BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
TASC, INC.,
ID. NO. 02-199510-00 9, NO. 97-31
PROTEST TO ASSESSMENT
NOS. 1931498 AND 1931497

DECISION AND ORDER

THIS MATTER comes on for determination before Gerald B. Richardson, Hearing Officer, following a formal hearing held on January 17, 1997. TASC, Inc., hereinafter, "Taxpayer", was represented by Stephen C. Newmark, Esq. of Newmark Irvine, P.A. of Phoenix, Arizona and by Patrick A. Casey, Esq., who appeared as local counsel. The Taxation and Revenue Department, hereinafter, "Department", was represented by Margaret B. Alcock, Esq. Following the hearing, the parties submitted proposed Findings of Fact and Conclusions of Law as well as briefs. The final pleadings were filed on May 27, 1997 and the matter was considered submitted for decision at that time. The parties have granted the Hearing Officer additional time, until August 22, 1997, to submit his decision.

Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Analytic Sciences Corporation, known as TASC, Inc., the Taxpayer herein, is a Massachusetts corporation whose corporate headquarters and principal place of business are located in Reading, Massachusetts.

2. The Taxpayer maintains an office in Albuquerque, New Mexico.

3. The Taxpayer is a professional services organization that provides professional services primarily to the federal government. Most of this work involves leading edge defense system design.

4. In 1990, the Taxpayer was awarded a contract by Office of the Secretary of Defense to provide programmatic and technical support to the Strategic Defense Initiative Organization ("SDIO") Space Experiments Program. The SDIO was located at the Pentagon, in Washington, D.C.

5. The Statement of Work portion of the contract defined the scope of effort under the contract to include programmatic support, independent technical analysis, administrative support, development of computer based simulations, installation of workstations and software, maintenance of workstations and software, technical integration support, specialized data collection, specialized data analysis, training, mission planning, data distribution, field tests and analytic support at the Directed Energy Systems Center.

6. The contract required the Taxpayer to furnish the necessary materials, labor, equipment and facilities to accomplish the work set forth in the Statement of Work.

7. The contract lists the contract type as "an indefinite quantity, Task Order, level of effort Cost Plus Fixed Fee contract". Under the task orders issued pursuant to the contract, the level of effort is tied to an estimated number of hours of work by professional and clerical employees. The Taxpayer's compensation under the contract is based upon hours worked and not upon the completion of specific tasks or objectives.

8. The work of the contract was to be furnished in accordance with the Statement of Work and by task orders to be issued under the contract.

9. The contract required the Taxpayer to prepare and deliver data and reports in accordance with the task orders issued under the contract.

10. The place of final acceptance for the work called for in the contract was the SDIO offices, located at the Pentagon, in Washington, D.C.

11. The SDIO was the organization in charge of the government project to design, develop and test a space-based laser defense system that would use satellite-mounted lasers to protect the United States from attack by inter continental ballistic missiles.

12. The SDIO engaged a number of different contractors to contribute to the laser defense system project. The SDIO contracted with Phillips Laboratory at Kirtland Air Force Base in Albuquerque, New Mexico, to develop, design, build and test the High Altitude Balloon Experiment ("HABE").

13. Phillips Laboratory requested that SDIO contract with the Taxpayer to provide programmatic and technical support services to Phillips Laboratory at Kirtland Air Force Base for the HABE project.

14. The SDIO did this by issuing task orders under its contract with the Taxpayer.

15. The scope of work to be performed by the Taxpayer for Phillips was set out in two task orders, PATS-05 and PATS-08, hereinafter task orders five and eight.

16. Task order five covered the period from February 29, 1992 to February 28, 1993. The scope of work under this task order required the Taxpayer to "provide program integration, simulation, mission planning, independent technical, data management, HABE controls and processors design, program control, and field test support to the Phillips Laboratory." This task order was later revised to add to the scope of work that in addition to the work already described, that the Taxpayer would also "provide engineering, analysis, design and development for trackers, sensors, algorithms, models, fire control systems, illuminators, advanced materials, LOS control systems, targets, testing and other ATP/FC elements." ATP/FC is an acronym for acquisition, tracking, pointing and fire control

17. Task order eight and its revisions extended the time period for performing the work described in task order five through December 31, 1994.

