

M e m o r a n d u m**515.0689**

To: Hollywood – Auditing (JKG)

March 7, 1974

From: Tax Counsel (GJJ) – Headquarters

Subject: The T--- M--- Company
T--- M--- PressSR -- XX XXXXXX
SR -- XX XXXXXX

This is in response to your memorandum of November 27, 1973.

In the process of auditing the referenced taxpayer, two problems have arisen which involve legal interpretations. The first concerns press plates made and used in California to print telephone directories which are shipped out of state. The other problem involves a contract for photo composition services. Although both problems concern the same customer, W--- E--- Co., and both concern the printing of telephone directories, the problems are not related and will be considered separately.

Press Plates

The taxpayer has a contract with W--- E--- to print telephone directories for an out-of-state subsidiary, M--- B---. The directories are printed in Los Angeles. Standard provisions of the contract state that title to the plates priced in the contract passes to the customer upon manufacture. You have questioned the charges for the press plates as possible sales and use of the manufacturing aids in California, including applicable composition charges.

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The “Standard Provisions,” drafted by W--- E---, provide as follows:

DEFINITION OF PRINTING MEDIA.

“PRINTING MEDIA. - - The term ‘printing media’ as used herein includes: type, molds, proofs, engravings, negatives and plates. Printing media shall be kept in good condition (adequate to provide uniform printing impressions of a quality satisfactory to us) with replacement of

worn (except for normal wear of printing media furnished by us without charge) or damaged printing media as required, all without extra charge.

“We shall have the right to purchase any or all standing type upon twenty-four hours notice at any time during the term of or upon the termination of this contract at the then current market price of metal of the grade, quality and net weight involved in the purchase. The current market price shall be understood to be the price of the metal in the city of your plant as of the date we notify you of our intention to purchase and shall be evidenced in part by a quotation in writing from your source of supply for linotype metal of the same analysis.

“We shall have the right to remove from your premises any or all printing media priced herein, including any or all type purchased, upon a) the occurrence of any cause, including but not limited to those listed in the section “Contingency,” which would prevent you from producing in accordance with the contract schedules or b) the termination of this contract. Upon demand, you shall deliver such printing media to us, in accordance with our instructions, properly wrapped and packed, invoicing us for applicable costs, if we have not previously paid for such printing media, as established by agreement of the parties. The expense of wrapping and packing shall be established by agreement of the parties and invoiced to us. If we request you to ship the printing media to us, shipment shall be made f.o.b. city of your plant with transportation charges prepaid and invoiced to us. Printing media shall be delivered in good condition.

“In the event that we shall purchase standing type pursuant to our right to have work produced elsewhere, as provided above, it is understood that at the time you resume production of our work you shall have the right to repurchase, and we shall sell and deliver, such type at the same price, and upon the same terms and conditions, as the price paid to you.

“Printing plates (or the molds, negatives, acetate proofs or reproduction proofs from which they are made, when it is impractical to reuse the printing plates for any reason) of any issue of a subscriber directory shall be stored by you without extra charge in a manner satisfactory to us until the delivery of the next issue.

“All type (including electrotypes or engravings of advertisements or parts thereof such as emblems and foundry type) used in the production of any

directory shall be held standing by you between issues. You shall make such changes in type as we may direct.”

TITLE

...

...

“Except as otherwise provided, title to printing media priced herein shall vest in us as they are manufactured. Title to printing media furnished to you without charge shall remain in us and such printing media shall be returned to us upon our request.”

With respect to W--- E--- Company Contract -- - XXX - -, the relevant pricing provisions are as follows:

<u>Electrotyping</u>	<u>Price</u>
“Alphabetical pages, per page	\$ 5.40
Classified pages, per page	5.40
Miscellaneous, Area Code Call Guide, and Area Street Guide Pages*, per page	5.40
Civic Section, per page	10.80

*Prices shown are applicable when miscellaneous, Area Code Call Guide, and Area Street Guide pages are part of alphabetical or classified sections.”

“Miscellaneous electrotypes and engravings when furnished by you are to be billed to us at prices to be mutually agreed upon.”

