STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DIVISION OF TAXATION

ADMINISTRATIVE HEARING

FINAL DECISION AND ORDER

#2012-10

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
DEPARTMENT OF REVENUE
DIVISION OF TAXATION
ONE CAPITOL HILL
PROVIDENCE, RHODE ISLAND 02908

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| IN THE MATTER OF: | : | Case No.: 11-T-0003<br>Case No.: 11-T-0006<br>Sales and Use Tax |
| Taxpayer. | : | Consolidated |

## DECISION

## I. INTRODUCTION

The above-entitled matter came before the undersigned as the result of a Notice of Hearing and Appointment of Hearing Officer dated February 2, 2011 and issued to the above-captioned taxpayer ("Taxpayer") by the Division of Taxation ("Division") in response to a request for hearing in regard to refund claims for the period of January 1, 2006 to December 31, 2006 (11-T-0006). The above-entitled matter also came before the undersigned as the result of a Notice of Hearing and Appointment of Hearing Officer dated January 27, 2011 and issued to the Taxpayer by the Division in response to a request for hearing in regard to refund claims for the period of January 1, 2007 to December 31, 2008 (11-T-0003). By agreement of the parties, these two (2) matters were consolidated. A hearing was held on August 3, 2011. At hearing, the parties were represented by counsel and briefs were timely filed by April 25, 2012.

## II. JURISDICTION

The Division has jurisdiction over this matter pursuant to R.I. Gen. Laws § 44-1-1 *et seq.*, R.I. Gen. Laws § 44-18-1 *et seq.*, the *Division of Taxation Administrative*

*Hearing Procedures, Regulation AHP 97-01*, and the Department of Administration's *Division of Legal Services Regulation 1 Rules of Procedure for Administrative Hearings.*

## III. ISSUE

The parties agreed that the issues were as follows: 1) whether any of the items disallowed in both of the Taxpayer's refund claims qualify for the manufacturers' supply exemption under R.I. Gen. Laws § 44-18-30(7); and 2) whether any of the items disallowed in both of the Taxpayer's refund claims qualify for the manufacturers' equipment exemption under R.I. Gen. Laws § 44-18-30(22).[1]

## IV. MATERIAL FACTS AND TESTIMONY

The parties agreed to exhibits and the following relevant facts:[2]

1. The Taxpayer is a Delaware corporation originally organized in December of 1953 and currently having its principal place of business located in Massachusetts. The Taxpayer qualified to do business in Rhode Island in July of 1986 and has local place of business on Rhode Island.

2. The Taxpayer is a defense contractor who develops, engineers and manufactures military electronic systems for the US Government. During the periods at issue, facility specialized in providing sensing, detection, signaling, combat management and undersea weapons systems for use by the US Navy in submarine and surface vessels. The Taxpayer was the prime contractor who designed, developed and manufactured systems and equipment for the Zumwalt class destroyer ("Destroyer"). Exhibits Three (3) and Four (4).

3. The Taxpayer has held a Rhode Island sales tax permit since 1991 and has a history of routinely and regularly filing and remitting taxes thereunder during the time frame at issue.

4. On February 14, 2009, the Taxpayer filed a claim for refund under the Sales and Use Tax with the Division for the period January 1, 2006 and December 31, 2006 ("2006 Refund Claim"). Exhibit Eight (8).

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[1] The parties agreed that the statutes and/or regulations at issue are R.I. Gen. Laws § 44-18-30(7), R.I. Gen. Laws § 44-18-30(22), R.I. Gen. Laws § 44-18-7.1(g), and Division's Regulation SU 00-58. The parties also agreed that also pertinent to this matter may be Regulation SU 09-25, Regulation SU 09-62, Regulation SU 00-126, and Regulation SU 98-122 insofar as they relate to computers and computer software.

[2] See joint submission of facts and exhibits.

5. The 2006 Refund Claim sought recovery of This sum represented sales tax collected on purchases at the point of sale or use tax subsequently remitted on extax purchases; said purchases for use at the Taxpayer's Rhode Island location and the taxes thereon being paid between January 1, 2006 and December 31, 2006. The Taxpayer characterized of the 2006 Refund Claim as attributable to "Non-Indirect" material items and of the 2006 Refund Claim as attributable to "Indirect" material items. See Exhibit Eight (8) at p. 1. Exhibits 10 (Non-Indirect Items) and 11(Indirect Items).

6. The grounds asserted for the 2006 Refund Claim included, but were not limited to, Sale for Resale Deduction, Exempt Research & Development Equipment, and Exempt Supplies & Assets Used or Consumed in Manufacturing. Exhibit Nine (9). The 2006 Refund Claim was adequately documented for review on an item by item basis. Exhibits Ten (10) and Eleven (11).

7. The 2006 Refund Claim was subject to desk audit and, as a result thereof, the Division allowed refund of Exhibit 12. During the course of this desk audit, the Division's auditor reviewed contracts, invoices, purchase orders, charts of account and tax returns. Exhibits 15 (breakdown of sales tax returns) and 35 (sample purchase documentation). The auditor communicated with the Taxpayer's representatives during the course of his review.

8. All items in the 2006 Refund Claim that were allowed for refund had been classified as "Non-Indirect Materials." Exhibits 13.[3]

9. All the Indirect Materials items in the 2006 Refund Claim were denied refund. Exhibit 14. The Taxpayer, during the course of the examination, also reclassified some "Non-Indirect Materials" as "Indirect Materials." Exhibit 14.

10. On August 9, 2010, the Taxpayer was provided with a set of the refund audit workpapers. Exhibit 16.

11. On September 17, 2010, the Division issued Notices with regard to the 2006 Refund Claim advising the Taxpayer that it was granting in tax and in statutory interest for a total refund of Exhibits 17 and 18.

12. The Taxpayer protested the partial denial of its 2006 Refund Claim and requested an administrative hearing in a letter dated October 15, 2010.

13. On October 19, 2010, a refund check for the 2006 Refund Claim in the amount of was sent to Taxpayer after offsetting outstanding tax receivables from prior periods.

[3] Some Non-Indirect Materials items that otherwise qualified for refund were denied on the grounds that their refund was time barred. Exhibit 13.

14. The Taxpayer was afforded an informal preliminary conference on the 2006 Refund Claim before a lay conferee at the Tax Division on January 25, 2011. The matter was not resolved and forwarded to this forum for full administrative hearing on January 31, 2011.

15. The amount of the 2006 Refund Claim that was denied and is currently in dispute is Exhibit 20.

16. On June 3, 2009, the Taxpayer filed a Claim for Refund under the Sales and Use Tax with the Division for the period January 1, 2007 and December 31, 2008 (2006-2008 Non-Indirect Refund Claim). Exhibit 21.

17. The 2007-2008 Non-Indirect Refund Claim sought recovery of This sum represented sales tax collected purchases at the point of sale or use tax subsequently remitted on extax purchases; said purchases for use at the Taxpayer's Rhode Island location and the taxes thereon being paid between January 1, 2007 and December 31, 2008. The Taxpayer characterized this Refund Claim as being attributable to "Non-Indirect" material items. Exhibit 21 at p. 1.

