

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
QUALEX, INC./CARHART PHOTO, INC.	:	DETERMINATION
for Revision of a Determination or for Refund	:	DTA NO. 811122
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period September 1, 1986	:	
through August 31, 1990.	:	

Petitioner, Qualex, Inc./Carhart Photo, Inc., 3000 Croasdaile Drive, Dunham, North Carolina 27705, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1986 through August 31, 1990.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on May 17, 1993 at 9:15 A.M., with all briefs to be filed by July 30, 1993. Petitioner submitted a trial memorandum at the hearing. The Division of Taxation's answering brief was received on July 8, 1993, and petitioner's reply brief was filed on July 30, 1993. Petitioner appeared by Philip M. Moilanen, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Carroll R. Jenkins, Esq., and Mary R. Hurteau, Esq., of counsel).

ISSUE

Whether petitioner's purchases of certain materials and equipment for use in processing film were exempt from sales tax under Tax Law § 1115(a)(12), which provides an exemption from tax for machinery or equipment used or consumed directly and predominantly in the production of tangible personal property.

FINDINGS OF FACT

The parties entered into a stipulation, which was dated May 17, 1993 by the attorney representing the Division of Taxation ("Division"). Relevant portions of this stipulation have been incorporated into this determination.

Petitioner, Qualex, Inc./Carhart Photo, Inc. ("Qualex"),¹ is engaged in the wholesale photo processing business. Its customers consist primarily of retailers such as drug stores, camera dealers and chain stores. Qualex has plants located throughout the United States including, during the audit period, three in New York State, located in Albany, Buffalo (since closed) and Syracuse, where it employed approximately 260 people. During the audit period, these three New York plants had approximately 1,900 accounts from which film rolls were picked up and to which negatives and prints were delivered. The retailers collected sales tax on their photo processing sales, with sales tax remitted on the entire charge. No mail order photo processing was done at the New York plants.

Petitioner processes approximately 6,125,000 rolls of film into approximately 239,091,000 color negatives at its New York plants each year. In all but an estimated .25% to .5% of the orders, the customer also requests that prints be made from the negatives.

Petitioner also produces approximately 6,628,000 reprints and enlargements at its New York plants each year. Approximately .25% to .5% of

its orders for reprints and enlargements are placed at the time of the initial processing of the film and prints, while the vast majority (99.75% to 99.5%) are orders placed subsequent to the initial processing.

Petitioner does not provide any artwork, creative work or other individualized professional service for its customers. Nor is it in the business of taking photographs.

¹The audit report noted that petitioner's legal name is Carhart Photo, Inc. while its trade name is Qualex, Inc. The stipulation entered into by the parties noted that petitioner's operating facilities were "formerly known as Carhart Photo, Inc."

The Division issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due dated May 17, 1991 against petitioner asserting sales tax due of \$68,363.12, plus interest, for the period September 1, 1986 through February 28, 1990. A second notice of determination, also dated May 17, 1991, was issued against petitioner asserting sales tax due of \$8,899.81, plus interest, for the period March 1, 1990 through August 31, 1990. A Conciliation Order dated May 22, 1992 reduced tax asserted as due from \$68,363.12 to \$64,177.47 for the period September 1, 1986 through February 28, 1990 and from \$8,899.81 to \$8,550.65 for the period March 1, 1990 through August 31, 1990. These reductions were based upon the conferee's treating petitioner's purchase of certain packaging equipment as exempt from sales tax as production items used to produce tangible personal property, i.e., photo prints.

Petitioner, on or about August 26, 1992, paid under protest additional sales tax of \$72,728.12 (\$64,177.47 plus \$8,550.65) and interest through September 1, 1992 of \$31,579.97 for a total of \$104,308.09. The parties agreed that if petitioner prevails in full in this matter, a refund of \$104,308.09, plus interest from the date of payment, would be due Qualex.

