

**STATE OF NORTH CAROLINA**

**BEFORE THE  
SECRETARY OF REVENUE**

**COUNTY OF WAKE**

**IN THE MATTER OF:**

The Proposed Assessment of Sales and Use )  
Tax for the period November 1, 2001 through )  
October 31, 2003 by the Secretary of )  
Revenue of North Carolina )  
 )  
 )  
 vs. )  
 )  
 [Taxpayer] )

**FINAL DECISION**  
**Docket No. 2004-304**

This matter was heard before the Assistant Secretary of Revenue for Administrative Tax Hearings, Eugene J. Cella, in the City of Raleigh, on July 27, 2004, upon application for hearing by the taxpayer wherein it protested the proposed assessment of tax, penalty and interest for the period November 1, 2001 through October 31, 2003. The hearing was held by the Assistant Secretary pursuant to the provisions of G.S. 105-260.1. Representing the Sales and Use Tax Division were W. Timothy Holmes, Assistant Director, and W. C. Shelton, Administration Officer. The Taxpayer was represented by [attorney], attorney for the Taxpayer, and [three representatives of the corporation].

Pursuant to G.S. 105-241.1, the Department mailed a Notice of Sales and Use Tax Assessment to the Taxpayer on March 16, 2004 assessing tax, penalty and interest in the amount of \$46,301.99. The Taxpayer objected to the proposed assessment in writing on April 5, 2004 and timely requested a hearing.

**ISSUES**

The issue to be decided in this matter is as follows:

Are photographs, photography supplies, transparencies, negatives and other items subject to sales and use tax when they are purchased by the Taxpayer from a vendor and delivered to third party printers who used them in the production of printed brochures or advertising material which is then sold by the Taxpayer to its customers?

## EVIDENCE

The following items were introduced into evidence by the Sales and Use Tax Division:

- (1) Copy of Memorandum dated May 16, 2001, from the Secretary of Revenue to the Assistant Secretary of Tax Administration, designated Exhibit E-1.
- (2) Copy of audit report dated February 27, 2004, covering the period November 1, 2001 through October 31, 2003, designated Exhibit E-2.
- (3) Copy of Notice of Sales and Use Tax Assessment dated March 16, 2004, designated Exhibit E-3.
- (4) Copy of Application for Hearing and Objection to Assessment dated April 5, 2004, from the Taxpayer's representative to the Department of Revenue (Department), designated Exhibit E-4.
- (5) Copy of letter dated April 14, 2004, from the Sales and Use Tax Division (Division) to the Taxpayer, designated Exhibit E-5.
- (6) Copy of letter dated April 26, 2004, from the Taxpayer's representative to the Division, designated Exhibit E-6.
- (7) Copy of letter dated May 4, 2004 and the following attached twenty-one invoices, from the Taxpayer's representative to the Division, designated Exhibit E-7.  
  
[Invoice Exhibits (a) through (t)]
- (8) Copy of letter dated May 14, 2004, from the Division to the Taxpayer's representative, designated Exhibit E-8.
- (9) Copy of Sales and Use Tax Technical Bulletin 24-1 dated June 1, 2002, designated Exhibit E-9.
- (10) Copy of redacted Final Decision, Docket Number 92-155, dated May 13, 1994, designated Exhibit E-10.
- (11) Copy of redacted Final Decision, Docket Number 94-138, dated August 16, 1994, designated Exhibit E-11.
- (12) Copy of redacted Final Decision, Docket Number 2003-212, dated July 31, 2003, designated Exhibit E-12.
- (13) Copy of letter dated June 25, 2004, from the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit E-13.

Evidence presented at the hearing consisted of the following:

- (14) Copy of Brief for Tax Hearing dated July 27, 2004 prepared in the Division, designated Exhibit E-14.
- (15) Copy of Petitioner's Brief for Tax Hearing dated July 27, 2004 to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit TP-1.
- (16) Copy of Affidavit dated July 27, 2004 from [Corporation Employee] to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit TP-2.

