BOARD OF EQUALIZATION

BUSINESS TAXES COMMITTEE MEETING MINUTES

HONORABLE BETTY T. YEE, COMMITTEE CHAIR
450 N STREET, SACRAMENTO
MEETING DATE: JULY 8, 2008, TIME: 9:30 A.M.

ACTION ITEMS & STATUS REPORT ITEMS

Agenda Item No: 1

Title: Informational Hearing: Nexus and Online Retailers; Recent Action New York and Texas.

Issue/Topic:

Informational hearing regarding nexus and collection of tax by online retailers in light of nexus issues in the States of New York and Texas, including a presentation by Amazon.com

Committee Discussion:

Board Member Yee introduced the topic and extended the invitation to Amazon.com to address the Board.

Staff summarized the California statute regarding nexus and the recent activities in New York and Texas.

Mr. Ernest Dronenburg of Deloitte Tax LLP, representing Amazon.com explained that their presentation will explain what associates are and how they relate to Amazon.

Mr. Richard Prem, Vice President - Indirect Taxes & Tax Reporting, Amazon.com, described Amazon’s business model and explained that the company’s focus is on technology. His presentation provided a brief history of the company and profiled its activities and products. Mr. Prem described the activities of its subsidiary, Amazon Services, which is focused on providing full service to small businesses. He explained that Amazon.com provides third party sellers with an opt-in tax program if they wish to subscribe.

Mr. Prem responded to various questions posed by Board Members regarding Amazon.com’s operations, relationship with third party sellers, tax activities, and status of litigation in New York.

Mr. Lenny Goldberg, with the California Tax Reform Association and also representing the Northern California Independent Booksellers Association, addressed the Board to express that Amazon’s associates in California are well known. They are fundraising organizations such as schools, churches, and other nonprofit organizations that represent Amazon in this state. He indicated Amazon.com has advanced technology to collect taxes in various states without experiencing undue burden.

Ms. Michele Pielsticker of the California Taxpayers' Association and Ms. Kyla Christoffersen of the California Chamber of Commerce addressed the Board to reiterate that nexus requires physical presence in this state. They testified that a reach to in-state presence based on computer server or online activities would have the unintended consequences of behavioral changes and litigation activities that would cause businesses to leave the state. In addition, Ms. Christoffersen indicated that nexus issues are considered at the federal level. She expressed the view that an outcome at the federal level would provide uniformity and clarity for the fifty states.

Dr. Chu and Ms. Yee asked Amazon.com to encourage their associates and customers to remit all taxes due to the Board.

Committee Action

This was a discussion item only. No Board action or recommendation was required or taken.

Agenda Item No: 2

Title: Proposed Revisions to Regulation 1602.5, R*eporting Methods for Grocers*, Regarding the Use of the Electronic Scanning Systems

Issue/Topic:

Whether to eliminate from the regulation the requirements that a grocer notify the Board and obtain Board approval before using an electronic scanning system for tax reporting purposes.

Committee Discussion:

Staff described the proposed changes to do the following: Eliminate the requirements that a grocer notify the Board and obtain approval before using an electronic scanning system for tax reporting purposes; and delete language urging grocers to seek Board approval prior to using the modified purchase ratio and the cost plus markup methods of reporting the tax.

Committee Action/Recommendation/Direction:

Upon motion by Mr. Leonard, seconded by Dr. Chu, the Committee unanimously approved and authorized for publication the proposed regulatory amendments. There is no operative date, and implementation will take place 30 days after approval by the Office of Administrative Law. Copy of the proposed amendments to Regulation 1602.5 is attached.

/s/ Betty T. Yee

Honorable Betty T. Yee, Committee Chair

/s/ Ramon J. Hirsig

Ramon J. Hirsig, Executive Director

BOARD APPROVED

at the July 8, 2008 Board Meeting

/s/ Diane Olson

Diane Olson, Chief
Board Proceedings Division

Regulation 1602.5. Reporting Methods for Grocers.

