CHESTER'S INTERNATIONAL, LLC 2750 GUNTER PARK DRIVE W. MONTGOMERY, AL 36109-1016,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 12-364
v.	§	
	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Chester's International, LLC ("Taxpayer") for State sales tax for November 2007 through October 2010. 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 October 25, 2012. Donald Johnson, David Wooldridge, and Greg Rhodes represented the Taxpayer. Assistant Counsel Christy Edwards represented the Department.

The Taxpayer is in the business of franchising quick-service fried chicken restaurants to convenience stores throughout North America. The Taxpayer has offices in Montgomery and Birmingham, Alabama, and a warehouse in Montgomery. It currently has over 2,000 franchisees.

The Taxpayer's franchise agreements before 2009 required the franchisees to sell the Taxpayer's chicken for five years. The franchisees were required to pay the Taxpayer a start-up fee and periodic franchise fees, and to also purchase up-front from the Taxpayer various tangible items, i.e., menu boards, counter graphics, etc., to be used in promoting, advertising, and preparing the chicken for sale. The franchisees thereafter periodically purchased food and supplies from the Taxpayer over the life of the agreement. The

Taxpayer primarily profited from its sale of the food and supplies to the franchisees. "Essentially all of the profit the Taxpayer earns from the franchise relationship is derived from the sale of the goods to the customer over the life of the franchise." Taxpayer's Reply Brief at 3.

Because of the sagging U.S. economy, the Taxpayer's franchising business slowed in the late 2000's because many potential franchisees could not afford to pay for the menu boards, graphics, etc. The Taxpayer accordingly changed its business model in 2009 so that if a potential franchisee was not financially able to pay for the menu boards, graphics, etc., the Taxpayer provided the items free of charge. Paragraph 3. of the new franchise agreement specified, however, that if the franchisee cancelled the agreement before the end of the five year period, "you (franchisee) agree to pay the prorated cost of the signage and graphics provided listed in Appendix A (to the agreement). Items will be prorated based on a sixty (60) month term." The "cost" of the items listed on Appendix A was the Taxpayer's wholesale cost for the items, plus a 30 percent markup.

The Taxpayer also continued selling the Appendix A items to some of its other new franchisees up-front if the franchisees were financially able to pay. When asked why some franchisees were required to buy the menu boards, graphics, etc. up-front and some were not, the Taxpayer's owner responded as follows:

> We go through a process when we're qualifying the lead as a part of our sales process of qualifying, do they have the money, are they qualified, and then if they're doing an Appendix A, we go through an analysis of their existing business, because most of them are already cooking chicken, they're not doing a startup, because if you'll see we're primarily just providing them graphics. So there's a whole lot of other equipment involved in cooking chicken. So we'll go through a return on investment from our perspective, do they do enough volume for us to invest in their store, so to speak, with

> Appendix A. So that's why some will do that, but if they clearly have the funds and the money – because we do business with a lot of larger companies that have plenty of capital and we sell everything to them, we don't Appendix A.

(T. 35 – 36).

The Taxpayer entered into 214 Appendix A franchising agreements during the period in issue. The Taxpayer waived the start-up fee in all of the agreements, and all but three of the franchisees were located outside of Alabama. Since 2009, at least one of the franchisees has defaulted on the agreement and paid the Taxpayer the Appendix A prorated amount. Other franchisees have also defaulted, and in those cases the Taxpayer has attempted to collect the prorated Appendix A amounts from the franchisees. If a franchisee could not be found or was unable to pay, the Taxpayer repossessed the property and returned it to inventory if it could be reused.

The Taxpayer is a licensed Alabama retailer, and thus purchased the food, supplies, and Appendix A items tax-free at wholesale during the assessment period using its Alabama sales tax number. The Appendix A items were stored in the Taxpayer's warehouse in Montgomery, and were subsequently delivered to the franchisees via common carrier.

The Department audited the Taxpayer and determined that the Taxpayer owed sales tax on its wholesale cost of the Appendix A items provided free-of-charge to the franchisees under the sales tax "withdrawal" provision at Code of Ala. 1975, §40-23-1(a)(10). It assessed the Taxpayer accordingly.[1]

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[1] The Department also preliminarily assessed the Taxpayer for sales tax on other items that were not contested. The Taxpayer paid the uncontested tax before the Department

The Taxpayer argues that the "withdrawal" provision does not apply because it sold the Appendix A items at retail to the franchisees. It contends that a franchisee's contractual obligation to sell the Taxpayer's chicken for five years constituted the consideration for the sale. "The Customers understand that it is their obligation to operate a store for 5 years and that obligation constitutes their consideration for the Appendix A Items." Taxpayer's Brief at 4, 5.

