

MICHAEL C. MARCATO  
Safety Guide of Alabama, LLC  
P.O. Box 210128  
Montgomery, AL 36121-0128,

Taxpayer,

v.

STATE OF ALABAMA  
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 03-412

### **AMENDED FINAL ORDER<sup>1</sup>**

The Revenue Department assessed State sales tax against Michael C. Marcato, Safety Guide of Alabama, LLC, for September 1999 through August 2002. Safety Guide of Alabama, LLC (“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 30, 2003. Will Sellers and Riley Roby represented the Taxpayer. Assistant Counsel Glen Powers represented the Department.

The Taxpayer sells highway construction supplies and devices at retail, and is headquartered in Montgomery, Alabama. The items sold by the Taxpayer include permanent and temporary traffic signs, barrels and cones used to funnel or direct traffic during construction, flashing lights, flags, marking paint, rain suits, Gatorade, safety vests, batteries, etc.

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<sup>1</sup> The original Final Order entered on January 28, 2004 incorrectly identified the Taxpayer as “Michael C. Marcato, d/b/a Safety Guide of Alabama, Inc.” The Final Order also incorrectly entered judgment against Michael C. Marcato, individually. This Amended Final Order correctly identifies the Taxpayer as “Safety Guide of Alabama, LLC.” The judgment is also correctly entered against that entity. References to the Taxpayer have been changed to reflect the proper entity. The substance of the January 28, 2004 Final Order was not otherwise changed.

The Taxpayer sold construction supplies tax-free to various individuals and road contractors in Alabama during the period in issue. This case involves two primary issues:

(1) Is the Taxpayer liable for sales tax on tax-free cash sales it made to individuals during the audit period, and,

(2) Is the Taxpayer liable for sales tax on property sold tax-free to road contractors pursuant to Code of Ala. 1975, §40-9-33. That statute exempts from sales and use tax “any tangible personal property to be incorporated into realty pursuant to a contract” with the U.S. Government, the State of Alabama, or any governmental subdivision of the State. Issue (2) involves two sub-issues:

(A) Was the property “incorporated into realty” within the scope of §40-9-33; and,

(B) Even if some of the subject property was not incorporated into realty, should the Taxpayer still be relieved of liability because it reasonably believed in good faith when it sold the property that it was exempt under the statute.

**Issue (1). The Cash Sales.**

The Taxpayer made numerous tax-free cash sales to individuals during the subject period. On audit, a Department examiner taxed the cash sales because the Taxpayer’s records did not establish or verify that the sales were to an exempt entity. The Department assessed the Taxpayer accordingly.

The Taxpayer claims that the cash sales in issue were to federal employees that purchased the items for the government. Its managing member explained that the employees normally used a government credit card, but that sometimes “their card wouldn’t work.” T. at 91. Consequently, the Taxpayer sold the items to the individuals tax-free for

cash because it believed that the property was being purchased for the exempt federal government.

All taxpayers are required to maintain adequate records from which their correct sales tax liability can be computed. Code of Ala. 1975, §40-2A-7(a)(1) (generally); Code of Ala. 1975, §40-23-9 (sales tax). The burden is also on a taxpayer to maintain records establishing or recording an exemption from tax, and in the absence of such records, the exemption cannot be allowed. *State v. Ludlum*, 384 So.2d 1089 (Ala.Civ.App.), cert. denied, 384 So.2d 1094 (Ala. 1980).

The Taxpayer claims it made the cash sales in issue to government employees that were buying for the exempt federal government. It failed, however, to present any purchase orders or other evidence verifying that the sales were to the government. Without such records, the undocumented cash sales to the individuals were properly taxed by the Department.

#### **Issue (2). The Sales to Contractors.**

The Taxpayer sold traffic barrels, construction signs, safety vests, etc. during the subject period to contractors that had contracted to perform road construction contracts with the Alabama Department of Transportation (“ALDOT”). In all but one case, the contractors provided the Taxpayer with a State sales and use tax exemption certificate, Form STE-1.<sup>2</sup> The Taxpayer consequently sold everything to the contractors tax-free.