18. The grounds asserted for the 2007-2008 Non-Indirect Refund Claim included, but were not limited to, Exempt Research & Development Equipment, Optional Service Contracts, and Exempt Supplies & Assets Used or Consumed in Manufacturing. Exhibit 22. The 2007-2008 Non-Indirect Refund Claim was adequately documented for review on an item by item basis. Exhibit 23.

19. On January 14, 2010, the Taxpayer filed a second Claim for Refund under the Sales and Use Tax with the Division for the period January 1, 2007 and December 31, 2008 (2007-2008 Indirect Refund Claim). Exhibit 24.

20. The 2007-2008 Indirect Refund Claim sought recovery of This sum represented sales tax collected on purchases at the point of sale or use tax subsequently remitted on extax purchases; said purchases for use at the Taxpayer's Rhode Island location and the taxes thereon being paid between January 1, 2007 and December 31, 2008. The Taxpayer characterized this Refund Claim as being attributable to "Indirect" material items. Exhibit 24 at p. 1. See Exhibit 26 (Details Items).

21. The grounds asserted for the 2007-2008 Indirect Refund Claim were the Sale for Resale Deduction. Exhibit 25. The 2007-2008 Indirect Refund Claim was adequately documented for review on an item by item basis. Exhibit 26.

22. Both of the 2007-2008 Refund Claims were subject to desk audit and, as a result thereof, the Division allowed refund of $756,391.16. Exhibit 27. During the course of this desk audit, the Division's auditor reviewed contracts, invoices, purchase orders, charts of account and tax returns. Exhibits 29 (breakdown of sales tax returns) and 35 (sample purchase documentation). The auditor communicated solely with representatives of Taxpayer during the course of his review.

23. All items in the 2007-2008 Refund Claims that were allowed for refund had been classified as "Non-Indirect Materials." Exhibit 28.

24. All the Indirect Materials items in the 2007-2008 Refund Claims were denied refund.

25. On June 24, 2010, the Taxpayer was provided with a set of the refund audit workpapers. Exhibit 30.

26. On September 17, 2010, the Division issued a Notice regarding the 2007-2008 Refund Claims advising the Taxpayer that it was granting in tax and in statutory interest for a total refund of Exhibits 31 and 32.

27. The Taxpayer protested the partial denial of its 2007-2008 Refund Claims and requested an administrative hearing in a letter dated October 14, 2010.

28. On October 19, 2010, a refund check in the amount of was sent to Taxpayer.

29. The Taxpayer was afforded an informal preliminary conference on the 2007-2008 Refund Claims before a lay conferee at the Tax Division on December 1, 2010. The matter was not resolved and forwarded to this forum for full administrative hearing on January 11, 2011.

30. The amount of the 2007-2008 Refund Claims that were denied and are currently in dispute is Exhibit 34.

31. The 2006 Refund Claim and the two (2) 2007-2008 Refund Claims have, by agreement of the parties, been consolidated for the purpose of hearing and decision.

("Auditor"), Senior Revenue Agent, testified on behalf of the Division. He testified that he reviewed these consolidated claims and the two (2) refund claims were initially presented in two (2) categories: first, direct items that were used to make the actual products; and second, indirect (e.g. overhead) items that were administrative or distributive costs. He testified that for both direct cost claims, the Taxpayer originally asserted 12 bases for refund including research and development and manufacturing equipment and supply exemptions.

The Auditor testified that each item contained in the direct refund claim had its own individual reason for the claim and for those items based on research and development, he rejected those because of another audit that had rejected research and development claims and that appeal was pending in court. He testified that it is not conclusive that an item is coded as manufacturing but rather the Division reviews how it will be used, what it is used to produce, what is needed to make it, and what materials are involved. He testified that for the coded manufacturing exemption items, he reviewed the vendor and purchase orders and toured the facility.

The Auditor testified that Exhibit 20 (2006 Refund Claim) and Exhibit 34 (2007-2008 Refund Claim) contain line items that were initially coded and requested to be exempt by the Taxpayer as research and development but were rejected by the Division. He testified that most of the items appear to be from major computer manufacturers including leased computer equipment. He testified that the Taxpayer is now claiming those items are part of production or manufacturing for the Taxpayer's Destroyer for the Navy. He testified that Exhibits 20 and 34 contain cost centers associated with the Destroyer program except a few are missing in the 2007-2008 Refund Claim.

The Auditor testified there are two (2) types of software: customized software specifically designed and made for a specific client or canned software that can be purchased and used by anybody. He testified that distinction was maintained with the adoption of the 2007 Sales and Use Tax Act. He testified that equipment that is used for providing a service would not be deemed to be producing a product (tangible personal property) so would not be exempt. He testified that if equipment is used to produce a product (tangible personal property), it would be exempt. He testified that this distinction

is contained in State statute and regulation. He testified that even if a product is produced for an exempt entity like the Federal government the distinction does not change.

testified on behalf of the Taxpayer. He testified that he has worked for 11 years as a Sales Tax Audit Manager where he manages the Taxpayer's sales tax audits for all states. He testified that both claims were filed with research and development and manufacturing refund claims. See Division's Exhibits Nine (9) (2006 Refund Claim) and 22 (2007-2008 Refund Claim). He testified that the difference between the Taxpayer's initial refund claims and its current claims is that it removed the research and development items and other non-manufacturing items and the Division granted some refunds. He testified that the majority of the transactions in Exhibits 20 and 34 are for the Destroyer program.

On cross-examination, testified that all of the items listed in Exhibits 20 and 34 were previously presented to the Division under research and development and are now being claimed as manufacturing exemptions. He testified that the manufacturing exemption is predicated on how the elements are used according to the statute and regulation. He testified that after the initial claim was filed, there was a facility tour and it was determined that those items were being used for software development and integrating software into hardware. He testified that to his knowledge, the equipment in question has always been used to develop software and integrate software into hardware components. He testified that the adverse ruling in October, 2010 on the Taxpayer's other research and development claims (in Sixth District Court)[4] did not cause the Taxpayer to change the basis of its claims but rather the facility tour caused the change.

[4] The parties took administrative notice of the decision issued on April 10, 2009 by the Sixth District Court with *certiorari* denied on October 13, 2010.

