

Memorandum**550.0275**

To : Ms. Patricia L. Parker
Audit Evaluation & Planning

Date: November 10, 1992

From : John L. Waid
Tax Counsel

Subject: M---'s C--- M---
Subsidies to Food Seller's
SY OHC XX-XXXXXX

I am answering your memorandum to me dated September 14, 1992. You asked whether or not the management fees paid by St. A---'s Maternity Home ("St. A---'s") to M---'s C--- M--- ("MCM"), allegedly to subsidize MCM to serve meals at St. A---'s, are excluded from its gross receipts for food sales under the rule of Szabo Food Service, Inc., of California v. St. Bd. of Equalization (1975) 46 Cal.App.3d 268. You attached several documents to your memorandum and raised several questions. For the sake of brevity, I have attached a copy of your memorandum rather than quote it here.

I. FACTUAL BACKGROUND

Principal Tax Auditor Glenn A. Bystrom, in his letter to Ms. B--- C---, Supervisor of MCM's Tax & License Department, dated August 12, 1992, recounted the factual background of this problem, as related in her letter dated June 1, 1992, to Mr. Warren Klomp of our Arcadia Office, a copy of which was forwarded to Mr. Bystrom, as follows:

"You operate a food service facility (cafeteria) at St. A---'s M--- Home. You receive as consideration for your services, the cost to operate plus a management fee from St. A---'s.

"The residents of St. A---'s M--- Home do not pay either St. A---'s or you for the meals provided at the cafeteria.

"Meals are also sold to visitors, employees, etc. within the cafeteria and you are collecting and remitting sales tax on those sales.

"Catering sales to outside groups and organizations are provided and you are collecting and remitting sales tax on these sales.

"You also provide catering services for meetings described by St. A---'s as being for 'official business'....

"Each month you bill St. A---'s for your cost to operate plus a set management fee (subsidy)."

In your memorandum to me, you indicated that Ms. C---, in a telephone conversation with you on September 9, 1992, gave additional background as follows:

"Any catering services for meals served at meetings or conferences are billed for a separate charge directly to St. A---'s and are not subsequently rebilled by St. A---'s to staff as a resale.

"Catering services performed for related outside entities are billed directly to the specific entity receiving the services."

Mr. Bystrom assumed that MCM's sales of meals to St. A---'s residents were exempt from tax under Regulation 1603(m), covering sales to certain institutions.

No information is provided on St. A---'s operation. The copy of its seller's permit which you attached identifies it as a hospital, but the copy of its contract with MCM calls it a maternity home. Thus, if it is not a hospital, it might be considered a community care facility pursuant to Regulation 1503(a)(2), sales of meals to which would be exempt under Regulation 603(m). We render no opinion on that issue, however, due to the lack of information.

OPINION

You indicated in your memorandum that Ms. C---, in a telephone conversation with you, indicated that she did not see how MCM's contract with St. A---'s differs from that at issue in Szabo. They differ in one very important respect. In Szabo, the persons who consumed the meals paid for part of the cost of their meals. Here, the residents of St. A---'s pay MCM no money at all for the meals it serves to them; its only remuneration comes from St. A---'s. Senior Tax Counsel Donald J. Hennessy, in his memorandum dated October 4, 1983, to Mr. Bystrom mentioned that this very problem occurred in one of the accounts which was the subject of the full claim for refund which Szabo Food Service litigated. He determined that this problem was not resolved in the case due to the fact that the difference between it and the contract before the court was not appreciated at the time. He further indicated that it would have been a perfect illustration of the problems raised by Szabo's position in the litigation. Mr. Hennessy concluded as follows:

"Even if we were to grant the correctness of the Szabo decision, we do not believe it would apply here. The very word 'subsidy' implies a subsidiary payment in support of a primary payment. Here, there is no primary payment. The subsidy is the only payment and we believe is gross receipts."

We concur with Mr. Hennessy's analysis. The Szabo court noted that in no case did the subsidy exceed 30% of sales, and, if cafeteria sales covered Szabo's costs plus the guaranteed management fee, no subsidy was paid. (Ibid. at 271.) The Court determined that the intermittent "subsidies paid by employers merely guaranteed Szabo a reasonable profit and gave it an incentive to continue to provide cafeteria service to employees at reasonable prices." (Ibid. at 272.) The only payment in this case, save for the sales to visitors and employees in the cafeteria and the catering services to outside entities, which apparently cover MCM's full costs for such sales, is the "subsidy." St. A---'s is not merely guaranteeing MCM's profit but is providing the entire source of income for the sales to the home's residents and for the catering services for the meals served at staff meetings and conferences. Thus, we are of the opinion that Szabo does not apply to exclude from gross receipts the "management fee" provided by MCM's contract with St. A---'s. We concur with Mr. Bystrom that the entire amount is subject to tax under Regulation 1603(h) unless St. A---'s qualifies as an "institution" under subdivision (m). In that case the portion of the "subsidy" which covers the sale of meals to residents would be exempt from tax under that regulation, and MCM must prorate the "subsidy" between those sales and the sales to St. A---'s for meetings and conferences. The gross receipts from all other sales are also subject to tax under Regulation 1603(h).

Regarding at what point does a "subsidy" become "gross receipts," there is, as noted by Mr. Hennessy, no clear answer. Is the line crossed only at 100%, as here, or at some lesser amount - say 50% or 70%? It seems clear that a "minimal charge" like you suggest would not trigger Szabo, but some amount larger than the 30% approved by that court might. We are of the opinion that the line should be drawn at 30%, the amount approved by the Szabo court. You are not the only one having difficulty understanding the court's reasoning.

JLW:es

cc: Mr. Glenn A. Bystrom