The intent of the §40-23-1(a)(10) sales tax "withdrawal" provision is to insure that sales tax is paid on tangible personal property purchased at wholesale by a licensed Alabama retailer, but later withdrawn from inventory and personally used or consumed by the wholesale purchaser, and not resold. "It is well-settled that the purpose of §40-23-1(a)(10) is to reach and tax transactions which would not be taxed because there was a withdrawal, use, or consumption by the purchaser at wholesale but not sold by him to another." *Home Tile & Equipment Co. v. State*, 362 So.2d 236, 238 (Ala. Civ. App. 1978). See also, *Alabama Precast Products, Inc. v. Boswell*, 357 So.2d 985 (Ala. 1975). The taxable sale occurs when and where the withdrawal occurs, and the taxable measure is the purchaser's wholesale cost of the property. See generally, *City of Huntsville v. City of Madison*, 628 So.2d 584 (Ala. 1993). Consequently, if the withdrawal provision applies in this case, Alabama sales tax would have accrued when the Taxpayer withdrew the Appendix A items from its warehouse in Montgomery.

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entered the final assessment in issue.

The "withdrawal" provision applies only if the wholesale purchaser does not resell the property at retail. This case thus turns on whether the Taxpayer sold at retail the Appendix A items that it provided free-of-charge to the 214 franchisees in issue.[2]

As indicated, the Taxpayer argues that it sold the Appendix A items to the franchisees at retail in return for the franchisees agreeing to sell the Taxpayer's chicken over a five year period. It contends that under the Appendix A agreements, the purchase price for the items "would be recovered over time," and that it is allowing the franchisees "to defer payment for the Appendix A Items in exchange for the Customer's promise to operate a store and use the Taxpayer's goods" for five years. Taxpayer's Brief at 5. It also claims that it was in substance financing the Appendix A items for the customers. "In response (to the bad economy), the Taxpayer determined that it was willing to finance the sale of the Appendix A Items to Customers." Taxpayer's Reply Brief at 4. The Taxpayer has, however, mischaracterized the Appendix A transactions in issue.

If an Appendix A franchisee complies with the agreement and sells the Taxpayer's chicken for five years, the franchisee pays the Taxpayer nothing for the Appendix A items. Consequently, the "purchase price" for those items is not "recovered over time," nor is payment somehow "deferred" because the franchisees never pay for the items. Likewise, the Taxpayer did not finance the sale of the Appendix A items to the franchisees, again

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[2] Assuming that the Taxpayer did sell the items at retail, then the sales were closed upon delivery to the franchisees by the common carriers outside of Alabama in all but three cases, in which case Alabama sales tax would not be due. In the three cases involving Alabama franchisees, Alabama sales tax would be due, but only if the franchisees defaulted on the five year agreement and paid the prorated Appendix A amounts. Again, this assumes that the Taxpayer was selling the items at retail, and that the prorated Appendix A amounts constituted the gross proceeds derived from those sales.

because if the franchisees comply with the contract, they are never obligated to pay for the items.

The Appendix A agreement does require a franchisee to pay a prorated amount if the franchisee defaults on the five year contract, but that payment is in the nature of a penalty that is intended to compensate the Taxpayer for its loss of the profitable sale of food and supplies to the franchisee over the five year agreement. As correctly argued by the Department at page 5 of its Brief:

> Just because the penalty imposed on a franchisee for breach of the contractual obligation to operate a restaurant for five years happens to be tied to the Taxpayer's cost of the items transferred at start-up to the franchisee does not negate the fact that the goods provided at start-up up free-of-charge were used by the Taxpayer to procure franchisee agreements, and thus procure a future stream of income. Substantively, the penalty is for breach of a contractual obligation and is not deferred payment for goods previously sold to the franchisee. Just like the taxpayers in the cases discussed above, the Taxpayer used the restaurant equipment, signage and other branded promotional items in order to attract the franchisees and to provide them with goods necessary to begin operation, thusly generating future income.[3]

Substance over form must govern in tax matters. *Sizemore v. Franco Dist. Co., Inc.*, 594 So.2d 143 (Ala. Civ. App. 1991); *Kirkland v. State*, 529 So.2d 1036 (Ala. Civ. App. 1988). In substance, the Taxpayer gave the Appendix A items to the franchisees free-of-charge in the calculated hope that the franchisees would purchase enough food and supplies from the Taxpayer over the next five years to make the agreement profitable. That is, the Taxpayer "used" the items to entice the franchisees into agreeing to sell its

[3] The cited cases referred to are *State of Alabama v. Cellular Pro Corp.*, Docket S. 94-303 (Admin. Law Div. O.P.O. 1/30/1995); and *Southeastern Cellular, Inc. v. State of Alabama*, Docket S. 96-195 (Admin. Law Div. 8/15/1996). Those cases are discussed below.

chicken products for five years, thereby insuring the Taxpayer a steady stream of profitable sales to the franchisees over that period.

