

KONICA MINOLTA PRINTING	§	STATE OF ALABAMA
SOLUTIONS USA, INC. &		DEPARTMENT OF REVENUE
MINOLTA QMS, INC.	§	ADMINISTRATIVE LAW DIVISION
1 MAGNUM PASS		
MOBILE, AL 36618-3412,	§	
Taxpayer,	§	DOCKET NO. S. 04-178
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

OPINION AND PRELIMINARY ORDER

The Revenue Department audited and assessed Konica Minolta Printing Solutions USA, Inc. (“Konica Minolta”) for State use tax for October 1999 through September 2002. It also assessed Minolta QMS, Inc. for State sales tax for the same period. Konica Minolta appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a.¹ Brian Hack represented Konica Minolta. Assistant Counsel Duncan Crow represented the Department.

ISSUES

Konica Minolta designs and manufactures laser printers. The primary issue is whether tangible personal property purchased by Konica Minolta and subsequently used in developing, designing, engineering, and testing software and the various other component parts of the printers were “machines” used in manufacturing, and thus subject to the reduced 1 1/2 percent use tax levied at Code of Ala. 1975, §40-23-61(b). A second

¹ Minolta QMS, Inc. merged into Konica Minolta during the Department’s audit. Konica Minolta subsequently appealed both final assessments to the Administrative Law Division. However, the Department has notified the Administrative Law Division that the issue involved in the sales tax assessment against Minolta QMS, Inc. has been settled. Consequently, this Order will only address the use tax final assessment against Konica Minolta.

issue is whether some of the tangible property purchased by Konica Minolta became an ingredient or component part of the printers, in which case the property would have been purchased tax-free at wholesale. Code of Ala. 1975, §40-23-60(4)b.

FACTS

The relevant facts concerning the tangible property in issue, and how Konica Minolta manufactures laser printers, are adequately explained in Konica Minolta's Brief, as follows:

Konica Minolta Printing Solutions U.S.A., Inc. was founded in Mobile, Alabama in 1978, and was formerly known as both "Minolta-QMS, Inc." and "QMS, Inc." KMPS is a manufacturer, designer and distributor of color and monochrome laser printers. In January, 2002, the final assembly of KMPS Printers shifted from Mobile to China and Japan, but the development, design and manufacture of the Software and Drivers that are essential and necessary components of a laser printer, required to enable the printer to function, continued to be done in Mobile by KMPS' Engineering Department until December of 2003.

A brief overview of the history and organization of KMPS and the functionality of a laser printer is set forth below. A review of this information is necessary to fully understand the contested issues in this action.

Konica Minolta Printing Solutions designs, manufactures and sells laser printers. A laser printer is composed (essentially) of a printer engine, intelligent controller and the drivers and software.

The printer engine is composed of plastic and steel and has mechanical and electrical functioning capabilities. A printer engine without an intelligent controller or without the drivers/software is not a completed product and cannot function.

The intelligent controller actually consists of two parts: a circuit board and the software embedded on the circuit board. The software on the circuit board enables the engine to function and gives the printer engine the ability to perform different functions during the operation and use of the printer. The intelligent controller is an integral part of the laser printer and again, a printer engine cannot function without a controller.

The final component of a laser printer is the software and drivers. Unlike the software embedded on a circuit board, this software is loaded onto an end

user's personal computer. The software and drivers are also necessary to the proper operating and functioning of a laser printer. The software and drivers act as a liaison or translator between the end users' computer and the laser printer engine and controller, enabling the printer to work under the different personal computer operating systems available and with many of the different software applications that may be found on end-user's computers.

The role of the KMPS engineering department varies with respect to each of the three components of a laser printer. KMPS historically acquired printer engines from a 3rd party on an OEM ("Original Equipment Manufacturer") basis and would incorporate the controller, software and drivers manufactured by KMPS onto the laser printer engine thereby creating a completed, final product. KMPS manufactured the software of the controllers and the software that is part of the drivers. During the manufacturing process, KMPS engineers would perform necessary quality and functionality testing on all components of the laser printer.

The software manufactured by KMPS (for both the controller and the drivers) is an essential, integral and necessary part of the laser printer. A laser printer is not a laser printer without these components. These items were manufactured by the KMPS engineering department. Manufacturing software is not just "burning" or copying a series of files onto a cd-rom – it is the actual creation of the code and integration of the code with existing proprietary and 3rd party software that is the essence of the software manufacturing process.

