

New York State Department of Taxation and Finance  
**Office of Counsel**  
**Advisory Opinion Unit**

TSB-A-09(21)S  
Sales Tax  
May 22, 2009

STATE OF NEW YORK  
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S090114A

Petitioner [REDACTED] asks whether the receipts from its sale of product development services and related items and its purchases of property and materials used in the performance of such services are subject to sales and use taxes.

We conclude that (1) Petitioner's sales of product development services are not enumerated taxable services, or taxable sales of tangible personal property, under Tax Law §1105, unless Petitioner makes taxable sales of product prototypes or software; and (2) some of Petitioner's purchases of tangible personal property may qualify for the exemption from sales and use taxes for property used or consumed in research and development pursuant to Tax Law section 1115(a)(10) if used directly and predominantly in such activities.

**Facts**

Petitioner is an engineering design firm that provides product development services to unrelated businesses that are attempting to develop new products or improve upon existing products. Businesses approach Petitioner with a concept for a new or enhanced product. Petitioner performs the product development tasks necessary to bring the concept to reality. These tasks may involve numerous revisions and refinements.

This process may include the following phases:

*Research and Product Definition* - Petitioner works with its customer to define the new product's purpose and function, providing a critical analysis of the customer's goals and requirements. This may result in the creation of a product specification detailing a general description of the new product.

*Concept Development* – Petitioner will generate possible solutions to the design challenges and requirements. Sketches, simple engineering drawings, and presentation boards of the new product may be created.

*Preliminary Design and Engineering* – Petitioner and its customer identify the most promising ideas from concept development. Product rendering may be produced and provided to the customer. The critical mechanical function elements are identified and preliminary mechanical engineering will be performed. Additional drawings, renderings, and first-draft computer aided design (CAD) data may be created and transferred to the customer.

*Concept Prototype* – A form study prototype designed to show the physical dimensions of the product and approximating the size, shape and look of the finished product is created. Once there is agreement upon the look of the final product, Petitioner begins the task of making the product functional.

*Detailed Engineering* - The agreed upon style and functional requirements are engineered and integrated, typically resulting in updated CAD data.

*Functional Prototype* – A functional (“breadboard”) prototype is made using the CAD data. This permits validation of functional aspects of the computer aided design and allows the customer to evaluate whether the product will function in accordance with the original concepts. This prototype merely demonstrates the functional capabilities of the new design, and is fabricated using components and materials appropriate for the prototype but not necessarily suitable for the final product. This prototype is not intended to reflect the look of the final product.

*Final Engineering* – Engineering revisions based on the fabrication and evaluation of the functional prototype are applied to the mechanical design and the CAD data are updated. Inspection drawings and 3-dimensional CAD models may be provided to the customer.

*Visual and Functional Prototype* – Using the CAD data, a final prototype is built. This prototype is a cosmetically finished, functional prototype suitable for testing and evaluation by the customer to ensure the final product meets design, function, and concept requirements.

*Manufacturing Release* – Final engineering revisions based on the evaluation of the final prototype are incorporated into the CAD data. Customers are provided with tooling-ready two-dimensional and three-dimensional CAD data necessary for manufacturing the new product.

Petitioner typically creates a prototype’s simple components in-house. More complex prototype components are purchased from third party fabricators, who use Petitioner’s CAD data to create the components. Petitioner passes its costs for the creation of the prototypes on to the customer.

In connection with the performance of its services, Petitioner may transfer to the customer some or all of the following property: (1) conceptual and engineering drawings; (2) an intermediate prototype that looks like the new product; (3) a functional intermediate or “breadboard” prototype that works like the new product; (4) a final prototype that closely resembles the new product in appearance and function; and (5) computer aided design data (CAD data) for the completed project. The CAD data allows the customer to begin manufacturing the new product and is essentially the mechanical blueprint for creating the finished product. The CAD data are transferred to the customer electronically via the Internet. Not all customers receive tangible personal property such as the prototypes. Some customers receive only the CAD data for the completed project. Petitioner does not separate charges for product development service from charges for the property created and transferred to the customer. Petitioner may, however, list separate charges for the various phases of the work it performs for a customer.

