



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0043  
TELEPHONE (916) 445-1441  
FAX (916) 445-2388  
www.boe.ca.gov

October 3, 2003

CAROLE MIGDEN  
First District, San Francisco

BILL LEONARD  
Second District, Ontario

CLAUDE PARRISH  
Third District, Long Beach

JOHN CHIANG  
Fourth District, Los Angeles

STEVE WESTLY  
State Controller, Sacramento

TIMOTHY W. BOYER  
Interim Executive Director

Dear Interested Party :

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the October 15, 2003, Business Taxes Committee meeting. This meeting will address the proposed amendments to Regulation 1628, *Transportation Charges*.

Action 1 on the Agenda concerns proposed amendments regarding reporting taxable transportation charges using an alternate method. Staff is recommending no amendments to the regulation.

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.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **October 15, 2003**, in Room 121 at the address shown above.

Sincerely,

Ramon J. Hirsig  
Deputy Director  
Sales and Use Tax Department

RJH: tdm

Enclosures

cc: (all with enclosures)  
Honorable Carole Migden, Chairwoman  
Honorable Claude Parrish, Vice Chairman  
Honorable Bill Leonard, Member, Second District (MIC 78)  
Honorable John Chiang, Member, Fourth District

Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel  
Ms. Carole Ruwart, Board Member's Office, First District (MIC 71)  
Ms. Sabina Crocette, Board Member's Office, First District  
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)  
Mr. Tim Treichelt, Board Member's Office, Second District (via e-mail)  
Mr. John Thiella, Board Member's Office, Fourth District (MIC 72)  
Mr. Timothy Boyer (MIC 73)  
Acting Chief Counsel (MIC 83)  
Ms. Janice Thurston (MIC 82)  
Mr. Warren Astleford (MIC 82)  
Ms. Sharon Jarvis (MIC 82)  
Mr. Bob Tucker (MIC 82)  
Ms. Jean Ogrod (via e-mail)  
Mr. Jeff Vest (via e-mail)  
Mr. David Levine (MIC 85)  
Mr. Steve Ryan (via e-mail)  
Mr. Rey Obligacion (via e-mail)  
Ms. Jennifer Willis (MIC 70)  
Mr. Dan Tokutomi (via e-mail)  
Mr. Dave Hayes (MIC 67)  
Ms. Charlotte Paliani (MIC 92)  
Mr. Joseph Young (via e-mail)  
Mr. Jerry Cornelius (via e-mail)  
Mr. Jeffrey L. McGuire (via e-mail)  
Mr. Vic Anderson (MIC 40 and via e-mail)  
Mr. Larry Bergkamp (via e-mail)  
Mr. Geoffrey E. Lyle (MIC 50)  
Ms. Laureen Simpson (MIC 50)  
Mr. Todd MacMurray (MIC 50)  
Ms. Laura Jonoubei (MIC 50)

**AGENDA —October 15, 2003 Business Taxes Committee Meeting**  
***Proposed Regulatory Change to Regulation 1628, Transportation Charges, Regarding Reporting Tax on Transportation Charges Based on an Alternate Method***

<p><b>Action 1 -- Optional method of reporting transportation charges based on estimate of the charges.</b></p> <p>Regulation 1628(d)          Agenda, page 2-3.          Issue paper Alternative 1.</p>	<p>Adopt either:</p> <p>Deloitte’s proposed amendments to Regulation 1628 by adding new subdivision (d), which would provide certain retailers the option to report future transportation charges by third party carriers using an estimate of the transportation charges developed from a test of past charges.</p> <p style="text-align: center;">OR</p> <p>Staff’s recommendation to make no changes to Regulation 1628.</p>
<p><b>Action 2 – Authorization to Publish</b></p>	<p>Recommend publication of amendments to Regulation 1628 if adopted in the above action.</p> <p>Operative Date: None.          Implementation: 30 days following OAL approval.</p>

**AGENDA — October 15, 2003 Business Taxes Committee Meeting**  
**Proposed Regulatory Change Regarding Reporting Tax on Transportation**  
**Charges Based on an Alternate Method**

