

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

550.0343

In the Matter of the Petition)
for Redetermination and Claim) DECISION AND RECOMMENDATION
for Refund Under the Sales and)
Use Tax Law of:)
)
[H---], A) No. SN EA XX XXXXXX-XXX, -XXX
LIMITED PARTNERSHIP)
)
Petitioner)

The preliminary hearing on the above taxpayer's petition for redetermination and claim for refund was held on April 24, 1985, in Santa Ana, California.

Hearing Officer: H. L. Cohen

Appearing for Petitioner: Ms. B. H---
Ms. J. F---
Certified Public Accountant

Mr. J. V---
Attorney at Law

Appearing for the Board: Mr. M. Lewis
Principal Auditor
Santa Ana District

Mr. A. Morales
Auditor
Santa Ana District

Protested Items

A claim for refund of \$25,770.24 paid in accordance with a notice of redetermination was filed May 2, 1984. The claim was in respect to an audit which covered the period from April 1, 1977 through June 30, 1980.

Petitioner also filed a petition for redetermination with respect to an audit covering the period from July 1, 1980, through June 30, 1983. The amount upon which the protested tax is based is \$1,187,697.

Both protests involve unreported sales of meals.

Contention

The amount upon which tax was asserted is excessive.

Summary

Petitioner is a limited partnership which operates a dinner playhouse. The general partner is A--- D--- P---, Inc. (hereinafter referred to as the Corporation). The limited partners are, in general, passive investors.

Petitioner produces plays and musicals. It selects the work to be presented, hires the director, actors, dancers, and other production personnel, and provides everything required for the production. The corporation buys and prepares food and serves meals to petitioner's customers. The corporation hires all food preparation and serving personnel. Petitioner and the corporation occupy the same premises.

During both audit periods the corporation charged petitioner \$3.50 for each meal served plus tax reimbursement of \$.21 (6% of \$3.50). The meals do not include dessert or alcoholic beverages. The corporation offers desserts and alcoholic beverages for sale and makes a separate charge to the customers for these items.

During the first audit period petitioner made a lump sum charge for tickets. Tickets entitled the purchasers to a meal and attendance at the theatrical performance. During most of the second audit period petitioner's advertising material advised prospective customers that theater tickets could be purchased separately. Petitioner deducted \$3.71 from its lump-sum price for any patron who wished to purchase admission to the theater without purchasing the meal. Customers are not informed as to the existence of the corporation. Customers are informed that the charge includes sales tax on meals but are not told the amount of the charge.

For the first audit, the auditor concluded that petitioner was the retailer of the meals and was thus responsible for the tax. The auditor also concluded the entire lump-sum price was the amount upon which tax was due. This latter conclusion was based on regarding the admission as being incidental to the taxable sale of the meals. Tax was asserted on the entire lump-sum charge, with a credit allowed for the tax paid to the corporation.

Petitioner filed a timely petition for redetermination with respect to the first audit. A preliminary hearing was held before this hearing officer on September 24, 1981, in Santa Ana. The hearing officer issued his Decision and Recommendation under cover of a letter to petitioner's attorney dated October 28, 1981. The hearing officer recommended that no adjustment be made to the amount subject to tax, but recommended deletion of the penalty which had been added for failure to file returns.

Petitioner thereupon requested an oral hearing before the Board. The oral hearing was held in Arcadia on February 17, 1982. At this hearing, the Board concluded that petitioner should be treated the same as an American plan hotel under Sales and Use Tax Regulation 1603, Subdivision (a). That subdivision provides that where meals and room are provided for a lump-sum price, tax applies to the amount for meals based on a reasonable segregation between room and board on the hotel's books. The Board then engaged in a discussion of the proper allocation of petitioner's \$15 to \$19 lump-sum charge to food. There is some question from the transcript as to whether the Board intended to impose tax on 100 percent markup on food cost to the corporation with a minimum of \$3.50 or whether it was intended to impose tax on 100 percent markup of the \$3.50 cost to petitioner. There is reference to a \$7 taxable amount on page 20 of the transcript; there is reference to a \$3.50 increase in the taxable amount on pages 21 and 22 of the transcript. Clarification was attempted on page 22 where it seems that 100 percent markup on the cost of food to the corporation with a minimum of \$3.50 was named.

