STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-00XX
TELEPHONE (916) 324-2656
FAX (916) 323-3387
www.boe.ca.gov

December 21, 2000

Ms. B--- S---
Tax Director
M--- L--- G---
XXXXX --- --- Drive
---, MN XXXXX

Re: M--- I---, Inc.;
Nexus

Dear Ms. S---:

This is in response to your October 10, 2000 letter to Business Taxes Compliance Specialist Bruce Barkley of the Board's Out-of-State District office. The district office requested that S---.com register with this agency to collect California use tax. We have subsequently learned that S---.com and SC---.com are electronic commerce web sites owned and operated by M--- I---, Inc. ("MLGI"). MLGI is a subsidiary of The M--- G---, Inc. ("TMG"), which operates S--- and SC--- retail stores throughout California. In your letter, you state your belief that, under the United States Constitution, MLGI cannot be required to register and to collect California's use tax. We disagree. As discussed below, MLGI's activities in this state do not come within the safe harbor set forth in applicable United States Supreme Court decisions, and come within California's use tax nexus statute.

FACTS

From your letter and our investigation, we believe certain pertinent facts are without dispute. TMG is a corporation which, among other activities, operates SC--- and S--- retail stores throughout California. MLGI is a subsidiary of TMG, and is engaged in electronic commerce including operation of the www.SC---.com and www.S---.com Internet web sites. You have represented, and we will therefore assume for purposes of this letter, that MLGI does not maintain any place of business as described in subdivision (c)(1) of Revenue and Taxation Code 6203. If this is incorrect, our opinion would obviously be different.

Both TMG and MLGI offer gift cards for sale. The cards operate like gift certificates, allowing use of the cards to make purchases from TLG's S--- and SC--- stores, and also to make online purchases through MLGI's Internet sites, www.S---.com and www.SC---.com. Signs are posted inside TLG's retail stores informing customers that they may purchase gift cards, which may be used online or at the named retail stores. Additionally, at the S--- retail store, promotional literature is distributed, with the heading "Are you online? So are we...with great prices and a huge selection!" The cards continues, "Tell us a little about yourself and we will let you now about special sales and events. Just fill out this form and drop it off at the store." Finally, signs are posted at S--- stores which state that customers can receive 20% off on their online orders when they shop with a gift card.

The United States Constitution prohibits the imposition of a use tax collection duty on an out-of-state retailer only if that retailer lacks a "substantial nexus" with the taxing state. The threshold requirement is that the retailer have some physical presence in the taxing state. (See generally *Quill Corp. v. North Dakota* (1992) 504 U.S. 298 (holding that physical presence is required to overcome the dormant Commerce Clause, but is not required to comply with the Due Process Clause).) The United States Supreme Court created a safe harbor for retailers whose only connection with the taxing state is by common carrier or the United States mail. *National Bellas Hess v. Department of Revenue of Illinois* (1967) 386 U.S. 753, 758. More recently, The Supreme Court in *Quill* confirmed the safe harbor announced in *National Bellas Hess*. *Quill*, supra at 315.

The permissible nexus reach in California, as relevant here, is set forth in Revenue and Taxation Code section 6203, subdivision (c)(2), which states that a "retailer engaged in business in this state" includes:

> "Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property."

Therefore, the Board may impose a use tax collection duty on an out-of-state retailer, based on the activities of another person in California ("any representative, agent, salesperson, canvasser, independent contractor, or solicitor"), when two conditions are present: (1) the other person must be authorized by the retailer to act on its behalf; and (2) the other person's activity must be "for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property." The terms "delivery, installation, assembling, or the taking of orders" are not relevant in this case. However, we believe that under the facts described above, TMG, through its retail stores located throughout California, is authorized by MLGI to perform "selling" activities on MLGI's behalf.

We believe that the term "selling" encompasses more than merely the taking of the order and the delivery of the item purchased. Taking of orders and delivering them are specifically covered by subdivision (c)(2). "Selling" must mean something more.

We believe that an in-state retailer who gives its customers coupons for purchases from an out-of-state retailer is soliciting sales on behalf of that out-of-state retailer, such that the out-of-state retailer is engaged in business in California. We have previously explained that an in-state retailer, which distributes catalogs to its own employees featuring mail-order opportunities of an out-of-state subsidiary, is an agent of the subsidiary for the purpose of selling tangible personal property. (See Sales and Use Tax Annotation 220.0047 (11/6/79), a copy of which is enclosed.) The sale of gift cards by TMG at its California retail locations, which may used to make purchases through MLGI's Internet web sites, constitutes the same selling activity as distribution of coupons or catalogs, with TMG acting as the in-state representative of MLGI. Therefore, MLGI has a duty to register with the Board, and to report and remit use tax arising from its California sales.

In your letter, you assert that the out-of-state retailer, MLGI, lacks control and authority over the in-state parent, TMG, such that no agency relationship exists. As set forth above, however, an agency relationship is not required. Section 6203, subdivision (c)(2), provides that a <u>representative</u> of the out-of-state retailer will qualify to create nexus. Clearly, in selling gift cards which can be used to purchase tangible personal property at MLGI's web sites, TMG acts as MLGI's representative.

