DIXIE NOVELTY COMPANY, INC. 906 31ST AVENUE TUSCALOOSA, AL 35401-2222,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 05-422
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Dixie Novelty Company, Inc. ("Taxpayer") for State sales tax for April 2000 through January 2003, and for State use tax for January 2000 through January 2003. 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 June 13, 2005. Darrell Westfaul represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

ISSUES

The Taxpayer owns and operates arcade machines and other amusement devices at various locations in Alabama and Mississippi. The issues are:

(1) Is the Taxpayer liable for sales tax on the total gross receipts derived from the machines operated in Alabama; or should the Taxpayer be allowed to back-out the sales tax in computing its taxable gross receipts;

(2) Is the Taxpayer liable for use tax on the toys, or "plush," that are used in various games operated by the Taxpayer; and,

(3) If use tax is owed on the plush, should the plush used by the Taxpayer in Mississippi be excluded from Alabama use tax pursuant to the temporary storage regulation, Reg. 810-6-5-.23?

FACTS

The Taxpayer is headquartered in Tuscaloosa, Alabama. It contracts to provide arcade machines, pool tables, jukeboxes, etc. to various businesses located in Alabama and Mississippi. The Taxpayer maintains control of the machines while they are at the customers' locations. It pays the location owners a fixed percentage of the net after-tax proceeds from the machines. That is, the Taxpayer backs out the sales tax due and then divides the remaining proceeds as required by the contracts with the location owners.

One type of machine provided by the Taxpayer is a "crane" machine. The player puts a quarter or quarters into the machine, which activates a crane device that the player uses to attempt to retrieve or remove a toy or plush from the machine. The Taxpayer provided the crane machines at various locations in Alabama during the entire audit period, and at locations in Mississippi beginning in May 2002.

The Taxpayer does not maintain an inventory of plush at its Tuscaloosa facility. Rather, it special orders the plush as needed from a supplier in Louisiana. The Taxpayer has an employee that runs regular routes in Alabama and Mississippi. A few days before each route, the Taxpayer orders the plush needed from the Louisiana supplier. The Taxpayer generally receives the plush at its Tuscaloosa facility the day before it is distributed to the various locations in Alabama and Mississippi.

The Taxpayer reported and paid Alabama sales tax on the receipts from its machines located in Alabama during the subject period. In computing the tax due, however, the Taxpayer deducted or backed out the sales tax in determining its taxable

gross receipts. The Taxpayer also failed to pay Alabama sales or use tax on the plush used in the crane machines.

The Department audited and assessed the Taxpayer for sales tax on the total receipts from the machines in Alabama, not the total receipts less the backed out sales tax. It also assessed the Taxpayer for use tax on the plush, including the plush used in the machines in Mississippi.

ANALYSIS

Issue (1). Can sales tax be deducted in computing taxable gross receipts?

Code of Ala. 1975, §40-23-2(2) levies a 4 percent sales tax on all taxpayers in the business of conducting or operating public places of amusement, including "amusement devices." Code of Ala. 1975, §40-23-26(a) requires that all taxpayers liable for a sales tax, including the gross receipts sales tax levied at §40-23-2(2), "shall add to the sales price and collect from the purchaser" the amount of tax due. Code of Ala. 1975, §40-23-26(b) also makes it illegal not to add sales tax to the sales price and collect it from the customer.

The Taxpayer concedes that it is liable for the gross receipts sales tax on the proceeds from its machines. It argues, however, that it should be allowed to back out sales tax in determining its taxable gross receipts because sales tax was included in the price charged to its customers.

The Department counters that the Taxpayer cannot back out the sales tax in computing its taxable receipts because (1) the tax was not separately stated in the price, and (2) the Taxpayer did not have a sign on the machines or at the business locations stating that sales tax was included in the price.

