



STATE BOARD OF EQUALIZATION

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August 29, 2005

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Executive Director

Dear Interested Party:

Staff has reviewed comments received in response to our July 26, 2005 interested parties meeting regarding the proposed amendments to Regulation 1699, *Permits*. After considering the comments and information provided to date, staff is recommending amendments to Regulation 1699. In particular, staff is recommending guidelines be amended to revise the term "sole purpose" to "primary purpose" throughout 1699(h); to expand the list of required elements to include evidence of separate identity with respect to employees, accounting records, facilities, and equipment; and to delete the final sentence of (h)(2).

Enclosed is the *Second Discussion Paper* on this subject. This document provides the background, a discussion of the issue and explains staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendment to Regulation 1699 (Exhibit 1).

A second interested parties meeting is scheduled for **September 8, 2005, at 10:00 A.M. in Room 122** at 450 N Street, Sacramento, California to discuss the proposed amendments to Regulation 1699. If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the September 8 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on September 8, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Lynn Whitaker at (916) 324-8483 or by e-mail at Lynn.Whitaker@boe.ca.gov prior to September 5. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the September 8 meeting must be received by **September 26, 2005**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed amendments to Regulation 1699 for discussion at the **Business Taxes Committee meeting** scheduled for **November 15, 2005**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the November Business Taxes Committee meeting is welcomed and encouraged. The meeting is scheduled for **9:30 a.m.** in Room 121 at 450 N Street, Sacramento, California.

Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Board Meetings and Committee Information" page on the Board's Internet web site (<http://www.boe.ca.gov/meetings/meetings.htm> two) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact Mr. Geoffrey E. Lyle, Supervisor, Business Taxes Committee and Training Section at (916) 322-0849.

Sincerely,

Jeffrey L. McGuire
Chief, Tax Policy Division
Sales and Use Tax Department

JLM:lw

Enclosures

cc: (all with enclosures)

Honorable John Chiang, Chair
Honorable Claude Parrish, Vice Chairman
Ms. Betty T. Yee, Acting Member, First District
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel (MIC 73)
Mr. Chris Schutz, Board Member's Office, Fourth District (MIC 72)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Board Member's Office, Third District (via e-mail)
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Ms. Judi Apfel, Board Member's Office, First District (via e-mail)
Ms. Sabina Crocette, Board Member's Office, First District
Mr. Kenneth Topper, Board Member's Office, First District (MIC 71)
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Ms. Kristine Cazadd (MIC 83)
Ms. Randie L. Henry (MIC 43)
Ms. Selvi Stanislaus (MIC 82)
Mr. Randy Ferris (MIC 82)
Ms. Trecia Nienow (MIC 82)
Mr. Brad Heller (MIC 82)
Mr. John Waid (MIC 82)

Ms. Janice Thurston (via e-mail)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Steve Ryan (MIC 85)
Mr. Todd Gilman (MIC 70)
Mr. Dave Hayes (MIC 67)
Mr. Jacob Roper (via e-mail)
Mr. Joseph Young (via e-mail)
Mr. Vic Anderson (MIC 44 and via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Larry Micheli (via e-mail)
Mr. Dan Cady (via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Leila Khabbaz (MIC 50)
Ms. Lynn Whitaker (MIC 50)
Mr. Charles E. Arana Jr. (MIC 50)

SECOND DISCUSSION PAPER

Proposed Regulatory Changes Regarding the Issuance of Seller's Permits to "Buying Companies" – Regulation 1699, *Permits*

I. Issue

Should Regulation 1699, *Permits*, be revised to clarify when a permit should be issued to a "buying company?"

II. Staff Recommendation

To better identify and issue seller's permits to buying companies that are formed and operate as separate business entities from their parents or affiliates, staff proposes revising subdivision (h) of Regulation 1699 as follows:

- Revise "sole purpose" language to "primary purpose" throughout subdivision (h).
- Revise subdivision (h)(2) to provide that the buying company must meet all of the elements listed, and expand those elements to include evidence of separate identity with respect to employees, accounting records, facilities, and equipment.
- Delete the final sentence of (h)(2), "The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax."

Staff's proposed amendments to Regulation 1699(h) are attached as Exhibit 1.

III. Other Alternatives Considered

Following the first interested parties meeting on July 26, 2005, staff received comments from Mr. Doug Boyd, representing the City of Oakland, and Mr. Eric Miethke, representing the Air Transport Association. Both submissions recommend no revision to subdivision (h) of Regulation 1699 and include detailed analyses of the City and County of San Francisco (San Francisco) and County of San Mateo (San Mateo) proposals to revise subdivision (h) of Regulation 1699. In addition, Mr. Miethke expressed concern about the retroactive impact of revisions and recommended that if the subdivision is revised, such amendment be handled prospectively. Mr. Boyd's comments are attached as Exhibit 4 and Mr. Miethke's comments are attached as Exhibit 5.

Alternative 1: Repeal Regulation 1699(h).

San Mateo and San Francisco petitioned the Board in December 2004 to repeal Regulation 1699(h). Although both have subsequently submitted proposals to revise Regulation 1699(h), they ask that in the alternative, the Board repeal subdivision 1699(h).

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Alternative 2: Do not revise Regulation 1699(h).

At this time, the only requests to revise Regulation 1699(h) have involved a buying company (United Aviation Fuels Company, Inc. [UAFC]) located in the City of Oakland (Oakland) whose purpose is to purchase jet fuel and sell it to United Airlines, Inc. (United). The Board may conclude that the United/UAFC situation is unique and there is no need to revise the regulation. In that regard, the Board may consider pending Assembly Bill (AB) 451 that addresses the allocation of local sales tax derived from sales of jet fuel and would resolve the Oakland/United/UFAC issue beginning January 1, 2008 (see discussion of AB 451 below). The City of Long Beach, Oakland, and the Air Transport Association support this alternative.

Alternative 3: Revise Regulation 1699(h) to provide better guidance to buying companies in obtaining seller's permits. Staff's suggested revisions focus on whether or not the buying company is truly engaged in the business of selling tangible personal property to persons separate and distinct from itself or is a shell with no independent existence from the entity that owns or controls it or to which it is otherwise related.

In addition to staff's proposal, San Mateo, San Francisco, and Mr. Robert Cendejas have submitted separate proposals to revise subdivision (h) of Regulation 1699. These proposals are discussed in detail in Section V, Discussion.

IV. Background

In December 2004, San Mateo and San Francisco filed petitions asking the Board to amend or repeal subdivision (h) of Regulation 1699, *Permits*. Their petitions contend that Regulation 1699(h) fails to provide meaningful protection from schemes to re-direct local tax. In part, the petitions allege that the Board exceeded its statutory authority in promulgating Regulation 1699(h) in that the subdivision sets up a special entity, a "buying company," that does not have to demonstrate it is a separate person within the meaning of Revenue and Taxation Code (RTC) section 6005.

