

Memorandum

To : Honorable, John Chiang Chairman
Honorable, Claude Parrish, Vice Chair
Honorable Bill Leonard
Ms. Betty T. Yee, Acting Member
Honorable Steve Westly

Date : March 24, 2006

From : Kristine Cazadd 
Chief Counsel

Subject: **Board Meeting – March 28, 2006**
Chief Counsel Matters, Item J1, Rulemaking Summary of
Alternative Approaches for Taxation of Third-Party Consideration
(Proposed Regulations 1671, subdivision (h), or 1671.1)

Issue: At the Board meeting on January 31, 2006, the Board directed that the issue of the taxability of retail transactions involving amounts a retailer receives from a party other than the purchaser or the retailer's vendor (hereafter third party) be added as a Chief Counsel Matters agenda item for the March 28, 2006, Board meeting. Specifically, the Board directed that staff prepare proposed language for two or more alternative approaches to this issue that the Board might consider pursuant to a regulatory process.

Action: Legal Staff has prepared four alternatives for purposes of Board discussion:

- **Alternative 1** - reflects an approach somewhat similar to the Streamlined Sales and Use Tax Agreement's (SSUTA) "knowledge-of-the-rebate" approach. This version of the proposed regulation incorporates an objective standard for determining the presence or absence of such knowledge:

Was the discount reflected in documentation submitted either by or to the purchaser?

If so, the purchaser had knowledge and, consequently, the third party payment must be included in gross receipts. Conversely, if no such documentation was submitted, then the purchaser did not have knowledge and, therefore, the third party payment is not included in gross receipts. This version also addresses manufacturer rebates or buy-downs only; it does not address situations where the retailer does not receive third party or manufacturer consideration or situations where the discount is between a vendor and retailer. If the Board were to decide that the Sales and Use Tax Department (Department) should modify its current audit practices with respect to consideration that retailers receive from third parties (hereafter third-party consideration), the Legal Department believes Alternative 1 provides the best

approach. Alternative 1 would create a new subdivision (h) for Regulation 1671, *Trading Stamps and Related Promotional Plans*.

- **Alternatives 2 and 3** - *Alternative 2* reflects staff's previously proposed version of Regulation 1671.1, *Discounts, Coupons, Rebates and Other Incentives*. Staff made this proposal at a Business Taxes Committee (BTC) meeting held on August 6, 2003.

Alternative 3 reflects industry's version of proposed Regulation 1671.1 presented at the same BTC meeting. The BTC took no action with respect to either version of the proposed regulation. For reference, a copy of the materials that were distributed for the August 6, 2003, BTC meeting are attached. Alternatives 2 and 3 are both broader in scope than Alternatives 1 and 4, and address issues in addition to the taxation of third-party consideration (such as vendor/retailer discounts). Therefore, they are not currently recommended by staff.

Alternative 4 - reflects the Department's current audit practices regarding third-party consideration. Like Alternative 1, this Alternative 4 has a narrow scope. In contrast to Alternative 1's approach, however, under Alternative 4, customer knowledge is not material with respect to the taxation of third-party consideration and such consideration therefore, would almost always be included in taxable gross receipts. Under this alternative, in order for third party consideration to be included in gross receipts, there are only two requirements: (i) the retailer must have made a retail sale of tangible personal property to a purchaser at a discount in response to an offer from a third party to provide consideration to the retailer with respect to each such discounted retail sale; and (ii) at the time of the sale, the amount of third-party consideration attributable to the sale must have been fixed in amount or otherwise determinable by the retailer. Like Alternative 1, this alternative does not address vendor/retailer discounts, and like Alternative 1, this alternative would also create a new subdivision (h) for Regulation 1671, *Trading Stamps and Related Promotional Plans*. The result under Alternative 4 however is the opposite of that achieved under Alternative 1. The Board should, therefore, only consider Alternative 4 to the extent the Board desires to promulgate in regulatory form the Department's current audit practices.

KEC;jlh

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