BARIATRIC HEALTH & WELLNESS, PC 1800 MCFARLAND BLVD. N., SUITE 150 TUSCALOOSA, AL 35406,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
	§	DOCKET NO. COUNTY 15-101
Taxpayer,	§	
v.	§	
TUSCALOOSA COUNTY SALES & USE TAX DIVISION	§	

OPINION AND PRELIMINARY ORDER

The Tuscaloosa County Special Tax Board ("Tuscaloosa County") assessed Bariatric Health & Wellness, PC ("Taxpayer") for sales and use tax for January 2008 through May 2014. The Taxpayer appealed to the Tax Tribunal pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on July 30, 2015. Bruce Ely and Will Thistle represented the Taxpayer. Clay Staggs represented Tuscaloosa County.

FACTS AND ISSUES

The Taxpayer operated a bariatric health clinic in Tuscaloosa County, Alabama during the period in issue. Bariatrics is a branch of medicine that deals with the causes, prevention, and treatment of obesity.

Dr. John Morgan is the Taxpayer's major shareholder and medical director. He is a board certified OB/GYN, and has practiced bariatric medicine for approximately 25 years.

When a patient first visits the Taxpayer's clinic, Dr. Morgan and his staff initially consult with and perform a medical evaluation of the patient, which includes a physical examination, complete blood tests, an electrocardiogram, and a review of the patient's eating habits, lifestyle, and personal and family medical history. The patient thereafter

participates in a customized weight loss program designed by Dr. Morgan to fit the patient's specific needs.

The weight loss program includes a special diet prescribed by Dr. Morgan, an exercise program, long-term behavior modification, and a structured long-term weight maintenance program. Patients under Dr. Morgan's care usually visit the clinic weekly for medical tests and evaluations, have their blood tested every six weeks, and have an annual EKG.

After Dr. Morgan determines the patient's dietary needs, the patient goes on a "fasting period" diet during which the patient eats only specific packaged food items prescribed by Dr. Morgan. The packaged food items are in powder form, and include various entrees, desserts, cookies, etc., that contain approximately the same amounts of minerals, vitamins, proteins, electrolytes, fiber, and other nutrients.[1]

The Taxpayer purchased the packaged food items from various vendors and then marked-up and resold the items to its patients during the period in issue. As discussed below, it also sold the items to non-patients during a portion of the assessment period. The Taxpayer concedes that it owes County sales tax on its sales to non-patients in Tuscaloosa County during the subject period. The issue is whether the Taxpayer is also liable for sales tax on the packaged food items it sold to its patients in the County during the period.

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[1] Dr. Morgan also sometimes requires the patient to eat a prescribed amount of food other than the packaged food items, depending on the patient's needs. For example, if a patient is diabetic, Dr. Morgan will follow a diabetic protocol and allow the patient to eat "[f]our ounces of lean chicken, some grains, things like that." (T. 38).

After a patient gets through the fasting phase of their diet, they enter into a realimentation phase during which regular or store bought food is slowly introduced back into the patient's diet. When a patient eventually reaches their weight loss goal, they begin a maintenance diet. The patient continues to purchase and eat the packaged food items during the realimentation phase, and also has the option of doing so while on the maintenance diet.

Before October 2011, the Taxpayer's patients could only purchase and pick-up the packaged food items at the Taxpayer's clinic in Tuscaloosa. In October 2011, the Taxpayer started selling the packaged food items online to accommodate its patients. The Taxpayer concedes, however, that it also sold the packaged food items online to non-patients beginning in October 2011.

The City of Tuscaloosa initiated a sales and use tax audit of the Taxpayer on September 27, 2013. The City audit alerted the Taxpayer to the possibility that it may owe sales or use tax on the packaged food items.

The Taxpayer's representative sent requests for a voluntary disclosure agreement ("VDA") to both the State Revenue Department and Tuscaloosa County on February 14, 2014.[2] The County responded by e-mail on February 18, 2014 that it follows the State's VDA procedures. It also asked the Taxpayer's representative to provide it with a VDA form.

[2] As explained below, a VDA allows a taxpayer that is not currently reporting and paying tax to voluntarily contact the State or a participating local jurisdiction for the purpose of paying all past due taxes for a limited three year lookback period, and thereby coming into compliance with the jurisdiction's tax laws.