The following additional evidence was presented after the hearing:

- (17) Copy of Affidavit dated August 24, 2004 from the Taxpayer's representative to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit TP-3.
- (18) Copy of Memorandum dated August 30, 2004 from the Division to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit E-15.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary of Revenue for Administrative Tax Hearings makes the following findings of fact:

- (1) The Taxpayer is a marketing broker of printed matter who out-sources all photography and printing to third party printers.
- (2) The additional tax was proposed in the audit report on the photography, photographic supplies, transparencies and negatives purchased by the taxpayer and furnished to third party printers for use in creating catalogs and other printed matter sold to the Taxpayer's customers.
- (3) In order to produce catalogs and other printed matter the Taxpayer must purchase photography and similar type property which is used or consumed by the printer in order to produce catalogs.
- (4) The Taxpayer segregated charges for photography and other tangible personal property acquired and used on its invoices for catalogs to its customers and added a small markup.

- (5) The Taxpayer provided a Certificate of Resale to its vendors for photography and other items used to produce the catalogs.
- (6) The photographs of images are an integral and necessary part of the catalog production process; however, the Taxpayer's clients contract for the production of catalogs, and the catalogs represent what the client actually bargains for and desires from the Taxpayer, not photography or "images."
- (7) The transfer of ownership of the photographs or images by the Taxpayer to its clients is incidental to the intended purpose of the transaction, which is to sell catalogs.
- (8) The Notice of Sales and Use Tax Assessment was mailed to the Taxpayer on March 16, 2004.
- (9) The Taxpayer notified the Department that it objected to the assessment on April 5, 2004 and timely requested a hearing.

### **CONCLUSIONS OF LAW**

Based on the foregoing findings of fact, the Assistant Secretary of Revenue for Administrative Tax Hearings makes the following conclusions of law:

- (1) When advertising agencies and others purchase items for use in the production of property for sale, they are the users or consumers of the property and must pay the State and local sales or use tax on the cost price without regard to the disposition that may be made of the item by the advertising agency or other retailer.
- (2) Sales and Use Tax Technical Bulletin 24-1 E. provides that "Purchases by advertising agencies of film, printing plates, photography, positives, negatives, transparencies, color separations, and similar tangible personal property for use in the production of advertising material are subject to applicable local sales or use tax because the property does not become incorporated into or become a component part of the property produced for sale."
- (3) Despite the Taxpayer's use of the term "images" the photography and other items purchased by the Taxpayer and used by the printer clearly constitute "tangible personal property" pursuant to G.S. 105-164.3(46).
- (4) The Sales and Use Tax Division's interpretation, that the separate sale of tangible personal property used is taxable, is supported by the court's reasoning in Atlas Supply v. A. J. Maxwell, 212 N. C. 624, (1937).

- (5) The use of the photography and similar items by the printer constitutes a taxable event pursuant to G.S. 105-164.3(49). Therefore, the State and applicable local tax is due on the delivered cost of the photography, photographic supplies, transparencies, negatives and any other items used or consumed by the printer to produce the catalogs.
- (6) In Final Decision Docket Number 94-138, the Assistant Secretary of Revenue for Legal and Financial Services opined that “The taxpayer’s purchases of proofs, negatives, film, photography prints, and similar items are taxable at the time of purchase since such items are being purchased for use in producing tangible personal property which is resold.”
- (7) The tax levied on the cost of tangible personal property used in the production of other tangible personal property, which is the issue in contention in this case, has been sustained in at least nine prior Secretary of Revenue Final Decisions.
- (8) The Notice of Sales and Use Tax Assessment was issued to the Taxpayer pursuant to G.S. 105-241.1.

