

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Reallocation)	
of Local Tax Under the Uniform Local Sales)	
and Use Tax Law of:)	
)	
CITY OF FILLMORE)	Case ID 626418
)	
Petitioner)	

Retailer:	Seller of medical and surgical products
Dates of Knowledge:	5/7/09
Allocation period:	1/1/09 – Current
Amount in Dispute:	\$2,489,919 ¹
Notification required:	City of San Diego

This appeal involves an amount in controversy that is \$500,000 or more and thus is covered by Revenue and Taxation Code section 40, as explained below.

BACKGROUND

The retailer is a seller of medical and surgical products whose headquarters is located outside California. Retailer maintained a warehouse in San Diego and at other locations inside California. Retailer opened an office in Fillmore on October 1, 2007, shortly after it entered into an Agency Agreement with an unrelated third party (UTP). The Agency Agreement was entered into in connection with an Economic Development Agreement that UTP had previously entered into with Fillmore in June 2003. Under these agreements, Fillmore pays UTP 85 percent of the local sales tax it receives from Retailer and retains only 15 percent. From its 85 percent share, UTP pays Retailer between 50 and 70 percent of the local sales tax Retailer reports to Fillmore, and UTP retains the remainder (i.e., 15 to 35 percent). The sales in dispute here were those made by Retailer on and after January 1, 2009, pursuant to master contracts entered into beginning October 1, 2007, where Retailer

¹ This is the amount of local sales tax through January 31, 2014, that would be reallocated to San Diego if the petition were denied.

delivered the goods from its San Diego warehouse to California customers. Retailer allocated the local sales tax on these sales to Fillmore based on the view that such sales were principally negotiated at the Fillmore office which was thus the place of sale.

The petition filed by Fillmore was received by the Sales and Use Tax Department (Department) on May 7, 2009, and covers the period beginning January 1, 2009.² The Department granted the petition for the sales at issue. San Diego filed a timely objection seeking reallocation to it of the disputed local sales tax. Our Decision and Recommendation (D&R) recommends that the petition be granted.

UNRESOLVED ISSUE

Whether the local sales tax on sales made on and after January 1, 2009, under master contracts entered into beginning October 1, 2007, was incorrectly allocated to petitioner. We conclude that such local tax was properly allocated to petitioner.

The disputed local sales tax must be allocated in accordance with subdivision (a)(2) of California Code of Regulations, title 18, section (Regulation) 1802 because Retailer has more than one business location in this state. (Rev. & Tax. Code, § 7205, subd. (b)(1).) Since the goods were delivered from Retailer's San Diego warehouse, that location clearly participated in the sales. If no other location participated in the sales, then the local sales tax should be allocated to San Diego. (Cal. Code Regs., tit. 18, § 1802, subd. (a)(2)(A).) If it were determined that the Fillmore office participated in the sales but that such participation did not qualify as principal negotiations, then the subject local tax would be allocable to whichever of the two locations were regarded as having the greater participation in the sales. However, if it were determined that the principal negotiations were conducted by the Fillmore office, then the subject local tax is properly allocable to petitioner. (Cal. Code Regs., tit. 18, § 1802, subdivision (a)(2)(B).) For these purposes, "an employee's activities will be attributed to the place of business out of which he or she works." (*Ibid.*)

² This petition was filed after petitioner failed to file a timely objection to the Department's February 11, 2009 supplemental decision regarding the same issues here which granted the petitions of Industry, Livermore, Palo Alto, and San Diego covering the period October 1, 2007, through December 31, 2008.

San Diego argues that the outside sales representatives³ did not work out of the Fillmore office because their business trips to negotiate the subject master contracts did not start from and end at that office. If San Diego does not prevail on this argument, it alternatively argues that the outside sales representatives did not negotiate the key terms of the master contracts, and that those key terms were instead communicated through third-party agreements or through orders “received”⁴ by the warehouse.⁵ It asserts that the master contracts involved only negotiations of markup and not negotiation of the price of the goods to the customer since the cost of the goods to Retailer was already fixed.⁶ Essentially, San Diego argues that even if the outside sales representatives engaged in some activities that constitute negotiations, those negotiations would not have qualified as the principal negotiations. San Diego argues further that the warehouse also performed some negotiations (e.g., by receiving the orders), and when the negotiations performed by the warehouse are added to the fulfillment performed by the warehouse, the activities by the warehouse constitute greater participation

³ Outside sales representatives are California employees of Retailer assigned the title of account specialists, account managers, account executives, sales directors, enterprise vice-presidents, and area vice presidents who perform sales activities while primarily working in the field or in their homes.

⁴ We note that San Diego states that the warehouse receives the order as if this process is something additional to fulfillment of the orders. Such is not the case. As explained in the D&R, the subject orders were placed electronically by the customer and routed to Retailer’s servers outside this state. The warehouse did not receive the orders from the customers. Rather, after the customers placed the orders, Retailer’s system forwarded the orders to the warehouse closest to the delivery location for fulfillment. That is, the warehouse received the order as a necessary element of its duties to pick, pack, and ship the ordered goods. If, in fulfilling the order, the warehouse detected an error, the problem would be forwarded to a customer service representative at the warehouse for resolution (which sometimes could involve communicating with the customer). In other words, the warehouse has no contact with the customer except when there is a problem in fulfilling the order and only if necessary to resolve that problem. Thus, the warehouse’s receiving of the order was merely a necessary step in fulfilling the order.

⁵ One theory proposed by San Diego is that Retailer’s master contracts are not actually binding sales contracts because they do not require the customers to purchase *all* of their medical supplies from Retailer. A contract for the sale of goods need not be a requirements contract to be an enforceable contract. The contracts here required that the purchasers purchase a specific percentage of their requirements of products available for sale by Retailer. San Diego has cited no authority remotely supporting the proposition that a quantity term based on a percentage of the requirements of the purchaser renders the agreement to be invalid and not binding. Instead, it misinterprets section 2306 of the Uniform Commercial Code as a provision requiring exclusivity rather than a provision providing guidance on the construction (not the formation) of a contract. Nor does the court case cited by San Diego (*Bank of America National Trust and Savings Assoc. v. Smith* (9th Cir. 1965) 336 F.2d 528, fn 1) say that a contract that provides for something less than exclusivity is not a valid and binding contract. Even San Diego agrees that, once the order was placed, the parties were bound to fulfill their duties with respect to that order in accordance with the terms of the previously negotiated master contract. In addition, the parties to the contracts have apparently regarded them as binding master contracts, and we conclude that they have done so because the contracts are, in fact, valid and binding contracts.

⁶ Another alternate theory propounded by San Diego is that since more than one outside sales representative participated in the negotiations, no *single* point of contact with the customer has been identified, which in turn means that the involvement in the negotiations by Retailer’s Fillmore office is irrelevant. We reject this concept out of hand. There is no requirement that negotiations are relevant to allocation of local sales tax only if a single point of contact can be identified and such a concept would produce truly aberrational results.

in the sales than the activities performed by the outside sales representatives. Thus, even if the activities of the outside sales representatives are attributed to the Fillmore office, San Diego argues that the local tax on the subject sales should be reallocated to it under Regulation 1802, subdivision (a)(2)(B) because the place of sale for these sales was the San Diego warehouse.

The Department and petitioner contend that the evidence shows that the outside sales representatives negotiated the key terms of the master contracts and that such negotiations are attributable to the Fillmore office under Regulation 1802, subdivision (a)(2)(B) and Compliance Policy and Procedures Manual (CPPM) Chapter 5 (Returns), Exhibit 5 (Traveling Sales personnel). By the time the customers placed their orders, all that was needed was for the customers to indicate the specific type of goods and quantity being ordered, and petitioner asserts that this did not involve any negotiation between the customer and any warehouse employee. Thus, the Department and petitioner argue that Retailer properly allocated the local sales tax to Fillmore.

All parties agree that the disputed sales were subject to state and local sales tax because the sales occurred in California with participation at least by Retailer's San Diego warehouse. (Cal. Code Regs., tit. 18, § 1620, subd. (a)(2)(A).) As such, the disputed local tax must be allocated to the place of sale. (Rev. & Tax. Code, § 7205; Cal. Code Regs., tit. 18, § 1802, subd. (d).)⁷ As explained above, when a retailer has more than one California location, as here, we look to the Board's rules set forth in Regulation 1802, subdivision (a)(2). (Rev. & Tax. Code, § 7205, subd. (b)(1).)

We first turn to San Diego's contention that the outside sales representatives did not work out of the Fillmore office. We have never regarded the term "out of" in the attribution rule included in subdivision (a)(2)(B) of Regulation 1802 ("an employee's activities will be attributed to the place of business out of which he or she works"), to have the narrow meaning proposed by San Diego. That is, without regard to whether a traveling salesperson departs from the employer's office to commence his or her business trips or the percentage of time a traveling salesperson spends physically in the employer's office, the CPPM explains that the salesperson works out of that office if he or she can be

⁷ The local sales tax is allocated directly to the jurisdiction of the place of sale if that location is required to hold a seller's permit, and otherwise is allocated indirectly to the jurisdiction of the place of sale through its countywide pool.

properly regarded as reporting to that office.⁸ Since the evidence shows that Retailer assigned the outside sales representatives to the Fillmore office beginning October 1, 2007, and the representatives thereafter received their administrative support and attended sales meetings at that office, we find that the outside sales representatives are properly regarded as reporting to the Fillmore office and thus their sales activities were correctly attributed to the Fillmore office.