The following description in the field audit report of the "closing conference and vendor's reaction" provides this explanation for the Division's assertion of additional tax due:

"The audit was reviewed with [petitioner's] Region Controller, Pat Galligan, who presented additional information which reduced the tax due of \$175,580.10. The vendor agreed with \$98,317.17 and disagreed with \$77,262.93. Their disagreement . . . is that the manufacturing exemption should extent [sic] from the time the film enters the plant until the product is ready for distribution. The State's position . . . is that the development of the negative is not producing tangible personal property for sale because the film is already owned by the customer. The vendor is providing a service that is subject to sales tax pursuant to Section 1105(c)(2) of the Tax Law. Therefore, the manufacturing exemption applies, only, to the portion of the process used to produce the photographic prints."

The parties stipulated that the following nine phases are involved in petitioner's photo processing operation (at each of its New York plants) after exposed, but unprocessed film, has been brought into the plant by a driver, who has picked up such unprocessed film from various retailers which petitioner services:

<u>Phase Number</u>	<u>Description</u>
1	Film Sorting

2	Film Splicing
3	Film Processing
3A	Notching of 35mm only
4	Paper Printing
5	Paper Processing
6	Full Roll Inspection
7	Packaging and Pricing
8	Finished Sorting
9	Billing (Invoicing)

The parties stipulated to the following description of the phases involved in producing photographic reprints when negatives, rather than exposed but unprocessed film, have been brought to the plant by the driver:

<u>Phase Number</u>	<u>Description</u>
1A	Reprint Sorting
1B	Reprint Laminating
4-9	Same phases as above for exposed film

The parties' stipulation referenced and incorporated a letter dated February 28, 1992 from petitioner's Region Controller, Patrick Galligan, to petitioner's attorney, Philip Moilanen, for the purpose of identifying the role of the items which the Division asserts were subject to sales tax upon purchase. Such items were grouped by a particular phase number as described above.

Mr. Galligan in his letter provided a "brief description of where the items in disagreement fall within the overall process." He first addressed the "assets" in dispute:

Phase Number 1B/Reprint Laminating

"The reorder laminator and Kodak laminator fall within this [phase]. The function served by a laminator is to attach a paper material to the negative (called webbing) which has information encoded on it. This information pertains to the number of the negative to reprint, how many of each, etc. This webbing is then read by an automatic printer and the frames are printed."

Phase Number 2/Film Splicing

"Falling within this category are: the 135 film splicers, the Ultima splicers, the conversion (upgrade) of same, and the take-up boxes, or magazines. In this [phase], all of the incoming rolls of film are connected together through the use of the splicer and collected on one magazine. The magazine is then transported to be processed. There are 2 types of splicers on the list -- dark room and day-lite (open area)."

Phase Number 3/Film Processing

"Located here are the Cine Processor, the Pako Model 215, and corresponding capitalized installation costs. Here, the magazines of spliced film are connected together and run through the chemistry which develops the film and prepares it for printing."

Phase Number 3A/Notching

"In the case of 35 mm film, the developed/processed film must be notched prior to printing. This process entails placing a notch on the negatives next to each printable frame. This notch enables the printers to position the frame for printing the image. The notch is also needed to cut the negatives at the correct spot to match with the finished print"

Phase Number 7/Packaging and Printing

"Located here are the tricutters, the c-lab tables and bases which support the equipment and the disc viewers. Also included here are the APG line monitors.

"The tricutters are part of an integrated cutting, packaging, and pricing station. The specific function performed by the tricutter is to cut the film into strips of negatives to be matched with the finished prints. This is accomplished by cutting at a notch designated at the notching stage explained above. The c-lab table tops and bases were designed specifically to meet the requirements of the machinery. There are cutouts and shelving to house each of the pieces which together perform the entire cutting, packaging and pricing function. At this point, the individual bags (envelopes) containing the finished product are priced and sent to be sorted by delivery route. Once sorted, invoices are printed for the dealer and matched with the correct grouping of finished goods.

"The disc viewer provides a magnified image of the disc negative and then matches the correct negatives with the finished prints.

"Prior to the merger of APG and Qualex, APG's billing system was on line with their corporate office in Salt Lake City 24 hours per day The line monitors were used to detect transmission problems Once Qualex's billing system was implemented, the APG line monitors were obsolete."