The Taxpayer subsequently applied to Tuscaloosa County for a sales and use tax license on March 12, 2014. Tuscaloosa County notified the Taxpayer two days later, on March 14, 2014, that it intended to audit the Taxpayer for sales and use tax for the period in issue. A County auditor subsequently determined that the Taxpayer was selling the packaged food items at retail, and was thus liable for County sales tax on the sales. When the Taxpayer failed to provide any records showing the gross proceeds from its packaged food sales, the auditor computed the gross proceeds using the Taxpayer's cost of the items as indicated on the Taxpayer's general ledger as "food cost of goods sold." He then applied a 100 percent mark-up based on the Taxpayer's CPA's statement that the packaged food items had been mark-up from 50 percent to 100 percent.

The Taxpayer's representative sent Tuscaloosa County a VDA form on April 3, 2014, as requested by the County. The Taxpayer and the State Revenue Department executed a VDA in October 2014, effective on the February 14, 2014 initial contact date. The Taxpayer and the County never executed a VDA.

Other relevant facts are set out in the below analysis.

The primary issue is whether the Taxpayer was selling the packaged food items to its patients at retail during the period in issue. Tuscaloosa County contends that the transactions constituted taxable retail sales of food. The Taxpayer argues that it was not selling the packaged food items, which it refers to as "nutritional supplements," but rather, was providing the items to its patients tax-free incidental to the medical services provided by Dr. Morgan and his staff. It argues in the alternative that the packaged food items are either "drugs" and/or "dietary supplements," and thus exempt from sales and use tax pursuant to Code of Ala. 1975, §§40-23-4.1(a) and 40-9-27, respectively.

Finally, the Taxpayer asserts that Tuscaloosa County should be required to grant the Taxpayer's requested VDA, and thereby limit the assessment period to January 2011 forward, because the County admittedly followed the Department's VDA guidelines during the period in issue, and that it qualified for a VDA under those guidelines, as evidenced by the fact that the Department granted the Taxpayer's request for a VDA.

ANALYSIS

Concerning the Taxpayer's primary argument, Alabama's courts have held that tangible personal property transferred by a doctor to a patient that is incidental to the professional services provided by the doctor is not subject to Alabama sales tax. In *Haden v. McCarty*, 152 So.2d 141 (Ala. 1963), the Alabama Supreme Court held that the transfer of dentures and other prosthesis by a dentist to the patient did not constitute a sale subject to sales tax.

> There can be no doubt that dentists are highly trained professional men; dentistry is a branch of the science of the healing arts which relates strictly to the diagnosis, treatment, restoration and prevention of diseases and abnormalities of the oral cavity and related structures. Dentists treat diseases, being specially trained in oral pathology. We do not feel that restorative dentistry can be placed in a class by itself, that is separated from diagnosis and dental treatment, and made subject to the sales tax. A dentist does more than prescribe and fit dentures into the mouth of a patient. The prosthesis is merely the end result of what has taken much time to develop. No one would contend that dentures could be repossessed and sold to another as they have no value except to the person for whom they are designed. The denture itself could not be separated from the treatment, examination, and other things leading up to fitting it in one's mouth, and separately charged for.
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> We, therefore, entertain the view that a transfer of dentures or other prosthesis cannot be distinguished or separated from the diagnosis and treatment rendered a dental patient.

Haden v. McCarty, 152 So.2d at 143.

The Revenue Department's Administrative Law Division, now the Tax Tribunal, also held that a plastic surgeon that used breast and other implants in performing cosmetic and reconstruction surgery was not reselling the implants at retail. Rather, he was using the implants incidental to his professional services, and thus owed Alabama use tax on his cost of the implants.

> The Alabama Supreme Court has held that doctors, as members of a learned profession, are not making retail sales when they provide or supply tangible property to their patients incidental to their professional services. *Hamm v. Proctor*, 198 So.2d 782 (Ala. 1967); *Haden v. McCarty*, 152 So.2d 141 (Ala. 1963). However, the use or consumption of the property by the doctors in providing the services in Alabama is clearly subject to Alabama use tax. (footnote omitted)
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> Doctors should pay sales tax when they purchase supplies and other tangible property, i.e., breast implants, that they use or consume in providing professional services to their patients. See, Dept. Reg. 810-6-1-.55.

Feagin v. State of Alabama, Docket S. 05-711 (Admin. Law Div. 1/18/2006) at 4.

This is a difficult case because Dr. Morgan is attempting to cure his patients of the insidious disease of obesity. He requires the patients to eat the packaged food items in issue in lieu of normal food as part of the cure. The above facts, standing alone, suggest that the rationale of *Haden v. McCarty* and *Feagin v. State of Alabama* may apply, and that the Taxpayer's sales of the packaged food items are not subject to sales tax. But a deeper analysis shows that the above cases can be distinguished from this case.