(a) FOOD PRODUCTS EXEMPTION — IN GENERAL. Tax does not apply to sales of food products for human consumption. Accurate and complete records of all purchases and sales of tangible personal property must be kept to verify all exemptions claimed as sales of exempt food products.

In preparing returns, grocers may use any method of determining the amount of their sales of exempt food products which does not result in an overstatement of the exemption. Grocers must be prepared to demonstrate by records which can be verified by audit that the method used properly reflects their sales of exempt food products.

(b) REPORTING METHODS.

(1) PURCHASE-RATIO METHOD. One method which may be used is the purchase-ratio method sometimes referred to as the “grocer’s formula”. Under this method, grocers may claim as sales of exempt food products that proportion of their total gross receipts from the sale of “grocery items” that the amount of their purchases of exempt food products bears to their total purchases of grocery items.

If the grocer elects to use the purchase-ratio method of reporting, the following criteria should be followed:

(A) The purchase-ratio method may be used only by grocers and only with respect to sales of “grocery items”.

(B) Grocers selling clothes, furniture, hardware, farm implements, distilled spirits, drug sundries, cosmetics, body deodorants, sporting goods, auto parts, cameras, electrical supplies, appliances, books, pottery, dishes, film, flower and garden seeds, nursery stock, fertilizers, flowers, fuel and lubricants, glassware, stationery supplies, pet supplies (other than pet food), school supplies, silverware, sun glasses, toys and other similar property should not include the purchases and sales of such items in the purchase-ratio method. These items are referred to as “nongrocery taxable” items.

When the purchase-ratio method is used for reporting purposes and sales of nongrocery taxable items are computed by the retail extension or markup method, the computation of nongrocery taxable sales should include adjustments for beginning and ending inventories of these items and may include adjustments for shrinkage as specified in (d) below.

(C) Grocers selling gasoline, feed for farm animals, farm fertilizers or who operate a snack bar or restaurant, or sell hot prepared food should not include the purchases and sales of such items or operations in the purchase-ratio method.

(D) The purchases and sales of meat, fruit, produce, delicatessen (except hot prepared food or food sold for immediate consumption at facilities provided by the grocer), beverage (except distilled spirits in the liquor department) and bakery departments must be included in the purchase-ratio method if these departments are operated by the grocer.

(E) The records should be complete and adequate and all sales and purchases should be properly accounted for in the records. All purchases of exempt food products, grocery taxable items and nongrocery taxable items should be segregated into their respective classifications.

(F) The following definitions apply to the purchase-ratio method:

1. “Exempt food products” means those items generally described as food products in Section 6359 and Regulation 1602. If grocers are uncertain as to the classification of any product, they should contact the nearest board office.

2. “Total gross receipts from the sale of grocery items” means the total amount of the sales price of all exempt food products and taxable grocery items, including sales tax reimbursement, amounts receivable from manufacturers, or others, for coupons (excluding any handling allowances) redeemed by customers, and the face value of federal food stamps. The term does not include receipts from sales of those items described in (b)(1)(B), above, which are commonly referred to as “nongrocery taxable items”, or from those sales described in (b)(1)(C),

above (gasoline, snack bar, etc.). It does not include amounts which represent “deposits”, as defined in Regulation 1589, e.g., bottle deposits. When deposits are not segregated, it will be presumed, in the absence of evidence to the contrary, that the total deposits received are equal to the deposits refunded.

3. “Grocery items” means exempt food products and taxable items other than those generally classified under (b)(1)(B) and (b)(1)(C), above.

4. “Purchases” means the actual amount which a grocer is required to pay to the suppliers of merchandise, net of any cash discounts, volume rebates or quantity discounts and promotional allowances. The term does not include the cost of transportation, processing, manufacturing, warehousing, and other costs, if these operations are self-performed. It does not include the cost of operating supplies such as wrapping materials, paper bags, string, or similar items. It does not include amounts which represent “deposits”, as defined in Regulation 1589, e.g., bottle deposits (see (b)(1)(F)2., above). If deposits are not segregated, it will be presumed, in the absence of evidence to the contrary, that the amount deposited with the supplier is equal to the credit received for bottles returned by the grocer.

A. As used herein, the term “cash discount” means a reduction from the invoice price which is allowed the grocer for prompt payment.

B. As used herein, the term “volume rebate or quantity discount” means an allowance or reduction of the price for volume purchases based on the number of units purchased or sold. Such rebates or discounts normally are obtained without any specific contractual obligation upon the part of the grocer to advertise or otherwise promote sales of the products purchased. The term does not include patronage dividends distributed to members by nonprofit cooperatives pursuant to Section 12805 of the Corporations Code, or rebates which constitute a distribution of profits to members or stockholders.

C. As used herein, the term “promotional allowance” means an allowance in the nature of a reduction of the price to the grocer, based on the number of units sold or purchased during a promotional period. The allowance is directly related to units sold or purchased although some additional promotional expense may be incurred by the grocer. Normally, grocers would feature the product in their advertising, although they may or may not be contractually obligated to do so. The retail price of the product may or may not be lowered during a promotional period.

The term does not include display or other merchandising plan allowances or payments which are based on agreements to provide shelf space for a price not related to volume of purchases, or cooperative advertising allowances which are based on a national line rate for advertising and are not directly related to volume of purchases and sales. Cooperative advertising allowances are intended to reimburse grocers for a portion of their advertising costs for a particular product or products.

(G) Sales tax reimbursement collected in accordance with Regulation 1700 which is included in total sales is an allowable deduction. An example of the computation of the purchase-ratio method which provides for an adjustment for sales tax included follows:

1. Taxable grocery purchases	$40,000	
2. Add sales tax adjustment (6%* x Item 1)	2,400	
3. Adjusted taxable grocery purchases (Item 1 + Item 2)	42,400	
4. Exempt food products purchases	130,000	
5. Total grocery purchases including sales tax (Item 3 + Item 4)	172,400	
6. Exempt food products ratio (Item 4 divided by Item 5)		75.41%
7. Total sales including sales tax	254,088	
8. Nongrocery taxable sales including sales tax (if such sales are not accurately segregated, mark up nongrocery taxable cost of goods sold to compute sales — add 6%* sales tax to total)**	31,500	
9. Grocery sales including sales tax (Item 7 - Item 8)	222,588	
10. Exempt food products sales (Item 6 x Item 9)	167,854	
11. Sales of taxable items including sales tax (Item 7 - Item 10)	86,234	
12. Less taxable items purchased with food stamps (2% of total food stamps redeemed for period, e.g., 2% x $100,000)	2,000	
13. Taxable Measure including sales tax (Item 11 - Item 12)	84,234	
14. Sales tax included (6/106* x Item 13)	4,768	
15. Measure of tax (Item 13 - Item 14)	79,466	
16. Sales tax payable (6%* x Item 15)	4,768	

(2) MODIFIED PURCHASE-RATIO METHOD. Any grocer who does not follow the procedure outlined in (b)(1), above, but reports on a purchase-ratio basis of some type is using a modified version of the purchase-ratio method. For example, grocers who include self-performed processing, manufacturing, warehousing or transportation costs in the purchase-ratio formula are using a modified version. Grocers using such a modified version must establish that their modified version does not result in an overstatement of their food products exemption. They may demonstrate the adequacy of their modified method by extending taxable purchases, adjusted for inventories, to retail for a representative period or computing taxable sales by marking up taxable purchases, adjusted for inventories, for a representative period. Grocers must retain adequate records which may be verified by audit, documenting the modified purchase-ratio method used. ~~Grocers contemplating use of a modified purchase-ratio reporting method are urged to notify the board of such intentions and to submit such methods to the nearest board office for review prior to use of such methods. Grocers submitting proposed modified purchase-ratio reporting methods meeting board approval will be furnished written notice indicating the period within which such modified methods are authorized for use.~~

(3) RETAIL INVENTORY METHOD AND MARKUP METHOD. Grocers who engage in manufacturing, processing, warehousing or transporting their own products may prefer to use a retail or markup method of reporting. These methods are described below:

(A) Retail Inventory Method.