18. Both task orders stated that the "End Items" or the "Deliverables" were monthly status reports. The task orders require that these reports be provided to both the SDIO offices at

the Pentagon and to Major Ken Barker at Phillips Laboratory at Kirtland Air Force Base.

19. The Taxpayer engaged two subcontractors, Applied Technology Associates ("ATA") and the Core Group, both of which were based in Albuquerque, New Mexico, to assist with meeting its obligations under task orders five and eight.

20. ATA was hired to work on the data management system and the management information system. ATA had about ten full time employees working on the HABE project. Eight were involved in developing a data management system for HABE and two were involved in developing software to control the steering mirrors that would be used to point the lasers. The data management system was to be a repository for all of the information relating to the HABE project. The information was to be entered in the system, catalogued so that it could be found and a graphical user interface system developed which would allow the users of the system to access the information in the system. This required developing data management system specifications, the development of the system, including acquiring the computer hardware and developing custom software to handle the data processing needs of the HABE. The data management system was provided to Phillips Laboratory. At the time the Taxpayer's involvement with the HABE ended, the system was a current, up-to-date system.

21. When the computer hardware arrived at Phillips Laboratory, the computers could be turned on, but performed no other function. ATA provided the services of its eight employees assigned to developing the data management system to create the software and enter the data necessary to develop and implement the system.

22. The Core Group was hired to perform two functions. One was to provide support to the illuminator laser subsystem. This work, which was not complete by the time the Taxpayer's involvement with the HABE ended, involved developing software for what amounted to a floodlight beam being developed by the government that would shine light out into space to illuminate and reflect off of laser targets. The other function was to provide scaled rockets to provide simulated laser targets. The Core Group provided the rocket motor,

rocket bodies and a launcher. This work was completed before the Taxpayer's involvement with the HABE ended.

23. The HABE was an early phase of the laser defense system project, intended to allow the testing of early versions of the laser defense system in a relatively inexpensive and accessible environment by using balloons to carry the laser equipment and systems to deploy the equipment high into the atmosphere, where it could be tested under relatively realistic conditions without incurring the expense of actually launching satellites by rocket. The balloons would allow the equipment to be recovered when the balloons returned to the ground.

24. As compared to an actual working space-based laser defense system, the HABE was intended to demonstrate the feasibility of creating systems to accurately point lasers at targets, not to actually destroy targets.

25. The HABE used two helium balloons. One was intended to carry the payload to 14,000 feet. At that point, explosive bolts were to be discharged, releasing the second balloon, intended to carry the payload to 85,000 feet. The payload structure was intended to contain the computers, power systems, communications systems and the laser system. If successful, the HABE was to be followed by further development and testing of the laser defense system in California or Florida, those being the locations from which the completed laser defense system would be launched into space.

26. The Taxpayer's work on the HABE effectively came to an end as a result of the failure of a preliminary test of the balloon system. The test was conducted at Clovis, New Mexico under the supervision of the government. To test the balloon system, the two balloons were placed atop a simulated payload structure containing barbells and weights to simulate a real payload. The Taxpayer's work on this test involved purchasing the weights located in the payload and assisting in the development of the communications software used to communicate with the balloon. In addition, ATA put in a small signal acquisition computer to record some data. What happened is that the explosive bolts were not wired properly and failed to fire. As a

result, the second balloon was not deployed. The first balloon rose to 21,000 feet, becoming highly pressurized. Ground control sent a signal to open a vent on the first balloon to allow it to descend. Ground control, however, lost line-of-sight with the balloon and could not determine when to re-close the vent. As a result, the vent remained open and the payload crashed to the ground.

27. After the balloon system experiment failed, the government reset the program and attempted to re-plan the project to mitigate future failures. The government has only now begun to spend money towards getting ready for another set of tests.

28. Although the Taxpayer sought to continue working on the HABE, it lost the bid for further work and has done no work on the project since early 1995.

