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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
 11) **CORPORATION FRANCHISE TAX APPEAL**
 12 **WILLIAMS-SONOMA, INC. &**) Case No. 519857
 13 **SUBSIDIARIES¹**)

<u>Years</u> <u>Ending</u>	<u>Claim</u> <u>For Refund</u>
January 31, 2002	\$42,499
January 31, 2003	\$83,969
January 31, 2004	\$37,792

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 19 Representing the Parties:

20 For Appellant: John G. Rucker, III, Deloitte Tax LLP
 21 For Franchise Tax Board: Irina Iskander Krasavtseva, Tax Counsel
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23 QUESTION: (1) Whether the gross receipts from shipping fees, on goods sent to California
 24 customers from locations outside of California and which are charged to
 25 customers for the shipping of goods to customer-designated locations, should be
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27 ¹ Appellant is headquartered in San Francisco.
 28

Throughout this document, Williams-Sonoma, Inc. and Subsidiaries are referred to in the singular, as “appellant”.

1 included in appellant's California sales factor numerator, along with the gross
2 receipts from the sale of those goods.

3 HEARING SUMMARY

4 Background

5 Appellant filed amended returns for the years ending January 31, 2002, January 31,
6 2003, and January 31, 2004, seeking claims for refund for the above amounts. On October 1, 2009,
7 respondent issued Notices of Action denying appellant's claims for refund for these years. Appellant
8 timely appealed these denials. (App. Opening Br., p. 5.)

9 On June 26, 2012, the Board adopted a decision in which it sustained respondent's
10 denial of appellant's claims for refund. Appellant then filed a timely petition for rehearing. On
11 December 18, 2012, the Board granted appellant's petition for rehearing. (App. Opening Br., p. 5.)

12 Applicable Law

13 Article 2 of Chapter 17 of the Corporation Tax Law sets forth the provisions of the
14 Uniform Division of Income for Tax Purposes Act (UDITPA) as adopted by California and set forth in
15 Revenue and Taxation Code (R&TC) sections 25120 through 25141. California's version of UDITPA
16 generally requires that the taxpayer's business income be apportioned by a four-factor formula
17 composed of a property factor, a payroll factor, and a double-weighted sales factor. (Rev. & Tax.
18 Code, § 25128.)² The numerators of the respective factors represent the taxpayer's property, payroll,
19 and sales in California, while the denominators represent the taxpayer's property, payroll, and sales
20 everywhere. (Rev. & Tax. Code, §§ 25129, 25132 & 25134.)

21 R&TC section 25120, subdivision (e), sets forth the definitions of the terms used in the
22 UDITPA and, as relevant here, provides that "'sales' means all gross receipts of the taxpayer not
23 allocated under Sections 25123 to 25127, inclusive." R&TC section 25134 provides that "[t]he sales
24 factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the
25 taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the
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27 ² For taxable years beginning on or after January 1, 2011, R&TC section 25128.5 provides that any apportioning trade or
28 business may make an irrevocable annual election on its return to use a single sales factor method of apportionment instead
of the three-factor formula based on property, payroll, and sales factors, as provided by R&TC section 25128.

1 taxable year.”

2 California Code of Regulations, title 18, section (Regulation) 25134 provides, in
3 relevant part that

4 (a) Sales Factor. In General.

5 (1) Section 25120(e) defines the term “sales” to mean all gross receipts of the
6 taxpayer not allocated under sections 25124 to 25127 inclusive. Thus, for the
7 purposes of the sales factor of the apportionment formula for each trade or
8 business of the taxpayer, the term “sales” means all gross receipts derived by the
9 taxpayer from transactions and activity in the regular course of such trade or
10 business. The following are rules for determining “sales” in various situations:

11 (A) In the case of a taxpayer engaged in manufacturing and selling or
12 purchasing and reselling goods or products, “sales” includes all gross
13 receipts from the sales of such goods or products (or other property of
14 a kind which would properly be included in the inventory of the
15 taxpayer if on hand at the close of the income year) held by the
16 taxpayer primarily for sale to customers in the ordinary course of its
17 trade or business. Gross receipts for this purpose means gross sales,
18 less returns and allowances and includes all interest income, service
19 charges, carrying charges, or time-price differential charges incidental
20 to such sales. Federal and state excise taxes (including sales taxes)
21 shall be included as part of such receipts if such taxes are passed on to
22 the buyer or included as part of the selling price of the product.

23 (B) . . .

24 (C) In the case of a taxpayer engaged in providing services, such as the
25 operation of an advertising agency, or the performance of equipment
26 service contracts, research and development contracts, “sales”
27 includes the gross receipts from the performance of such services
28 including fees, commissions, and similar items.

(D) . . .

(E) . . .

(F) . . .

(b) Sales Factor: Denominator. The denominator of the sales factor shall include the total
gross receipts derived by the taxpayer from transactions and activity in the regular course
of its trade or business, except receipts excluded under Regulation 25137(c).

(c) Sales Factor: Numerator. The numerator of the sales factor shall include gross
receipts attributable to this state and derived by the taxpayer from transactions and
activity in the regular course of its trade or business. All interest income, service charges,
carrying charges, or time-price differential charges incidental to such gross receipts shall
be included regardless of the place where the accounting records are maintained or the
location of the contract or other evidence of indebtedness.

(Cal. Code Regs., tit. 18, § 25134, subs. (a)(1)(A), (b), & (c).) (Underlining added.)

R&TC section 25135, subdivision (a)(1), provides that sales of tangible personal
property are in this state if the property is delivered or shipped to a purchaser in California regardless of

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1 the f.o.b. point or any other condition of the sale.³ R&TC section 25136, conversely, addresses sales
2 other than sales of tangible personal property. R&TC section 25136 provides that sales, other than
3 sales of tangible personal property, are in California if (1) the income-producing activity is performed
4 in California, or (2) the income-producing activity is performed both in and outside of California and a
5 greater proportion of the income-producing activity is performed in California than in any other state,
6 based on costs of performance.⁴

7 Regulation 25136 provides as follows:

8 (a) In General. Section 25136 provides for the inclusion in the numerator of the sales
9 factor of gross receipts from transactions other than sales of tangible personal property
10 (including transactions with the United States Government); under this section gross
11 receipts are attributed to this state if the income-producing activity which gave rise to the
12 receipts is performed wholly within this state. Also gross receipts are attributed to this
13 state if, with respect to a particular item of income, the income-producing activity is
14 performed within and without this state but the greater proportion of the income-
15 producing activity is performed in this state, based on costs of performance.

