FUNZONE ENTERPRISES, INC. 465 WESTGATE PARKWAY DOTHAN, AL 36303-2964,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 11-940
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Funzone Enterprises, Inc. ("Taxpayer") for State sales tax for August 2007 through September 2010, and State use tax for January 2007 through December 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 March 15, 2012. David Johnston represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

FACTS

The Taxpayer operated an amusement facility, Funzone Skate Center, in Dothan, Alabama during the periods in issue at which it offered roller skating, laser tag, arcade games, bumper cars, and other forms of entertainment to the public. The Taxpayer also rented space in the facility to churches for Sunday and Wednesday night services, body pump and Zumba exercise classes, schools for graduation exercises, doctors for advertising, etc.

The Taxpayer's owners also incorporated a second business, After School Zone, Inc., ("After School") in 2007.[1] After School provided after school and Summer childcare

[1] Robert McIlwain apparently was the sole owner of both the Taxpayer and After School. Lisa McIlwain was married to Robert McIlwain during the periods in issue. She testified at

services for children ages 5 to 12 years during the periods in issue. After School operated Monday through Friday from 3:00 p.m. to 6:00 p.m. and charged $49 per week during the school year. It operated from 6:30 a.m. to 6:00 p.m. and charged $90 per week in the Summer. The After School participants paid the weekly amounts directly to After School.

The Taxpayer and After School entered into a rental agreement in July 2007 whereby the Taxpayer agreed to provide After School the use of space in its facility, the assistance of some of its employees at the facility, and the use of its buses for transportation. The Taxpayer also agreed to provide the After School children with food and drinks at the facility for an additional charge. The Taxpayer separately recorded the monthly After School rent receipts and the concession receipts on its point of sale accounting system.

After School used the Taxpayer's buses to pick up the participating children from local schools during the school year. Once the children arrived at the Taxpayer's facility, they received a snack, and were then grouped by age and led in various activities by counselors. The counselors or tutors also tutored the children with their homework. The children were allowed to skate two days a week at the facility after they had completed their homework, but only as supervised by their counselors. They were also given tokens and allowed to play the games at the facility on Fridays, but again, only after they had completed their homework and as supervised by their counselors.

The After School participants also sometimes independently purchased a discounted special package from the Taxpayer that allowed the participants to use the

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the March 15 hearing that she helped her husband operate both businesses during those periods. For ease of reference, the McIlwains are referred to jointly as "owners."

facility at nights and on Saturdays. The participants paid that money directly to the Taxpayer.

In the Summer, the After School children had the exclusive use of the Taxpayer's facility from 6:30 a.m. until 10:00 a.m., when the facility opened to the public. After 10:00 a.m., the counselors took the children on outside field trips to swimming pools, the movies, bowling, etc. After returning to the facility, the After School children used the rooms in the back of the facility that were separate from the public access areas.

As indicated, the Taxpayer also leased rooms or space in the facility to various individuals or groups, including churches, schools, exercise classes, etc. Those individuals or groups used the facility for worship services, graduations, wall advertising, and other purposes unrelated to the Taxpayer's business of providing entertainment to the public.

The Taxpayer required a $50 deposit when a reservation was made for a birthday or other type party. The Taxpayer recorded the deposit as an account payable until the party took place and the customer paid the balance due. The Taxpayer then credited the entire amount as paid, and reported and paid sales tax on the total amount at that time.

The Taxpayer routinely purchased tokens, tickets, and toys/plush for use in its facility. The Taxpayer's customers obtained the tokens from the Taxpayer, and then used the tokens in lieu of coins to operate the machines/games at the facility. If a customer won while playing a game, the customer was issued a ticket or tickets that could be redeemed for a toy or plush offered by the Taxpayer. Customers also purchased the toy and plush items from the Taxpayer for cash.