You further argue that TMG, in offering gift cards for sale, acts on its own behalf, and not on the authority of MLGI. However, the test under subdivision (c)(2) of section 6203 is whether the in-state representative (TMG) is <u>authorized</u> by the out-of-state retailer (MLGI) to act in the given selling manner. There can be no doubt here that MLGI authorized TMG to include the MLGI Internet sites on the gift cards as locations where the gift cards could be redeemed. In your letter you stated that MLGI is a distinct and separate corporate entity from TMG, and that MLGI maintains its own property, employees, accounts, and records. It is therefore inconceivable that there is not some form of agreement or understanding between MLGI and TMG which allows TMG to sell gift cards redeemable at MLGI's on-line sites.

You also argued that the sale of the gift card was not a sale of tangible personal property, and is therefore not defined as part of the selling process. We agree that the sale of a gift card is not a taxable transaction, just as the selling of a gift certificate is not a taxable transaction. (See Sales and Use Tax Annotation 280.0350 (12/19/78), a copy of which is enclosed.) We disagree, however, on whether the sale of the gift card is selling activity within the meaning of subdivision (c)(2) of section 6203. Clearly the selling of a gift certificate for a bricks and mortar retail store constitutes selling activity. The recipient of the certificate may have had no intention of shopping at the subject retail store. After presentation of the certificate, however, the recipient has a reason to visit the store – in order to purchase merchandise using the gift certificate instead of cash. The gift of the certificate enhances the retailer's ability to sell some tangible personal property. The same situation occurs when someone purchases a gift card from a S--- or a SC--- retail store. Either the purchaser or a donee of the purchaser may use the gift card at one of MLGI's Internet sites. That they may also use it at one of TMG's retail stores is irrelevant. Including the option to use it online increases the chances of a sale of tangible personal property by MLGI. Or stated another way, if TMG did not want its customers to shop online through MLGI, it would not have included the online option on the gift cards.

You argue that the parties do not know whether merchandise will be purchased from MLGI when gift cards are sold. However, the success of the venture is irrelevant. What matters is that MLGI is attempting to induce sales of tangible personal property by using TMG as its California representative to sell gift cards which are redeemable through MLGI's web site.

You assert that there is no purposeful direction of activities by MLGI towards creating and maintaining a California marketplace. We believe the fact that MLGI's Internet sites are featured on the gift card belies that argument. Like many "dot com" retailers, MLGI is clearly attempting to capture a portion of California's market share for Internet purchases of tangible personal property, and has authorized the California retail stores of its parent company to promote this effort. The gift cards not only create awareness of MLGI's Internet web site, they promote its sales by creating an incentive to shop there - a method to purchase tangible personal property without transmitting confidential credit card information through the Internet.

Next, you argued that TMG does not perform any activities connected with MLGI's sale of tangible personal property. It may be true that TMG does not take orders for tangible personal property on behalf of MLGI, does not distribute or accept returns of MLGI's merchandise, and does not service MLGI's merchandise. However, the absence of these activities on TMG's part does not preclude a finding of nexus. We have previously found nexus on very similar facts, as set forth in Annotation 220.0047 (11/6/79) (discussed above), where the parent entity distributed catalogs in California on behalf of its out-of-state subsidiary. Taking orders and handling merchandise are not required elements for finding of nexus.

The case of *Standard Pressed Steel Co. v. State of Washington Department of Revenue* (1974) 419 U.S. 560 is particularly instructive. In that case, the out-of-state taxpayer had a single employee in the taxing state, and that employee worked out of his home and consulted with the taxpayer's customer. The employee took *no* orders. The taxpayer argued that imposition of the tax was not constitutional because the in-state activities were so thin and inconsequential. The Court phrased the question as "whether the state has given anything for which it can ask return," and stated that "[w]e think the question in the context of the present case verges on the frivolous." (*Id.* at 562.) As the Court noted, the taxpayer's employee in the taxing state "made possible the realization and continuance of valuable contractual relations" between the taxpayer and its customer. (*Id.*) It is clear that the very same, and more, can be said about the physical presence of TMG client in this state. That presence is directly related to MLGI's sales of tangible personal property to California consumers, and it enables MLGI to maintain or expand the market for its product in this state.

You also asserted that from MLGI's perspective, accepting a gift certificate is similar to accepting a VISA card to pay for merchandise. You argue that use of a VISA card does not create nexus, and the mere sale of a gift certificate is not part of the selling process and does not create nexus. We disagree. The activity creating the nexus is not MLGI's acceptance of gift cards at the time of sale, it is TMG's promoting the sale of merchandise on MLGI's Internet sites by selling the gift cards. As discussed above, the sale of a gift card is selling activity within the meaning of section 6203, as it encourages holders of the gift cards to visit the Internet sites to make purchases of tangible personal property.

Finally, you noted that the Governor of California recently vetoed Assembly Bill 2412, an action that was urged by Board of Equalization member Dean Andal. You argue that the Board's position in requiring MLGI to register and begin collecting and remitting use tax is a "direct contradiction to public pronouncements of these representatives." This argument is flawed. AB 2412 would have amended section 6203 to add a new subdivision (g), which would have created an "attributional nexus" rule based on common ownership of an in-state retailer and an out-of-state retailer, as an additional method to find the out-of-state retailer as engaged in business in California. Because we believe MLGI is a retailer engaged in business pursuant to subdivision (c)(2) of section 6203, the veto of AB 2412 is irrelevant to our analysis.

For these reasons, MLGI must register with this Board. It should do so without delay, in order to reduce its liability for interest and penalties.

Sincerely,

Jeffrey H. Graybill
Tax Counsel

JHG:ef
Enclosures
Annotations: 280.0350 (12/19/78)
220.0047 (7/6/79)

cc: Mr. Bruce Barkley - OH