A "De Minimus" Test for Taxability? Missouri Supreme Court Imposes Tax on Just a Little Bit of Fun

Advising taxpayers on multistate sales tax issues, it can be easy to assume that a "true object," "primary purpose," "essence of the transaction," or similar test applies to determine the classification of a transaction and its taxability. These types of tests generally consider whether the predominant aspect of the transaction is taxable and often look to the intent of the buyer.

A recent Missouri Supreme Court decision provides a reminder that the true object test is not universal. In *Miss Dianna's School of Dance*,[1] the court continued a line of cases applying a "*de minimus*" test to determine whether the sales tax on amusement or recreation admissions applied. If more than a minimal aspect of the business was amusing or recreational, then the service was taxable.

While an understandable result in light of existing Missouri precedent, it is a troubling decision that poses significant risks for Missouri businesses providing services that might have an element of enjoyment. And more broadly, while this *de minimus* test seems unique to Missouri, there are reasonably analogous concepts in other parts of sales and use tax systems where a lesser part of a transaction can trigger tax on the entirety.

Dance class can be fun . . . and taxable. The taxpayer, Miss Dianna's School of Dance, operated a dance studio on the north side of Kansas City. It charged fees for dance classes. Classes were offered in a variety of dance styles and for a variety of age groups. Many classes were for children learning dance.[2]

The Missouri Department of Revenue audited the taxpayer and assessed sales tax on the dance lesson fees. It assessed under the clause imposing sales tax on "fees paid to, or in any place of amusement, entertainment or recreation."[3] The basis for the assessment was that the dance classes were sufficiently recreational to be taxable.

The Department emphasized the marketing materials of Miss Dianna's stating that various classes were "fun." At an administrative hearing, Miss Dianna herself testified that dance students get recreation and hopefully have fun in class.[4] The Administrative Hearing Commission ruled in favor of the Department of Revenue and the taxpayer appealed to the Supreme Court of Missouri.

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Taxing when recreation is more than *de minimus*. The Supreme Court, in affirming the assessment of tax, applied a test that considers whether entertainment or recreation comprise more than a *de minimus* part of the business activities. To be taxable, a charge or fee must be paid to or in a place of amusement, entertainment, or recreation. Determining whether a business is a place of amusement, entertainment, or recreation is a facts-and-circumstances question that generally considers three factors: (1) the way that the place of business holds itself out to the public, (2) how much of the revenue at the place of business is generated by amusement or recreational activities, and (3) the pervasiveness of the amusement or recreational activities at the place of business.

As applied to Miss Dianna's, these factors weighed in favor of taxation:

1. *Holding out as recreational:* The court noted that the evidence of dance classes being promoted as "fun" supported the first factor.
2. *Revenue sources:* Dance classes provided a majority of Miss Dianna's revenue. To determine the second factor, the court had to decide whether the dance classes constituted amusement or recreational activities. Dual-nature activities that were in part recreational were considered to be recreational activities for purposes of this test, consistent with prior precedent.[5] The dance classes thus were held to be recreational. Since these deemed recreational dance classes constituted more than two-thirds of total revenue, the second factor also indicated that Miss Dianna's was a place of amusement.
3. *Pervasiveness of recreational activities:* As dance classes were considered recreational, the pervasiveness of the dance class activities also weighed in favor of taxation.

While the court worked its way through the three factors, the case essentially turned on whether the recreational aspect of the business's activities was more than *de minimus:* "Because amusement or recreational activities comprise more than a *de minimus* portion of Miss Dianna's business activities, it is considered a place of amusement or recreation with fees taxable under § 144.020.1(2)."

Miss Dianna's was decided by a narrow 4-3 majority. The dissenting opinion fo-

cused on the educational aspect of the school and held that any recreational aspect was *de minimus*. Prior precedent involving gyms was distinguished as principally involving self-directed activity rather than a series of educational classes of increasing difficulty.

No escaping classification questions. This strange result in *Miss Dianna's* comes from a line of Missouri Supreme Court cases searching for a way to define places of amusement, entertainment, or recreation—the admission to which is taxable. Amusement taxes inherently result in uncertainty because they turn on the subjective question of whether pleasure or diversion is the purpose of the event. In seeking to escape the burden of fact-intensive discernment of the primary nature of an activity, the court made things worse.

The *de minimus* test evolved as an attempt to sidestep classification issues, but in doing so the Missouri Supreme Court has broadened the tax—and the classification questions—by lowering the threshold of taxability to whether a place of business is more than minimally a place of amusement or recreation.

The mischief arguably began in a case involving a billiard hall, *Spudich v. Director of Revenue*,[6] where the court employed the *de minimus* test in the rebuttal of an equal protection argument. The tax already was determined to apply because a billiard hall was a place of "amusement" in the ordinary sense of the word.[7] However the taxpayer claimed an equal protection violation because coin-operated device charges were not taxable if they were not in a place of amusement or recreation.

