



STATE BOARD OF EQUALIZATION

To : Mr. Glenn Bystrom

July 10, 1996

From : Gary Jugum

Subject: Non-Attorney Opinions

I have reviewed Principal Tax Auditor's memorandum of April 22, 1987 to Santa Barbara District Principal Auditor.

We are in agreement with his conclusion as follows:

X-Rays. Where a manufacturer chooses to x-ray its product to detect defects, the manufacturer is the consumer of the film even though the x-ray is subsequently sold with the product. Where the x-ray is taken only upon the buyer's request, the film may be purchased for resale even though it may incidentally be viewed to detect defects.

4/22/87

Santa Barbara District Principal Auditor

April 22, 1987

Principal Tax Auditor

X-----,

On April 5, 1985, I wrote to the Law Offices of X----- regarding the general application of tax to X-Rays produced and sold by their client X----- --.

That letter became a part of our Internal Tax Correspondence file and was subsequently used as a basis for disallowing purchases of X-rays for resale, in the audits of X----- ----- . Both these audits were petitioned on the grounds that the primary purpose for purchasing such X-rays was to fulfill the customer's purchase order and not to routinely detect manufacturing defects. Such purchases were allowed in the prior audit and petitioner claimed that it was now unfair for the Board to change its interpretation (copy of October 29, 1986 petition attached).

The purpose of this memorandum is to make it clear that my letter of April 5, 1985 (copy attached), was not intended to change or supersede the interpretation provided in Annotation 420.0700. In the case of X-----, I explained that the mere fact that the X-ray is sold along with the tank or vessel does not in and of itself exempt the sales of the X-ray to the manufacturer as a sale for resale. As I stated, the application of tax is "...contingent upon the customer's intended use of the X-ray."

Where a manufacturer chooses to routinely X-ray its products to detect defects, I remain of the opinion that the manufacturer is the consumer of the film, even though the X-ray may be subsequently sold along with the product. However the application of tax becomes less clear where the X-ray's are not routinely used as a quality control tool by the manufacturer, but rather, are ordered only upon the purchaser's request and, may or may not be incidentally viewed to spot check a weld or seam. As is often the case, we must distinguish the facts of each case and make a determination based on the merits of each.

I have noted that X----- closed out its permit December 12, 1985, and subsequently took out a new permit (X-----) on January 1, 1986. Please contact this taxpayer and inform them of this further clarification to my letter of April 5, 1985.

If you have any questions regarding this matter please let me know.

GAB:gjm
Attachment (2)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

In the Matter of the Petition for
Redetermination of State AND Local
Sales and Use Tax

Petitioner.

DECISION AND RECOMMENDATION

In the matter of the Petition for
Redetermination of State and Local
Sales and Use Tax

Petitioner.

The above-entitled matters came on regularly for hearing on Wednesday, October 29, 1986, in Arcadia, California before Robert H. Anderson.

Appearing for Petitioners: X-----
X-----
X-----

Appearing for the Board: Mr. John Duncanson
Auditor
Arcadia District

Mr. Ronald J. Swenson
Auditor
Arcadia District

Protest

Petitioner, X----- was audited for the period from 1-1-83 through 12-31-85, and a notice of determination was issued on August 28, 1986.

Petitioner, X----- was audited for the period from 1-1-82 through 12-31-84, and a notice of determination was issued on April 4, 1986.

Counsel for both petitioners filed petitions for redetermination which are in the respective petition files. Petitioners protest the assessment for use tax on ex-tax purchases of X-ray film audited as consumed on commercial contract jobs. The measure of tax is:

X-----: \$484,331 X-----: \$491,628

Contentions

Petitioners contend that the x-ray film was resold in the regular course of business without having been used as manufacturing aids as the auditors have concluded.

Petitioners contend that in prior audits the purchases of x-ray film have been recognized and allowed as purchases for resale.

Summary

Petitioners are related divisions of X----- . X----- is a subsidiary of X----- . In 1974, prior to a reorganization, both X----- and X----- were one company under a single management organization. Later they became two separate divisions of X----- . The divisions manufacture castings for various customers. The essential difference between the two manufacturing activities is that X----- does investment casting, a "lost wax" type of process, and X----- is X-----'s largest customer, which purchases castings for custom jet engines.