The Taxpayer also did not sell the Appendix A items to the franchisees in return for the franchisees' promise to sell the Taxpayer's chicken over the next five years. The financially-able franchisees that purchased the Appendix A items up-front were also contractually obligated to sell the Taxpayer's chicken for five years. The Taxpayer made a simple business calculation that it could give the Appendix A items to certain franchisees free-of-charge and still make an overall profit on the agreement. The Taxpayer's owner explained that "we'll go through a return on investment from our perspective, do they do enough volume for us to invest in their store, so to speak, with Appendix A." (T. 36). That is, the Taxpayer "invested" in certain franchisees by giving the Appendix A items to those franchisees with the expectation that it would make a sufficient profit on the sale of the food and supplies to the franchisees.

The Taxpayer is correct that title to the Appendix A items was transferred when it gave the items free-of-charge to the franchisees. But a transfer of title by itself is not sufficient to constitute a sale. A gift of tangible personal property also involves a transfer of title, and under Alabama law, the Appendix A transactions in issue clearly involved gifts, not retail sales.

"Sale or sales" is defined at Code of Ala. 1975, §40-23-1(a)(5) as "[i]nstallment or credit sales and the exchange of properties as well as the sale thereof for money, every closed transaction constituting a sale." That somewhat circular definition of a "sale" as constituting "every closed transaction constituting a sale" is not helpful.

Alabama's appellate courts have on occasion relied on the Uniform Commercial Code, Title 7, Code 1975, in deciding issues involving when and where a sale occurs for sales tax purposes. See generally, *State v. Delta Air Lines, Inc.*, 356 So.2d 1205 (Ala. Civ. App. 1978), cert. denied 356 So.2d 1208.

The UCC, at Code of Ala. 1975, §7-2-106(1), defines a "sale" as "the passing of title from the seller to the buyer for a price." The UCC does not define "price," but the term is generally defined as "[t]he amount of money or goods, asked for or given in exchange for something else." The American Heritage College Dictionary, 4th Ed., at 1105. The title to the Appendix A items in issue passed to the franchisees, but not for a price because the franchisees were not required to pay the Taxpayer anything for the items. The Appendix A franchisees also did not agree to sell the Taxpayer's chicken as consideration for receiving the free Appendix A items because, as discussed, the franchisees that purchased and paid for the Appendix A items up-front were also obligated to sell the chicken for five years. Even if an Appendix A franchisee defaulted on the agreement, the prorated amount the franchisee would be required to pay was not the "purchase price" for the Appendix A items, but rather was a penalty that compensated the Taxpayer for the lost profits it would have received from the continued sale of the food and supply items to the franchisee.

The Department cites *State of Alabama v. Cellular Pro Corp.*, Docket S. 94-303 (Admin. Law Div. O.P.O. 1/30/1995); and *Southeastern Cellular, Inc. v. State of Alabama*, Docket S. 96-195 (Admin. Law Div. 8/15/1996), in support of its position.

In *Cellular Pro*, the taxpayer sold cellular telephones and also solicited customers for cellular service provided by Alltel. The taxpayer provided a customer with a cellular

telephone for a nominal $.99 if the customer purchased Alltel service from the taxpayer for a specified period. In return, the taxpayer received a sales commission from Alltel. As in this case, a customer was penalized if they failed to continue the Alltel services for the agreed period. The Administrative Law Division held that the withdrawal provision applied because the taxpayer had "clearly 'used' the promotional phone" to generate commissions from its sale of Alltel service.