The *de minimus* test was explained as a pragmatic distinction based on administrability: Missouri did not tax admissions to places where amusement or recreation was *de minimus*, because the costs of collecting tax from such an establishment would be out of proportion to the tax revenue.[8]

In a series of decisions involving athletic clubs, this *de minimus* test evolved from a question of the proportion of recreational activity to a question of whether an activity was recreational. In *Columbia Athletic Club*,[9] the Missouri Supreme Court applied a primary purpose test in considering whether the fitness center was for health benefits or recreation, and it concluded that the evidence in the case supported a nontaxable primary purpose of providing health benefits. (This is the type of analysis that one ordinarily would expect for a classification question.)

But three years later, the court reversed its position in *Wilson's Total Fitness*,[10] reinstating the *de minimus* test. The court's reasoning was that the primary purpose test was "unworkable in fact," because of the challenge in distinguishing health purposes from recreation purposes.[11]

Critically, *Wilson's Total Fitness* had the court shifting from a *de minimus* test on the various activities occurring in a location to a *de minimus* test in considering whether a given activity—various benefits from a gym membership—would be considered recreational. The court subsequently applied the *de minimus* test in another case to tax personal trainer fees in a gym where users could only work with personal trainers.[12]

While the brief opinion in *Wilson's Total Fitness* rejected the primary purpose test as unworkable, it did not explain how the reinstated *de minimus* test would be practicable on the whole. It certainly yielded an easier decision in that case, but the court did not consider the inevitable borderline cases in which amusement, entertainment, or recreation might now be considered a more than minimal aspect of the business activity.

This was especially a risk given the court's prior holding that an activity could be considered amusing while simultaneously also having another nontaxable purpose; in that case an educational helicopter ride over historic sites in St. Louis had been considered partly amusing and therefore taxable.[13] In sum, despite a canon of construing taxing statutes narrowly,[14] the court had arrived at a very broad reading of what constitutes a place of amusement, entertainment, or recreation.

The framework thus was established to impose tax on a dance studio—or any other business offering a service that can be fun for the purchaser. Educational organizations were particularly at risk because of the court's treatment of dual-nature activities as supporting taxation. Miss Dianna's had not filed returns given a Missouri Department of Revenue ruling from 2008 that had treated dance lessons and other sports lessons as nontaxable services.[15]

It is unclear why the Missouri Department of Revenue changed its position, but the prior letter ruling was basically disregarded by the Missouri Supreme Court. It is likely that numerous businesses—particularly small businesses—are now at risk under this broad ruling in favor of taxability.

***De minimus* concepts elsewhere in tax systems.** While at first glance Missouri's *de minimus* test is unique (and uniquely problematic) in a world that otherwise follows true object tests, on further examination there are *de minimus* aspects to many states' sales tax systems where the lesser part of a transaction can "wag the dog" and trigger taxability. Under bundled transaction rules, for example, an entire transaction is often taxable if any product or service included in the bundle is taxable.[16] It also can arise in questions of whether tangible personal property is being sold in conjunction with a service.[17]

In sum, while taxpayers are generally well served to begin a taxability analysis with a true object test in mind, they should bear in mind the variability and potential risks of other approaches to classification. ■

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1 *Miss Dianna's School of Dance, Inc. v. Director of Revenue*, No. SC95102 (Mo. Jan. 12, 2016) (en banc).

2 If you want to see for yourself, its Facebook page is https://www.facebook.com/mdsod/.

3 Mo. Rev. Stat. § 144.020.1(2).

4 Query whether some of the taxpayer's school-age students would have testified otherwise.

5 *See Wilson's Total Fitness Center, Inc. v. Director of Revenue*, 38 S.W.3d 424, 426 (Mo. 2001) (en banc); *Fostaire Harbor, Inc. v. Missouri Director of Revenue*, 679 S.W.2d 272 (Mo. 1984) (en banc).

6 745 S.W.2d 677 (Mo. 1988) (en banc).

7 745 S.W.2d at 680-81.

8 745 S.W.2d at 682.

9 *Columbia Athletic Club v. Director of Revenue*, 961 S.W.2d 806 (Mo. 1998) (en banc).

10 *Wilson's Total Fitness Center, Inc. v. Director of Revenue*, 38 S.W.3d 424 (Mo. 2001) (en banc).

11 38 S.W.3d at 426.

12 *Michael Jaudes Fitness Edge, Inc. v. Director of Revenue*, 248 S.W.3d 606 (Mo. 2008) (en banc).

13 *Fostaire Harbor, Inc. v. Missouri Director of Revenue*, 679 S.W.2d 272 (Mo. 1984) (en banc).

14 *See Spudich*, 745 S.W.2d at 680 ("Statutes relating to taxation are strictly construed against the taxing authority and in favor of the taxpayer.")

15 *See* Mo. Dep't of Revenue Ltr. Rul. No. LR4912 (July 17, 2008).

16 *See, e.g.*, Ohio Rev. Code Ann. § 5739.012. Ohio's provision even includes an express "*de minimis*" rule if the value of the taxable product or service is 10% or less of the entirety of the transaction. Ohio Rev. Code Ann. § 5739.012(B)(3).

17 *See, e.g., Urso & Brown, Inc. v. Director, Div. of Taxation*, 19 N.J. Tax 246, 257-58 (2001), *aff'd*, 353 N.J. Super. 248, 802 A.2d 543 (2002).