The Department audited the Taxpayer for State sales and use tax for the periods in issue. It determined that the Taxpayer had improperly failed to pay sales tax on the

following: (1) the monthly amounts that After School had paid the Taxpayer pursuant to their rent agreement, which included the building rent and the food and drink concessions; (2) the amounts allegedly paid by the schools, churches, exercise classes, etc. for the rental of space in the Taxpayer's facility; (3) the discounted amounts paid by the After School participants for the special nighttime/weekend packages; and (4) the unused birthday and other party deposits paid by the Taxpayer's customers. The Department also assessed the Taxpayer for use tax on its cost of the tokens, tickets, and toys/plush purchased by the Taxpayer for use in the facility.[2]

Other relevant facts are stated as necessary in the below analysis.

ANALYSIS

The Department examiner taxed the monthly rent amounts paid by After School to the Taxpayer pursuant to the lease agreement "[b]ecause unlike Zumba and the church rental, when After School leases that building, it is used for its intended purpose as a place of amusement." (T. 56). The examiner explained further:

> A. I suppose it would be the same as if a private party came and rented the facility to have a private skating rink function. We would tax – we would have taxed that as well.
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> It really had nothing to do that the parties were related. We would have taxed it regardless, whether it came from the After School Zone or whether it came from a private party who just wanted to close the whole place down and use it for their – you know, for their own skating rink party, which I believe probably happens on occasion as well. We taxed it the same way we would have anything else, you know, in that nature.

(T. 58).

[2] The Department examiner also taxed other items that are not disputed by the Taxpayer.

I agree that if After School or any individual, group, or entity rented all or a part of the Taxpayer's facility for a private skating party, or to otherwise use the facility for its intended purpose, the amounts received by the Taxpayer would be subject to the amusement gross receipts tax. That conclusion is supported by the Administrative Law Division's holding in *2MC, Inc. v. State of Alabama*, Docket S. 07-587 (Admin. Law Div. 3/11/2008).

In *2MC, Inc.*, the taxpayer operated a Pump It Up franchise that offered party rooms to the public. The rooms included inflatable devices and other equipment commonly played on or used by children. The taxpayer rented the rooms for private birthday and other parties. The taxpayer argued that the proceeds were not subject to the amusement gross receipts tax because the rooms were being rented for private parties that were not open to the public. The Administrative Law Division disagreed.

> The Taxpayer's argument is compelling. However, §40-23-2(2) levies the tax on any place "at which any exhibition, display, amusement, or entertainment is offered to the public *or* place or places where an admission fee is charged." By using the conjunction "or," the Legislature clearly intended for the tax to apply not only to individual admission fees charged at a public place, but also to receipts derived from any place "offered to the public."
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> The Taxpayer was in the business of offering its arenas and party rooms to the public. The intent of §40-23-2(2) was to tax "the gross receipts of any such business." The fact that the Taxpayer's customers reserved the rooms in advance did not change the nature of the Taxpayer's business as a place open to the public for entertainment or amusement. (footnote omitted) As correctly argued by the Department – "The reservation for a private party does not create a private facility. The Pump It Up facility is open to the public to reserve the facility for a fee." Department's Answer at 4. The gross receipts derived from the Taxpayer's business that was open to the public were thus subject to the amusement gross receipts tax.

2MC, Inc. at 6.

This issue is difficult because the After School children had some access to the skating rink, games, etc. at the Taxpayer's facility that were also offered to the public. This case can be distinguished from *2MC, Inc.*, however, because most of the activities engaged in by the After School participants were unrelated to the entertainment activities offered by the Taxpayer to the public. That is, After School did not rent the Taxpayer's facility to provide the participating children with the private use of the machines and games at the facility. Rather, After School's primary purpose in renting space in the facility, and also the use of the Taxpayer's employees and buses, was to provide childcare and educational services to the participating children. After School bused the participating children to the Taxpayer's facility after school, and then provided counselors and/or tutors that monitored the children and helped them with their homework. During the Summer, the counselors took the children swimming, bowling, to the movies, and on other outside field trips. The above activities were all unrelated to the Taxpayer's operation of the facility as a public place of amusement.

