STATE OF CALIFORNIA **420.0343**

STATE BOARD OF EQUALIZATION

BT-169 REV 2(4-63)
PRELIMNARY HEARING REPORT

STATE BOARD OF EQUALIZATION
DEPARTMENT OF BUSINESS TAXES

Report of Hearing Officer W. E. Burkett/kc 4-17-70

Taxpayer X---------- Account Number Z----------

Date of Hearing 12-19-69

Appeared on behalf of Petitioner

X----------

Board of Equalization Representatives

X----------

Comments and Recommendations

PROTESTED ITEMS

		Measure	
1.	Value of unexposed film distributed to customers Contracting for developing and photography prints (item P of report of field audit)	@4% $978,371	@5% $834,800
2.	Sales of fixtures fabricated by petitioner not Reported (item E of report of field audit)	$1,010,607	$526,910

PETITIONER'S CONTENTIONS:

(1) a. The staff has erroneously concluded that a portion of the unexposed film was distributed or sold with a developing service. In each instance the film was sold as a premium with the sale of photography prints.

b. In any event the measure of tax attributable to the unexposed film is excessive.

(2) a. The fixtures were not prefabricated. Since tax has been paid on the cost of materials there is no additional measure of tax.

b. In any event the measure of tax includes exempt freight charges.

REPORT ON FACTS:

The petitioner is a large chain store retailer engaged in selling X---------- at retail. It operates approximately 300 store outlets in the State of California.

The first protested item consists of the computed value of a portion of the cost of unexposed rolls of photography film distributed by petitioner to customers who contracted to have petitioner perform developing of exposed film and to produce prints there from. It includes only that portion of the total cost of the unexposed film which was equivalent to the ratio that the charge for developing bore to the total contract price for developing and producing prints. For a number of years petitioner has followed the practice of distributing a "free" unexposed roll of new film to customers who contract with petitioner to develop negatives of exposed film and purchase prints of the developed negatives. The unexposed roll of film was given to the customer at the time he placed the order for developing and prints. A separate charge was made for the prints and for the developing. No specific charge was made for the unexposed film. In some instances the customer failed to pick up its order and pay the agreed charges. No attempt was made to collect these charges. The developing charge was claimed to be exempt from tax pursuant to the provisions of sales and use taxes ruling 23.

The theory of the staff's determination is that petitioner consumed the unexposed roll of film to the extent it was given with the exempt developing service. It has been established that a customer could not receive a roll of unexposed film for an order of prints without developing or for an order for developing without purchase of prints. A copy of petitioner's advertised offer is included in the field audit report.

It is petitioner's contention that the unexposed roll of film must be considered to represent a premium sold to the customer for the price paid for the prints. Since tax was paid on the sales price of the prints it is submitted that there is no additional gross receipts to which the tax applies. The provisions of the paragraph (b) of former sales and use taxes ruling 72 have been cited in support of petitioner's contention.

Additionally petitioner has submitted a schedule setting forth the dates for which the free film policy was adopted for each series of film and the store affected thereby. The schedule provides as follows:

Date policy introduced	Type and size of film subject to free film offer (Black & white, X----- brand given; Color, X------ brand given)	Free film policy becomes applicable to these X------ stores in California
Unknown date Prior to 1960	B & W only sizes 120, 127, 620	All No. Calif. Stores
May 21, 1963	B & W and Kodacolor, sizes 120, 127, 620	All stores except 30 in No. Calif.

June 1, 1963	Kodacolor sizes 120, 127, 620 (added to prior B & W sizes)	30 stores in No. Calif.
Sept. 28, 1966 to Oct. 25, 1966	B & W size 126 added to foregoing	86 stores in chain outside Los Angeles metropolitan area
Nov. 1, 1967	B & W size 126 added to foregoing	Los Angeles area store
Nov. 1, 1967	Color size 126 added to foregoing	All 300 stores in X--------- chain.

(The above table is a direct quote from the Memorandum In Support of August 1, 1969, Refund Claim submitted by petitioner's attorneys.)

The field auditor made appropriate adjustments for the operative dates for each type of film and the stores affected thereby.