16 (b) Income-Producing Activity: Defined. The term “income-producing activity” applies
17 to each separate item of income and means the transactions and activity engaged in by the
18 taxpayer in the regular course of its trade or business for the ultimate purpose of
19 producing that item of income. Such activity includes transactions and activities
20 performed on behalf of a taxpayer, such as those conducted on its behalf by an
21 independent contractor. Accordingly, income-producing activity includes but is not
22 limited to the following:

- 23 (1) The rendering of personal services by employees or by an agent or
24 independent contractor acting on behalf of the taxpayer or the utilization of
25 tangible and intangible property by the taxpayer or by an agent or independent
26 contractor acting on behalf of the taxpayer in performing a service.
- 27 (2) The sale, rental, leasing, licensing or other use of real property.
- 28 (3) The rental, leasing, licensing or other use of tangible personal property.
- (4) The sale, licensing or other use of intangible personal property.

The mere holding of intangible personal property is not, of itself, an income producing activity.

24 ³ As operative for the years at issue in this appeal, R&TC section 25135 provides:

25 Sales of tangible personal property are in this state if:

- 26 (a) The property is delivered or shipped to a purchaser, other than the United States government, within this
27 state regardless of the f.o.b. point or other conditions of the sale.
- (b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and
28 (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.
- (c) This section shall become operative on December 1, 2000.

⁴ This is the version of the statute that was in effect for the years at issue in this appeal. This version of the statute will be repealed as of December 1, 2013. (Rev. & Tax. Code, § 25136, subd. (d).)

1 (c) Costs of Performance: Defined. The term “costs of performance” means direct costs
2 determined in a manner consistent with generally accepted accounting principles and in
3 accordance with accepted conditions or practices in the trade or business of the taxpayer
4 incurred to perform the income-producing activity which gives rise to the particular item
5 of income. Included in the taxpayer’s costs of performance are taxpayer’s payments to
6 an agent or independent contractor for the performance of personal services and
7 utilization of tangible and intangible property which give rise to the particular item of
8 income.

9 The fundamental purpose of statutory interpretation is to determine the Legislature’s
10 intent so as to effectuate the law’s purpose. First, the words of the statute are examined and given a
11 plain and commonsense meaning. If the language is clear and unambiguous, there is no need for
12 construction or for an examination of extrinsic evidence of legislative intent. (*Lungren v. Deukmejian*
13 (1988) 45 Cal.3d 727, 735.) If there is ambiguity, then extrinsic sources may be consulted, including
14 the objective of the legislation and the legislative history. In that event, the language is to be construed
15 in a manner that “comports most closely with the apparent intent of the Legislature, with a view to
16 promoting rather than defeating the general purpose of the statute, and avoid an interpretation that
17 would lead to absurd consequences.” (*Estate of Griswold* (2001) 25 Cal.4th 904, 911.)

18 “But the ‘plain meaning’ rule does not prohibit a court from determining whether the
19 literal meaning of a statute comports with its purpose or whether such a construction of one provision is
20 consistent with other provisions of the statute. The meaning of a statute may not be determined from a
21 single word or sentence; the words must be construed in context, and provisions relating to the same
22 subject matter must be harmonized to the extent possible.” (*Lungren v. Deukmejian, supra* at 735.)
23 Additionally, whenever possible, every word and clause of a statute must be given effect so that no part
24 or provision will be useless or meaningless, and none of its language rendered surplusage. (*Briggs v.*
25 *Eden Council for Hope & Opportunity* (1999) 19 Cal.4th 1106, 1118.) It is assumed that statutory
26 amendments have a purpose and “[g]enerally, a substantial change in the language of a statute or
27 constitutional provision by an amendment indicates an intention to change its meaning.” (*Mosk v.*
28 *Superior Court* (1979) 25 Cal.3d 474, 493.)

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1 Contentions⁵

2 Appellant's Contentions

3 Appellant states that it is a specialty retailer and that it provides shipping services to its
4 retail customers for a fee, based on the purchase price of the merchandise to be shipped. Appellant
5 asserts that the gross receipts from its shipping services should be sourced as sales of other than
6 tangible personal property, pursuant to R&TC section 25136. (App. Opening Br., p. 1.)

7 Appellant states that, over the years, it has expanded to more than 250 retail stores in the
8 United States and that it has a "direct-to-customer" business which includes a catalog sales medium and
9 an e-commerce platform. Appellant asserts that it separately manages its retail store operations and its
10 direct-to-customer operations because the business units utilize two distinct distribution and marketing
11 strategies. Appellant states that its retail business generates revenue primarily by selling products at its
12 retail store locations and that its retail stores also provide a shipping service in which a customer can
13 request that the products purchased be shipped from the store to another location of the customer's
14 choosing. Appellant states that its direct-to-customer business generates revenue primarily by selling
15 products through its catalogs and e-commerce websites. Appellant also states that its direct-to-
16 customer business also generates revenue by providing shipping services to its customers who direct
17 that the product purchased be shipped from appellant's warehouses to a location of the customer's
18 choice. Appellant further states that the products purchased through its direct-to-customer business are
19 shipped from its warehouse facilities and not from its retail stores. (App. Opening Br., p. 2.)

20 During the years at issue, appellant states that its corporate facilities were located in San
21 Francisco, it leased warehouse facilities in Mississippi and Tennessee, had call centers in Nevada,
22 Oklahoma, and Pennsylvania, and had office, warehouse, design/photo studio and data center space in
23 California and New York. Appellant states that the Tennessee and Mississippi warehouses, in addition
24 to being utilized for the storage of inventory, provided the shipping services related to its direct-to-
25 customer business, and housed the administrative offices related to the handling of its inventory, the
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28 ⁵ After the Board granted appellant's petition for rehearing, the parties filed a total of three briefs in this appeal. For
purposes of simplicity, the briefs will be referred to, and abbreviated, as follows: Appellant's Opening Brief (App. Opening
Br.); Respondent's Opening Brief (Resp. Opening Br.), which respondent gave the title "Reply Brief"; and, Appellant's
Reply Brief (App. Reply Br.).

1 distribution departments for the outbound and inbound shipping of products destined for its retail
2 stores, and the departments which handled quality control, repackaging, monogramming, gift wrapping,
3 and vendor returns. (App. Opening Br., p. 3.)