> However, . . ., the Taxpayer is liable for sales tax on the wholesale cost of the promotional phones sold for $.99 under the sales tax "withdrawal" provision found at Code of Ala. 1975, §40-23-1(a)(10). That section defines "retail sale" in part to include the withdrawal, use or consumption of tangible personal property previously purchased at wholesale for the personal and private use of the wholesale purchaser/withdrawer. *Ex parte Sizemore*, 605 So.2d 1221 (Ala. 1992).
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> The Taxpayer in this case purchased the promotional phones at wholesale. In my opinion, selling the phones for $.99 for promotional purposes constituted in substance a personal use or consumption of the phones by the Taxpayer. The sale of the phones for $.99 was tied to and contingent on the customer agreeing to buy Alltel service, in which case the Taxpayer would receive a commission. The Taxpayer clearly "used" the promotional phones to acquire the commissions, and thus owes sales tax on its wholesale cost of the phones.
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> If the Taxpayer had given the promotional phones away free-of-charge in return for the customer buying Alltel service, then clearly the "withdrawal" provision would apply and tax would be due on the Taxpayer's wholesale cost. Certainly the Taxpayer should not be allowed to charge a nominal $.99 and thereby escape tax on the difference between $.99 and the wholesale cost of the phone. The "withdrawal" provision applies even though the phones were technically resold for $.99. Substance over form must govern, and in substance the $.99 phones were used by the Taxpayer to obtain the Alltel commissions.
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> In summary, the general rule to be applied is that if a retailer sells tangible personal property at below cost (or free), and the reduced selling price is linked to an obligation by the customer to purchase or subscribe to some form of service for which the retailer receives compensation, then the retailer owes sales tax on its wholesale cost of the property. The above is a practical

rule and clearly in accord with the intent of the "withdrawal" provision.

Cellular Pro, O.P.O. at 5 – 6.

In response to the *Cellular Pro* decision, the Alabama Legislature enacted Act 95-608 in July 1995. That Act amended §40-23-1(a)(10) to specify that the sale of equipment, accessories, etc. at below cost in connection with the sale of mobile telephone services constituted a “sale at retail,” and that such sales “shall not also be taxable as a withdrawal, use, or consumption of such tangible personal property.”

Southeastern Cellular was decided shortly after *Cellular Pro* and the passage of Act 95-608. The issue was whether the withdrawal provision applied when Southeastern provided its customers a free cellular telephone in return for the customer buying cellular service from Southeastern. Southeastern conceded that the telephones would have been taxable under the withdrawal provision before the passage of Act 95-608, but argued that they were specifically exempted from tax by that Act.

The Administrative Law Division disagreed, holding that Act 95-608 only addressed telephones and other equipment sold at below cost, but not such tangible items given away without charge.

> However, while Act 95-608 clearly removed telephones sold at below cost from the "withdrawal" provision, it did not address telephones that are given away. The intent of the Legislature can only be gleaned from the plain and unambiguous language of the statute. *Heater v. Tri-State Motor Transit Co.*, 644 So.2d 25 (Ala. Civ. App. 1994); *Kimberly-Clark v. Eagerton*, 445 So.2d 566 (Ala. Civ. App. 1983). Consequently, telephones and related equipment given away in return for a customer buying cellular phone service are still taxable under the "withdrawal" provision.
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> I agree with the Taxpayer that there is little difference between telephones sold for $.99 and telephones given away. But again, the specific language of §40-23-1(a)(10), as amended by Act 95-608, plainly excludes from the

> "withdrawal" provision only telephones sold at retail at below cost. Consequently, for the reasons stated in *Cellular Pro*, the telephones given away by the Taxpayer in this case are taxable under the "withdrawal" provision.

Southeastern Cellular at 5.

The Taxpayer argues that the *Cellular Pro* rationale applies only when "(1) tangible personal property is sold at below cost (or free), (2) the purchaser of the property is required to subscribe to a service, and (3) the seller/taxpayer receives compensation for the service." Taxpayer's Reply Brief at 11. The Taxpayer asserts that the *Cellular Pro* rationale does not apply because none of the above facts are present in this case. I disagree.

Cellular Pro and *Southeastern Cellular* were decided on the particular facts in those cases, and admittedly the facts in this case are somewhat different, but the legal rationale on which those cases were decided is equally applicable in this case.

In *Cellular Pro* and *Southeastern Cellular*, the taxpayers provided cellular telephones to their customers free-of-charge or for a nominal amount, and in return the customers agreed to purchase telephone services for which the taxpayers received a commission. The taxpayers in those cases thus "used" the telephones to obtain the commissions.

Likewise, in this case the Taxpayer "used" the Appendix A items when it gave them free-of-charge to induce the convenience store operators to sign the franchise agreement, which in turn guaranteed the Taxpayer a steady stream of future profits on the sale of its food and supplies to the franchisees. The fact that the franchisees were not obligated to purchase a specific or minimum amount of food and supplies from the Taxpayer is

irrelevant. They were required to actively operate the franchise and offer the Taxpayer's chicken products for sale, which as a practical matter required the franchisees to regularly purchase the food and supply items from the Taxpayer.