Mr. Galligan in his letter then addressed the "expenses" in dispute by placing "each supply [expense] within the correct phase of the process", with a brief description of the supply (or expense) included in an attachment, and the noting of an audit reference number as follows:

Reference Number	Description	Phase Utilized	Amount of Invoice	Tax Asserted Due
22	Antistatic cloth [used to clean negatives to print reorders]	2, 3	\$ 56.40	\$ 3.95
35	Photosonic rack cleaner [solution used to clean	3, 4, 5	350.75	24.55

45	processing racks] Repair of film processor PVC tank [which holds chemistry]	3	104.00	7.28
50	Repair of Ultima film splicer	2	6,334.85	443.44
58	Repair to infrared scope used in the darkroom to monitor processing	3, 5	685.00	47.95
63	same as #22	2, 3	80.60	5.64
72	film splicing pliers	2	67.50	4.75

113-15	heat splice leader [leader is used to connect the rolls of film, paper and negatives to provide a continuous production flow]	2, 3, 4, 5, 7	346.40 259.80 130.00	24.25 18.19 9.10
118-120	Repairs to film splicer	2	183.40 1,806.95 657.40	12.84 126.49 46.02
125	Reels used to collect the continuous rolls of film	2, 3	348.00	24.36
155	Additional 75% of 5977 heat leader	2, 3, 4, 5, 7	2,523.75	176.66
	Additional 75% of 7977 heat leader	2, 3, 4, 5, 7	222.00	15.54
156	C41 Bleach monitor control strips [used to test the mixture of bleach in the chemistry being used]	3	74.95	5.25
158-60	Additional 75% of 7977 heat leader ²	2, 3, 4, 5, 7	277.50 277.50 3,028.50	19.43 19.43 212.00
160 ³	Film cleaner	1B, 2	73.44	5.14

²Petitioner is apparently claiming that the total amount of its purchasers of leader should be exempt.

³There is no specific explanation in the record why there are two references to number 160. It may be that more than one item was purchased on a particular invoice, and each invoice was given a reference number. In addition, the following two items were listed on the attachment to Mr. Galligan's letter but were not addressed in the body of his letter:

- (1) Number 165, additional 75% of 5977 heat leader in the amount of \$1,514.25; and
- (2) Number 187, a "work center ribbon" in the amount of \$96.25.

Furthermore, the attachment shows charges for electric service as follows which were not addressed in the body of Mr. Galligan's letter: (1) Number 29, \$3,652.20; (2) Number 30, \$3,694.03; (3) Number 85, \$3,828.71; (4) Number 102, \$1,673.80; (5) Number 103, \$1,527.02; and (6) Number 104, \$1,571.15. The attachment explained that the Division treated 50% of the electrical service as taxable while the taxpayer asserts that only 20% for storage and office space should be subject to tax for the Syracuse plant and 10% for the Albany plant.

162	Tapered leader [used when the type of film changes during a part of the process, e.g., 35mm film is finished and 16mm film is next]	2, 3, 4, 5, 7	150.75	10.55
165	Film cleaner	1B, 2	73.44	5.14
166-69	Technet software license for colorwatch film processing	2, 3, 4, 5	900.00	63.00
170	Leader and film cleaner	1B, 2, 3, 4, 5, 7	4,038.00 56.50 76.32	282.66 3.96 5.34
171-173	Leader	2, 3, 4, 5, 7	277.50 222.00 67.30	19.43 15.54 4.71
175	Control strips	3	144.40	10.11
176	Leader	2, 3, 4, 5, 7	2,019.00 79.10	141.33 5.54
177	Control strips	3, 5	378.20	26.47
178-79	Leader	2, 3, 4, 5, 7	27.75 114.60	1.94 8.02
180-86	Leader/film cleaner	1B, 2, 3, 4, 5, 7	76.32 2,523.75 55.50 55.50 277.50 144.60	5.34 176.66 3.89 3.89 19.43 8.02
187	Leader	2, 3, 4, 5, 7	56.50 78.97	3.96 5.53
188-91	Technet	2, 3, 4, 5	541.00 215.00	37.87 15.05
192	Leader	2, 3, 4, 5, 7	100.95	7.07
193	Control strips	3	144.10	10.09
194	Technet	2, 3, 4, 5	215.00	15.05
195	Control strips	3	244.85	15.74

The parties stipulated as follows with regard to the amount at issue:

"The parties are not in dispute over the audit methods or numbers derived therefrom but do dispute whether the tax can legally be asserted on the processes described in this proceeding."