On re-direct examination, testified that DDX transactions which are the same as the Destroyer represents about 90% of the dollar amount of the claim but the other cost centers are very similar to the DDX program so that those would also be used in the manufacturing process.

testified on behalf of the Taxpayer. She testified that she is the Program Manager for the Destroyer specifically the total ship compute environment ("TSCE") infrastructure hardware which is the networking and data processing centers for the ship. She testified the Destroyer is a 21st Century multi-mission destroyer for the US Navy. She testified the engineering development models ("EDM") phase of the contract began in 2005. She testified her role is to build and deliver to the ship all the hardware for the infrastructure. She testified that at the same time, there is a software team that is developing production software in the Taxpayer's laboratories on equipment that mimics the equipment that she is delivering to the ship. She testified that she works very closely with the software team to ensure that the software and hardware work together for an integrated system.

testified that TSCE is effectively all combat systems functionality. She testified that "TSCEI" is the total ship compute environment infrastructure capability which is the hardware and software integrated together for the whole ship. She testified that "EME" are electronic modular enclosures which are steel structures housing all the electronics and the data centers are a suite of processing hardware built inside.

testified that her duties are to manage the actual production team for the manufacturing of hardware. She testified that the engineers define the appropriate interconnectivity for the commercially bought pieces of hardware and the engineering

team defines how everything is put together and develops the documentation and drawings so that the people on the manufacturing team know how to physically build it. See Taxpayer's Exhibit Three (3) (video describing the EME).

testified that the EME is built by a subcontractor and delivered to the Taxpayer, and the Taxpayer then integrates the electronics and tests it as a big solid data room and delivers it as a data room to the Destroyer. She testified that the innovation is that the Taxpayer assembles the data room together on the floor and then delivers it as one (1) data room to the ship and just cables it up since the integration was already performed during production. She testified that previously the data room components were delivered individually to the ship and integration was performed on the ship. She testified that the data room is the same concept as an office data server in that one is connecting all the computers but since it is on the Destroyer, it is more complex because instant responses have to be provided with rigid timing requirements. She testified there are thousands of voice-over IP telephones, cameras, and speakers which are managed on a single network. She testified that there are 16 EME's on a Destroyer including those for general infrastructure, radar, sonar and sensor, and external communications.

testified that the Taxpayer has a government contract for the Destroyer with incentives for certain delivery dates and diminishing fees if delivery is late. She testified that the Taxpayer has a large earn value management system to track costs in order to break down costs and expenditures to their lowest level. She testified that the Taxpayer reviews its costs but costs also have to be approved by the Navy's Defense Contract Management Agency which receives a monthly cost performed report. She testified that when the hardware is delivered to the ship, the software is delivered and

integrated on the hardware by the Taxpayer's team at the shipyard. She testified that equipment and software is being delivered to the Navy and the hardware cannot do anything without the software as it is an integrated system.

On cross-examination, testified that she mostly works on hardware and the equipment in Exhibits 20 and 34 were used to develop software but was not physically used to make the hardware such as the metal enclosures or cabling. She testified that the Taxpayer re-uses some software to keep costs down but it is written to the Navy's specification and could not be re-used without permission of the U.S. government which to her knowledge has never happened. She testified that the Taxpayer does not acquire any proprietary rights in the software.

On redirect examination, testified that the software going into the ship is a mix of customized and canned software that is integrated. On re-cross examination, she testified that some software is bought off-the-shelf such as anti-virus software which the Taxpayer will buy and integrate or the Taxpayer might buy licenses for certain software. She testified that the Taxpayer does not change commercial products but does integrate the products together by writing software that is the "glue," telling the software what to do. On redirect examination, she testified that the software ends up in the EME's to create the TSCE which includes the commercial software.

testified on behalf of the Taxpayer. He testified he is a Senior Manager in the Naval Software Department. He testified that the software is developed in a secure room and is ultimately installed on the Navy ship. He testified that thousands of pieces of software are installed in the Taxpayer's facilities where they are integrated and tested together to ensure they all work together before being delivered. He

testified that the whole system is made of many different pieces including large pieces purchased from "commercial vendors off-the-shelf" such as Oracle. He testified that the Navy also has an open architecture environment so that the interfaces on the various ships are the same so the Navy can move systems. He testified that the software is a mandatory piece of the puzzle and the Destroyer cannot run without it. He testified that the Taxpayer buys "almost exclusively" (Tr 91[5]) off-the-shelf computing hardware. He testified that costs are monitored every day.

On cross-examination, testified that the items in Exhibits 20 and 34 were all purchased or leased from outside vendors. He testified that the Taxpayer uses commercially purchased software, specially written software, and software from other developments that are made into one integrated system with open architecture so that the system can be modified. He testified that the Taxpayer would like to re-use the system but would need permission from the Navy to sell it.

On re-direct examination, testified that the Taxpayer customizes some of the software even the purchased software. On re-cross examination, testified that for the purchased software, the Taxpayer has to choose configurations for usage but cannot modify the software since it does not have the source code. He testified that the Taxpayer can modify its software from its previous programs. On questioning from the undersigned, testified that the Taxpayer does not deliver a "turn key" system but rather the commercial products it buys have to be integrated into the whole system being delivered to the Navy.

[5] Tr refers to the transcript of the August 3, 2011 hearing with the number referring to the page number.

## V. DISCUSSION

### A. Legislative Intent

The Rhode Island Supreme Court has consistently held that it effectuates legislative intent by examining a statute in its entirety and giving words their plain and ordinary meaning. *In re Falstaff Brewing Corp.*, 637 A.2d 1047 (R.I. 1994). See *Parkway Towers Associates v. Godfrey*, 688 A.2d 1289 (R.I. 1997). If a statute is clear and unambiguous, "the Court must interpret the statute literally and must give the words of the statute their plain and ordinary meanings." *Oliveira v. Lombardi*, 794 A.2d 453 (R.I. 2002) (citation omitted). The Supreme Court has also established that it will not interpret legislative enactments in a manner that renders them nugatory or that would produce an unreasonable result. See *Defenders of Animals v. Dept. of Environmental Management*, 553 A.2d 541 (R.I. 1989) (citing *Cocchini v. City of Providence*, 479 A.2d 108 (R.I. 1984)). In cases where a statute may contain ambiguous language, the Rhode Island Supreme Court has consistently held that the legislative intent must be considered. *Providence Journal Co. v. Rodgers*, 711 A.2d 1131 (R.I. 1998). The statutory provisions must be examined in their entirety and the meaning most consistent with the policies and purposes of the legislature must be effectuated. *Id.*

### B. Relevant Statutes and Regulations

Pursuant to R.I. Gen. Laws § 44-18-18, Rhode Island imposes a sales tax of 7% on gross receipts of a retailer. Pursuant to R.I. Gen. Laws § 44-18-19, the retailer is responsible for the collection of sales tax. Pursuant to R.I. Gen. Laws § 44-18-20, a use tax is imposed on the storage, use or consumption of tangible personal property. "The use tax . . . is a complement to Rhode Island's sales tax . . . The sales tax applies to 'sales

at retail in this state.' (citation omitted). The use tax, in contradistinction, is imposed on 'the storage, use, or other consumption in this state of tangible personal property.'" *Dart Industries, Inc. v. Clark*, 696 A.2d 306, 309 (R.I.1997). R.I. Gen. Laws § 44-18-10 defines "use" as "the exercise of any right or power of tangible personal property incident to the ownership of that property."

