ALABAMA TAX TRIBUNAL

BUNN-O-MATIC CORPORATION,	§	
Taxpayer,	§	DOCKET NO. S. 17-614-JP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND FINAL ORDER

This appeal involves final assessments of state and local seller's use tax entered against Bunn-O-Matic Corporation ("Taxpayer") by the Alabama Department of Revenue. The assessments consist of tax and interest and cover the periods of June 2012 through May 2015. A hearing was conducted on May 1, 2018, followed by the submission of briefs.

Question Presented

The Alabama legislature has imposed an excise tax "on the storage, use or other consumption in this state of tangible personal property . . . at the rate of four percent of the sales price of such property. . ." Ala. Code § 40-23-61(a). However, the legislature taxes "the storage, use or other consumption . . . of any machines used in mining, quarrying, compounding, processing and manufacturing of tangible personal property" at a rate of only 1½ percent. Section 61(b). Here, the question presented is whether the Taxpayer's coffee and tea brewers and related items qualified as machines that were used to process tangible personal property.

Law

The pertinent statutory provisions which address Alabama's reduced "machine rate" read as follows:

> An excise tax is hereby imposed on the storage, use or other consumption in this state of any machines used in mining, quarrying, compounding, processing and manufacturing of tangible personal property . . . at the rate of one and one-half percent of the sales price of any such machine . . .; provided, that the term "machine," as herein used, shall include machinery which is used for mining, quarrying, compounding, processing, or manufacturing tangible personal property, and the parts of such machines, attachments and replacements therefor, which are made or manufactured for use on or in the operation of such machines and which are necessary to the operation of such machines and are customarily so used.

§ 40-23-61(b). The remaining use tax statutes in Alabama's Revenue Code do not contain any other definition or description of "machine" or "machinery" and do not define "process" or "processing."

In an administrative rule, the Revenue Department has defined the term "processing" for purposes of interpreting Alabama's sales and use tax statutes:

> "Processing" means to subject to some special process or treatment. To heat, as fruit with steam under pressure so as to cook or sterilize. To subject, especially 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, waste matter or inferior, defective, decomposed substance or product by a process, often chemical process, as to process rancid butter, rayon waste, coal dust, beet sugar.

Ala. Admin. Code r. 810-6-4-.17.05.

Facts

The Taxpayer, which is headquartered in Springfield, Illinois, manufactures coffee and tea brewers, cappuccino mixers, and frozen beverage dispensers, as well as related accessories and repair and replacement parts. It sells these products all over the world, including to several customers in the State of Alabama.

One of the Taxpayer's Alabama customers is Red Diamond, Inc., which has its headquarters in this state. Red Diamond processes green coffee beans and raw tea leaves into a marketable form by roasting the coffee beans and cutting and blending the tea leaves and packaging those products in dry form. It then sells the products to retailers, distributors, restaurants, hotels, and law and accounting firms, among other types of businesses. Concerning the cappuccino mixers and frozen beverage dispensers that are sold by the Taxpayer, Red Diamond supplies cappuccino mix and juice concentrate but does not process those items at Red Diamond's facilities.

Generally, Red Diamond's sales can be characterized in one of two ways – to wholesale customers such as grocery stores and food distributors who in turn sell Red Diamond's products at retail, or to customers such as restaurants, convenience stores, and those in office settings who serve or consume Red Diamond's products on site. Red Diamond's sales to wholesale customers do not involve the equipment purchased by Red Diamond from the Taxpayer. To many of its other customers, though, Red Diamond provides the Taxpayer's equipment with the packaged coffee, tea, cappuccino mix, or juice concentrate.

In situations where Red Diamond provides the Taxpayer's equipment with the products that Red Diamond sells, trial testimony explained that the coffee and tea brewers convert those packages of dry coffee and tea into consumable drinks. Likewise, the cappuccino mixers combine hot water with a powder base and then whip the contents at a high revolution rate to produce drinkable cappuccino. Also, the frozen beverage dispensers freeze a pre-mixed base concentrate that has been diluted with water, continuously scrape and mix that combination, and then dispense a drinkable product.

When the Taxpayer sold these products and their related accessories and parts to Red Diamond during the audit period, the Taxpayer collected and remitted use tax at the reduced machine rate. During that same period, the Taxpayer sold the same products and accessories and parts to Royal Cup, Inc., which manufactures and sells coffee and tea products in a manner that apparently is very similar to that of Red Diamond. Likewise, the Taxpayer collected and remitted use tax from Royal Cup at the reduced machine rate.

In conducting the audit, the Revenue Department's examiner testified that she viewed the Taxpayer's website and that she traveled to its headquarters. She noted that, during the audit period, the Taxpayer reported tax on some items at the general rate but reported at the machine rate on the items in question. Some items that were reported by the Taxpayer at the general rate were changed by the examiner to the machine rate because the Taxpayer "sold directly to those companies, not directly to another party."

Concerning the Taxpayer's sales to Red Diamond, however, the examiner concluded that all should have been taxed at the general rate. Therefore, the final assessments are based on the difference between the two rates. The examiner testified that her decision concerning the items in question was based on her brief review of Red Diamond's website and her understanding that Red Diamond allowed its customers to use those items free of charge as long as the customers continued to buy Red Diamond's products. But the examiner did not speak with anyone at Red Diamond to confirm her belief. And Red Diamond's Assistant Vice President of Accounting testified that the company did not give away the items that it had purchased from the Taxpayer, nor did it allow its customers to use the items free of charge. The examiner testified, however, that her analysis would not have changed even if she had known that Red Diamond was not

giving away the items for promotional purposes. Instead, she believed that "[t]hey are not processing coffee for sale. They're just placing it in their customer's locations if the customer purchases items to use in the machine." Thus, she understood that it was Red Diamond's customers, and not Red Diamond, who were engaged in processing. She further testified that Red Diamond is allowed to purchase at the machine rate only those items that Red Diamond uses to manufacture the products that it sells.

In instances where the Taxpayer sold its coffee and tea brewers and related items to restaurants, the examiner applied the machine rate because of an administrative rule that lists restaurants as processors of food and thus lists coffee makers as machines. The examiner acknowledged, however, that the machines that the Taxpayer sold to Red Diamond were the same types of machines that the Taxpayer sold to restaurants. She also stated her understanding that coffee and tea brewers convert coffee grounds and tea leaves into a drinkable product, and that the Taxpayer's coffee and tea brewers located in a restaurant do not operate differently from those same brewers when located in an office. Nevertheless, she reiterated her reliance on the fact that the Revenue Department adopted a rule that specifically characterizes coffee makers used in restaurants as machines for purposes of the machine rate.

As to the Taxpayer's sales to Royal Cup during the audit period, the examiner acknowledged that the items sold were similar to those sold by the Taxpayer to Red Diamond. She also acknowledged that she made no change to the machine rate that was applied by the Taxpayer to the Royal Cup sales, although she did not recall why. The examiner noted, however, that some of the same items that the Taxpayer sold to Red Diamond were taxed at both the general rate and the reduced machine rate.

Analysis

As quoted, the legislature imposed an excise tax of 1½ percent on machines that are used in processing tangible personal property. In a preceding statute, however, the legislature had chosen to exempt such machines from use tax. Title 51, § 789(p), Code of Ala. 1940. The wording in the current statute is virtually identical to its predecessor.

In *State v. Newbury Mfg. Co.*, 93 So.2d 400 (Ala. 1957), our Supreme Court considered whether sand and steel shot used in the manufacture of cast iron pipe fittings were exempt, under the predecessor statute, as parts of machines used in manufacturing or compounding tangible personal property. The court held that they were exempt:

> The term 'machines, attachments and replacements' in this connection have been given a broad meaning. Their status is not controlled by the material of which they are composed, but by the office they serve in the process. If the article in question performs an integral function in the procedure by which the tangible personal property is produced, we think it is a part and parcel of the machinery used in its production. It is not controlled by the fact that in its use it wears out its valuable properties in that connection. Many parts of machinery wear out and have to be replaced.
>
> On the other hand, if a product, such as grease or fuel is useful only as an aid, though vital in enabling the machine or some part of it to operate, but not itself performing a distinct function in the operation, it does not come within the exception.
>
> The 'sand' and 'steel shot' here in question have an independent function in the operation. That is not simply as an aid to some other part in the performance of its service. The question is not controlled by whether it is necessary to the operation of a machine--grease and fuel are that, but they perform no specific function in the operation. It is sometimes said to depend upon whether the article has a direct part in the processing program.

Id. at 402 (citations omitted).

In a subsequent opinion, the court reiterated the meaning of the term "processing" as used in the predecessor to § 40-23-61(b):

> "'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 chemical process; *** d. to produce or copy by photo-mechanical methods; to develop, fix, wash and dry, or otherwise treat (in exposed film or plate).'

State v. Four States Drilling Co., 177 So.2d 828, 831 (Ala. 1965), quoting *State v. Advertiser Co.*, 59 So.2d 576, 579 (Ala. 1952).

The court held that the equipment in question – casing which extended 11,000 feet below ground – processed crude oil by assisting in separating the oil from sediment, sand, gas, and water as the mixture was brought to the surface. *State v. Four States Drilling*. In so doing, the court rejected the idea that the separating of the mixture "was merely incidental to the transportation of the" oil, noting that the natural mixture containing oil was "not ready for use by the consumer before it reaches the pump in the bottom of the well." *Id*. at 832. Thus, the court upheld the exemption. (In the opinion, the court explained that the legislature replaced the exemption with the reduced machine rate of 1½ percent beginning October 1, 1959. *Id*. at 829.)

Subsequently, the Revenue Department adopted its administrative rule defining "processing." That definition is substantially similar to the definition quoted in *Four States Drilling* at 831.

Here, the evidence is clear that the Taxpayer's coffee and tea brewers, cappuccino mixers, and frozen beverage dispensers that it sold to Red Diamond qualified as machines that were used in processing tangible personal property. Specifically, these items of equipment converted dry coffee and tea, cappuccino base, and pre-mixed base concentrate into consumable drinks. And the dry and base forms of those products were not consumable prior to the direct operation of the Taxpayer's equipment. The Taxpayer's Senior Vice President of Engineering testified in detail concerning the manner in which the Taxpayer's equipment brings water at a certain temperature into contact with the dry coffee, how the filtering of the coffee occurs, the ratio of coffee to water in the cup, and the fact that the equipment is programmable, among other things. He testified in similar detail concerning the other equipment. Also, the representative from Red Diamond testified that the company's ultimate product is the consumable drink.

Thus, the Taxpayer's equipment performed "an integral function in the procedure by which the" consumable drinks were produced and played "a direct part in the processing program." *Newbury Manufacturing*, *supra*, at 402. And these functions directly prepared and converted into marketable form the dry and base products that were served or consumed on site. *Four States Drilling Co.*, *supra*, at 831; Ala. Admin. Code r. 810-6-4-.17.05. In other words, the functioning of the equipment was not "merely incidental" to the processing of the dry and base forms of Red Diamond's products, because those products were not "ready for use by the consumer" prior to being acted on by the Taxpayer's equipment. *Four States Drilling Co.*, *supra*, at 832. Of course, it is undisputed that the consumable drinks constituted tangible personal property.

In its brief, the Revenue Department states that "[t]he sole question in this case is whether the machine rate applies to a machine which the purchaser does not use to process tangible personal property into marketable form." Apparently, the premise of the Revenue Department's statement is found on the next page of its brief: "Red Diamond's customers are the parties that use the machines to create beverages that the customer either consumes or sells at retail." If, however, it had been Red Diamond's customers who used the machines, then it would have been those customers, and not Red Diamond, who owed the use tax, in which case the Taxpayer should not have collected use tax from Red Diamond at either rate. Also, as noted, Red Diamond's representative testified that its ultimate product was the consumable drink. And it was the machines sold to Red Diamond that processed Red Diamond's dry coffee and tea, base, and base concentrate into those consumable drinks.

In summary, the Taxpayer's equipment that it sold to Red Diamond met the criteria set by statute, by case law, and by administrative rule to qualify as machines that process tangible personal property. That is all that the law requires to subject the use of the machines to the reduced tax rate. *See, e.g., State v. Television Corp.*, 127 So.2d 603, 606 (Ala. 1961). (The parties stipulated prior to trial that the related accessories and repair and replacement parts would be subject to the same tax rate as the equipment.)

The final assessments are voided. Judgment is entered accordingly.

This Opinion and Final Order may be appealed to circuit court within 30 days, pursuant to Ala. Code § 40-2B-2(m).

Entered April 30, 2020.

/s/ *Jeff Patterson*
JEFF PATTERSON
Chief Judge
Alabama Tax Tribunal

jp:dr
cc: Bruce P. Ely, Esq.
William T. Thistle, Jr., Esq.
Mary Martin Mitchell, Esq.