4 Thus, for the years at issue in this appeal, appellant asserts that the costs associated with
5 its shipping services occurred at its Tennessee and Mississippi warehouses. Appellant states that the
6 warehouses included a full service shipping department that provided shipping services for its direct-to-
7 customer business segment. Appellant states that its shipping department activities included the
8 retrieval of a customer's merchandise from inventory upon purchase, the assembly of shipping boxes,
9 the addition of air pillows to protect the merchandise, the sealing of the shipping box, the attachment of
10 the shipping label, the calculation of the size and the weight of the filled shipping container, and the
11 completion of the shipping paperwork for the common carrier. Appellant asserts that the activity
12 performed by the common carrier was limited to the pick-up of the package from the warehouse and the
13 delivery of the package to the customer's home or other destination, as directed by the customer. (App.
14 Opening Br., p. 3.)

15 Appellant argues that it operated its shipping function as a profit center separate from its
16 operations as a seller of merchandise and actively managed the shipping function to optimize the
17 income that it earned from providing the shipping service. Appellant states that the price that a
18 customer paid for the shipping service was not appellant's actual cost of performing the shipping (e.g.,
19 by product weight or by shipping distance). Instead, appellant asserts that its pricing model for its
20 shipping service was the price of the product purchased and requested to be shipped, in contrast with a
21 pure cost reimbursement model. As such, appellant contends that its business plan was to make its
22 shipping service a profitable business segment and that, starting with fiscal year 2002, appellant began
23 generating profits from its shipping services. Appellant also contends that it implemented procedures
24 to keep its costs in check and to maximize profits, such as consolidating its freight providers and
25 renegotiating its freight-to-customer contracts as a cost containment measure. (App. Opening Br., p. 4.)

26 Appellant asserts that, during the years at issue, a customer that purchased products from
27 its direct-to-customer business segment was permitted to return the merchandise to appellant's retail
28 stores in the event that the customer decided, for any reason, that they did not want the merchandise.

1 With the exception of extenuating circumstances, appellant states that customers who returned
2 merchandise to its retail stores, which was purchased through its catalog medium or its e-commerce
3 platform, were not entitled to a refund of the shipping charges that such customers paid to have the
4 merchandise delivered.⁶ (App. Opening Br., p. 4.)

5 Appellant argues that R&TC section 25136, which provides the rules for the sourcing of
6 sales other than tangible personal property, is the appropriate methodology to source its gross receipts
7 from its shipping services because its shipping services comprise a revenue stream from a distinct
8 income-producing activity. Based upon R&TC section 25136, appellant contends that its receipts from
9 its shipping services from its direct-to-customer business segment should be sourced outside of
10 California because the location of appellant's underlying income-producing activity associated with
11 such services occurred exclusively in Mississippi and Tennessee. (App. Opening Br., pp. 5-6.)

12 Appellant states that California law, under UDITPA, defines the sales factor as "a
13 fraction, the numerator of which is the total sales of the taxpayer everywhere during the taxable year."
14 (Rev. & Tax. Code, § 25134.) For purposes of computing the sales factor, appellant states that R&TC
15 section 25120, subdivision (e), defines "sales" as "all gross receipts of the taxpayer not allocated under
16 Sections 25123 through 25127 of this code." Appellant next states that R&TC sections 25135 through
17 25137 determine when sales are attributable to California and included in the California sales factor
18 numerator, as R&TC section 25135 determines when sales of tangible personal property are attributable
19 to California and R&TC section 25136 determines when sales of other than tangible personal property
20 are attributable to California. Finally, appellant notes that R&TC section 25137 determines when an
21 alternative apportionment provisions are required to "fairly represent the extent of the taxpayer's
22 business activity in this state." With the above in mind, appellant asserts that the sole issue in this
23 appeal is whether appellant's gross receipts from its shipping service fees, charged to its customers for
24 the shipment of catalog and e-commerce retail purchases to a customer-designated location, should be
25 sourced as sales of tangible personal property, pursuant to R&TC section 25135, or as sales of other
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28 ⁶ Appellant does note, however, that customers were entitled to a refund of the shipping charges in the event that
merchandise was shipped to the incorrect address and that, in instances in which there was a delay in shipping merchandise
and a customer complained to appellant, such shipping charges were usually refunded. (App. Opening Br., p. 4.)

1 than tangible personal property, pursuant to R&TC section 25136. (App. Opening Br., p. 6.)

2 Appellant states that each of its business segments (i.e., its retail store operations and its
3 direct-to-customer operations through catalogs and e-commerce platforms) generate income from the
4 sale of retail merchandise and the sale of shipping services. Further, appellant states that it does not
5 dispute that the gross receipts from its sales of retail merchandise are sourced pursuant to R&TC
6 section 25135 as the sale of tangible personal property. Rather, appellant asserts that its gross receipts
7 from its shipping services are from a distinct income-producing activity which should be attributed to
8 California under R&TC section 25136, which governs the source of sales of other than tangible
9 personal property. (App. Opening Br., p. 7.)

10 Appellant states that R&TC section 25136 requires that sales of other tangible personal
11 property should be sourced based upon where the income-producing activities occur as measured by the
12 “costs of performance”. Appellant states that Regulation 25136 provides that a “cost of performance”
13 analysis is performed for each of a taxpayer’s separate and discrete revenue streams. Specifically,
14 appellant states that Regulation 25136, subdivision (b)(1), provides that the rendering of personal
15 services by employees or the utilization of tangible and intangible property by a taxpayer in performing
16 a service are separate income-producing activities. In addition, appellant asserts that respondent, in its
17 *Internal Procedures Manual: Multistate Audit Technique Manual*, acknowledges that receipts from the
18 provision of services are attributed to California pursuant to R&TC section 25136. (App. Opening Br.,
19 pp. 7-8.)

20 Appellant contends that customers shop its retail stores, catalogs, and e-commerce
21 platforms to purchase specialty merchandise and that, while other retailers may not be able to charge a
22 fee and generate income by providing related services, the quality of appellant’s products and
23 appellant’s brand reputation enable appellant to increase its overall revenues by charging for shipping
24 services based upon an economic model which takes into consideration variables other than costs (i.e.,
25 the price of the item purchased). Appellant argues that the fees it can charge for its shipping services
26 are a discrete income-producing activity, separate and apart from those business activities that appellant
27 engages in to purchase and resell its merchandise. As such, appellant asserts that California law
28 requires that its shipping service receipts be attributed to California pursuant to R&TC section 25136.

1 (App. Opening Br., p. 8.)

2 Appellant argues that its shipping service is distinguishable from the situation present in
3 the *Appeal of Babcock and Wilcox Company (Babcock)* (78-SBE-001, Jan. 11, 1978) in which the
4 Board determined that the sale of a large steam generating system was the sale of tangible personal
5 property even though the taxpayer had performed many service functions (such as planning, drafting,
6 engineering, installation, and testing in the manufacturing process). Unlike *Babcock*, however,
7 appellant argues that its shipping service is not performed in the manufacturing process or otherwise
8 performed before the merchandise sold is a finished product. Appellant asserts that its shipping service
9 is an additive service that provides a convenience element for the customer, after the merchandise has
10 already been made. Thus, appellant's gross receipts from its shipping service, as a separate and discrete
11 income-producing activity, should be attributed to California pursuant to R&TC section 25136. (App.
12 Opening Br., p. 8.)