29. Although a part of the Taxpayer's work on task orders five and eight could be considered completed, much remained incomplete at the end of the time period covered by the task orders. As a result of its separation from the HABE project, the Taxpayer does not know if all of the work it was hired to do in support of the HABE would have actually worked.

30. In July, 1994, the Department contacted the Taxpayer to discuss its business activities in New Mexico.

31. As a result of the information the Taxpayer provided the Department, on May 18, 1995 the Department issued two assessments. Assessment No. 1931498 assessed $280,441.12 in gross receipts tax, $28,044.14 in penalty and $83,719.74 in interest for the reporting period of January 1992 through September, 1994. Assessment No. 1931497 assessed $3,391 in corporation income tax, $339.10 in penalty and $889.17 in interest.

32. On May 24, 1995 the Taxpayer filed a written protest to Assessment Nos. 1931498 and 1931497.

33. Prior to the formal hearing in this matter, the Department agreed to abate the penalty portion of Assessment Nos 1931497 and 1931498.

34. The Department's gross receipts tax assessment was based upon taxing the Taxpayer's receipts from performing services in New Mexico or upon the Taxpayer's receipts from performing research and development services out-of-state where the Department believes such services were initially used in New Mexico.

35. During the audit period the Taxpayer received consideration of $3,842,504.02 for services performed in New Mexico pursuant to its contract with the Department of Defense. Applying the Albuquerque tax rate, this resulted in $222,999.51 of the gross receipts tax assessed to the Taxpayer.

36. During the audit period the Taxpayer received consideration of $1,148,831.35 for services performed out-of-state, which services the Department believes were initially used in New Mexico. Applying the out-of-state tax rate, this resulted in $57,441.61 of the gross receipts tax assessed to the Taxpayer.

37. The only evidence presented by the Taxpayer with respect to the services it performed out-of-state was that it prepared a simple computer program at its Huntsville, Alabama office which was part of its mission planning support work under the task orders. This computer program was designed to determine where the balloon should be launched from, given wind conditions, so that it could be seen and tracked. This program was delivered to Phillips Laboratory at Kirtland Air Force Base. The Taxpayer's witness testified that the program was not used by Phillips at the point the Taxpayer's involvement with the HABE ended. No evidence was presented to identify how much of the Taxpayer's receipts which were taxed at the out-of-state rate were attributable to this work.

38. The Taxpayer's receipts from development of the data management system, which work was subcontracted to ATA, totalled $1,207,514. These receipts were broken down into $463,712 for computer hardware and $743,802 for the costs of labor, travel and other expenses incurred with respect to the data management system.

39. In computing the gross receipts tax assessment issued to the Taxpayer, the Department excluded the cost of the computer hardware used in the data management system from the Taxpayer's gross receipts, but it included the balance of $743,802 and declined to treat those receipts as incidental to the sale of the hardware to the government.

40. The subcontractors who worked for the Taxpayer passed their gross receipts tax expense on to the Taxpayer as part of the selling price of their services.

41. The Taxpayer did not issue or receive any New Mexico nontaxable transaction certificates during the audit period.

42. The parties have agreed that the issues involved in the Taxpayer's protest of the corporation income tax assessment will be determined by the decision on the gross receipts tax issues.

DISCUSSION

From 1992 through 1994, the Taxpayer was under contract with the Department of Defense in Washington, D.C. to provide programmatic and technical support services in support of the High Altitude Balloon Experiment ("HABE") to Phillips Laboratory at Kirtland Air Force Base in Albuquerque, New Mexico. Phillips Laboratory was under contract with the Department of Defense to design, develop, build and test the HABE as a preliminary part of the government's Strategic Defense Initiative, commonly called "star wars", whose purpose was to develop a satellite based laser defense system to protect the United States from an attack by intercontinental ballistic missiles. The primary issue herein is whether the Taxpayer's receipts for its work under its contract with the Department of Defense are subject to New Mexico's gross receipts tax.

In pertinent part, § 7-9-3(F) NMSA 1978 defines gross receipts as follows:

> "gross receipts" means the total amount of money or the value of other consideration received from selling property in New Mexico, from leasing property employed in New Mexico, from selling services

> performed outside New Mexico the product of which is initially used in New Mexico or from performing services in New Mexico.

The majority of the Taxpayer's receipts are attributable to services performed in New Mexico, although about one-third of its receipts are for services performed outside of New Mexico which services, the Department argues, were initially used in New Mexico.

With respect to the Taxpayer's receipts for services performed in New Mexico, the Taxpayer argues that it is entitled to claim the deduction found at § 7-9-57 NMSA 1978, which provides for a deduction from gross receipts tax for the sale of services to an out-of-state buyer under certain specified conditions. In pertinent part, § 7-9-57 provides as follows:

> A. Receipts from performing a service may be deducted from gross receipts if the sale of the service is made to a buyer who delivers to the seller either a nontaxable transaction certificate or other evidence acceptable to the secretary that the transaction does not contravene the conditions set out in Subsection C of this section.
>
> B. The buyer delivering the nontaxable transaction certificate or other evidence acceptable to the secretary shall not contravene the conditions set out in Subsection C of this section.
>
> C. Receipts from the performance of a service shall not be subject to the deduction provided in this section if the buyer of the service or any of the buyer's employees or agents:
>
> (1) makes initial use of the product of the service in New Mexico; or
>
> (2) takes delivery of the product of the service in New Mexico.

The dispute with respect to the Taxpayer's receipts from performing services in New Mexico for the Department of Defense concerns whether the conditions of Subsection C have been violated under the circumstances of this case.

The Department's audit focused on the first condition, taking the position the Taxpayer was not entitled to claim the deduction because the Department of Defense or its employees or agents contravened the first condition because they made initial use of the product of the Taxpayer's services in New Mexico. The Department's brief also argues that the second

condition was violated because the Department of Defense or its employees or agents took delivery of the product of the Taxpayer's services in New Mexico. The Department argues that the conditions of Subsection C of the statute are written in the disjunctive because of use of the word, "or" between the conditions and, accordingly, a violation of either condition requires that the deduction be denied.

The Taxpayer argues that even though written in the disjunctive, that the two conditions relate to the same issue and so should construed together. The Taxpayer argues that the conditions should be read to prevent the deduction if there is actual initial use of the product of the services in New Mexico or if the product is delivered to the purchaser *in such a condition that it can be initially used* in New Mexico. The Taxpayer argues that this would prevent a taxpayer from qualifying for the deduction merely by refraining to use a usable product.

There are several problems with the Taxpayer's construction. First, it would require reading the above-italicized language into the statute. Statutes are to be given effect as written, and where they are free from ambiguity, there is no room to construe them. ***State v. Elliott***, 89 N.M. 756, 557 P.2d 1105 (1977). Additionally, construing authorities should not read into a statute language which is not there, particularly if the statute makes sense as written. ***State ex rel. Barela v. New Mexico State Board of Education***, 80 N.M. 220, 453 P.2d 583 (1969). Finally, the word "or" should be given its normal disjunctive meaning unless the context of the statute clearly demands otherwise. ***Hale v. Basin Motor Company***, 110 N.M. 314, 795 P.2d 1006 (1990). The statute is unambiguous as written. The deduction is denied if either there is initial use of the product of the service in New Mexico or if the product of the service is delivered in New Mexico. There is no need for the addition of the language the Taxpayer argues for into the statute. Under the existing language, the deduction would be denied regardless of whether the buyer actually uses the product of the service, so long as the buyer has the product of the service delivered in New Mexico.

In this case, the deliverables, or to use the statutory term, the product of the Taxpayer's service under the task orders were monthly reports.[1] The task orders required that these be delivered both to the SDIO offices at the Pentagon and to Major Ken Barker at Phillips Laboratory at Kirtland Air Force Base. Thus, there is no question that the purchaser of the Taxpayer's services, the Department of Defense, through its employee, Major Barker, took delivery of the product of the Taxpayer's services in New Mexico. As such, the Taxpayer is not entitled to claim the deduction at § 7-9-57 with respect to its receipts for performing the services it performed in New Mexico.

The main thrust of the Taxpayer's arguments in this case were to the issue of whether there was initial use of the product of its services in New Mexico so as to disqualify it from claiming the deduction provided at § 7-9-57. As discussed above, with respect to services, the product of which it delivered to the Department of Defense in New Mexico, it need not be determined whether there was initial use of the product of its service in New Mexico. Nonetheless, this issue must still be determined with respect to services which it performed out-of-state which were taxed under the Department's assessment. This is because the Taxpayer claims exemption for those receipts pursuant to § 7-9-13.1 NMSA 1978. That section provides an exemption for services performed out of state, the product of which is initially used in New Mexico, but excepts from that exemption "research and development services." The Taxpayer claims exemption under that section based upon two theories. First, it claims that the Department has failed to establish that the services it performed out-of-state were research and

[1] The contract under which the task orders were issued also required that the Taxpayer provide the materials necessary to fulfill its contractual obligations. Accordingly, the Taxpayer also supplied certain computer hardware and scaled rockets pursuant to the task orders. These items were also delivered to Phillips Laboratory. The Department's audit, however, allowed a deduction for the computer hardware as the sale of tangible personal property to the government pursuant to Section 7-9-54 NMSA 1978.

development services. Second, it argues that the product of those services was not initially used in New Mexico.

"Research and development services" are defined at § 7-9-3(P) NMSA 1978 as follows:

> "research and development services" means any activity engaged in for other persons for consideration for one or more of the following purposes:
>
> (1) advancing basic knowledge in a recognized field of natural science;
>
> (2) advancing technology in a field of technical endeavor;
>
> (3) the development of a new or improved product, process or system with new or improved function, performance, reliability or quality, whether or not the new or improved product, process or system is offered for sale, lease or other transfer;
>
> (4) the development of new uses or applications for an existing product, process or system, whether or not the new use or application is offered as the rationale for purchase, lease or other transfer of the product, process or system;
>
> (5) analytical or survey activities incorporating technology review, application, trade-off study, modeling, simulation, conceptual design or similar activities, whether or not offered for sale, lease or other transfer; or
>
> (6) the design and development of prototypes or the integration of systems incorporating advances, developments or improvements included in Paragraphs (1) through (5) of this subsection

With respect to the Taxpayer's argument that the Department failed to present evidence to establish that it had performed research and development services out-of-state, the Taxpayer misapprehends where the burden of proof lies. Section 7-1-17(C) NMSA 1978 provides that, "[A]ny assessment of taxes or demand for payment made by the department is presumed to be correct." This means that the burden of proof is on the taxpayer contesting the assessment to overcome the presumption of correctness. ***Archuleta v. O'Cheskey,*** 84 N.M. 428, 504 P.2d 638

(Ct. App. 1972). This means that the burden was on the Taxpayer to establish that the services it performed out-of-state were not research and development services. This is especially so since the Department's audit papers segregated non-research and development services from the Taxpayer's taxable receipts so the Taxpayer was on notice of what the Department considered to be taxable research and development services. See, Department Exhibit A. Besides, given the experimental nature of the HABE project and the highly technical nature of the Taxpayer's work in support of this project, as described in the work orders, it can hardly be seriously argued that the Taxpayer's services were not research and development services under the above-quoted definition. Thus, this argument is without merit. The Taxpayer next argues that the product of its services was not initially used in New Mexico. Although the Taxpayer made this argument with respect to all of its services because of its claim of deduction pursuant to § 7-9-57, as discussed above, it has been determined that with respect to services performed in-state, the deduction is not allowed because of the delivery of those services in New Mexico. Other than the evidence offered by the Taxpayer, discussed in Finding No. 37 with respect to the computer program it developed in Alabama, however, the record in this case does not establish or describe what part of the work described in the task orders was performed out-of-state. Accordingly, other than with respect to the computer program developed in Alabama, it will be assumed that the work performed out-of-state could have fallen under any of the work described in the task orders and the Taxpayer's argument that the product of its services was not initially used in New Mexico will be discussed in general with respect to the Taxpayer's work under the various task orders.