The audit staff subsequently reviewed the corporation's records and verified that the cost of food alone was less than 50 percent of the charge of \$3.50 made by the corporation to petitioner.

The notice of redetermination on this petition included tax based on a charge of \$7 per meal with a credit of the \$3.50 on which tax had already been paid. The notice of redetermination contains a statement of Board action to the effect that the Board found that the reasonable allocation for meals consisted of marking up the \$3.50 wholesale price paid for meals by 100 percent to arrive at the retail price which is subject to tax.

Petitioner requested a rehearing before the Board but the request was denied.

Petitioner then entered into a payment plan with the Santa Ana District Office. Payments were made on the liability as redetermined as follows:

<u>Date</u>	<u>Amount</u>
December 9, 1982	\$ 1,500.00
April 4, 1983	10,590.08
May 3, 1983	1,500.00
June 2, 1983	1,500.00
July 5, 1983	1,500.00

<u>Date</u>	<u>Amount</u>
August 3, 1983	1,500.00
September 1, 1983	1,500.00
October 3, 1983	1,500.00
November 1, 1983	1,590.08
December 1, 1983	1,590.08
January 15, 1984	<u>1,500.00</u>
Total	\$ 25,770.24

The claim for refund was filed May 2, 1984. Subsequently additional payments were made as follows:

<u>Date</u>	<u>Amount</u>
May 30, 1984	\$ 9,500.00
June 19, 1984	4,000.00
June 20, 1984	1,297.91
October 10, 1984	<u>662.46</u>
Total	\$ 15,460.37

Petitioner contends that the staff has misunderstood the Board's intent and that tax is due on only \$3.50 per meal, which amount was previously reported by the corporation. The entire amount paid by petitioner should therefore be refunded.

Subsequent to the first audit, petitioner continued to pay \$3.50 plus \$.21 tax reimbursement to the corporation for meals. Petitioner reported and paid no tax with respect to meals. Petitioner was audited for the period from July 1, 1980, through June 30, 1983. On January 27, 1984, a deficiency determination was issued based on an audit report dated November 17, 1983. The deficiency was based on sales of meals at \$7 per meal with a credit for tax paid to the corporation on meals at \$3.50 per meal.

The auditor established that the raw food cost to the corporation remained below 50 percent of the \$3.50 charge. The auditor noted, however, that a number of costs related to the food operation were paid directly by petitioner. These include rent, utilities and most advertising costs. The auditor felt that these costs which were borne by petitioner, reinforced the position that \$3.50 was not a reasonable allocation for the retail price of the meals. The auditor stated that the corporation could not make a profit if it had to pay its share of overhead costs.

Petitioner states that the contractual arrangement for meals between it and the corporation provides that all of the corporation's profits shall come from the sale of meals and beverages. Petitioner states that in fact that is where the corporation's profits are derived. Petitioner's profits are to come from its stage production activities. Under this arrangement it is unreasonable for the Board to insist that petitioner must make a profit on the retail sale of the meals.

Petitioner contends that the intent of the Board at the hearing is clear from the transcript, and that it was intended that the tax actually paid, based on \$3.50 per meal is all that was due. If the intent was unclear, or if the Board changed its position, the Board should have granted Petitioner a rehearing before issuing the final redetermination.

Petitioner contends that the \$3.50 charge by the corporation for meals constitutes a reasonable allocation for food within the meaning of Regulation 1603. Petitioner also contends that the auditor is incorrect in his statement that some meal service expenses are paid directly by petitioner. Petitioner maintains that the agreement between petitioner and the corporation strictly allocates the costs of the combined operation between the corporation and petitioner.

