COLOR CRAFT, INC. 1616 Mt. Meigs Road Montgomery, Alabama 36103-4279,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. S. 96-323
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER

The Revenue Department assessed sales tax against Color Craft, Inc. ("Taxpayer") for November 1992 through October 1995. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. A hearing was conducted on October 8, 1996. Attorneys Stan Gregory and Stephanie McGhee and CPA Mike Butler represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer sells color separations at retail. The Taxpayer uses a computer to help produce the separations. The issue in this case is whether the separately stated computer charges must be included in taxable "gross proceeds of sale," as that term is defined for sales tax purposes at Code of Ala. 1975, '40-23-1(a)(6). If the computer charges are taxable, a second issue is whether the penalty assessed by the Department should be waived.

The Taxpayer is in the photographic film services business. The Taxpayer produces and sells color separations at retail as a part of its business.

Color separation is a process by which a color photograph is prepared for

printing by commercial printers. The color photograph is divided into three or four basic colors. Each color is imprinted on a separate film negative, which is the tangible color separation. The color separations are then sold to a printer and used in printing the color photograph.

If a customer wants the photograph changed or enhanced for printing, the Taxpayer makes the required changes using a computer (primarily a Scitex, but also a Macintosh). The photograph image is scanned into the computer, and the required changes are made, i.e. the color is changed or enhanced, objects or people are added, deleted, rearranged, etc. The altered computer image is then downloaded, and the tangible color separation is produced.

The computer changes usually take several hours, depending on the extent of the changes and the skill of the computer operator. The Taxpayer charged $100 to $150 per hour for use of the computer during the subject period. The charges were separately stated on the customer invoices.

The Taxpayer concedes that color separations are subject to sales tax.[1] However, the Taxpayer deleted from taxable gross proceeds the separately stated computer charges.

The Department audited the Taxpayer, included the computer charges in taxable gross proceeds, and based thereon entered the final assessment in issue. The

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[1]Department Reg. 810-6-2-.53 specifies that "Gross receipts accruing from the retail sale of . . . color separations sold to printers . . ." are taxable at the reduced 1**2** percent "machine" rate.

Taxpayer appealed to the Administrative Law Division.

"Gross proceeds of sale" is defined for Alabama sales tax purposes as "[T]he value proceeding or accruing from the sale of tangible personal property . . . without any deduction on account of the cost of the property sold, the cost of the materials used, labor or service costs, . . . or any other expenses whatsoever . . . ." Code of Ala. 1975, '40-23-1(a)(6).

The Taxpayer argues that the computer charges should not be taxed because use of the computer constitutes a non-taxable service that is not necessarily and customarily performed in making a color separation. I disagree.

Generally, labor and service costs incurred or charged by a retailer must be included in taxable gross proceeds, even if separately stated on the invoice, if the labor or service is required to manufacture or prepare the sale item, or to otherwise complete the sale. See generally, State v. Mary B. Montgomery, S. 94-132 (Admin. Law Div. 12/29/94) (separately itemized engraving charges on plaques, trophies, etc. sold by a trophy shop held to be taxable).

Service and labor costs may be taxable in some cases and non-taxable in others, depending on whether the service or labor is performed as a part of a retail sale. For example, the engraving charges in issue in Mary B. Montgomery were taxable because the engraving was performed on items subsequently sold at retail by the trophy shop. However, the trophy shop did not charge sales tax for engraving a trophy or other item brought in by a customer because the trophy shop was not making a retail sale.

The above principle is clearly illustrated in Thigpen Photography v. State, S. 95-127 (Admin. Law Div. 8/30/95). The sale of photographs is subject to sales tax. See, Dept. Reg. 810-6-1-.119(1). The issue in Thigpen was whether various service charges and fees charged by a professional photographer were also taxable. The services and labor included general photographic services, rush charges, inventory search fees, stock fees, and typesetting and mosaic services. The taxability of the charges depended on whether the service or labor was performed as a part of a taxable retail sale by the photographer. For example, typesetting and mosaic services were taxed in some cases and not taxed in others.

> These services may or may not be taxable, depending on whether a sale by the Taxpayer is also involved. If the typesetting and mosaic services are performed in conjunction with a sale by the Taxpayer, those services are necessary in preparing the final product for sale, and are taxable. If the services are performed on photographs provided by the customer, then no sale by the Taxpayer is involved, and the services are not taxable. See, Reg. 810-6-1-.130(4), which holds that typesetting services performed by a printer are not taxable if there is no sale by the printer.

Thigpen, S. 95-127 at 9.

In this case, the Taxpayer produces a new product, the color separation, which the Taxpayer concedes is subject to sales tax. The computer work required to change the computer image of the photograph is a necessary and essential step in producing the finished color separation. The computer services are thus performed in conjunction with preparing the color separations for sale, and are subject to sales tax.