Adopted by the Board in February 2002, Regulation 1699(h), "Buying Companies – General," attempts to provide criteria for distinguishing between buying companies that are established for the sole purpose of re-directing local tax and those that are not. The regulation defines a buying company as a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services for the other legal entity. The regulation goes on to provide that a buying company formed for the sole purpose of re-directing local tax shall not be recognized as a separate entity for the purpose of issuing a seller's permit. Regulation 1699(h) describes when a buying company is not formed for the "sole purpose" of re-directing local tax, as follows:

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(2) ELEMENTS. A buying company is not formed for the sole purpose of redirecting local sales tax if it has one or more of the following elements:

(A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.

(B) Issues an invoice or otherwise accounts for the transaction.

The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.

The San Francisco and San Mateo petitions stem from the issuance of a sub-permit in Oakland to UAFC. The issuance of this permit had the effect of re-directing local sales tax from San Francisco and San Mateo to Oakland. The Board heard the San Mateo and San Francisco petitions at the March 22, 2005 Board meeting and referred the buying company issue to the Business Taxes Committee (BTC).

Local Tax in General

The Board of Equalization administers the 1.00 percent Bradley-Burns Uniform Local Sales and Use Tax on behalf of all California cities and counties.¹ For each sale, 0.25 percent of the local tax is allocated to the county where the sale occurs, for transportation projects. The remaining 0.75 percent local tax is allocated to the county if the sale or use occurred in the unincorporated portion of the county, or to a city if the sale or use occurred in that city. For purposes of the following discussion, the term "cities" includes cities, counties, cities and counties, and redevelopment agencies unless otherwise specified.

In fiscal year 2003-04, approximately \$6.03 billion in Bradley-Burns sales and use taxes were returned to the state's 58 counties and 478 cities. The Board contracts with each city and county to administer its local tax ordinance. (RTC § 7202(d) & (h)(4).) By the terms of these contracts, the Board has the responsibility of distributing the cities' and counties' local taxes to the jurisdiction of the place of sale for local sales tax and to the jurisdiction of the place of use for local use tax, as accurately and economically as possible.

Pending AB 451 (Yee, et al.)

AB 451 (2005-2006) would amend RTC sections 7204.03 and 7205 to change the way local sales tax is allocated on sales of jet fuel. Currently, to allocate local sales tax to the place where the fuel is delivered to the aircraft, the principal negotiations for the sale must be conducted in California, and the retailer of the fuel must have more than one place of business in California. Thus, a buying company with only one business location in California is not subject to the special rules for allocating local sales tax from jet fuel sales under RTC sections 7204.03 and 7205. Instead, it remains subject to the general local tax rules, which allocate local sales tax

¹ The actual Bradley-Burns county/city tax rate is 1.25%/1.00%. (RTC §§ 7202(a) & (h), 7203.) During the pendency of the "Triple Flip," however, the tax rates are temporarily reduced to 1.00%/0.75%. (RTC § 7203.1.)

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based on the location of the sales office of the buying company, regardless of where the fuel is delivered. (See Reg. 1802(a).)

Beginning January 1, 2008, AB 451 would remove both the requirements that the principal negotiations take place in California and that the retailer has more than one place of business in California. As a result, local sales tax would be allocated to the place where the fuel is delivered to the aircraft.²

If AB 451 becomes law, any economic incentive agreement between Oakland and United, at least as it relates to sales tax, will no longer be an issue as the local tax revenues will be allocated based on where the jet fuel is delivered instead of where the sales office of the buying company is located. AB 451 does not affect buying companies that do not sell jet fuel. At the time of this paper, AB 451 had passed in the Assembly and was sent to the Senate for Third Reading.³

The Board's BTC is scheduled to discuss the buying company issue at its meeting on November 15, 2005.

V. Discussion

When deciding if a business should be issued a seller's permit, the Board must determine whether:

1. The buying company is engaged in the business of selling tangible personal property within the meaning of RTC sections 6014, 6015, and 6066; and
2. A sufficient separation exists between the buying company and its parent or affiliates such that they are separate persons under RTC section 6005 and thus not abusing the use of a resale certificate under RTC section 6094.5.

In other words, an entity not satisfying both of these requirements is a shell with no independent existence from the entity that owns or controls it or to which it is otherwise related. Staff believes that the current language of Regulation 1699(h) should be revised to provide better guidance in meeting these requirements.

² Exceptions for multijurisdictional airports, including San Francisco and Ontario would remain in the law. Multijurisdictional airports are airports where the airport is located in a different local jurisdiction than the jurisdiction that owns or operates the airport. These airports share the local tax revenue from jet fuel sales. For jet fuel sales at the San Francisco airport, the tax is split evenly between the City and County of San Francisco and the County of San Mateo. For Ontario, the city of Ontario receives the tax at the city-imposed rate of ¾ percent, and the County of San Bernardino receives ¼ percent.

³ AB 451 was last amended August 17, 2005, to take out Section 3 of the bill, which would have required a study of the local tax system.

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Staff recommendation

"Sole" vs. "Primary" Purpose. Regulation 1699(h) currently provides that a buying company formed for the sole purpose of re-directing local tax will not be recognized as an entity separate from its parent or affiliates and will not be issued a seller's permit. San Mateo and San Francisco have both proposed that the term "sole purpose" be revised to "primary purpose." Staff agrees with this recommendation. San Francisco and San Mateo's proposed revisions to Regulation 1699(h) are attached as Exhibits 2 and 3 respectively.

Staff interprets the term "sole purpose" literally. For example, if a parent company can find one reason for establishing a buying company other than the benefits of re-directing local tax, the buying company has not been formed for the "sole purpose" of re-directing local tax. Staff believes the Board should examine the overall function and operation of a buying company in order to determine if the company is in the business of making sales and is a person truly separate from its parent or affiliates in order to determine whether a permit should be issued. The subdivision's "sole purpose" language obstructs the Board's ability to make this determination. As the intent of the subdivision is to distinguish sham companies from those actually in the business of selling tangible personal property, replacing the word "sole" with "primary" will better achieve this intent.

Expand the list of required elements. As stated above, the key to determining whether a buying company should be issued a permit is determining whether sufficient separation exists between the buying company and its parent or affiliates such that they are separate persons under RTC section 6005. Staff believes that both elements listed in subdivision (h)(2) should be met before a permit is issued. In addition, staff believes that in order to establish that a buying company is truly separate from its parent or affiliates, a buying company should maintain separate employees, accounting records, facilities, and equipment. Staff's specific language included in Exhibit 1 is similar to the language staff proposed when the regulation was presented to the Board in 2002.

The additional elements proposed by staff are similar to those suggested by San Francisco and San Mateo, although San Francisco also suggests that the buying company and its parent should not share insurance policies, and/or share one payroll/employee benefits department. San Mateo proposes that the parent and buying company also not share bank accounts. Staff believes these additional elements may be too restrictive, and that the elements proposed in subdivision 1699(h)(2)(C) are sufficient to establish separate identity.

Delete the final sentence of 1699(h). In essence, subdivision (h)(2) states that if either of the listed elements are met, a buying company is not formed for the sole purpose of re-directing local tax and will be issued a seller's permit. The final sentence of the subdivision provides, "The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax." Staff agrees with San Francisco and San Mateo's contention that this final sentence negates the intent of the preceding text and thus, should be deleted.

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Repealing subdivision (h)

As proposed in the San Mateo and San Francisco petitions, the Board could repeal subdivision (h) of Regulation 1699. Repealing this subdivision would return staff and taxpayers to the situation that existed prior to June 2002. The retroactive effect of this action is discussed in detail below in the section entitled "Impact of Revoking Permit."

Repealing the subdivision would mean there would be no specific regulatory guidance for taxpayers that are contemplating forming buying companies. Once again, staff would have to determine what "business purpose" the buying company accomplished, without having the guidance of specific criteria.⁴ Businesses would have to rely on their interpretation of the Revenue and Taxation Code to determine whether their buying company would be considered a separate entity requiring a seller's permit; a buying company's criteria for establishing business purpose is not examined by the Board at the time of registration. When a buying company registers, it is identified and coded as a retailer of whatever it is selling (e.g., a fuel supplier, or an office supply retailer) - it is not identified or registered as a "buying company."

Revising subdivision (h)

Exclusion of sellers. Mr. Robert Cendejas suggested that Regulation 1699 be revised to exclude retailers that primarily sell jet fuel from the buying company provisions of subdivision (h). San Mateo echoed this idea and expanded on it by recommending that the subdivision be revised to state that a seller's permit not be issued to a buying company created (1) for the primary purpose of purchasing jet fuel for a related entity or (2) primarily for the purpose of purchasing a single good or service for a related entity. San Francisco also addressed the issue by proposing that a permit not be issued to a buying company that makes less than 50% of its sales to companies other than its parent. While such action may resolve the issue of United and its buying company UAFC, staff does not believe there is sufficient statutory authority to make such revisions.

Sections 7204.03 and 7205 of the Bradley-Burns Uniform Local Sales and Use Tax Law provide for special allocation of local tax for sales of jet fuel. However, those sections do not address whether a seller's permit should be issued to a retailer of jet fuel. To conclude that the special handling of jet fuel sellers provided in those statutes gives the Board the authority to deny permits to buying companies that sell jet fuel is not appropriate. The purpose of Regulation 1699 is to provide guidance on the issuance of seller's permits as provided in RTC sections 6066 through 6075. If a retailer meets the requirements provided in those sections, the Board is obligated to issue that seller a permit.

⁴ Re-direction of local tax is sometimes an unintended side effect. A few years ago, staff investigated a situation where a state-wide hospital formed a buying company but continued to allocate local sales tax as if the buying company did not exist. On the other hand, staff has learned of a situation, again involving a hospital, where the "buying company" is little more than a folder in the hospital's procurement officer's desk.

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In addition, in accordance with the Bradley-Burns Uniform Local Sales and Use Tax Law, cities and counties have the right to have that law administered in a uniform manner. (RTC § 7224.) Treating buying companies selling jet fuel differently than other buying companies would violate the direction of the Legislature, i.e., that the law be applied uniformly. Finally, treating certain buying companies differently than others in the regulation would not satisfy the "consistency" standard of the Administrative Procedure Act and would likely cause the regulation to be rejected by the Office of Administrative Law. (See Govt. Code § 11349.1(a).)

Economic incentives from local jurisdictions. San Mateo and San Francisco both recommend denying seller's permits to buying companies that receive economic incentive payments from local jurisdictions. Specifically, San Mateo's submission provides that, "If at any time, a buying company or a related company receives a business incentive for locating the buying company in a particular jurisdiction that exceeds more than twenty percent (20%) of the yearly sales and use taxes generated by the buying company, the seller's permit issued to the buying company becomes void." Similarly, San Francisco's submission provides that a buying company is formed for the primary purpose of re-directing local sales tax if, "the buying company or the entity that owns, controls, or is otherwise related to the buying company receives revenue from the local jurisdiction where the buying company is located, which is based upon or tied to an increase in tax collected on sales made by the buying company."

Staff understands San Francisco's and San Mateo's purpose for suggesting these proposals. However, staff believes the Board lacks the authority to condition its issuance of a seller's permit solely on the existence or non-existence, or terms of these economic incentive agreements.⁵

Additional elements suggested by San Francisco. In addition to the issues discussed above, San Francisco suggested several other elements for buying companies to meet before they would be issued a permit. Specifically, a buying company would be considered formed for the primary purpose of re-directing local tax if:

1. The buying company was recently organized as an entity that is separate from the entity that owns, controls, or is otherwise related to it.
2. The buying company and the entity that owns, controls, or is otherwise related to it do not have independent business purposes.
3. The buying company or the entity that owns, controls, or is otherwise related to it has stated publicly or in writing that the buying company was formed in order to re-direct sales tax revenue.

Staff does not support item 1 because it would prohibit issuing seller's permits to any new buying company. This outcome is not the intent of Regulation 1699(h). With regard to item 2,

⁵ The existence of an incentive agreement is, however, evidence that the buying company may have been formed for the purpose of re-directing local tax revenues.

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staff believes this element requires staff to analyze vague "purposes" of the buying company and does not give either staff or taxpayers guidance prospectively. Staff believes the underlying issue is better addressed in staff's proposed Regulation 1699(h)(2)(C) regarding maintaining separate identity. Although staff agrees with the spirit behind item 3, staff believes that it would be difficult to document and enforce.

The full text of San Francisco's submission is included in Exhibit 2.

Additional elements suggested by San Mateo. In addition to the issues discussed above, San Mateo proposes that a buying company not be issued a permit unless it establishes that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation. Staff agrees that one of the elements of being a retailer, being in the business of selling tangible personal property (RTC § 6014), requires that the person be engaged in selling for gain. Staff believes that the underlying issue – determining whether or not the company is selling tangible personal property at enough of a markup to sustain a business independent of the creating entity (RTC § 6013), is already addressed in subdivision (h)(2)(A) which provides that a buying company add a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.

The full text of San Mateo's submission is included in Exhibit 3.

Impact of Revoking Permits

At the first interested parties meeting, participants asked what action would trigger a retroactive impact and what such impact would mean. Under RTC section 7051, if the Board does not specifically limit the retroactive effect of a regulatory action, it is retroactive to the limits of the applicable statute of limitations, usually three years. (RTC § 6487.) If the Board repeals subdivision (h) of Regulation 1699, the effect would be retroactive. Similarly, unless an operative date is provided in the body of the regulation, any amendment would also be retroactive. Such retroactive effect is discussed in detail below in the sections entitled "Present and future transactions" and "Reallocation of past transactions." If the regulation is repealed, taxpayers who relied on subdivision (h) of Regulation 1699 when forming their buying companies would have to show that their business should continue to hold that permit under the general rules of Regulation 1699(a). That is, the Board would not revoke a seller's permit as long as the taxpayer is engaged in business as a seller of tangible personal property to a separate person. If the taxpayer cannot show it meets that criteria, the Board would revoke the seller's permit.

Present and future transactions. With its permit revoked, the buying company could no longer issue resale certificates or make sales. For example, while the buying company may continue to function as a purchasing mechanism for its parent and/or affiliates, those purchases would be taxable retail sales to the parent or affiliates, as applicable. Consequently, the local sales tax associated with those purchases would be allocated to the location of the vendor, rather than the

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location of the buying company, under Regulation 1802(a). This shift in local tax revenue would be detrimental to cities that budgeted based on expected local sales tax from buying companies whose permits were revoked. On the other hand, the cities where supply vendors are located would see an increase in local tax revenue.