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The factual background in this case has been described by the attorneys for taxpayer’s customers, W--- E--- and Mountain States, as follows:

T--- M--- prints telephone directories for M--- B---. The directories are printed in Los Angeles, California, and are all immediately shipped directly to M--- B--- facilities located outside California.

T--- M---’s work for M--- B--- represents an ongoing printing operation involving the printed of basically two separate products. First, there are interim directories, termed “Monthly Reports,”

that are used by information operators and which reflect the deletion and additions of telephone subscribers on a monthly basis. Second, there are the annual subscriber directories. Only the latter involve the manufacture of metal press plates.

The printing services performed by T--- M--- for M--- B--- involves two phases: the composition process and the plate making process.

A. The Composition Process

The composition process involves the purchase, fabrication and typesetting of standing type by T--- M---. Purchased standing type consists of that type which T--- M--- purchased from W--- E--- in 1969 when T--- M--- obtained the present contract, as well as type purchased from W--- E--- on an ongoing basis. This latter represents type manufactured and used by various local printers for printing daily inserts for use by M--- B--- information operators. This practice is necessary because M--- B--- is required to provide its information operators with the names and telephone numbers of all new subscribers on the day following the installation of a new telephone. For time reasons, it would not be possible for M--- B--- to transmit to T--- M--- the information regarding new subscribers and for T--- M--- to prepare the standing type, print the new subscriber list and furnish a new list to M--- B--- within a one-day period.

Some standing type used in preparing directories for M--- B--- is manufactured by T--- M--- on its linotype machines. It is prepared based upon information which M--- B--- provides to T--- M---.

The balance of the composition process involves typesetting, i.e., insertion and deletion of standing type. New type, whether purchased or manufactured by T--- M---, is simply inserted alphabetically into a galley. M--- B--- also furnishes T--- M--- with copies of directory pages that have the names of deleted subscribers lined out. These pages are used by T--- M--- in removing from the galleys standing type representing deleted subscribers. As this type is removed, it is melted and reused by T--- M---.

The composition process also involves the preparation of paper and acetate press plates on the proof press. The paper press plates are used to print the monthly reprints. These plates are not reusable. The acetate plates represent an interim step in the manufacture of a metal press plate.

B. Plate Making Process

T--- M--- presently utilizes two basic printing methods in producing M--- B--- directories. One such method involves the letterpress technique and the other the offset technique. Both processes utilize metal press plates, but the cost of the raw materials and the number of plates necessary to print a given number of directory pages differ substantially between the two methods.

The letterpress method begins by photographing a reproduction proof to obtain a page negative. The page negatives are then exposed to zinc or magnesium plates that have been presensitized with a photo-sensitive coating. Under exposure to an arc light the coating is hardened in the areas representing the printing so as to resist an etching solution. After this exposure, the plates are placed in an etching solution which produces a relief image of the type and/or the illustrations on the page. This operation is completed by beveling, curing, and mounting the plates on metal saddles to bring them to the required plate thickness for use on a press. Each plate represents two pages of a telephone directory.

The offset press plates also require a page negative similar to that required in the letterpress process. However, because an offset press plate represents 96 pages of a directory, 96 full page negatives are assembled and exposed to a single photo-sensitive offset plate. The plates are developed after exposure and given a slight etch in the non-printing areas so that water will adhere thereto. Completed plates are coated with a solution to protect the plate from oxidation prior to printing.

Whether a letterpress or offset press is involved, the plate making process does not begin until immediately prior to the time that the annual directory is to be printed. Annually, after printing the requisite number of each directory, T--- M--- sells the prior year's press plates as scrap and retains whatever revenue it obtains. T--- M--- does not give M--- B--- credit in any form for the revenues thus received.

M--- B--- alleges that T--- M--- carries the metal used in manufacturing letterpress and offset plates as an inventory item. The records show, however, that as this metal is used, it is charged out of inventory to job costs. T--- M--- has generally paid a sales tax on the metal it purchases. However, T--- M--- has on occasion purchased metal without paying a sales tax. T--- M--- initially treats the revenues received from the sale of the scrap press plates as waste sales income. On the consolidated financial report of its parent corporation, T--- M--- Company, these revenues are reflected as a reduction in the cost of directories sold.