KMPS acquired various items and materials necessary to the manufacturing process of the software and drivers that are essential to the Printer Products that KMPS sells and distributes. A list of those items is attached hereto as Exhibit "A" and incorporated herein by reference as if copied in full and shall be referred to herein collectively as the "Equipment." These items can be broken down into the following categories:

Hardware: Items in this category include things like Special circuit boards, mother boards, print engines and switches. The Equipment in this category related to and was used by KMPS to develop and test circuit boards, manufacture the controllers and to perform quality control testing throughout the manufacturing process.

Tools: Items in this category include things like fixtures, tools, tooling, dies, molds and lead sets. These items were necessary to the manufacture by KMPS of the software and drivers that were integral parts of KMPS' laser printers and were essential in that role because they were used by engineers

to create and manufacture the embedded software of the controller and the circuit boards of the controller. These items were also used for testing at various stages of the manufacturing process. The software and drivers were created on the computers and servers and incorporated into the circuit boards for installation into the final printer assembly.

Miscellaneous: Items like the logic analyzer, image-examine system, and color matching systems are included in this category and were necessary for the development of software and half tones that generated excellent print quality and were also used for testing and quality control of the software and drivers manufactured by KMPS. Some of these items were also used to debug circuit boards throughout the manufacturing process.

Software: This category of equipment includes software programs and licenses purchased by KMPS to either create software or incorporate existing software and applications into the controller or drivers manufactured by KMPS or to test the final product and perform quality control thereon. Examples include various Adobe programs, MS Visual CT++6, PC Anywhere SOL 9.0, Installshield Professional Software, Codewarrior Pro, etc. The software and drivers manufactured by KMPS could not have been produced or distributed without the software programs purchased by KMPS and used throughout the manufacturing process.

Printers and Printer accessories or consumables: This group includes a few printers and many printer consumables (i.e. toner) that were heavily used in performing the necessary function of quality control on KMPS controllers, drivers and end products.

Computer and Computer accessories: This category represents the largest group and is comprised of various computers, monitors, computer cards, accessories and servers. These items were the most critical pieces of Equipment in the manufacturing process because the software for the controllers and the drivers was actually manufactured on these machines. Finally, some of the Equipment at issue was purchased by KMPS with the intent to be used, and were so used as ingredients in the final software products (both controllers and drivers) manufactured by KMPS. These items included certain software programs, computer chips and circuit boards. A complete list of said items is set forth on Exhibit "C" attached hereto and incorporated herein by reference as if copied in full. These items, which total \$195,922.04 for consumer use tax assessment purposes and \$171,797.17 for sales tax purposes all constituted ingredients or became components of KMPS' finished products. Note, that the list attached as Exhibit "C" was provided by the Department based on its audit of our records.

Konica Minolta failed to pay sales or use tax on any of the equipment in issue. The Department audited Konica Minolta and assessed it for use tax on the equipment at the 4 percent general rate levied at Code of Ala. 1975, §40-23-61(a). As indicated, Konica Minolta appealed, arguing that the property was used in manufacturing the printers, and thus taxable at the reduced 1 1/2 percent “machine” rate.

ANALYSIS

Issue (1). The use tax “machine” rate issue.

Section 40-23-61(b) levies a reduced 1 1/2 percent use tax on machines used in mining, quarrying, compounding, processing, and manufacturing tangible personal property. The Administrative Law Division has held that the reduced rate applied to storage bins attached to a sawdust and wood chip conveyor system in a sawmill, stacking sticks used to separate lumber being dried in kilns, and coolant and lubricant necessary and essential to the production of roller bearings. See, *Kykenkee, Inc. v. State of Alabama*, S. 01-618 (Admin. Law Div. O.P.O. 5/7/02); *Overseas Hardwood Co., Inc. v. State of Alabama*, S. 00-664 (Admin. Law Div. 10/1/01); and *NTN Bower Corp. v. State of Alabama*, S. 01-273 (Admin. Law Div. 10/1/01), respectively. Conversely, the Administrative Law Division has also held that the reduced rate did not apply to overhead cranes used to move products in a building, a substance used to help crack concrete, or to coolant used to maintain cutting tools. See, *W.E. Richardson Machine Co., Inc.*, S. 96-480 (Admin. Law Div. O.P.O. 7/16/98); *Bluegrass Bit Co., Inc. & Demolition Technologies, Inc.*, U. 96-294 & S. 96-287 (Admin. Law Div. O.P.O. 1/16/97); and *Ona Corporation v. State of Alabama*, U. 90-315 (Admin. Law Div. O.P.O. 2/10/95), respectively.

