to produce

electricity; the technology which enabled petitioner to be the first utility in the country to demonstrate the viability of "crevice-flushing" to reduce corrosion in tubes carrying reactor water during the steam generating process at nuclear reactor plants; and the technology which allowed removal of radiation build-up in steam generators in nuclear plants and improved worker's safety.

To say that the written reports which are available to the public at little or no charge are the focal point of such projects, as the Division asserts, in our judgment, distorts the true nature of the relationship and the transaction.

Stated succinctly, we find no basis in the Division's assertion, which, carried to its logical end, would render taxable, as an information service, any activity where a written report is furnished without regard for the nature of the activity which produces the report (see, Matter of Audell Petroleum Corp. v. New York State Tax Commn., 69 NY2d 818, 513 NYS2d 962).

We deal next with petitioner's assertion on exception that installation of nuclear fuel was an integral part of the purchase of the fuel itself and exempt under Tax Law § 1115(c), i.e., as fuel used for the production of electricity. Petitioner asserts that for the years at issue, 1984 and 1985, the nuclear refueling was done by one vendor, Westinghouse. Petitioner's point is that for these years its refueling process was different from that employed in the years at issue in Matter of Rochester Gas & Electric Corp. v. New York State Tax Commn. (128 AD2d 238, 516 NYS2d 341, affd 71 NY2d 931, 528 NYS2d 810) since in those years the fuel was purchased from one party and installed by another. Petitioner asserts that for 1984 - 1985 its situation is analogous to airline refueling as covered by the Division's regulations (20 NYCRR 528.10[c][1][i]).

We affirm the determination of the Administrative Law Judge on this point. The Appellate Division in Matter of Rochester Gas & Electric Corp. v. New York State Tax Commn. (supra) determined that the installation of nuclear fuel was a highly skilled task which required the services of specialists, and as a consequence, the installation of the fuel was sufficiently

independent of the purchase of the fuel to be considered a separate transaction. The same is true here. As the Administrative Law Judge determined, "[t]he separateness of the installation task is evidenced by testimony establishing that the service could be purchased separate from the nuclear fuel, invoices showing that Westinghouse separately billed for refueling services and the nuclear fuel, and the magnitude of the charge for refueling" (Determination of the Administrative Law Judge, Conclusion of Law C).

We deal finally with petitioner's assertion that it had reasonable cause for its failure to report tax due on contract labor charges for the 1982 through 1985 audit period. Petitioner asserts that its substantial compliance with the Tax Law is reasonable cause for waiver of the penalty.

We affirm the determination of the Administrative Law Judge on this point. Substantial compliance is not in itself reasonable cause for waiver of the penalty. Under the circumstances herein, petitioner was aware of the tax due on its labor costs but, because its accounting and computer systems were being redesigned, decided not to report the transactions until the redesign was completed. We agree with the Administrative Law Judge that these difficulties do not constitute reasonable cause.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Rochester Gas and Electric Corporation is denied;
2. The exception of the Division of Taxation is denied;
3. The determination of the Administrative Law Judge is affirmed;
4. The petitions of Rochester Gas and Electric Corporation are granted to the extent indicated in conclusions of law "A", "B", "E", and "F" of the Administrative Law Judge's determination but such petitions are otherwise denied; and

5. The Division of Taxation shall modify the notices of determination dated November 4, 1983 and June 20, 1986 in accordance with paragraph "4" above but such notices are otherwise sustained.

DATED: Troy, New York
January 4, 1991

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner