WARRIOR TRACTOR & EQUIPMENT COMPANY, INC P.O. BOX 412 NORTHPORT, AL 35476-0412,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 12-821
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Warrior Tractor & Equipment Company, Inc. ("Taxpayer") for State and local sales tax and State rental tax for January 2006 through December 2008. 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 17, 2013. Blake Madison represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

FACTS AND ISSUES

The Taxpayer sells heavy equipment used in the construction and forestry industries. It is headquartered in Northport, Alabama, and has retail locations throughout Alabama.

The Department audited the Taxpayer for State and local sales tax and State rental tax for the period in issue. It subsequently entered the three final assessments in issue. The Taxpayer does not contest the local sales tax and State rental tax final assessments.[1]

[1] The Taxpayer initially contended that it did not have nexus with some of the local jurisdictions in issue. It now concedes that the local tax in issue is due because it collected the local tax from its customers, and consequently, is now required to remit the tax to the Department, see Code of Ala. 1975, §40-23-26(d). The Taxpayer also argues that it never

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It does dispute the State sales tax final assessment concerning three issues. It also contends that if additional tax is determined to be due, a portion of the statutory interest that has accrued on that tax should be abated pursuant to Code of Ala. 1975, §40-2A-4(b)(1)c. due to undue Department delay.

The first disputed issue involves 16 pieces of heavy forestry equipment, i.e., skidders, log loaders, cutters, etc., that the Department assessed pursuant to the sales tax "withdrawal" provision at Code of Ala. 1975, §40-23-1(a)(10). That statute defines "retail sale" in part to include the withdrawal of tangible personal property from inventory for personal use or consumption by the wholesale purchaser.

The Taxpayer had purchased the equipment at wholesale for resale. Before selling the equipment, however, two logging crews employed by the Taxpayer used the equipment to harvest timber primarily on land owned by Alawest-AL LLC ("Alawest"). Alawest owns several thousand acres of timberland in Alabama. It is 90 – 95 percent owned by Gene Taylor, who also owns 90 percent of the Taxpayer. As discussed below, Alawest did not reimburse or otherwise pay the Taxpayer for harvesting the timber on its property.

The Taxpayer argues that the withdrawal provision does not apply because the equipment was being used on the Alawest property as demonstrators for prospective customers. The Taxpayer's owner testified that potential customers wanted to observe a piece of equipment being operated before buying it, and that the Taxpayer routinely took

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received a rental tax preliminary assessment from the Department. That due process issue is moot, however, because, as indicated, the Taxpayer does not contest the rental tax due as assessed by the Department.

customers to observe the equipment being used by its logging crews on the Alawest property.

The equipment remained in the Taxpayer's inventory for sale while being used on the Alawest property, and all of the equipment was subsequently sold at retail. The Taxpayer collected and remitted Alabama sales tax to the Department on the equipment sold in Alabama. The equipment was generally used by the logging crews from 12 to 24 months before being sold. The Taxpayer's total cost for the 16 pieces was $2,657,346, and it sold the equipment for a total of $2,603,174, for a net loss of $54,172.

The Department audit states that "Warrior Tractor receives income from Alawest for furnishing the harvesting services." Confidential Audit Report at 7. Unfortunately, the Department examiner was not asked to expound on that statement at the January 17 hearing, nor did she testify about or identify what evidence she found that supported that statement.

The Taxpayer's owner testified that Alawest does not pay or reimburse the Taxpayer for harvesting the Alawest timber. He acknowledged that Alawest pays the Taxpayer for hauling if the harvested trees are transported from the land in the Taxpayer's trucks. The Department's attorney referred to a 2007 Alawest income tax return at the January 17 hearing on which Alawest had deducted $213,529 for contract services paid to the Taxpayer. The subsequent testimony concerning what that dollar amount represented was inconclusive, and the Taxpayer's comptroller testified that an amended 2007 Alawest return was filed on which the contract services amount was not included. He did not,

explain, however, why the amount was subsequently omitted. None of the Taxpayer's or Alawest's income tax returns were offered into evidence.

The Taxpayer's logging crews were full-time employees. The owner explained that his company needs skilled operators that can make the equipment look good for potential buyers, and to keep skilled operators the company has to employ them full-time. When not working on the Alawest property, the crews and equipment were used elsewhere.

> Ms. McNeill: Is any of the equipment ever used when it's not being demonstrated?
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> The Witness: We do use that equipment to maintain our – to maintain our operators and to maintain our crews that – that does do that type work. We do. We do continue running those crews. Yes, ma'am.
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> ALJ Thompson: I'm not sure I understand that. You use the demonstrators not when you're demonstrating to a customer, potential customer, but just to practice, so your employees can practice on them.
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> The Witness: We will continue to use those machines. If you don't have – if you don't have – I mean, how do you afford your operators, you know, to operate that piece of equipment? How are you going to have skilled operators if you don't do that? So, you know, they act as a crew that does run and does demonstrate that tractor and we do use that tractor. Yes, sir. We do. But if you don't do it, then you're not going to have any people. You just can't get – we've got to have full-time people. You can't hire just people to come in and do that. You've got to have full-time people on the job or on the payroll to be able to utilize them. We may want to send them to Arkansas. We may want to send them to South Alabama or wherever. So if you don't maintain those people, you just can't call them up and get them to do that type work, you know?

(T. 43 – 45).

The second disputed issue involves oil filters, air filters, and fuel filters that the Taxpayer provided to its customers free-of-charge as part of its "100 hour" service/maintenance program. The owner explained that when his sales people sell a

piece of equipment, they tell the customer that the Taxpayer will service the equipment free-of-charge after it has been used anywhere from 100 to 200 hours.

The Taxpayer has always serviced the equipment it sells without extra charge, and many of its customers are repeat customers that expect the free service. The owner testified that the Taxpayer factors the cost of the filters into the prices it charges for the equipment, the same as it factors in freight and all other costs incurred by the business. The Taxpayer is, however, not contractually obligated to provide the filters free-of-charge.

The Department contends that the Taxpayer owes sales tax on its cost of the filters under the withdrawal provision because it withdrew and used the filters to service the customer's equipment free-of-charge.

The Taxpayer argues that additional sales tax is not owed on the filters because it included the cost of the filters in the retail prices it charged its customers for the equipment, and consequently, that sales tax has already been collected and paid on the filters.

The third disputed issue involves ether that the Taxpayer used in engines to help the engines start in cold weather, and degreaser the Taxpayer used to clean hydraulic engine parts so that they would work properly. The Department assessed those items at the general 4 percent rate because, according to the Department examiner, they were used to maintain the equipment.

The Taxpayer contends that the ether and degreaser are taxable at the 1½ percent "machine" rate levied at Code of Ala. 1975, §40-23-2(3). That reduced rate applies to machines used in processing or manufacturing tangible personal property. The Taxpayer argues that the "machine" rate should apply "because (the ether and degreaser) are

necessary and essential to the proper operation of the equipment to which they are applied." Taxpayer's Post Hearing Brief at 8.

ANALYSIS

Issue (1) – The "Demonstrator" Equipment.

The intent of the §40-23-1(a)(10) "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 wholesale purchaser's cost of the property. See generally, *City of Huntsville v. City of Madison*, 628 So.2d 584 (Ala. 1993).

Two Alabama appellate court cases involving the withdrawal provision are relevant in this case. In *Drennan Motor Co. v. State*, 185 So.2d 405 (Ala. 1966), the issue was whether new automobiles designated and used as demonstrators by an automobile dealership were taxable under the withdrawal provision. The demonstrators were at all times available for sale, and were not depreciated on the dealership's income tax returns. The demonstrators were not otherwise leased, and as stated by the Court – "The only purpose of a demonstrator is to sell new automobiles." *Drennan Motor*, 185 So.2d at 408.

The Court had no apparent trouble holding that the use of the automobiles as demonstrators was not a taxable withdrawal.

> We are not persuaded that the language of the statute expresses an intention to tax, prior to the sale, the use of a piece of merchandise as a demonstrator when the merchandise remains in stock, is available at all times for sale, is used only to promote selling, and is, in every case without exception, sold, and the average selling price is approximately four and one-half per cent less than the average selling price of new merchandise which has not been used as a demonstrator.

Drennan Motor, 185 So.2d at 411.

In *State v. Barnes*, 233 So.2d 83 (Ala. Civ. App. 1970), a music store sold new and used phonograph records at retail and also operated coin-operated jukeboxes at various locations in Alabama. The taxpayer withdrew new records from its inventory and used them in its jukeboxes. It periodically changed the records in the jukeboxes, and the records removed from the machines were returned to the taxpayer's store and sold as used records for a reduced price.

The Court held that a taxable withdrawal occurred when the taxpayer removed the records from its inventory for use in the jukeboxes. Important factors in the Court's reasoning were that the records used in the taxpayer's jukeboxes were not available for sale at all times, and were used in a profit-motivated activity apart from the taxpayer's retail record business. The Court also rejected the taxpayer's double taxation argument by pointing out that the levy of two taxes on the same property is acceptable if the taxes are levied on different parties, citing *Starlite Lanes v. State*, 214 So.2d 324 (Ala. 1968).

The above cases generally establish that if property withdrawn from inventory by the wholesale purchaser is no longer being held for sale in the wholesale purchaser's

inventory, and is being used in a profit-motivated business activity separate and apart from the purchaser's retail business, the withdrawal provision applies and sales tax is due. If, however, the property is used only for the purpose of promoting the sale of the property, as a demonstrator for example, and the property is not otherwise used in a profit-motivated activity unrelated to the sale of the property, then the withdrawal provision does not apply.

This case is difficult because the Taxpayer's use of the equipment on the Alawest property served two purposes. First, the equipment was used to demonstrate the equipment. But unlike the demonstrators in *Drennan Motors*, which were "used only to promote selling" the dealership's vehicles, *Drennan Motors*, 185 So.2d at 411, the use of the equipment to harvest the Alawest timber free-of-charge also personally benefitted the Taxpayer's owner because he also owns 90 – 95 percent of Alawest. It could be argued that when a retail business entity owned by an individual withdraws an item from inventory and uses the item in an activity that financially benefits the owner, as in this case, then the withdrawal provision should apply. The Alabama Supreme Court has held, however, that two commonly-owned but separate entities must be treated as separate entities for sale tax purposes. *Ex parte Capital City Asphalt*, 437 So.2d 1291 (Ala. 1983). Consequently, the fact that the Taxpayer's use of the equipment financially benefited another entity, Alawest, and not the Taxpayer, is not necessarily fatal to the Taxpayer's case.

The evidence also shows, however, that the Taxpayer's logging crews also used the equipment to harvest timber on property not owned by Alawest. As discussed above, when the owner was asked if the equipment was ever used when it was not being demonstrated, he responded that "[w]e will continue to use those machines. . . . We may want to send

(the crews and equipment) to Arkansas. We may want to send (the crews and equipment) to South Alabama or wherever." (T. 44, 45).

The details concerning how often the Taxpayer's crews used the equipment "wherever" other than on the Alawest land, or how much the Taxpayer was paid for that work, is not in evidence. But the above testimony establishes that the equipment was used in a profit-motivated activity unrelated to the use of the equipment as demonstrators on the Alawest property. That is, unlike the demonstrator vehicles in *Drennan Motors*, the equipment in issue was substantially used for a purpose other than as demonstrators to sell the equipment. And while the Taxpayer may have technically held the equipment for sale in inventory, there is no evidence that the equipment was demonstrated for potential customers when it was being used at the various locations away from the Alawest property. The equipment was thus in practical effect removed from the Taxpayer's inventory and not readily available for sale while being used at those other locations.

The owner explained that the Taxpayer used the crews and equipment at locations away from the Alawest property so that it could afford to employ the operators full-time. I can think of no reason, however, why one full-time logging crew would not have been sufficient to fully demonstrate the equipment on the Alawest property. Consequently, I can only conclude that the Taxpayer employed a second full-time crew primarily to harvest the trees on the Alawest property and elsewhere, and not primarily to demonstrate the equipment.

Requiring the Taxpayer to pay sales tax on its withdrawal and use of the equipment to harvest the timber also will not result in impermissible double taxation. In *Starlite Lanes*,

the Supreme Court held that two taxes on the same item is permissible if the taxes are levied on different taxpayers. "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. We do not feel that this is objectionable in the present case." *Starlite Lanes*, 214 So.2d at 327.

Likewise, the Taxpayer in this case is liable for sales tax under the withdrawal provision for its separate use of the equipment in a profit-motivated activity unrelated to the sale of the equipment. The Taxpayer's customers that subsequently purchased the equipment at retail were liable for and paid the sales tax on the retail price charged by the Taxpayer. See, Code of Ala. 1975, §40-23-26(a), which requires the retail seller to add sales tax to the retail price and collect said tax from the purchaser. See also, Code of Ala. 1975, §40-23-26(c) – "All taxes paid pursuant to this division . . . shall conclusively be presumed to be a direct tax on the retail consumer, precollected for the purpose of convenience and facility only." *Matter of Fox*, 609 F.2d 178, cert. denied, 101 S. Ct. 78; *Hill v. State*, 281 So.2d 440 (Ala. Civ. App. 1973).

In summary, the Taxpayer's use of the equipment on the Alawest property served a dual purpose. It allowed the Taxpayer to demonstrate the equipment for potential buyers, which, by itself, was not a taxable use under the withdrawal provision. But using the equipment to harvest the Alawest timber free-of-charge also benefitted the Taxpayer's owner, who also owns 90 – 95 percent of Alawest. And importantly, the Taxpayer also used the equipment to harvest timber on property not owned by Alawest. The equipment was not demonstrated for potential customers on those occasions, and thus was used in a

profit-motivated activity unrelated to the sale of the equipment. Sales tax is thus due under the withdrawal provision on that separate use of the equipment for profit.

Issue (2) – The "100 Hour" Maintenance Filters.

The Taxpayer argues that because it factored the cost of the filters used in its maintenance program into the retail price of the equipment, sales tax was paid on the filters when it collected the sales tax on the equipment from its customers and remitted it to the Department.

The fact that the Taxpayer may factor its cost of the filters into the sales price of the equipment does not, in my opinion, mean that the Taxpayer is also selling the filters when it sells the equipment. All retailers either directly or indirectly factor all costs into the retail sales prices they charge for their products, and in fact must do so to pay those costs and make a profit. But it does not follow that the retailers are selling to their customers the items that those costs represent.

In this case, the Taxpayer's customers were told and expected the Taxpayer to perform the maintenance, i.e., provide filters, as a free service, which the Taxpayer did. The Taxpayer also was not contractually obligated to provide the filters as a part of the free service. Consequently, when the Taxpayer withdrew the filters from inventory and installed them in the equipment free-of-charge, it was using/consuming the filters in providing the free service. Sales tax should accordingly be paid on the filters under the §40-23-1(a)(10) withdrawal provision.

The Taxpayer cites the wheel weights at issue in *Town & Country Ford, LLC v. State of Alabama*, Docket S. 06-493 (Admin. Law Div. O.P.O. 4/10/2007) in support of its position

on this issue. The taxpayer/car dealership in that case purchased wheel weights in bulk tax-free. It used some of the weights to balance the tires on new vehicles it sold at retail, and the others to balance the tires on vehicles brought in for servicing.

The Administrative Law Division held that the wheel weights put on the new cars were not subject to use tax because they were sold with the new vehicles. The Taxpayer argues that those wheel weights are analogous to the filters in issue. I disagree.

The wheel weights used on the new vehicles were not subject to a separate use tax because they were physically attached to and sold as a part of the new vehicles on which sales tax was collected. The filters in issue were not attached to and made a part of the equipment when it was sold. And, as discussed, the Taxpayer was under no legal obligation to provide the filters to its customers.

The filters in issue are more analogous to the wheel weights used in *Town & Country* to balance the tires on vehicles brought in for service. As held by the Division – "the weights used in servicing vehicles were used or consumed by the Taxpayer in performing that service, and are thus subject to use tax." *Town & Country* at 15. Likewise, the filters used by the Taxpayer in servicing its customers' equipment were used and consumed by the Taxpayer in performing that free service, and thus should be subject to sales tax.

Notwithstanding the above, the filters cannot be separately taxed based on the rationale of *Logan's Roadhouse, Inc. v. State, Dept. of Revenue*, 85 So.3d 403 (Ala. Civ.

App. 2011).[2] Logan's operates restaurants in Alabama and sells its menu items for a specific price. It also provides unlimited peanuts to its customer free-of-charge. The issue was whether Logan's was selling the peanuts to its customers at retail.

Logan's presented a "menu mix" document into evidence in circuit court showing that it factored nine cents into the price of each menu entrée to offset the cost of the free peanuts. Based on that evidence, the Court of Civil Appeals affirmed the circuit court's holding that Logan's was selling the peanuts to its customers at retail.

The Taxpayer in this case did not submit into evidence a written document showing that it had factored the cost of the filters into the prices it charged for the equipment. The Taxpayer's owner testified to that fact, however, and I can find no reason to distinguish between a fact established by documentary evidence and a fact established by undisputed testimony. Because the Taxpayer factored the cost of the filters into the cost of the equipment, the Taxpayer was selling the filters to its customers with the equipment per the *Logan's Roadhouse* rationale.[3] Consequently, no additional tax is owed on the filters.[4]

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[2] I respectfully disagree with the rationale in *Logan's Roadhouse* for the reasons explained in *Kelly's Food Concepts of Alabama LLP v. State of Alabama*, Docket S. 10-1131 (Admin. Law Div. 1/5/2012) at 7, note 1. But that case is controlling and, of course, must be followed.

[3] I do not question the owner's testimony in this case. But pursuant to the *Logan's Roadhouse* holding, any retailer can testify after the fact that it factored the cost of a particular item (or all costs) into the price it charges for the goods being sold at retail, and thereby avoid sales or use tax on otherwise taxable items being used or consumed by the retailer.

[4] The above holding that the Taxpayer is selling the filters to its customers raises several potential problems. If the Taxpayer sells a piece of equipment outside of Alabama, but performs the "100 hour" service on the equipment in Alabama, no Alabama sales tax will

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Issue (3) The "Machine" Rate Items.

The Taxpayer argues that the "machine" rate statute should be given a "broad and all inclusive" meaning, citing *Konica Minolta Printing Solutions USA, Inc. v. Alabama Dept. of Revenue*, Docket S. 04-178 (Admin. Law Div. O.P.O. 9/29/2005). It further contends that the ether and degreaser in issue should be taxed at the reduced rate because they are "necessary for the proper operation of the machines in question," i.e., the trucks and equipment owned and/or serviced by the Taxpayer. Taxpayer's Post-Hearing Brief at 8. That may in some respects be correct, but the "machine" rate does not apply because the items are not used in the processing or manufacturing of tangible personal property.

The ether is used to help engines start in cold weather. It obviously does not assist in the processing or manufacturing of the engines or the vehicles. Likewise, the degreaser, while it may help lubricate engine parts so they work better and/or last longer, is also not used in the processing or manufacturing of tangible personal property. "Materials used primarily to operate or maintain plant machinery are not entitled to the reduced rate." *Alabama Power Company v. State*, 103 So.2d 780 (Ala. 1958)." *ONA Corporation v. State of Alabama*, Docket U. 90-315 (Admin. Law Div. O.P.O. 2/10/1995).

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be paid on the equipment/filters, even though the sale of the filters would have occurred when the Taxpayer installed the filters in Alabama. Conversely, if the equipment is sold in Alabama but later removed from and serviced by the Taxpayer outside of Alabama, the sale of the filters would be closed when the filters were installed outside of Alabama. Alabama sales tax thus would not be owed on the filters. In that case, could the Taxpayer and the customer file a joint petition for refund for that part of the Alabama sales tax paid on the equipment (and filters) attributable to the Taxpayer's cost of the filters that was factored into the retail sales price of the equipment?

In the above cited *ONA Corporation* case, the taxpayer manufactured diesel engine parts that had to be cut to specific measurements. It applied coolants to the cutting tools, which prolonged the useful life of the tools. The Administrative Law Division held that the "machine" rate did not apply because "the coolants in issue do not serve a direct, independent function in the manufacture of the engine parts. Rather, the coolants' primary function is to cool and thereby prolong the useful life of the cutting tools. . . ." *ONA Corporation* at 4.

In *NTN Bower Corp. v. State of Alabama*, Docket S. 01-237 (Admin. Law Div. O.P.O. 10/1/2001), the issue was whether coolant and lubricant used in the manufacture of roller bearings was subject to the "machine" rate. The coolant and lubricant dissipated the heat over the bearings, and thus prevented damage to the bearings. The Division held that the reduced rate applied because the "coolant performs a direct and needed function in the manufacturing process by preventing heat damage in the parts being manufactured." *NTN Bower* at 7.

The above cases delineate between a product used only to help service or maintain a machine used in manufacturing, which is not entitled to the reduced rate, and a product directly involved and necessary to the manufacturing process, which is entitled to the reduced rate. The ether and degreaser helps engines and engine parts operate, and the degreaser also extends their useful life. The rationale of *ONA Corporation* clearly applies. Importantly, the Taxpayer also is not engaged in the processing or manufacturing of tangible personal property. The "machine" rate clearly does not apply.

Issue (4) – The Undue Delay Issue.

Finally, the Taxpayer claims that at least a portion of the interest that has accrued on the tax determined to be due should be abated pursuant to §40-2A-4(b)(1)c. due to undue Department delay.

The Department examiner completed her audit in late 2009. The Department entered preliminary assessments against the Taxpayer on December 21, 2009. The Taxpayer petitioned for a review of the preliminary assessments, and an informal conference between the Taxpayer and the Department's Sales and Use Tax Division hearing officer was conducted on February 10, 2010.

The Taxpayer presented additional records at the conference. The examiner that conducted the audit reviewed the records and adjusted the audit in April 2010. The Department hearing officer subsequently sent the Taxpayer a May 18, 2010 letter indicating that no additional changes would be made concerning the contested items in the audit. There is no evidence that the Taxpayer submitted any additional records or that the Department took any action subsequent to the May 18, 2010 letter until the Department entered the final assessments in issue on June 20, 2012.

Section 40-2A-4(b)(1)c. authorizes the Department's Taxpayer Advocate to abate all or a portion of any interest that has accrued due to undue Department delay. The Taxpayer claims that the Department's failure to take any action in the case from May 2010 until the final assessments were entered in June 2012 constitutes undue delay.

The Department responded in its March 11, 2013 letter brief at 2, that "the Department was working with the Taxpayer in adjusting the audit as the Taxpayer

continued to produce additional records." The record indicates, however, that the Department examiner did not review any additional records or otherwise work on the case after April 2010, and that there was no correspondence or contact between the parties after the May 18, 2010 letter from the Department until the final assessments were entered on June 20, 2012.

A copy of this Opinion and Preliminary Order is being forwarded to the Taxpayer Advocate for review. The Advocate should investigate and then notify the Administrative Law Division what amount, if any, of accrued interest should be abated due to undue Department delay. The Department will then be directed to recompute the liability in accordance with this Opinion and Preliminary Order. A Final Order for the recomputed amount due 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 pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered July 8, 2013.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
Blake A. Madison, Esq.
Joe Walls
Mike Emfinger
Brenda Russ