R.I. Gen. Laws § 44-18-25[6] presumes that all gross receipts are subject to sales tax and all use of tangible personal property is subject to use tax and that the burden of proving otherwise falls on the taxpayer. The Taxpayer requested refunds pursuant to R.I. Gen. Laws § 44-18-30(7) and (22)[7] but the Division argued that the Taxpayer was not

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[6] R.I. Gen. Laws § 44-18-25 states as follows:

> Presumption that sale is for storage, use, or consumption – Resale certificate. – It is presumed that all gross receipts are subject to the sales tax, and that the use of all tangible personal property is subject to the use tax, and that all tangible personal property sold or in processing or intended for delivery or delivered in this state is sold or delivered for storage, use, or other consumption in this state, until the contrary is established to the satisfaction of the tax administrator. The burden of proving the contrary is upon the person who makes the sale and the purchaser, unless the person who makes the sale takes from the purchaser a certificate to the effect that the purchase was for resale. The certificate shall contain any information and be in the form that the tax administrator may require.

[7] R.I. Gen. Laws § 44-18-30 states in part as follows:

> Gross receipts exempt from sales and use taxes. – There are exempted from the taxes imposed by this chapter the following gross receipts:
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> (7) *Purchase for manufacturing purposes*
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> (i) From the sale and from the storage, use, or other consumption in this state of computer software, tangible personal property, electricity, natural gas, artificial gas, steam, refrigeration, and water, when the property or service is purchased for the purpose of being manufactured into a finished product for resale, and becomes an ingredient, component, or integral part of the manufactured, compounded, processed, assembled, or prepared product, or if the property or service is consumed in the process of manufacturing for resale computer software, tangible personal property, electricity, natural gas, artificial gas, steam, refrigeration, or water.
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> (iv) "Manufacturing" means and includes manufacturing, compounding, processing, assembling, preparing, or producing.
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> (v) "Process of manufacturing" means and includes all production operations performed in the producing or processing room, shop, or plant, insofar as the operations are a part of and connected with the manufacturing for resale of tangible personal property, electricity, natural gas, artificial gas, steam, refrigeration, or water and all production operations performed insofar as the operations are a part of and connected with the manufacturing for resale of computer software.

eligible for its claimed refunds. The Division also relied on *Sales and Use Tax Regulation SU 07-58 Manufacturing, Property and Public Utilities Service Used In* ("07-58").[8] Additionally, pursuant to R.I. Gen. Laws § 44-19-33, regulations promulgated by

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(vi) "Process of manufacturing" does not mean or include administration operations such as general office operations, accounting, collection, sales promotion, nor does it mean or include distribution operations which occur subsequent to production operations, such as handling, storing, selling, and transporting the manufactured products, even though the administration and distribution operations are performed by or in connection with a manufacturing business.

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(22)(i) From the sale and from the storage, use, or other consumption in this state of tools, dies, and molds, and machinery and equipment (including replacement parts), and related items to the extent used in an industrial plant in connection with the actual manufacture, conversion, or processing of tangible personal property, or to the extent used in connection with the actual manufacture, conversion or processing of computer software as that term is utilized in industry numbers 7371, 7372, and 7373 in the standard industrial classification manual prepared by the technical committee on industrial classification, office of statistical standards, executive office of the president, United States bureau of the budget, as revised from time to time, to be sold, or that machinery and equipment used in the furnishing of power to an industrial manufacturing plant. For the purposes of this subdivision, "industrial plant" means a factory at a fixed location primarily engaged in the manufacture, conversion, or processing of tangible personal property to be sold in the regular course of business;

(ii) Machinery and equipment and related items are not deemed to be used in connection with the actual manufacture, conversion, or processing of tangible personal property, or in connection with the actual manufacture, conversion or processing of computer software as that term is utilized in industry numbers 7371, 7372, and 7373 in the standard industrial classification manual prepared by the technical committee on industrial classification, office of statistical standards, executive office of the president, United States bureau of the budget, as revised from time to time, to be sold to the extent the property is used in administration or distribution operations;

(iii) Machinery and equipment and related items used in connection with the actual manufacture, conversion, or processing of any computer software or any tangible personal property which is not to be sold and which would be exempt under subdivision (7) or this subdivision if purchased from a vendor or machinery and equipment and related items used during any manufacturing, converting or processing function is exempt under this subdivision even if that operation, function, or purpose is not an integral or essential part of a continuous production flow or manufacturing process;

(iv) Where a portion of a group of portable or mobile machinery is used in connection with the actual manufacture, conversion, or processing of computer software or tangible personal property to be sold, as previously defined, that portion, if otherwise qualifying, is exempt under this subdivision even though the machinery in that group is used interchangeably and not otherwise identifiable as to use.

[8] *Sales and Use Tax Regulation* SU 07-58 *Manufacturing, Property and Public Utilities Service Used In*

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II. Property used in production

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III. Section 44-18-30(22) provides a further exemption from the sale (including lease or rental) and from the storage, use, or other consumption in this state of tools, dies and

molds, and machinery and equipment (including replacement parts thereof) to the extent used in an industrial plant in the actual manufacture, conversion or processing of tangible personal property including computer software as that term is utilized in SIC numbers 7371, 7372 and 7373, or in the corresponding industry sectors of the North American Industry Classification System (NAICS Code), to be sold or such machinery and equipment used in the furnishing of power to an industrial manufacturing plant.

Under section 44-18-30(22) the sales or use tax applies to the sale, (including lease or rental), storage, use, or other consumption in this state of tools, dies and molds, and machinery and equipment (including replacement parts thereof) to the extent used in administration and distribution operations.

The exemption provided in section 44-18-30(22) applies to the sale (including lease or rental) and to the storage, use or other consumption in this state of tools, dies and molds, and machinery and equipment (including replacement parts thereof) to the extent used in the production of tangible personal property including computer software to be sold.

In the event that a manufacturer purchases equipment that does not qualify for exemption, it shall pay the tax due at time of purchase. Provided, however;

(a) If the equipment purchased partially qualifies for exemption and the manufacturer knows the extent of the partial exemption, the manufacturer shall give the vendor a Manufacturer's Exemption Certificate and file a use tax return with the Division of Taxation and pay a use tax based on the percentage of the nonexempt use of the equipment, or

(b) If the equipment purchased partially qualifies for exemption and the manufacturer does not know the extent of the partial exemption, it shall give the vendor a Manufacturer's Exemption Certificate and file a use tax return with the Division of Taxation and pay use tax on the entire cost of the equipment.

If a manufacturer files a use tax return under the provisions of (a) or (b) above, it shall, twenty-four months thereafter, analyze the machinery usage to determine the actual exempt usage for that machinery. This shall be compared to the original estimate made and any balance due or credit due the manufacturer must be reported on the next month's use tax return. Any balance due or credit due shall bear interest from time of original purchase.

The word machinery includes tools, dies and molds, and machinery and equipment (including replacement parts thereof).

