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

TSB-A-87 (17) C
Corporation Tax
June 24, 1987

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION PETITION NO. C861215C

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

The issues raised are (1) whether Petitioner, an Article 9-A taxpayer, is allowed an investment tax credit, pursuant to section 210.12 of the Tax Law, with respect to research and development equipment used in the design and development of computer hardware and software to be used in a data communications environment and (2) whether Petitioner qualifies for a research and development credit, pursuant to section 210.18 of the Tax Law with respect to such equipment. Also, since Petitioner has not earned any profits to date, can the investment tax credit be allowed in the current taxable year, as a refund, rather than carrying the credit to future years.

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

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

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

The equipment used in Petitioner's research and development is depreciable and was acquired since February, 1983. The equipment consists of:

PC based development stations - used for software development
Data analyzers - used to monitor and analyze data transmission and can be programmed to emulate host and terminal processors
Data scopes - used to monitor data transmissions

Data analyzer/simulator - used for simulation of network environment, data analysis and test procedures
Test units
Test/debug equipment - in-circuit emulators, used to control processor execution during software debugging phase of development
Ironics 1600 development system - multi-user development environment for 68000 based products
Asynchronous terminals - used for testing/debug of software and access Ironics System
Sperry printer, terminal and controller - used to develop and maintain Sperry based products
Burroughs printer and terminal - used to develop and maintain Burroughs based products
Honeywell printer and terminal - used to develop and maintain Honeywell based products
Various modems - used to construct test environment for product development
Digital equipment corporation VAX11/780 mainframe - used for development of data communications software protocols and other R & D maintenance of data (including required software)

ISSUE (1)

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

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

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

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

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

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

(6) is principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing.

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

Section 210.12(f) of the Tax Law provides that:

> (f) At the option of the taxpayer . . . research and development facilities which qualify for elective deduction under subparagraphs two and three of paragraph (e) of subdivision three of this section may be treated as property 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, provided the property otherwise qualifies under paragraph (b) of this subdivision, in which event... a credit shall not be allowed under such subdivision eleven and a deduction shall not be allowed under such subparagraph three of paragraph (e).

Section 210.3(e)(2) and (3) of the Tax Law and section 4-8.7 of the Business Corporation Franchise Tax regulations (hereinafter Article 9-A regulations) provide that a taxpayer may elect to deduct from allocated entire net income expenditures paid or incurred during the taxable year for the construction, reconstruction, erection or acquisition of any new property used or to be used for purposes of research and development in the experimental or laboratory sense. Such purposes do not include the ordinary testing or inspection of materials or products for quality control, efficiency surveys, management studies, consumer surveys, advertising promotions or research in connection with literary, historical or similar projects. For tangible property to qualify for the deduction it must be depreciable pursuant to section 167 of the Internal Revenue Code, have a situs in New York State and be used in the taxpayer's trade or business.

It appears that the language contained in section 210.3(e)(2) and (3) was derived from section 1.174-2 of the federal income tax regulations, which states:

> (a) In general. (1) The term "research or experimental expenditures", as used in section 174, means <u>expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense</u>. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. <u>The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions...nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects</u>. (emphasis added) 26 CFR 1.174-2

In applying federal income tax regulation section 1.174-2, Revenue Procedure 69-21 established guidelines to be used in connection with the examination of federal income tax returns involving the costs of computer software. Revenue Procedure 69-21 provides that the costs of developing software (whether or not the particular software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 of the Internal Revenue Code as to warrant accounting treatment similar to that accorded such costs under section 174.

Section 1-2.1 of the Article 9-A regulations provides that any term used in such regulations shall, unless a different meaning is clearly required, presumably have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes and regulations promulgated thereunder. In addition, section 607(a) of the Tax Law relating to personal income tax provides that "[a]ny term used in this article shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required." It is now beyond question that when an interpretation of a law of the United States relating to federal income taxes is established by the Internal Revenue Service through a Revenue Ruling or a Revenue Procedure, such federal interpretation will be followed for New York State personal income tax purposes, as well.