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Deloitte
<p><b>Action 1—Optional method of reporting transportation charges based on estimate of the charges.</b></p>	<p>Staff recommends making no change to the regulation.</p>	<p><b><u>(d) TESTING METHOD FOR REPORTING TAXABLE TRANSPORTATION CHARGES.</u></b></p> <p><u>The following optional method of reporting taxable transportation charges is available only in regard to transactions subject to sales tax and where no sales tax reimbursement is added for the transportation charge. The process is as follows:</u></p> <p><u>(1) Develop a taxable percentage from a test of the amounts charged for transportation. This is a transaction by transaction test with no offsets for charges where the retailer’s charge is for less than the actual cost. The amounts charged by the retailer which exceed the actual cost of the transportation to the retailer, being considered taxable, over the total recorded transportation charges for the test period. This test, which would be done annually, must follow a method acceptable to the Board. (Chapter 13 of the Audit Manual (titled Statistical Sampling))</u></p> <p><u>(2) The succeeding quarterly period bases are then evaluated to determine if there are any expected material changes in the transportation charges base from the facts and circumstances surrounding the base tested. Examples of a material change are; (1) an exceptionally large increase (25%) in the charge made by the common carriers, or (2) an exceptionally large increase (25%) in the charge made by the retailer for freight. In the case of a material change retesting would be required for the succeeding quarters.</u></p> <p><u>(3) Then the taxable percentage, as determined in (1) above, is applied against the amount of recorded transportation charges and the product is reported as taxable sales or reduction from excludable transportation charges. The parameters of the population base used to determine the taxable amount to be reported must be consistent with the test population base. The test sample will be drawn from within one quarter’s transactions and applied to the following four quarters. After a period of one year a retest must be done. If the results of the test are within a</u></p>

**AGENDA — October 15, 2003 Business Taxes Committee Meeting**  
**Proposed Regulatory Change Regarding Reporting Tax on Transportation**  
**Charges Based on an Alternate Method**

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Deloitte
		<p><u>plus or minus 5% variance of the previous number, the new amount may be used without the Board approval. After the third year the Board must once again review the taxpayer's process and test and issue a new approval letter.</u></p> <p><u>(4) The Board shall verify the methods used and the amounts reported in the normal audit cycle. At the retailer's request the Board will review the test procedure prior to or at the time the test is undertaken. If the test procedures and supporting documentation are consistent with the Board audit standards Sec. 6596 protection will be available to the retailer. The protection under Sec. 6596 will apply on test-by-test basis.</u></p> <p><u>This process is a final process and no claims for refund would subsequently be allowed and no audit liabilities could be levied, without the proof of fraud, for the period covered by the section 6596 letter. Without the 6596 letter the taxpayer who reports per the method described above is at the same risk as any other taxpayer under audit.</u></p>

Issue Paper Number 03 - 011



BOARD OF EQUALIZATION  
**KEY AGENCY ISSUE**

- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

---

## **Proposed Regulatory Change Regarding Reporting Tax on Transportation Charges Based on an Alternate Method Regulation 1628, Transportation Charges**

### **I. Issue**

Should Regulation 1628, *Transportation Charges*, be amended to provide retailers the option to report taxable transportation charges developed from a test and projected into the future, rather than reporting the transportation charges on an actual basis?

### **II. Staff Recommendation**

Make no change to the Regulation. See Issue Paper pages 6-12, and Agenda Action Item 1.

### **III. Other Alternative Considered**

Ernest J. Dronenburg, Jr. of Deloitte and Touche (Deloitte) proposes to amend Regulation 1628 by adding subdivision (d), which would provide retailers the option to report future transportation charges by third party carriers, such as United States mail, common carriers and contract carriers, using an estimate of the transportation charges developed from a test of the past charges. The proposal would require the Board to issue written advice under Revenue and Taxation Code (RTC) section 6596 authorizing the reporting of tax that is based upon estimates, if the proposed methodology is followed. Deloitte's proposed amendments to Regulation 1628 are illustrated in Exhibit 3. See Issue Paper pages 3-6, and Agenda Action Item 1.

Issue Paper Number: **03 - 011**

#### **IV. Background**

The Revenue and Taxation Code provides that tax does not apply to “separately stated” charges for the retailer’s cost to transport tangible personal property from the retailer’s place of business, or other point from which shipment is made “directly to the purchaser,” provided the transportation is by other than facilities of the retailer, such as by United States mail, independent contract or common carrier and provided the property is not sold for a “delivered price.” (RTC sections 6011(c)(7), 6012(c)(7).) Transportation charges are deemed separately stated only if they are separately set forth in the contract for sale or in a document reflecting that contract, issued contemporaneously with the sale, such as the retailer’s invoice. (Reg. 1628(a).) The retailer may only exclude the actual cost of the transportation. (RTC sections 6011(c)(7), 6012(c)(7); Reg. 1628(b)(2).) To be entitled to the exclusion, the retailer must retain records showing the actual cost of transportation for each transaction. Therefore, the exclusion does not apply when a retailer fails to separately state the cost of transportation or fails to retain records showing the actual cost of transportation for each transaction. In such instances, any charge for the actual cost of transportation is included in the taxable measure.

When transportation is by facilities of the retailer or where the property is sold for a delivered price,<sup>1</sup> tax applies to charges for transportation to the purchaser, unless (1) the transportation charges are separately stated, (2) are for transportation from the retailer’s place of business or other point from which shipment is made directly to the purchaser, and (3) the transportation occurs after the sale of the property is made to the purchaser. (*Ibid.*) If transportation is by facilities of the retailer, the retailer may only exclude a reasonable charge for its transportation from the measure of tax. (RTC sections 6011(c)(7), 6012(c)(7); Reg. 1628(b)(2).)

Interested parties meetings were held on June 27, 2003 and August 7, 2003. At those meetings, Mr. Dronenburg presented his proposal and answered questions from staff and other interested parties. Following each meeting, Mr. Dronenburg made adjustments to Deloitte’s proposed language to amend the regulation. This issue is scheduled for discussion at the October 15, 2003 meeting of the Business Taxes Committee.

By a letter dated August 21, 2003, and proposed regulatory language received September 3, 2003, Arthur D. Levy of Levy, Ram & Olson LLP (Levy) submitted a suggestion that the Board amend Regulation 1628 to require retailers to collect the correct amount of tax or tax reimbursement on handling and shipping charges. Levy suggests that Regulation 1628 be amended to (1) require retailers to maintain records of actual transportation costs on a per transaction basis, and (2) only permit retailers that collect tax or tax reimbursement to do so measured by the amount by which shipping and handling charges exceed the actual cost of transportation for each transaction.

It has been determined that Levy’s proposal is outside the narrow scope of the current proposed regulatory change since it deals with retailers that do collect sales tax reimbursement or use tax on handling and shipping charges and is not a proposal to provide retailers an optional method of reporting transportation charges.

---

<sup>1</sup> Property is sold for a delivered price when the price agreed upon in the contract for sale includes whatever cost or charge may be made for transportation of the property directly to the purchaser. (Reg. 1628(b)(1).)

Issue Paper Number: 03 - 011

## V. Deloitte's Proposal (Alternative 1)

### A. Description of Deloitte's Proposal

Deloitte's proposal seeks to amend Regulation 1628 by adding subdivision (d), which would provide certain retailers the option to report future transportation charges by third party carriers, such as United States mail, common carriers and contract carriers, using an estimate of the transportation charges developed from a test of the past charges. See Exhibit 3 for Deloitte's proposed amendments. The proposal would require Board acceptance under RTC section 6596 of the future reported tax that is based upon estimates, if the proposed methodology is followed and the test is reviewed and approved by Board staff. The proposed methodology is as follows:

"The following optional method of reporting taxable transportation charges is available only in regard to transactions subject to sales tax and where no sales tax reimbursement is added for the transportation charge. The process is as follows:

"(1) Develop a taxable percentage from a test of the amounts charged for transportation. This is a transaction by transaction test with no offsets for charges where the retailer's charge is for less than the actual cost. The amounts charged by the retailer that exceed the actual cost of the transportation to the retailer being considered taxable, over the total recorded transportation charges for the test period. This test, which would be **done annually**, must follow a method acceptable to the Board. (Chapter 13 of the Audit Manual (titled *Statistical Sampling*))

"(2) The succeeding quarterly period bases are then evaluated to determine if there are any expected material changes in the transportation charges base from the facts and circumstances surrounding the base tested. Examples of a material change are, (1) an exceptionally large increase (25%) in the charge made by the common carriers, or (2) an exceptionally large increase (25%) in the charge made by the retailer for freight. In the case of a material change, re-testing would be required for the succeeding quarters.

"(3) Then the taxable percentage, as determined in (1) above, is applied against the amount of recorded transportation charges and the product is reported as taxable sales or reduction from excludable transportation charges. The parameters of the population base used to determine the taxable amount to be reported must be consistent with the test population base. The test sample will be drawn from within one quarter's transactions and applied to the following four quarters. After a period of one year a retest must be done. If the results of the test are within a plus or minus 5% variance of the previous number, the new amount may be used without the Board approval. After the third year the Board must once again review the taxpayer's process and test and issue a new approval letter.

"(4) The Board shall verify the methods used and the amounts reported in the normal audit cycle. At the retailer's request, the Board will review the test procedure prior to or at the time the test is undertaken. If the test procedures and supporting documentation are consistent with the Board audit standards, Sec. 6596 protection will be available to the retailer. The protection under Sec. 6596 will apply on test-by-test basis.

Issue Paper Number: **03 - 011**

“This process is a final process and no claims for refund would subsequently be allowed and no audit liabilities could be levied, without the proof of fraud, for the period covered by the section 6596 letter. Without the 6596 letter, the taxpayer who reports per the method described above is at the same risk as any other taxpayer under audit.”

The remainder of this section consists of a compilation of statements made by Deloitte in its letters of July 14, 2003 and August 25, 2003. Staff’s comments on the proposal are in Section VI.

It is quite difficult, if not impossible, for retailers to comply with the provisions of Regulation 1628. The timing between when freight is charged to the customer and when delivery actually occurs is a major factor that contributes to the difficulty in complying with the regulation. In a retail setting, freight is traditionally charged at the time the order is placed, which is generally before delivery occurs. At this point, the retailer often does not know what the actual transportation cost will be, and therefore is forced to estimate the taxable component of the freight charge.

On the surface, it would appear relatively easy for taxpayers to pass through the actual cost of freight to the taxpayers. However, in the reality of the current business practices, there are factors that make passing the actual cost of the freight to customers quite difficult, if not impossible. A Wall Street Journal article titled, “Shipping Firms Deliver Hidden Fee Increases” (Exhibit 4) illustrates the ever-increasing complexity for the retailer of pricing freight charges.

The most efficient means of determining the cost of the freight is looking at past experience, which typically results in a historical average. However, the problems associated with using a historical average are that price changes and ancillary charges are not factored into that number. An example of a typical ancillary charge is when the common carrier has to climb multiple floors of a building in order to complete the delivery. Another possible ancillary charge is when the carrier has to make two or three attempts at delivering the product. Factors such as these affect the transportation charge, but the taxpayer has no way of taking such factors into consideration at the time the order is placed. Deloitte says that in some cases, the amount the customer pays for transportation charges is determined by the customer [as instructed by the retailer], and is based solely on the total dollar amount of the customer’s purchase.

Taxpayers currently have three options available to deal with transportation charges, each of which poses problems:

1. Collect tax reimbursement on the entire amount of the separately stated transportation charges;
2. Do not collect tax reimbursement on transportation charges [and presumably do not remit tax to the state until audited]; or
3. Perform a real-time calculation of separately stated freight charges and bill each customer the result of the calculation.

Under Option 1, a retailer who collects tax reimbursement on the entire amount of the separately stated transportation charges is at a competitive disadvantage in relation to a retailer who does not charge tax reimbursement on transportation charges. Such a retailer also runs the risk of having a class action suit filed against him or her under Business and Professions Code sections 17200 and

Issue Paper Number: **03 - 011**

17204 for the collection of excess tax reimbursement on the excluded portion of the transportation charge.

