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| CAPITOL MACHINE & EQUIP. CO. LLC AND ITS MEMBERS: SUN ENTERPRISES LLC, ROBERT W. SHIVER 702 DAY STREET ROAD MONTGOMERY, AL 36108-2532, | § | STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION |
| Taxpayer, | § | DOCKET NO. S. 08-619 |
| v. | § | |
| STATE OF ALABAMA DEPARTMENT OF REVENUE. | § | |

**FINAL ORDER**

The Revenue Department assessed Capitol Machine & Equipment Company, LLC ("Taxpayer"), and its members: Sun Enterprises, LLC and Robert W. Shiver, for State sales tax for July 2004 though July 2007. 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 January 6, 2009. Courtney Williams represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

**ISSUES**

The Taxpayer manufactures and sells pneumatic insulation blowing machines and related parts. The issues in this case are as follows:

(1) Are the blowing machines and related parts machines used in processing tangible personal property, and thus taxable at the reduced one and one-half percent sales tax "machine" rate levied at Code of Ala. 1975, §40-23-2(3);

(2) Is the Department barred from assessing the Taxpayer for July through October 2004 because those months are outside of the statute of limitations for assessing tax at Code of Ala. 1975, §40-2A-7(b)(2);

(3) Are the individual members of the LLC Taxpayer personally liable for the sales tax in issue; and,

(4) Should the penalty assessed by the Department be waived for reasonable cause pursuant to Code of Ala. 1975, §40-2A-11(h).

**FACTS**

The facts are undisputed. As indicated, the Taxpayer manufactures pneumatic insulation blowing machines and related parts ("equipment"). It sells the equipment primarily to insulation contractors, who use the equipment to blow both loose-fill and wet-spray insulation into buildings.

Insulation contractors purchase insulation in compact form from the manufacturer at retail.[1] If a contractor is blowing loose-fill insulation, the equipment operator sets the engine speed and adjusts various gates and valves on the equipment to produce the desired insulation density. The operator then feeds the compressed insulation into the equipment. The compact insulation is preconditioned by an auger, and is fed through a control gate into shredders. The shredders convert the unidirectional fibers in the insulation into multidirectional fibers, which improves the material's insulating qualities. The shredded insulation then flows from the shredders into an air lock feeder. The feeder contains rotating, sealed veins, which provide a constant air stream on the insulation. The air expands the fibers in the insulation to condition its density. The insulation is further conditioned to its desired density when it bounces off the hose walls

[1] The Department examiner noted in his audit report that insulation is a building material that should be sold to the end user, the insulation contractor, at retail. I agree. But that has no relevance to whether the Taxpayer's equipment constitutes a machine used in processing the insulation for purposes of the machine rate statute.

while being blown onto the desired location. The blown insulation covers four times more area than it did in compacted form.

If the insulation is intended for open walls or the underside of ceilings, a contractor may install wet-spray insulation, which is a type of fiberglass or cellulose insulation that adheres to the surface onto which it is sprayed. Wet-spray insulation is also purchased by the insulation contractor at retail in compact form, and is shredded and otherwise prepared for application by the Taxpayer's equipment the same as loose-fill insulation.

With wet-spray insulation, however, the blower is equipped with an attached water pump. The pump extracts water from a water spigot or other outside source, and pumps it through a nozzle attached to the end of the hose through which the insulation is blown. The water is then sprayed as a mist into the air in front of the insulation hose. The mist mixes with the blown insulation, which triggers an adhesive in the insulation that causes it to stick to the wall or ceiling.

The Taxpayer charged its customers sales tax on the blowing equipment at the reduced one and one-half percent machine rate during the period in issue. The Department audited the Taxpayer and determined that the equipment was taxable at the general four percent rate. It also determined that the Taxpayer had failed to collect tax on retail sales to customers located outside of Alabama that had picked up the equipment at the Taxpayer's location in Alabama.

The Taxpayer conceded that it owed sales tax on its sales to out-of-state customers that were closed in Alabama. It consequently paid the tax due on those sales at the one and one-half percent machine rate, except concerning a sale in August

2004, which the Taxpayer claims is outside the statute of limitations for assessing the tax.

The Department subsequently entered a preliminary assessment against the Taxpayer, and its two members, on December 17, 2007. The Taxpayer petitioned for a review of the preliminary assessment. The Department denied the petition, and entered the final assessment in issue.

## ANALYSIS

### Issue (1). Does the Machine Rate Apply?

The Department argues that the machine rate does not apply because the compressed insulation is already in marketable form when it is purchased by the insulation contractor. It contends that the Taxpayer's machines do not convert the insulation into a new or different product. Rather, according to the Department, "[a]ll the Taxpayer's machines do is fluff the insulation that had been compressed. The Taxpayer's machine does not do anything to change or alter the basic nature of the insulation. The insulation is compressed by its manufacturer and all that happens is that the Taxpayer's insulation machines uncompress the insulation." Department's Brief at 5.

The Taxpayer asserts that the compressed insulation is not in its final usable form when purchased by a contractor, and that the insulation must be run through and processed by the blowing machine before it can be applied to the intended surface. It argues that the equipment is not a mere applicator, such as a paint sprayer, but rather fundamentally alters the shape, size, and nature of the insulation. The Taxpayer thus

contends that the equipment "processes" the insulation within the purview of the machine rate statute. I agree.

Section 40-23-2(3) levies a reduced one and one-half percent sales tax on "machines used in mining, quarrying, compounding, processing, and manufacturing" tangible personal property. In *Sizemore v. Franco Distributing Co., Inc.*, 594 So.2d 143, (Ala. Civ. App. 1991), the Alabama Court of Civil Appeals discussed the meaning of "processing" within the context of the machine rate statute, as follows:

> When ascertaining the meaning of the term "processing" as used in §40-23-2(3) and its predecessor, our supreme court stated the following:
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> "We have had occasion to quote approvingly in several cases, *State v. Advertiser Co.*, 257 Ala. 423, 428, 59 So.2d 576, 579 (1952); *Curry v. Alabama Power Co.*, 243 Ala. 53, 60, 8 So.2d 521, 526-27 (1942), the following definition of the word 'process' as given by Webster's New International Dictionary, 2nd Ed.:
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> > "'A series of actions, motions, or operations definitely conducing to an end, whether voluntary or involuntary; progressive act or transaction; continuous operation or treatment; a method of operation or treatment, esp. in manufacture; . . .
> >
> > "'To subject to some special process or treatment. . . . To subject (esp. raw material) to a process of manufacture, development, preparation for the market, etc; to convert into marketable form, as livestock by slaughtering, grain by milling, cotton by spinning, milk by pasteurizing, fruits and vegetables by sorting and repacking . . . . To make usable, marketable, or the like, as waste matter or an inferior, defective, decomposed substance or product, by a process, often a chemical process . . . . To produce or copy by photo-mechanical methods; to develop, fix, wash and dry, or otherwise treat (an exposed film or plate).'"
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> *Southern Natural Gas Co. v. State*, 261 Ala. 222, 227, 73 So.2d 731, 735 (1954). Under this definition, it is apparent that the word "process" is synonymous with the expressions "preparation for market" and "to convert into marketable form." *Id.*

*Franco*, 594 So.2d at 146.

The Taxpayer's blowing equipment clearly processes the compacted insulation within the scope of the above definition of the term. While the compressed insulation is obviously manufactured before it is purchased by an insulation contractor, it is not ready for its intended final use. Rather, the contractor must use the Taxpayer's equipment to shred, expand, and otherwise prepare and process the insulation into usable form. The evidence confirms that the compacted insulation cannot be effectively applied unless it is processed and blown into place using the Taxpayer's equipment. As indicated by the above quote from *Franco*, "process" includes "[t]o make usable, marketable, or the like, . . . by a process, . . . ." Only by processing the compacted insulation through the Taxpayer's equipment is the insulation converted into its usable form.

I also disagree with the Department's claim that the machine rate does not apply because "the bags of insulation do not become a new or different product and no new tangible personal property is created, . . . ." Department's Brief at 3. Neither the machine rate statute, §40-23-2(3), nor Alabama case law on the issue require that a new or different product must be created. The Department regulation on the issue, Reg. 810-6-4-.17.05, also gives examples of processing that do not involve the creation of a new product. For example, the regulation provides that fruits and vegetables are processed by sorting and repacking. No new or different product is created in that instance, yet the machine rate still applies.

In any case, the Taxpayer's blowing equipment clearly alters the insulation and creates a new product that is distinct from the compacted insulation that is fed into the equipment. The equipment does not merely fluff the insulation. Rather – "By shredding

the insulation, converting it from unidirectional fiber into multidirectional fiber, and further expanding the insulation fibers through the introduction of an air stream, the Equipment alters the physical state and density of the compressed insulation to produce the processed loose-fill insulation, a 'new and different product.'" Taxpayer's Reply Brief at 5. And concerning the wet-spray insulation, the water further alters the density of the insulation and triggers the adhesive in the insulation, which causes it to adhere to the intended surface.

**Issue (2). The Statute of Limitations.**

This issue is moot given the holding in Issue (1), except concerning one sale in August 2004 that the Taxpayer failed to report and pay tax on.

The Department entered a preliminary assessment against the Taxpayer on December 17, 2007. The Department can generally only assess tax within three years from the due date of the applicable return. Code of Ala. 1975, §40-2A-7(b)(2). Consequently, the Department could normally only assess the Taxpayer for the month of November 2004 forward.[2] The Department nonetheless assessed the Taxpayer back to July 2004 based on §40-2A-7(b)(2)b. That statute provides that if a taxpayer omits more than 25 percent of the tax due on a return, the Department can assess the taxpayer back six years.

The Department applied the 25 percent omission statute based on its claim that the Taxpayer had incorrectly reported and paid tax at the machine rate, and thus underreported by more than 25 percent. But because the machine rate does apply, the

[2] The November 2004 return was due December 20, 2004, or within three years from when the preliminary assessment was entered on December 17, 2007.

Taxpayer did not underreport by 25 percent, in which case the pre-November 2004 months are barred from being assessed.

**Issue (3). The Liability of the LLC Members.**

In *Bayside Tire & Exhaust, LLC v. State of Alabama*, W. 98-272 (Admin. Law Div. 10/13/1998), the Administrative Law Division held that the members of a multi-member LLC that had not elected to be taxed as a corporation were individually liable for the withholding tax owed by the LLC. The Taxpayer in this case argues that *Bayside Tire* was incorrectly decided. The Taxpayer's brief on the issue reads as follows:

> The Taxpayer believes that the Department incorrectly included the Taxpayer's members, Sun Enterprises, LLC and Robert W. Shiver (collectively, the "Members"), in its assessment. The Taxpayer is a limited liability company organized under the laws of the State of Alabama. Under Alabama law, ". . . a member of a limited liability company is not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company, whether arising in contract, tort, or otherwise . . ." Code of Alabama, 1975 section 10-12-20(a). The Taxpayer acknowledges that the Administrative Law Judge has previously held that members of a limited liability company may be individually liable for the tax debts of the company. See Bayside Tire & Exhaust, LLC v. State, W. 98-272, 10/13/1998. However, the Taxpayer feels that the Bayside Tire & Exhaust, LLC holding was incorrect and asks the Administrative Law Judge to reconsider his position on this issue. In Bayside Tire & Exhaust, LLC, the Administrative Law Judge held:
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> > Bayside Tire is an LLC, and thus is treated as a partnership for tax purposes. Code of Ala. 1975, §10-12-8. Partners are jointly and severally liable for the debts of the partnership. Code of Ala. 1975, §10-8A-306. Consequently, the Taxpayer, as a member of Bayside Tire when the penalties accrued, is individually liable for those penalties.
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> Id. Section 10-12-8 does provide that a limited liability company is treated as a "partnership" for tax purposes. However, there is more than one form of partnership under Alabama law. Although partners in a general partnership are jointly and severally liable for the debts of the partnership, partners in a registered limited liability partnership are "not personally accountable, directly or indirectly . . . for debts, obligations and liabilities of

. . . the registered limited liability partnership." Code of Alabama, 1975 section 10-8A-306(c). Similarly, limited partners in a limited partnership are not generally liable for the obligations of the limited partnership. Code of Alabama, 1975 section 10-9B-303(a). The Bayside Tire & Exhaust, LLC holding unduly restricts the meaning of "partnership" to include only general partnerships. A limited liability company is more analogous to a registered limited liability partnership than a general partnership. Limited liability companies and registered limited liability partnerships are similar in that, for example, they both provide limited liability to their owners, their existences both become effective when required filings are made in probate court, and they are both required to maintain a registered office and registered agent. General partnerships have none of the foregoing characteristics. Thus, under section 10-12-8, a limited liability company should be treated for sales tax purposes as a registered limited liability partnership, rather than a general partnership.

It is important to note the distinction between taxes which are a liability of a limited liability company and taxes which are a liability of its members. Under federal and state income tax laws, income of a limited liability company flows through the company to its members and the members are thus liable for tax on such income. Tax on the income of a limited liability company is never imposed on the company itself and the company itself is never liable for tax on its income. In other words, the members of a limited liability company are primarily liable for its income taxes. Alabama sales tax, however, is levied on the "person, firm, or corporation" engaged in the business of selling at retail. *See* Code of Alabama, 1975 section 40-23-2(1). Since Capitol Machine & Equipment Company, LLC, and not its members, are conducting the business of selling the Equipment, sales taxes are a liability of Capitol Machine & Equipment Company, LLC. The same applies in the case of a general partnership: a partnership that conducts a business activity which gives rise to a sales tax liability is primarily liable for such sales tax. However, the sales tax liability of a general partnership and a limited liability entity are different in that partners of a general partnership are secondarily liable for sales taxes of the general partnership because they are jointly and severally liable for the debts of the partnership. Conversely, the Taxpayer's members are not secondarily liable for the Taxpayer's sales tax liabilities, which are an obligation of the Taxpayer, because debts and obligations of limited liability companies, registered limited liability partnerships, and limited partnerships are not chargeable against the members, partners, or limited partners of such respective entities.

In Revenue Ruling 2004-41, the Internal Revenue Service clarified a similar issue, whether members of a limited liability company are liable for the company's employment tax liability. The Service held:

> If under state law the members of the LLC are not liable for the debts of the LLC, then absent fraudulent transfers or other special circumstances, the IRS may not collect the LLC's employment tax liability from the members, including by levy on the property and rights to property of the members.

> Rev. Rul. 2004-41, 04/30/2004. Like federal employment taxes, Alabama sales taxes are a liability of the business entity conducting the business activity that brings about the tax liability. Since members and partners of Alabama limited liability companies and registered limited liability partnerships are not liable for the debts and obligations of their respective entities, the Department may not collect sales taxes from the Taxpayer's members.

> If the holding in Bayside Tire & Exhaust, LLC is correct, members of limited liability companies would be personally liable for non-income taxes of the company, but partners in registered limited liability partnerships and limited partners in limited partnerships would not be liable for non-income taxes of such partnerships. We do not think the legislature intended such a result when it enacted section 10-12-8. We think that, in enacting section 10-12-20(a), the legislature clearly intended for members of limited liability companies to have the same limited liability protection as shareholders in a corporation and partners in a registered limited liability partnership.

Taxpayer's Brief at 8 – 11.

I now agree that *Bayside Tire* was incorrectly decided, and that members of an LLC are not personally liable for the non-income taxes owed by the LLC.

Code of Ala. 1975, §10-12-8(b) provides that an LLC shall be treated as a partnership, unless the LLC elects to be treated as a corporation. The Taxpayer in this case did not elect to be treated as a corporation. Code of Ala. 1975, §10-8A-306(a) provides generally that partners in a partnership are liable for the debts and obligations of the partnership. That statute also provides, however, that the partners are liable ". . . unless otherwise . . . provided by law." Code of Ala. 1975, §10-12-20(a) specifies that members of an LLC are not liable for any debts or obligations of the LLC.

Consequently, although an LLC may be taxed as a partnership, Alabama law otherwise provides that the members of an LLC are not liable for the debts of the LLC. The "unless otherwise . . . provided by law" caveat in §10-8A-306(a) thus applies, in which case LLC members cannot be held personally liable for the taxes owed by the LLC, other than their direct liability for income tax on their distributive share of the income of the LLC.[3]

The above conclusion is supported by how the IRS assesses and collects taxes other than income tax from individual members of a multi-member LLC that has not elected to be taxed as a corporation. The IRS's position on the issue is set out in Revenue Ruling 2004-41, which is discussed in the above quote from the Taxpayer's brief, and also in Chief Counsel Advice 2002-350-023. The Chief Counsel Advice addresses the collection of tax, but applies equally to the assessment of tax. It provides in pertinent part as follows:

> In analyzing an LLC's federal tax liability, the first consideration is whether an LLC is a single member LLC or a multi-member LLC. If it is determined that the LLC is a multi- member LLC, the next consideration is whether the LLC is taxed as a corporation or a partnership.
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> * * *
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> Most multi-member LLCs are taxed as partnerships, because association (taxed as a corporation) status is not elected. Thus, an income tax liability arising from an LLC's activities flows through to its members. If the Service filed a NFTL (notice of federal tax lien) to collect the income tax liability, a partner's name as the taxpayer is listed on the NFTL.
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> In regard to employment taxes, an LLC, like a partnership, could incur an employment tax liability as the employer. In that case, if the Service filed a NFTL, the partnership would be listed on the NFTL as the taxpayer.