1. The opening inventory is extended to retail and segregated as to exempt food products and taxable merchandise.

2. As invoices for merchandise are received, they are extended to retail and segregated as to exempt food products and taxable merchandise.

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* Use applicable tax rate — tax rate of 6% used for illustration purposes.
** Adjust for shrinkage if applicable — see paragraph (d).

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3. The ending inventory at retail is segregated as to exempt food products and taxable merchandise.

4. The total of segregated amounts determined in 1 and 2 less 3 represent anticipated exempt and taxable sales.

5. The segregated amounts determined in 4 are adjusted for net markons, net markdowns, and shrinkage to determine realized exempt and taxable sales.

6. Physical inventories are taken periodically to adjust book inventories.

(B) Cost Plus Markup Method — Taxable Merchandise.

1. The cost of all taxable merchandise is marked up to anticipated selling prices at the time of purchase. Records are kept of net markons, net markdowns, and shrinkage for all taxable merchandise. Such records are used to adjust the anticipated selling price to the realized price. Inventory adjustments are required unless the inventory of taxable merchandise at the beginning and ending of reporting periods is substantially constant. Returns should reflect as taxable sales the realized selling price of all taxable merchandise during a reporting period (anticipated sales price on purchases adjusted for inventory changes and other adjustments of the types mentioned).

2. If the grocer elects to use the cost plus markup method of reporting, the following criteria should be followed:

A. Markup factor percentages[1] applicable to taxable merchandise should be determined by a shelf test sample of representative purchases, covering a minimum purchasing cycle of one month within a three-year period, segregated by commodity groupings, i.e., beer, wine, carbonated beverages, tobacco and related products, paper products, pet food, soap, detergents, etc. The markup factor percentages determined for commodity groupings should be applied to the cost of sales of the respective commodities for the reporting to determine taxable sales.

In order to insure that markup factor percentages typical of the total business are determined, grocers who conduct multistore operations should include purchases from several representative stores in the shelf test sample of markup factor percentages.

B. As an alternate procedure to A., above, the overall average markup factor percentage for all taxable commodity groupings may be used to determine taxable sales for the reporting period. This markup factor percentage is applied to the overall cost of taxable sales for the reporting period.

The overall average markup factor percentage should be determined as follows:

a. Determine markup factor percentages by commodity groupings based on shelf tests covering a minimum purchasing cycle of one month within a three-year period.

b. Determine cost of sales, segregated by commodity groupings, for a representative one-year period.

c. Apply markup factor percentages (Step a) to the cost of sales of the respective commodity groupings (Step b) to determine anticipated sales by commodity groupings and in total.

d. Divide total anticipated sales (Step c) by the respective total cost of sales to determine the overall average markup factor percentage.

C. In calculating markup factor percentages, appropriate consideration should be given to markon and markdown price adjustments, quantity price adjustments such as on cigarettes sold by the carton, liquor sold by the case and other selling price adjustments. Quantity and other price adjustments may be determined by a limited test of sales of a representative period or by sales experience of a representative store within the operating entity.

D. The computation of taxable sales for the reporting period should be based on cost of sales for the period. If for any particular reporting period or periods, cost of sales is not determinable because actual physical

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[1] Markup factor percentage is the markup + 100%. When applied to cost, it computes the selling price. For example, an item costing $1.00 and selling at a 25% markup will have a markup factor of 125%. The markup factor (125%) when applied to $1.00 cost results in a $1.25 selling price.

inventories are unknown and inventories remain substantially constant, the computation of taxable sales may be based on purchases for the period. However, if inventories are not substantially constant, adjustments for physical inventories should be taken into consideration in one of the reporting periods occurring within the accounting year.

E. Shrinkage should be adjusted as specified in (d) below.

F. Taxable markup factor percentages based on shelf test samples will generally be considered valid for reporting purposes for a period of three years, provided business operations remain substantially the same. A substantial change in business operations will be considered as having occurred when there is a significant change in pricing practices, commodities handled, commodity mix, locations operated, sources of supply, or other circumstances affecting the nature of the business.