Option 2 has the disadvantage that on audit the retailer will pay the tax on unreported taxable freight charges plus interest. [Staff assumes that Deloitte is presuming that the retailer does not pay the tax liability until audited.] Over a typical three-year audit period, tax and interest associated with the charge on freight may be significant. For financial reporting purposes, retailers are generally required to estimate a potential tax liability and set that amount aside in a reserve account. This is not a desirable accounting outcome, especially if the estimate is insufficient to cover the liability.

Option 3 is tremendously expensive to implement from an information technology perspective. The cost of implementing a “real-time cost matrix system” for calculating freight charges far outweighs the benefits achieved. Even the very best systems are not completely accurate.

The solution to the problems inherent in these three options is a new methodology whereby the taxpayer (working with the Board’s district office) would conduct a test of transactions and calculate a taxable percentage of transportation charges. The resulting percentage would be applied to the total transportation charges to calculate excludable transportation charges to be reported on the sales and use tax return for the four succeeding quarterly reporting periods. This approach is identical to the methodology applied to the examination of exempt transportation charges during the course of a sales and use tax audit. In addition, it is a real-time measure of the occurrences and it will self-adjust for changes in business conditions and company policy changes.

The taxpayer will be responsible for reviewing each of the succeeding quarters to determine if there are major changes that would effect the reporting. A guide to determine a material change and a course of action is laid out in the “Renewal,” “Significant Business Changes” and “Revised Percentages” section of the Alternative Method of Reporting Use Tax (AMRUT) Program Guidelines. (See Exhibit 5)

This method would be appropriate for taxpayers that charge their customers an estimated amount for the cost of freight, but do not make a sales tax reimbursement charge. Furthermore, this new optional method would not affect the amount of tax due on any transaction nor would it change the documentation requirement for supporting an exclusion from taxable gross receipts.

**B. Pros of the Alternative**

- May make reporting transportation charges easier for approved retailers.
- Provides RTC section 6596 written advice for retailers using this method.

**C. Cons of the Alternative**

- Staff believes legislation is required.
- Expands scope of RTC section 6596 written advice.
- Requires additional Board auditor time and resources.

Issue Paper Number: **03 - 011**

#### **D. Statutory or Regulatory Change**

Staff believes the proposal would require an amendment to RTC section 6012(c)(7).

#### **E. Administrative Impact**

Staff will be required to notify taxpayers of the amendments to the regulation through an article in the Tax Information Bulletin, and to update and distribute the amended regulation.

#### **F. Fiscal Impact**

##### **1. Cost Impact**

It is anticipated that retailers would be notified of the amendments to the regulation through an article in one of the scheduled Tax Information Bulletins (TIBs). The costs associated with the distribution of scheduled TIBs, which are routinely prepared and distributed to taxpayers, are accommodated within the Board's existing budget.

The proposal will require additional Board auditor time spent verifying and approving the retailer's test when requested to do so by a retailer, and reviewing the retailer's process and test, and issuing a new approval letter every three years. This process will take an approximate average of 80 hours per retailer. At an average cost of \$50 per hour, the estimated unfunded cost per retailer is \$4,000. Staff does not know how many retailers will use this methodology; therefore the total cost associated with Alternative 1 is unknown. Additionally, there will be an unknown opportunity cost when auditors spend time verifying the retailer's test rather than on normal audit activities (i.e., lost production of revenue).

##### **2. Revenue Impact**

The proposed amendment could have a revenue impact. However, it is not possible to calculate the size of any such impact. See Revenue Estimate (Exhibit 1).

#### **G. Taxpayer/Customer Impact**

Staff expects that this amendment may make it easier for certain retailers to report transportation charges.

#### **H. Critical Time Frames**

The proposed amendment has no operative date.

### **VI. Staff Recommendation**

#### **A. Description of the Staff Recommendation**

Make no change to the Regulation.

