STATE OF ARIZONA

Department of Revenue
Office of the Director
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CERTIFIED MAIL [redacted]

The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[redacted]	)	**Case No. 200900056-S**
ID No. [redacted]	)	

On January 14, 2010, the Administrative Law Judge ("ALJ") issued a decision ("Decision") regarding the protest of [redacted] ("Taxpayer"). The Taxpayer appealed this Decision on January 29, 2010. As the appeal was timely, the Director ("Director") of the Department of Revenue ("Department") issued a notice of intent to review the Decision.

In accordance with the notice given the parties, the Director has reviewed the ALJ's Decision and now issues this order.

STATEMENT OF CASE

The Transaction Privilege and Use Tax Section in the Audit Division ("Division") of the Department audited Taxpayer for the period of January 1, 2002 through December 31, 2005 and determined that Taxpayer was taxable under the restaurant classification for the audit period. The Division disallowed deductions from transaction privilege tax that Taxpayer had claimed for a percentage of its gross proceeds that it attributed to sales of food for home consumption and for sales for resale. The Division assessed additional transaction privilege and use tax, penalty and interest ("Assessment") and later amended that Assessment to remove the additional use tax and penalty ("Amended Assessment"). Taxpayer protested the Amended Assessment, and the matter went to hearing. The ALJ upheld the Division's Amended Assessment and denied Taxpayer's protest.

On appeal, Taxpayer argues that it is entitled to the claimed deductions. The Division argues that the Amended Assessment was proper under the circumstances.

FINDINGS OF FACT

The Director adopts from the findings of fact in the Decision of the ALJ and makes additional findings of fact based on the record as set forth below:

1. Taxpayer operates a business at which it prepares and sells baked goods such as decorated cakes, doughnuts, pastries and cookies. Taxpayer also prepares and sells made-to-order sandwiches and side salads such as potato and pasta salads, and sells packaged chips and non-alcoholic drinks.

2. Taxpayer's business location has chairs and tables where customers can sit down and eat.

3. Taxpayer advertises itself as a bakery, café and deli.

4. Taxpayer's business activity also involves some catering.

5. Taxpayer distributed its "[redacted] Sales Tax Policy and Procedures" to its employees and instructed them to treat items sold for consumption on its premises as taxable and to treat to-go orders as non-taxable. The policy further instructs employees that deli food, drinks, chips and salads are taxable and that bread, cakes, baked goods for home consumption and meat and cheese sold by the pound are not taxable.

6. Taxpayer uses one computerized cash register that has a 72-button key pad with a separate key for each type of item sold. The cash register is programmed to calculate and add tax on those items that Taxpayer considers taxable. The cash register also has a "taxable key" to be used when items that Taxpayer generally considers intended for home consumption are sold open and consumed on the premises.

7. The Division audited Taxpayer for the period of January 1, 2002 through December 31, 2005 ("Audit Period.")

8. During the Audit Period, Taxpayer filed and paid Arizona transaction privilege tax under the retail classification on [redacted] % of its gross income and treated the remaining [redacted] % of its income as exempt from tax. Those percentages had been calculated and used by Taxpayer's prior accountant. Taxpayer has no records to explain that calculation.

9. Taxpayer treated its catering sales as exempt sales for resale.

10. Taxpayer gave the Division's auditor a cash register tape that includes sales transactions for an unspecified period of time ending February 1, 2006, one month after the end of the Audit Period. Based on that tape, the auditor created a take-off spreadsheet showing total amounts of gross proceeds for the different types of items identified on the tape. In addition to the items listed in the auditor's spreadsheet in a total amount of $[redacted], the register tape included items identified only as "miscellaneous" that accounted for an amount of $[redacted].

11. The Division determined that Taxpayer's receipts from its business were taxable under the restaurant classification of A.R.S. § 42-5074 and disallowed the deductions Taxpayer had taken for [redacted] % of its proceeds.

12. The Division did allow a deduction for sales for resale based on an exemption certificate issued by a hotel, but disallowed deductions for catering proceeds where Taxpayer had no resale certificate.

13. The Division also determined that Taxpayer owed use tax on its food donations.

14. In January 2007, the Division issued the Assessment of additional tax in the amount of $[redacted] tax plus penalty and interest.

15. Taxpayer timely protested the Assessment.

16. Based on additional information provided by Taxpayer, the Division amended the Assessment to remove the use tax and the penalty. The Amended Assessment, dated August 13, 2007, is for $[redacted] tax plus interest.

17. Taxpayer continued to protest and the matter went to hearing.

18. At the formal hearing, Taxpayer testified that it did not apply to be eligible during the Audit Period to participate in the federal food stamp program.

CONCLUSIONS OF LAW

The Director adopts from the conclusions of law in the Decision of the ALJ and makes additional conclusions of law as follows:

1. A.R.S. § 42-5061 ("retail classification") imposes transaction privilege tax on the business of selling tangible personal property at retail. The tax base is the gross proceeds of sales or gross income derived from the business.

2. A.R.S. § 42-5102 provides an exemption for sales of food by certain retailers, but not for food for consumption on the premises.

3. "Food for consumption on the premises" includes hot or cold sandwiches, beverages sold in cups, glasses, or open containers, food sold by caterers, and other food items listed in A.R.S. § 42-5101(4). The listed items are "food for consumption on the premises" even when they are sold on a take-out or to go basis. A.R.S. § 42-5101(4)(h).

4. A.R.S. § 42-5102 defines six types of retailers in its Subsections (A)(1) through (A)(6) that are eligible for the exemption. Those six types of retailers include retailers who conduct a delicatessen business, A.R.S. § 42-5102(A)(4).

5. A delicatessen business pursuant to A.R.S. § 42-5102(A)(4) must be conducted "either from a counter which is separate from the place and cash register where taxable sales are made or from a counter which has two cash registers which are used to record taxable and tax exempt sales" or the business must use "a cash

register which has at least two tax computing keys which are used to record taxable and tax exempt sales."

6. Arizona Administrative Code ("A.A.C.") Rule 15-5-1860(5) defines a "delicatessen" as "a business which sells specialty food items, such as prepared cold meats, perishable food and grocery items kept under refrigeration."

7. Taxpayer has not shown that it accounted separately for sales of any taxable and not taxable delicatessen items during the Audit Period.

8. Taxpayer does not conduct a delicatessen business within the meaning of A.R.S. § 42-5102(A)(4).

9. A retailer who conducts an "eligible grocery business" is a qualifying retailer under A.R.S. § 42-5102(A)(1) and is eligible for the exemption for sales of food for consumption off the premises.

10. A.R.S. § 42-5101(1) defines an "eligible grocery business" to mean an establishment whose sales of food are such that it is eligible to participate in the federal food stamp program.

11. Taxpayer did not apply to be eligible during the Audit Period to participate in the federal food stamp program and does not conduct an "eligible grocery business" within the meaning of A.R.S. § 42-5102(A)(1).

12. Taxpayer's primary business is the sale of food, and it is not a qualified retailer under A.R.S. § 42-5102(A)(2) whose primary business is not the sale of food but who sells food in a similar manner as an eligible grocery business.

13. Taxpayer provides facilities for its customers to consume food on Taxpayer's premises, and it is not a qualified retailer under A.R.S. § 42-5102(A)(3).

14. A.R.S. § 42-5074 ("restaurant classification") imposes transaction privilege tax on the business of operating restaurants and other establishments where articles of food or drink are sold for consumption on or off the premises.

15. Taxpayer sells articles of food and drink for consumption on and off the premises and qualifies as a restaurant under A.R.S. § 42-5074.

16. Arizona Administrative Code ("A.A.C.") Rule 15-5-1862(A) provides that restaurants "are generally not qualified retailers, and therefore cannot sell food tax free, but are taxable upon all of their gross income or gross proceeds of sale."

17. A.R.S. § 42-1105(D) requires every person who is subject to taxes including the transaction privilege tax to keep and preserve "suitable records and other books and accounts necessary to determine the tax for which the person is liable . . . ."

18. All gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification is presumed to comprise the tax base for the business until the contrary is established. A.R.S. § 42-5023.

19. Whether activities constitute a separate line of business that may be taxable under a separate tax classification depends on whether it can be readily ascertained without substantial difficulty which portion of the business is for the activity that differs from the main line of business, whether the amounts in relation to the company's total taxable Arizona business are not inconsequential, and whether those activities are not incidental to the main business. *See State Tax Commission of Arizona v. Holmes & Narver, Inc.,* 113 Ariz. 165, 548 P.2d 1162 (1976).

20. Taxpayer does not have a separate line of retail business besides its restaurant business.

21. Taxpayer is not a qualified retailer eligible for the exemption provided in A.R.S. § 42-5102 for sales of food for consumption off the premises.

22. Taxpayer is taxable under the restaurant classification of A.R.S. § 42-5074 on all of its gross proceeds in the Audit Period, except for the catering sales for resale for which Taxpayer submitted a resale certificate and which the Division allowed in the Amended Assessment.

23. Taxpayer is not entitled to any additional deductions.

24. The ALJ properly denied Taxpayer's protest.

DISCUSSION

Taxpayer is requesting the review of the ALJ's Decision, which upheld the Amended Assessment. Taxpayer argues that its business is a bakery and deli that is a retailer under A.R.S. § 42-5061 and that it is not a restaurant. Taxpayer points out that it has only bakery equipment such as ovens and not restaurant equipment such as stoves. Taxpayer further argues that it is a delicatessen and a qualified retailer pursuant to A.R.S. §§ 42-5101 and 5102 and that the [redacted] % figure it used during the Audit Period for determining its taxable sales is essentially right. In its post-hearing opening memorandum, Taxpayer conceded that its CPA's post-audit evaluation would support adjusting that figure to approximately [redacted] % and would justify an assessment of additional tax of approximately $[redacted], with [redacted] % of its sales for the Audit Period being exempt sales for home consumption. However, in its post-hearing reply memorandum, Taxpayer argues that its taxable deli and catering sales constitute approximately [redacted] % of its income for the Audit Period with only the remaining [redacted] % being exempt sales of bakery goods for home consumption or resale.

The Division argues that Taxpayer is a restaurant, not a retailer, and that Taxpayer did not operate an eligible grocery business within the meaning of A.R.S. § 42-5102(A)(1) or a retail delicatessen business within the meaning of A.R.S. § 42-5102(A)(4). The Division argues that Taxpayer sold ready to eat food and drink items for consumption on or off the premises, that Taxpayer's entire delicatessen operation consists of selling taxable restaurant food, and that taxpayer cannot use its deli restaurant to transform its bakery operations into a qualified retailer for purposes of the food exemption in A.R.S. § 42-5102. The Division also argues that Taxpayer did not use its cash register to record taxable and tax exempt sales and did not maintain any documents to identify an amount of tax exempt sales during the Audit Period. The Division requests that its Amended Assessment be upheld.

The retail classification is comprised of the business of selling tangible personal property at retail. A.R.S. § 42-5061(A). The restaurant classification of A.R.S. § 42-5074, on the other hand, imposes transaction privilege tax on "the business of operating restaurants, dining cars, dining rooms, lunchrooms, lunch stands, soda fountains, catering services or similar establishments where articles of food or drink are sold for consumption on or off the premises." Taxpayer provides tables and chairs for its customers and does sell food and drinks for consumption both on and off its premises. Thus, Taxpayer meets the only qualification of a restaurant provided under A.R.S. § 42-5074, and neither the statute nor corresponding rules provide any further definition of the term "restaurant".

Pursuant to A.A.C. R15-5-1862(A), restaurants are generally not qualified retailers and cannot sell food tax free. The rule further provides that if a qualified retailer also operates a restaurant, the gross income or gross receipts of a sale from the two activities must be kept separate. A.A.C. R15-5-1862(B). The gross income from the operation of the restaurant is always taxable, and only tax-exempt foods sold by a qualified retailer not in connection with its restaurant operation are exempt.

Taxpayer argues that it conducts a delicatessen business and that it can therefore make tax exempt sales of food for home consumption. Under A.R.S. § 42-5102(A)(4), the categories of retailers who are eligible for that exemption include a delicatessen business described as:

> A retailer who conducts a delicatessen business either from a counter which is separate from the place and cash register where taxable sales are made or from a counter which has two cash registers which are used to record taxable and tax exempt sales or a retailer who conducts a delicatessen business and who uses a cash register which has at least two tax computing keys which are used to record taxable and tax exempt sales.

Pursuant to A.A.C. R15-5-1860(5), a "delicatessen" means "a business which sells specialty food items, such as prepared cold meats, perishable food and grocery items kept under refrigeration." That definition describes a specialized type of retail store and not a business where sandwiches are prepared for immediate consumption. Taxpayer describes

its business as a bakery and "deli", with the bakery component of its business selling baked products and the "deli" component of the business selling made to order sandwiches and beverages. However, merely using the term "deli" in conjunction with food related business does not make that business qualify as a delicatessen retailer as defined in the rule. Also, using delicatessen grocery items, such as meats and cheeses, as components of the made to order sandwiches on its lunch menu does not make Taxpayer a delicatessen business within the meaning of A.A.C. R15-5-1860(5) and A.R.S. § 42-5102(A)(4).

Besides meeting the definition of a "delicatessen", a business must also meet the requirements in A.R.S. § 42-5102(A)(4) relating to a separate recording of taxable and tax exempt sales if the business is to qualify for the exemption. Taxpayer argues it used a cash register programmed to record sales of certain items as taxable or not taxable. To support that argument, Taxpayer produced written instructions for its employees in the form of a "policy" and a copy of its cash register keyboard pad, but Taxpayer does not have any records resulting from such cash register use during the Audit Period that could substantiate its argument. Taxpayer's cash register tape from an unspecified period ending one month after the end of the Audit Period and the auditor's takeoff spreadsheet based on that register tape show only total amounts of gross proceeds for specific food and drink items, but do not distinguish taxable and not taxable sales. Moreover, items recorded only as "miscellaneous" represent the majority of the gross proceeds on the tape.

Taxpayer argues that the exemption provided in A.R.S. § 42-5102(A)(4), relating to delicatessen businesses, should require only that the business have the cash register in place and use it to differentiate between taxable and nontaxable sales, but not that it must actually use the cash register records to calculate its monthly tax liability. That argument would render the requirements in A.R.S. § 42-5102(A)(4) meaningless. Exemptions from tax are to be narrowly construed. *Kitchell Contractors* v. *City of Phoenix***,** 151 Ariz. 139, 144, 726 P.2d 236 (App. 1986). A requirement to record taxable and tax exempt sales separately, logically, means that such records form the basis of determining any amounts of exempt sales and must be kept and preserved pursuant to A.R.S. § 42-1105(D) to determine the tax liability.

Referring to the restaurant classification, A.A.C. R15-5-1862(C) provides:

> To the extent that a delicatessen may sell taxable food, such as hot or cold sandwiches, such delicatessen will be required to report under this classification. Since a delicatessen business may constitute a qualified retailer, such business may still be eligible to sell tax exempt food, if such sales are separately accounted for.

Taxpayer has not shown that it accounted separately for its taxable sandwiches and for any other delicatessen items during the Audit Period. Taxpayer does not conduct a delicatessen business within the meaning of A.R.S. § 42-5102(A)(4) and has not substantiated any exempt delicatessen sales.

Other types of retailers that qualify for the exemption in A.R.S. § 42-5102, besides street or sidewalk vendors and vending machines, include retailers who conduct an "eligible grocery business," retailers whose primary business is not the sale of food but who sell food which is displayed, packaged and sold in a similar manner as an eligible grocery business, and retailers who do not provide or make available any facilities for the consumption of food on the premises. Taxpayer testified that it did not apply to be eligible during the Audit Period to participate in the federal food stamp program, as required under A.R.S. § 42-5101(1) for an "eligible grocery business" within the meaning of A.R.S. § 42-5102(A)(1). Second, Taxpayer does not qualify under A.R.S. § 42-5102(A)(2) as a retailer whose primary business is something other than the sales of food, because Taxpayer's primary business is the sale of bakery products, sandwiches and drinks which is the sale of food within the meaning of A.R.S. § 42-5101(4). Finally, Taxpayer provides tables and chairs for its customers and is not a retailer who sells food without providing facilities for the consumption of food on the premises as described in A.R.S. § 42-5102(A)(3). Therefore, Taxpayer does not meet the definitions of any of the types of retailers that qualify for the exemption in A.R.S. § 42-5102.

With tables and chairs for customers to sit down and consume sandwiches, salads and other items on Taxpayer's lunch menu, Taxpayer's business has more similarity with restaurants than with retail stores. Taxpayer sells food and drinks for consumption on and

off its premises within the meaning of the restaurant classification of A.R.S. § 42-5074. To be taxed separately under the retail classification for certain bakery transactions, Taxpayer would have to be in separate lines of business under *State Tax Commission of Arizona v. Holmes & Narver, Inc.,* 113 Ariz. 165, 548 P.2d 1162 (1976). The *Holmes & Narver* test requires that it can be readily ascertained without substantial difficulty which portion of the business is for the activity that differs from the main line of business, that the amounts in relation to the company's total taxable Arizona business are not inconsequential, and that those activities are not incidental to the main business.

Taxpayer has not shown that retail sales were recorded separately during the Audit Period so that this portion of Taxpayer's business could be separately identified. Petitioner's business therefore does not meet the *Holmes & Narver* test for the Audit Period.

Moreover, even if Taxpayer were able to show separately recorded sales of bakery products for the Audit Period, as a business that sells baked goods and provides tables and chairs for their consumption on the premises, Taxpayer would still qualify as a restaurant under A.R.S. § 42-5074, and would not be a qualified retailer eligible for the exemption provided in A.R.S. § 42-5102 for sales of food for consumption off the premises.

As a result, Taxpayer is taxable under the restaurant classification of A.R.S. § 42-5074 on all of its gross proceeds in the Audit Period except for the catering sales for resale for which Taxpayer submitted a resale certificate and which the Division allowed in the Amended Assessment. Taxpayer has not shown that it is entitled to any additional deductions.

ORDER

The ALJ's Decision is affirmed. .

This decision is the final order of the Department of Revenue. Taxpayers may contest the final order of the Department in one of two manners. Taxpayers may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140, Phoenix, AZ 85007 or may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty

(60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 17th day of May 2010.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed to:

[redacted]

cc: Transaction Privilege and Use Tax Section
Office of Administrative Hearings
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