The auditor regarded petitioner, rather than the corporation, as the retailer of the meals. Because petitioner held no seller's permit and had filed no returns, a penalty for failure to file returns was asserted.

Petitioner states that the current audit period was more than half over by the time that the Board issued the notice of redetermination with respect to the first audit. Petitioner believed at least until that time that tax was being reported properly. Nothing was directly stated during the first audit with respect to petitioner obtaining a seller's permit and filing returns. Even after the issuance of the notice of redetermination, petitioner was not instructed to obtain a seller's permit until the second audit was started. When so instructed, petitioner promptly obtained a seller's permit and commenced filing returns. Petitioner filed a statement signed under penalty of perjury attesting to the above and requested relief from the penalty for failure to file returns.

Analysis and Conclusions

Before addressing the substantive issues, we must first look at a procedural issue. Section 6902 of the Revenue and Taxation Code provides that no refund with respect to a determination may be approved by the Board unless a claim for refund is filed within six months from the date the determination became final or within six months from the date of the overpayment, whichever period expires later. The claim for refund was filed May 2, 1984. Under the statute, the claim can be considered only for a period of six months prior to that date. That period commenced November 2, 1983. The total amount for which a refund can be considered is \$3,090.08 plus interest.

Except for the penalty for failure to file returns, the facts and issues are the same for both the claim for refund and the petition for redetermination. The Board has already ruled that petitioner should be treated the same as an American plan hotel under Sales and Use Tax Regulation 1603. The only issue is what constitutes a fair and reasonable allocation of charges to the meals sold by petitioner.

Petitioner lays stress upon its agreement with the corporation which allocates meal profits to the corporation and theatrical profits to petitioner. We do not believe that the Board is necessarily bound by an agreement of this type. The amount subject to tax on a sale of a meal by petitioner cannot be predetermined by petitioner's agreement with its supplier, the corporation.

Petitioner contends that the tax should apply only to \$3.50 per meal because this amount exceeds a 100 percent markup on raw food cost to the corporation and because the corporation makes a profit at this price. The auditor states that the corporation makes a profit at the \$3.50 price only because petitioner pays for a number of meal related expenses that should be the obligation of the corporation. Petitioner disagrees with the auditor, claiming that the auditor has not made a full review of the allocation of expenses between petitioner and the corporation. We believe that it is immaterial whether or not the corporation makes a profit. The issue is only whether \$3.50 is a fair and reasonable allocation of petitioner's charges to its customers.

As a general principal, where a taxpayer provides exempt services while also selling taxable tangible personal property in the same transaction, the taxpayer will not be permitted to allocate its entire profit to the nontaxable portion of its transaction, thus minimizing the tax liability.

Petitioner's agreement with the corporation is not the transaction with which we are concerned for purposes of the tax. The taxable transaction is between petitioner and its customers. Following the general principal, petitioner cannot be allowed to shift all profit and markup to the nontaxable element of the transaction.

The amount of markup to be added to petitioner's \$3.50 cost for meals is a matter of judgement. That judgement has already been exercised by the Board as a result of petitioner's hearing before the Board on the first audit. Regardless of what occurred at the hearing, the final conclusion of the Board is expressed in the notice of redetermination which was adopted at a point in time after the hearing.

Section 6592 of the Revenue and Taxation Code provides that the Board may grant relief from the penalty for failure to file returns if the failure was due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. A person seeking relief from the penalty must file with the Board a statement signed under penalty of perjury setting forth the facts upon which the claim for relief is based. Petitioner has filed the required statement, and the grounds

presented are valid. It should be recommended to the Board that relief be granted from the penalty for failure to file returns.

Recommendation

Deny claim. Petitions Unit to recommend to the Board that relief be granted from the penalty for failure to file returns. Redetermine without other adjustment.

H. L. Cohen, Hearing Officer

Date