It is commonly understood that when a surgeon operates on a patient, the surgeon is primarily providing the patient with his or her knowledge and skill as a trained surgeon, and that any tangible item used by the surgeon, i.e., a stent, pacemaker, implant, etc., is only incidentally transferred to the patient. The same applies when a dentist creates or

orders a custom prosthesis and then fits the patient with the prosthesis. The patient is paying for the dentist's intangible knowledge, skill, and medical expertise, and not the tangible prosthesis. As stated in *Haden v. McCarty*, supra, "a transfer of dentures or other prosthesis cannot be distinguished or separated from the diagnosis and treatment rendered a dental patient." *Haden v. McCarty*, 152 So.2d at 143. In short, the surgeon and dentist are themselves using and consuming the tangible items incidental to and as a part of their treatment of the patient.

In this case, Dr. Morgan uses his professional skill and knowledge to diagnose the patient, determine the patient's dietary needs, and then monitor the patient during the course of treatment. He also directs the patient to eat the packaged food items. But unlike the surgeon that uses the stent, pacemaker, implant, etc., when he or she operates on a patient, or the dentist that uses the prosthesis that he or she fits into the patient's mouth, Dr. Morgan is not using the packaged food items incidental to his professional care. Rather, he is selling the packaged food items to the patient for use by the patient. That is, the packaged food items are not "the end result of what has taken (the dentist) much time to develop." *Haden v. McCarty*, 152 So.2d at 143. The sales of the packaged food items can thus be distinguished and separated from Dr. Morgan's diagnosis and monitoring of his patients.

Importantly, while Dr. Morgan prescribes the packaged food items for the patient, the patient can and sometimes does purchase the items from a vendor other than the Taxpayer. Consequently, while implants and dental prosthesis can only be implanted or fitted by trained physicians or dentists incidental to their treatment of the patient, the packaged food items can be purchased from any number of non-physician sources. And

when one of Dr. Morgan's patients purchases the food items from another vendor in Alabama, the sale is subject to Alabama sales tax, and also Tuscaloosa County sales tax if the sale is closed in the County. I see no principled reason why the sale of the items by the Taxpayer should be exempt, and the sale of the same items by a third party vendor should be taxable.[3]

The Taxpayer also argues that the packaged food items are "drugs" and/or "dietary supplements," and thus exempt from sales tax pursuant to Code of Ala. 1975, §40-23-4.1.[4] To begin, if the Taxpayer's primary argument is correct that any item prescribed by a physician and thereafter sold by the physician to the patient is not subject to sales tax because it is transferred incidental to the physician's treatment of the patient, there would be no need for the drug exemption at §40-23-4.1. It is presumed that the Legislature did not enact a meaningless statute. *Druid City Hospital Board v. Epperson*, 378 So.2d 696 (Ala. 1979). Consequently, the sale of drugs by a physician to a patient would be subject to sales tax but for the §40-23-4.1 exemption. It follows that the Taxpayer's sale of the packaged food items to its patients are subject to sales tax, unless the drug exemption at §40-23-4.1 or the dietary supplement exemption at §40-9-27 applies.

For the §40-23-4.1 exemption to apply, the substance must be (1) a medicine; (2) prescribed by a physician; (3) either filled by a licensed pharmacist or sold to the patient by the physician; and (4) for human intake or consumption. See generally, *Baptist Medical*

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[3] The County auditor testified that he had also audited another bariatric weight loss clinic in Tuscaloosa County, and that that clinic had been reporting and paying County sales tax on its packaged food item sales.

[4] Dept. Reg. 810-6-3-47.01(1) also specifies that the §40-23-4.1 sales tax exemption also applies to use tax.

Centers v. State, Dept. of Revenue, 545 So.2d 45 (Ala. Civ. App. 1987). The last three elements of the exemption are satisfied in this case. The issue thus is whether the packaged food items constitute "medicine" within the purview of the exemption.