To restate and broaden the "general rule" applied in *Cellular Pro*, when a retailer purchases tangible personal property at wholesale for resale, but later uses and/or consumes the property for a personal or business-related purpose, the "withdrawal" provision applies and the purchaser/user owes sales tax on the wholesale cost of the property.[4] The classic example of property withdrawn from inventory and used for personal purposes is the grocery store owner that removes food from the store shelf and takes it home for his family to consume.

The withdrawal and subsequent use or consumption of property for a business-related purpose within the scope of the withdrawal provision could involve a myriad of factual situations. For example, a carpet store that withdrew carpet from inventory in Alabama and used the carpet on furnish and install contracts in Mississippi was liable for Alabama sales tax on the withdrawal of the carpet in Alabama. *Home Tile & Equipment v. State of Alabama*, 362 So.2d 236 (Ala. Civ. App. 1975) cert. denied, 362 So.2d 239. A

[4] In *Cellular Pro*, the Administrative Law Division stated that the holding did not "apply to items sold at below cost for promotional or advertising purposes, i.e., loss leaders, where the retailer does not receive a direct, additional monetary benefit." *Cellular Pro*, Final Order on Application for Rehearing at 8. On further reflection, that statement may not be correct. A retailer's use of inventory for advertising purposes constitutes a business-purpose use of the property. The Taxpayer in this case in fact conceded that certain of the Appendix A items that it withdrew and used in trade shows, i.e., for advertising and promotion purposes, were taxable under the withdrawal provision.

newspaper that withdrew ink and newsprint from inventory and used the items to print newspapers owed sales tax under the withdrawal provision on its wholesale cost of the items. *Ex parte Sizemore*, 605 So.2d 1221 (Ala. 1992). A manufacturer that withdrew items from inventory in one municipality and subsequently used the items in its own testing and development processes in another municipality owed sales tax on its wholesale cost at the point of withdrawal. *City of Huntsville v. City of Madison*, 628 So.2d 584 (Ala. 1993).

The cellular telephones given away free or for a nominal amount in *Cellular Pro* and *Southeastern Cellular* are also good examples of property withdrawn from inventory and used by the wholesale purchaser for a business purpose. The taxpayers in those cases benefitted from their "use" of the telephones because they received commissions when the customers signed up for cellular telephone service. Likewise, the Taxpayer in this case benefitted by giving the menu boards, graphics, etc. free to its Appendix A franchisees because the Taxpayer profited when it subsequently sold its food and supply items to the franchisees over the life of the agreement.

Although not raised in its Brief or Reply Brief, the Taxpayer cited *Alabama Department of Revenue v. Logan's Roadhouse, Inc.*, 85 So.3d 403 (Ala. Civ. App. May 31, 2011) in its notice of appeal for the proposition that a sale may occur even if there is no stated consideration for the goods transferred. The *Logan's Roadhouse* holding is not applicable in this case.

The Court of Civil Appeals held in *Logan's Roadhouse* that Logan's was selling at retail the "free" peanuts it gave without extra charge to its restaurant customers because it had, pursuant to an internal "menu mix" document, factored its cost of the peanuts into the

stated retail prices it charged for its menu items. That is, the Court held that Logan's was also selling the peanuts along with the menu items.[5]

In this case, however, the Taxpayer did not transfer the Appendix A items to the franchisees in conjunction with the retail sale of other tangible items to the franchisees. It also cannot be argued that the franchisees were somehow paying for the Appendix A items when they later purchased the food and supplies from the Taxpayer. First, there is no evidence that the Taxpayer factored its cost of the Appendix A items into the prices it charged for the food and supplies. The evidence is also undisputed that the Taxpayer charged all of its franchisees the same price for the food and supplies, regardless of whether the franchisees purchased the Appendix A items up-front or not.

The Legislature enacted the withdrawal provision to ensure that tangible personal property purchased at wholesale for resale that is later used or consumed by the wholesale purchaser, and not resold, would not escape sales tax. If the Taxpayer's position is accepted, however, sales tax would never be paid on the Appendix A items given to the franchisees that fully comply with the agreements. That result would be inconsistent with the intent of the withdrawal provision.

The final assessment is affirmed. Judgment is entered against the Taxpayer for tax and interest of $21,235.17. Additional interest is also due from the date the final assessment was entered, March 7, 2012.

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[5] The Administrative Law Division is bound by the Court's holding in *Logan's Roadhouse*, and accordingly applied the Court's rationale in *Kelley's Food Concepts of Alabama v. State of Alabama*, Docket S. 10-1131 (Admin. Law Div. 1/5/2012). *Kelley's Food Concepts* includes, however, a respectful dissent from the Court's *Logan's Roadhouse* rationale.

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

Entered April 10, 2013.

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BILL THOMPSON
Chief Administrative Law Judge

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