"Initial use" is defined at § 7-9-3(O) as follows:

> "initial use" or "initially used" means the first employment for the intended purpose and does not include the following activities:
>
> (1) observation of tests conducted by the performer of services;

(2) participation in progress reviews, briefings, consultation and conferences conducted by the performer of services;

(3) review of preliminary drafts, drawings and other materials prepared by the performer of the services;

(4) inspection of preliminary prototypes developed by the performer of services; or

(5) similar activities

The Taxpayer's arguments focus on the aspect of the definition which refers to use for the "intended purpose". The Taxpayer argues that it does not meet this part of the definition of initial use because it was hired to provide programmatic and technical support on the HABE project and the purpose of the HABE project was to test laser pointing at a high altitude. The Taxpayer argues that since this never occurred, due to the failure of the first balloon test, that for all practical purposes, its services were never used for their intended purpose. In further support of this argument, the Taxpayer relies upon the evidence it presented which demonstrated that many of the various tasks outlined in the task orders were not completed by the Taxpayer at the time its involvement in the HABE terminated. This, the Taxpayer argues is further evidence that the product of its services could not have been used for their intended purposes because in many cases, they were not completed. Finally, the Taxpayer points to the fact that the Strategic Defense Initiative, of which the HABE was only a small part, was never even intended to be used in New Mexico, since the next phase of the Strategic Defense Initiative was to be carried out in Florida and California, and ultimately, the end product of the project was intended to be used in space, not in New Mexico.

The issue of what constitutes initial use for the intended purpose is a matter of first impression in New Mexico, and thus, we only have the statute to guide us in making this determination. Even with just the statute to guide us, however, it is clear that at least some of the Taxpayer's arguments are erroneous. This is because the Taxpayer's argument ignores the

language of the definition of initial use which refers to the "first employment" for the intended purpose. Thus, the fact that perhaps some of the Taxpayer's work would ultimately be used in Florida, California or space is irrelevant since that would not be its first employment. The Taxpayer's work involved the HABE project, which was intended to precede any space launches of any lasers.

We must look to the task orders themselves to determine whether the product of the Taxpayer's services which were performed out-of-state were first employed for their intended purpose in New Mexico. In making this determination, the fact that we don't really know which services were performed out of state greatly hampers any detailed analysis of this issue. Thus, we must look, in general, at the broad description of the services the Taxpayer was to provide rather than analyzing the specific tasks enumerated in the task orders.

The objective listed under the first version of task order five (Taxpayer Exhibit 5) provides that:

> [T]he objective of this effort is to provide programmatic and technical support *to the Phillips Laboratory (PL)* located at Kirtland AFB, Albuquerque, New Mexico. The support will be for the High Altitude Balloon Experiment (HABE), and Advanced and Fine Tracking activities. (emphasis added).

This objective was modified somewhat in later versions of the task order and in task order eight to read as follows:

> [T]he objective of this effort is to provide Acquisition, Tracking, Pointing and Fire Control (ATP/FC) technical support *to the Phillips Laboratory (PL)* located at Kirtland AFB, Albuquerque, New Mexico. The support includes experiment systems development, subsystem analysis and design, and support of testing for the High Altitude Balloon Experiment (HABE). (emphasis added).

Taxpayer Exhibit 7.

The scope of the Taxpayer's work under the first version of task order five provides:

> [T]he contractor shall provide program integration, simulation, mission planing, independent technical, data management, HABE controls and processors design, program control, and field test support *to the Phillips Laboratory*. (emphasis added).

This was expanded under a later revision (Taxpayer Exhibit 6) of task order five to add to the above quoted language, the following:

> [T]he contractor shall provide engineering, analysis, design and development for trackers, sensors, algorithms, models, fire control systems, illuminators, advanced materials, LOS control systems, targets, testing and other ATP/FC elements.

Task order eight restated essentially the same scope of work.