Machinery used in the actual manufacture, conversion, or processing of any computer software or tangible personal property which is not to be sold and which would be exempt under this section or section 44-18-30(22) if purchased from a vendor shall be exempt under this paragraph even if such operation, function or purpose is not an integral or essential part of a continuous production flow or manufacturing process. This is so even though the tangible personal property being produced by such machinery would in itself be exempt under 44-18-30(7) or under 44-18-30(22) if purchased from a vendor thereof.

Where a portion of a group of portable or mobile machinery is used in the actual manufacture, conversion or processing of tangible personal property or computer software to be sold, as heretofore defined, such portion, if otherwise qualifying, shall be exempt under this paragraph even though the machinery in said group is used interchangeably and not otherwise identifiable as to use.

The term "industrial plant" means a factory at a fixed location primarily engaged in the manufacture, conversion or processing of tangible personal property to be sold in the regular course of business.

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V. The following guidelines may be used to determine if the exemption applies.

1. Machinery must be used by a manufacturer in manufacturing tangible personal property to be sold to be exempt. This excludes from the exemption all machinery used in the furnishing of services. For example, the machinery of a laundry or dry cleaner, since it does not manufacture tangible personal property, but rather provides a service, cannot be within the exemption.

the Tax Administrator regarding R.I. Gen. Laws § 44-18-1 *et seq.* and R.I. Gen. Laws § 44-19-1 *et seq.* are "are prima facie evidence of their [the statutes] proper interpretation."

Effective January 1, 2007, tangible property is defined in R.I. Gen. Laws § 44-18-16 as follows:

> Tangible property defined. – "Tangible personal property" means personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. "Tangible personal property" includes electricity, water, gas, steam, and prewritten computer software.[9]

Effective January 1, 2007, "computer software" and "prewritten computer software" was defined in R.I. Gen. Laws § 44-18-7.1(g) as follows:

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2. Machinery used by a manufacturer before the manufacturing process has begun or after it has been completed is taxable. For example, machinery used for delivery to or from a plant, repair or maintenance of facilities, and crating or packaging for shipment are not within the exemption, except as provided in paragraph 4 below.

3. Machinery used by a manufacturer to produce component parts which are to become an integral part of the finished product to be sold would be exempt. For example, a milling machine used to make parts which are to become a component of the finished product to be sold would be exempt.

4. Packaging machinery when used to place the property to be sold in the primary container, package or wrapping in which such property is normally sold to the ultimate consumer is exempt. For example, a primary package or container includes the bottle or cap used for a carbonated beverage, the aerosol can, the wrapper for a candy bar or the tray for frozen convenience foods. Machinery used in packaging for the purposes of transporting, displaying or merchandising the product, where such packaging is normally discarded by the wholesaler, retailer, or ultimate consumer prior to the use or consumption of the product is taxable. Such packaging includes shipping cartons, cases in which goods are placed for case lot sales, wooden cases, or six-pack containers for carbonated or alcoholic beverages.

5. Materials used in constructing a foundation to hold production machinery would be subject to the tax in that such a foundation is part of a building or structure and does not qualify for the production exemption.

6. The parts and repair service for exempt machinery also are exempt. Examples of such items would be conveyor belts, grinding wheels, grinding balls, machine drills, auger bits, milling cutters, emery wheels, jigs, saw blades, machine tool holders, reamers, dies and molds.

SU 07-58 superseded SU 00-58 effective January 3, 2007 which is toward the beginning of the audit period. There were no relevant substantive changes.

[9] P.L. 2006, ch. 246, art. 30 § 9 added the last sentence about prewritten software to the definition of tangible personal property. Section 21 of Article 30 provided for an effective date of January 1, 2007.

Computer and Related Items

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(ii) "Computer software" means a set of coded instructions designed to cause a "computer" or automatic data processing equipment to perform a task.

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(vi) "Prewritten computer software" means "computer software," including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two (2) or more "prewritten computer software" programs or prewritten portions thereof does not cause the combination to be other than "prewritten computer software." "Prewritten computer software" includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the specific purchaser. Where a person modifies or enhances "computer software" of which the person is not the author or creator, the person shall be deemed to be the author or creator only of such person's modifications or enhancements. "Prewritten computer software" or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains "prewritten computer software;" provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute "prewritten computer software."[10]

## C. Arguments

The Taxpayer argued that the software is delivered and integrated on the ship and in order to develop the software, the Taxpayer uses a development lab that mimics the operations of the ship. The Taxpayer argued that the equipment at issue was purchased in the production phase of the project and items in the refund claim (server blades, cables, hard drives) are being used in an actual manufacturing plant and are part of and connected with the actual manufacturing of computer software as provided for by statute.

The Division argued that the refund claims should be denied since they do not fall under the manufacturing exemptions, the Taxpayer reclassified the bases for its refund

[10] These definitions were added by P.L. 2006, ch. 246, art. 30 § 10. Section 21 of Article 30 provided for an effective date of January 1, 2007.

requests at the last minute and elevated form over substance, and the Taxpayer included items not related to the Destroyer in its listed assets.

### D. Whether the Taxpayer Owes the Assessed Tax

A tax exemption statute is construed against a taxpayer and a taxpayer has the burden of proof to establish that it is entitled to an exemption. *Dart Industries v. Clark*, 657 A.2d 1062 (R.I. 1995). Tax credits compensate a taxpayer for the costs of providing something of benefit to society but it is not to be a gratuitous gift from public coffers at the expense of other taxpayers. Since tax benefits are not to be a gratuitous gift, tax benefits are narrowly construed against a taxpayer and in favor of the public. *American Hoechst Corp. v. Norberg*, 462 A.2d 269 (R.I. 1983). See also *Fleet Credit Corp. v. Frazier*, 726 A.2d 452 (R.I. 1999).

#### i. Prewritten Computer Software

*Hasbro Industries, Inc. v. Norberg*, 487 A.2d 124 (R.I. 1985) found that a "canned program" – one "prepared for general or repeated use and could be transferred to buyer's computer with little or not modification" – fell under tangible personal property and was taxable as a good. *Id.* at 128. *Hasbro* refers to "ready-to-execute" programs as being canned programs. *Id.* The Taxpayer's software is clearly not a ready-to-execute program. It is not prepared for general or repeated use.

*Hasbro*'s statutory interpretation of taxing prewritten computer software as tangible personal property but not custom software was incorporated into the Division's regulations as reflected in Regulations SU 94-25, SU 92-25, and SU 87-25 *Computers and Related Systems.*[11] As set forth above, the statutory definition of tangible personal

[11] The predecessor regulations to Regulation SU 09-25.

property was amended effective January 1, 2007 to specifically include prewritten computer software but this merely codified the statutory distinction found in *Hasbro*.[12]

Prewritten computer software is defined as "'computer software' . . . not designed and developed by the author or other creator to the specifications of a specific purchaser."[13] However, the Taxpayer argues that it falls under the statutory definition of prewritten computer software because it combined a myriad of prewritten software. However, the statutory definition merely states that the "combining of two (2) or more 'prewritten computer software' programs" does not cause the combination to be other than prewritten computer software. In other words, the combination of prewritten software cannot be used to find that a program is customized but there are other factors in the statute to consider.