13 Appellant argues that respondent has asserted that Regulation 25134, subdivision
14 (a)(1)(A), requires that all services charges which are incidental to the sale of tangible personal
15 property are assigned to the California numerator in the same manner as the sale of tangible personal
16 property, pursuant to R&TC section 25135. Appellant contends, however, that respondent
17 misinterprets the meaning of the term "service charges" contained in Regulation 25134, subdivision
18 (a)(1)(A), and mischaracterizes the purpose of R&TC section 25134 and Regulation 25134 as being
19 sourcing provisions for the performance of a personal service. (App. Opening Br., p. 9.)

20 Appellant contends that respondent has misinterpreted the phrase "service charges",
21 found in Regulation 25134, subdivision (a)(1)(A), to include a discrete service, and a separate income-
22 producing activity, performed in connection with the sale of tangible personal property. However, read
23 in its proper context, appellant argues that the phrase "service charges" is clearly a reference to a fee in
24 the category of a charge for financing or indebtedness. (App. Opening Br., p. 9.)

25 Appellant states that Regulation 25134, subdivision (a)(1)(A), provides that the
26 definition of "sales" in R&TC section 25120, subdivision (e), for a taxpayer that is engaged in the
27 purchasing and selling of goods or products, includes those gross receipts from "interest income,
28 service charges, carrying charges, or time-price differential charges incidental to such sales." Appellant

1 notes, however, that the phrase “service charges” is not specifically defined in Regulation 25134, the
2 Revenue and Taxation Code, or in any other regulation thereunder. (App. Opening Br., p. 10.)

3 Rather, within the context of Regulation 25134, subdivision (a)(1)(A), however,
4 appellant asserts that the phrase “service charges” is inserted between “interest income”, “carrying
5 charges”, and “time-price differential charges” which are terms/phrases that refer to debt-servicing
6 charges or financing charges, and not to a broader set of services performed in connection with the sale
7 of tangible personal property. Further, appellant argues that the interpretation of the entire string of
8 terms as related to financing has further support when read within the broader context of the other
9 subdivisions of Regulation 25134. Specifically, appellant states that Regulation 25134, subdivision (c),
10 defines the sales factor numerator to include “[a]ll interest income, service charges, carrying charges, or
11 time-price differential charges incidental to such gross receipts shall be included regardless of the place
12 where the accounting records are maintained or the location of the contract **or other evidence of**
13 **indebtedness**. (Cal. Code Regs., tit. 18, § 25134, subd. (c) (emphasis added by appellant).) (App.
14 Opening Br., p. 10.)

15 Appellant argues that the fact that Regulation 25134, subdivision (c), uses the phrase “or
16 other evidence of indebtedness”, highlights the fact that the terms “interest income, service charges,
17 carrying charges, and time-price differential charges” are meant to solely refer to debt-service charges
18 or to finance charges. As a result, appellant asserts that a plain reading of Regulation 25134 clarifies
19 that the phrase “service charges”, as used in Regulation 25134, subdivision (a)(1)(A), does not relate to
20 services generally but rather to a specific set of finance charges that often accompany the activities of
21 companies that are engaged in manufacturing and the selling or purchasing and reselling of goods or
22 products. (App. Opening Br., pp. 10-11.)

23 Appellant argues that its interpretation of this string of terms is consistent with the
24 Board’s own interpretation of these terms in the *Appeal of Sears, Roebuck and Co. (Sears)* (70-SBE-
25 020, June 4, 1970).⁷ In *Sears*, appellant states that the company was engaged in the sale of general
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27 ⁷ Board staff notes that the Board’s opinion in *Sears* relates to that company’s tax years ending January 31, 1960, 1961, and
28 1962. California adopted UDIPTA in 1966, such that the *Sears* opinion is a pre-UDIPTA decision. The statute at issue in
Sears was R&TC section 24344 relating to interest expense.

1 merchandise with substantial sales made on credit and that, when Sears' customers made a purchase on
2 credit, the company imposed additional service charges, carrying charges, and time-price differential
3 charges "as an incident of the credit sale." Appellant contends that the issue considered by the Board
4 was whether all or any part of these charges, that were incident to the credit sale, constituted interest
5 income subject to a formula within the meaning of R&TC section 24344, subdivision (b).⁸ Appellant
6 contends that the Board concluded that Sears did not establish that the charges incidental to the credit
7 sales constituted interest, as opposed to a finance charge, within the meaning of R&TC section 24344,
8 subdivision (b). Appellant contends that there is a direct connection to the *Sears* decision and its case
9 as the activities of a merchandise retailer and the specific types of charges that are generally associated
10 with retail sales made on credit, as the decision specifically identified interest charges, service charges,
11 carrying charges, and time-price differential charges as interest or finance charges which are incidental
12 to the sale of merchandise on credit. Appellant argues that it cannot be a coincidence that Regulation
13 25134, subdivision (a)(1)(A), includes the same four terms as gross receipts that are incidental to the
14 sale of tangible personal property that should be included in the sales factor. Thus, for purposes of
15 defining what is a gross receipt for a taxpayer that is engaged in the sale of tangible personal property,
16 appellant asserts that the appropriate and logical interpretation of the meaning of the phrase "service
17 charges" is debt-servicing charges or financing charges, in contrast to any type of service that could be
18 provided in connection with the sale of tangible personal property, such as appellant's shipping
19 charges. (App. Opening Br., pp. 11-12.)

20 Appellant asserts that the clear purpose of R&TC section 25134, and Regulation 25134,
21 is to define the composition of the California sales factor, but not to determine how a taxpayer's sales
22 are sourced (i.e., whether the sales are attributable to the numerator of the California sales factor).⁹
23 Instead, appellant argues that R&TC section 25135 through 25137, and the regulations thereunder, are
24 the applicable law for determining whether a taxpayer's sales are attributable to the numerator of the
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26 ⁸ In *Hunt-Wesson, Inc. v. Franchise Tax Board* (2000) 528 U.S. 458, the United States Supreme Court held that R&TC
27 section 24344, subdivision (b), was unconstitutional.

28 ⁹ Appellant cites *Communications Satellite Corporation v. Franchise Tax Board* (1984) 156 Cal.App.3d 726; Statement of
Decision, *Microsoft Corp. v. Franchise Tax Board* (2012) 212 Cal.App.4th 78; and, the *Appeal of Proler International
Corporation*, an unpublished Board opinion from 1995.

1 California sales factor. As a result, appellant contends that respondent has misinterpreted R&TC
2 section 25134 as a sourcing statute. (App. Opening Br., p. 12.)

3 Under R&TC section 25134, appellant contends that its receipts from shipping services
4 are sales under Regulation 25134, subdivision (a)(1)(C), rather than Regulation 25134, subdivision
5 (a)(1)(A) (i.e., sales from the sale of tangible personal property). Appellant states that Regulation
6 25134, subdivision (a)(1)(C), provides in part that “[i]n the case of a taxpayer engaged in providing
7 services . . . ‘sales’ includes the gross receipts from the performance of such services including fees,
8 commissions, and similar items.” Accordingly, appellant argues that R&TC section 25136 controls the
9 sourcing of sales of other than tangible personal property. (App. Opening Br., pp. 12-13.)

10 Appellant states that, under R&TC section 25136, gross receipts are attributed to
11 California if the income-producing activity which gave rise to the receipts is performed within and
12 without California, but the greater proportion of the income-producing activities are performed in
13 California, based on the costs of performance. Here, appellant asserts that its income-producing
14 activities from its shipping services for its direct-to-customer business segment, based on the costs of
15 performance, occur exclusively in Tennessee and Mississippi. Based on this, appellant argues that
16 R&TC 25136 requires that the sales from appellant’s shipping services be attributed outside of
17 California. (App. Opening Br., p. 13.)

18 Appellant asserts that it is entitled to source its gross receipts from its shipping services
19 based upon the rules for sourcing services of “other than tangible personal property” pursuant to R&TC
20 section 25136, because appellant’s shipping services provide a revenue stream from a discrete income-
21 producing activity performed outside of California. Appellant contends that its shipping service
22 revenue comprises a separately-managed profit center due to the unique characteristics of appellant’s
23 high-end specialty retail business. In other words, appellant contends that, by performing, managing,
24 and pricing a service in a manner which provides a meaningful revenue stream and profit for its
25 business, appellant’s receipts and corresponding profits from this service are far from being an
26 “incidental” component of appellant’s sales receipts as respondent suggests. (App. Opening Br.,
27 pp. 13-14.)

28 In addition, appellant argues that respondent’s interpretation of R&TC section 25134 as

1 a sourcing statute, potentially applicable to a broad array of services performed by a retailer in
2 connection with its sales of tangible personal property, is overly broad and is at odds with the
3 longstanding and established sourcing provisions of California law. Accordingly, appellant asserts that
4 its receipts from its shipping business are properly sourced as sales of “other than tangible personal
5 property” pursuant to R&TC section 25136 and, as such, are not includable in the California sales
6 factor numerator since the income-producing activity and the associated costs of performance occur
7 exclusively outside of California. (App. Opening Br., p. 14.)

8 Respondent’s Contentions

9 Respondent asserts that appellant primarily argues that appellant’s shipping activity
10 constitutes an income-producing activity that is separate and distinct from its sales of merchandise and,
11 as such, its shipping receipts should be apportioned as sales of other than tangible personal property.
12 Respondent contends that appellant’s secondary arguments are based on a strained reading of otherwise
13 unambiguous statutes and regulations. (Resp. Opening Br., p. 1.)

14 Respondent argues that there are three parts to appellant’s arguments: (1) that
15 appellant’s receipts from shipping, incidental to the sale of merchandise, should be apportioned as
16 receipts from sales of other than tangible personal property; (2) the definition of sales in Regulation
17 25134, subdivision (a)(1)(A), should be disregarded for the purposes of determining the sales factor
18 composition of retailers, in favor of R&TC section 25136’s sourcing rule; and (3) even if Regulation
19 25134 is applicable, its definition of “gross receipts” which “includes all interest income, service
20 charges, carrying charges, or time-price differential charges incidental to such sales”, should not be
21 interpreted to include shipping charges that are incidental to the sale of appellant’s merchandise. (Resp.
22 Opening Br., pp. 1-2.)

23 Respondent contends that it is undisputed that appellant is in the business of purchasing
24 and reselling specialty home goods¹⁰ and is not engaged in the shipping business, nor does it market
25 itself as a shipper of goods and products. Rather, respondent argues that the shipping that appellant
26 offered was limited to the shipments of merchandise it sold, enabling it to increase the volume of its
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28 ¹⁰ At times in this document, Board staff makes use of the term “merchandise” in place of the term “goods”.

1 sales. In other words, respondent argues that appellant does not offer shipping as a service separate and
2 apart from its sales of merchandise, such that its shipping charges are clearly ancillary or incidental to
3 the sale of merchandise. Respondent asserts that this is demonstrated by the fact that, throughout its
4 briefs and in its annual reports, appellant describes its business as involving only two, not three,
5 business segments—a retail stores segment and a direct-to-customer segment (consisting of catalog and
6 Internet sales). However, respondent notes that none of appellant’s annual reports refer to appellant’s
7 shipping activity as a separate business activity. (Resp. Opening Br., p. 2.)

8 Respondent argues that each of appellant’s retail businesses (such as Williams-Sonoma,
9 Williams-Sonoma Home, and Pottery Barn) offers a specific range of household goods through each of
10 appellant’s two business segments, targeting a range of consumers defined in terms of age, income, and
11 style preferences, and selling their products via their retail stores, catalogs, and websites. And, whereas
12 appellant’s retail stores provide customers with an opportunity to order unavailable items online,
13 respondent asserts that appellant’s catalog and e-commerce retail businesses provide its customers with
14 the means of receiving the merchandise that they purchase remotely, including shipping and delivery.
15 Thus, respondent argues that appellant’s shipping service is purely ancillary and incidental to the sale
16 of its merchandise online and via catalogs. In fact, respondent contends that, on each of its websites,
17 shipping information is located under its general customer service web link, which indicates that
18 shipping is just a customer service incidental to the sale of merchandise. (Resp. Opening Br., pp. 2-3.)

19 Respondent states that appellant offers both domestic and international shipping to its
20 customers who purchase merchandise online and that appellant uses a third-party shipper (FiftyOne)¹¹
21 for its international shipping needs. Respondent contends that FiftyOne, not appellant, determines the
22 shipping fees that appellant’s customers will pay when a customer opts for international shipping. For
23 domestic shipping, respondent contends that appellant calculates, applies, and collects applicable
24 shipping charges, but that these charges are always incidental to the sale of merchandise. In addition,
25 respondent asserts that appellant does not always charge a shipping fee, as each of appellant’s retail
26 businesses offers a considerable selection of merchandise under a “Free Shipping” option. In addition,
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¹¹ Board staff notes that, in 2012, FiftyOne acquired Borderfree, another international ecommerce company, and changed its name to Borderfree in 2013.

1 respondent states that some of appellant’s websites (such as Williams-Sonoma) offer free domestic
2 shipping for many of its orders over \$49 and that, until recently, Williams-Sonoma offered customers a
3 reward membership, for a small annual fee, which gave members free nationwide shipping on most
4 purchases of Williams-Sonoma merchandise. (Resp. Opening Br., pp. 3-4.)

5 Respondent asserts that, when free shipping is not available, appellant charges its
6 customers variable shipping fees based on the total price of the customer’s order. Respondent states
7 that a pricier customer order has a smaller overall shipping rate, as appellant’s shipping fee is not
8 determined based on its actual shipping costs, but on the cost of the goods shipped. Respondent asserts
9 that, in the retail industry, the practice of reducing shipping fees, as the total price of a customer’s order
10 increases, has proven to be very effective in creating incentives for larger orders of merchandise,
11 positively impacting the overall sale of merchandise. (Resp. Opening Br., p. 4.)

12 If and when a shipping fee applies, respondent states that appellant’s sales receipts list
13 the prices of merchandise and the shipping fees separately. Respondent asserts that, on its financial
14 statements, however, appellant hasn’t always reported its shipping fees and costs separately from its
15 sales of merchandise. Respondent contends that appellant began to report its shipping fees and costs
16 separately in the fourth quarter of fiscal 2000, after appellant’s adoption of Emerging Issues Task Form
17 (EITF) No. 00-10 “*Accounting for Shipping and Handling Fees and Costs*”.¹² Respondent asserts that
18 nothing in appellant’s explanation of its segregation of its shipping charges refers to shipping as a
19 separate business activity. (Resp. Opening Br., pp. 4-5.)

20 Beginning with its annual reports for the fiscal 2001 through 2004 years, respondent
21 contends that, although appellant stated “shipping costs” and “shipping fees” separately, its “shipping
22 costs” included only the costs associated with “third-party delivery services and shipping materials”,
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25 ¹² In its annual report for the fiscal year ending on January 28, 2001, appellant stated:

26 EIFT No. 00-10 requires revenues from shipping and handling to be reported gross as revenues in the
27 statement of operations and the costs of shipping and handling to be reported as either cost of goods sold or
28 selling expense with appropriate disclosures in the notes to the financial statements. As a result, shipping
fees are included in net revenues and shipping costs are included in cost of goods sold. Previously,
shipping fees and costs had been presented net in selling, general and administrative expenses. All prior
period revenue, cost of goods sold, gross margin and selling, general and administrative expenses have
been reclassified to conform to the current presentation. The reclassification has no effect on net earnings
or earnings per share.

1 while its “shipping fees” constituted “revenues received from customers for [the] delivery of
2 merchandise”. As such, respondent contends that appellant’s annual reports excluded appellant’s own
3 internal shipping and handling costs and that such costs were included in its Cost of Goods Sold.
4 Respondent states that, as of fiscal year 2005, appellant discontinued the separate reporting of its
5 shipping fees and costs of on its financial statements and annual reports. Respondent asserts that this
6 reporting by appellant demonstrates that appellant did not consider its shipping activities to be a
7 separate business activity. (Resp. Opening Br., p. 5.)

8 Subsequent to this time, respondent states that FASB Accounting Standards Codification
9 Topic 605 (FASB Topic 605), *Revenue Recognition*, was issued. Respondent asserts that this
10 accounting standard is instructive of how retailers were required to handle shipping and handling items
11 for accounting and financial purposes prior to codification and that, for retailers such as appellant who
12 report shipping fees on a gross basis, “*all amounts billed to a customer in a sale transaction related to*
13 *shipping and handling represents revenue earned for the goods provided* and shall be classified as
14 revenue.” (Emphasis added by respondent.) Respondent also states that FASB Topic 605 provides that
15 “shipping and handling costs shall not be deducted from revenues (that is, netted against shipping and
16 handling revenues)” which, respondent argues, clearly indicates that, even for accounting and reporting
17 purposes, a retailer’s shipping service was not to be treated as a separate income-producing category.¹³
18 (Resp. Opening Br., pp. 5-6.)

19 Based upon this, respondent argues that appellant reported its shipping fees and costs
20 separately merely as an accounting practice, and for as long as the accounting standards required it to
21 do so. Further, respondent asserts that appellant’s own practice of reporting its shipping fees and costs,
22 including its own definition of terms, clearly indicates that appellant views its shipping function as
23 being incidental to its sales of merchandise, and not as an income-producing activity that is separate
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25 ¹³ Respondent also states that FASB Topic 605 also provides that:

26 The classification of shipping and handling costs is an accounting policy decision that shall be disclosed
27 pursuant to Topic 235. An entity may adopt a policy of including shipping and handling costs in costs of
28 sales. If shipping costs or handling costs are significant and are not included in costs of sales (that is, if
 those costs are accounted for together or separately on other income statement line items), an entity shall
 disclose both the amount of such costs and the line item or items on the income statement that include
 them.

(Resp. Opening Br., p. 6.)

1 and distinct from its sales of merchandise. As such, respondent concludes that appellant’s shipping
2 activity does not have separate service receipts and should not be apportioned pursuant to R&TC
3 section 25136. Instead, respondent argues that appellant’s shipping activities are demonstrably
4 incidental to the sale of its merchandise such that those receipts should be apportioned according to the
5 provision of R&TC section 25135 and Regulation 25134, subdivision (a)(1)(A). (Resp. Opening Br.,
6 p. 6.)

7 Respondent states that R&TC section 25136 provides how gross receipts from sales of
8 other than tangible personal property should be included in the sales factor numerator. However,
9 respondent argues that appellant is in the business of selling merchandise, and not in the business of
10 providing shipping services. Respondent asserts that appellant’s shipping services are entirely
11 incidental and ancillary to the sale of merchandise and, as such, do not generate receipts from sales of
12 other than tangible personal property as contemplated by R&TC section 25136. As incidental charges,
13 respondent contends that appellant’s shipping receipts must be apportioned in tandem with the receipts
14 from the sale of merchandise shipped. (Resp. Opening Br., p. 7.)

