Rhode Island Department of Revenue
Division of Taxation

Declaratory Order 2017-05

Request for Ruling Regarding the Taxability of Supply Item Purchases

Request for Ruling

Taxpayer requested a declaratory ruling ("Ruling Request") to determine whether its supply item purchases are subject to the Rhode Island Sales and Use Tax.

Facts

The facts set forth below are taken from the statement of facts presented in the Ruling Request dated August 16, 2017.

Taxpayer contracts with numerous Rhode Island public schools within the Rhode Island Statewide School Food Service Program to enable those schools to provide meals to their students. The contracts are entered into between Taxpayer, which is referred to as the Food Service Management Company ("FSMC"), and the public school, which is referred to as the Local Education Agency ("LEA"). All of the provisions within the contracts between Taxpayer and LEAs are identical. The relevant provisions of that standard contract are as follows:

Section 5.1 LEA OVERSIGHT AND ACCESS –

> The LEA will supervise and monitor **the FSMC's daily operation of the Food Service Program** with respect to all matters (including working conditions for the food service employees and safety, sanitation, and maintenance of the food service facilities). [Emphasis added.]

Section 5.5 CONTROL OF FOOD SERVICE PROGRAM –

> [T]he LEA shall retain control of the quality, extent and general nature of its Food Service Program.

Section 6.18 PURCHASING –

> **The FSMC, as an authorized agent of the LEA, shall purchase and pay for, as a Direct Operating Cost, all food, supplies, and services utilized in the LEA's nonprofit food service program.** Such purchases shall be made exclusively for the benefit of the LEA and shall be used solely in the LEA's nonprofit food service program. All food and related supplies purchased on behalf of the LEA shall be kept separate and apart and title thereto shall remain with the LEA at all times. All such purchases shall be made in the name of the LEA. [Emphasis added.]

Section 7.1 PAYMENT FOR DIRECT OPERATING COSTS –

> For each Accounting Period, the LEA will pay/reimburse the FSMC for all Direct Operating Costs less all applicable credits, discounts and rebates.

Section 3.5 DIRECT OPERATING COSTS [DEFINITION] –

> All costs and expenses directly incurred in connection with the operation of the Food Service Program on the premises of the LEA.... **Direct operating costs consist of invoiced amounts to the FSMC for goods (food, beverages, merchandise, supplies, and small equipment) used directly in the Food Service Program of the LEA**, labor costs for non-management employees who work in the LEA's food service program, i.e., salaries, wages, taxes and benefits.... [Emphasis added.]

Under the standard agreements, Taxpayer operates the food service program that is required to be provided by each school. To operate that program, Taxpayer provides supervisors and hires on-premises Food Service Employees. The salaries of the on-premises Food Service Employees are billed to and reimbursed by the LEA. In addition to operating the dining facilities, Taxpayer acts as the LEA's agent in purchasing the food and supplies needed to provide the required food service program. The contract includes a specific grant of agency from the LEA to Taxpayer.

The food and supplies are ordered by Taxpayer on behalf of each LEA. The purchase orders are issued by Taxpayer but identify that the order is issued on behalf of the LEA and list the LEA's school's address as the delivery address for the purchased materials. Each purchase order is for a specific LEA and specific school. Taxpayer does not purchase any food or supplies on its own behalf. Rather, the orders are shipped to the specific school and all food and supplies are stored at the school. Taxpayer does not have its own storage facilities and does not store any food or supplies for the schools.

The LEA takes possession and title of the food and supplies upon delivery to the school. The LEA assumes any risk of spoilage or damage to the food and supplies. All of the purchased food and supplies are used to provide each school's require food service program. After use, any disposable supplies are deposited in the school's garbage and disposed of by the school. The food and supplies are not and cannot be transferred by Taxpayer from one LEA to another LEA. If Taxpayer's contract were cancelled, the food and supplies would remain at the schools and the title and possession of the food and supplies would remain with the LEA.

Under its contracts with each LEA, Taxpayer pays the vendor for the purchases on behalf of the LEA and then bills the LEA for the amount paid to the vendor. Within Taxpayer's accounting system, each order, invoice, payment, and reimbursement is recorded to a subaccount attributable to a specific LEA. In accordance with Generally Accepted Accounting Principles,

Taxpayer records the payment as a cost of goods sold and records the reimbursements as gross receipts.

Ruling Requested

Based on the facts provided, whether Taxpayer's purchases of supply items are subject to the Rhode Island Sales and Use Tax.

Pertinent Local Statutory and Regulatory Law

R.I. Gen. Laws § 44-18-18 imposes a sales tax on all "sales at retail" in Rhode Island. The state also imposes a use tax under R.I. Gen. Laws § 44-18-20 "on the storage, use, or other consumption in this state of tangible personal property; prewritten computer software delivered electronically or by load and leave; or services as defined in § 44-18-7.3." R.I. Gen. Laws § 44-18-8 defines "retail sales" or "sale at retail" as "any sale, lease or rentals of tangible personal property, prewritten computer software delivered electronically or by load and leave, or services as defined in R.I. Gen. Laws § 44-18-7.3 for any purpose other than resale, sublease or subrent in the regular course of business."

Under R.I. Gen. Laws § 44-18-7(1), the term "sales" means and includes "any transfer of title or possession, exchange, barter, lease, or rental, conditional or otherwise, in any manner or by any means of tangible personal property for a consideration. 'Transfer of possession', 'lease', or 'rental' includes transactions found by the tax administrator to be in lieu of a transfer of title, exchange, or barter." "Sales" also includes "the sale, storage, use or other consumption of prewritten computer software delivered electronically or by load and leave as defined in paragraph 44-18-7.1(v),"[1] and "the furnishing of services in this state as defined in § 44-18-7.3."[2]

Under R.I. Gen. Laws § 44-18-25, all gross receipts are presumed to be taxable until the taxpayer proves otherwise to the Tax Administrator. The burden of proving to the contrary is on the person who makes the sale and the purchaser, unless the person who makes the sale takes from the purchaser a certificate indicating that the purchase was for resale. The certificate must be in the form that the Tax Administrator requires. R.I. Gen. Laws § 44-18-30 provides a list of specific exemptions to the Sales and Use Tax in Rhode Island. If a good falls outside of this list, it is generally taxable.

R.I. Gen. Laws § 44-18-30(3) provides that gross receipts from the following are exempt from Rhode Island sales and use tax: "From the sale and from the storage, use, or other consumption in this state of meals served by public, private, or parochial schools, school districts, colleges, universities, student organizations, and parent-teacher associations to the students or teachers of a school, college, or university whether the meals are served by the

[1] R.I. Gen. Laws § 44-18-7(14).

[2] R.I. Gen. Laws § 44-18-7(16).

educational institutions or by a food service or management entity under contract to the educational institutions."

R.I. Gen. Laws § 44-18-30(8) further exempts sales to political subdivisions within the state: "From the sale to, and from the storage, use, or other consumption by, this state, any city, town, district, or other political subdivision of this state."

Discussion

Taxpayer argues that its purchases of supplies on behalf of the LEAs are exempt because it acted as an agent on behalf of the exempt LEAs or, alternatively, because the purchases were non-taxable sales for resale. As will be discussed further below, the supply items that Taxpayer purchased, used, and consumed on behalf of the LEAs are subject to Rhode Island use tax because of the legal incidence test and Taxpayer's taxable use of the items to prepare meals. Regardless of the fact that Taxpayer's contract with the LEA specifies that Taxpayer is the LEA's agent, Taxpayer is an independent contractor that paid for the items and used or consumed them in the course of its business activities. Tax exemptions are not transferable by attribution.

I. Agency Argument

Taxpayer first argues that its purchases of supply items are exempt because it made the purchases on behalf of tax-exempt LEAs. The governing exemption statute for this claim would be R.I. Gen. Laws § 44-18-30(8). The school lunches exemption, R.I. Gen. Laws § 44-18-30(3), does not apply to this matter because it relates only to school meals themselves, not to the supply items at issue that were used to prepare the meals. The legal incidence test, Taxpayer's taxable use of the supply items, and Rhode Island's strict and narrow construction of exemption statutes prevent Taxpayer from claiming an exemption as a government agent. Each of these categories will be discussed further below.

A. Legal Incidence Test

Taxpayer is ultimately liable for the use tax here because it paid for the supply items. In *Keystone Auto Leasing v. Norberg*, 486 A.2d 613 (R.I. 1985), the Tax Division assessed deficiencies against United States government employees who rented automobiles and purchased gasoline and personal accident insurance. The taxpayer automobile rental companies in the case failed to charge Rhode Island sales tax on the employees' purchases. The federal government employees paid for the rentals with cash or their own personal credit cards and were reimbursed by the United States government upon proof of payment. There were contractual agreements between the rental companies and the federal government that required the rental companies to have available a set number of automobiles for lease to government employees who were on official business.

The taxpayers argued that since the federal government reimbursed the employees for their purchases, the transactions were exempt from state tax for sales to the federal government

under R.I. Gen. Laws § 44-18-31 ("There shall be exempted from the computation of the amount of the sales tax the gross receipts from any sale of any tangible personal property to the United States, its agencies and instrumentalities."). The Rhode Island Supreme Court looked to the "legal incidence test", which requires a determination of who is the purchaser on whom the ultimate burden of the tax will fall. The Court held that since the federal government's employees paid the automobile lease charges themselves, the legal incidence of the state tax fell upon them, not the United States government, even though the economic burden of the tax ultimately fell on the federal government. Additionally, the sales of gasoline and insurance were included in the taxable measure because they were services that were part of the overall sale under then R.I. Gen. Laws § 44-18-12(A).

In the present scenario, Taxpayer purchases the supplies at issue to prepare meals for its clients, the schools, but Taxpayer is billed for and pays for the supplies. Just like the federal government employees in *Keystone* who paid for the automobile leases with their own cash or credit cards, Taxpayer here bears the incidence of the Rhode Island sales and use tax, not the governmental entity for which it worked. R.I. Gen. Laws § 44-18-25 mandates that all gross receipts are subject to sales and use tax unless the taxpayer can prove otherwise. Taxpayer here pays for the supply items it uses, even though the LEAs ultimately reimburse Taxpayer for the purchases. Therefore, Taxpayer is directly responsible for paying the use tax on the items it purchases.

B. Taxable Use

Taxpayer is also liable for the use tax because it made a taxable use of the supply items. In *Great Lakes Dredge & Dock Co. v. Norberg*, 369 A.2d 1101 (R.I. 1977), the Rhode Island Supreme Court discusses what constitutes a taxable "use" of tangible personal property. The taxpayer, a contractor, leased four (4) tugboats and four (4) scows to use during its dredging operations to deepen the Providence River's navigable channel. Three (3) of the tugboats were manned by masters and crews provided by their respective lessors while the fourth tugboat was operated by taxpayer's own personnel. The taxpayer argued that it did not have sufficient control over the three (3) lessor-manned tugs to constitute a taxable use.

The Court disagreed with the taxpayer and looked to the definition of "use" under R.I. Gen. Laws § 44-18-10 as "the exercise of *any* right or power over tangible personal property incident to the ownership of that property." (Emphasis added.) Since taxpayer's employees would direct the lessor-manned tugboats as to where and when to pick up scows, the Court found that taxpayer exercised sufficient control over the tugboats to be a taxable use of the leased property. R.I. Gen. Laws § 44-18-10 indicated that "any right or power" over tangible personal property served as a taxable use of the property. The fact that the captains of the tugs exercised their own control over the vessels did not change the result.

The Rhode Island Supreme Court applied its interpretation of what constitutes a taxable "use" in the recent case of *WMS Gaming, Inc. v. Sullivan*, 6 A.3d 1104, 1110 (R.I. 2010). In *WMS Gaming*, the Court determined that the taxpayer gaming company made a taxable use of its video gaming lottery terminals where the taxpayer retained title to the machines during the audit

period and had the right to increase the machines' productivity. The taxpayer also assisted its central systems provider in maintaining the machines, installed new games on the machines, and executed five (5) player promotions per year. The taxpayer was actively involved in ensuring that the machines were as profitable as possible and used its knowledge of the machines to achieve that goal. The Court held that this activity was more than the minimal amount of control needed to constitute a taxable use.

In the present matter, Taxpayer used the supply items it purchased to prepare meals for public school students. There was even more control by Taxpayer here than in *Great Lakes* where its own employees used and consumed the supplies to prepare school meals. In *Great Lakes*, the taxpayer directed its lessor's agents where to move their tugboats and such control was a taxable use. Here, Taxpayer had direct control over its own agents who used and consumed the supply items to prepare meals. This activity is clearly a taxable "use" according to *Great Lakes* and *WMS Gaming*.

C. Agency

Taxpayer does not qualify as an agent under a strict and narrow reading of the exemption statute. In *Raytheon v. Clark*, A.A. No. 02-118 (2009), the Sixth Division District Court rejected a taxpayer's claims that are similar to Taxpayer's claims in the present ruling. The taxpayer in *Raytheon* argued that its purchase of fuel was nontaxable under R.I. Gen. Laws § 44-18-31 because the taxpayer purchased the fuel as an agent of the United States government. *Id.* at 43. The fuel was purchased under the taxpayer's name, using the taxpayer's credit, and it was delivered to employees of the taxpayer. *Id.* at 45-46. Although there was no indication in the taxpayer's contract with the government that the taxpayer was acting as a government agent, the court held that even if such language had been in the agreement, the language would have been insufficient to bind the government under federal regulations. *Id.* at 47. The Court also indicated that agency does not exist where the principal asserts no control over the activity in question. *Id.* at 48.

Even though the agreement between Taxpayer and the LEA designated Taxpayer an agent of the LEA, Taxpayer still paid for the supply items and used them to prepare school meals. The situation would have been different under the legal incidence test discussed earlier if the LEA had purchased the supply items, but that was not the case here. The exemption under R.I. Gen. Laws § 44-18-30(8) applies strictly to sales to political subdivisions, not their contractors. The political subdivision must have purchased the items itself to qualify for the tax exemption. The Rhode Island Supreme Court has frequently held that sales tax exemptions are strictly and narrowly construed against the taxpayer unless the legislature's intent to grant the exemption to the taxpayer is clear on the face of the statute.[3] As a contractor that bears the legal

[3] *Dart Indus. v. Clark*, 696 A.2d 306, 310 (R.I. 1997); *Cookson America, Inc. v. Clark*, 610 A.2d 1095, 1098 (R.I. 1992); *Rhode Island Lithograph Corp. v. Clark*, 519 A.2d 589, 591 (R.I. 1987); *American Hoechst Corp. v. Norberg*, 462 A.2d 369, 372 (R.I. 1983); *Rice Mach. v. Norberg*, 391 A.2d 66, 70 (R.I. 1978); *Great Lakes Dredge & Dock Co. v. Norberg*, 369 A.2d 1101, 1106 (R.I. 1977); *Sportfisherman Charter, Inc. v. Norberg*, 340 A.2d 143, 146 (R.I. 1975); *Preservation Society v. Assessor of Taxes*, 209 A.2d 701, 704 (R.I. 1965).

incidence of the transactions and makes a taxable use of the supplies, Taxpayer's purchases are subject to Rhode Island sales and use tax.

II. Resale Argument

Taxpayer's second argument is that its purchases of supply items are exempt as tangible personal property for resale. R.I. Gen. Laws § 44-18-8 exempts sales for resale from the state sales and use tax. Sales for resale are proven when purchasers provide resale certificates to sellers.[4] In *Raytheon v. Clark*, A.A. No. 02-118 (2009), the taxpayer, a defense contractor, claimed that overhead materials it purchased pursuant to a contract with the United States government were not subject to Rhode Island sales tax because the sale was for resale. *Id.* at 17. The contract in question had a title-vesting clause that passed title of the items from the taxpayer to the government as soon as the taxpayer acquired them. *Id.* The Court rejected this argument because the taxpayer did not provide its vendors with certificates that the materials were purchased for resale. *Id.* at 19.

Here, there is no evidence that the LEAs provided resale certificates to Taxpayer. Nor did Taxpayer provide resale certificates to its vendors. Even if Taxpayer's contract indicated that Taxpayer purchased the supply items on the LEA's behalf and the LEA reimbursed Taxpayer for the purchases, there is no evidence that the LEAs provided resale certificates to the Taxpayer showing that the purchases were for resale. In this case it does not matter that title and possession of the purchased goods transferred from Taxpayer to the LEA. Even if Taxpayer or the LEAs had provided resale certificates, their validity would be questionable as Taxpayer and the LEAs do not resell the supply items in the regular course of their business operations. *See Raytheon*, A.A. No. 02-118 at 31. Instead, Taxpayer is the end consumer of the supply items as it prepares school meals.

Ruling

Based on the facts provided, Taxpayer's purchases of supply items are subject to Rhode Island Sales and Use Tax because Taxpayer pays for the supply items and makes a taxable use of them.

This ruling is limited to the facts stated herein and may be relied upon by the Taxpayer and shall be valid unless expressly revoked because (1) the applicable statutory provisions of law are amended in a manner that requires a different result; (2) the underlying facts described herein materially change; or (3) a decision on point has been issued by the Rhode Island or Federal courts.

Neena S. Savage
Tax Administrator
November 17, 2017

[4] R.I. Gen. Laws § 44-18-25.