

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition	:	
of	:	
<b>QUALEX, INC./CARHART PHOTO, INC.</b>	:	<b>DECISION</b>
	:	DTA No. 811122
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.	:	

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The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 20, 1994 with respect to the petition of Qualex, Inc./Carhart Photo, Inc., 3000 Croasdaile Drive, Dunham, North Carolina 27705. Petitioner appeared by Pattison, Sampson, Ginsberg & Griffin, P.C. (Michelle Santucci, Esq., of counsel) and Bullen, Moilanen, Klaasen & Swan, P.C. (Philip M. Moilanen, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta and Mary Rinaldi Hurteau, Esqs., of counsel).

The Division of Taxation filed a brief on exception. Petitioner filed a brief in opposition. The Division of Taxation also filed a reply brief. Oral argument was heard on September 22, 1994, which date began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner Koenig concurs.

***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***

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

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"),<sup>1</sup> 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.

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<sup>1</sup>The 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."

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.

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 processing racks]	3, 4, 5	350.75	24.55
45	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 <sup>2</sup>	2, 3, 4, 5, 7	277.50 277.50 3,028.50	19.43 19.43 212.00

160 <sup>3</sup>	Film cleaner	1B, 2	73.44	5.14
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

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<sup>3</sup>There 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;
- (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.

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	$37.8 \pm 0.15$	3'15"	3'15"	Full dark
2	Bleaching	$38 \pm 3.0$	6'30"	9'45"	Full dark
3	1st washing	$18 \sim 42$	3'15"	13'00"	Room lighting
4	Fixing	$38 \pm 3.0$	6'30"	19'30"	Room lighting
5	Final washing	$18 \sim 42$	4'20"	23'50"	Room lighting
6	Stabilizing	$38 \pm 3.0$	2'10"	26'00"	Room lighting
7	Drying	$43 \sim 52$	--	--	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 in the yellow filter and anti-halation layers is also changed to silver halide.	Contrast, Color turbidity and Minimum density
Fixing	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

### ***OPINION***

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 (emphasis added).

The Administrative Law Judge determined that:

"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" (Determination, conclusion of law "C").

On this latter point, the Administrative Law Judge distinguished Matter of Empire Vision Ctr. (Tax Appeals Tribunal, November 7, 1991) from this case stating that here "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" (Conclusion of Law "E").<sup>4</sup>

In his determination, the Administrative Law Judge also rejected the Division's assertion that since the development of film by a photographic laboratory is a taxable processing service under the Division's regulations (20 NYCRR 527.4[d]), the equipment used for processing the film could not be exempt as production equipment. The Administrative Law Judge stated as follows:

"[t]he 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])" (Determination, conclusion of law "D").

On exception, the Division asserts that:

"petitioner's operations involve two separate processes, the development of film into negatives and the production of prints from negatives. The evidence clearly shows that the operations are not integrated because petitioner's customers do not have to order prints when they place an

order for film processing, nor do the customers have to order film processing in order to obtain prints. In fact, the evidence clearly indicates

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<sup>4</sup>In Empire, we held 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. We focused on the fact that there was a gap between the principal function of the computer, i.e., to perform calculations and to produce instructions for the production of the eyeglasses, and the actual production of the eyeglasses.

that customers can, and in fact do, supply petitioner with negatives which have already been processed and request and pay for prints to be developed . . . petitioner can and does produce innumerable prints without ever engaging in film processing. The two processes are not in any manner dependent upon one another nor would the ceasing of one of petitioner's processes seriously or even slightly impair the other because petitioner can solely process film or produce prints from negatives" (Division's brief, pp. 14-15).

Petitioner asserts that the Administrative Law Judge correctly concluded that film processing is the production of property for sale.

We affirm the determination of the Administrative Law Judge.

The critical question is whether petitioner's film processing equipment was used directly and predominantly in the production of photographic prints. Directly and predominantly means that the machinery or equipment must, during the production phase of a process, either act upon or effect a change in material to form the product to be sold, or have an active causal relationship in the production of the product to be sold (20 NYCRR 528.13[4][c][1][i] and [ii]). Machinery and equipment is used predominantly in production, if over 50 percent of its use is directly in the production phase of a process (20 NYCRR 528.13[4][c][4]). Production includes the production line of a plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished and packaged for sale (20 NYCRR 528.13[4][b][ii]).

Guided by the principle that a taxing statute should receive a practical construction (Matter of Niagara Mohawk Power Corp. v. Wanamaker, 286 App Div 446, 144 NYS2d 458, affd 2 NY2d 764, 157 NYS2d 972), we conclude, as did the Administrative Law Judge, that the equipment used in the film processing portion of the production line is directly and predominantly used in the production of the photographic prints. The critical fact here is that, in order for the film to be processed into photographic prints, the exposed film must first be processed into negatives. In short, and as the Administrative Law Judge found, the processing of the film into negatives is an essential and active part in the production of photographic prints. It is also clear that petitioner's production line encompasses the equipment needed to process the film and produce the prints. In fact, nearly 100% (99.50-99.75 percent) of the exposed film

delivered to petitioner went through the entire production line, i.e., was processed from exposed film into negatives and into photographic prints. Thus, contrary to the Division's assertion, the cessation of either process would preclude petitioner from providing the service it furnishes to 99.50-99.75 percent of its customers, i.e., the development of film into photographs.

Finally, petitioner's use of the concededly exempt photo processing equipment to produce prints from "other negatives," i.e., film not processed by petitioner, does not alter the fact that petitioner's film processing equipment is part of petitioner's production line and is used directly and predominantly in the production of prints.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Qualex, Inc./Carhart Photo, Inc. is granted; and
4. The claim for refund of additional sales tax paid by Qualex, Inc./Carhart Photo, Inc. is granted.

DATED: Troy, New York  
February 23, 1995

/s/John P. Dugan  
John P. Dugan  
President

/s/Francis R. Koenig  
Francis R. Koenig  
Commissioner