STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. S. 89-191
FRANCO NOVELTY COMPANY 42 North Perry Street Montgomery, AL 36104; and FRANCO DISTRIBUTING CO., INC. 1469 Jean Street Montgomery, AL 36107,	§	
FRANCO DISTRIBUTING CO., INC. 1469 Jean Street Montgomery, AL 36107,	§	DOCKET NO. S. 89-192
Taxpayers.	§	

FINAL ORDER

This case involves disputed joint petitions for refund of State, county and municipal sales tax filed by Franco Distributing Company, Inc. and Franco Novelty Company for the period May 1, 1986 through April 30, 1989. Direct petitions for refund were also filed by Franco Distributing Company, Inc. for the same period. The Department denied both the joint and the direct petitions and Franco Distributing Company Inc. (Franco Distributing) appealed to the Administrative Law Division. The appeals were consolidated and a hearing was conducted on October 18, 1989. Gerald W. Hartley, Esq. represented the Assistant counsels J. Wade Hope and Gwendolyn Garner for the Department. Upon review of the record proceedings before the Administrative Law Division, including the Recommended Order, the following is entered as the Final Order of the Department of Revenue.

FINDINGS OF FACT

Franco Distributing made retail sales of video games, pinball machines, juke boxes, vending machines, candy and drink machines and related components during the period May 1, 1986 through April 30, 1989. Franco Distributing collected sales tax on the sales at the general State rate of 4 percent and the applicable municipal and county rates of from 1 to 3 percent. Franco Distributing reported and paid all tax collected to the Revenue Department.

Franco Distributing subsequently filed Petitions for refund of sale tax based an their contention that the various machines process tangible personal property, i.e., electricity, and thus should have been taxed at the reduced 1 and 1/2 percent "machine" rate levied at Code of Ala. 1975, §40-23-2(3). Consequently, Franco Distributing and Franco Novelty filed joint petitions for refund an June 20, 1989 concerning the period May 1, 1986 through April 30, 1989 based on the difference between the general rate and the reduced machine rate. Direct petitions were also filed for the same period concerning tax collected by customers other than Franco Distributing from its numerous customers other than Franco Novelty.

The Department denied the petitions on two grounds. First, the Department argues that the machines should not be taxed the reduced machine rate because they do not process tangible personal property within the scope of §40-23-2(3). Second, the Department maintains that the direct petitions filed by the Taxpayer were improper in that joint petitions should have been filed by Franco Distributing,

as the seller who collected the tax, and the individual purchasers who actually paid the tax, see Reg. 810-6-4-.16.

Franco Distributing provided testimony at the administrative hearing which explained in detail the electronic workings of the various components of a video game machine. In summary, electricity in the form of alternating current (AC power) is received from an outside power source, usually from a wall outlet. Upon entering the machine, the electricity passes is converted to direct current (DC power). The electricity then flows through a transformer which reduces the voltage. The electricity then travels to a switching regulator which channels the electricity to the logic board. The logic board channels the electricity to various components which causes the images and colors to appear and move on the video screen. Sound is created by the flow of electrical current and impulses through an amplifier in the logic board. The machines also contain a power capacitor, traps, a video sequencer, character generators, converters and resistors. Juke boxes, pinball machines and the other machines in issue function electronically in substantially the same manner as video games.

Franco Distributing acknowledges that joint petitions should have been filed concerning each of its individual customers. However, Franco Distributing filed joint petitions with only its largest customer, Franco Novelty, in order to avoid the time and expense of filing joint petitions with each customer prior to a decision on whether the machines should be taxed at the reduced

machine rate.

Franco Distributing agrees that if the reduced machine rate is applicable, it will be necessary to file Joint Petitions to insure that the customer that paid the tax also receives the refund. However, Franco Distributing argues that any subsequently filed joint petitions should relate back to the date the direct petitions were filed.

CONCLUSIONS OF LAW

The Department acknowledges that the courts have held that electricity constitutes tangible personal property within the scope of §40-23-2(3). Curry v. Alabama Power Company, 8 So.2d 521; State v. Television Corporation, 127 So.2d 603.

In the above cases, the courts ruled that various components that amplified, modified directed or otherwise changed or altered electricity constituted machines used in the processing of tangible personal property and thus should be taxed at the reduced machine rate. Those components included condensers, generators and transformers (Curry v. Alabama Power Co.); amplifiers and transformers (State v. Television Corp.).

In response to the various court decisions, the Department has issued Reg. 810-6-2-.101, which specifically provides that transformers, power capacitors and voltage regulators are machines used in the processing of tangible personal property and thus should be taxed at the lower machine rate. Further, Reg. 810-6-2-

.98 provides as follows:

> (1) Amplifiers used by television, cable T.V. and radio stations in broadcasting are machines used in compounding, processing and manufacturing tangible personal property. State of Alabama v. Television Corp., 271 Ala. 692, 127 So.2d 603; Mountainbrook Cable Vision, Inc. v. State of Alabama and Cablevision Company, Inc. v. State of Alabama. The Supreme Court in Curry v. Alabama Power Co., 243 Ala. 53, 8 So.2d 521, held that electricity is tangible personal property within the meaning of that term used in the sales and use tax law.
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> (2) In view of the holdings under these three cases, it can be stated as a general rule that any machine or equipment, such as, but not limited to, traps, receivers, video sequencers, filters, data scanners, taps, character generators, equalizers, modulators and modules, power supplies and standby power supplies attenuators and converters (wherever located), which amplifies or modifies or otherwise controls electrical currents and signals imposed on electrical current and the attendant electromagnetic waves is a machine used in processing tangible personal property and is subject to the machine rate of tax.

Section 40-23-2(3) provides for the levying a sales tax as follows:

> (3) Upon every person, firm or corporation engaged or continuing within this state in the business of selling at retail machines used in mining, quarrying, compounding, processing and manufacturing of tangible personal property an amount equal to one and one-half percent of the gross proceeds of the sale of such machines; provided, that the term "machines" as used herein, 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 therefore, 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.

Although no definition of the word "processing" is found in the statutes, the Alabama Supreme Court in State v. Advertiser Company,

257 Ala. 423, 59 So.2d 576, at page 579, did provide a definition of the word "Processing" as found in Webster's New International Dictionary as follows:

> 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 a chemical process;..... d. to produce or copy by photo - mechanical methods; to develope, fix, wash and dry, or otherwise treat (an exposed film or plate).

Under the authority delegated to it by the Legislature under §40-23-31, the Department promulgated Sales and Use Tax Rule 810-6-4-.17.05 Processing, Definition which provides as follows:

> The word "Processing" as used in the Sales and Use Tax Law is understood to have the following meaning:
>
> "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.

Upon comparison, the definition of "processing" found in the

Sales and Use Tax Rules Is very similar to the definition provided by the Alabama Supreme Court in State v. Advertiser Company, supra.

In the present case, it cannot be said that the machines actually process electricity. Rather, the machines use or consume the electricity as an energy source. The electricity, as an energy source, provides power for the machines and then dissipates. See Transcript Page 99-100.

The expert witness provided by Franco Distributing testified that electricity is simply the movement of electrons from one location to another. (Transcript Page 139-140). The expert testified that the electricity moves from place to place in the machines through switches which are either open or closed. (Transcript Page 143). When a machine is plugged into Franco Distributing movement of electrons an electric outlet, the electric current flows or is routed through the various on and off switches. Nothing happens until some external force is exerted such as a coin hitting a slot or a button Is pushed by a player of a game. (Transcript Page 142-143). The electric current obtained exerted such as a by a player of a from the wall outlet does not contain any information that is extracted from it by the machines. The video arcade game machines, and etc., certainly do not process electricity in the manner contemplated by the Sales and Use Tax Rule defining "Processing" or under the definition of "Processing" provided by the Alabama Supreme Court in State v. Advertiser Company, supra.

Although Franco Distributing cited two circuit court cases and one Supreme Court case as authority and support for their contention that video arcade games process electricity, those cases are clearly distinguishable from the facts in the present case. In State v . Television Corp , 127 So.2d 603 (1961) and Mountainbrook Cablevision, Inc. v. State of Alabama, Montgomery Co. Cir. Ct., CV-82-1469TH, the machines were not simply processing electricity, but were processing the attendant electromagnetic waves and signals that had been generated at a television station. The expert witness testified that it is electromagnetic waves generated at the television station's antenna that is actually being processed. (Transcript Page 115 and Page 140). Those electromagnetic waves contain information, in the form of either a video or audio signal, which are transformed into what we see as a picture and hear when we turn on our television set. The electric energy that is used to power the television set does not contain the electromagnetic waves or information. Neither does the electric current that is obtained from the wall outlet by video arcade games, etc.

Likewise, in Gulf Telephone v . James M. Sizemore , Jr., CV 87-1730-G, which was the result of a negotiated settlement entered into by the parties, the central office equipment was not simply processing electricity. Rather, the central office equipment was processing telephone calls which had been converted to electrical impulses which were passed through various pieces of switching

equipment. The telephone calls were simply audio signals, similar to the electromagnetic waves generated by television antennas which we hear as a voice over our telephone receivers.

Although there are no cases which have construed whether the use of electrical energy is the processing of electricity, and, therefore, the processing of tangible personal property thereby triggering the favorable one and one-half percent machine rate, the Alabama Supreme Court in State v. Newbury Manufacturing Company, Inc., 265 Ala. 600, 93 So.2d 400 at Page 402 wrote as follows:

> 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. (Citations omitted).

The above quote from State v. Newbury, supra, was again cited by the Alabama Supreme Court in State v. Calumet and Hecla, Inc., 281 Ala. 549 at Page 553. In the present case, the electricity is used as a source of energy to power the machinery in the same manner which is referred to by the Alabama Supreme Court as the fuel in State v. Newbury Manufacturing Company, supra. Electricity although necessary to the operation of video arcade machines, etc., does not itself perform a distinct function in the operation of the

machines. The electricity, in the form of electrons, merely moves from place to place throughout the machines by passing through various switches which open and close. As the electricity moves from place to place within the machines, it is used or consumed and dissipates.

The electricity is not encoded with audio or video signals, such as was the case in State v. Television Corp., supra. In a video arcade machine the logic board, which has been programmed with various options, determines which switches shall be opened or closed by the electric current which is sent to the logic board in response to an outside stimulus, such as the movement of a joystick. In the machines, the electricity is not processed or changed except as to the direction in which the electricity flows, such as when it is changed from AC to DC, and when the volume of the flow of the electric current is reduced. The basic nature of the electricity is not changed by the operation of the machines. (Transcript Page 150).

An examination of the statute, §40-23-2, and the legislative preamble to the 1959 Act establishing the Sales and Use Tax Law in Alabama with the reduced machine rate, reveals no evidence to indicate that the Legislature intended that the reduced machine rate apply to amusement games or common household appliances. It is well known that the cardinal rule of statutory construction is that one must ascertain and give effect to the true legislative

intent of the statute as manifested by the Legislature in the language of the statute itself. Clark v. Houston Co. Commission, 507 So.2d 902 (Ala. 1987); Eagerton v. Exchange Oil and Gas Corporation, 404 So.2d 1 (Ala. 1981); Boswell V. South Central Bell Telephone Company, 293 Ala. 189, 301 So.2-d 65 (Ala. 1974).

The Legislature intended to promote industry in Alabama by reducing the sales tax charged to taxpayers purchasing machines used in mining, quarrying, compounding, processing and manufacturing tangible personal property. It is fairly clear that the one and one-half percent rate is designed to promote industry in the State of Alabama by providing a tax break for the manufacturing and processing of products in Alabama and in preparing products for the market place.

If it is held that a video arcade game processes electricity, the door will swing wide open for any electrical appliance to receive the special one and one-half percent rate, such as television sets, radios, calculators, typewriters, refrigerators, and even toasters. This is certainly not what the Legislature intended when it enacted the special one and one-half percent rate into the Sales and Use Tax Law. This position is even further supported when one takes into account the vast number of transactions in this State involving the use of products powered by electricity and the devastating effect upon the revenues of this state that would result if a decision is rendered holding that video arcade games process electricity and, therefore, are entitled

to the special one and one-half percent rate.

Franco Distributing concedes that a joint petition between the seller and the Purchaser is necessary as required by Department Reg. 810-6-4-.16. However, the Taxpayer argues that the filing of a direct petition by the seller should stop the three year statute set out in §40-1-34, and that any subsequent joint petition or petitions filed with the Department should relate back to the period covered by the direct petition.

Section 40-1-34 provides that a taxpayer may file a petition for the refund of any tax paid directly to the Department. The petition must be filed within three years from the date the disputed tax was paid.

Section 40-1-34 does not require the filing of a joint petition. However, Reg. 810-6-4-.16 provides that any petition for refund of sales tax must be a joint petition by both the seller and the Purchaser, unless the seller can establish that the tax was never actually collected from the purchaser. Reg. 810-6-4-.16 is a reasonable exercise of the Department's regulatory authority and was promulgated to prevent any unjust enrichment to a seller who has only acted as a conduit in collecting the tax from the purchaser and remitting it to the Department. Consequently, refunds should not be paid in the present case until joint petitions are properly filed by the Taxpayer and each of its customers.

However, concerning the three year statute, §40-1-34 requires only that a petition must be filed by a taxpayer within three years from payment of the tax. The retail seller is liable for sales tax and thus is the "taxpayer" under the sales tax law only when he fails to collect the tax from his customer who actually pays the tax. In the present case, Franco Distributing collected the tax from Its customers. Since Franco Distributing does not have a financial interest in the funds collected from its customers it does not have standing to request a refund without having the customer join in the request for refund. Consequently, the filing of the direct petitions by Franco Distributing is not sufficient to stay the running of the three year refund period under §40-1-34.

The above considered, the machines in issue are not entitled to be taxed at the reduced machine rate set out at §40-23-2(3). The joint petitions filed by Franco Distributing, and Franco Novelty were properly denied.

Entered this 28th day of February, 1990.

JAMES M. SIZEMORE, JR.,
Commissioner