



STATE BOARD OF EQUALIZATION

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

Petitioner.

DECISION AND RECOMMENDATION

The above-entitled matter came on regularly for hearing on Thursday, May 29, 1980 in Santa Ana, California before Robert H. Anderson, hearing Officer.

Appearing for Petitioner:

X-----

Appearing for the Board:

M. L. Lewis
District Principal Auditor
Orange County District

K. A. Nicholas
Auditor
Orange County District

Protest

Petitioner was audited for the period from 4-1-76 through 3-31-79, and a determination for tax plus interest to September 1, 1979 was issued on July 30, 1979. Petitioner protests the assessment for sales tax on radiographic film measured by \$499,752 and a credit for tax paid purchases of film resold measured by \$-48, 253.

Contentions

1. Petitioner is selling a service and in doing so consumes radiographic film,
2. Petitioner offers a repair service in repairing critical machine parts.
3. Petitioner is not an X-ray laboratory nor a producer of X-ray film.

4. Petitioner's competitors engaged in the same type of business are not taxed in the manner the Board auditor seeks to tax petitioner.

Summary

Petitioner is a California corporation engaged in the business of non-destructive testing of metal machine parts which encompasses one of four types of technical inspection procedures, which are: (1) radiographic inspection; (2) liquid penetrant; (3) magnetic partical or (4) ultra-sonic. Visual inspection is always performed in conjunction with the above four types, and the customer receives a written report on the test results.

The business is described as inspecting and .certifying machinery and equipment for other businesses and municipalities.

The firm transacts business with several industrial and municipal clients such as X-----, X-----, and X----- . Customers request petitioner inspect, test and certify machinery, equipment or parts thereof. On some occasions, petitioner's employees go to a customer's jobsite to make the inspection and certification. However, the transactions that were taxed in the audit were performed at petitioner's place of business in Santa Ana.

When a purchase order is received by petitioner it normally contains a request that the inspection and certification conform to a given specification. Some of these specifications are set by the customers themselves. Some are set by societies such as the American Society for Testing and Material ("ASTM") or American Society of Mechanical Engineers ("ASME"). All orders do, however, contain some specification.

Depending on the specification requested, petitioner will perform one of the above four types of inspection service. In the audit only the radiographic inspection service was taxed and it was taxed as a sale of radiographic film. However, it is alleged that each of the four inspection services involves the use or incorporation of some material or product by petitioner.

The radiographic inspection process involves the following:

1. A part, such as a valve, is received by petitioner for inspection, testing and certification. It is first visually inspected for imperfections.
2. If the inspector detects a defect by visual inspection; it is-removed by a grinding process. All visually detectable defects are removed in this manner.
3. The part is then radio graphed using radiographic film.
4. The radiographic film is reviewed by an inspector to ascertain if there'are any internal defects in the part.

5. If internal defects exist, they are ground out and repaired by a welding process.
6. The part is again radio graphed to determine if the defect was corrected.
7. The radiograph and grinding process continues until the part is free from all defects.
8. Petitioner prepares a report on the inspection which is sent to the customer along with the part and the radiographic films of the part.
9. The customer is billed for the inspection labor, including. the charge for grinding and/or removal of the defect and repair if it is done. A separate charge is made for the film given to the customer, but no sales tax is added to the charges made.

X----- estimated that in about 10 percent of the jobs there is inspection, removal of a defect or defects and repair. In about 20 percent of the jobs there is inspection and removal of defects only, and in 70 percent of the jobs there is inspection only. All jobs involve the writing and submitting of an inspection report and the transfer of some radiographic film.

It is alleged that on an average less than 10 percent of the labor involved in the inspection process relates to the radio graphing of the parts. Petitioner submitted a typical billing to illustrate how the customer is invoiced:

| DESCRIPTION | AMOUNT |
|---|--------|
| Radiographic Inspection - Part #31701-1 | |
| 2 hrs. at \$30.00 per hour | 60.00 |
| Film 6 - 4 1/2 x 17 at 1.53 each | 9.13 |

In the foregoing example the auditor picked up the entire \$69.13 as a taxable sale of film and gave credit for tax paid on the film.

The radiographic examination report includes a space for inserting the name of the person who performed the radiography, the person who interpreted the film and the name of the "authorized inspector".