The Department currently has two regulations that specify that sales tax must be added to the sales price. Dept. Reg. 810-6-4-.20 concerns the sales tax on retail sales of tangible property. It requires that the invoice, bill, charge ticket, receipt, etc. provided to the customer must separately state the amount of sales tax being charged. Otherwise, tax will be due on the total sales price. The regulation further provides, at paragraph (3)(a), that "where it is practically impossible to furnish a customer with an invoice, bill, charge ticket, etc. . . ., the retailer shall conspicuously post a sign indicating that the charge for the item being purchased includes the price of the item and the total percentage of sales tax being collected." If the appropriate sign is posted, the retailer will be allowed to back out the sales tax before computing the tax due.

Dept. Reg. 810-6-1-.125 concerns the gross receipts sales tax on places of public amusement. Paragraph (1) of the regulation specifies that the "total receipts accruing from the operation of places of amusement or entertainment are subject to the sales tax." Subparagraph (2) addresses admissions to places of public amusement. It provides that sales tax must either be stated as a separate line item, or there must be a sign showing the admission price and the amount of tax due.

The Taxpayer's representative articulately argues that Reg. 810-6-1-.125(2) applies only to admission fees charged by places of public amusement. The representative is technically correct. However, he conceded at the June 13 hearing, and I agree, that the regulation applies to all activities subject to the gross receipts sales tax, not just admission fees.

> The Witness: So 40-23-2 includes amusement – places of amusement and amusement devices.
>
> Administrative Law Judge: Right.

> The Witness: So I would assume, then, that (Reg. 810-6-1.125) over here which says that you can post a sign and back out your tax is going to apply to everything in that section.
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> Administrative Law Judge: I would think you're probably right, but I'm going to look at it and then I will address it in my order.

(T. 38 – 39.)

In any case, the posting of a sign as provided in Reg. 810-6-1-.125(2) is an alternative allowed by the Department in lieu of separately stating the sales tax in the price. Consequently, even if the sign provision in Reg. 810-6-1-.125(2) did not apply to amusement devices, the operator is still required to add sales tax to the price and collect it from the customer. There is no evidence the Taxpayer did so in this case.

The Taxpayer argues that sales tax cannot as a practical matter be added to the quarters used to operate the machines, and that it should be assumed that tax is included because it is illegal not to add sales tax to the price. But the fact that it is illegal not to add sales tax to the price does not establish that the tax was included in the quarters charged by the Taxpayer. To the contrary, the Department's position is that the Taxpayer illegally failed to add sales tax because there is no evidence that sales tax was added as a separate item, as required by §40-23-26, and there was no sign indicating that sales tax was included in the price, as allowed by Reg. 810-6-1-.125(2). Without such evidence, the Department's finding that sales tax was not included must be affirmed.

I understand the Taxpayer's argument that only quarters are used to operate arcade machines, and that a penny tax cannot as a practical matter be added and charged to the customer. But that is why the Department allows the posting of a sign in

lieu of separately adding the tax. If the appropriate sign is posted, there is no need to separately add tax to the lump-sum price.

Alabama's appellate courts have never directly addressed this issue. However, in *State of Alabama v. Mack*, 411 So.2d 799 (Ala. Civ. App. 1982), the issue was whether a video machine operator could deduct the 50 percent "commissions" he paid to the location owners. The Court of Civil Appeals held that the commissions could not be deducted, and that sales tax was due on the total gross receipts. The Court did not hold or suggest that the taxable measure was total gross receipts, less sales tax, as argued by the Taxpayer in this case.

Finally, the Taxpayer argues that it should be taxed the same as retailers that sell through coin-operated vending machines. It contends that Dept. Reg. 810-6-1-.183.02 allows vending machine operators to back out sales tax in computing taxable gross receipts, and that vending machines and arcade machines are sufficiently analogous to warrant similar treatment.

The Taxpayer is correct that Reg. 810-6-1-.183.02 allows vending machine operators to back out sales tax in determining taxable gross receipts. That provision is based solely on the Alabama Supreme Court's holding in *State of Alabama v. Automatic Sales*, 167 So.2d 146 (Ala. 1964), which is cited as authority in the regulation. The issue in *Automatic Sales* was whether retailers that sold cigarettes through vending machines could deduct the applicable 3 percent sales tax in determining their taxable gross proceeds. The Department argued that the retailers could not back out the tax because, as in this case, there was no sign stating that sales tax was included in the price. The Supreme Court disagreed, holding that the sales tax could be backed out.

While the Supreme Court's holding in *Automatic Sales* seems to support the Taxpayer's position, it can be distinguished on two grounds. First, the Court found in *Automatic Sales* that the "evidence shows without contradiction . . . that (the retailers) included in their sales price of 35¢ for each package of cigarettes . . . the state sales tax of 3% imposed by the state during the audit period." *Automatic Sales*, 167 So.2d at 148.[1] In this case, however, there is no evidence, uncontradicted or otherwise, indicating that sales tax was included in the price charged by the Taxpayer.

Second, the Court noted in *Automatic Sales* that there was no Department regulation at the time that required retailers to post a sign indicating that sales tax was included in the price. The Court thus held that the retailers could back out the tax without a sign showing that tax was included.

As discussed above, the Department now has a regulation, Reg. 810-6-4-.20, that requires all retailers to post a sign if sales tax is not separately stated as a line item in the price. The Supreme Court in *Automatic Sales* withheld comment as to the possible effect of such a regulation. *Automatic Sales*, 167 So.2d at 148. The Court has subsequently held, however, that a Department regulation must be followed unless it is contrary to a statute or is unreasonable. *Ex parte White*, 477 So.2d 422 (Ala. 1985). Requiring a sign in lieu of separately stating the tax in the price is not contrary to §40-23-26 or any other statute, nor is it unreasonable. Consequently, all retailers, including vending machine operators, should be required to post a sign indicating that sales tax is included in the price. In short, the Supreme Court's holding in *Automatic Sales*, and by extension the provision in Reg. 810-6-1-.183.02 that allows vending machine operators

[1] The Court's opinion did not identify the uncontradicted evidence that established that sales tax was included in the price.

to back out sales tax without a sign, is no longer correct in light of Reg. 810-6-4-.20. Theoretically, vending machine operators should not be allowed to back out sales tax unless they post the sign required by Reg. 810-6-4-.20. However, Reg. 810-6-1-.183.02 is still in effect, and thus binding on the Department.

It could be argued that form is being allowed to control over substance when a taxpayer is allowed to back out sales tax if a sign is posted stating that tax is included in the price, but not when there is no such sign. The same lump-sum price is being charged in both cases. However, §40-23-26 requires all taxpayers subject to sales tax to add the tax to the price and collect it from the customer. The Department must have some method or means to ensure that the statute is complied with. The only practical method of ensuring compliance is to require either that the tax be added as a separate line item in the price, or, if it is impractical to separately add the tax, as in this case, the taxpayer must have a sign showing that tax is included in the price. Otherwise, the Department could not determine if the lump-sum price charged by a taxpayer included sales tax, as required by §40-23-26.

Issue (2). Is plush subject to use tax?

The Taxpayer argues that the plush is not subject to use tax because it is being sold through the crane machines, and that tax is being paid on the plush when sales tax is paid on the gross receipts from the machines. I disagree.

Unlike a vending machine operator that sells goods through their machines, the Taxpayer is not selling the plush at retail through the crane machines. Rather, it is

selling entertainment.[2] A person that purchases tangible property through a vending machine is entitled to possession of and title to the property once the appropriate money is deposited and the selection is made. The same is not true concerning the plush in the crane machines. A player that deposits money into a crane machine is not entitled to a toy, only the right to use the crane to attempt to obtain the toy.

I agree with the Department that Reg. 810-6-1-.129 applies. That regulation holds that the person that purchases property for use as a prize is liable for tax on the property, either when the property is purchased, or, as in this case, when the property is subsequently used in Alabama. The Taxpayer is thus liable for Alabama use tax on the plush it purchased tax-free and then used as prizes in its crane machines in Alabama.

The Taxpayer also is not being impermissibly double taxed on the plush. The sales tax on the gross receipts from the Taxpayer's machines is a tax on the Taxpayer's customers, not the Taxpayer. *Blockbuster, Inc. v. White*, 819 So.2d 43 (Ala. 2001); *State v. T.R. Miller Mill Co.*, 130 So.2d 185 (Ala. 1961). On the other hand, the use tax is on the Taxpayer, directly, as the user of the plush in Alabama. The use tax and the gross receipts sales tax are thus levied on different parties, which the Alabama Supreme Court has found to be acceptable.

In *Starlite Lanes, Inc. v. State*, 214 So.2d 324 (Ala. 1968), the Court held that the taxpayer, a bowling alley, was liable for sales tax when it purchased bowling shoes, and also for the gross receipts sales tax on the gross receipts derived from the rental of the

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[2] The Taxpayer's representative conceded at the June 13 hearing that he may be selling entertainment. "Well, if I'm not selling plush then I am selling a chance to get a piece of plush or I am selling entertainment for the quarter that goes in the machine." (T. 46 – 47.)

shoes.[3] "Thus, the burden of the sales tax falls upon the (bowling alley) when he buys the shoes and the 'gross receipts' tax upon the (bowling alley's) customers when they rent the shoes. Although there is double taxation in the sense that two taxes have been paid on the same item, the two taxes do not fall upon the same person." *Starlite Lanes*, 214 So.2d at 327. See also, *State v. Barnes*, 233 So.2d 83 (Ala. Civ. App. 1970).

Issue (3). The temporary storage exclusion.

The Alabama use tax is on the storage, use, or other consumption of tangible personal property in Alabama. Code of Ala. 1975, §40-23-61. "Storage" is defined as "[a]ny keeping or retention in this state for any purpose except . . . subsequent use solely outside this state. . . ." Code of Ala. 1975, §40-23-60(7). Consistent with the above definition, the Department has adopted Reg. 810-6-5-.23, which specifies that property intended for use outside of Alabama that is temporarily stored in Alabama is not subject to Alabama use tax. Paragraph (3) of the regulation also provides that "records must reflect that it was the intent of the purchaser to use the property in another state at the time of its coming to rest in Alabama."

The Department examiner did not allow the temporary storage exclusion for the plush used by the Taxpayer in Mississippi because the Taxpayer failed to provide the examiner with evidence that it intended to use the plush in Mississippi. The Department thus concluded that the plush was drawn from the Taxpayer's general stock, and thus subject to Alabama use tax.

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[3] When *Starlite Lanes* was decided in 1968, Alabama did not have a lease tax. Consequently, the sale of property purchased for the purpose of leasing it to others was a taxable sale. However, the lease tax law enacted in 1971 included a provision that made such purchases non-taxable wholesale sales. See, Code of Ala. 1975, §40-12-224.

At the June 13 hearing, the Taxpayer's representative presented a contract indicating that the Taxpayer was obligated to provide crane machines at various Pizza Hut locations in Mississippi beginning in May 2002. The contract also obligated the Taxpayer to provide the plush in the machines. The representative testified that he did not keep a stock of plush, and that plush was special ordered as needed. He also provided a calendar showing the dates his route man delivered plush to Mississippi, and his cost of the plush taken to Mississippi. See, Taxpayer Exs. 2 and 3. The above evidence is undisputed by the Department, and establishes that a portion of the plush delivered by the Louisiana supplier to the Taxpayer's facility in Tuscaloosa was intended to be used and was used outside of Alabama. That plush, with a cost of $23,530.37, was thus not subject to Alabama use tax.

The Department is directed to recompute the Taxpayer's use tax liability by removing the Mississippi plush from the taxable measure. It should then notify the Administrative Law Division of the adjusted amount due. An appropriate Final Order will then be entered.

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.

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BILL THOMPSON
Chief Administrative Law Judge