### **DECISION**

The Taxpayer is a marketing broker of printed matter who out-sources all photography and printing to third party printers. In order to produce the catalogs and other printed matter which the Taxpayer sells, they must purchase photography, photographic supplies, transparencies, negatives and similar type property which is used or consumed by the printer to produce the catalogs offered for sale by the Taxpayer. The Taxpayer refers to these types of items as “images.” Despite the Taxpayer’s use of the term “images” these items are clearly “tangible personal property” pursuant to G.S. 105-164.3(46). The Taxpayer segregates the charges for photography and other tangible personal property acquired and used on its invoices for catalogs to its customers and a small markup is added.

The Taxpayer argues that the photography, photographic supplies, transparencies and other items become the property of its clients and that the Department should consider the transactions as an exempt sale for resale. The Taxpayer also contends that since the sales tax is ultimately collected on the “sales price” of the catalogs or printed matter sold by the Taxpayer, the photography, photographic supplies, transparencies and other items used by the printer should not be taxable because they are using these items in manufacturing the printed matter ultimately sold to the customers. The Taxpayer provided a Certificate of Resale to its photography and other vendors of items used to produce the catalogs.

In this case, however, the transactions involved an obvious use of tangible personal property (photographs or “images”) in the production of other tangible personal property (the catalogs), which was then sold to the Taxpayer's clients. The Department contends that because the primary purpose of the photography or “images” was to be used to produce the catalogs, then the tax should be applicable to their original purchase. The transfer of ownership of the photographs or images by the Taxpayer to its clients is incidental to the intended purpose of the transaction, which is to sell catalogs.

This interpretation is supported by the court's reasoning in Atlas Supply v. A.J. Maxwell, 212 N.C. 624, (1937), wherein a plumbing supply company argued that its “lump sum” contract for installing plumbing fixtures should be considered a resale of the individual parts used in performing the job, and therefore not a use of those fixtures

under the statute and subject to sales and use tax upon their purchase from the supplier. Although the plumbing parts in that case became an integral part of the building in which they were installed, while the photographs or “images” here are “identifiable and separate in form” from the catalogs produced by the Taxpayer, I believe that an important aspect of the decision was the court's refusal to dissect an integrated transaction consisting of several separable, albeit interdependent, parts into its individual elements in order to permit the avoidance of the sales and use tax.

The Taxpayer's argument also fails to recognize the real intent of the parties to these transactions. The photographs or images are an integral and necessary part of the catalog production process. However, the clients contract for the production of catalogs, and the catalogs represent what the client actually bargains for and desires from Taxpayer, not photography or “images.” If the question were asked of the Taxpayer and its client, “Why were the images purchased?” The answer would surely be “To be used in producing a catalog.” This use constitutes a taxable event pursuant to G.S. 105-164.3(49) and the tax is due on the delivered cost of the photography, photographic supplies, transparencies, negatives and any other items used or consumed by the printer to produce the catalogs.

There is ample support in prior tax hearings for the Department's longstanding position to tax sales of film and other property to advertising agencies and others for their use. The question of film, photography, transparencies, negatives, color separations and other property purchased and used by printers and other users to

produce other printed matter has been addressed by the Department numerous times. For example, in Final Decision Docket Number 94-138, the Assistant Secretary of Revenue for Legal and Financial Services opined that "The taxpayer's purchase of proofs, negatives, film, photography prints, and similar items are taxable at the time of purchase since such items are being purchased for use in producing tangible personal property which is resold." This position has been sustained in at least nine prior Secretaries' final decisions and the Sales and Use Tax Division provided three examples (Exhibits E-10, E-11 and E-12).

Therefore the proposed assessment of tax and interest is deemed correct under the law and the facts and is hereby sustained. Because the failure to pay the tax was not the result of a negligent or intentional act by the Taxpayer, I find reasonable cause to waive the penalties. The proposed assessment of tax and accrued interest is hereby declared to be finally determined and immediately due and collectible with interest as allowed by law.

This 13th day of September 2004.

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Eugene J. Cella  
Assistant Secretary of Revenue for  
Administrative Tax Hearings