In deciding the above cases, the Administrative Law Division relied on numerous “machine” rate cases decided by the Alabama Supreme Court. That Court has held that the “machine rate” statute should be given a “broad and all inclusive meaning,” and that the terms “manufacturing, processing and compounding” were intended to encompass “all the operations or processes by which the finished or ultimate product has been integrated from elements originally diverse in their forms.” *State v. Try-me Bottling Co.*, 57 So.2d 537, 539 (Ala. 1952). The Court has also held that the statute should be construed for the taxpayer and against the Department. *Calumet & Hecla*, 206 So.2d at 357; see also, *Boswell v. Abex Corp.*, 317 So.2d 314 (Ala. Civ. App. 1975).

The general rule applied by the Court is the “integral function” test, which the Court summarized in *State v. Newbury Mfg. Co.*, 93 So.2d 400 (1957), as follows:

Their (the machines’) status is not controlled by the material of which they are composed, but by the office they serve in the process. If the article in question performs an integral function in the procedure by which the tangible personal property is produced, we think it is part and parcel of the machinery used in its production.

State v. Newbury Manuf. Inc., 93 So.2d at 402.

The Supreme Court has also held that a machine used in manufacturing qualifies for the reduced rate even if it is occasionally used for something other than manufacturing. *State v. Calumet & Hecla Consol. Copper Co.*, 66 So.2d 726 (Ala. 1953).² The reduced rate has also been applied to a machine used to test the product being manufactured during the manufacturing process. *State of Alabama v. Phifer Wire Products*, U. 85-179

² When *Calumet & Hecla Consol. Copper* was decided, machines used in manufacturing were exempt from sales and use tax. See, Code of Ala. 1940, Title 51, §751(p) (sales tax) and §789(p) (use tax). The Legislature imposed the reduced 1 1/2 percent levy on such machines in 1959. See, Acts 1959, 2nd Exec. Sess., No. 100, p. 298 §2 (sales tax); and

(Admin. Law Div. 5/21/86).

The Department initially argued in this case that the computers used in Konica Minolta's engineering department did not qualify for the reduced rate because they were sometimes used by Konica Minolta's employees for personal or other non-manufacturing purposes. T. at 14, 15. The Department examiner testified that if the computers were used solely to manufacture software, they would qualify for the reduced rate. T. at 14. The Department now correctly concedes that the "dual usage" of any item in dispute does not prevent it from being eligible for the reduced rate. Department's Brief at 3. I agree. See, *Calumet & Hecla Consol. Copper, supra*.

The software developed by Konica Minolta is an integral and necessary part of the printers manufactured by Konica Minolta. Computer software constitutes tangible personal property. *Wal-Mart Stores, Inc. v. City of Mobile*, 696 So.2d 290 (Ala. 1996). The third party software packages and the computers, monitors, accessories, servers, tools, dies, molds, etc., used by Konica Minolta to develop or manufacture the software, drivers, and the other components of the printers thus constitute machines used in manufacturing the printers. Those items are thus taxable at the reduced 1 1/2 percent rate. The computers, printers, toner and the other items used to test the various components of the printers or for quality control purposes also qualify for the reduced rate.

The Department is directed to recompute Konica Minolta's liability by applying the reduced 1 1/2 percent rate to the property in issue in lieu of the 4 percent general rate.

Issue (2). The "ingredient or component part" issue.

Various of the items in issue, i.e., software, computer chips, and circuit boards, for example, became physically embedded in or attached to the finished printers. All such items that became component parts of the printers were purchased at wholesale pursuant to Code of Ala. 1975, §40-23-60(4)(b), and thus were not subject to use tax.

The Department concedes that any items that were physically attached to the printers were purchased at wholesale, and thus not taxable. The Department claims, however, that no such property was included as taxable in the audit. (T. 31.)

Konica Minolta argued at the hearing that only a few component parts were included as taxable in the audit. (T. 32, 33.) In its Brief, however, Konica Minolta claims that various component parts with a total purchase price of \$195,922 were included in the use tax assessment, see pages 1 and 2 of Exhibit C enclosed with Konica Minolta's Brief.

The evidence is unclear as to whether the Department included any component parts as taxable in the audit, and if so, in what amount. The Department should notify the Administrative Law Division when it submits Konica Minolta's adjusted liability addressed in Issue (1) as to whether the items listed on pages 1 and 2 of Exhibit C became component parts of the printers, and if so, were they included as taxable in the Department's audit. Konica Minolta will be allowed an opportunity to respond, if necessary. Appropriate action will then be taken.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days from the date of this Order pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered September 29, 2005.

BILL THOMPSON
Chief Administrative Law Judge