Consequently, these Findings of Fact will not specifically address how the amount of tax asserted as due was calculated.

The parties stipulated that:

"[t]he following descriptions apply to the photo processing operation:

"a. There are six stages which comprise the operation for exposed, unprocessed film. They are called 'splicing', 'film processing', 'notching', 'printing', 'paper processing' and 'packaging'.

"b. For customers seeking 'reprints', there is no film processing stage at the time of making the reprints, since that had been done on a prior occasion. The reprint operation begins at the 'reprint station' where individual negatives are joined by the 'reprint laminator' to produce a continuous roll of previously processed negatives.

"c. The 'Splicer' connects individual rolls of film into a continuous reel of film. Each reel contains many rolls of customer film.

"d. The reel of film rolls connected by the splicer is used in four places:

- 1) in the film processor to permit making negatives;
 - 2) in the notcher to permit making the prints;
 - 3) in the printer, to permit high speed exposure of the raw paper;
- and
- 4) at the packaging station, to permit mechanized cutting, stuffing and packaging of the finished product.

"e. 'Film processing' refers to one portion of the process during which exposed film is converted into a negative. This operation takes place in a 'film processor' machine. Through chemical reactions . . . , materials are removed from the film as well as added to the film base to create the negative.

"f. 'Notching' is performed on 35 mm film after the film is processed, but before it goes to the printer. The 'notching machine' electronically makes physical cuts ('notches') into the side of the negatives. The notches serve as codes to the printer, which are also encoded onto the roll of paper, to provide instructions to the printer and packaging station to position the frame and to instruct the cutters where to cut the negative and prints. This information must be communicated to have the printer and packaging station properly operate

"g. 'Printing' follows the 'notching' and occurs in a machine known as a 'printer' In printing, light is passed through the negatives onto raw photographic paper to expose the paper to the same image that is contained on the negative. At the end of the printer, take-up reels pick up the negatives on one reel and raw exposed photographic paper on the other, which consists of over a thousand feet of paper per roll.

"h. The paper is processed in a manner similar to the processing of the film. This operation takes place in the 'paper processor' machine. After the paper has been processed, the paper is still on the continuous roll, and the negatives are still on a continuous reel, and they are brought together at the 'packaging station'.

"i. The 'packaging station' consists of machines and specially designed table operation centers which cut the exposed paper into individual prints, cut the reel of negatives (typically into four negative segments), mount the negatives into protective sleeves and packages the prints and negatives for further handling and delivery to the customer."

Petitioner offered the testimony of Bryan Galloway, an industrial engineer, who serves

as petitioner's senior director of corporate management services. Mr. Galloway gave his opinion that film processing represents the production of a new product, the negatives, rather than the servicing of a customer's film:

"A new product is created because the customer actually provides film, that if you were able to look at it, shows nothing of the image in [sic] which the person has taken a picture of. No color, no clarity of the image. It is through the chemical process that is provided by our facility and the chemicals that are added to that particular product that the image is then converted from a latent image into a negative, which then provides the opportunity to produce prints for a customer."

Mr. Galloway also testified that the processing of film into negatives and negatives into prints was "a continuous operation" made possible by the use of continuous rolls.

Petitioner introduced into evidence as its Exhibit "27" a copy of a technical book concerning the fundamentals of color photography, which provides a detailed analysis of the chemicals added as well as removed in order to develop exposed, unprocessed film into negatives. On page 21 of this text, the following tables summarize the "[s]tandard processing procedure of color negative film" and the "function of processing step", respectively:

<u>Number</u>	<u>Processing Step</u>	<u>Temperature (°C)</u>	<u>Time</u>	<u>Cumulative Time</u>	<u>Lighting</u>
1	Color development	37.8 + 0.15	3'15"	3'15"	Full dark
2	Bleaching	38 ± 3.0	6'30"	9'45"	Full dark
3	1st washing	18 ~ 42	3'15"	13'00"	Room lighting
4	Fixing	38 ± 3.0	6'30"	19'30"	Room lighting
5	Final washing	18 ~ 42	4'20"	23'50"	Room lighting
6	Stabilizing	38 ± 3.0	2'10"	26'00"	Room lighting
7	Drying	43 ~ 52	--	--	Room lighting