The shift in local tax revenue created by buying companies is not limited to sales tax transactions. If property is purchased from a vendor located out-of-state and a buying company re-sells that property to its parent or affiliates, such transaction would have been a use tax transaction if sold by the vendor directly to the parent or affiliates but becomes a sales tax transaction when sold by the buying company to the parent or affiliates. Local use tax revenues that would have been distributed to the place of first functional use of the property, become local sales tax revenue allocated solely to the location of the buying company, except as provided under RTC sections 7204.03 and 7205.

In addition, because the buying company purchases for resale to its parent or affiliates, this affects when state tax applies. The use of a buying company can give a taxpayer the opportunity to manipulate the timing of its state tax liability because a buying company's purchases are for resale. Sales for resale are excluded from sales and use tax under RTC section 6007. Thus, tax is not due until the buying company sells the property. This means that the state may have received the revenue sooner if the buying company did not exist, i.e., if the vendor sold directly to the parent or affiliates in a reporting period earlier than the period in which the buying company made the sale.

Reallocation of past transactions. If the Board revokes a buying company's permit retroactively, staff believes that the Board may reallocate local tax back to the date the buying company began reporting sales. In essence, this means that the buying company was not entitled to hold a seller's permit and its sales should be disregarded. Staff believes the appropriate way to handle these transactions would be to reallocate based on vendor information in the purchasing records of the buying company. Staff does not recommend retroactively disallowing a resale certificate accepted by a vendor in good faith at the time that vendor's sale was made.

A full retroactive treatment could mean a multi-year impact on the city hosting the buying company. Using the United/U AFC buying company as an example, U AFC began reporting sales in Oakland in the 4th Quarter of 2003. If U AFC's permit for the Oakland office was revoked, a retroactive application back to 4th Quarter 2003 would mean millions of dollars re-allocated from Oakland. Determining how much to reallocate and to what jurisdiction these funds should be reallocated, would also be complicated and differ given a sales versus use tax transaction.

Continuing with the United/U AFC buying company example and looking only at transactions at the San Francisco International Airport (SFO), the allocation of local tax would depend on the activities of the fuel vendor. In general, there are three ways the local tax would be reallocated:

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1. If the sales were negotiated in California and the vendor had only one location in California, local sales tax would be allocated to the location of the vendor.
2. If the sales were negotiated in California and the vendor had more than one location in California, local sales tax would be allocated based on where the fuel was delivered. Following SFO's special multijurisdictional airport rules, the local sales tax would be split evenly between the City and County of San Francisco and the County of San Mateo.
3. If the sales were negotiated outside California and delivered to United's fuel storage tanks in South San Francisco, local use tax would be allocated to the San Mateo countywide pool.

Thus, in order to reallocate, the circumstances of each jet fuel purchase made by UAFC would have to be analyzed since 4th Quarter 2003. In addition, assuming UAFC reported its fuel sales at a marked-up price, UAFC would be entitled to a refund of tax on the markup amount on all sales to United. In other words, if the Board determined that United and UAFC were really the same entity, tax is only due on the sales price of the fuel to United/UAFC.

In actuality, a reallocation of United/UAFC sales tax transactions would be relatively easy to calculate because few suppliers and sales transactions are involved. For a buying company that did not charge its parent or affiliate the same markup on all transactions, and made thousands of purchases from perhaps hundreds of suppliers inside and outside the state, an accurate reallocation would be more difficult to calculate.

Options to full retroactive treatment. Staff believes that if the revisions to subdivision (h) of Regulation 1699 were retroactive, the Board has several options:

1. The Board could decide administratively not to exercise its discretion to reallocate local tax revenues because subdivision (h) of Regulation 1699 was unclear and it would be unfair to reallocate local sales tax revenues due to lack of clarity. (See Sales and Use Tax Annot. 702.1050 (10/30/02).)
2. The Board could decide to reallocate local sales tax revenues back two quarters from the date of knowledge of improper distribution under RTC section 7209. The Board would identify the date that it had knowledge of tax being allocated to the location of a buying company when it did not meet the adopted criteria.
3. The Board could conclude that subdivision (h) had unintended consequences and should be amended prospectively. If the Board exercises this option, it would need to determine whether buying companies established prior to the operative date would prospectively retain their seller's permits for a period of time, or whether buying companies that fail the new criteria would have their permits revoked.

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VI. Summary

Staff believes that the current provisions of Regulation 1699(h) should be revised to ensure that buying companies understand what is necessary to establish that they are in the business of selling tangible personal property to consumers separate and distinct from themselves and that they are truly separate from their parent or affiliates. Interested parties are welcome to submit comments or suggestions on the issues discussed in this paper, and are invited to participate in the interested parties' meeting scheduled for September 8, 2005, in Sacramento, to discuss the differences between the staff recommendation and their views.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 08/24/2005

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Regulation 1699. PERMITS

References: Sections 6066-6075, Revenue and Taxation Code.

(a) IN GENERAL – NUMBER OF PERMITS REQUIRED. Every person engaged in the business of selling (or leasing under a lease defined as a sale in Revenue and Taxation Code section 6006(g)) tangible personal property of a kind the gross receipts from the retail sale of which are required to be included in the measure of the sales tax, and only a person actively so engaged, is required to hold a permit for each place of business in this state at which transactions relating to sales are customarily negotiated with his or her customers. For example:

A permit is required for a branch sales office at which orders are customarily taken and contracts negotiated, whether or not merchandise is stocked there.

No additional permits are required for warehouses or other places at which merchandise is merely stored and which customers do not customarily visit for the purpose of making purchases and which are maintained in conjunction with a place of business for which a permit is held; but at least one permit must be held by every person maintaining stocks of merchandise in this state for sale.

If two or more activities are conducted by the same person on the same premises, even though in different buildings, only one permit is required. For example:

A service station operator having a restaurant in addition to the station on the same premises requires only one permit for both activities.

(b) PERSONS SELLING IN INTERSTATE COMMERCE OR TO UNITED STATES GOVERNMENT. A permit is not required to be held by persons all of whose sales are made exclusively in interstate or foreign commerce but a permit is required of persons notwithstanding all their sales (or leases under a lease defined as a sale in Revenue and Taxation Code section 6006(g)) are made to the United States or instrumentalities thereof.

(c) PERSONS SELLING FEED. Effective April 1, 1996, a permit is not required to be held by persons whose sales consist entirely of sales of feed for any form of animal life of a kind the products of which ordinarily constitute food for human consumption (food animals), or for any form of animal life not of such a kind (nonfood animals) which are being held for sale in the regular course of business, provided no other retail sales of tangible personal property are made.

If a seller of hay is also the grower of the hay, this exemption shall apply only if either:

1. The hay is produced for sale only to beef cattle feedlots or dairies, or
2. The hay is sold exclusively through a farmer-owned cooperative.

(d) CONCESSIONAIRES. For the purposes of this regulation, the term concessionaire is defined as an independent retailer who is authorized, through contract with, or permission of, another retail business enterprise (the prime retailer), to operate within the perimeter of the prime retailer's own retail business premises, which to all intents and purposes appear to be wholly under the control of that prime retailer, and to make retail sales that to the general public might reasonably be believed to be the transactions of the prime retailer. Some indicators that a retailer is *not* operating as a concessionaire are that he or she:

- Appears to the public to be a business separate and autonomous from the prime retailer. Examples of businesses that may appear to be separate and autonomous, while operating within the prime retailer's premises, are those with signs posted on the premises naming each of such businesses, those with separate cash registers, and those with their own receipts or invoices printed with their business name.
- Maintains separate business records, particularly with respect to sales.
- Establishes his or her own selling prices.
- Makes business decisions independently, such as hiring employees or purchasing inventory and supplies.
- Registers as a separate business with other regulatory agencies, such as an agency issuing business licenses, the Employment Development Department, and/or the Secretary of State.

- Deposits funds into a separate account.

In cases where a retailer is not operating as a concessionaire, the prime retailer is *not* liable for any tax liabilities of the retailer operating on his or her premises. However, if a retailer is deemed to be operating as a concessionaire, the prime retailer may be held jointly and severally liable for any sales and use taxes imposed on unreported retail sales made by the concessionaire while operating as a concessionaire. Such a prime retailer will be relieved of his or her obligation for sales and use tax liabilities incurred by such a concessionaire for the period in which the concessionaire holds a permit for the location of the prime retailer or in cases where the prime retailer obtains and retains a written statement that is taken in good faith in which the concessionaire affirms that he or she holds a seller's permit for that location with the Board. The following essential elements must be included in the statement in order to relieve the prime retailer of his or her liability for any unreported tax liabilities incurred by the concessionaire:

- The permit number of the concessionaire
- The location for which the permit is issued (must show the concessionaire's location within the perimeter of the prime retailer's location)
- Signature of the concessionaire
- Date

While any statement, taken timely, in good faith and containing all of these essential elements will relieve a prime retailer of his or her liability for the unreported sales or use taxes of a concessionaire, a suggested format of an acceptable statement is provided as Appendix A to this regulation. While not required, it is suggested that the statement from the concessionaire contain language to clarify which party will be responsible for reporting and remitting the sales and/or use tax due on his or her retail sales.

In instances where the lessor, or grantor of permission to occupy space, is not a retailer himself or herself, he or she is not liable for any sales or use taxes owed by his or her lessee or grantee. In instances where an independent retailer leases space from another retailer, or occupies space by virtue of the granting of permission by another retailer, but does not operate his or her business within the perimeter of the lessor's or grantor's own retail business, such an independent retailer is not a concessionaire within the meaning of this regulation. In this case, the lessor or grantor is not liable for any sales or use taxes owed by the lessee or grantee.

(e) AGENTS. If agents make sales on behalf of a principal and do not have a fixed place of business, but travel from house to house or from town to town, it is unnecessary that a permit be obtained for each agent if the principal obtains a permit for each place of business located in California. If, however, the principal does not obtain a permit for each place of business located in California, it is necessary for each agent to obtain a permit.

(f) INACTIVE PERMITS. A permit shall be held only by persons actively engaging in or conducting a business as a seller of tangible personal property. Any person not so engaged shall forthwith surrender his or her permit to the Board for cancellation. The Board may revoke the permit of a person found to be not actively engaged in or conducting a business as a seller of tangible personal property.

Upon discontinuing or transferring a business, a permit holder shall promptly notify the Board and deliver his or her permit to the Board for cancellation. To be acceptable, the notice of transfer or discontinuance of a business must be received in one of the following ways:

(1) Oral or written statement to a Board office or authorized representative, accompanied by delivery of the permit, or followed by delivery of the permit upon actual cessation of the business. The permit need not be delivered to the Board, if lost, destroyed or is unavailable for some other acceptable reason, but notice of cessation of business must be given.

(2) Receipt of the transferee or business successor's application for a seller's permit may serve to put the Board on notice of the transferor's cessation of business.

Notice to another state agency of a transfer or cessation of business does not in itself constitute notice to the Board.

Unless the permit holder who transfers the business notifies the Board of the transfer, or delivers the permit to the Board for cancellation, he or she will be liable for taxes, interest and penalties (excluding penalties for fraud or intent to evade the tax) incurred by his or her transferee who with the permit holder's actual or constructive knowledge uses

the permit in any way; e.g., by displaying the permit in transferee's place of business, issuing any resale certificates showing the number of the permit thereon, or filing returns in the name of the permit holder or his or her business name and under his or her permit number. Except in the case where, after the transfer, 80 percent or more of the real or ultimate ownership of the business transferred is held by the predecessor, the liability shall be limited to the quarter in which the business is transferred, and the three subsequent quarters.

Stockholders, bondholders, partners, or other persons holding an ownership interest in a corporation or other entity shall be regarded as having the "real or ultimate ownership" of the property of the corporation or other entity.

(g) DUE DATE OF RETURNS - CLOSEOUT OF ACCOUNT ON YEARLY REPORTING BASIS. Where a person authorized to file tax returns on a yearly basis transfers the business to another person or discontinues it before the end of the yearly period, a closing return shall be filed with the Board on or before the last day of the month following the close of the calendar quarter in which the business was transferred or discontinued.

(h) BUYING COMPANIES - GENERAL.

(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the ~~sole primary~~ purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall not be issued a seller's permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the ~~sole primary~~ purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.

(2) ELEMENTS. A buying company is not formed for the ~~sole primary~~ purpose of re-directing local sales tax if it ~~has one or more~~ includes all of the following elements:

- (A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.
- (B) Issues an invoice or otherwise accounts for the transaction as provided in Regulation 1698, Records.
- (C) Maintains a separate identity from the entity owning or controlling it. Maintaining a separate identity includes, but is not limited to, hiring or leasing and firing its own employees, maintaining separate accounting records (including accounting for cash receipts and disbursements), and owning or leasing its own facilities and equipment.

~~The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.~~

(i) WEB SITES. 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.

PROPOSAL BY THE CITY AND COUNTY OF SAN FRANCISCO RE: REVISION OF BOARD OF EQUALIZATION REGULATION 1699(h)

(h) BUYING COMPANIES - GENERAL.

(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the ~~sole~~ primary purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall not be issued a seller's permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the ~~sole~~ primary purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.

(2) ELEMENTS. ~~A-The presence of any of the following factors shall indicate that a buying company is not formed for the sole primary purpose of re-directing local sales tax if it has one or more of the following elements:~~

(A) ~~The buying company does not add~~ Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses;

(B) ~~The buying company does not issue~~ Issues an invoices or otherwise account for ~~the~~ transactions.

(C) ~~The buying company was recently organized as an entity that is separate from the entity that owns, controls, or is otherwise related to it;~~

(D) ~~The buying company and the entity that owns, controls, or is otherwise related to it do not maintain distinct corporate identities, for example, they share office space, have common insurance policies, and/or share one payroll/employee benefits department;~~

(E) ~~The buying company and the entity that owns, controls, or is otherwise related to it do not have independent business purposes;~~

(F) ~~Less than 50% of the sales made by the buying company are sales to companies other than an entity that owns, controls, or is otherwise related to it;~~

(G) ~~The buying company or the entity that owns, controls, or is otherwise related to the buying company receives revenue from the local jurisdiction where the buying company is located, which is based upon or tied to an increase in tax collected on sales made by the buying company;~~

(H) The buying company or the entity that owns, controls, or is otherwise related to it has stated publicly or in writing that the buying company was formed in order to re-direct sales tax revenue.

~~The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.~~

PROPOSAL BY THE COUNTY OF SAN MATEO RE: REVISION OF BOARD OF EQUALIZATION REGULATION 1699(h)

(h) BUYING COMPANIES - GENERAL.

(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. ~~It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related.~~¹ A buying company formed, however, for the sole primary purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall not be issued a seller's permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the sole primary purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.

(2) ELEMENTS. A buying company shall be deemed formed for the primary purpose of re-directing local sales, is shall not be recognized as a separate legal entity and shall not be issued a seller's permit unless the buying company does each of the following: ~~formed for the sole primary purpose of re-directing local sales tax if it has one or more of the following elements:~~

(A) Establishes that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation ~~Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.;~~

(B) Issues an invoice or otherwise accounts for its the transactions.; ~~and~~

¹ Strikethrough denotes deleted text. Underline denotes added text.

(C) Maintains a separate identity with respect to the use of employees, accounting systems, facilities, equipment and bank accounts.

~~The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.~~

(3) MISUSE OF A SELLER'S PERMIT. If at any time, a buying company or a related company receives a business incentive for locating the buying company in a particular jurisdiction that exceeds more than twenty percent (20%) of the yearly sales and use taxes generated by the buying company, the seller's permit issued to the buying company becomes void.

(4) EXCLUSIONS. In no event shall a seller's permit be issued to a buying company:

(A) Created for the primary purpose of purchasing jet fuel for a related entity; or

(B) Created primarily for the purpose of purchasing a single good or service for a related entity.

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August 15, 2005

Jeffrey L. McGuire, Tax Policy Manager
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RE: Proposed Revisions to Regulation 1699(h)

Dear Mr. McGuire,

The following submission is the Preliminary Response of the City Oakland to the Initial Discussion Paper on Proposed Regulatory Charges Regarding the Issuance of Seller's Permits to "Buying Companies" – Regulation 1699, Permits.

Petitioners Proposal is Regulatory Overkill

Petitioners are proposing to throw the buying company "baby" out with the "bathwater" (or in this case, jet fuel). There is no question these proposals would not be before us today if not for an ongoing dispute over allocation of local taxes from sales of jet fuel. Indeed, Petitioners have been at odds with other jurisdictions and with each other over allocations from sales of jet fuel to companies operating out of San Francisco International Airport for more than ten years.

Yet their proposed solution to a jet fuel tax allocation issue goes far beyond jet fuel. It would hobble a well-established business practice that promotes economic efficiencies in the purchase of thousands of commodities, and simplifies tax administration for hundreds of companies.

Other than petitioners, not one of the 478 cities and 58 counties in California has asked the Board to change Regulation 1699(h).

Section (h) was subjected to a full set of hearings and requests for input from interested parties less than four years ago, and then adopted by the Board just three and a half years ago.

Hundreds of jurisdictions and private businesses have relied upon this Regulation in fashioning relationships that benefit both local governments and companies. This type of consensual agreement resulting in a “win-win” situation for both parties is in the long-standing tradition of our American free enterprise system.

Regulation 1699(h) has been implemented fairly and effectively by Board staff, without incident, until now. One allocation dispute between three local jurisdictions in three and a half years is hardly reason to eliminate, or even change, a Board Regulation.

Petitioners Solution Is Worse Than the Problem

Consolidating purchases of commodities through the mechanism of a buying company is a standard part of doing business on a large scale in the 21st Century.

Petitioners attempt to discourage use of this well established business tool poses numerous problems for the Board and for taxpayers.

They would have the Board impose a requirement that buying companies maintain a separate identity with respect to the use of employees, accounting systems, facilities, equipment and bank accounts. What is the definition of “separate identity”? Is the buying company required to be housed in a separate building? Have its own, parallel set of office equipment? Separate accounting “systems” as opposed to accounts?

It is quite common for subsidiaries to use employees that are employees of the parent company. This proposal would apparently require that buying companies have their own set of employees, regardless of whether or not that made economic sense.

Their proposed Section 4(A) provides a clear look at the real reason for this regulatory change. It flatly prohibits buying companies from being recognized, under any circumstances, where their primary purpose is the purchase of jet fuel. Why only jet fuel among the thousands of possible commodities?

Section 4(B) goes on to prohibit buying companies completely when created primarily for the purchase of a single good or service. Why should the purchasing of one commodity prohibit use of buying companies, but purchasing two or more commodities render its use acceptable?

One petition goes even farther and lists eight criteria which must *all* be met for a buying company to be recognized. Among them is a requirement that more than 50% of said buying company’s sales be to companies other than the related company. This arbitrary requirement seems to have no purpose other than to disqualify the majority of buying companies in existence.

Another of their criteria bars recognition of buying companies that were “recently organized”, yet does not define “recent”.

Adoption of Petitioner’s criteria would increase the administrative burden on the Board while interfering with a well established and useful business practice that helps California businesses meet competitive challenges.

Petitioners Would Undermine Legislative Direction

The Legislature addressed the issue of jet fuel allocation from multi-jurisdictional airports in 1998 with enactment of Revenue and Taxation Code Section 7204.3. This amendment specifically applied to jet fuel retailers having more than one place of business in this state. It specifically did not apply to jet fuel retailers having only one place of business in this state. Petitioners inappropriately seek to have the Board accomplish via regulation, what the Legislature chose not to do via statute.

The Legislature Is Appropriate Forum For Resolution Of This Dispute

As noted by Board staff in the briefing materials, Assembly Bill 451 (Yee) proposes a further modification of jet fuel local tax allocations. Effective January 1, 2008, it would remove both the requirement that the retailer have more than one in state place of business, and that principal negotiations take place in California with respect to sales of jet fuel only.

AB451 has passed the Assembly and appears to have strong momentum in the Senate. The Board should defer to the Legislature on this subject as there is good potential that the problem will be solved for us.

It is noted that Petitioners and Oakland all support AB451. It is inappropriate for Petitioners to now seek to “change the deal”, made at the legislative level through extensive negotiations and public input, with a back door regulatory petition that is inconsistent with said legislation.

Oakland’s Economic Development Agreement With United Air Lines Was Created For Business Purposes

Regulation 1699(h) properly provides that buying companies created solely for redirecting local tax will not be recognized by the Board. United Aviation Fuels (Buying Company) was formed more than twenty years ago to take advantage of economies of scale and administrative convenience in the purchase of jet fuel.

Oakland and United recite many sound business reasons for locating Buying Company in Oakland on pages one through three of the Economic Development Agreement (the Agreement) dated April 1, 2003.

At the time of the Agreement, United employed over 1,000 people in Oakland. United leased 324,000 square feet at Oakland International Airport, for which it paid over \$4.8 million annually to the Port of Oakland. United purchased over \$12 million annually in goods and service from Oakland vendors, thereby making a substantial contribution to the economic well being of the City. In addition, United paid substantial property taxes and business license fees to Oakland.