X----- does "sand" casting; its largest customer is X----- which purchases X----- parts, etc.

The fact that the two divisions were once one company under a single management is important to the question of having been advised by the Board that their purchases of raw, unexposed, x-ray film for resale could be made without incurring use tax liability, a question that arose in an audit of the company back in 1974.

As noted, in these matters two petitions were filed, one for X----- and one for X-----, they are identical as to the arguments made, the pertinent facts stated, and the authorities cited.

Petitioners fabricate and sell metal castings which are used in aircraft and missile construction. The selling prices of the castings range from less than \$100.00 per unit to several thousands of dollars per unit.

Some of petitioners' customers not only require petitioner to fabricate the castings they purchase in accordance with precise specifications, they also require petitioners to perform radiographic inspections and to deliver exposed x-ray film along with the castings. The x-ray technique that is used by petitioners for each customer is spelled out or specified by the customer. Each customer has different requirements such as the number of castings to be x-rayed and the number of pictures to be taken of a given casting, and even the angles from which they are to be taken. Some customers require every casting to be x-rayed; others require only a representative sample, such as one in every ten castings.

It is understood that the x-rays are permanent evidence of the casting itself so that, for example, in the case of an aircraft accident, the x-rays are evidence of whether or not there might have been some structural failure attributable to the casting itself.

Some of petitioners' customers do not require any radiographic (x-rays) inspection of castings purchased, and where this is the case petitioners do not perform any x-raying of the castings. Petitioners have submitted examples of purchase orders calling for radiographic x-ray evidence of the castings to be made and furnished with the castings and to be identified with the specific castings.

As noted, petitioners perform radiographic inspection only when the customer specifically orders it and wants it delivered with the casting purchased. Where x-raying is so required, the charge for the exposed film is included in the price charged for the castings. No separate amount is stated for x-rays on the invoices even though they are called for on the purchase order for the castings.

When petitioners perform radiographic inspection in accordance with the customer's specific orders and requirements, the exposed film must be examined by petitioner to make sure that it satisfies the customer's requirements. This process will also disclose, on occasion, certain types of manufacturing defects in the x-rayed castings, if they exist. When that occurs the defects must be corrected and the exposed x-ray film is discarded. Petitioners contend that use of the film is purely incidental to the primary purpose for which the film was purchased.

The primary purpose is to supply x-ray pictures to the customer as per the purchase order and as an integral part of what the customer is buying; i.e., not only castings, but x-ray pictures which are related to specific castings as evidence that the castings were manufactured to the customer's specifications and are free from defects. Petitioners' customers then resell both the castings and the x-ray certification pictures.

Petitioners contend it is significant to note that the customers who order x-ray pictures to be furnished with the castings consider the quality of the pictures delivered to be of crucial importance. If the pictures do not meet the customer's specifications, they may, and have in the past, been rejected by the customer even though the castings have passed all inspections in petitioners' manufacturing process. Petitioners submitted a letter dated July 18, 1985 from one customer, X-----, to illustrate this point; X----- rejected the x-ray pictures.

Petitioners point out that in the present audits the Board auditors took the position that petitioners make use of x-ray film as a manufacturing aid prior to delivery to their customers since the x-rays are used to detect defects in the manufactured parts. Petitioners note that this same position was taken by the Board in an audit of petitioners, over ten years earlier, when the two divisions were one company. However, on a petition for redetermination the Board conceded that it was incorrect. In support of this fact petitioners presented four exhibits which are a series of letters exchanged between petitioners and the Board setting forth their respective positions, on the issue, in the prior audit.

Back in 1974-1975 petitioners relied on a sales tax counsel opinion dated October 13, 1964 which was, and still is, analogous to petitioners' situation. The tax counsel opinion is published in Business Taxes Law Guide as annotation number 420.0700; it reads as follows:

X-ray film purchased for resale, exposed and identified with specific footage of welded tubing used in missile and aircraft construction is not subject to use tax when sold with the tubing for resale, pursuant to specific orders from the customer.