## **Analysis**

Petitioner asks (1) whether its charges to customers for product development and related items are subject to sales tax; and (2) whether its purchases of tangible personal property for its use in product development are subject to tax.

### *Issue 1 – Petitioner’s charges for product development and related items*

Sales tax is imposed on the sale of all tangible personal property, unless otherwise exempted (See Tax Law §1105(a) and §1115), and on the sale of certain specifically enumerated services in Tax Law Section 1105. Design and engineering services are not among the enumerated services subject to sales tax. However, if such services were provided to a customer in conjunction with taxable services or tangible personal property, and were not offered for sale separately from the taxable services or property, the entire charge to the customer would be taxable. See *ECVS, Inc.*, Adv Op Comm T & F, December 27, 1993, TSB-A-93(66)S.

Petitioner's product development services, which may include the *Manufacturing Release* phase and each of the preliminary phases of its product development services described in this Opinion, whether performed with respect to the creation of a new product or the improvement of an existing product, are not among the enumerated services subject to sales tax pursuant to section 1105 of the Tax Law. Thus, unless these services were provided to a customer in conjunction with taxable services or tangible personal property, and were not offered for sale separately from taxable services or property sold by Petitioner, Petitioner's charges to its customers for product development services are not subject to sales tax.

Petitioner's product development service as ultimately sold to a customer generally includes CAD data that are furnished to the customer for use in manufacturing the customer's product. If the CAD data constitute a taxable service or tangible personal property, Petitioner's charges for its product development service would be subject to sales tax.

The provision of the CAD data to customers does not constitute an information service subject to sales tax under Tax Law §1105(c)(1). Petitioner is paid for performing the service of product development rather than for furnishing information to its customer. However, even if these data were considered an information service, the service would be excluded from tax unless the information is not personal or individual in nature or is or may be substantially incorporated into reports furnished to others.

Likewise, the CAD data in and of itself do not appear to be software. Rather, they appear to be a blueprint for the manufacture of the product, which is not subject to sales tax if furnished to a customer electronically via the Internet. See *Spiritual Compass, LLC*, Adv Op Comm T & F, June 22, 2007, TSB-A-07(16)S; *Debra Horn Stachura*, Adv Op Comm T&F, November 22, 2004, TSB-A-04(26)S.

Even if the CAD data did constitute software, they would not be subject to tax if they were designed and developed by Petitioner to the specifications of a specific purchaser. In that case, the CAD data would be custom software, not prewritten software. See Tax Law §1101(b)(14). However, any portion of the CAD data that constituted prewritten computer software would be tangible personal property subject to tax under Tax Law §1105(a). See Tax Law §1101(b)(6). Sales by Petitioner of prewritten software to a customer would qualify for exemption under Tax Law §1115(a)(12) if the software was for use directly and predominantly in the production of tangible personal property for sale (e.g. if the software (CAD data) was used to operate the customer's machinery that produces the customer's product for sale). See *Dresser-Rand Company*, Adv Op Comm T & F, February 6, 1997, TSB-A-97(5)S.

Thus, Petitioner's receipts from sales of its product development services are not subject to the sales taxes imposed by Tax Law §1105, unless the CAD data resulting from these services constitute prewritten software that is not otherwise exempt. If the CAD data are prewritten software, then reasonable, separately stated charges for custom modifications or enhancements to the software would not be taxable. See Tax Law, §1101(b)(14).

Petitioner's transfers of a prototype to its customer in conjunction with Petitioner's design services would not be subject to sales tax, provided that Petitioner does not separately contract for or charge for the sale of the prototypes to the customer. If prototypes are not separately sold by Petitioner to its customers, Petitioner's costs in creating the prototypes are part of its expense in performing the product development services and preparing the final CAD data. However, if Petitioner separately sold prototypes that are delivered to customers in New York, the charges for the prototypes, unless otherwise exempt as described below, would be subject to sales tax. In that case, Petitioner's product development services might constitute an expense item that is part of the cost of production of the prototype being sold and included in the receipt subject to tax.