As pointed out by the Taxpayer, at 13 of its Post-Hearing Brief, the term "medicine" is not defined by Alabama statute or Department regulation. The Administrative Law Division addressed what constituted "medicine" for purposes of the §40-23-4.1 exemption in *Alcon Laboratories, Inc. v. State of Alabama*, Docket S. 06-980 (Admin. Law Div. 3/7/2007). The issue in that case was whether viscoelastic solutions injected into the eye during cataract surgery qualified as a medicine. The Division held that the solution was a medicine, as follows:

> "Medicine" is not defined by the Alabama revenue code, Title 40, Code of Ala. 1975. In such cases, a word must be given its normal, generally accepted meaning. *State v. American Brass*, 628 So.2d 920 (Ala. Civ. App. 1993). The American Heritage College Dictionary, Fourth Ed., at 862, defines the term as "[a]n agent, such as a drug, used to treat disease or injury." "Drug" is defined by the same source, at 431, as "[a] substance used in the diagnosis, treatment, or prevention of a disease."
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> The viscoelastic solution in issue is a substance used in the treatment of eye disease, i.e., the removal of cataracts during surgery. The solution is thus a medicine as defined above.

Alcon Laboratories at 2 – 3.

The Taxpayer relies on the Division's statement in *Alcon Laboratories* that a drug is "a substance used in the diagnosis, treatment, or prevention of a disease." It thus contends that because the packaged food items are used to treat obesity, they qualify as a medicine. I disagree.

The primary rule of statutory construction is that the intent of the Legislature in enacting a statute must be followed. *Bailey v. USX Corp.*, 850 F.2d 1506 (Ala. 1988). The language used in a statute also should not be construed so as to lead to an absurd or nonsensical result. *Blue Cross Blue Shield of Alabama v. Nielsen*, 116 F.3d 1406 (11th Cir. 1997); *Abranson v. Hand*, 155 So. 590 (1934).

The packaged food items in issue are food that the Taxpayer's patients ingest to live on, at least during the initial stage of their diet. I do not believe that when the Legislature enacted the §40-23-4.1 drug exemption, it intended to exempt food that is required to keep a person alive, regardless of the nutritional value or content of the food. And if the Taxpayer's argument is correct, a gastroenterologist could treat a patient's stomach or intestinal problem by prescribing a particular diet of fruits and vegetables for the patient. The doctor could then open a fruit and vegetable market and sell the fruits and vegetables to the patient sales tax-free, or, similar to this case, the doctor could sell the patient packaged fruit and vegetable items tax-free. That absurd result was not intended when the Legislature enacted the §40-23-4.1 exemption. The packaged food items thus are not drugs within the scope of the §40-23-4.1 exemption. The above holding is supported by the rule of statutory construction that an exemption statute must be strictly construed against the taxpayer and for the Department, or in this case, the County. *Fleming Foods of Alabama, Inc. v. Dept. of Revenue*, 648 So.2d 580, cert. denied 115 S. Ct. 1690 (1995).

The packaged food items also are not exempt as a dietary supplement pursuant to §40-9-27. A "supplement" is by definition "[s]omething added to complete a thing, . . ." The American Heritage College Dictionary, 4th Ed., at 1386. In this case, however, the

Taxpayer's patients eat only the packaged food items during the initial phase of their diet. The items thus do not supplement anything when eaten during the fasting stage of the diet. They thus cannot be dietary supplements. And again, the above holding is supported by the rule of statutory construction that an exemption must be construed against the exemption and for the government. *Fleming Foods of Alabama*, supra.

The State Revenue Department has offered a VDA program since July 2008. The Department is not required by statute to offer a VDA program. Rather, it does so "to encourage businesses that are not in compliance with the Alabama tax laws to come forward voluntarily to register and bring their accounts into compliance." See, July 2008 Voluntary Disclosure Program brochure.

The program includes a limited three year lookback period, and also provides that the effective date of a VDA shall be the date on which the Department received the initial contact from the taxpayer. To qualify for the program, "the applicant must not have been contacted by the Department or an agent of the Department, such as the Multi State Tax Commission, . . . nor filed a tax return for seven years prior to the initial written request for voluntary disclosure." The taxpayer also must not be "currently under audit, . . ." See again, July 2008 Voluntary Disclosure Program brochure.

The Taxpayer in this case requested a VDA with both the Revenue Department and Tuscaloosa County by letter dated February 14, 2014.[5] The individual that handled VDAs for the County responded by e-mail on February 18, 2014 that "[o]ur office follows the State

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[5] Following standard Department guidelines that are followed by all taxpayers that request a VDA, the Taxpayer did not disclose its identity when it requested the VDA with both the Department and the County.

of Alabama procedures for Voluntary Disclosure." Taxpayer Ex. 1. Having been told by County personnel that the County followed the Revenue Department's VDA guidelines, the Taxpayer subsequently applied to the County for a sales tax license on March 12, 2014. That filing prompted the County to send the Taxpayer a sales and use tax audit notice on March 14, 2014. The Taxpayer's representative subsequently sent the County a VDA form on April 3, 2014, as requested by the County.