Petitioners point out that at first the Board's contrary position was stated by Tax Counsel in a letter dated October 7, 1974, as follows:

In any event, it does appear that X----- makes a use of the film before it sells it to the customer. The inspection of the casting makes the film a manufacturing aid for the production and sale of the casting. In addition the inspection allows to specifically extend a guaranty that the castings are sound. We cannot see that these uses constitute a use incident to the sale of that film. It is incident to the sale of the castings. That is why it appears to us that the use of the film is subject to tax even if it is later sold to customers. If the film were simply exposed and developed and shipped along with the castings as part of the agreed contract of sale, then the disposition would appear to us to be a use incident only to the sale of the films.

Petitioners point out that in the audit ten years ago the Board, by letter dated 12-6-74, attempted to distinguish the 10-13-64 tax counsel opinion by contending:

In that case there is no indication that the tubing manufacturer used the x-ray photos to inspect the tubing to decide upon shipment or as a basis for the extension of any specific or general guaranty. The sole described disposition of the film was shipment; the sale of the film was an express subject of a contract of sale; the film did not appear to support the manufacture of the tubing. I would suppose the buyer did his own inspections.

After receiving petitioners' arguments in reply to the foregoing distinction, Tax Counsel on 3-27-75 ruled as follows:

After carefully considering your arguments and the materials presented under this petition, it appears to me that the questioned x-ray films should be considered to have been held solely for resale (along with the castings) by X-----.

Petitioners point out that tax counsel went on to state that petitioner was required to submit proof that its customers resold the pictures along with the castings in the regular course of business. Petitioners state that proof was subsequently supplied by petitioner to the satisfaction of the Board, thus petitioner prevailed on its 1975 petition for redetermination.

Petitioners have since relied on the 1975 ruling and are still selling x-ray exposed film pictures of castings in the same way and for the same reasons as they were when both divisions were one company.

The facts in the 1975 petition were allegedly brought to the attention of the auditors who made the current audits of X----- and X-----, but the audit staff allegedly indicated it no longer had the case and suggested that the facts should be raised in the petitions for redetermination. The auditors indicated that they disallowed the sales for resale in the respective audits because of a letter written on 4-5-85 by the Principal Auditor to the Santa Barbara District office of the Board. A copy of that letter is in the petition file, and we will comment on it under our Analysis and Conclusions to follow.

In any event, petitioners now submit that it is unfair for the Board to change its interpretation of the law and facts and then apply the changed interpretation retroactively. Particularly, where, as in this case, petitioners have been relying on a ruling expressly in its favor on the exact same facts and issue as in the 1975 petition for redetermination.

Petitioners contend that its use of x-ray film is governed by the Board's Regulation 1528(b)(3)(C) which reads as follows:

(C) X-ray Laboratories. Producers of x-ray films or photographs for the purpose of diagnosing medical or dental conditions of humans, excluding such films and photographs used only for cosmetic purposes, are the consumers of materials and supplies to laboratories producing x-ray films or photographs for the purpose of such diagnoses. Whether the laboratory is a "lay laboratory" or is operated by a physician, surgeon, dentist or hospital is immaterial. Producers of x-ray films or photographs for any other purpose such as inspection of metals, welds and similar purposes are retailers of the films or pictures, and tax applies to the gross receipts from the retail sale thereof. If, however, an x-ray laboratory contracts to furnish an x-ray inspection service, retaining title to and possession of the x-ray or pictures produced, charges for the performance of such an inspection service are not subject to tax.

Petitioners contend the regulation says that anyone who produces and sells x-ray films or photos for the purpose of inspection of metals and similar purposes is a retailer of the films or pictures, as distinguished from a consumer of the film used in the production. Petitioners contend that this clearly applies to them. Also, since petitioners' sales of the exposed films are themselves for resale by petitioners' customers along with the castings to which they relate, petitioners are not liable for any sales tax on the sales to their customers.