*Issue (2) – Petitioner’s purchases of tangible personal property*

If Petitioner is otherwise engaged in sales of tangible personal property, i.e., if Petitioner separately charges or contracts for the sale of a prototype to a customer, then Petitioner would be eligible to purchase the prototype, or component materials for making the prototype, for resale. The resale exemption will apply only if the prototype or materials are purchased exclusively for resale and not otherwise used by Petitioner. See Tax Law §1101(b)(4)(i). However, Petitioner’s purchases of prototypes, or of materials for making the prototypes, or of other property that is not separately sold to the customer but is transferred to the customer in the performance of a nontaxable service, do not qualify as purchases for resale as such or as a component part of a taxable service. See Tax Law §1101(b)(4)(i); 20 NYCRR 526.6(c)(7). Accordingly, unless otherwise exempt, these purchases by Petitioner of prototypes or other tangible personal property are retail purchases subject to tax under Tax Law §1105(a).

The Tax Law provides an exemption for tangible personal property used directly and predominantly in research and development in the experimental or laboratory sense. This research and development exemption does not encompass the activities of ordinary testing or inspection of materials or products for quality control or the performance of efficiency surveys, management studies, consumer surveys, advertising, promotions or research in connection with literary, historical or similar projects. (See Tax Law §1115(a)(10)).

The testing of manufactured products intended for sale is not research and development in an experimental or laboratory sense. But testing models of a new product for quality and performance standards before manufacturing the new product is an experimental function qualifying as use in research and development. (*Matter of Protocom Devices*, Adv Op Comm T & F, December 3, 1987 TSB-A-88(4)S.) The use of a computer to design or redesign a new product’s appearance for cosmetic purposes does not qualify as exempt research and development. But the use of a computer to test a new product’s ability to meet function and reliability standards before manufacture does qualify as exempt research and development. (*Matter of Sybron Corp*, Adv Op STC, June 12, 1985, TSB-A-85(17)S) Thus, the intermediate functional “breadboard” prototypes and the final prototypes that are used by Petitioner and its customers to test the new product’s functional capabilities and to determine whether the product can meet design, function, and concept requirements, are used and consumed in research and development for the purposes of Tax Law §1115(a)(10). Accordingly, Petitioner’s purchases or use of these prototypes, or of the component parts or other materials of these prototypes, would be exempt from sales and use tax under Tax Law §1115(a)(10), provided that the prototypes or the components or materials are used predominantly (more than 50% use) in research and development. See 20 NYCRR 528.11(c)(2).

The intermediate “form study” prototype used by Petitioner and its customers appears analogous to the architectural models used by architects. (See *Matter of Lenon Sokolowski Models*, TAT, decision dated Oct 1, 1992, DTA no. 807478,807479 AND 807481 TSB-D-92(70)s; *Awad Architectural Models, Inc.*, Adv Op STC, February 14, 1986, TSB-A-86(9)S.) These prototypes provide the customer with a conceptual image of the product but are not used to test the functionality of the product. Thus, Petitioner’s purchases or use of such prototypes, or of the component parts or materials of these prototypes, does not qualify for the exemption from sales tax for property used and consumed in research and development in the experimental or scientific sense. Likewise, sketches, drawings, presentation boards, and renderings used by Petitioner and its customers in the *Research and Product Definition, Concept Development, and Preliminary Design and Engineering* phases are not used or consumed in research and development in determining the functionality of the new product. Thus, purchases and use of these items do not qualify for the research and development exemption under Tax Law §1115(a)(10). Additionally, these prototypes, sketches, drawings, presentation boards, and renderings are not used directly in the production of tangible personal property for sale by Petitioner or its customers. Accordingly, these items are not exempt from sales tax under Tax Law §1115(a)(12). As previously noted, such property is not purchased by Petitioner for resale pursuant to Tax

Law §1101(b)(4)(i). Thus, Petitioner's purchases of these items are subject to sales or use tax under Tax Law §1105(a) and §1110.

DATED: May 22, 2009

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NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion.