CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:

PAHWA & ASSOCIATES, INC.,
dba Subway 28855

Petitioner

Account Number: SR Y CH 100-445910
Case ID 531030

Pinole, Contra Costa County

Type of Business: Subway restaurants

Audit period: 04/01/06 – 03/31/09

Item	Disputed Amount
Disallowed claimed exempt food sales	$357,430

Tax as determined	$58,035.43
Post-D&R adjustments	-14,029.32
Post SD&R adjustments	-13,179.85
Proposed tax redetermination	$30,826.26
Interest through 08/31/14	13,570.28
Total tax and interest	$44,396.54
Monthly interest beginning 09/30/14	$ 154.13

This matter was heard by the Board July 17, 2014. Although the Board voted regarding the matter, the vote was rescinded and the matter was taken under submission until the next Board meeting and is now scheduled on the nonappearance calendar.

UNRESOLVED ISSUES

Issue 1: Whether additional adjustments to the amount of disallowed claimed exempt sales of food are warranted. We find no further adjustments are warranted.

Petitioner began operating three Subway restaurants in California (in Richmond, El Cerrito, and Pinole) in July 2004. For audit, petitioner provided federal income tax returns, cash register tapes, general ledgers, and sales journals. The Sales and Use Tax Department (Department) compared the gross receipts reported on petitioner's income tax returns with petitioner's reported total sales and found no significant differences. The Department then compared the gross receipts with the costs of goods sold reported on petitioner's income tax returns, and computed book markups of 217 percent, 222 percent, and 210 percent for 2006, 2007, and 2008, respectively. Since the book markups seemed reasonable, the Department accepted the accuracy of petitioner's reported total sales. However, petitioner reported only 36 percent of its total sales as taxable sales, on average, which seemed low to the Department. Thus, the Department questioned the accuracy of petitioner's reported taxable sales.

To determine the average ratio of petitioner's taxable sales to its total sales, the Department conducted three observation tests, one at each location, from 9:00 a.m. to 3:00 p.m. on October 30, 2009, November 4, 2009, and November 6, 2009. Results of these tests showed taxable sales ratios of 62 percent, 50 percent, and 41 percent for the shops in Richmond, El Cerrito, and Pinole, respectively. The Department concluded that the taxable sales ratios from the observation tests supported petitioner's recorded taxable sales ratios of 60 percent, 47 percent, and 58 percent for the shops in Richmond, El Cerrito, and Pinole, respectively, for the week ending November 10, 2009, and originally established audited taxable sales by multiplying petitioner's recorded total sales for each location by the recorded taxable sales ratios from the one-week test. However, petitioner provided documentation showing that it added toaster ovens to the shops in El Cerrito, Richmond, and Pinole in July 2006, May 2007, and June 2007, respectively, and argued that the recorded taxable sales ratios for the week ending November 10, 2009, were higher than its taxable sales ratios prior to adding taxable toasted sandwiches to its menu. Based on this argument, the Department reduced the taxable sales ratios applied to petitioner's recorded total sales for the periods prior to the installation of the toaster ovens at each location by 10 percentage points. Results of this revised audit showed disallowed claimed exempt food sales of $622,558 for the audit period. Following the appeals conference, the Department conceded that the audited taxable sales ratio for each location for the four quarters following the installation of the toaster ovens should be reduced by 5 percentage points to allow for a gradual increase in sales of toasted sandwiches. This adjustment reduced the deficiency measure by $115,467, from $622,558 to $507,091.

Petitioner contends that the taxable sales ratios from the Department's observation tests should be reduced by 1.25 percentage points for each quarter from the fourth quarter of 2009 (4Q09), when the baseline taxable sales ratios were computed, back until the quarters in which the toaster ovens were installed to accurately reflect the gradual increase in Subway restaurants' taxable sales during the audit period. Petitioner argued that applying the taxable sales ratios computed for 4Q09 as the baseline taxable sales ratios for the last quarter of the audit period, 1Q09, did not allow for the continuing gradual increase in the percentage of its sales subject to tax during 2009. Alternatively, petitioner proposes that the baseline taxable sales ratios for the last quarter of the audit period be established by using a taxable sales ratio of 48 percent from the "purchasing method" for nearby Subway restaurants, or by using the taxable sales ratio of 45 percent from an email sent by the Department's Chief of Field Operations (CFO) to all district offices regarding taxable sales by Subway restaurants, generally.[1]

Petitioner provided no documentation or other evidence to show how a taxable sales ratio of 48 percent based on the "purchasing method" used by other Subway owners might accurately reflect its sales. Regarding petitioner's contention that the taxable sales ratio of 45 percent identified in the CFO's email for 2009 should be used as the basis for determining audited taxable sales for 1Q09, we find that petitioner's reported taxable sales ratios of 54 percent, 58 percent, and 60 percent for 2Q09, 3Q09, and 4Q09, respectively, show that petitioner's taxable sales ratios were not consistent with the CFO's guidelines. Given that not all Subway restaurants are the same and several factors affect their taxable sales ratios, we concluded that the sales observed by the Department and recorded sales shown in petitioner's cash register tapes constitute the most reliable evidence of petitioner's operations.

We find that reducing baseline taxable sales ratios for 4Q09 by 1.25 percentage points for each quarter back until the quarters in which the toaster ovens were installed, as petitioner proposed, accurately reflects the gradual increase in Subway restaurants' taxable sales during the audit period. However, while petitioner contends that the taxable sales ratios from the Department's observation tests should be used as the baseline ratios for 4Q09, petitioner failed to explain why the Department's observations from 9:00 a.m. to 3:00 p.m. on three days more accurately represent its sales overall than its recorded sales for entire days. We examined petitioner's cash register tapes for each day of the Department's observation tests, and computed taxable sales ratios of 56 percent, 57 percent, and 53 percent for the shops in Richmond, El Cerrito, and Pinole, respectively. These taxable sales ratios

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[1] At the appeals conference, a copy of an email sent on July 28, 2011, by the Department's Chief of Field Operations (CFO) to all district offices listing acceptable taxable sales ratios for Subway restaurants was discussed. In the email, the CFO concludes that the average Subway operation had a gradual increase in its taxable sales ratios from 2007 through 2010, and states that, as a result, the Department has developed taxable sales ratios of 40 percent for 2007 and 2008, 45 percent for 2009, and 55 percent for 2010, to account for this gradual increase that should mirror sales by the majority of typical, stand-alone Subway restaurants.

are similar to the ratios computed from the cash register tapes for the one-week test, but, unlike the one-week test, the cash register tapes for the three days are supported by the Department's observations for a part of each day. Also, use of the ratios computed using the cash register tapes affords a benefit to petitioner as opposed to the one-week test. Accordingly, we used these ratios as the baseline taxable sales ratios for 4Q09. We reduced the ratios by 1.25 percentage points to compute audited taxable sales ratios for each previous quarter back until the toaster ovens were installed. Applying the audited taxable sales ratios for each quarter to the respective recorded total sales for each location results in a reduction to the amount of disallowed claimed exempt sales of food from the amount originally determined, $622,558, to $357,430. We find that no additional adjustments are warranted.

OTHER MATTERS

None.

Summary prepared by Lisa Burke, Business Taxes Specialist III