The Taxpayer re-uses some software to keep costs down but the system is written to the Navy's specification and could not be re-used without the Navy's permission which has never happened. The Taxpayer does not have any proprietary rights in the software. Much of the software that is used is bought off-the-shelf but is integrated together by writing software and some of the software used is customized. The whole system is made of many different pieces including off-the-shelf software, specially written software, and software from other developments that are integrated into the

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[12] An agency's acquiescence to a continued practice is entitled to great weight in determining legislative intent. After *Hasbro*, the Division adapted *Hasbro*'s statutory interpretation that prewritten software is tangible personal property. It is a well-recognized principle that a longstanding, practical and plausible interpretation given a statute of doubtful meaning by an agency without any interference by the Legislature should be accepted as evidence that such a construction conforms to the legislative intent. *Trice v. City of Cranston*, 297 A.2d 649 (R.I. 1972). In this matter, the statute is clear and unambiguous but similarly, the Legislature instead of changing the *Hasbro* statutory interpretation merely confirmed it in the 2007 amendments.

[13] Computer software has been defined in the same statutory section as "a set of coded instructions designed to cause a 'computer' . . . to perform a task."

Navy's open architecture environment.[14] The whole system is produced for the Destroyer and has to meet specialized requirements relating to communications (telephones, cameras, speakers), sonar and sensor, timing, etc. The evidence at hearing was that the Taxpayer provided the US Navy with a system made to the Navy's specification.

The statutory definition for prewritten computer software "includes software designed . . . by the author . . . to specifications of a specific purchaser when it is sold to a person other than the specific purchaser." In other words, a program written for a specific purchaser can be become prewritten if it sold to someone other than the specific purchaser. But in this matter, the software was written for and sold to the Navy. It has not been sold to another purchaser.

The software at issue was developed specifically for the Destroyer in accordance with the Navy's specifications. The clear and unambiguous meaning of the statute is that prewritten computer software is not designed or developed for a specific purchaser. Combining prewritten software does not necessarily make it custom software because it could be that the combination was not for a specific purchaser but that is not the situation here. There is no dispute that this computer system – using prewritten and customized software - has been designed and developed to the "specifications of a specific purchaser."

The Taxpayer argues that under the statute the combination of prewritten computer software does not cause it to be anything other than prewritten software. However, the definition clearly provides that prewritten software is not made to a specific purchaser's specification. The combination provision merely ensures that combined

[14] See testimony of

prewritten software not written for a specific purchaser will not be considered custom software. All provisions of the statute must be given effect and the statute is clear and unambiguous.

Since the Taxpayer's computer system is not prewritten computer software it is not tangible personal property as defined effective January 1, 2007. The statutory amendment regarding tangible personal property codified case law. Thus, the Taxpayer's system is customized software under *Hasbro* and its pertinent statutes and the post-2007 statutes and as such is not tangible personal property so is not eligible for the manufacturing tax exemptions. However, the undersigned will still review another issue within R.I. Gen. Laws § 44-18-30(7) and (22).[15]

### ii. Manufacturing Equipment – R.I. Gen. Laws § 44-18-30(22)

The Taxpayer argued that pursuant to R.I. Gen. Laws § 44-18-30(22)(i), the equipment being claimed is used in an actual manufacturing plant in the actual manufacturing of the computer software being sold to the Navy. The Taxpayer argued that the software being sold to the Navy is a component part and becomes an integral part of the total ship computing environment to run the ship. R.I. Gen. Laws § 44-18-30(22) provides in part as follows:

> (22) manufacturing machinery and equipment
> (i) From the sale and from the storage, use, or other consumption in this state of tools, dies, and molds, and machinery and equipment (including replacement parts), and related items to the extent used in an industrial plant

[15] A review of the two (2) statutory sections at issue indicates that the exemptions are two-fold. The exemption for "purchase for manufacturing purposes" exempts from the storage or use when the property is purchased for "the purpose of being manufactured into a finished product for resale" and is part of the manufactured product. R.I. Gen. Laws § 44-18-30(7). Therefore, products purchased must be used for manufacturing and manufactured into a product for resale. The same exemption also applies to equipment used for the actual manufacture of products for sale. R.I. Gen. Laws § 44-18-30(22). Thus, the machinery and equipment used in the manufacturing of products to be sold are exempt. There is no question that the Taxpayer sold its computer system so it meets the sale requirement. The issue is whether it is making something that is exempt under either provision.

> in connection with the actual manufacture, conversion, or processing of tangible personal property, or to the extent used in connection with the actual manufacture, conversion or processing of computer software as that term is utilized in industry numbers 7371, 7372, and 7373 in the standard industrial classification manual prepared by the technical committee on industrial classification, office of statistical standards, executive office of the president, United States bureau of the budget, as revised from time to time, to be sold, or that machinery and equipment used in the furnishing of power to an industrial manufacturing plant. For the purposes of this subdivision, "industrial plant" means a factory at a fixed location primarily engaged in the manufacture, conversion, or processing of tangible personal property to be sold in the regular course of business.

There was a debate between the parties regarding the applicability of the standard industrial classification ("SIC") to the Taxpayer's computer software. The statute is very clear: there is an exemption for equipment used in the manufacturing of tangible personal property **or** the manufacturing of computer software as defined by certain SIC numbers. The exemption is not for all computer software but only for certain types of computer software which is found in SIC classifications.

In its reply brief, the Taxpayer agreed that "as that term is utilized" refers to "computer software." The Taxpayer argued that the SIC codes are not limiting an exemption to only a particular industry but rather the use of equipment and machinery determines the exemption. However, the exemption is for the manufacturing of tangible personal property or specific computer software. It is not for the use of **any** equipment and machinery but rather is based on what the equipment is being used for (actual manufacture rather than a service like dry cleaning, see SU 07-58).

The SIC numbers do not define "tangible personal property" but rather the type of computer software being manufactured that is eligible for the exemption. The Taxpayer is right that the SIC codes define the term "computer software," but by incorporating the SIC and defining the term as such the exemption is limited to the computer businesses as

defined in the SIC that make that kind of computer software. Therefore, the exemption is for the manufacturing of computer software that falls under SIC 7371, 7372, and 7373.

There was discussion by the parties about whether the SIC numbers are still applicable in light of a newer classification system, North American Industry Classification ("NAIC"). However, SU 07-58 addressed that issue by adapting the corresponding industry sections of NAIC to the SIC codes. SU 07-58 provides in part as follows:

> III. Section 44-18-30(22) provides a further exemption from the sale (including lease or rental) and from the storage, use, or other consumption in this state of tools, dies and molds, and machinery and equipment (including replacement parts thereof) to the extent used in an industrial plant in the actual manufacture, conversion or processing of tangible personal property including computer software as that term is utilized in SIC numbers 7371, 7372 and 7373, or in the corresponding industry sectors of the North American Industry Classification System (NAICS Code), to be sold or such machinery and equipment used in the furnishing of power to an industrial manufacturing plant.