The Taxpayer argues that this case is analogous with the tinting or coloring of

photographs provided by a customer, which is not taxable. See, Dept. Reg. 810-6-1-.27. The analogy fails, however, because the tinting of a photograph supplied by a customer does not involve a retail sale (the same as engraving a trophy already owned by a customer is not taxable, see Mary B. Montgomery). On the other hand, as discussed, the computer is used to create a new product, the separations, which are then sold at retail. The computer is not simply used to change the customer's photograph, as argued by the Taxpayer.

The Taxpayer cites State v. Harrison, State v. Kennington, and Selma Hospital v. State Dept. of Revenue in support of its case.[2] Those cases can be distinguished, however, because they involved whether a transfer of tangible personal property by the taxpayer constituted a taxable retail sale or a non-taxable service. In each case, the transfer was held to be incidental to the service performed, and thus not subject to sales tax.[3]

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[2]Harrison v. State, 386 So.2d 460, *cert. denied* 386 So.2d 461 (1980), State v. Kennington, ___ So.2d ___ (Ala.Civ.App. 1995), Selma Animal Hospital v. State Dept. of Revenue, S. 95-231 (Admin. Law Div. 3/26/96).

[3]For a general discussion of Harrison, Kennington, and prior cases involving Alabama's "learned profession" line of sales tax cases, see Selma Animal Hospital. S. 95-231 (Final Order on Application for Rehearing 3/26/96). For a good discussion of how other states have distinguished between taxable sales and non-taxable services, see, Jerome R. Hellerstein & Walter Hellerstein, State Taxation, Chapters 12 & 13.

In this case, however, the issue is not whether a taxable retail sale has occurred - the Taxpayer concedes that the retail sale of a color separation is taxable. Rather, the issue is whether the charges for the computer services performed in producing the separations must be included in the taxable gross proceeds of that sale. As discussed above, clearly they are.

The Taxpayer relies heavily on Department Reg. 810-6-1-.84, titled "Labor, Service." That regulation provides in part that "services not necessarily or customarily performed incidental to the sale of property or services unusual in nature and for which a separate and additional charge is made are not to be included in the gross proceeds of sales." The Taxpayer argues that the computer services cannot be taxed under Reg. 810-6-1-.84 because they are "not necessarily or customarily" performed in the production of color separations. Again, I disagree.

To begin, Reg. 810-6-1-.84 is vague and misleading, if not wrong. It is irrelevant whether a labor or service is "necessarily or customarily performed" by the retailer, or is "unusual in nature." Rather, all labor and service costs incurred in making or producing a product for sale are taxable. This is true even if the service or labor is not customarily performed by the seller and is most unusual in nature. For example, if a retail machine shop builds a special machine for sale that requires special tools (such as a computer) and a special mechanic to build the machine, the charge for the special machine and the labor cost for the mechanic cannot be separately billed and excluded from taxable gross proceeds, even though use of the

special tool and mechanic was an unusual, one-time event.

In any case, whether an activity is "unusual in nature" within the context of Reg. 810-6-1-.84 must be considered in the context of the retailer's business.

In Mary B. Montgomery, the taxpayer argued that unique hand engraving performed by the shop owner was "unusual in nature", and thus not taxable under Reg. 810-6-1-.84. That argument was rejected as follows:

> The Taxpayer argues that the hand engraving was "unusual in nature" and thus should not be taxed under Reg. 810-6-1-.84 because it was unique to and could only be performed by Mr. Montgomery. However, the phrase "unusual in nature" must be read in the context of the retailer's business. That is, was the service or labor "unusual in nature" relative to the particular retailer in question. Hand engraving was not "unusual in nature" relative to Mr. Montgomery because he customarily and usually performed hand engraving in the normal course of his business. In other words, the design and hand engraving was "necessarily and customarily performed" by Mr. Montgomery and was not "unusual in nature" relative to his business so as to be excluded from tax even under Reg. 810-6-1-.84.

Mary B. Montgomery S. 94-132 at 3.

Likewise, the Taxpayer normally and regularly uses a computer to create the specific color separations ordered by a customer. The computer work is not "unusual in nature" relative to the Taxpayer. Consequently, the computer charges must be included in gross proceeds of sale under '40-23-1(a)(6).

Penalties levied by the Department may be waived for "reasonable cause." Code of Ala. 1975, '40-2A-11(h). Arguably, reasonable cause exists in this case because a Department auditor previously informed the Taxpayer that the charges in issue were not taxable. The Taxpayer relied on that statement when it excluded the charges from taxable gross proceeds. However, the issue of reasonable cause need

not be decided because the failure to timely pay penalty in issue should not have been assessed in the first place.

Code of Ala. 1975, '40-2A-11(b) levies a 10 percent penalty if a taxpayer fails to pay "the amount of tax shown as due on a return . . . ." The tax in issue resulted from an audit. It was not reported on the Taxpayer's returns. Consequently, the failure to timely pay penalty is inapplicable.

The final assessment, less penalty, is affirmed. Judgment is entered against the Taxpayer for State sales tax of $14,796.41, plus applicable interest.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, '40-2A-9(g).

Entered February 12, 1997.

BILL THOMPSON
Chief Administrative Law Judge