What both the objectives of the task orders and the scope of work make clear is that the Taxpayer's work was to provide various technical support services to Phillips Laboratory, which was the entity in charge of the HABE project. Thus, as stated in the contracts, the intended purpose of the Taxpayer's work was to provide technical support services to Phillips Laboratory. We know that the Taxpayer's services, be they in the form of reports or otherwise, were provided to Phillips Laboratory. The record is basically silent as to how Phillips incorporated the information and services it received into its work for the SDIO. As noted above, however, the burden of establishing that the assessment is incorrect, and therefore the burden of establishing its entitlement to its claim of exemption under § 7-9-13.1 rests with the Taxpayer. The fact that the first experiment with the HABE was a failure does not establish that the services were not first employed by Phillips Laboratory in designing the many components of that experiment or that they will not be first employed under the continuation of the HABE project. This is especially so given the highly experimental nature of both the HABE and the Strategic Defense Initiative project. Even though information developed through research is not directly used in an experiment, it may be used in designing the experiment or it may have been used in redesigning the experiment during its development

based upon the results of the research as it was conveyed by the Taxpayer to Phillips Laboratory.

Nor does the fact that the Taxpayer's evidence demonstrated that many of the enumerated items listed in the scope of work were not completed when the Taxpayer's involvement with the project ended establish that the product of its services were not first employed for their intended purpose of supporting Phillips Laboratory's work on the HABE. Nothing in the contracts or task orders requires completion of work in order for the Taxpayer to be compensated under its contract. The contract is a "level of effort" contract which bases compensation upon hours of work. This is typical for these kinds of experimental research contracts. By their very nature, it is impossible to predict the results of the research and how long it will take to obtain those results, given the experimental nature of the work. What the contracts and work orders call for is ongoing technical and programmatic support to Phillips Laboratory's efforts to develop and oversee the HABE project. This is what the Taxpayer did and it delivered those services, whether performed in-state or out-of-state, to Phillips Laboratory in New Mexico. It is hardly unreasonable to infer that those services were somehow employed by Phillips Laboratory in performing its job of overseeing the HABE project.

This brings us to discuss the one matter for which evidence was presented with respect to services performed out-of-state, the computer program developed by the Taxpayer at its Huntsville, Alabama offices to provide information as to where to launch the balloons from, which program was delivered to Phillips Laboratory. The Taxpayer's witness testified that as far as he knew, at least at the time the Taxpayer's contract expired, that Phillips had not used the program. Given the fact that the HABE project was not terminated after the first test failure, and given the fact that the HABE project was restarted and that Phillips Laboratory remains involved in that project, this does not establish that the program has not been employed by Phillips as part of its ongoing work on the HABE project. Thus, the Taxpayer has failed to

establish its entitlement to the deduction provided at § 7-9-13.1 with respect to the services performed out-of-state.

The remaining issues to be determined relate to the Taxpayer's receipts with respect to its subcontractor, Applied Technology Associates or ATA. Part of the scope of the Taxpayer's work under the task orders was to provide a data management system and management information system. The data management system was to be a repository for all of the information relating to the HABE project. The information was to be entered in the system, catalogued so that it could be found and a graphical user interface system developed which would allow the users of the system to access the information in the system. This required developing data management system specifications, the development of the system, including acquiring the computer hardware and developing custom software to handle the data processing needs of the HABE. The Taxpayer subcontracted this work to ATA.

The Taxpayer's receipts with respect to its subcontract with ATA, totalled $1,207,514. These receipts were broken down into $463,712 for computer hardware and $743,802 for the costs of labor, travel and other expenses incurred with respect to the data management system. The Department did not include the amount representing the cost of the computer hardware in the Taxpayer's assessment, allowing the Taxpayer the deduction provided at § 7-9-54 NMSA 1978 for sales of tangible personal property to governmental entities, including the United States government. The Taxpayer argues that the remaining costs should also be allowed under the same deduction on the theory that these costs were incidental to the sale of the computer hardware. The Taxpayer bases its argument on the fact that it was required to provide a working computer system to the government and that the costs of programming and setting the computer system up so that it performs as required should be considered incidental to the sale of the computer equipment to the government.