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The central question is: Are the metal plates in question "printing media priced herein" within the meaning of that phrase as it is used in the "title" clause of the "Standard Provisions" quoted above?

We think it clear that the term "printing media" includes both letterpress and offset printing plates.

The difficult issue is whether the plates are “priced herein.” The pricing provisions of the contract are broken down into the categories “composition and proofreading,” “electrotyping,” “presswork,” “covers,” “machine binding,” “miscellaneous bindery operations,” “paper,” etc.

The term “electrotyping” seems to cover the preparation of the letterpress and offset plates in question, although strictly speaking “electrotyping” refers to a method of making metal duplicate plates for use in letterpress printing.

The question resolves itself into one as to whether the charges specified in the pricing provisions are charges for the metal press plates as items of property or charges for labor, services, materials, pro rata overhead, etc., related to one phase of the overall production contract, the object of which is the annual directory.

M--- B--- argues that the price schedule does not “price” the plates, it only provides a method for calculating the total price charged for the various printing services involved in manufacturing a given directory. The incremental charges for a particular printing service listed in the Price Schedule do not vary among the various directories printed by T--- M--- pursuant to the Agreement, but the amounts of a particular service necessary to complete a given directory, and hence total printing costs, do vary. For example, two identically sized directories may differ substantially in their total cost if one has significantly fewer subscriber changes, and thus a lower composition cost. Further, the Agreement permits T--- M--- in certain circumstances to pass on increased labor costs. When this occurs the incremental charge for particular printing services listed on the Price Schedule may be increased. The price schedule must therefore be organized along labor classifications so that appropriate price changes can be made.

M--- B--- argues, in summary, that the price schedule lists various printing services or labor classifications so that both the total printing charge for a directory can be calculated and any wage increase translated into an appropriate Price Schedule change; but, it does not list or price particular items of printing media.

The nature of this argument is brought out upon examination of the sections of the “Standard Provisions” dealing with “standing type.” It is clear that the contract price for the standing type includes basically service costs only, since M--- B--- can acquire title to the standing type at the current market price of the metal contained in the type, that is, by paying the materials cost only.

While the issue is certainly a close one, we can find no adequate basis for concluding that the contract specified other than what both parties to the contract now contend -- that title was to pass only to printing media “priced” in the contract and that the press plates in question were not “priced” in the contract. The manner in which The T--- M--- handles the metal used in the obsolete plates, selling it for its own account, while not conclusive, is supportive of M--- B---’s

position. It would follow, of course, that T--- M--- should pay tax with respect to its purchases of metals used in the plates, which it apparently has not done in every case.

Photo Composition Services

T--- M--- has a contract with W--- E--- which provides for processing of magnetic tape copy furnished by the telephone company and for photo composition production materials (film, chemicals, paper, and paper plates, etc.).

During the early stages of the contract, the program involved research and development of the photo composition method of reproduction. No use was made of the photo composition production materials produced in this period.

At this time telephone directories were being printed by hot metal composition method. As the program progressed, T--- M--- began using the newly developed procedure to print parts of the directories. Finally, in 1972, the entire directory was printed using the photo composition method.

Time Mirror had billed and reported tax on all charges accruing from this contract from its inception. Taxpayer now believes that the tax was improperly applied to the research and development stage of this contract and is requesting a refund of tax for this period. T--- M--- will, of course, return this money to W--- E--- if claim is upheld.

We are of the opinion that the refund should not be granted. The contract in question [W--- E--- Co. --- XXX - -] calls for the production of:

“Photocomposition of pages to be used as direct or indirect printing source for subscriber telephone directories, traffic information records and other directories or documents as ordered by us from January 1, 1968 to December 31, 1972, inclusive.”

The monthly processing charge, initially \$40,690, included as a cost element “Development costs write-off.” This was one of seventeen cost elements included in the monthly processing charge. The monthly charges covered the processing of up to 100,400 photocomposed pages per calendar year. In addition, photocomposition production materials (chemicals, film, paper, paper plates, etc.) were billable to W--- E--- at taxpayer’s cost. Under the circumstances of this contract tax applies to the full contract price without a deduction for the developmental costs. [Regulation 1501 “Service Enterprises Generally.”]

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