Petitioners also contend that the audit staff's contention, in the audits of X----- and X-----, is contrary to the Tax Counsel Opinion dated 10-13-64 and the Board's ruling in the 1974-75 petition for redetermination discussed above. Petitioners contend that those rulings recognized that where the exposed x-ray film is identified with specific manufactured goods and was specifically ordered by the customer for resale

along with the manufactured goods to which it relates, the manufacturer/producer's use of the film for that purpose is not a taxable use. Any use made of the film to detect and correct defects in the manufactured goods is purely incidental to the sale of the x-rayed goods and their related x-ray pictures. Hence, the primary purpose for the purchase of the film by petitioner was to resell it as tangible personal property, and not to use it as a manufacturing aid. Petitioners point out and argue that the "primary purpose" test is controlling and they cite Kaiser Steel Corp. v. State Board of Equalization, (1979) 24 Cal.3d 188, 192-193.

Also, petitioners contend that the x-ray film, which petitioners deliver to their customers, is nothing like the items given as examples of manufacturing aids in Regulation 1521.1, "dies, patterns, jigs and tooling". Those items are actually used to manufacture goods, and while they can be used again to manufacture more goods of the same type, they are of no further use in connection with any of the goods after they have been manufactured. In contrast, each x-ray picture delivered by petitioners to their customers is identified with and relates to only one specific casting and it provides certification, guaranty and evidence that the particular casting was manufactured in accordance with the customer's specifications and is free from defects. That is the very purpose for which the customer ordered the x-rays and they are resold by the customer along with the castings to which they specifically relate, for that same purpose. Accordingly, the x-ray films produced and delivered by petitioners are far more analogous to components of the castings to which they relate, than they are to manufacturing aids.

In summary, petitioners say it is significant to note that radiographic inspection is not part of petitioners' own quality control procedure. Petitioner does not routinely x-ray all of its castings to inspect them for possible defects. It only performs radiographic inspection when it has been ordered by the customer, and even then it is performed only in accordance with the customer's precise specifications. Therefore, the primary purpose of petitioners' radiographic inspection is not to aid its own manufacturing process; instead, it provides the customer with a form of certification for those parts which the customer ordered to be inspected, and that certification will follow those parts to the ultimate consumer. The fact that some amount of film may be scrapped in the process, because a particular casting is defective and scrapped or reworked and must be x-rayed again for whatever reason, does not make the film taxable to petitioner; citing Kaiser Steel Corp., supra.

Analysis and Conclusions

As we see it, there is no question about the fact that the only purpose, and therefore the primary purpose petitioner purchases x-ray film is to fulfill the customer's purchase order. The film, after exposure, directly, only and forever relates to the casting which was photographed; it is intended that it follow the casting always.

Any film, which we understand is very small percentagewise, that is discarded because the casting is deemed defective or because the photograph is not in accordance with what the customer wants is more in the category of a production loss, and analogous to

production line quality control which was the subject of a tax counsel opinion annotated on 6-4-64 in Business Taxes Law guide at 570.1400; it reads:

Items selected from a production run for high quality testing, a greater degree of testing than is normally used for quality control, entail no tax consequences and are treated as a production loss the same as quality control test samples or defective items which are removed from the production and destroyed. The theory is that production involves certain losses and that items removed from production are not really self-consumed by the taxpayer.

A defective casting automatically makes the x-rayed picture of it defective and both are losses involved in their production. Thus, items (film and castings) which have to be discarded are not self-consumed by petitioners~.

The auditors conceded that if it were not for the 4-5-85 letter from the Principal Auditor, and the interpretation of what it says, this controversy would not have arisen.

We have analyzed the 4-5-85 letter to see if it was meant to overrule or supersede the 10-13-64 tax counsel opinion since it distinguishes the opinion with the facts of the inquiry giving rise to the letter. The underlying basis for taxing radiographs in the letter dated 4-5-85 is a conclusion that x-rays used primarily to check the product, prior to being sold, are subject to use tax and may not be purchased for resale. We agree, but that is not the reason X----- and X----- purchased x-ray film for resale. The letter does not discuss tax aspects where the customer specifically orders the x-raying of the product being purchased, and also wants the x-ray picture of it as well as the product. The letter provides that the question of whether a company can properly accept a resale certificate (for the sale of x-ray film) is contingent upon the customer's intended use of the x-ray, and herein lies the distinction between the ruling in the letter and petitioners' situation.

