LOGAN'S ROADHOUSE, INC. 2890 FLORENCE BLVD. FLORENCE, AL 35630,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 08-700
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Logan's Roadhouse, Inc. ("Taxpayer") for State sales and local use tax for January 2004 through September 2006, and State use tax for February 2001 through September 2006. 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 March 13, 2009. Bruce Rawls represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUE

The Taxpayer operates full-service restaurants in Alabama and other Southeastern states. It purchased peanuts at wholesale during the period in issue and then provided those peanuts at no charge to its customers. The issue is whether the Taxpayer is liable for Alabama use tax on its wholesale cost of the peanuts. If the Taxpayer was reselling the peanuts to its customers, then the Taxpayer correctly purchased the peanuts at wholesale and use tax is not due. If, however, the Taxpayer was not reselling the peanuts, use tax would be due on the Taxpayer's use of the peanuts.

FACTS

The facts are undisputed.

The Taxpayer operates numerous full-service restaurants in Alabama. It provides

peanuts in small buckets or pails on the tables in its restaurants. Customers may eat the peanuts at their leisure before, during, and after they eat their meals. The peanuts are also available to customers that are waiting to be seated, and also to individuals in the restaurants that do not order food from the Taxpayer. The Taxpayer does not charge an extra or specific amount for the peanuts, whether the consumer orders food from the Taxpayer or not.

The Taxpayer purchased the peanuts at wholesale during the period in issue. The Department audited the Taxpayer for sales and use tax and assessed it for State and local use tax on its wholesale cost of the peanuts.[1] The Department made other adjustments

[1] Technically, the Department could have assessed the Taxpayer for sales tax on the peanuts under the sales tax "withdrawal" provision at Code of Ala. 1975, §40-23-1(a)(10). The Taxpayer purchased the peanuts at wholesale, put the peanuts in inventory, and then, if the Department's position is correct, withdrew the peanuts for its own use. The sales tax withdrawal provision clearly applies under those facts, assuming that the Taxpayer is not reselling the peanuts.

Notwithstanding the above, as explained below, because the Taxpayer did not pay sales tax on the peanuts, the Department also correctly assessed the Taxpayer for use tax on its subsequent use of the peanuts, again assuming that the Department's position is correct that the Taxpayer is not reselling the peanuts to its customers.

The Alabama sales and use taxes are complimentary. The sales tax is on retail sales of tangible personal property in Alabama. The use tax is on the use, storage, or consumption in Alabama of tangible personal property purchased at retail. The use tax as a practical matter generally applies only to property purchased outside of Alabama that is subsequently use, stored, or consumed in Alabama. Alabama's appellate courts have so stated that general rule on numerous occasions, see *State of Alabama v. Marmon Industries, Inc.*, 456 So.2d 798 (Ala. Civ. App. 1984) ("The sales tax statutes apply to retail sales or purchases taking place within the state; the use tax statutes apply to goods purchased at retail outside of the state and brought into the state for use by the purchaser." *Marmon Industries*, 456 So.2d at 800, 801.).

(continued)

that are not contested. As indicated, the sole issue is whether the Taxpayer owes use tax on its wholesale cost of the peanuts.

The Taxpayer argues that use tax is not owed on the peanuts because "the peanuts were acquired by the Taxpayer in a wholesale sale (for resale) because the peanuts become part and parcel of the finished product the Taxpayer sells at retail to its customers

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But the use tax levying statute itself, §40-23-61(a), does not limit the scope of the use tax to only property purchased at retail outside of Alabama. Rather, the use tax levy applies to all property purchased at retail that is subsequently used, stored, or consumed in Alabama. To prevent double taxation, however, that is, to prevent the same property from being subject to Alabama sales tax when sold at retail in Alabama and also Alabama use tax when later used, stored, or consumed in Alabama, the Legislature initially exempted from the Alabama use tax all property that was subject to the Alabama sales tax when purchased. Code of Ala. 1975, §40-23-62(1).

Unfortunately, the §40-23-62(1) use tax exemption, as originally enacted, contained an inadvertent loophole. That is, if an out-of-state retailer without nexus with Alabama made a retail sale closed in Alabama, the Alabama sales tax would apply. See, *State v. Dees*, 333 So.2d 818 (Ala. Civ. App. 1975), cert. denied, 333 So.2d 821 (1976). Because the transaction was subject to Alabama sales tax, the subsequent use of the property in Alabama was exempt from Alabama use tax pursuant to §40-23-62(1), as originally enacted. But because the out-of-state seller did not have nexus with Alabama, the Department also could not assess sales tax on the sale. Consequently, neither Alabama sales tax nor use tax could be collected. For a good discussion of the loophole, see *Whatley Contract Carriers, LLC v. State of Alabama*, U. 03-372 (Admin. Law Div. 3/23/2004).

Once the Alabama Legislature became aware of the loophole in 1997, it amended the use tax exemption at §40-23-62(1) so that it now applies only if Alabama sales tax is actually paid on the subject property. See, Acts 1997, No. 97-301. Under current law, if sales tax is owed on a retail sale in Alabama but is not paid, the §40-23-62(1) exemption does not apply, and the subsequent use, storage, or consumption of the property in Alabama is subject to Alabama use tax. Consequently, because the Taxpayer in this case did not pay Alabama sales tax on the peanuts, either when it purchased the peanuts from the vendor or when it withdrew them from inventory, the Taxpayer's subsequent use of the peanuts in Alabama was subject to Alabama use tax, again assuming that the Department is correct that the Taxpayer was not reselling the peanuts at retail. That issue is addressed below.

in the ordinary course of business." Taxpayer's Brief at 2. The Taxpayer contends that it is reselling the peanuts to its customers because it considers the cost of the peanuts in the price it charges for its menu items, and also because title to the peanuts is transferred to its customers.

The Taxpayer cites the testimony of the Department examiner in support of its position. The examiner testified at the March 13 hearing that the Department does not tax various condiments, i.e., packets of ketchup, mayonnaise, etc., that are given away at fast food restaurants. The Taxpayer asserts that free peanuts given to customers are no different, and thus also should not be subject to Alabama use (or sales) tax.

ANALYSIS

The Alabama use tax is levied on tangible personal property purchased at retail that is subsequently used, sold, or consumed in Alabama. Code of Ala. 1975, §40-23-61(a). This case turns on whether the Taxpayer is reselling the peanuts at retail to its customers. If so, the Taxpayer correctly purchased the peanuts at wholesale for resale, and use tax is not due. If, however, the Taxpayer is not reselling the peanuts, but rather is giving them away as an advertising or marketing tool to attract customers, then Alabama use tax is due.

Alabama's courts have never addressed the specific issue in this case, i.e., is a restaurant that provides a complimentary, non-menu food item to its customers selling the food item at retail to its customers. Courts in other states have, however, addressed related issues that provide some guidance.

The New York Court of Appeals, in *In Matter of Burger King v. State Tax*

Commission, 416 N.E.2d 1024 (1980), addressed the issue of whether Burger King was reselling hamburger wrappers, cups for beverages, and french fry "sleeves" that it transferred to its customers with the food items. The Court held that the wrappers, cups, and sleeves were "a critical element of the final product sold to customers. So regarded, the packaging material is as much a part of the final price as is the food or drink item itself." *Burger King*, 416 N.E.2d at 1028. The Court held that it was irrelevant that Burger King did not list a separate price for the packaging material, and that in substance Burger King was reselling the packaging to its customers.

The Missouri Administrative Hearing Commission decided a similar issue in *Wendy's of Mid-Missouri & Southwest Missouri v. Director of Rev., State of Missouri*, 1982 Mo. Tax Lexis 72. The issue in that case was whether foil and wax paper used to wrap hamburgers sold to customers and also the bags into which the wrapped burgers were placed were being sold to Wendy's customers. The Commission held that "[t]he wrappings and bags have no other purpose or function . . . except their incorporation, in terms of both cost and form, into the food product sold to the consumer. Moreover, neither the wrapper nor the bags are given away without a purchase." *Wendy's* at 14. The Commission thus held that like the wrappers, cups, and sleeves in the above discussed *Burger King* case, Wendy's was reselling the wrappers and bags to its customers.

In *Celestial Food of Massapequa Corp. v. New York State Tax Comm.*, 473 N.E.2d 737 (1984), the same New York Court that decided *Burger King* addressed the issue of whether a fast food restaurant was reselling the napkins, straws, stirrers, plastic utensils, and similar items that it provided to its customers. The Court first acknowledged its holding

in *Burger King* that wrappers for hamburgers, sleeves for french fries, and cups for beverages were being resold to the customers. The Court then distinguished the napkins, straws, etc. in issue, as follows:

> Unlike the packaging in *Burger King*, the items respondent here seeks to exclude from sales tax are not a critical element of the product sold and thus are not purchased "for resale as such." Whereas a cup of coffee cannot be purchased without a container, the same cannot be said of napkins, stirrers and utensils, which are more akin to items of overhead, enhancing the comfort of restaurant patrons consuming the food products. The Appellate Division's reasoning in this case, that because "the fast food customer expects to be provided with a stirrer for coffee, a straw for soft drinks, plastic utensils for food, and napkins for cleanliness" such items are purchased "for resale as such" (cite omitted), has potentially limitless application. Although the cost of such items may well be taken into account by the restauranteur when setting the price of food, so are other amenities a restaurant patron expects, such as service, utilities and fixtures, which do not become a part of the product being sold merely because their cost is a factor in determining the price a customer pays. Only when, as in *Burger King*, such items are necessary to contain the product for delivery can they be considered a critical element of the product sold, and excluded from sales tax. Accordingly, the items referred to in (cite omitted) were not purchased "for resale as such" by respondent and the challenged regulation requiring payment of sales tax on its purchases of such items is not at odds with the Tax Law.

Celestial Food, 473 N.E.2d 738.

The general rule to be taken from the above cases is that when wrappers, disposable cups, and similar items are necessarily transferred to the customer along with food, those items are being sold as an integral part of the food. As stated by the New York Court in *Celestial Food*, "only when, as in *Burger King*, such items are necessary to contain the product for delivery can they be considered a critical element of the product sold, and (thus purchased for resale)." *Celestial Food*, 473 N.E.2d at 738.

Conversely, items provided by a restaurant that are not an integral and necessary

part of the food being sold, i.e., straws, stirrers, napkins, etc., although perhaps expected by the customer, are not being sold to the customer. This is true even though the restaurant may consider the cost of such items in fixing its menu prices for the food items. "Although the cost of such items may well be taken into account by the restauranteur when setting the price of food, so are other amenities a restaurant patron expects, such as service, utilities and fixtures, which do not become a part of the product being sold merely because their cost is a factor in determining the price a customer pays." *Celestial Food*, 473 N.E.2d at 738.

Turning to this case, Alabama law defines "sale" as "the passing of title from the seller to the buyer for a price." Code of Ala. 1975, §7-2-106(1).[2] "Price" is not defined by the Alabama Revenue Code, Title 40, Code 1975, or the UCC, but is commonly defined as "[t]he amount of money or goods, asked for or given in exchange for something else." American Heritage College Dictionary, Fourth Ed. at 1105.

The Taxpayer in this case is exchanging its menu items to its customers for a stated amount. It is thus selling the menu items to its customers. The Taxpayer is not, however, selling the peanuts to its customers because the customers pay no price or other consideration in exchange for the peanuts. Rather, the peanuts are complimentary, and can be eaten by a customer or not. The customer pays the same price in either case for any menu item that may be ordered. Importantly, an individual visiting one of the

[2] Section 7-2-106(1) is part of the Uniform Commercial Code. Code of Ala. 1975, §7-1-101, et seq. Alabama's courts have routinely looked to the UCC provisions in interpreting Alabama's sales and use tax laws. See generally, *Alabama Precast Products v. State, Dep't of Revenue*, 332 So.2d 160 (Ala. Civ. App. 1976), cert. denied 332 So.2d 164.

Taxpayer's restaurants can consume the peanuts, even if the individual does not purchase a menu item from the Taxpayer. The peanuts thus may be consumed without a retail sale being made.

In summary, the Taxpayer is using the peanuts as a marketing or advertising tool to entice customers into its restaurants. And while title to the peanuts technically passes to the consumer, they are not being sold because the consumer pays no price or consideration for the peanuts. The peanuts also are not a necessary and essential part of the menu items purchased by the Taxpayer's customers, as were the wrappings, bags, etc. in the above discussed cases.[3]

The Taxpayer contends that peanuts are like condiment packets, and that because the Department deems that condiment packets are sold by a restaurant to its customers, then its peanuts are also being sold to its customers. I disagree.

The Department's unwritten policy that condiment packets of ketchup, mustard, mayonnaise, etc. are being sold to restaurant customers is presumably based on the fact

[3] As a matter of tax policy, it could be argued that a retail business should never pay sales tax on items it uses in its business, i.e., business inputs, because the cost of those items will ultimately be reflected in the price of the taxable retail sales by the business. See generally, J. Hellerstein & W. Hellerstein, *State Taxation* ¶12.06 (3d ed. 2001). For an excellent discussion of the various cases involving the taxation of nonfood items purchased by restaurants, see again, J. Hellerstein & W. Hellerstein, *State Taxation* ¶14.02(1)(b) (3d ed. 2001). But as recognized by Professor Hellerstein, a court is constrained by the law as enacted by the state legislature, and Alabama law defines "wholesale sale" as a sale to a licensed retailer for resale. Code of Ala. 1975, §40-23-1(a)(9). Because the Taxpayer did not resell the peanuts in issue, it purchased the peanuts at retail and should have paid sales tax at the time of purchase. Because it did not, use tax is now due.

that those items enhance the flavor of and are added to and eaten with the food being sold. The Taxpayer's peanuts can thus be distinguished because the peanuts have nothing to do with and are independent of the menu items being sold by the Taxpayer.

In any case, I respectfully disagree with the Department's position that condiment packets offered by fast food and other restaurants are being sold to the customers. The packets are there for the taking by customers, just as are napkins, straws, etc. As shown in *Celestial Foods*, *supra*, such items are not being sold because, unlike burger wrappers and the like that are included with and a necessary part of the food being sold, the napkins, straws, condiment packets, etc. are optional complimentary items provided by a fast food restaurant at no charge.[4]

In *John Q. Hammons Hotels v. State of Alabama*, S. 96-484 (Admin. Law Div. 7/30/1997), the issue was whether a hotel was selling a complimentary breakfast buffet and complimentary beverages that it provided for its hotel guests. The hotel argued that it was reselling the items to its customers. The Administrative Law Division rejected the hotel's argument, as follows:

> First, the Taxpayer did not resell the food and beverages at retail. The food and beverages were not separately invoiced, and the lump-sum room charge was the same whether the guest ate the complimentary breakfast or drank the free drinks. Rather, the Taxpayer used the free food and beverages to attract customers, and its cost of the food and beverages was an operating cost, the same as its cost of "free" soap, shampoo, and other complimentary items provided with each room.

Hammons at 2.

[4] Because of the Department's longstanding policy that condiment packets are being resold, the Department must follow that policy unless and until it properly promulgates a regulation to the contrary.

The Taxpayer asserts that *Hammons* can be distinguished from this case because *Hammons* did not address "the sales tax treatment of personal property that is transferred by a licensed retailer." Taxpayer's brief at 4, 5. That statement is incorrect because the hotel in *Hammons* was licensed to sell food and drinks at retail, just as the Taxpayer in this case is licensed to sell food at retail. But in neither *Hammons* nor in this case was the retailer selling the items in issue at retail. Rather, just as the hotel in *Hammons* was giving away the complimentary food and drinks, the Taxpayer in this case is giving away the complimentary peanuts.

The Taxpayer further claims that "the Department reads *John Q. Hammons Hotels* to hold that a licensed retailer will not be treated as selling items of tangible personal property, even though the items are actually transferred to the ultimate consumer in connection with a retail sale, if the retailer does not inform the customer that there is a specific charge for the items." Taxpayer's brief at 5.

The above statement is incorrect because the peanuts were not "actually transferred to the ultimate consumer in connection with a retail sale. . . ." To the contrary, the complimentary peanuts were independent of and not related to the Taxpayer's sale of its menu items. As discussed, individuals may eat the Taxpayer's peanuts without purchasing a menu item from the Taxpayer. Obviously, the peanuts are not transferred in connection with a retail sale in that instance.

Also, the fact that the Taxpayer may consider and allocate a part of the cost of the peanuts to its cost of each menu item is irrelevant. A prudent retailer considers all of its overhead costs, its cost of goods sold, profit, etc. in determining what price to charge for its

products. The cost of the peanuts is an overhead cost, just as are the Taxpayer's labor costs, utilities, napkins, plates, etc. The fact that the Taxpayer sells food at retail, and that the peanuts are food items, is also of no legal significance.

The final assessments are affirmed. Judgment is entered against the Taxpayer for State use tax and interest of $43,796.21 and local use tax and interest of $2,115.08. Additional interest is also due from the date the final assessments were entered, August 27, 2008.

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

Entered May 28, 2009.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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