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<sup>2</sup> The one exception involved sales to Mobile Asphalt, which purchased the items tax-free using its Alabama sales tax number. The Department does not issue STE-1 exemption certificates to licensed retailers. Dept. Reg. 810-6-5-.02(2). However, the rationale concerning whether the Taxpayer is liable for tax on the sales to the contractors that used  
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A Department examiner audited several of the road contractors and determined that some of the items sold by the Taxpayer were not intended to be incorporated into realty, and thus should not have been sold tax-free. He consequently audited and assessed the Taxpayer on those items, i.e. temporary construction barrels and signs, safety vests, etc., that were not designed or intended to be permanently attached to realty,<sup>3</sup> The examiner did not tax permanent road signs or the other items sold by the Taxpayer that were attached to and intended to remain permanently in the realty.

**Sub-Issue (A). How Should “Incorporated into Realty” be Interpreted?**

The sales and use tax exemption at §40-9-33 was enacted in 2000, and has not been addressed by Alabama’s appellate courts. When interpreting an exemption statute, the statute must be strictly construed against the exemption. *Bean Dredging Corp. v. State of Alabama*, 454 So.2d 1009 (Ala. 1984).

Section 40-9-33 exempts property that is “to be incorporated into realty. . . .” How should that phrase be interpreted? “Incorporated” is defined by The American Heritage Dictionary, Fourth College Ed., at 702, as “united into a body; combined.” Consequently, the personal safety devices, Gatorade, and the other items sold by the Taxpayer that were never intended to be attached to realty were clearly not exempt under §40-9-33.<sup>4</sup> The harder question, however, concerns the construction signs and barrels that may have been temporarily placed on poles or otherwise attached to the ground, but were not intended as

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the STE-1 exemption certificates applies equally to the tax-free sales to Mobile Asphalt.

<sup>3</sup> For a complete list of the items taxed by the Department examiner, see Dept. Ex. 5.

<sup>4</sup> The managing member conceded, grudgingly, at the October 30 hearing that such items probably were not exempt. T. at 111, 112.

permanent additions to the realty. That is, does the exemption apply only to property that is intended to be a permanent addition to the realty, or does it also apply to property that is only temporarily attached to realty.

In *Dept. of Revenue v. James A. Head & Co., Inc.*, 306 So.2d 5 (Ala.Civ.App. 1974), the issue was whether auditorium seats, carpet, and library carrels purchased by a building contractor were taxable under the sales tax “contractor” provision. Code of Ala. 1975, §40-23-1(a)(10). That provision defines “retail sale” to include “sales of building materials to contractors . . . for resale or use in the form of real estate. . . .” The Court of Civil Appeals concluded that for property to become a part of realty, the property must be attached or incorporated into realty with the “intention to make the article a permanent accession to the freehold.” *Head*, 306 So.2d at 10, citing *Patterson v. Chaney*, 24 N.M. 156, 173 P. 859, 6 A.L.R. 90. That is, property becomes a part of and is incorporated into realty if it is securely attached and is intended to become a permanent addition to the realty. The Court thus determined that the auditorium seats, carpet, and library carrels in issue became a part of the realty because they were intended as permanent fixtures.

The rationale of *Head* was followed in *State, Dept. of Revenue v. Montgomery Woodworks, Inc.*, 389 So.2d 510 (Ala.Civ.App. 1980). In that case, the Court of Civil Appeals held that cabinets and woodwork became a part of realty because they were permanently attached to the realty. “In the case at hand the cabinets and woodwork were . . . to be permanently attached to the wall or place so attached. Therefore we find that the cabinets and woodwork became a part of the realty.” *Montgomery Woodworks*, 389 So.2d at 512.

Applying the above rationale, and also the rule of construction that an exemption must be narrowly construed, property is “incorporated into realty” pursuant to §40-9-33 only if it is affixed to realty with the intent that it remain a permanent part of the realty. The Department examiner thus correctly determined that the temporary traffic barrels and construction signs in issue that were not intended to become permanent additions to the realty were not exempt under the statute.<sup>5</sup>

**Sub-Issue (2). Did the Taxpayer Act in Good Faith and Exercise Reasonable Care When It Sold the Items Tax-free?**

Even though the personal safety devices and other non-permanent construction supplies were not exempt under §40-9-33, the Taxpayer would still be relieved of liability if it “acted in good faith and reasonably believed” that the items were exempt when it sold them tax-free to the contractors. Code of Ala. 1975, §40-23-121. If not, however, the Taxpayer would be liable for tax on the items.