The same provision is found in the predecessor regulation to SU 07-58, SU 00-58. The Division's regulations are *prima facie* evidence of the statute's proper interpretation.

Thus, assuming that the Taxpayer is manufacturing computer software, the computer software must fall under the SIC or the equivalent NAIC code. There is no requirement that other types of tangible personal property fall under SIC codes, but the statute clearly limits computer software to a specific type.

SIC 7372 Prepackaged Software is equivalent to NAIC 51121 Software Publishers and 334611 Software Reproducing.[16] The Taxpayer is not distributing or publishing software and is not making software publishing[17] or software reproducing.[18]

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[16] Administrative notice is taken of the 2007 NAIC equivalents to SIC found at http://www.census.gov/epcd/naics/NSIC8A.HTM#S73

[17] Software Publishers are described in the NAIC as follows:

> This industry comprises establishments primarily engaged in computer software publishing or publishing and reproduction. Establishments in this industry carry out operations necessary for producing and distributing computer software, such as designing, providing documentation, assisting in installation, and providing support services to software purchasers. These establishments may design, develop, and publish, or publish only.

NAIC equivalencies are as follows:

| NAICS | SIC | Corresponding Index Entries |
|---|---|---|
| 511210 | 7372 | Applications software, computer, packaged |
| 511210 | 7372 | Computer software publishers, packaged |
| 511210 | 7372 | Computer software publishing and reproduction |
| 511210 | 7372 | Computer software publishing including design and development, packaged (i.e., establishments known as publishers) |
| 511210 | 7372 | Games, computer software, publishing |
| 511210 | 7372 | Operating systems software, computer, packaged |
| 511210 | 7372 | Packaged computer software publishers |
| 511210 | 7372 | Packaged computer software publishing (i.e., establishments known as publishers) |
| 511210 | 7372 | Programming language and compiler software publishers, packaged |
| 511210 | 7372 | Publishers, packaged computer software |
| 511210 | 7372 | Software computer, packaged, publishers |
| 511210 | 7372 | Software publishers |
| 511210 | 7372 | Software publishers, packaged |
| 511210 | 7372 | Utility software, computer, packaged |

[18] 334611 Software Reproducing is described in the NAIC as follows:

> This U.S. industry comprises establishments primarily engaged in mass reproducing computer software. These establishments do not generally develop any software, they mass reproduce data and programs on magnetic media, such as diskettes, tapes, or cartridges. Establishments in this industry mass reproduce products, such as CD-ROMs and game cartridges.

NAIC equivalencies are as follows:

| NAICS | SIC | Corresponding Index Entries |
|---|---|---|
| 334611 | 7372 | CD-ROM, software, mass reproducing |
| 334611 | 7372 | Compact discs (i.e., CD-ROM), software, mass reproducing |
| 334611 | 7372 | Game cartridge software, mass reproducing |
| 334611 | 7372 | Games, computer software, mass reproducing |
| 334611 | 7372 | Prepackaged software, mass reproducing |
| 334611 | 7372 | Software, packaged, mass reproducing |

SIC 7371 is equivalent to the NAIC 541 code series which refers to Professional Scientific, and Technical Services in which the "[t]he individual industries of this subsector are defined on the basis of the particular expertise and training of the services provider.[19] The NAIC code 541511 is Custom Computer Programming Services described as "[t]his U.S. industry comprises establishments primarily engaged in writing, modifying, testing, and supporting software to meet the needs of a particular customer."[20] The 541 code refers to industries that are selling worker skill and the "expertise" of the workers and the code itself states that equipment and materials are not of "major importance."

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[19] Such services are described by the NAIC as follows:

> 541 Professional, Scientific, and Technical Services
>
> Industries in the Professional, Scientific, and Technical Services subsector group establishments engaged in processes where human capital is the major input. These establishments make available the knowledge and skills of their employees, often on an assignment basis, where an individual or team is responsible for the delivery of services to the client. The individual industries of this subsector are defined on the basis of the particular expertise and training of the services provider.
>
> The distinguishing feature of the Professional, Scientific, and Technical Services subsector is the fact that most of the industries grouped in it have production processes that are almost wholly dependent on worker skills. In most of these industries, equipment and materials are not of major importance, unlike health care, for example, where "high tech" machines and materials are important collaborating inputs to labor skills in the production of health care. Thus, the establishments classified in this subsector sell expertise. Much of the expertise requires degrees, though not in every case.

[20] The NAIC equivalencies are as follows:

| NAICS | SIC | Corresponding Index Entries |
|---|---|---|
| 541511 | 7371 | Applications software programming services, custom computer |
| 541511 | 7371 | Computer program or software development, custom |
| 541511 | 7371 | Computer programming services, custom |
| 541511 | 7371 | Computer software analysis and design services, custom |
| 541511 | 7371 | Computer software programming services, custom |
| 541511 | 7371 | Computer software support services, custom |
| 541511 | 7371 | Programming services, custom computer |
| 541511 | 7371 | Software analysis and design services, custom computer |
| 541511 | 7371 | Software programming services, custom computer |
| 541511 | 7371 | WEB (i.e., internet) page design services, custom |

SIC 7373 Computer Integrated Systems Design is equivalent to NAIC 541512 Computer Systems Design Services (pt).[21] The services included in 541512 indicate that the Taxpayer could fall under "computer systems integrator services." The Taxpayer is not performing computer aided engineering or design or manufacturing and is not consulting or providing office automation. The Taxpayer provided testimony that it is integrating the software and hardware on the ship in order to operate the ship.

The NAIC codes requires that a business be "primarily engaged" in the defined industry. The Taxpayer might fall under two (2) of the codes but the Taxpayer is not

[21] Computer Systems Design Services is described in the NAIC as follows:

> This U.S. industry comprises establishments primarily engaged in planning and designing computer systems that integrate computer hardware, software, and communication technologies. The hardware and software components of the system may be provided by this establishment or company as part of integrated services or may be provided by third parties or vendors. These establishments often install the system and train and support users of the system.