Petitioner has also provided a historical record of prices charged for developing and prints for the series of film sizes affected. This record is as follows:

	Thrifty processing charges for film sizes 120, 127, 620 and 126*			
	Black & White		Color	
Date charge was first effective	Develop 1 roll	1 giant size print	Develop 1 roll	1 giant size print (3x)
Unknown date prior to Aug. 1960	20¢	10¢	90¢	25¢
June 1964	20¢	10¢	90¢	25¢
April 14, 1967	25¢	10¢	90¢	25¢
Sept. 1, 1967	40¢	12¢	1.00	29¢

(The above is a direct quote from the Memorandum In Support of August 1, 1969 Refund Claim submitted by petitioner's attorneys.)

During the period in which the free film policy was in effect stores not authorized to deliver an unexposed roll of film without making a specific charge allegedly made the same charge for developing as did stores authorized to deliver the film. Additionally the charge for developing without an order for prints was not altered by reason of the absence of a requirement to provide a roll of unexposed film.

Other Information

The California Department of Justice has conducted an investigation of petitioner's advertised offer of a free roll of film with an order for developing and prints purchase. According to petitioner it was determined to the satisfaction of the department that the film was distributed to the customer without the making of an additional charge. The investigation was headed by Deputy Attorney General X---------- of the Los Angeles office of the Attorney General.

Subsequent to the date of the issuance of this deficiency determination petitioner discontinued its policy of distributing a roll of unexposed film without the making of a specific charge. Simultaneously it reduced its charge for developing and its unit charge for producing photography prints (see memo from West Los Angeles Auditing dated March 13, 1970, copy in petition file). The alleged reasons for the change are detailed in a letter prepared by petitioner's attorney X---------- dated March 9, 1970. The provisions of this letter have been made a part of the petitioner's file and it is hereby incorporated by reference as a part of this report.

It is also contended that the measure of tax is excessive. No detailed information has been provided in support of this contention.

The second protested item consists primarily of the audited sales price of fixtures constructed by petitioner in its workshops and installed in new leased retail outlets. The fixtures were sold to the lessor of the premises and subsequently leased back to petitioner as real property. The items transferred also includes some property purchased prefabricated from third parties and some items of equipment. Since all material incorporated in the property was purchased tax paid the measure of tax has been limited to the portion of the charge attributed to labor, overhead and freight. The labor and overhead have been estimated at 40.5 percent of the total billing to the lessor (see audit comments schedule lf). The freight costs were obtained from petitioner's cost records.

It is petitioner's contention that the property was not prefabricated prior to installation and therefore constituted materials as defined by sales and use taxes ruling 11. According to the audit staff the cost of installing the fixtures amounted to 12 to 14 percent of the contract price.

It is also contended that the measure of tax included exempt freight charges. A lump sum billing was rendered for the fixtures and no portion of his billing is identified as freight. According to the audit report the fixtures were hauled to the jobsite by employees of petitioner using vehicles rented from the Hertz Rental Company (see audit comments schedule lf).

CONCLUSIONS:

The unexposed film, the finished prints, and the developing service all represent consideration received by the customer in exchange for the payment of the agreed contract price. While the customer received the unexposed film prior to the time he

received delivery of the prints and the developing service it is nevertheless clear that the customer received the unexposed film only if he agreed to pay the price specified for the prints and the developing and not as a gratuity. Accordingly the unexposed film must be regarded as sold rather than self-consumed. This conclusion is not altered by the failure of petitioner to enforce collection with respect to persons who failed to pick up their finished prints and negatives. The failure to collect the contract price on these transactions was based on business expediency rather than the absence of a remedy.

Since the unexposed film was given for the customer's promise to contract for the purchase of property and a service without addition of a specific charge and its receipt did not depend upon chance or skill it represented premium merchandise. With respect to premiums the provisions of former sales and use taxes ruling 72 (now regulation 1670) provided as follows:

> "Tax does not apply to sales of tangible personal property to be given as a premium, together with tangible personal property sold by the purchaser of the premium. The transaction is regarded as a sale of both articles and the sale of the premium for such purpose is therefore a sale for resale, provided the obtaining of the premium is certain and does not depend upon chance or skill. Tax applies to the entire gross receipts received by the retailer from the purchaser of the goods and the premium, except where a premium, not a food product for human consumption or other exempt item, is delivered along with food products for human consumption or other exempt item, to a purchaser thereof. In such case tax applies to the gross receipts from the sale of the premium, which will be regarded as the cost of the premium to the retailer, in the absence of any evidence that the retailer is receiving a larger sum. If there is no such evidence, and if the retailer has paid sales tax reimbursement to his vendors of the premiums, or use tax to his vendors or to the State, measured by the sale price of the premiums to him, no further tax is due from him." (Emphasis added.)

