

STATE OF CALIFORNIA

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matters of the Petition)
for Redetermination and Claim for) DECISION AND RECOMMENDATION
Refund Under the Sales and Use)
Tax Law of:)
)
M--- F--- S---, INC.) Nos. SY -- XX-XXXXXXX-020
) and -002
)
)
Petitioner/Claimant)

The Appeals conference in the above-referenced matters was held by Staff Counsel Lucian Khan on August 11 and September 8, 19XX in Culver City, California.

Appearing for Petitioner/Claimant
(hereinafter Petitioner):

F--- N---
District Manager

C--- H---
Senior Account Clerk

J--- J--- C---
Attorney at Law

Appearing for S---, A---,
S---, M---, & F--- (S---),
Interested Party:

J--- D. R---
Attorney at Law

J--- B. V---
Attorney at Law

Appearing for P---, H---,
J--- & W--- (P---),
Interested Party:

J--- B. D---
Attorney at Law

Appearing for the
Sales and Use Tax Department:

Albert Lai
Senior Tax Auditor

Protested Item

Unreported management fees (subsidies) measured by \$2,611,027 in the audit period covering January 1, 1987 through December 31, 1990.

Contentions

1. The subsidies paid by petitioner's clients (i.e., S---, P---) and assessed as taxable by the Sales and Use Tax Department (SUTD) was not includable in the measure of gross receipts subject to tax.
2. The determination was issued after the expiration of the statute of limitations.
3. The Board's failure to follow the Szabo case and Business Taxes Law Guide (BTLG) Annotation 295.0300 or enact a regulation is a violation of the Administrative Procedure Act (Government Code Section 11340).

Petitioner Only

4. The meals or hot prepared food products served by petitioner were valid sales for resale and therefore not taxable.

Summary

Petitioner is a corporation engaged in the business of preparing and serving meals in cafeterias and executive dining rooms pursuant to written agreements with various clients in the Los Angeles area. As part of its business, it also caters special functions for its ongoing clients (employers) and operates a restaurant and various vending machines.

On April 23, 1990, SUTD issued a determination in the amount of \$19,340.54 for the period covering January 1, 1987 through December 31, 1987. Petitioner made payment, and on June 18, 1990, filed a written petition for redetermination and claim for refund, requesting a refund of the amount paid, as well as overpayments made on quarterly returns for the period of January 1, 1987 through December 31, 1988.

On March 29, 1991, the SUTD auditor obtained a signed waiver form which granted an extension through July 31, 1991 for the first quarter 1988. On June 26, 1991, a second waiver form was signed, which granted an extension until August 31, 1991 for the first and second quarters of 1988.

In the subsequent audit covering the period January 1, 1987 through December 31, 1990, SUTD determined that the amount billed in the earlier determination of April 23, 1990 (for 1987) was in excess of the amount actually due. Adjustments were made against other periods to offset the earlier overpayment. On July 26, 1991, petitioner promptly paid in full the amount assessed in the audit, and on August 16, 1991, a determination was issued, crediting petitioner with the payment previously made.

On September 16, 1991, S--- and P--- (clients of petitioner) filed a joint petition for redetermination and claim for refund on behalf of petitioner. On January 27, 1992, the Board received another petition for redetermination and claim for refund by petitioner's attorney, Mr. J--- C---.

In support of both petitions and claims for refund, petitioner has submitted numerous documentation consisting of agreements with its clients, billings to clients and clients' billings to their employees, menus, luncheon and catering request order forms, dinner checks, monthly and weekly sales recaps, and copies of checks made payable to petitioner and petitioner's bank deposit tickets.

Generally, of the agreements submitted, petitioner is required to provide food services and operate executive facilities and cafeterias at the client's (employer's) business locations. The employers own, furnish and maintain the cafeteria or dining room premises; grant petitioner use of those premises; furnish utilities necessary to operate the cafeteria; furnish and maintain the equipment in the cafeterias; bear cost of replacement for all dishes and utensils; and determine the hours in which the cafeterias and dining rooms will be operated.

All agreements (except M--- & F--- and P---) provide for either a "management" or a "service" fee, which is calculated at a specified percentage of gross sales or a fixed sum of money, whichever is greater. It also provides for a subsidy, if necessary, to guarantee petitioner an adequate return on the operation. The subsidy is calculated as the amount by which the "cost of business" exceeds the "gross sales" of petitioner. In the alternative, if gross sales exceed the cost of business, the excess must be rebated by petitioner to the employer. "Cost of business" is defined to include:

1. Wages, salaries, and fringe benefits of direct labor and management employed by petitioner at the employer's locations;
2. Costs of food, food products, confections and other merchandise served;
3. Costs of all direct materials and supplies used in the premises;
4. Costs of insurance and other direct operating expenses attributable to the contract;

5. Cost and expense of all taxes and licenses attributable to the contract; and
6. Cost of routine indirect overhead expenses, not to exceed a stated percentage, as specified in the contract or a fixed amount as specified.

"Gross sales" is generally defined as the total cash and charge receipts from sales made by petitioner, on the premises and as approved by the client. Some of the agreements also include sales made off the premises or billings in connection with special occasion meals. The term generally excludes commissions paid to petitioner by vending machine subcontractors and sales taxes or tips and gratuities to petitioner's employees.

The contract with M--- & F--- provides for a management fee of \$37,000, and starting in 1992, the fee increases annually by the lesser of five percent and the Consumer Price Index increase for the preceding year. "Cost of business" in this contract is defined essentially as that indicated above; however, this contract does not mention a stated percentage or fixed amount. In the contract with P---, the management fee is \$365 per week, and "cost of business" is the same as defined above; however, an "administrative service fee" of \$245 per week is assessed, rather than a percentage. Although neither of these agreements provide a definition of gross sales, both allow for payment of a subsidy as do the other contracts indicated above.

By the terms of all the agreements, employees of petitioner's clients and others ordered and consumed the meals. All meals were billed periodically to the client at a later time according to the terms of the individual agreements. When the cost of business exceeded petitioner's gross sales, petitioner would receive a separate subsidy payment as well.

Arguments of Petitioner/Skadden-Arps/Paul-Hastings

Subsidy - In the briefs and at the conference, petitioner argued that in Szabo Food Service, Inc. v. State Board of Equalization (1975) 46 Cal.App.3d 268, 119 Cal.Rptr. 911, the court held that a subsidy which could not be traced to the sale of meals could not be included in the measure of tax. In this case (as in Szabo), the employees paid for the meals because they were required to reimburse the employers (petitioner's clients). It is clear from the language in the case that even if the employer (rather than employee) had been billed by Szabo, the subsidy would not have been taxable; thus, this rule extends to both in-house subsidies as well as those paid to an outside service provider.

Furthermore, in Szabo, the Board stipulated that when an employer operates a cafeteria for employees and takes a loss on the sale of meals, no tax is payable on a subsidy (see p. 272).

In a prior Decision and Recommendation dated July 17, 1990 (relating to petitioner and the prior audit for the prior period of January 1, 1984 through December 31, 1986), Staff Counsel Tony Nevarez concluded that the subsidy was subject to tax. However, in a November 13, 1990 response to petitioner's September 25, 1990 Request for Reconsideration, Mr. Nevarez stated that had petitioner proved what amounts were paid as consideration for meals, and that the employees themselves paid for the meals, then the subsidy would have been excluded from gross receipts. Petitioner argues that the submitted documentation which consists of luncheon order forms and accounting records traced the meals from the time of order until actual payment by the employees of petitioner's clients. (For further details, see pp. 3 and 4 of the November 18, 1993 letter authored by attorney Jeffrey B. Valle.)

Petitioner further argues the period of January 1, 1987 through June 30, 1988 was barred by the statute of limitations on the date the determination was issued. Although Revenue and Taxation Code Section 6488 provides for a waiver of the three-year statute of limitations period imposed under Section 6487 when a return has been filed, a waiver was only given through June 30, 1991. Therefore, the August 16, 1991 determination was untimely.

Finally, petitioner argues that in issuing the determination of August 16, 1991, the Board has indicated its intention not to follow Szabo or BTLG Annotation 295.0300. Without issuing a regulation and otherwise complying with the notice and hearing requirements of the Administrative Procedures Act (Government Code Section 11340, et seq.), the Board has violated the Administrative Procedures Act.

Separate Arguments of Petitioner

In the alternative, petitioner argues it is not a retailer because its sales to its clients (employers) were exempt sales for resale. Since petitioner did not charge the employees, the employers were retailers as defined under Section 6015. The tax paid by petitioner to the Board was simply paid as a matter of convenience to the employer.

Furthermore, Sales and Use Tax Regulation 1603(k)(3) provides that where an employer provides meals to its employees and makes no specific charge, the employer is the consumer of the food products; therefore, petitioner's alleged sales would not be taxable.

SUTD's Arguments

SUTD argues Szabo does not apply in the instant case. In Szabo, the employees, rather than employers, paid for the meal. Here, because the employers were billed directly and also paid the subsidy to petitioner, it can be directly traced to particular meals and therefore taxable. Furthermore, there is no evidence all meals were reimbursed by employees. Sometimes meal order forms showed expenses charged to employers and sometimes to a client account or project number. There is no evidence showing the employees actually paid the employers, with the

exception of meals occasionally consumed by employees of S---. It may have been merely a debit on the books of the employer to show where expenses could be allocated.