<u>Processing Step</u>	<u>Function</u>	<u>Affect on Photography Characteristics</u>
Color development	During this step, the silver halide exposed to light is reduced to metallic silver by a color developing agent. At the same time, the oxidized developing agent reacts with couplers to form dye images. This is the most critical step that requires careful control.	Sensitivity, Minimum Density, Contrast, Sensitivity balance, and Gamma balance, etc.
Bleaching	The metallic silver produced during color development is returned to silver halide. The colloidal silver	Contrast, Color turbidity and Minimum density

Fixing	in the yellow filter and anti-halation layers is also changed to silver halide. The silver halide left unexposed in the emulsion that was converted from metallic silver during the bleaching step is melted and removed from the film, leaving only clear dye images.	Color image stability, Minimum density
Washing	A lot of running water is used to wash the fixer and other chemicals away from the film.	Color image stability
Stabilizing	The couplers remaining unaffected by the reaction in the emulsion are made harmless. The film is further treated to prevent uneven drying and keep the pH of the emulsion coating stable during storage.	Patches, Color image stability

SUMMARY OF THE PARTIES' POSITIONS

Petitioner contends that the Division was incorrect to separate film processing from paper processing because "developing and processing the negative is one of the necessary steps in producing the photographic print." Petitioner argues that the "photofinishing process is continuous from the time the film enters the plant until it is ready for distribution." Petitioner uses the terminology of "single integrated operation" to describe its photo processing operation and argues that the "integrated plant rule" should be applied so that film processing (changing film into negatives) is not "broken out from" paper processing (changing raw paper into a finished picture). In the alternative, petitioner contends that film processing, in its own right, involves the creation of a new product, i.e., the negatives, so that the production exemption should apply to the film processing operation as well as the paper processing operation. Film processing does not merely service the customer's property, but rather produces tangible personal property.

Petitioner also contends that if it is determined that film processing was properly separated from paper processing for purposes of applying the production exemption, certain equipment (i.e., notchers, reprint laminators and splicers) was predominantly used in the printing/paper processing operation. Therefore, purchases of such equipment should be exempt from tax.

The Division concedes that the printing, processing and packaging of photographic paper represents the production of tangible personal property. However, the processing of film into negatives is a taxable processing service. Therefore, it considered "anything that dealt with the negatives . . . to be processing, and any of the equipment that dealt with the printing of the picture and thereafter we considered to be production." According to the Division, 20 NYCRR 527.4(d) expressly lists film developing as a taxable processing service. The Division relies on the reasoning of an Advisory Opinion issued to Photo Lab, Inc., dated February 9, 1989 (TSB-A-89[5]S), which noted:

"Petitioner develops a negative from film furnished by the customer. This process consists of passing the film through a series of tanks of chemicals in a processor. In these tanks, the latent image contained on the film becomes visible and fixed. This process results in a negative. Thus, Petitioner is not producing tangible personal property for sale to its customer since the film is already owned by the customer. Accordingly, Petitioner is providing a service that is subject to sales tax pursuant to Section 1105(c)(2) of the Tax Law. However, Petitioner's machinery and equipment used in such a process does not qualify for exemption under section 1115(a)(12) of the Tax Law because such machinery and equipment is not used to produce tangible personal property for sale."

CONCLUSIONS OF LAW

A. Tax Law § 1115(a)(12) provides, in pertinent part, that receipts from the sale of "[m]achinery or equipment for use or consumption directly and predominantly in the production of tangible personal property . . . by manufacturing, processing, generating, assembling . . . , but not including parts with a useful life of one year or less or tools or supplies used in connection with such machinery, equipment or apparatus" are exempt from sales and use tax.