A review of the cost breakdown between the cost of the equipment and the cost of the services, with the cost of the equipment representing less than one third of the total expenditure

is indicative that the services provided were not incidental to the sale of the computer equipment. Even more persuasive, however, is a review of the description of the services to be provided in connection with the actual hardware itself. Paragraph 8.0 of task order five, entitled Data Management Support, describes the work subcontracted to ATA with respect to the data management system and provides as follows:

> [T]he contractor shall implement and support a data management system providing data acquisition and processing of all HABE telemetry signals through all phases of integration testing, and mission operations. The data management system will track the processing algorithms, calibration, and location of each instrumentation signal through a database software system. This software system shall include definitions to track the subsystem specifications, component drawings and engineering reports. The data management system shall also provide an electronic mail system to provide information exchange between program members. The implementation of the data management system will be accomplished through four primary tasks, system specifications, information management support, data management system development and integration and operations support.
>
> Given data systems requirements provided by the HABE program office, the contractor shall perform trade studies, create system specifications, and generate implementation plans for the HABE date management system. The data management system shall include capabilities of acquiring, processing and analyzing all HABE telemetry signals including video signals. The contractor shall support the specification of payload instrumentation including signal sample rate and filtering to assure adequate telemetry sources for later analysis. The contractor shall document the data management system through a Data Management Plan (DMP). The contractor shall participate in interchange meetings and coordinate with groups performing subsystem and integrated systems testing, system simulation, ground station implementation and system instrumentation.
>
> After system implementation and integration, the contractor shall perform work in collecting, processing, analyzing and archiving of data from the balloon platform and other experiment sources for both ground testing and mission operations.

Even a cursory reading of this job specification reveals that the government was purchasing far more than computer equipment. It was purchasing the services to create system specifications, to do studies to determine the best equipment available, to create, design and develop custom software to perform the many functions required of this highly specialized system and to input essentially all of the information about the HABE project into the system. These services can not accurately be characterized as incidental to the purchase of the computer equipment. Given the highly specialized and customized services being rendered with respect to the provision of the computer equipment, I consider the Department generous in allowing the deduction for the computer equipment itself. The Department could have been justified in treating the provision of the computer hardware as incidental to the services provided to make it function and treating the entire amount as the provision of a service and subjecting it to gross receipts tax. (See, § 7-9-3(K) which defines a service as including activities which involved predominately the performance of a service as distinguished from selling property.)

The final argument presented by the Taxpayer with respect to the amount taxed with respect to its subcontract with ATA and the Core Group is that because the Taxpayer paid the passed on cost of the gross receipts taxes which the subcontractors charged pursuant to their contracts with the Taxpayer, the Taxpayer argues that it should not be subjected to gross receipts taxes on those same amounts. The Taxpayer cites to no legal authority that such double taxation is illegal, nor could it do so. There are two separate transactions involved, the sale of services which occurred between the subcontractors and the Taxpayer, and the sale of services which occurred between the Taxpayer and the government. Both are subject to tax absent any applicable deductions or exemptions. In this case, there was a deduction available to the subcontractors which would have prevented the pyramiding of tax which occurred in this case. Section 7-9-48 NMSA 1978 provides a deduction for the receipts for selling a service for resale. It can be claimed if the buyer of the services provides a proper non-taxable transaction certificate to the seller. In this case, the Taxpayer did not avail itself of the opportunity to

provide a non-taxable transaction certificate to its subcontractors to avoid being charged gross receipts tax. It cannot now complain of the unfairness of the tax pyramiding which has occurred.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to the assessments of tax at issue herein, pursuant to § 7-1-24 NMSA 1978, and jurisdiction lies over both the parties and the subject matter of this protest.

2. The product of the Taxpayer's services under task orders five and eight was delivered to Phillips Laboratory in Albuquerque, New Mexico; accordingly the Taxpayer's receipts from performing those services are not deductible pursuant to § 7-9-57 NMSA 1978.

3. The Taxpayer has failed to carry its burden of proving that it is entitled to claim a deduction pursuant to § 7-9-13.1 with respect to the services which it performed out-of-state.

4. The services performed to design, develop and implement the data management system were not incidental to the sale of the computer hardware used to run the data management system. Accordingly, the Taxpayer's receipts from designing, developing and implementing the data management system are not deductible pursuant to § 7-9-54 NMSA 1978.

5. The Taxpayer is liable for New Mexico corporate income tax on its receipts from performing services under task orders five and eight of its contract with the Department of Defense.

For the foregoing reasons, the Taxpayer's protest IS HEREBY DENIED.

DONE, this 22nd day of August, 1997.