[3] Dept. Reg. 810-3-24.01(1)(a) specifies that for income tax purposes "[a] partnership is considered to be a 'conduit' of income to each partner and not a taxable entity under Alabama income tax law."

> A major difference, however, exists between a general partner's liability for the partnership's employment taxes and a member's liability when an LLC is treated as a partnership and incurs an employment tax liability: while each general partner is derivatively liable for the full amount of the employment tax liability under state law, no member of the LLC has any liability for the employment tax liability under state law. It must be emphasized that state law creates the difference in treatment between general partners and LLC members, not federal law.
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> When a partnership incurs an employment tax liability, under state law the general partners are liable for the tax, just as they are liable under state law for other debts of the partnership. See Ballard v. United States, 17 F.3d 116 (5th Cir. 1994); United States v. Hays, 877 F.2d 843, 844 n. 3 (10th Cir. 1989). When the Service files a NFTL in this situation, the Service lists the name of the partnership and the names of the known general partners, so that notice is provided of the federal tax lien encumbering not only the partnership assets but also the general partners assets. I.R.M. 5.19.4.6.3(6).
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> In contrast, where an LLC has incurred an employment tax liability as a partnership, there is no state law imposing a derivative liability on the LLC's members. Indeed, quite the opposite occurs: state law explicitly provides that a member is not liable for an LLC's debts. See, e.g., Del. Code Ann. Tit. 6, § 18-303(a). Consequently, the Service cannot collect an employment tax liability from an LLC's member, even though the LLC is treated as a partnership for federal tax purposes, since the members have no derivative state-law employment tax liability. A NFTL for that liability should not be filed against the members, but solely in the name of the partnership as the taxpayer.
>
> Since the members are not liable for the employment tax liability of the LLC taxed as a partnership, the Service may consider asserting the trust fund recovery penalty against members, depending on the facts and circumstances of the case.

The above is consistent with Alabama law in that while an LLC may be taxed as a partnership, Alabama law at §10-12-20(a) explicitly provides that an LLC member is not liable for the LLC’s debts, including the taxes owed by the LLC.

The above applies to federal trust fund withholding and other employment taxes. The rationale should likewise apply to Alabama’s withholding tax, sales and use tax, and other non-income taxes. For purposes of taxation, Alabama classifies an LLC the

same as it is classified for federal tax purposes. See, Code of Ala. 1975, §10-12-8(b); Rev. Proc. 98-001. It follows that the members of an LLC should also be taxed (or not taxed) pursuant to federal guidelines. Consequently, consistent with the IRS's position on the issue, LLC members cannot be held personally liable for any taxes owed by the LLC.[4] But as under federal law, the members may, under the appropriate circumstances, be held personally liable for any trust fund taxes under Alabama's 100 percent penalty statutes, Code of Ala. 1975, §§40-29-72 and 40-29-73. [5]

In summary, reading §§10-12-8(b) and 10-12-20(a) together, members of LLCs that are taxed as partnerships are still LLC members, and thus, pursuant to §10-12-20(a), are not personally liable for the tax obligations and other debts of the LLC. That holding is consistent with how the IRS taxes such members for federal withholding and other employment taxes. Alabama law provides that where Alabama has adopted a federal provision relating to the determination of income for federal tax purposes, as in this case relating to the classification and treatment of LLCs, the use of federal judicial and administrative determinations as a guideline is appropriate. See, Code of Ala. 1975, §40-18-1.1; *Ex parte Jones Mfg. Co., Inc.*, 589 So.2d 208 (Ala. 1991). Consequently, the IRS's guidelines on the issue, which are consistent with Alabama law, should also be followed.

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[4] As discussed, income tax on the income of an LLC is a direct liability of the LLC members, and thus is not a tax owed by the LLC.

[5] Code of Ala. 1975, §40-29-72(b) defines "person" for purposes of the 100 percent penalty to include "a member of a partnership." Consequently, because members of an LLC that has not elected to be taxed as a corporation are treated as (limited) partners in a partnership, they are subject to the 100 percent penalty if they are responsible for paying the trust fund taxes of the LLC and willfully fail to do so.

**Issue (4). The Penalty Waiver Issue.**

This issue is moot.

The final assessment in issue is voided.

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

Entered April 20, 2009.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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