The STE-1 forms restricted the exemption “to the purchase of tangible personal property . . . , where such property is to be incorporated into realty. . . .” The forms further provided that the “seller must exercise reasonable care to determine that the tangible personal property obtained under this certificate is for the purpose indicated. A seller failing to exercise such care will be held liable for sales or use tax due on such purchases.”

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<sup>5</sup> It is irrelevant that some of the items became the property of ALDOT after the construction was completed. The fact that the Taxpayer was required by the contracts to leave those items at the construction site does not mean that the items were “incorporated into realty.” Rather, they only became the property of ALDOT, which could then use the items on subsequent construction projects.

The Taxpayer claims it accepted the STE-1 forms in good faith because it knew that the items “would become the property of the project and be incorporated into the project.” T. at 75. It argues that to require “a post-sale review of the various purchased items to make certain that the items were incorporated into realty would create a burden on the Taxpayer that was not originally intended by the Alabama Legislature . . .” Taxpayer’s Brief at 5. Unfortunately, the Taxpayer misunderstood its duty under the law.

The fact that the Taxpayer knew the items were to be used on a government contract was not sufficient. Rather, the Taxpayer had an affirmative duty to investigate and determine if each of the items were intended to be incorporated into realty, and thus exempt under §40-9-33. The Form STE-1 specifies that the “seller is required to act in good faith and to exercise reasonable care to determine“ that all of the property being sold is exempt. The Taxpayer failed to exercise such reasonable care in this case. Rather, it accepted the STE-1 forms as a blanket exemption, and thus sold all items tax-free, even those items, i.e. Gatorade, safety vests, etc., that clearly are never incorporated into realty. It did so at his own peril.<sup>6</sup>

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<sup>6</sup> The Taxpayer’s duty to exercise reasonable care before selling property tax-free pursuant to §40-9-33 is similar to a retailer’s duty to exercise reasonable care before selling goods tax-free at wholesale. When a retailer sells to a customer at wholesale, the retailer is under an affirmative duty to know the general nature of the customer’s business, and that the customer is in the business of reselling the type of property being purchased. See, Dept. Reg. 810-6-1-.184. If the retailer fails to exercise reasonable care in determining if a sale is for resale, he will later be held liable for tax on any such sales that were not for resale. See generally, *Alabama Liquidation & Collection Agency, Inc. v. State of Alabama*, S. 03-345 (Admin. Law Div. 12/11/03). Likewise, a retailer selling tax-free pursuant to §40-9-33 must also exercise reasonable care in determining that the property is intended to be incorporated into realty.

A retailer also is not required to conduct a post-sale review to determine if items sold tax-free pursuant to §40-9-33 are in fact incorporated into realty by the contractor. Rather, a retailer must only determine that the items are of the type intended as permanent additions to the realty. If the retailer reasonably believes at the time of sale that the property will become permanently incorporated into realty, it can sell the property tax-free, and will not later be liable if for some reason the property is not incorporated into realty. As indicated, however, the Taxpayer failed to reasonably investigate whether the items in issue were intended to be incorporated into realty.

The Taxpayer is liable for the sales tax in issue.<sup>7</sup> But while the Taxpayer, as the retailer, is directly liable to the Department for the tax, the Taxpayer's customers as the final consumers are ultimately liable for the tax. *Alabama Dept. of Revenue v. Fox*, 609 F.2d 178 (5<sup>th</sup> Cir.), cert. denied, 101 S.Ct. 78 (1980); *Hill v. State*, 281 So.2d 440 (1973). The Taxpayer thus has a cause of action against its customers for the unpaid sales tax in issue.

The Final Order entered on January 28, 2004 is voided. The tax and interest assessed by the Department is affirmed. Under the circumstances, the penalty of \$1,473.33 is waived for reasonable cause. Code of Ala. 1975, §40-2A-11(h). Judgment is entered against Safety Guide of Alabama, LLC for \$32,799.30. Additional interest is also due from the date of entry of the final assessment, May 16, 2003.

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<sup>7</sup> When the Department examiner audited the contractors that had purchased the items in issue tax-free from the Taxpayer, he discovered that the contractors had been billed for and paid sales tax to other vendors on similar items. T. at 69, 70. The Taxpayer would thus be given an unfair competitive advantage if it was allowed to sell the items tax-free.



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

Entered February 3, 2004.