The participating After School children also had only limited free access to the skating rink two days a week, and to the games, etc. only on Fridays. The children used the skating rink and the games only after finishing their homework, and only when accompanied by their counselors. They also had to purchase a special package from the Taxpayer to use the facility at night and on weekends. Lisa McIlwain explained at the March 15 hearing that "[w]hen the children participate in the activities at FunZone, it's almost like their counselor is taking them on a field trip." (T. 97).

In summary, the primary function and purpose of the After School program was to provide daycare and educational services for the participating children. The Taxpayer

allowed After School the limited use of its facility for that purpose separate and apart from the Taxpayer's operation of the facility as a public place of amusement. The participating children's limited use of the skating rink, games, etc. at the facility was only incidental to After School's use of the facility in providing its child care and educational services. Consequently, the monthly rent paid by After School to the Taxpayer was not subject to the gross receipts sales tax because it was not derived by the Taxpayer from operating a public place of amusement.

The above rationale is consistent with the Administrative Law Division's holding in prior cases. In *State of Alabama v. Huntsville Baseball Club, Inc. and Birmingham Baseball Club, Inc.*, Docket Nos. S. 92-208 and S. 92-170 (Admin. Law Div. O.P.O. 2/23/1994), the taxpayers owned and operated baseball stadiums. The gate admissions and other receipts were subject to the amusement gross receipts tax. One of the disputed issues was whether receipts derived from the selling of advertising space on outfield walls, billboards, etc., were also taxable. The Division held that such receipts were not taxable.

> The Department argues that because the Taxpayers operate public places of amusement, their gross receipts derived from all sources, including the advertising revenues in issue, are taxable. I disagree.
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> The gross receipts tax is levied on taxpayers that operate public places of amusement or entertainment and is based on "an amount equal to 4% of the gross receipts of <u>any such business</u>." See, §40-23-2(2). "Any such business" relates only to the public business or activity engaged in by a taxpayer. Consequently, the tax is levied only on the gross receipts paid for attending or engaging in the public activity or amusement offered by a taxpayer. Just as the true sales tax levied by §40-23-2(1) is levied on the gross proceeds paid by the consumer of tangible personal property, the gross receipts tax levied at §40-23-2(2) is levied only on the gross receipts paid by the "consumer" of the public amusement. Thus, admission fees paid to attend public athletic or entertainment events should be taxed, as should the amounts paid to engage in a specific activity in a public place, i.e., bowling alley fees, pool table fees, video game receipts, etc.

> However, the public amusement tax does not apply to gross receipts that are not paid by the public to attend or engage in the specific public activity offered by a taxpayer. The sale of advertising time and space by the Taxpayers in this case to third-party advertisers is not a public amusement, and thus the gross receipts derived from those activities are not taxable. The fact that the Taxpayers would probably not have received any of the advertising revenues in question "but for" the public baseball games is not relevant.

Huntsville Baseball Club at 3 – 4.

Likewise, the rent amounts paid by After School for the use of the Taxpayer's facility, some of the employees' at the facility, and the Taxpayer's buses, were not paid to use the facility as a public place of amusement. Rather, as indicated, After School used the facility primarily in furtherance of its primary function as a childcare/education service provider.

Concerning the Taxpayer's After School concessions account, those funds were separate from the After School rental account, and constituted taxable proceeds derived from the Taxpayer's sale of concession items to the After School participants. This is confirmed by Section 7.1 of the lease between the parties, which specifies that the Taxpayer may cater food to After School, which "will be separate and distinct from the rent. . . and will be separately invoiced to" After School. Consequently, while the After School rental account proceeds were not taxable, the After School concession proceeds were derived from the taxable retail sales of food and drinks, and were thus correctly assessed by the examiner.