It follows that the cost of equipment used in the design and development of computer software products, which is treated as research or experimental expenditures for federal income tax purposes, pursuant to Revenue Procedure 69-21, should be accorded the same treatment for research and development purposes under section 210.3(e)(2) and (3) of the Tax Law. Therefore, the research and development expenditures of Petitioner for equipment used in the design and development of computer software products is deemed to be used for purposes of research and development in the experimental or laboratory sense for purposes of section 210.3(e)(2) and (3).

Petitioner's equipment that is used in the design and development of computer hardware, is used to create experimental models of the hardware products. As such, the equipment is clearly used for purposes of research and development in the experimental sense for purposes of section 210.3(e)(2) and (3) of the Tax Law.

However, if any item of Petitioner's research and development equipment is used in the ordinary testing or inspection of materials or products for quality control, efficiency surveys, management studies, consumer surveys or advertising promotions such item does not qualify for the deduction under section 210.3(e)(2) and (3) of the Tax Law.

It is determined that Petitioner's research and development equipment is used in its trade or business for purposes of research and development and if it is depreciable pursuant to section 167 of the Internal Revenue Code and has a situs in New York State, the equipment meets the other requirements of section 210.3(e)(2) and (3) of the Tax Law, and such equipment may be treated as property principally used by Petitioner in the production of goods by manufacturing,

processing, etc. for purposes of the investment tax credit pursuant to section 210.12(f) of the Tax Law. If such property also meets the other requirements for eligible property under section 210.12 of the Tax Law, Petitioner may elect to claim an investment tax credit based on the cost or other basis of such equipment.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ISSUE (2)

Section 210.18 of the Tax Law allows a research and development credit against the tax imposed under Article 9-A of the Tax Law equal to ten percent of the cost or other basis of equipment which:

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

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

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

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

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

(6) is used or are to be used for purposes of research and development in the experimental or laboratory sense. Such purposes do not include the ordinary testing or inspection of materials or products for quality control, efficiency surveys, advertising promotions, or research in connection with literary, historical or similar projects.

Generally, the credit is allowed for all property used directly to perform research to develop experimental or pilot models, plant processes, formulas, inventions and similar properties and improvements of already existing properties of the type mentioned.

Inasmuch as it has already been determined that the property here at issue, qualifies as equipment used for purposes of research and development in the experimental or laboratory sense for purposes of section 210.3(e)(2) and (3) of the Tax Law, it is also concluded that such property also qualifies as property used for purposes of research and development in the experimental or laboratory sense within the meaning of section 210.18 of the Tax Law.

It should be noted that the research and development credit under section 210.18 of the Tax Law is not allowed for any property for which the research and development deduction under section 210.3(e)(3) of the Tax Law has been taken; the eligible business facility credit under section 210.11 of the Tax Law has been taken; the eligible business facility credit under section 210.11 of the Tax Law has been taken or the investment tax credit under section 210.12 of the Tax Law has been taken. Thus, if Petitioner's property qualifies for both the investment tax credit under section 210.12 of the Tax Law and the research and development credit under section 210.18 of the Tax Law, Petitioner must elect to claim one credit or the other. It may not claim both. Additionally, the credit is not allowed if the property is leased to any other person or corporation.

Such credit must be claimed for the taxable year in which the taxpayer first qualifies for the credit.

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

Section 1087(a) of the Tax Law provides that a claim for credit or refund of an overpayment of tax must be filed by a taxpayer within three years from the date the return was filed or two years from the date the tax was paid, whichever of such periods expires later. If a taxpayer files such an amended return, it may claim a refund to taxes previously paid (subject to the limitations set forth in sections 210.12(e), 210.12-A(c) and 210.18(e)) or it may carry over the credits to the following year or years and apply the credits against taxes for such year or years.

DATED: June 24, 1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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