The presence of United in Oakland is obviously important. It benefits hundreds of businesses that provide goods and services to the Company and its Oakland based employees.

United filed for bankruptcy protection under Chapter 11 of Title 11 of the United States Code on December 9, 2002. It was, and is today, under severe pressure to reduce overhead and create administrative efficiencies.

The Agreement guaranteed United's continued presence in Oakland, and averted the imminent layoff of hundreds of employees. The Agreement has proven to be a sound business arrangement for both parties. Agreements furthering and ensuring United's continued presence in Oakland are a priority for the City. Despite layoffs during the past few years, the Company is still a significant Oakland employer providing well-paying benefited positions.

Retroactivity Element Of Petitioners Proposal Would Wreak Havoc Upon The Board And Local Governments

Petitioners insist that repeal of Regulation 1699(h) be made retroactive to its February 2002 date of adoption.

Literally hundreds of buying company arrangements have been made in reliance upon this regulation. Reallocating these funds would result in a tidal wave of reallocation appeals and present new opportunities for some to game the system. It would greatly increase the workload of Board staff and eventually of the Board itself, as concerned local jurisdictions appeal to their Board Members for assistance.

For local governments, retroactivity would involve reallocation of funds spent years ago. Devastating cuts in essential government services would occur as reallocations slice large amounts of money from current and prospective budgets.

Cities employing economic incentives distribute those on a quarterly basis to contracting companies. Oakland has disbursed funds to United on a regular basis for more than two years. It would be fundamentally unfair to reallocate funds away from Oakland that it paid to third parties in detrimental reliance upon a recently established Board regulatory framework specifically authorizing this type of arrangement.

Summary

Petitioners propose to solve a local problem by dismantling a statewide framework that has worked well for many other jurisdictions. They propose to replace it with a cumbersome set of ill-defined criteria that will effectively punish a well-established, sound business practice and limit local government flexibility. Finally, they seek to make their changes retroactive, creating instability and major budgetary disruption for many jurisdictions while greatly increasing the appellate workload of Board staff and the Board itself.

The City of Oakland therefore respectfully requests that the Petitions of San Francisco and San Mateo be denied.

Sincerely,

Douglas R. Boyd, Sr.

cc: Ms. Kathleen Salem-Boyd
Deputy City Attorney
City of Oakland

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August 15, 2005

Honorable John Chiang
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State Board of Equalization
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Re: Written Comments of the Air Transport Association (ATA)
on the Proposal to Amend Regulation 1699.

Dear Chairman Chiang:

On behalf of our client, the Air Transport Association, we are pleased to submit these comments on the petitions of the City and County of San Francisco ("San Francisco") and the County of San Mateo ("San Mateo") to amend Sales and Use Tax Regulation 1699.

The Proposed Amendments are Unnecessary.

At the outset, neither San Francisco nor San Mateo have presented any evidence that the specific concern which was the reason for their filing petitions is a statewide problem; rather, the Interested Parties meeting revealed that their proposal is little more than an isolated fight for revenue between 3 jurisdictions. It would be a great mistake for the Board to change statewide policy with unpredictable results in order to address a fight for funds between San Francisco, San Mateo and the City of Oakland ("Oakland").

Amendment Would Eliminate a Corporate "Best Practice" Whether an Incentive Payment Were Involved or Not.

While there is no demonstrated statewide problem with buying companies, the petitions would potentially eliminate buying companies altogether, whether they involve an incentive payment or not. Buying companies have become a corporate "best practice" for several reasons. They include centralized procurement which is more efficient, particularly when the ultimate destination of the goods is not known when procured by the buying company. In

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effectively eliminating the use of buying companies even *when no incentive payments are involved*, the San Francisco and San Mateo petitions cause inefficiency and increase costs for everyone.

The Legislature Has Already Engaged This Issue and Has Fashioned a Compromise Which the Petitioners Agreed To Support.

AB 451 (Yee) is pending in the California Senate. That bill was amended in the Revenue and Taxation Committee to address San Francisco's and San Mateo's concerns while also balancing those of Oakland and the airline industry. This legislative compromise came after extensive investigation and testimony in both houses of the legislature.

The petitions of San Francisco and San Mateo are an attempt to achieve through the "back door" what they could not achieve legislatively. In this particular case, the Board should not take action on these petitions and instead let the legislative process play itself out.

The San Francisco and San Mateo Petitions Would Create Unintended and Undesirable Statewide Consequences

The petitions should be denied because their passage would have unintended and undesirable statewide consequences unrelated to buying companies. Under current California law that has been well settled for decades, sales between related parties that are not for resale or otherwise exempt are taxable sales. The state of California and local governments receive millions of dollars in sales tax receipts on such sales.

As was discussed at the Interested Parties meeting, the San Francisco and San Mateo proposals would result in such final sales between related parties being disregarded. This would result in the loss of any taxable "value" which was added by the related party/seller and would require the Board to pay refunds to *someone* for the tax on that now disregarded increment. The proposals would change the incidence of tax "upstream" to an outside vendor (who accepted a resale certificate in good faith from a permitted retailer meeting the requirements of Regulation 1699). It would also complicate audit administration of the underlying transactions and touch off a blizzard of requests to reallocate the Bradley-Burns portion of the sales tax based on these now disregarded intercompany sales.

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None of these issues were addressed by either San Francisco or San Mateo.

The San Francisco and San Mateo Proposals are Unadministrable

Even if a policy change were warranted by the evidence (which it isn't), the proposals submitted by San Francisco and San Mateo are unadministrable and are completely at odds with modern business practices.

For example, on page 13 of the materials compiled by staff for the Interested Parties meeting is the San Francisco proposal. In it, San Francisco would disregard all intercompany sales if any one of a list of eight factors were present. One of the factors would disqualify a buying company that was "recently" organized. There is no definition of "recently", and no way for a taxpayer to determine whether an affiliate it has that is already in existence is within or without the statute. Moreover, the San Francisco proposal also would disqualify a buying company if less than 50% of the affiliate's sales are to unrelated "companies". Not only would this provision eliminate many intercompany sales that are currently taxed by the Board, but it also would be impossible to administer. Would the taxpayer have to wait to the end of some measurement period to see if retroactively it had 50%+ of its sales to an unrelated entity? If it failed the test, what next? Would the taxpayer have to file amended returns, eliminating its sales, and moving the point of sale "upstream" with a refund of tax to the now-defunct buying company? The proposal, if enacted, would create a statewide administrative nightmare.

It was noted at the Interested Parties meeting that it is very common today for related corporations to share accounting systems and bank accounts (for cash management reasons). Further, it is not uncommon for employees to be on the payrolls of multiple subsidiaries at the same time. Corporations share accounting systems, bank accounts, and employees because it is efficient to do so. The San Francisco and San Mateo proposals force a corporation to choose between inefficiencies and extra costs or potentially having its buying company disregarded. This is also bad public policy.