The County contends that the Taxpayer was not eligible for a VDA when the Taxpayer first contacted the County about a VDA on February 14, 2014 because the Taxpayer was under audit by the City of Tuscaloosa on that date. The County asserts that because the City has a reciprocal audit exchange agreement with the County, the Taxpayer was "currently under audit" on the initial contact date, and thus not eligible for a VDA. I disagree.

While the County had an information exchange agreement with the City of Tuscaloosa, the City was not the County's agent. The Tuscaloosa County Special Tax Board's Assistant Manager testified at the July 30 hearing, as follows:

Q. Does the City of Tuscaloosa audit on your behalf?

A. Do they audit on our behalf?

Q. Uh-huh.

A. No. They audit. They send us their audit. We audit from that audit.

Q. So –

A. They don't.

Q. So they're not an agent of yours? They're not auditing on your behalf; otherwise, it wouldn't have been necessary for you to have this audit.

A. No. They're not – they're not auditing on our behalf.

(T. 150).

Reading the Department's VDA guidelines in context, the phrase "currently under audit" means that a taxpayer is currently under audit by the State or an agent of the State. Applying those guidelines to local governments that admittedly follow the Department's guidelines, as in this case, a taxpayer is under audit only if it is being audited by the local jurisdiction to which the taxpayer has applied for a VDA, or an agent of that jurisdiction. For example, if the local jurisdiction has hired a private auditing firm to conduct audits on its behalf, an audit conducted by the private auditing firm would be an audit by an agent of the jurisdiction, and if ongoing when a taxpayer requested a VDA, the taxpayer would be ineligible for the VDA. Having a reciprocal audit exchange agreement with another local jurisdiction does not, however, make the local jurisdictions agents for each other.

It is also irrelevant that the Taxpayer's representative provided the County with a VDA form on April 3, 2014, after the County began its audit of the Taxpayer. What is relevant is that when the Taxpayer requested a VDA on February 14, 2014, it had not been contacted by the County or an agent of the County within the prior seven years, and also was not currently under audit by the County or an agent of the County. The Taxpayer thus qualified for a VDA on the initial contact date.

As discussed, the Department implemented the VDA program to encourage taxpayers that are not currently paying a tax that may be due to voluntarily come forward and become tax compliant by paying the tax due for a three year lookback period, and then going forward. The Taxpayer in this case in good faith did not believe that its packaged food sales were subject to sales tax. It was alerted to that possibility by the City of

Tuscaloosa audit. It thereafter voluntarily attempted to come into compliance by filing VDA requests with the State and Tuscaloosa County. After the County notified the Taxpayer that it followed the State VDA guidelines, and believing that it qualified under the State guidelines for a County VDA, the Taxpayer thereafter registered with the County to begin filing and paying sales tax to the County. The County is estopped from not granting the VDA under those circumstances.

Importantly, pursuant to the Revenue Department's guidelines, if a taxpayer qualifies for a VDA on the initial contact date, the Department will automatically grant the VDA, effective on the initial contact date. Because the County admittedly followed the Department's guidelines during the period in issue, and because the Taxpayer qualified for a VDA on the initial contact date, the County was also required to grant the VDA pursuant to the Revenue Department's guidelines, effective February 14, 2014.[6]

The County is directed to recompute the tax and interest due from January 2011 through May 2014. The County concedes, and I agree, that the penalties in issue should be waived for cause. A Final Order will be entered when the County notifies the Tribunal of the adjusted amount due.

[6] The County indicates in its Reply Brief, page 6, note 4, that perhaps it "would be better served to cease accepting VDAs." The County decision to follow the Department's VDA guidelines is, of course, voluntary, and the County may cease doing so. It may also continue following Department guidelines, but announce that for Tuscaloosa County purposes, "currently under audit" includes an audit being conducted by another local jurisdiction with which it has an audit exchange agreement. In any case, my understanding is that the Department's VDA program has successfully resulted in the voluntary payment of past due taxes and taxes going forward by taxpayers that otherwise would have never been paid. It is assumed that the County has received the same positive benefits, and will continue to do so if it continues to accept VDAs from Tuscaloosa County taxpayers.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2B-2(m).

Entered December 30, 2015.

BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: Clay Staggs, Esq.
Bruce P. Ely, Esq.
William T. Thistle, II, Esq.