

M e m o r a n d u m

702.1050

To : Rich Goodrich
Local Tax Appeals Auditor Sec. (MIC:49)

Date: October 30, 2002

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Subject: SR -- XX-XXXXXXX
E---
Place of Sale- Electronically Processed Internet Orders

I am answering your memorandum to me dated August 22, 2002. You ask for our opinion as to the place of sale when an Internet order process is used.

BACKGROUND

You describe the taxpayer's operation as follows:

"e--- is headquartered in --- ---, with a warehouse in ---, California and in Virginia. The servers are located in --- and in --- ---. e--- also had a 1-800 phone for phone orders which is answered by some staff at --- ---, but that represents only about 1% of all sales. e--- goal is to process all internet orders electronically. A typical internet transaction is as follows:

- An internet user chooses the items he/she wishes to purchase. After credit card information is entered, the customer clicks the checkout icon.
- "The credit card information is electronically processed, and a hold is places on the appropriate funds. This processing is done through the e--- server in ---, California.

- The order information is then transmitted to the e--- server in --- ---, California.
- The e--- server in --- --- electronically sorts the order by zip code and product availability, and then transmits the information to the appropriate warehouse either in Virginia or ---. An order fulfillment manager at the warehouse receives the information, fills, packages, and ships the order. After shipping, a capture of funds request is issued to collect the funds originally placed on hold.
- There are safeguards built in to the company's software program which when certain criteria are met, will cause a flag, and the order is reviewed by a customer service rep. The rep can re-enter the order data or have the customer re-enter the data. This communication is made by e-mail though the customer could respond via e-mail or telephone. e--- had indic[a]ted these occurrences or infrequent and not material.

“e--- currently allocates all the local sales tax to the --- --- headquarters because that is where the order is processed and sales reports are generated.”

In a telephone conversation on October 29, 2002, you indicated that this matter was kicked off by an inquiry from the City of C---. That inquiry established a date of knowledge of September 28, 1999. The reallocation period thus begins with 4Q98. During the entire period, e--- was allocating all local sales tax revenues directly to --- ---. The reorganization discussed below occurred effective January 1, 2000. Resolution of this matter has been delayed by factual problems and also by the recent amendments to Regulation 1699.

B. Tax Consequences to e---.

You asked two questions.

Scenario 1. “Is the POS for e--- internet sales the location where the order is electronically processed in --- ---, or is it the location where a person is first involved at the warehouse?”

Although you are primarily concerned with local sales tax allocation, we should tie up the package with the easy issue first. You indicate that orders may be fulfilled from warehouses located either in ---, California, or in Virginia. Generally in such situations, the sale occurs at the point of shipment. (Cal. U. Comm. Code 2401(2).) When such point of shipment is outside of California, the sale occurs outside of this state—in this case, Virginia. Therefore, under Regulation 1620(a)(2) and (b)(1), the sales to

California customers fulfilled by the Virginia warehouse are subject to use tax, with the local use tax revenue being allocated to the place of use (usually the place of delivery), through the medium of the county-wide pool where it is located.

In order for local sales tax to be allocated to a city, the retailer must have a place of business there in which the retailer has a proprietary interest, and employees of the retailer must be involved in the transaction. (In this discussion, the word "city" refers to a county as well unless otherwise specified.) Regarding web servers as places of sale, the Board recently adopted Regulation 1699(i) as follows:

"The location of a computer server on which a web site resides may not be issued a seller's permit for sales tax purposes except when the retailer has a proprietary interest in the server and the activities at that location otherwise qualify for a seller's permit under this regulation."

This subdivision put the staff conclusion in Annotation 710.0013.600 (12/30/97) into the regulation. There, we concluded that when the order is placed through an Internet web site and forwarded through the site to a location in California where the retailer's employees process the order, the place where the order is processed is the place of sale for local sales tax purposes. Most often, such place will be at a warehouse, but that is not required. The rationale for this result is that section 7205 and Regulations 1699(a) and 1802(a) require the Board to determine where persons customarily contact the retailer's employees for the purpose of making sales. In addition, the server, on which the web site is located, often does not belong to the retailer. Thus the location of electronic forwarding equipment, be it telephone switching equipment or a web server, cannot be, in and of itself, a place of sale.

Annotation 710.0150 is directly on point:

"An on-line retailer has no sales office in California. Its corporate headquarters, the computer server on which the retailer's website is located, and the warehouse from which orders are shipped are located in three different California cities. Customers place orders on the retailer's website. The orders are transmitted electronically to the warehouse, where the orders are processed and the goods are placed on the retailer's truck for delivery to the customers. A website is not a place of business for purposes of the local sales and use tax. Here, the retailer's employees first become involved in processing the orders at the warehouse. Accordingly, the warehouse is the place of sale for local sales tax purposes. The local sales tax is allocated to the place where the customer negotiates the sale with the retailer. 8/18/99."

The slight variation between the fact pattern in this case and the one in the annotation is that two computers are involved. The customer places the order with the web server, and the web server transmits the order to the corporate server. The latter does the final processing and then transmits the order to the warehouse, where human hands touch it for the first time. This is a distinction without a difference. Employees of the retailer do not come in contact with the order, in the normal course of business, until after the corporate server transmits the order to the warehouse. Consequently, under the annotation, --- is the place of sale for Internet orders fulfilled in California in this scenario.

Scenario 2. "E--- created a buying company, e--- LLC during the reallocation period which acted as the sole supplier of their product. This subsidiary now owns the warehouses, and has their own employees. They also have their own seller's permit but makes no taxable sales since all sales are for resale to the parent."