It is alleged that petitioner is in the inspection business, and not in the radiographic film business; all radiographic film is purchased tax paid; and petitioner does not make money charging for the film used. It is also alleged that in each inspection matter the customer seeks the inspection report and not the film. The film is not used by the customer other than storage.

X----- stated that in the majority of cases there are government requirements that the film be retained in case it is needed. It must be stored and petitioner has the option of

storing it, but as a matter of business policy and because of space needed, the film is "given" to the customer. X----- stated that customers do not send parts for defect removal. The only reason they are sent is for the inspection certification, and inspection report.

Conclusions

The basic issue in this matter involves the question of whether petitioner is selling film that includes some services connected with the sale and for which a separate charge is made, or whether petitioner is selling a service and is the consumer of the film.

Petitioner's method of billing and the fact that a separate charge is made for the film has raised the issue. Also, petitioner's description of what is done raises a collateral issue in respect to the removal of defects and repair work.

In every instance the film is used by petitioner. The use is not physical, but it involves looking at it and interpreting what is on it so that a report may be written. This is sufficient to preclude allowing a tax paid purchase resold credit where, in fact, the exposed film or some of it is sold to the customer. All of the elements of a sale of the film are present; the customer gets title and possession and pays a consideration.

One phase of petitioner's work has been referred to as "repair". This may be misleading and possibly inaccurate. If the part on which work is done to remove defects and/or repair is a new unused part that has never been an operating part of a machine; for example, it is not being repaired when defects are removed or corrected. The work is part of the fabrication of the part before it is put to the use intended and all charges for removal of defects and correction (repair) of defects are subject to tax notwithstanding the question of whether there was a sale of film. The charge for removal of defects and/or repair of them on new parts would be subject to tax even if no film were transferred to the customer.

On the other hand, if the part is a used one that has been removed from an operating machine for inspection and testing, the work for removal of a defect or repair of one would be a form of repair labor and the provisions of Regulation 1546 (Installing, Repairing, Reconditioning, In General), would come into play to determine if petitioner was a retailer of material needed to do the work or was a consumer of it.

Even if petitioner were found to be the consumer of the materials needed to do the work in removal of defects and repair of them on used parts, petitioner is still the retailer of the film sold.

Petitioner alleged that its competitors are not being taxed in the same way as it is in this audit and has named several of them in its brief containing a, statement of facts and arguments plus exhibits.

A check was made on the five competitors listed to see if they had seller's permits. Permits were held by three and could, be held by the other two but not under the name listed. All of the three were engaged in business of non-destructive testing of metal parts. One obtained its permit in March of 1980 and there is no evidence of how it reports tax on film needed to perform the testing.

The other two are reporting tax as consumers of the film and are so considered. However, there is one very important distinction in their operations and petitioner's; that is the fact that they do not transfer the film to the customers, they retain it and there is no separate charge made for the film in billing for non-destructive testing.

In petitioner's case the true object of contracts to perform non-destructive testing of metal parts is not the sale of radiographic film, it is the sale of the information obtained from exposing the film to the parts and that information is transferred to the customer in report form; the transfer and sale of the film is only incidental to the report. It could be retained by petitioner since that is an option.

In summary, the following conclusions apply to petitioner's business of non-destructive testing of machine parts and other similar items:

1. Petitioner is the consumer of the film needed to perform the test and write the report. Tax has been paid on the purchase price of the film and no use tax is due.
2. Petitioner is the retailer of the film transferred to the customer and for which a separate charge is made. Tax is to be measured by the charge for the film unless it is a resale item. No tax paid purchase credit is allowable for the reason or conclusion in "1" above.
3. Charges for radiographic inspection are not subject to tax.
4. Charges for work in removal of defects and/or repair of them on new unused parts being inspected are subject to tax as a part of the charge for fabricating the parts into a finished useable product, Again, if the transaction involves a resale, such charge would not be subject to tax.
5. Charges for work in removal of defects and/or repair of them on used parts being inspected are not subject to' tax. Petitioner is the consumer of materials needed to perform the removal and/or repairs unless a separate charge is made for the materials and if this is done petitioner is the retailer of the materials. It is understood that except for the radiographic film there is no separate charge made for any materials.

Recommendation

Redetermine. Reaudit and adjust the measure of tax in accordance with the foregoing conclusions.

Reaudit and adjustment to be made by Orange County District Auditing.

Robert H. Anderson, Hearing Officer

June 19, 1980