In the November 13, 1990 response to petitioner's earlier Request for Reconsideration, Staff Counsel Tony Nevarez stated it must be shown the employees themselves made payment to petitioner. He did not state that if petitioner could show reimbursement was paid by the employees, then the subsidy would be nontaxable. The facts and law are the same in the current dispute as that covered by the prior Decision and Recommendation in which Mr. Nevarez held that the subsidy payment was taxable.

SUTD does not agree with petitioner's argument that the employer was the retailer of meals, because none of the employers had seller's permits and no resale certificates were provided on the purchase of the meals.

The determination of August 16, 1991 was issued timely. On March 29, 1991, a waiver was executed which granted an extension through July 31, 1991. On June 26, 1991, a further extension was granted through August 31, 1991. Therefore, the earlier determination of August 16, 1991 was timely.

Analysis and Conclusions

Subsidy

The first issue to consider is whether the amounts paid as subsidies should be included in the gross receipts. I note that this same issue was considered by Staff Counsel Tony Nevarez in the Decision and Recommendation of July 17, 1990. (See Exhibit 1 attached.) In that decision, Mr. Nevarez held that the subsidy payment would be included as part of petitioner's "gross receipts" as defined under Revenue and Taxation Code Section 6012(b)(2). He found that the facts relating to petitioner's prior petition were distinguishable from Szabo in that the employees of Szabo's clients paid for the meals at the time of service, while in petitioner's case, it was the employers who made payment. He also concluded that the meals were not sold for resale to the employers because petitioner did not present evidence of a resale certificate or alternative evidence in order to satisfy the requirements of Regulation 1668(c). He noted that the employers' personnel never participated in the preparation or serving of meals and that petitioner's contracts with its clients specifically required petitioner to operate the dining rooms, purchase the food, and prepare and serve the meals. Meals were only served by petitioner's personnel. He also held that Regulation 1603(k)(3) did not apply because petitioner was not a restaurant, hotel, club, or association in the business of selling meals. Although petitioner presents a few additional arguments in the current petition, the facts remain essentially the same. On March 20, 1991, the Board adopted this decision without adjustment. We agree with this decision, and that Szabo is distinguishable, for the reasons stated.

As to whether Mr. Nevarez previously indicated in his November 13, 1990 letter that showing employee reimbursement to the employer would be sufficient proof to exempt the subsidy payment, it is noted that in the last paragraph of page 3 and first paragraph of page 4, he states as follows:

"Had you proved what amounts were paid as consideration for the meals, and that the employees themselves paid for the meals, then, as to these three contracts too, the amounts received as subsidy and fees would have been excluded from gross receipts....

"Absent the proof as to how much was paid for the meals and who paid for the meals, all amounts received under these three contracts are considered gross receipts. Mere references to `claim check' or `chit' signed by the employees are not the proof which will prove the case. The actual claim checks or chits, the documents reflecting the billings to the employees, or actual testimony from the employers' personnel is the credible and convincing evidence which would go a long way towards proving the case.... Since it was not proved that the employees paid for the meals, it must be presumed that the employers paid for the meals." (Emphasis added.)

As to this issue, I agree with petitioner's interpretation. However, I also find that this advice is incorrect, because whether or not the employees reimbursed the employers is irrelevant. Considering Mr. Nevarez was well aware of the facts of the case and could have simply stated that petitioner must prove payment was made by the employees direct, and he did not do so, petitioner's interpretation seems more reasonable.

Because Mr. Nevarez' advice appeared in written form, it must be determined whether petitioner may be entitled to relief under Revenue and Taxation Code Section 6596. This section provides that if a person's failure to make a timely return or payment is due to the person's reasonable reliance on written advice from the Board, the person may be relieved from the sales or use taxes imposed and any penalty or interest added thereto.

It is my conclusion that the earlier advice, although incorrect, does not entitle petitioner to relief. I see no evidence of petitioner's reliance on this advice. There is no evidence that petitioner contacted customers or changed its contracts to reflect the fact that employee reimbursement must be documented and proven. Without reliance, petitioner suffered no harm. Furthermore, even if petitioner had relied, it could have only done so from the date the misinformation was proffered (November 13, 1990) until the end of the audit period (December 31, 1990). Even then, petitioner would still be required to prove the employers received reimbursement from the employees.

I disagree with petitioner's argument that Szabo held tax could not be charged on the subsidy regardless of how it was handled between the food service provider and the employer. In the last paragraph of page 272, and first paragraph of page 273, the court states as follows:

"While it is true that the cost of services which are part of the sale must be included in gross receipts on the sale of tangible personal property and that amounts received from more than one source may be included in gross receipts it is still necessary to establish that amounts received from whatever source are consideration for the sale, including services." (Emphasis added.)

It is clear from this statement that amounts may be received from more than one source, and still be considered part of gross receipts.