15 To properly apportion appellant’s shipping charges, respondent asserts that the Board
16 should look at R&TC section 25135, a statute which contemplates that merchandise sold may be
17 shipped from outside of California to a California address. Respondent argues that, despite the fact that
18 shipping is a service that may be provided by retailers at a cost to them, it strains credibility to read into
19 the statute the notion of a separate sale of a stand-alone service. Instead, respondent argues that the
20 issue is squarely addressed in the definition of sales in Regulation 25134, subdivision (a)(1)(A), which
21 provides that, for retailers, the term “sales” includes “*all* gross receipts from the sales of such goods or
22 products . . . held by the taxpayer primarily for sale to customers in the ordinary course of its trade or
23 business” and that term “gross sales” “includes *all* . . . carrying charges . . . incidental to such sales.”
24 (Emphasis by respondent.) Because appellant’s shipping fees are incidental to its sales of merchandise,
25 the Board, in its previous summary decision of this matter, was correct to include these incidental
26 charges in the California sales factor numerator along with the gross receipts from the sales of
27 merchandise shipped pursuant to R&TC section 25135. (Resp. Opening Br., pp. 7-8.)

28 Respondent next asserts that, when the language of a statute or of a regulation is clear

1 and ambiguous, the plain meaning of the language governs. Here, respondent argues that the plain
2 meaning of Regulation 25134, subdivision (a)(1)(A), is clear and ambiguous and it is clear that
3 shipping fees are an example of incidental carrying charges. (Respondent Opening Br., pp. 8-9.)

4 Here, respondent contends that appellant attempts to interpret the second “includes all”
5 clause of Regulation 25134, subdivision (a)(1)(A), as limiting the inclusion of incidental charges to
6 only finance-type charges. Respondent asserts that case law provides that the term “includes” is
7 ordinarily a word of enlargement and not of limitation. As such, contrary to appellant’s position, the
8 “including all” phrase in Regulation 25134, subdivision (a)(1)(A), has an illustrative and not an
9 exclusionary purpose, as the type of charges listed in the regulation provide examples of charges
10 incidental to the sales of merchandise. (Resp. Opening Br., p. 9.)

11 In addition, respondent contends that shipping charges are already included in the
12 regulation’s illustrative list of incidental charges under “carrying charges”. Respondent asserts that, for
13 example, in the context of the transportation of goods, the Cambridge Dictionary defines the term
14 “carrying charges” as “an amount charged for transporting goods”. Similarly, respondent asserts that
15 the McMillan Dictionary defines “carrying charges” as “a charge for storing and delivering a
16 customer’s goods”. As such, respondent concludes that the phrase “carrying charges” under these
17 circumstances includes shipping charges that are incidental to the sales of merchandise. (Resp.
18 Opening Br. pp. 9-10.)

19 Respondent argues that, despite its plain meaning, appellant seeks to restrict the scope of
20 the regulation (i.e., Regulation 25134, subdivision (a)(1)(A)) by framing the regulation’s four incidental
21 charge examples to include only finance charges, which runs counter to the inclusive language of the
22 clause and effectively renders three of the four enumerated examples as being superfluous. With regard
23 to appellant’s reference to *Sears*, respondent states that the statute at issue in that appeal (R&TC section
24 24344) did not even contain the term “carrying charges”. Instead, respondent asserts that the term
25 “carrying charges” was coined by the Board in the opinion for the convenience of referencing several
26 charges that the taxpayer applied in relation to its credit sales. Respondent argues that the issue before
27 the Board in *Sears* was not whether a statutory or regulatory reference to “carrying charges” was

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1 limited to finance charges.¹⁴ As such, respondent contends that appellant's reference to *Sears* is
2 ineffective and of no value in interpreting the language of the regulation at issue in this appeal.
3 Consequently, respondent concludes that appellant's sales receipts are clearly incidental to its sales of
4 merchandise and, as a result, must be apportioned pursuant to Regulation 25135 in the same manner
5 that the receipts from the sales of merchandise shipped are apportioned. (Resp. Opening Br.,
6 pp. 10-11.)

7 Appellant's Reply Brief

8 Appellant asserts that there are significant and material factual and legal flaws in
9 respondent's position. First, appellant argues that (1) respondent relies upon numerous facts that did
10 not exist during the tax years at issue in this appeal to show that appellant's shipping services were not
11 a distinct income-producing activity during those years and ignores facts which show that appellant
12 operated its shipping services as a distinct income-producing activity during these tax years, and
13 (2) respondent mischaracterizes California law that governs the sourcing of gross receipts from sales of
14 other than tangible personal property. (App. Reply Br., p. 2.)

15 Appellant asserts that, during the tax years at issue, appellant's shipping services were a
16 discrete income-producing activity which was separate from those business activities that appellant
17 engages in to purchase and resell specialty home and kitchen merchandise. Appellant contends that
18 respondent's summation of the facts relate to appellant's shipping services as such existed several years
19 after the tax years at issue in this appeal, such that respondent has grossly mischaracterized the facts
20 that existed during the relevant tax years. For example, appellant asserts that (1) it did not contract with
21 FiftyOne during the tax years, (2) it did not offer free shipping on items over a certain dollar threshold
22 during the tax years, and (3) it did not have a reward membership program that offered unlimited free
23 shipping in exchange for a fee during the tax years. (App. Reply Br., pp. 2-3.)

24 Regarding its partnership with FiftyOne, appellant contends that, during the tax years, it
25 did not contract with FiftyOne, or with any other third party to perform shipping services on its behalf,
26 to determine the amount of the shipping fees that it should charge its customers for international
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28 ¹⁴ Instead, respondent asserts that the issue in *Sears* was whether any income from "carrying charges" was "interest income subject to allocation by formula' within the meaning of section 24344 subdivision (b)". (Resp. Opening Br., p. 10.)

1 shipping. Appellant states that its relationship with FiftyOne did not begin until August 2010, such that
2 the FiftyOne relationship and those practices do not reflect its shipping practices during these tax years.
3 (App. Reply Br., pp. 3-4.)

4 Regarding respondent’s assertion that appellant did not charge a shipping fee at times
5 for its domestic shipping, appellant asserts that, except for de minimis free shipping on select items,
6 appellant did not have a policy of offering free or reduced rate shipping as part of its direct-to-customer
7 business segment and that its policy to offer free domestic shipping on certain orders over \$49 began in
8 April 2012. As such, appellant argues that its policy to offer free shipping was not offered to customers
9 until many years after the tax years at issue here. (App. Reply Br., p. 4.)

10 Regarding a membership reward program, appellant asserts that this program was not
11 offered to customers until October 2010, and a free shipping program for co-branded VISA card
12 holders did not begin until the fall of 2011. As such, appellant argues that these shipping policies are
13 not relevant to the tax years at issue and do not change the fact that appellant operated its shipping
14 services as a separate income-producing activity during the tax years. (App. Reply Br., pp. 4-5.)