NAIC equivalencies are as follows:

| NAICS | SIC | Corresponding Index Entries |
|---|---|---|
| 541512 | 7373 | CAD (computer-aided design) systems integration design services |
| 541512 | 7373 | CAE (computer-aided engineering) systems integration design services |
| 541512 | 7373 | CAM (computer-aided manufacturing) systems integration design services |
| 541512 | 7373 | Computer systems integration analysis and design services |
| 541512 | 7379 | Computer systems integration design consulting services |
| 541512 | 7373 | Computer systems integrator services |
| 541512 | 7373 | Computer-aided design (CAD) systems integration design services |
| 541512 | 7373 | Computer-aided engineering (CAE) systems integration design services |
| 541512 | 7373 | Computer-aided manufacturing (CAM) systems integration design services |
| 541512 | 7373 | Information management computer systems integration design services |
| 541512 | 7373 | Local area network (LAN) computer systems integration design services |
| 541512 | 7373 | Network systems integration design services, computer |
| 541512 | 7373 | Office automation computer systems integration design services |
| 541512 | 7373 | Systems integration design consulting services, computer |
| 541512 | 7373 | Systems integration design services, computer |

primarily engaged in providing integrated hardware, software, and communications to customers or in providing custom software to customers. The parties agreed that the Taxpayer is a defense contractor which develops, engineers, and manufactures military electronic systems for the US Government and was the prime contractor who designed, developed, and manufactured systems and equipment for the Destroyer. The evidence at hearing is that the Taxpayer is building a "21st century multimission (sic) destroyer for the US Navy." Tr 55. See also Tr 84.

The Taxpayer argues that the statute is using the codes to define the term "computer software," but the codes refer to businesses making that type of product. The statute incorporates "computer software as that term is utilized" in the codes. The codes categorize software by businesses and types of software. The Taxpayer is not a business primarily making any of the specified codes' products. Thus, none of the codes are applicable to the type of business that the Taxpayer is in. Therefore, the Taxpayer cannot claim a refund for any of its expenses it deems to fall under R.I. Gen. Laws § 44-18-30(22) for manufacturing machinery and equipment.

### iii. Purchase for Manufacturing Purposes – R.I. Gen. Laws § 44-18-30(7)

The Taxpayer argues that the types of items at issue are being used in the actual manufacturing and are part of and connected with the actual manufacturer of computer software being sold in the Navy. R.I. Gen. Laws § 44-18-30(22) exempts the machinery and equipment used in manufacturing but R.I. Gen. Laws § 44-18-30(7) exempts purchases for manufacturing purposes. If a taxpayer does not fall under R.I. Gen. Laws § 44-18-30(22) (because its equipment is not used for manufacturing), can that taxpayer fall under R.I. Gen. Laws § 44-18-30(7) (purchases for manufacturing)? While R.I. Gen.

Laws § 44-18-30(7) does not include the SIC codes when referring to computer software, a taxpayer that is not manufacturing software cannot be making purchases for manufacturing purposes. To find otherwise would be an unreasonable result.

**E. Conclusion**

To be eligible for the manufacturing exemptions, a taxpayer must be manufacturing tangible personal property. The Taxpayer is not manufacturing tangible personal property because its software is not prewritten computer software under the pre-2007 and the post-2007 statute. Since the software is not tangible personal property, the Taxpayer's two (2) refund request claims were properly denied by the Division.

Nonetheless, the undersigned further reviewed the statutory manufacturing exemptions which speak of computer software as well as tangible personal property. However, the manufacturing computer software exemption is limited by SIC (NAIC) codes. The Taxpayer does not fall under the exemption in R.I. Gen. Laws § 44-18-30(22) as the Taxpayer does not meet the SIC (NAIC) limitations. Furthermore, without a finding that a taxpayer is using equipment for manufacturing, a taxpayer cannot make purchases for manufacturing so the Taxpayer's claims under R.I. Gen. Laws § 44-30-30(7) would fail as well.[22]

[22] The Division argued that the Taxpayer initially claimed research and development tax exemptions and then late in the game after an adverse court case changed its reasons for the claimed exemptions to the manufacturing exemptions. The Taxpayer argued it included the manufacturing exemption as one of the many reasons for its refund request in its initial refund claim. As the claim is disallowed, there is no reason to discuss whether there is a statutory or regulatory basis for disallowing claimed exemptions that morph in primacy over time.

The Division also argued that not every item claimed by the Taxpayer fell under the Destroyer program which was admitted at hearing by the Taxpayer. The testimony was that 90% of the dollar amount claim was related to the Destroyer. Tr 54. Since the refund request is denied, the refund claim does not need to be re-visited in order to determine if a revision of the claimed exemptions is needed.

## VI. FINDINGS OF FACT

1. On or about February 2, 2011, a Notice of Hearing and Appointment of Hearing Officer was issued to the Taxpayer by the Division regarding a refund claim for the period of January 1, 2006 to December 31, 2006. On or about January 27, 2011, a Notice of Hearing and Appointment of Hearing Officer was issued to the Taxpayer by the Division regarding a refund request for the period of January 1, 2007 to December 31, 2008. By agreement of the parties, these two (2) matters were consolidated.

2. A hearing in this matter was held on August 3, 2011 and all briefs were timely filed by April 25, 2012.

3. The facts contained in Sections IV and V are reincorporated by reference herein.

## VII. CONCLUSIONS OF LAW

Based on the testimony and facts presented:

1. The Division has jurisdiction over this matter pursuant to R.I. Gen. Laws § 44-1-1 *et seq.* and R.I. Gen. Laws § 44-18-1 *et seq.*

2. Pursuant to R.I. Gen. Laws § 44-18-30(7) and (22), the Taxpayer has not demonstrated that it is eligible for its two (2) claimed tax exemptions and the Division properly denied the Taxpayer's 2006 Refund Claim and 2007-2008 Refund Claim.

## VIII. RECOMMENDATION

Based on the above analysis, the Hearing Officer recommends as follows:

Pursuant to R.I. Gen. Laws § 44-18-30, the Taxpayer's claimed refunds are denied.

Date: July 19, 2012

Catherine R. Warren, Esquire
Hearing Officer

## ORDER

I have read the Hearing Officer's Decision and Recommendation in this matter, and I hereby take the following action with regard to the Decision and Recommendation:

_____ ADOPT
_____ REJECT
_____ MODIFY

Date: July 24, 2012

David Sullivan
Tax Administrator

## NOTICE OF APPELLATE RIGHTS

**THIS DECISION CONSTITUTES A FINAL ORDER OF THE DIVISION. THIS ORDER MAY BE APPEALED TO THE SIXTH DIVISION DISTRICT COURT PURSUANT TO THE FOLLOWING WHICH STATES AS FOLLOWS:**

**R.I. Gen. Laws § 44-19-18 Appeals**

Appeals from administrative orders or decisions made pursuant to any provisions of this chapter are to the sixth (6th) division district court pursuant to chapter 8 of title 8. The taxpayer's right to appeal under this chapter is expressly made conditional upon prepayment of all taxes, interest, and penalties, unless the taxpayer moves for and is granted an exemption from the prepayment requirement pursuant to § 8-8-26.

## CERTIFICATION

I hereby certify that on the 25th day of July, 2012 a copy of the above Decision and Notice of Appellate Rights was sent by first class mail, postage prepaid to the Taxpayer's attorney's and representatives' addresses on file with the Division of Taxation and by hand-delivery to Bernard Lemos, Esquire, Department of Revenue, One Capitol Hill, Providence, RI 02908.

Lori Belasco