Petitioners' intended use is to fulfill the purchase order by purchasing and exposing the film to the specific casting ordered, and if both are not defective, to sell both. Where both are defective it is an ordinary, unintended, production loss not subject to tax.

The x-ray film purchased by petitioners was properly purchased ex-tax for resale and was resold in the regular course of business without having been consumed by petitioner in the process.

Recommendation

Redetermine both determinations and delete the protested item in each.

Robert H. Anderson, Hearing Officer

Dated



STATE BOARD OF EQUALIZATION

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Fourth District, Pasadena

KENNETH CORY
Controller, Sacramento

DOUGLAS D. BELL
Executive Secretary

April 5, 1985

X-----

Dear X-----,

Your letter of February 20, 1985, to the Board's Santa Barbara office, has been forwarded to me for reply. You ask whether your client, X----- could properly accept a resale certificate from purchasers who claim to be reselling radiographs along with the metal tanks or vessels they produce.

Section (a) of Regulation 1528, "Photographers, Photostat Producers, Photo Finishers, and X-Ray Laboratories, copy attached, explains that the application of tax is contingent upon the object of the contract between the X-Ray producer and its customer. Where an X-Ray laboratory contracts to furnish an X-Ray inspection service, retaining title to and possession of the X-Ray or pictures produced, charges for the performance of such an inspection service are not subject to tax. Where the object of the contract is to supply the film or picture, the producer is a retailer and tax applies to the gross receipts from the retail sale of the X-Ray.

In your client's case, you indicate that the X-Rays are generally sold to manufacturers who are required to sell the radiograph along with their product to substantiate the product's compliance with state and federal safety codes.

Whether X----- can properly accept a resale certificate from such customers is contingent upon the customer's intended use of the X-Ray. Where an intervening use will be made by the purchaser prior to reselling the X-Ray, tax would apply to their purchase from your client. Tax would also apply to the X-Rays' subsequent sale.

A manufacturer's purpose in purchasing your client's X-Rays could be twofold. First, to satisfy that their products meet state and federal safety guidelines and are, therefore saleable; secondly, to serve as proof of such compliance. Should the X-Ray identify any defects, the manufacturer would probably make the required repairs and have the item X-Rayed again.

Sales and Use Tax Regulation 1525, "Property Used In Manufacturing," copy attached, explains that tangible personal property is regarded as having been purchased for the purpose of use in manufacturing tangible personal property and not for the purpose of being physically incorporated into the manufactured article to be sold, if the property is first utilized as an aid in the manufacturing process prior to being resold as an end product. If your client's customer will use the radiograph prior to its subsequent sale, the customer

cannot properly issue a resale certificate to your client, and if X-----knows that the radiograph will be so used, it cannot in good faith accept a resale certificate.

You cite Sales and Use Tax Annotation 420.0700 as support for not taxing the sale of X-Ray film when it is purchased for resale and sold with an end product. The full analysis of this annotation further explains that if the film is used by a manufacturer to check welds, etc., prior to being resold, the purchase is subject to tax. Only if the manufacturer makes no intervening use of the X-Rays may the property be purchased for resale.

In summation, your client is not prohibited from selling radiographs for resale. However, such X-Rays are generally considered to be used as taxable manufacturing aids by manufacturers, even though they may eventually be resold. If purchasers insist that no use will be made of the radiographs, your client may accept a specific resale certificate, but should insist that under the description of the item sold, the purchaser state that the specific property is being purchased for resale in the regular course of business. See Regulation 1668, "Resale Certificates," Section (d), copy attached.

You also indicated in your letter that there is an apparent inconsistency in the Board's enforcement of the laws governing X-Ray laboratories, placing your client at a competitive disadvantage. We are unaware of such a problem and ask that you supply us with any information that you have so we can ensure the tax is being consistently applied.

Should you have any further questions or need further assistance, please let me know.

Sincerely,

Glenn A. Bystrom
Principal Tax Auditor

GAB:jb
Enclosures (3)

Cc: Santa Barbara - Auditing