15 Appellant contends that, during the tax years, it operated its shipping function as a profit
16 center separate from its operations as a seller of specialty home and kitchen merchandise and actively
17 managed the shipping function to optimize the income that it earned from providing shipping services.
18 During the 2001 fiscal year, appellant states that it hired new senior executives and that one of the goals
19 for these new executives was to increase the overall profitability of appellant’s businesses. Appellant
20 states that one of the new executives identified various ways to improve logistics and to improve costs,
21 such as opening new distribution centers in strategic locations, the consolidation of freight providers,
22 and the renegotiation of freight-to-customer contracts. In addition, appellant contends that it analyzed
23 its pricing model for ways to increase its net shipping revenue and that its three-year plan identified
24 increasing corporate profitability for shipping and handling as a key to reaching its operating margin
25 goal.¹⁵ (App. Reply Br., pp. 5-6.)

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28 ¹⁵ For example, appellant states that its “three-year plan review” included the following bullet items: (1) “[r]eassess rate table and surcharges and execute a corporate profitability goal for shipping and handling”; and (2) “[i]dentify one management team that owns and is accountable for shipping and handling”. (App. Reply Br., p. 6.)

1 Appellant asserts that, as a result of the changes that it implemented in the 2002 fiscal
2 year, it began generating profits from its shipping services in the 2003 fiscal year. Appellant argues
3 that such was not a coincidence, as it spent much time and effort to ensure that its shipping services
4 pricing model would result in a profit from its shipping business segment and because it proactively
5 implemented procedures to reduce its costs and to maximize its profits for its shipping segment.
6 Appellant states that, after the tax years at issue here, it began to change its shipping policies for
7 various reasons, including: (1) appellant received feedback from customers that it was overcharging for
8 shipping services; (2) appellant decentralized the oversight of its shipping costs and its associated
9 income; and (3) changes taking place in the retail marketplace related to shipping fees. (App. Reply
10 Br., pp. 6-7.)

11 First, regarding customer resistance to its shipping fees, appellant asserts that, many
12 years after the tax years at issue here, it reviewed its shipping fee structure and began reducing or
13 discounting its shipping fees to align with a reduction in its shipping costs. Second, regarding the
14 decentralization of oversight, appellant asserts that, after the tax years at issue here, each of its brands
15 was given the authority to decide how it wanted to manage its pricing of shipping services. And, third
16 and finally, appellant asserts that changes in the marketplace occurred such that appellant made an
17 internal business decision to begin offering certain shipping promotions. (App. Reply Br., p. 7.)

18 Appellant reiterates that, under R&TC section 25136, sales of other than tangible
19 personal property should be sourced based on where the income-producing activities occur as measured
20 by the “costs of performance” and that, under Regulation 25136, the “cost of performance” analysis is
21 performed for each of a taxpayer’s separate and discrete revenue streams. Appellant argues that, during
22 the tax years at issue in this appeal, the fees that it charged for its shipping services are a discrete
23 income-producing activity, separate and apart from the business activities that appellant engaged in to
24 purchase and resell specialty home and kitchen merchandise, such that these receipts should be sourced
25 pursuant to R&TC section 25136. (App. Reply Br., p. 8.)

26 Appellant next argues that respondent mischaracterizes R&TC section 25134 and
27 Regulation 25134 as a sourcing provision for the performance of a personal service. Appellant instead
28 argues that the clear purpose of R&TC section 25134 and Regulation 25134 is to define the

1 composition of the California sales factor, but not to determine how a taxpayer's sales are sourced (i.e.,
2 whether such sales are attributable to the numerator of the California sales factor). Rather, appellant
3 contends that the determination of whether a taxpayer's sales are attributable to the numerator of the
4 California sales factor is left to R&TC sections 25135 through 25137 and the related regulations. In
5 other words, appellant asserts that respondent has misinterpreted R&TC section 25134 to be a sourcing
6 statute. Appellant asserts that its receipts from its shipping services are sales under Regulation 25134,
7 subdivision (a)(1)(C),¹⁶ rather than under Regulation 25134, subdivision (a)(1)(A). Accordingly,
8 appellant contends that R&TC section 25136 controls the sourcing of sales of other than tangible
9 personal property. (App. Reply Br., pp. 9-10.)

10 Appellant states that, under R&TC section 25136, gross receipts are attributed to
11 California if the income-producing activity which gave rise to the receipts is performed within and
12 without the state, but the greater proportion of the income-producing activities are performed in the
13 state, based on the costs of performance. In applying the sourcing rule of R&TC section 25136 then,
14 appellant asserts that the revenue from its shipping services properly results in such revenue being
15 sourced outside of California because the costs of performance related to these shipping services
16 occurred exclusively in Tennessee and Mississippi. (App. Reply Br., p. 10.)

17 STAFF COMMENTS

18 Appellant asserts that the fees it can charge for its shipping services are a discrete
19 income-producing activity, as a sale of "other than tangible personal property", separate and apart from
20 those business activities that appellant engages in to purchase and resell its merchandise. And, at the
21 same time, appellant also asserts that, during the relevant years, shipping fees were charged, with few
22 exceptions, on all sales of its merchandise. At the hearing, appellant may wish to address whether there
23 were instances during the relevant years in which it charged and collected shipping fees from customers
24 unrelated to the sale of its merchandise and how this impacts its argument that shipping services
25 constituted a separate income-producing activity.

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28 ¹⁶ Regulation 25134, subdivision (a)(1)(C), provides in part that:

In the case of a taxpayer engaged in providing services . . . 'sales' includes the gross receipts from the performance of such services including fees, commissions, and similar items.

1 Appellant describes its shipping service as “an additive service that provides a
2 convenience element for the customer”. (App. Opening Br., p. 8, fn. 4.) This description is arguably
3 similar to respondent’s characterization of appellant’s shipping fees as being ancillary or incidental to
4 appellant’s sale of merchandise. At the hearing, the parties should be prepared to discuss the factors
5 that should be considered in determining whether a line item on a receipt constitutes a separate income-
6 producing activity. If appellant’s shipping service is merely a “convenience element” for its customers,
7 at the hearing, appellant should be prepared to address whether a California customer, during the
8 relevant time period, had the option of negotiating a waiver of the shipping fees charge if the customer
9 agreed to pick up the merchandise he or she purchased at appellant’s Tennessee or Mississippi
10 warehouse locations.

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14 Williams-Sonoma Inc_ase

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