Finally, the fact that a buying company with sales to unrelated parties cannot meet one of the eight factors does not

change the fact that the buying company still has a valid contract with its vendor for the purchase of property and a valid contract for its resale with the unrelated party. However, because the buying company is disregarded, the sales price for calculating the sales tax is "deemed" to be the price charged by the vendor. Thus, the unrelated party will now know the price the buying company paid and the markup charged. This is information that buying companies consider as highly confidential. Besides making bad policy, the Petitioner's proposal would be disruptive to the normal course of commerce.

The Proposals Lack Statutory Support

Neither the San Francisco nor the San Mateo proposal have statutory support, and for that reason fail the requirements of the Administrative Procedures Act. For example, the 50% threshold discussed above in the San Francisco proposal lacks any support in the statutes or case authorities.

The San Mateo proposal has two specific provisions that are particularly egregious in this regard. First, the San Mateo proposal would deny a seller's permit to a buying company if that company or a related company receives a "business incentive" that exceeds greater than 20% of the annual sales tax generated by the buying company. Revenue-sharing agreements and other business development incentives are legal under California law. However, the legislature has moved to limit business incentives granted to "big box" retailers (Government Code section 53084). The fact the Legislature chose not to include buying companies in this limitation is evidence that there simply is no statutory authority for what San Mateo proposes, and as such contravenes the Administrative Procedures Act.

So too does San Mateo's proposal to prohibit the issuance of seller's permits to a buying company which either purchases jet fuel for a related entity or which purchases a single good or service for a related entity. There is no statutory authority for the Board unilaterally deciding what types of generic businesses it will or will not recognize as a retailer, any more than a taxpayer can argue that it should not be treated as a retailer because it sells a certain type of commodity or has a certain type of customer. This also conflicts with the holding in *Davis Wire Corp. v. State Board of Equalization* (1976) 17 Cal. 3d. 761, which requires the Board to issue a permit even if 100%

of a seller's sales are at wholesale.

San Francisco's and San Mateo's Proposals are Not Supported by Case Law.

In its petition and at the Interested Parties meeting, San Mateo erroneously asserted that existing Regulation 1699(h) is inconsistent with *Mapo v. State Board of Equalization* 53 Cal. App. 3d 245 (1976) because it "allow[s] the Board to recognize corporate sub-units that lack identity separate from the parent."

First, Regulation 1699(h) (1) states:

"(1) DEFINITION. For the purposes of this regulation, a buying company is a legal entity *that is separate from another legal entity that owns, controls or is otherwise related to, the buying company,* and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity." (emphasis added)

Thus, even before application of the specific elements in subdivision (h) (2), a buying company must have: 1) a separate identity; and 2) an identifiable business purpose of servicing other corporate entities in the corporate family. Nothing in existing Regulation 1699(h) is inconsistent with *Mapo*.

Moreover, San Mateo apparently misunderstands the unique factual context of *Mapo*, and in particular the application of the Sales and Use Tax Law to fabrication labor in the motion picture context. In *Mapo*, the issue was whether fabrication labor¹ was taxable when performed on behalf of a corporate parent by employees of a corporate affiliate. The motion picture industry has had a long tradition of "loaned employees", where employees of a studio are under the direction and control of a producer not directly affiliated with the studio as they performed labor on property owned by the producer (i.e., the tangible film). The Board has had a longstanding view that in this type of a direct supervision case, the producer "stepped into the shoes" of the studio, and therefore the labor was not taxed because it was not

¹The corporate grandparent owned and retained title to all materials and completed devices. *Mapo* at p. 248.

deemed to be a sale. In *Mapo*, the Board had given the corporate grandparent a legal ruling that found that the fabrication labor of *Mapo* was not taxable to its corporate grandparent for that reason². The trial court agreed that the fabrication labor was not taxable, because ". . . Productions was fabricating items for itself, and because it directed, employed and controlled the *Mapo* personnel who were doing the work." *Mapo* at p. 248 (emphasis added). *Mapo* is therefore more appropriately viewed as a case discussing the parameters of "direct supervision and control" of one entity's employees by another rather than a case about when a corporate entity should be disregarded. This background is important because it would be far too easy to overstate *Mapo's* importance and project its holdings far beyond its facts, as San Mateo has done.

Next, it should be noted that many of the criteria that San Francisco and San Mateo propose to exclude an entity from the definition of a "buying company" are nowhere to be found in the Court's discussion in *Mapo*. These include: 1) the failure of the buying company to make 50% or more of its sales to an unrelated party; 2) the receipt of revenue pursuant to an incentive program by the buying company; 3) public statements that the buying company was formed for the purpose of redirecting sales tax revenue; 4) receipt of a business incentive greater than 20% of the yearly sales tax generated by the buying company; 5) a primary purpose of selling jet fuel; or 6) the primary purpose of selling a single good or service to a related entity.

Finally, the *Mapo* court came to its conclusion based on *all the facts and circumstances* in that case, and applying those facts and circumstances to *all* the appropriate legal criteria it listed. The San Francisco and San Mateo petitions proceed on a totally different tack which is inconsistent with *Mapo*. The San Francisco proposal lists six new criteria, and disqualifies an entity as a buying company if they possess *any one* of the criteria. By contrast, San Mateo lists a number of criteria (some internally consistent with *Mapo*, other not), and then

²The Board subsequently reversed its earlier position because it felt that the corporate grandparent "did not satisfy the provision of the tax ruling which required Productions to exercise day-to-day control over *Mapo* operations." *Mapo* at p. 249.

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disqualifies an entity from being treated as a buying company unless they possess *all* the criteria.

Mapo, therefore, does not stand for the proposition that all of one list of criteria must be present, or none of another list of criteria must be present to be disregarded as a seller for sales tax purposes. Yet that is the approach urged by San Francisco and San Mateo. It is their petitions, rather than existing Regulation 1699(h), that are inconsistent with *Mapo*.

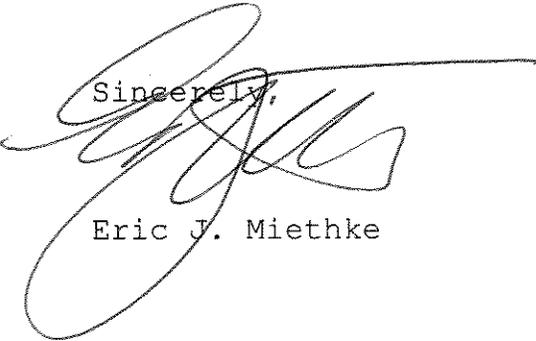
Any Actions by the Board Should Be Prospective Only.

For the reasons stated above, the ATA respectfully suggests that the petitions of both San Francisco and San Mateo be denied outright; however, if the Board chooses to change the buying company regulations, it requests that the Board exercise its authority under section 7051 to make all changes prospective only.

Regulation 1699(h) was adopted after extensive discussion and review by all stakeholders. It has been relied upon by private businesses and local government entities statewide. A retroactive change in the regulations would cause severe disruptions in local government budgets and corporate operations. A retroactive change in the law would also trigger refunds statewide, and potential shifts in tax liability upstream as described above. It would also trigger a huge number of local tax redistribution appeals, as local governments and their consultants see opportunities for redistributions under the new rules. For these reasons, any changes should be prospective only.

Thank you for the opportunity to present our views. If you have any questions, please feel free to contact me at (916)446-6752.

Sincerely,



Eric J. Miethke