As indicated, the parents paid After School directly for their children to participate in the After School program. For convenience, the Taxpayer's owners also recorded those receipts on the Taxpayer's point of sale accounting system. The proceeds were then

deposited into a separate After School bank account.

It is unclear if the Department examiner assessed the Taxpayer on the above amounts, in addition to the After School rental and concession accounts discussed above. The Taxpayer's representative believes that the those payments were taxed because he asserts in Issue (1) in the Taxpayer's Brief that "[t]he Department has erroneously assessed amusement sales taxes against the Taxpayer for revenues and operations of After School, a separate non-profit corporation. . . . The Taxpayer should not be held liable for any alleged amusement sales tax . . . when such revenues are received by a separate taxpayer." Taxpayer's Brief at 2, 3.

I agree that the Taxpayer is not liable for tax on the weekly amounts paid by the After School participants directly to After School. Although owned by the same individuals (or individual), the Taxpayer and After School were separate entities, and the proceeds received by After School, although run through the Taxpayer's point of sale accounting system, were subsequently deposited into After School's separate bank account. Separate corporate entities cannot be disregarded for tax purposes because they are owned and/or operated by the same individual or individuals. *State v. Capital City Asphalt, Inc.*, 437 So.2d 1288 (Ala. Civ. App. 1983), affirmed 437 So.2d 1291. The Taxpayer thus is not liable for tax on the receipts paid by the After School participants directly to After School.

The Department concedes that when the Taxpayer rented space in its facility to churches, exercise classes, etc., the proceeds from those rentals were not subject to the gross receipts sales tax. As explained by the examiner – "The Department does not believe that things like that (space rental) are subject to tax because the facility is not being used for its intended purpose as a place of amusement." (T. 29).

The examiner stated further, however, that she removed a receipt from the audit only if she had documentation establishing that the receipt was nontaxable. For example, she removed a $200 payment received from "the Zumba lady" because she saw proof that the amount had been paid for that purpose. (T. 30). She also allowed a credit for a receipt from an exempt entity, but only if she saw "a check from an Alabama school, public, private, whatever, I would give credit for those items. Any sort of other exempt organization, such as Boys/Girls Clubs, anytime. . . . I would see a check stub from them, of course, I would take that out." (T. 32). She did not remove any receipts, however, it the Taxpayer failed to provide evidence that the receipt was for nontaxable space rental, or was paid by an exempt entity.

The Department examiner is correct that the burden was on the Taxpayer to maintain records showing that some of its receipts were nontaxable facility rental proceeds, or were received from a tax-exempt individual or entity. See, *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App.), cert. denied, 384 So.2d 1094 (Ala. 1980); *State v. T.R. Miller Mill Co.*, 130 So.2d 185 (Ala. 1961) (If a taxpayer fails to keep records distinguishing taxable and non-taxable receipts or transactions, the taxpayer must suffer the consequences and pay tax on those receipts or transaction not properly recorded as exempt.).

Lisa McIlwain testified at the March 15 hearing that she has written leases with all of the entities and individuals that leased space at the facility during the periods in issue. She indicated that she would provide the documents to the examiner in due course. Unfortunately, she only provided two documents after the March 15 hearing, one lease that had previously been considered by the Department, and a second lease for a period after the sales tax period in issue.

Because the Taxpayer failed to present evidence showing that some of the gross receipts taxed by the examiner were derived from the nontaxable rental of the facility, or from a tax-exempt customer, the examiner's computations on this issue must be affirmed.[3]

The Taxpayer agrees that the party deposits are taxable, but only after the party takes place and the balance of the proceeds are paid by the customer. "Taxpayer therefore contends that the sale is not completed until the party actually takes place, and that birthday deposit accounts are not subject to the amusement sales tax until the birthday deposit is applied to the party statement when the party actually occurs." Taxpayer's Brief at 5. I disagree.

The amounts paid by the Taxpayer's customers to have a party at the Taxpayer's facility constituted gross receipts subject to the amusement gross receipts sales tax. And like the sales proceeds derived from the sale of tangible personal property, the receipts are taxable when received by the "seller." For example, if a retailer sold an appliance to a customer for $500, and the customer paid $100 down and agreed to pay $400 in installments, the $100 would be taxable when received by the retailer, as would the installments when later paid by the customer. See, Code of Ala. 1975, §40-23-8. Likewise, when the Taxpayer's customers paid the $50 deposit for a party, the amount was a current taxable receipt derived from operating a public place of amusement. The fact

[3] The examiner also testified that any proceeds paid by out-of-state schools would not be exempt because Alabama law only exempts Alabama schools. But out-of-state schools may also be entitled to an exemption on Commerce Clause grounds based on the Alabama Supreme Court's holding in *Ex parte Hoover, Inc.*, 956 So.2d 1149 (Ala. 2006). In any case, the Taxpayer failed to document that any out-of-state schools had paid to use the Taxpayer's facility. Consequently, any undocumented amounts allegedly paid by out-of-state schools were correctly included as taxable in the audit.

that the deposit was recorded as an account payable on the Taxpayer's internal accounting system is irrelevant. The Department examiner thus correctly assessed the party deposits in the month they were received by the Taxpayer.

Finally, the examiner assessed the Taxpayer for use tax on its cost of the tokens, tickets, and the toys/plush purchased by the Taxpayer for use and/or consumption at the facility. The Taxpayer argues that the tokens have to be replaced every four or five months, that the tickets cannot be used again, and that the toys/plush can either be redeemed with tickets or purchased with cash. "With the testimony of Ms. McIlwain, the tokens have to be replaced often and are therefore not reusable, the tickets are not reused, and the large percentage of prizes are sold for cash. Therefore, the final assessment for consumers use tax should be adjusted accordingly." Taxpayer's Brief at 5.

The Alabama use tax is levied on the use, storage, or consumption of tangible personal property in Alabama that was previously purchased at retail. Code of Ala. 1975, §40-23-61(a). Although the Taxpayer did not pay sales tax when it purchased the tokens and tickets from its suppliers, the purchases constituted retail transactions because the Taxpayer was not in the business of reselling the items.[4] The Taxpayer subsequently used the tokens and tickets in operating its business. The fact that the tokens were lost or taken by the Taxpayer's customers, and thus had to be periodically replaced, is irrelevant, as is the fact that the tickets were destroyed, i.e., consumed, after being used. The examiner thus correctly assessed the Taxpayer for use tax on its cost of the tokens and tickets.

[4] The Taxpayer should have paid sales tax to its vendors when it purchased the tokens and tickets. And because the Taxpayer failed to pay sales tax on the items, the use tax exemption at Code of Ala. 1975, §40-23-62(1), which exempts from the use tax any property on which sales tax was paid, does not apply.

Concerning the toys/plush, the Taxpayer also purchased those items tax-free. It then either gave the items as prizes to customers, or sold them to customers for cash. Lisa McIlwain indicated at the March 15 hearing that she had records showing the amount of toys/plush sold versus the amount given away. (T. 115).

The Taxpayer correctly purchased the toys/plush at wholesale because while it subsequently used some of the items as prizes, it also sold some of the items at retail to its customers. The Taxpayer owes sales tax, not use tax, on the toys/plush sold at retail to its customers. The taxable measure is the retail sales price charged by the Taxpayer for the items. The Taxpayer's cost of the toys/plush sold by the Taxpayer should thus be removed from the use tax audit, and the gross receipts from the sale of those items should be added to the sales tax audit. The sales tax and use tax final assessments should then be adjusted accordingly.[5]

Concerning the toys/plush given away as prizes, that issue was previously addressed by the Administrative Law Division in *Dixie Novelty Co., Inc. v. State of Alabama*, Docket S. 05-422 (Admin. Law Div. O.P.O. 9/29/2005). In that case, the taxpayer purchased plush tax-free and then used the plush as prizes in its coin-operated game machines. The Administrative Law Division held that the taxpayer was liable for Alabama use tax on the items.

> The Taxpayer argues that the plush is not subject to use tax because it is being sold through the crane machines, and that tax is being paid on the plush when sales tax is paid on the gross receipts from the machines. I disagree.

[5] Code of Ala. 1975, §40-2A-7(b)(5)d.1. provides that "[t]he Administrative Law Division . . . on appeal may increase or decrease the (final) assessment to reflect the correct tax due."

> Unlike a vending machine operator that sells goods through their machines, the Taxpayer is not selling the plush at retail through the crane machines. Rather, it is selling entertainment. (footnote omitted) A person that purchases tangible property through a vending machine is entitled to possession of and title to the property once the appropriate money is deposited and the selection is made. The same is not true concerning the plush in the crane machines. A player that deposits money into a crane machine is not entitled to a toy, only the right to use the crane to attempt to obtain the toy.
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> I agree with the Department that Reg. 810-6-1-.129 applies. That regulation holds that the person that purchases property for use as a prize is liable for tax on the property, either when the property is purchased, or, as in this case, when the property is subsequently used in Alabama. The Taxpayer is thus liable for Alabama use tax on the plush it purchased tax-free and then used as prizes in its crane machines in Alabama.
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> The Taxpayer also is not being impermissibly double taxed on the plush. The sales tax on the gross receipts from the Taxpayer's machines is a tax on the Taxpayer's customers, not the Taxpayer. *Blockbuster, Inc. v. White*, 819 So.2d 43 (Ala. 2001); *State v. T.R. Miller Mill Co.*, 130 So.2d 185 (Ala. 1961).
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> On the other hand, the use tax is on the Taxpayer, directly, as the user of the plush in Alabama. The use tax and the gross receipts sales tax are thus levied on different parties, which the Alabama Supreme Court has found to be acceptable.
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> In *Starlite Lanes, Inc. v. State*, 214 So.2d 324 (Ala. 1968), the Court held that the taxpayer, a bowling alley, was liable for sales tax when it purchased bowling shoes, and also for the gross receipts sales tax on the gross receipts derived from the rental of the shoes. (footnote omitted) "Thus, the burden of the sales tax falls upon the (bowling alley) when he buys the shoes and the 'gross receipts' tax upon the (bowling alley's) customers when they rent the shoes. 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." *Starlite Lanes*, 214 So.2d at 327. See also, *State v. Barnes*, 233 So.2d 83 (Ala. Civ. App. 1970).

Dixie Novelty at 8 – 10.

The above rationale applies in this case. The Taxpayer was not selling the toys/plush that it gave to its customers as prizes for winning on the games. The examiner thus correctly assessed the Taxpayer for use tax on its cost of those items.

The Department examiner conducted a thorough and professional audit, and she did a good job explaining the audit at the March 15 hearing. Other than holding that the toys/plush sold by the Taxpayer were subject to sales tax, not use tax, the only disagreement I have with the audit is the taxability of the monthly rent paid by After School. As discussed, that issue was close because the After School participants did have limited use of the Taxpayer's facility for its intended purpose. With different facts, the proceeds from the long-term rental of space in an entertainment facility could be subject to the amusement gross receipts tax. But given the facts in this case, the Taxpayer was not liable for tax on the rent paid by After School to use the Taxpayer's facility, the Taxpayer's employees at the facility, and the Taxpayer's buses for transporting the children to the facility.

The Department should recompute the sales and use tax due as directed above. If necessary, the Taxpayer should provide the Department with any records needed for the Department to correctly recompute the sales tax versus use tax due on the toys/plush, or to otherwise determine the correct tax due. An appropriate Final Order 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 September 14, 2012.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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