Furthermore, I disagree with petitioner that in Szabo the Board stipulated that when an employer operates a cafeteria for employees and takes a loss on the sale of meals, no tax is payable on the subsidy. In the second paragraph of page 272 of the case, it states as follows:

"The Board and Szabo agree that payments for employees for cafeteria meals are subject to sales tax. They further agree that when an employer in operating a cafeteria for its employees takes a loss on the sale of meals no sales tax is payable on the implied subsidy provided by the employer to underwrite the cafeteria operation. They differ only on the applicability of the sales tax when an employer pays the subsidy to a third party to operate the employer's cafeteria." (Emphasis added.)

It is clear from the last sentence of the above quotation that the Board was distinguishing between situations where the employer operates a cafeteria, as opposed to a third-party operation such as the current case.

I also disagree with petitioner's position that the Board has failed to follow the rules set forth in Annotation 295.0300. The legal opinion which preceded Szabo and was the basis for this annotation, involved a payment from an oil company to new service station operators to provide a guaranteed profit for those operators. The opinion held the difference paid by the oil company to the operator was not part of the service station's taxable gross receipts because the payment is neither directly related to the sale of gasoline nor consideration for the transfer to the gasoline. Simply stated, payment for the gasoline purchased from the service station operator was made by a different party (the customer) than payment of the guaranteed profit or subsidy which the operator received from the oil company. Therefore, this annotation is clearly distinguishable from the present case where both payment for meals and subsidies are received from the same party.

Statute of Limitations

Revenue and Taxation Code Section 6487, which applies to the issuance of deficiency determinations, provides for a three-year statute of limitation period for taxpayers filing on other than an annual basis, and when there is no evidence of fraud or intent to evade the tax. Section 6488 allows this period to be extended providing the taxpayer consents in writing and before the expiration of the three-year period.

Applying the above sections, the determination issued on April 23, 1990 which billed additional amounts for the four quarters of 1987 was timely. The three-year period relating to the first quarter of 1987 had to be billed before May 1, 1990, and was. The remaining three quarters of 1987 were therefore timely billed as well. Although the later billing of August 16, 1991 again included the year 1987, it did not include an increase for this period. In fact, after determining the earlier billing of April 23, 1990 assessed tax in excess of the amount due, the auditor made the necessary adjustments which were reflected in this later billing.

Absent timely waivers, both the first and second quarters of 1988 with respective due dates of April 30, 1988 and July 30, 1988, would outlaw prior to the issuance of the August 16, 1991 billing. Prior to the expiration of the three-year statute (March 29, 1991), petitioner signed the required waiver form for the first quarter of 1988. On June 26, 1991, petitioner signed the second waiver form further extending through August 31, 1991 the period in which SUTD could timely issue the Notice of Determination for the first quarter of 1988. In that same form, petitioner also provided an extension for the second quarter of 1988 as well. Since the billing covering both the first and second quarters of 1988 was issued on August 16, 1991, and therefore prior to the extension date of August 31, 1991, the determination was timely issued preventing the running of the statute of limitations.

Alleged Violation of the Administrative Procedure Act

Petitioner misinterprets the language in Szabo where the court noted that the Board had not adopted any formal regulation interpreting the employer's subsidies. Petitioner interprets this statement as a mandatory requirement pre-empting the Board's authority to tax subsidies.

In the last paragraph on page 271, the court states as follows:

"A threshold problem concerns the scope of judicial review of the Board's assessment of sales taxes on the employer's subsidies. The Board characterizes its assessment as an administrative `classification', to which the judiciary should give great deference and which it may overturn only if made arbitrarily and capriciously.... However, this is not a classification case. The Board has not adopted any formal regulation interpreting employer's subsidies. Since Szabo has challenged the Board's finding that the employer's subsidies are subject to sales

tax, the Board's findings become subject to judicial review for errors in factual analysis and legal interpretation. Because the facts are undisputed, only the problems of applying the sales tax statute to the facts remains."

From the above language, it is clear the court was not requiring the Board to adopt a regulation interpreting tax application on employer's subsidies. Rather, the court was merely noting that the Board was characterizing the assessment of tax on subsidies as an administrative classification, and since the Board had not enacted a regulation, the court found it necessary to interpret the statutes to determine whether tax may be applied to the payment of the subsidy. In the first paragraph of page 272, the court took special note of Section 6012 (Definition of Gross Receipts) and in paragraph 3 of that page and for the remainder of the case, the court analyzes whether a subsidy may ever be considered part of gross receipts. It was never specifically stated or implied that the Board must first adopt a regulation prior to assessing tax on a subsidy.

Recommendation

SY AP XX XXXXXX-002 - Deny the claim.

SY AP XX XXXXXX-020 - Deny the petition.

Lucian Khan, Staff Counsel

Date

Attachments: Exhibit 1