It can be seen that the provisions of the ruling defines the tax consequences where a premium is purchased and resold with an item subject to tax as a retail sale and provides for an allocation of gross receipts to the retail sale of a premium sold with a food product or other item exempt from the sales tax. While the provisions of the ruling do not expressly provide for allocating the price of the premium where it is sold and delivered as part of a contract of sale of property and an exempt item (the developing) it does provide that the tax applies to the gross receipts from the sale of a premium sold with a food product or other exempt item and that the price of the premium shall be regarded as the cost of the premium to the retailer in the absence of evidence that the retailer is receiving a larger sum.

To the extent the unexposed roll of film was sold for the consideration received for the prints any tax liability has been satisfied. Therefore the remaining question is whether the premium was sold for this consideration or for the entire contract price. If the premium was sold and delivered for the entire contract price then the audit staff's determination of a tax deficiency measured by the portion of the cost of the premium that the ratio of the

developing service bears to the total contract price is correct (although improperly classified) because ruling 72 provides that the gross receipts from the sale of the premium shall be regarded as its cost price in absence of evidence of a higher price. The effect of the auditor's computation is to allocate the cost price of the film to the prints and the developing charge in the ratio that each bore to the total contract price.

The delivery of the unexposed roll of film was concededly conditioned upon the purchase of both the photography prints and the developing service. The contract was therefore entire in its obligation and the customer's right to obtain the premium was thus conditioned upon the payment of the entire contract price and not just the price of the prints. A contract will be treated as entire even when the obligation of one party consists of different acts to be separately paid for where the taking of the whole was intended by the parties (Lewis v. Shell Oil Co., 220 Cal.80, 83: Sweet v. Watson's Nursery, 23 Cal.App.2d 379)

Since the customer was required to pay the entire contract price in order to obtain the premium it is the conclusion of the hearing officer that it was entirely consistent with law and the provisions of former ruling 72 to allocate a portion of the total contract price to the unexposed roll of film sold and delivered as part of the contract. In substance petitioner must be regarded as having discounted the price of the prints and the developing charge to reimburse itself for the cost of the unexposed film. Section 6012 of the Revenue and Taxation Code provides that the cost of property sold may not be deducted from gross receipts from sales. To allow the petitioner to reimburse itself for a portion of the cost of property sold under the guise of an exempt service charge would exalt the form and allow the petitioner to accomplish indirectly what the Legislature has provided it cannot do directly.

The hearing officer has examined the auditor's computations and comments relative to computing the taxable portion of the charge attributed to the unexposed film. While the computations involve" several assumptions the amount computed appears to represent a reasonable estimate of the pro-rata cost of film attributed to the developing. In absence of detailed information submitted to show wherein the computations are incorrect no adjustment is recommended.

It concluded that no basis exists for adjustment of the charge made for the store equipment and fixtures sold to the lessors of the real property. The information accumulated by the audit staff is regarded as sufficient to support the conclusion that beneficial ownership of the fixtures passed to the lessors and that the sale was made at retail. The tax in each instance has been measured by the cost of fabricating the fixtures plus the cost of freight. The amount of shop labor required to fabricate the fixtures was substantial and petitioner has not presented any information which would support a finding that a substantial amount of additional labor and materials were required ·in order to install them at the jobsite. Accordingly the fixtures are considered to be prefabricated.

The amount added for freight was derived from the cost records of petitioner. Since it was not separately stated to the customer no deduction may be allowed (sales and use tax

ruling 58). It would also appear that the property was delivered by petitioner's facilities with title passing to the customer subsequent to the time the delivery was performed.

RECOMMENDATION:

It is recommended that the taxes be redetermined without adjustment.

W. E. Burkett, Hearing Officer

APPROVED:

Principal Tax Auditor 4/24/70