B. In Matter of Deco Builders (Tax Appeals Tribunal, May 9, 1991), the Tribunal, in reversing the Administrative Law Judge, decided that the taxpayer's purchase of certain custom-made wooden staves later assembled on site into a penstock was exempt from sales tax as the purchase of machinery or equipment used directly and predominantly in the production of tangible personal property for sale pursuant to Tax Law § 1115(a)(12). The Administrative Law Judge had determined that although the penstock was machinery and equipment within the meaning of the statutory provision at issue, it was used to produce electricity which was used in the production process, and therefore its relationship to production was secondary and did not

have the "active causal relationship" to the product to be sold as required by 20 NYCRR 528.13(c)(1). To the contrary, the Tribunal held that the penstock was directly used in production as defined by the Division's regulation:

"The Division's regulation provides several alternative definitions for the term 'directly' (20 NYCRR 528.13[c][1]). The meaning which is relevant to the facts here requires that the machinery and equipment must, 'during the production phase of a process', 'have an active causal relationship in the production of the product to be sold' (20 NYCRR 528.13[c][1][ii]). The determination as to whether a particular piece of machinery qualifies for the exemption depends upon the peculiarities of a taxpayer's operation and must be individually assessed on its own fact pattern (Matter of Rochester Independent Packer, Inc. v. Heckelman, 83 Misc 2d 1064, 374 NYS2d 991, 993).

". . . [T]he penstock was a required element in the process of producing electricity at the Newton Falls paper mill. The electricity produced was used to run the machinery in the mill that made the paper. The Division argues that these facts show that the penstock's relationship to production was secondary to production and insufficiently 'active' because it did not actually operate on the paper or on materials used to form the paper. We find this to be a strained interpretation of the language of the regulation. Clearly, electricity was an essential and active part of production at the mill, (in fact, there would have been no production process without electricity) (see, Matter of T. V. Data, Tax Appeals Tribunal, March 2, 1989, [where a computer that produced commands that drove typesetting equipment, while not actually connected to the typesetting equipment, was found to be an integral and essential part of the production process and therefore, met the tests for exemption in 20 NYCRR 528.13(c)(1); see, also Matter of Niagara Mohawk Power Corporation v. Wanamaker, 286 App. Div. 446 [4th Dept. 1955], aff'd 2 NY2d 764, [where coal and ash handling equipment was found to be essential equipment to the production of electricity although this equipment did not produce the electricity])."

C. Similarly, in the matter at hand, the development of film into negatives was an essential and active part in the production of photographic prints. In fact, there would have been no production of photographic prints without such negatives. It is observed that petitioner established that its photo processing operation represented a single, integrated and continuous operation. As a result, it is determined that petitioner's development of film into negatives had an "active causal relationship" to the photographic prints to be sold.

D. The Division is correct that example 2 of 20 NYCRR 527.4(d) provides that the development of film by a photographic laboratory is a taxable processing service. However, it is observed that 20 NYCRR 527.4(d) elaborates on processing services which are subject to tax, and is not relevant to the issue at hand. Moreover, as noted above, Tax Law § 1115(a)(12)

exempts machinery or equipment for use in the production of tangible personal property by processing as well as by manufacturing (cf., Matter of Niagara Frontier Services, Tax Appeals Tribunal, August 9, 1990). As noted in Finding of Fact "11", petitioner established that in developing film into negatives (by processing), it created a new product. The "nature, shape, or form" of the exposed, but undeveloped film clearly has been changed (20 NYCRR 527.4[d]).

E. In Matter of Empire Vision Center (Tax Appeals Tribunal, November 7, 1991), the Tribunal reversed the Administrative Law Judge and decided that the purchase of a computer by Empire Vision Center was not exempt from sales tax because the computer was not used directly in the production for sale of tangible personal property:

"Here, there is a gap between the principal function of the Wang computer, i.e., to perform calculations and to produce instructions for the production of the eyeglasses, and the actual production of the eyeglasses."

As noted in Finding of Fact "10", the film processing stage was part of petitioner's continuous operation to produce photographic prints. There was no gap between the development of film into negatives and the production of photographic prints. It is observed that in Empire Vision Center (supra), the computer at issue was located at a central manufacturing center in Syracuse, physically far removed from the eight offices where eyeglasses were produced.

F. The petition of Qualex, Inc./Carhart Photo, Inc. is granted, and petitioner's claim for refund of the additional sales tax paid under protest, as detailed in Finding of Fact "4", plus interest, is granted.

DATED: Troy, New York
January 20, 1994

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE