UPDATE ON LITIGATION REGARDING Sales and Use Tax on Complimentary Meals

By John S. Bartlett

After approximately 12 years of litigation, a settlement was recently reached between the gaming industry and the Nevada Department of Taxation (the "Department"), on the application of sales or use tax to complimentary meals provided to gaming patrons and employees. This settlement also has application to other taxpayers who provide free meals to their employees on the premises of the workplace.

To recap, when gaming companies began filing claims with the Department in 2002, the Department had for many years enforced their interpretation of the applicable law that required taxpayers that provided complimentary meals to their patrons and/or free meals to their employees to accrue and remit a use tax on the cost of the food used to provide these meals. In their refund claims, the taxpayers asserted that the Department could not impose a use tax on the cost of food used to provide free meals, because Article 10, §3A of the Nevada Constitution, supported by NRS 372.284(1), exempted the retail purchase of unprepared "food for human consumption" from sales or use tax.

Taxpayers and the Department agreed to litigate a "test case" with the implicit understanding that the ultimate result would be applied to all the other taxpayers, with the result that the initial refund claim of Sparks Nugget, Inc., was chosen. After presenting the taxpayer's arguments unsuccessfully at both the administrative level and in District Court, the taxpayer finally broke through when the Nevada Supreme Court (ultimately) unanimously agreed with their argument in *Sparks Nugget, Inc. v. State, Department of Taxation*, 124 Nev. 159, 179 P.3d 579 (2008), and ruled that use tax could not be imposed on the cost of food used to provide meals free of charge to gaming patrons and employees. A refund of use tax to the taxpayer was ordered.

As a result of the *Sparks Nugget* decision, the State was now faced with the prospect of providing millions of dollars in refunds to the taxpayers that filed timely refund claims for periods up to the date of that decision. Instead of doing so, in reliance on a footnote from the *Sparks Nugget* decision, the State for the first time took the position that the transfer of both complimentary meals provided to patrons and free meals provided to employees would be considered transfers for consideration and thereby subject to sales tax. In short, the State sought to set up an offsetting sales tax liability to avoid having to pay out millions of dollars in use tax refunds.

Litigation on the State's new sales tax theory ensued, and, one by one, the Department's administrative law judge began hearing the taxpayer's cases. Those taxpayers having the largest refund claims were chosen to proceed first. Since the State chose its new legal theory to substantiate why it was denying the refund claims before it had any facts to back it up, the first few cases involved substantial pre-trial discovery conducted by the State to uncover facts it could use to support its theory.

Ultimately, the State argued that the transfer of a complimentary meal to a gaming patron who obtained the meal through redeeming rewards generated through participation in a player's club was a transfer in exchange for the patron's alleged agreement to provide personal contact information to the casino (that the casino could use for future marketing efforts), and to gamble in the casino. The State argued that the full retail value of the meal was the proper measure of the sales tax. The State further argued that meals provided free of charge to employees in employee dining rooms or cafeterias were transferred for

consideration in the form of the employee's alleged agreement to come to work. Interestingly, the State argued the taxable measure of these meals was the same as the cost of the food used to provide them (the same measure as the use tax accrued and remitted by the taxpayers).

Besides arguing that neither complimentary meals provided to gaming patrons nor free meals provided to employees were transfers for sufficient legal consideration, the taxpayers interposed several other defenses to the Department's sales tax assessments, including waiver and equitable estoppel (the Department admitted it was enforcing the use tax rule throughout the period covered by the refund claims), statute of limitations (the sales tax assessments were made 5-10 years after the periods for which refund claims were filed); and violation of the taxpayers' due process rights (retroactive application of a sales tax theory when taxpayers could no longer pass on the sales tax to patrons and employees, especially in light of contrary law being enforced by the Department).

At the time settlement discussions began, the taxpayers had obtained partial victories in two District Court decisions, both holding that free meals provided to employees were not subject to sales tax, and one holding the applicable statute of limitations barred the sales tax assessment on complimentary and employee meals as a setoff for refund claims filed prior to October 1, 2005. The administrative tribunal had held in every case that the maximum sales tax setoff allowed was an amount equal to the use tax already remitted, and that on complimentary meals provided to patrons that were not the result of patron participation in a player's club, no sales tax was due and a use tax refund was ordered.

As the initial cases decided in District Court were heading to the Nevada Supreme Court, the State took a look at a potential refund exposure of at least $250 million, and decided it was time to seek a settlement. The State's primary goal was to avoid a large cash payout. The taxpayers' goal was to get the full benefit of their refund claims while at the same time establishing the law prospectively as exempting the furnishing of complimentary meals from sales or use tax. The remedy was an agreement on the part of the taxpayers to trade their rights to a refund as established by the *Sparks Nugget* decision, in return for the State's agreement to seek and enact legislation clarifying specifically that neither complimentary meals nor free meals provided to employees were subject to sales or use tax. To ensure that the taxpayers will receive the full financial benefit of their refund claims, the settlement includes a provision requiring the State to pay at least a pro rata share of the refund claims to the taxpayers if a future Legislature changes the law to subject these meals to sales or use tax at any time prior to January 31, 2019. For those taxpayers who have been sold or have gone out of business, cash refunds will be issued. In addition, credits will be issued for those taxpayers who established they previously paid use tax on "non-gaming" related complimentary meals.

The financial benefit to the taxpayers from this settlement is substantial. Assuming the law is not changed prior to January 31, 2009, the taxpayers will receive 11 years (the five years since the *Sparks Nugget* decision *plus* the next 6 years at a minimum) of tax relief from paying sales or use tax on complimentary and employee meals. The amount of tax savings will easily exceed the present value of the refund claims the taxpayers traded in. In sum, as a result of the settlement the casino industry has achieved a significant victory and garnered substantial financial benefits from this litigation. In turn, the State avoided a huge payout of funds that it could not afford. For the author, who has been involved in this case from the beginning, the settlement was a satisfactory conclusion to a long and winding road.

John is a sole practitioner based in Carson City, Nevada, practicing in the area of state and local tax disputes. He formerly was a Senior Deputy Attorney General assigned to represent the Nevada Department of Taxation and Nevada Tax Commission from 1987 to 1999. He has been involved in most of the Nevada Supreme Court cases involving sales and use taxation since 1988. John also regularly lectures on sales and use taxes in Nevada.

*For more background on the complimentary meal taxes see the following *Nevada Gaming Lawyer* articles, available at http://www.nvbar.org/content/gaming-law-section:

John S. Bartlett, Esq. *Nevada Supreme Court Confirms Meals Provided Free Are Not Subject to Sales or Use Tax*, Nevada Gaming Lawyer (September 2008).

John S. Bartlett, Esq. *Update on Ongoing Dispute Over the Application of Sales and Use Tax to Complimentary Meals and Free Meals to Employees* Nevada Gaming Lawyer (September 2012).