We next turn to San Diego's contention that the outside sales representatives only negotiated the markup and that such negotiation should be ignored for allocation purposes because the cost of the goods to Retailer had already been established by third-party agreements between the customers and the suppliers or set by the manufacturers. That the cost of goods sold to Retailer may have been fixed and thus not a variable in its negotiations does not alter the fact that Retailer negotiated with its customers for the final total retail price of those goods. Principal negotiations for purposes of local tax allocation includes negotiating the retail price of the goods to be sold, which obviously must include the markup above the retailer's cost of goods. There is absolutely no basis for ignoring the negotiations between the outside sales representatives and the customers that led to the master contracts in determining the correct allocation of local tax from sales resulting from those master contracts.

Regarding the orders downloaded for purposes of fulfillment, the warehouse had no authority to negotiate price, nor are we aware of any discussions occurring at the warehouse that could be

⁸ Nor does the attribution rule require that a traveling salesperson "do sales work related to the taxable transactions while in the Fillmore office" as San Diego argues in its opening brief. In fact, the reason for this rule is because many contracts are negotiated on a retailer's behalf by a person who is not physically present at any location of the retailer. Obviously, the attribution rule would not be necessary where salespersons are working in or at a location of the retailer while negotiating the contract. For example, a retailer's traveling salesperson may negotiate a sales contract during a visit to the customer's location or such salesperson may conduct negotiations by telephone from his or her home office or while "on the road" visiting customers. In such situations, the salesperson's activities are attributed to the location out of which he or she works. San Diego's argument is based on *City of Los Angeles v. Shell Oil* (1971) 4 Cal.3d 108, 121, fn 7, which it cites for the proposition that article XI, section 7 of the California Constitution prohibits "extraterritorial" application of tax laws (i.e., that a city cannot impose its tax on activities occurring outside its jurisdiction). We agree that a city cannot impose its sales tax on activities occurring outside its jurisdiction. Here, however, there is no possible issue of extraterritorial application of tax laws. Neither Fillmore nor San Diego is making the decision, but rather the Board will make the decision in furtherance of its uniform administration of the Bradley-Burns Uniform Local Sales and Use Tax Law. In doing so, the Board must apply Regulation 1802, subdivision (a)(2)(B) to the applicable facts to make a finding on the location where the subject sales were consummated. The local sales tax of the jurisdiction of that location applies, and that tax applies to activities that did occur in the jurisdiction (e.g., by way of attribution), that is, consummation of the sales as provided in Regulation 1802. In other words, the Board's making a finding on where the sales were consummated eliminates any possible concern regarding "extraterritorial" application of tax laws.

characterized as negotiations. Even if there were, we conclude that the negotiations leading to the master contracts which govern all orders placed thereunder were far more significant than any discussions that may have been conducted by the warehouse to resolve problems concerning orders placed under the previously negotiated master contracts. Thus, we find that the primary California point of contact for negotiations was the outside sales representatives working out of the Fillmore office.⁹ Accordingly, we conclude that the disputed local tax was properly allocated to petitioner and that there is no basis upon which to reallocate the local sales tax paid on sales made under master contracts entered into beginning October 1, 2007 for the periods at issue.

RESOLVED ISSUE

There is no dispute that San Diego should receive \$109,629 (\$114,273 less \$4,644 which it already received as its share of the local tax reported for third quarter 2012) through January 31, 2014, for local tax on sales made during the periods at issue related to master contracts principally negotiated by the outside sales representatives assigned to San Diego that were entered into *before* October 1, 2007, and related to orders taken by the San Diego warehouse that were not subject to a master contract. Thus, we agree that such tax should be reallocated to San Diego.

SECTION 40 MATTER

As noted above, this matter is subject to Revenue and Taxation Code section 40. Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written opinion (i.e., Summary Decision or Memorandum Opinion) must be published on the Board's website. (Cal. Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become final 30 days following the date on which notice of the Board's decision is mailed to the parties, except when a petition for rehearing is filed within that period.¹⁰ (Cal. Code Regs., tit. 18, § 5561, subd. (a).)

Following the conclusion of this hearing, if the Board votes to decide the appeal, but does not specify whether a Summary Decision or a Memorandum Opinion should be prepared, staff will expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for

⁹ This means that Retailer was properly issued a seller's permit for the Fillmore location under Regulation 1699.

¹⁰ If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will be considered until after the petition for rehearing is resolved.

consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board directs otherwise, the proposed Summary Decision would not be confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the Summary Decision.

Any party may request that the Board hold in abeyance its vote to decide the appeal so the parties may review the Board's written opinion prior to the expiration of the 30-day period for the filing of a petition for rehearing. If the vote is held in abeyance, the proposed Summary Decision will be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).) Any request that the Board's vote be held in abeyance should be made in writing to the Board Proceedings Division prior to the hearing or as part of oral argument at the hearing. Any such request would then be considered by the Board during its deliberations on the appeal.

OTHER MATTERS

None.

Summary prepared by Trecia M. Nienow, Tax Counsel IV