This factual wrinkle causes a problem. Section 7205 and Regulation 1802(a) are very clear that, in order for a location to be considered a "place of sale" for local tax purposes, employees of the retailer must participate in the sales negotiations at a place in which the retailer has a proprietary interest. (Annots. 710.0013 (7/18/91) & 710.0024 (8/5/83).)

What we have here is essentially a three-party transaction in which a subsidiary of the retailer drop ships the property sold to the retailer's customers. As you note, e--- LLC sells the property to e--- ex tax for resale. Thus, there is no tax at all on the sales made by e--- LLC, so no revenue can be allocated to ---. Therefore, the taxable event is e---' retail sale to the consumer. The second paragraph of Section 6007 does not make e--- LLC the retailer, since e--- is a California retailer. e---' web server in --- also cannot be considered a place of sale, as it merely forwards orders to the corporate server in --- --- which then forwards the order to the warehouse, which now belongs to a third party. (Reg., 1699(i).) Moreover, you point out that e---' --- office does not come into contact with the sales at all unless there is a flag, and that occurs after the order is placed.

Here, then, we have a retailer selling property in California with no place of business in this state that participates in the sales at issue. The applicable tax is sales tax. As the retailer has only one office in the state, the only place to which the local sales tax revenue can be allocated is --- ---, where the headquarters is located. In in-state transactions, the retailer's employees must participate in negotiating the sale for local sales tax to be allocated directly. By contrast, in interstate transactions the retailer's employees may participate in the transaction after the sales negotiations to give the same result. (Regs. 1620(a)(2) & 1802(a); Long Beach Container Terminal (Bd. Memo. Opn. 11/17/94).) Since e---' employees do not become involved in the sales, if at all, until after the order is placed, the local sales tax derived from these transactions must be allocated to --- --- through the medium of the --- --- County-wide pool.

You indicate that some sales, fewer than 1% of the total, are made through a phone bank located in --- ---. We agree that local sales tax revenues for the entire inquiry period derived from the phone bank should be allocated to --- ---. e--- has a permit for this operation, but this makes no difference in the analysis as these employees have nothing to do with the sales at issue.

D. Reallocation.

Section 7209 provides that the Board “may” redistribute local tax. “The rule is that “may” used in legislation is to be given its common and ordinary meaning and to be construed as permissive or conferring discretion. It is only to be construed as mandatory when it appears from the terms of the statute in which it is used that it was the clear policy and intent of the legislature to impose a duty, and not simply to confer a discretionary power, and when the public or third persons have a claim de jure to have the power exercised, that it is to be construed in a mandatory sense. (Kemble v. McPhail, 128 Cal. 444, [60 Pac. 1092.])” (Roberts v. Duffy (1914) 167 Cal. 629, 638.) Section 7209 was enacted not to confer reallocation authority upon the Board but to put a limit on reallocations in order to avoid causing the losing city severe financial hardship. There is nothing in the legislative history of Section 7209 to indicate that the Legislature was directing the Board to make reallocations in all circumstances. Indeed, the very circumstances that provided the motivation for the statute indicate that the Legislature wanted the Board to have discretion in whether or not to make a reallocation.

As a result we have previously determined that revenue should not be reallocated in circumstances where the factual and legal issues that resulted in a prior mis-allocation are only just now being resolved. In addition, Internet sales is an evolving area with new issues arising all the time, as shown by the factual difference between this case and the one in Annotation 710.0150. Especially in view of the fact that the losing city will have already spent the money previously allocated to it, reallocations should not be made under such circumstances.

In this case, we have two separate factual circumstances. In the first, e--- owned and operated the warehouse. After the reorganization, e--- spun off the warehouse into a separate legal entity. We assume for the purpose of this discussion that e--- LLC meets the criteria for a buying company that the Board recently promulgated in Regulation 1699(h). After the reorganization, as noted above, the warehouse company makes sales for resale to the retailer. Two different local tax results are thus mandated.

The first case - Internet orders processed by the retailer’s employees at a separate location - has been the subject of two previous annotations -- 710.0013.600 and 710.0150. The back-up letters were written in 1997 and 1999, respectively, and the annotations were published in Mailings 1999-2 and 2000-2, respectively. The Board’s

interpretation of its regulations in the case of Scenario 1, then, had been in effect since at least a year prior to the beginning of the reallocation period. It was re-published once in another annotation and again in the regulation. Therefore, we conclude that, as regards Scenario 1, the facts and law were clear so that local sales tax revenues derived from e---' Internet sales processed at its warehouse in the City of C--- should be reallocated from --- --- to C--- for the period 4Q98 through 4Q99.

Scenario 2 - Internet orders processed by the personnel of a different retailer who sold the property ex tax for resale to e--- - is a different case. While the basic set-up is the same (the order is placed through the web site and processed by a retailer's employees at the warehouse), a crucial element has changed. The employees processing the order do not belong to the retailer, e---, but to a separate legal entity, e--- LLC. As a result, since there is no tax on e--- LLC's sales to e---, the warehouse cannot be a place of sale under Regulation 1802. e--- itself has no office that comes into contact with the sales at their inception. Therefore, under the above authority, the local sales tax revenues from e---' Internet sales after January 1, 2000, should be allocated to --- --- through the medium of the --- --- County-wide pool. Pool allocation in this case gives a fairer result than direct allocation to --- ---. C--- carries the bulk of the burden of the entire operation, as it plays host to the warehouse operation, while --- --- only has the administrative headquarters. With pool allocation, both cities will get some revenue to recompense them for their expenses. Under the standards stated above, however, and given the confusion in this area, we recommend that the revenue that --- --- has already received under Scenario 2 from and after 1Q00 not be reallocated. Such revenue must be reported pursuant to our opinion beginning 1Q03.

JLW:ljt

Cc: Mr. Larry Micheli (MIC:27)
Mr. Chuck Gentry (MIC:39)