SMARTSMILES ORTHODONTICS PC 6741 TAYLOR CIRCLE MONTGOMERY, AL 36117,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 05-772
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Smartsmiles Orthodontics, P.C. for use tax for April 2002 through March 2005. Dr. Foch Smart ("Taxpayer") owns and operates Smartsmiles Orthodontics. He appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on November 10, 2005. The Taxpayer represented himself. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer is a practicing orthodontist in Montgomery, Alabama. He purchased retainers and other orthodontic appliances tax-free from two out-of-state dental laboratories during the period in issue. He subsequently used the appliances in performing dental services for his patients. He failed, however, to report and pay Alabama use tax on the appliances.

The Department audited the Taxpayer and assessed him for use tax on the amounts he paid the laboratories for the appliances. The Taxpayer concedes that he owes Alabama use tax on the appliances. He argues, however, that he only owes tax on the laboratories' cost of the materials it used in making the appliances. The Taxpayer cites Dept. Reg. 810-6-1-.50(3) in support of his position.

Reg. 810-6-1-.50(3) provides that a dentist that buys prosthetic devices from an out-of-state dental laboratory owes Alabama use tax on only the laboratory's cost of the materials used to make the devices. The regulation also specifies, however, that if the laboratory fails to separately state its cost of materials and its cost of services on the billing or invoice issued to the dentist, tax is due on the full price.

In this case, the laboratories that sold the appliances to the Taxpayer did not separately state the cost of the materials on its billings to the Taxpayer. Consequently, the Taxpayer would be liable under the regulation for use tax on the full cost of the appliances.[1] However, the regulation is contrary to Alabama law, and thus invalid, because under current Alabama law, dentists are not liable for Alabama use tax on dental appliances purchased from out-of-state laboratories (or sales tax on appliances purchased from in-state laboratories). I will explain.

The Alabama Supreme Court held in 1963 that dentists are not selling dentures and other prosthetic devices when they transfer such items to their patients. Rather, as members of a "learned profession," they are using or consuming the items incidental to performing their professional services. Consequently, they are not liable for sales tax on the items. *Haden v. McCarty*, 152 So.2d 141 (Ala. 1963).

Apparently in response to the Supreme Court's holding in *Haden*, the Department promulgated Reg. P-18-133 in 1963. That regulation held that dental

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[1] The Alabama Supreme Court held in *Ex parte White*, 477 So.2d 422 (Ala. 1985), on remand 477 So.2d 425, that a regulation that specifies a particular method of recordkeeping must be followed unless it is contrary to a statute or unreasonable. Reg. 810-6-1-.50(3), to the extent it requires the cost of materials to be separately stated, is neither.

laboratories sell dental prosthesis and appliances to dentists at retail, and are thus liable for sales tax on those items.

A group of laboratories sued the Department, seeking to have the regulation declared invalid. The Alabama Supreme Court ruled for the laboratories, holding that dental laboratories were providing a service, and thus were not liable for sales tax when they transferred dental appliances to dentists. *Hamm v. Proctor*, 198 So.2d 782 (Ala. 1967). In so holding, the Court relied solely on a 1939 Department regulation which stated that "[d]entists or dental laboratories primarily render services." As stated by the Court, "[w]e give (the Department's) administrative construction, issued in 1939, favorable consideration for the reason that it has stood unchallenged for approximately twenty-five years." *Hamm*, 198 So.2d at 785.

Finally, in *Crutcher Dental Supply Co. v. Rabren*, 246 So.2d 415 (Ala. 1971), the Supreme Court decided whether sales of materials by a dental supply company to dental laboratories and dentists were subject to sales tax. The Court affirmed its prior holdings in *Haden* and *Hamm* that dentists and dental laboratories were not selling at retail. In affirming those cases, however, the Court recognized that the holdings "may not appear to be strictly logical from a purely theoretical viewpoint, . . ." *Crutcher Dental*, 246 So.2d at 419.[2] It nonetheless held that the holdings were reasonable, and consequently that the sales by the dental supply company were taxable retail sales to the ultimate consumers of the materials, i.e., the dentists and dental laboratories.

To summarize, under current Alabama law, as construed by the Alabama Supreme Court in the above cases, the sale of materials by a dental supply company to

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[2] As explained below, the Court's holding in *Haden* concerning dentists is theoretically correct. It's holding in *Hamm* concerning dental laboratories is not.

a dental laboratory is a taxable retail sale, see *Crutcher*. The transfer of the finished dental appliance by the laboratory to a dentist is a service, not a taxable retail sale, see *Hamm*. The subsequent transfer of the appliance by the dentist to the patient is likewise a service, and not taxable, see *Haden*.

The Department follows the above rationale when an Alabama dentist buys a dental appliance from an in-state laboratory. That is, the dentist does not owe Alabama sales tax when he or she purchases the appliance from the laboratory, nor is the dentist liable for Alabama use tax when he or she uses the appliance in providing services to the patient.

The Department applies different rules, however, concerning an appliance purchased from an out-of-state laboratory. Pursuant to Reg. 810-6-1-.50(3), if the Alabama dentist buys an appliance from an out-of-state laboratory, the dentist owes Alabama use tax on either the out-of-state laboratory's cost of the materials used to make the appliance, if the cost of the materials is separately stated on the invoice, or on the total cost of the appliance, if the cost of the materials is not separately stated.

The regulation is wrong because Alabama use tax applies only if the subject property is "purchased at retail." Code of Ala. 1975, §40-23-61(a). As discussed, the Supreme Court held in *Hamm* that dental laboratories provide services and do not make retail sales to the dentists. The holding applies to both in-state and out-of-state laboratories. Consequently, because dentists do not buy the appliances from out-of-state laboratories at retail, Alabama use tax is not due when the dentists later use or consume the appliances in Alabama. The above holding is consistent with the Alabama Supreme Court's holding in *State v. Hanna Steel Corp.*, 158 So.2d 906 (Ala. 1963), in

which the Court held that Alabama use tax is due on property purchased outside of Alabama and subsequently used or consumed in Alabama only if Alabama sales tax would have been due if the sale had occurred in Alabama. As indicated, Alabama sales tax would not have been due if the dentist had purchased the appliance from an in-state laboratory.

Reg. 810-6-1-.50(3), to the extent it conflicts with the above holdings of the Alabama Supreme Court, is contrary to Alabama law. Because the Taxpayer did not purchase the dental appliances in issue at retail, Alabama use tax is not due.[3] The final assessment in issue is voided.

With due respect, I must add that the Supreme Court's holding in *Hamm* that dental laboratories do not sell appliances to dentists at retail is theoretically incorrect. Unfortunately, as discussed, the Court in *Hamm* relied solely on a 1939 Department regulation which incorrectly stated that dentists and dental laboratories primarily render services. The Court apparently felt compelled to require the Department to follow its own regulation, regardless of its substantive accuracy.

Equating dentists with dental laboratories, as did the Department's erroneous 1939 regulation, is, with due respect to dental laboratories, improper. Dentists, as doctors, clearly provide professional services that involve the incidental transfer of dentures, appliances, etc. to their patients. The Supreme Court correctly so held in

[3] The regulation is also constitutionally suspect because it taxes property purchased by dentists from out-of-state sellers in interstate commerce, but not the same property purchased from in-state sellers. It thus discriminates against interstate commerce in violation of the Commerce Clause, U.S. Constitution, Article I, §8, cl. 3. See generally, *State v. Bay Towing and Dredging Co.*, 90 So.2d 743 (Ala. 1956).

Haden, and that position has been adopted in most other states. See generally, J. Hellerstein & W. Hellerstein, *State Taxation* (3d ed. 2001) at ¶13.01(2).

Dental laboratories, on the other hand, are clearly selling the appliances to the dentists at retail. The laboratories certainly use skill and expertise in making the appliances, but ultimately they are selling the tangible items to the dentists, not providing an intangible professional service. The transfer of the tangible appliance is the ultimate purpose or true object of the transaction, not the providing of a professional service.[4] As stated by Professor Hellerstein in this leading treatise – "A consequence of such decisions (holding that dentists are not reselling the devices obtained from dental laboratories) is that, in the absence of (a statutory exemption), dentists are taxable on their purchases of dental prosthetics from the laboratory, since they are treated as the consumers of such articles in rendering their dental services." *State Taxation*, at ¶13.01(2).

Dental laboratories should purchase materials from their suppliers tax-free at wholesale. They should then collect tax on the retail sales price they charge the dentist for the manufactured product. If the laboratory is in Alabama, Alabama sales would be due on the sale. If the laboratory is out-of-state, it should collect either Alabama sales or use tax, depending on whether the sale, i.e., delivery, occurred in Alabama, in which case Alabama sales tax would be due, or outside of Alabama, in which case Alabama

[4] For a good discussion of the "true object" or "dominant purpose" test, and how it has been applied by various state courts, see *State Taxation*, at ¶12.07(1). Professor Hellerstein believes that the true object test has several weaknesses, and that the better approach is the "community appraisal" test, see ¶12.07(2). That is, does the average person view the transaction as a sale or a service. But under either test, the transfer of manufactured dental appliances by a dental laboratory to a dentist constitutes a sale of tangible property, not the providing of an intangible service.

use tax would be due. However, if the out-of-state laboratory does not have nexus with Alabama or otherwise fails to collect and remit Alabama tax on the transaction, the dentist would subsequently owe Alabama use tax when he or she used or consumed the item in Alabama as part of their professional services. In the above scenario, in-state and out-of-state laboratories would be taxed equally, and dentists would pay the same tax for the same product regardless of whether they purchased from an in-state or an out-of-state laboratory.

The above notwithstanding, the Alabama Supreme Court's holding in *Hamm* and *Crutcher* must be followed until the Alabama Legislature sees fit to clarify the law, or the Supreme Court reverses itself in a subsequent case. In the meantime, dentists in Alabama are not liable for Alabama sales tax when they buy appliances from a dental laboratory in Alabama, nor are they liable for Alabama sales or use tax when they buy the appliances from an out-of-state dental laboratory.

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

Entered December 29, 2005.

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BILL THOMPSON
Chief Administrative Law Judge