~~G. Grocers contemplating use of the cost plus markup method of reporting are urged to notify the board of such intentions and to submit a general outline of proposed markup procedures to the nearest board office for review prior to use of such procedures. Grocers submitting proposed markup procedures meeting board approval will be furnished written notice indicating the period within which such procedures are authorized for use.~~

(4) ELECTRONIC SCANNING SYSTEMS. The use of a scanning system is another acceptable reporting method for grocers. Electronic scanning systems utilize electronic scanners and central computers to automatically compile and record taxable and nontaxable sales, sales tax, and related data from scanning of products imprinted with the Universal Product Code. It is the grocer's responsibility to establish the propriety of reported amounts. Grocers must ensure that proper controls are maintained for monitoring and verifying the accuracy of the scanning results and tax returns. Adequate documentation must be retained which may be verified by audit, including all scanning programs relating to product identity, price, sales tax code, program changes and corrections to the programs. Records which clearly show a segregation of taxable and nontaxable merchandise purchases would provide an additional source from which the scanning accuracy may be monitored or verified.

~~Grocers contemplating use of electronic scanning systems results as a reporting method are required to notify the board of such intentions and to submit a general outline of the proposed procedures to the board for review and approval prior to adoption of such method for reporting purposes. Grocers submitting proposed scanning system procedures meeting board approval will be furnished written notice indicating the period within which such procedures are authorized for use.~~

(c) FOOD STAMPS. Tangible personal property eligible to be purchased with federal food stamps and so purchased is exempt from the tax. Grocers who receive gross receipts in the form of federal food stamp coupons in payment for such tangible personal property which normally is subject to the tax, e.g., nonalcoholic carbonated beverages, may deduct on each sales tax return an amount equal to two percent (2%) of the total amount of food stamps redeemed during the period for which the return is filed. Effective January 1, 1993, grocers may claim amounts in excess of two percent whenever the following computation results in a greater percentage: total purchases of taxable items eligible to be purchased with federal food stamps divided by an amount equal to the total of the exempt food product purchases as defined in subdivision (b)(1)(F)1 plus the purchases of taxable items eligible to be purchased with federal food stamps. For example, for a reporting period, if the total purchases of carbonated beverages equals $5,000 and the total purchases of exempt food products equals $130,000, a percentage of 3.7% ($5,000 ÷ $135,000) may be used in computing the allowable food stamp deduction for that period. This deduction may be taken in lieu of accounting separately for such sales.

(d) SHRINKAGE. As used herein, the term “shrinkage” means unaccounted for losses due to spoilage, breakage, pilferage, etc. Grocers who incur such losses, may, for reporting purposes, adjust for such losses as follows:

(1) An adjustment of up to 1 percent of the cost of taxable merchandise may be taken into consideration when the retail inventory or markup method is used for reporting purposes.

(2) An adjustment of up to 3 percent of the cost of nongrocery taxable items may be taken into consideration when the purchase-ratio method is used for reporting purposes and sales of nongrocery taxable items are computed by the retail extension or markup method. The adjustment is limited to an overall 1 percent of taxable purchases when other than the purchase-ratio method is used for reporting purposes.

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The proposed amendments contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

Losses in excess of the above are allowable when supported by records which show that a greater loss is sustained.

(e) LIST OF METHODS NOT EXHAUSTIVE. The methods by which grocers may determine their sales of exempt food products are not limited to the methods described above. Grocers may use any method which they can support as properly reflecting their exempt food sales. As is the case for all exemptions, it is the grocer's responsibility to establish the propriety of the amount of the claimed exemption.

(f) AUDITS. Taxpayers using one of the approved methods of reporting described in this regulation will normally be audited by application of the same approved procedure in the audit to verify the accuracy of claimed deductions. However, determinations may be imposed or refunds granted if the board, upon audit of the retailer's accounts and records, determines that the returns did not accurately disclose the amount of tax due.

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