Ernest J. Dronenburg, Jr. of Deloitte and Touche (Deloitte) proposes to amend Regulation 1628 by adding subdivision (d), which would provide retailers the option to report future transportation charges by third party carriers, such as United States mail, common carriers and contract carriers, using an estimate of the transportation charges developed from a test of the past charges. The proposal would require the Board to issue written advice under Revenue and Taxation Code (RTC) section 6596 authorizing the reporting of tax that is based upon estimates, if the proposed methodology is followed. Deloitte's proposed amendments to Regulation 1628 are illustrated in Exhibit 3. See Issue Paper pages 3-6, and Agenda Action Item 1.

Issue Paper Number: **03 - 011**

Staff considered the changes proposed in Deloitte's alternative and is unable to support the proposal for the following reasons:

1. Proposal Contrary to Law

Staff believes that Deloitte's proposal is not authorized by law, and, therefore, cannot be adopted by regulation, but would require a legislative amendment to RTC section 6012(c)(7). (See Exhibit 2 for the text of RTC section 6012(c)(7).) RTC section 6012(c)(7) specifically states that to be excluded from the measure of tax, transportation charges must be "Separately stated... but the exclusion shall not exceed ... the cost to the retailer of transportation by other than facilities of the retailer." Thus, as to the amount that may be excluded from the measure of tax, under the current statute, only the actual cost of transportation may be used to calculate the exclusion, because the amount of transportation charges excluded "shall" not exceed the actual cost of the transportation to the retailer on a transaction by transaction basis. Annotation 557.0690 (4/21/89) further articulates this opinion, providing that a retailer cannot use an "average cost of shipping" to calculate an exclusion for transportation charges, and stating, "Only the actual cost of transportation on each order may be excluded from tax under [RTC] section[s] 6011(c)(7) and 6012(c)(7)."

A regulation adopted by a state agency is not valid or effective unless it is consistent and not in conflict with the statute. (Gov. Code sec. 11342.2.) Since Deloitte's proposed amendment to Regulation 1628 would exclude transportation charges from tax based upon something other than the actual cost specified by the statute, staff is of the opinion that the proposal is beyond the scope of a regulatory change, and would require legislative action.

2. Proposal Significantly Enlarges Scope of RTC Section 6596 Advice

Under current law RTC section 6596 provides that written advice may be relied upon under certain specified factual circumstances. If the facts upon which the advice is based changes, the taxpayer may no longer rely upon the advice. However, Deloitte's proposed amendment states that the advice, provided under RTC 6596, may be relied upon unless fraud is disclosed. Therefore, although facts might change, the advice provided by staff will remain in effect, unless fraud is proven. This could result in a significant underreporting of the tax liability, and would increase the burden upon staff by requiring proof of fraud, rather than the proof of changed factual circumstances that is the current standard for invalidating reliance upon 6596 advice.

3. Proposed Testing Not Representative

The Board of Equalization's authority to use sampling in conducting audits is supported by statute and case law. However, the limitation placed upon the Board's authority to use sampling in an audit is that the test must be representative of the period reviewed, and the findings must be supported by substantial evidence. (See *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 444.)

The Board of Equalization has established guidelines to ensure that audit samples are representative and supported by substantial evidence. For example, the Sales and Use Tax Department's audit staff is instructed to complete form BOE-472, *Audit Sampling Plan*, with the taxpayer's input and assistance to document and define the type of test, either statistical or non-statistical, and the parameters for the test, to ensure that the test will be representative of the taxpayer's typical transactions.

Issue Paper Number: **03 - 011**

Audits are conducted using statistical sampling (the preferred method) and block sampling. Under either method, however, the results of the test are used to come to a conclusion about past transactions, not future transactions. This is because the sample is examined to assure it is representative of the population tested, and the evaluation of the sample is solely related to a specific (known) population.

Under Deloitte's proposal, there is no way to assure that the test of a current quarter is representative as a base for projecting an accurate estimated amount of taxable transportation charges for future quarters. Since the projection of the taxable transportation charges is for a future period, it can never be determined, until after the fact, whether or not the current period used to establish the test base is representative of the future. The statute requires certainty, (i.e., the actual cost of transportation), but because the future cannot be predicted with any certainty, the proposed method for reporting tax by using estimates does not comply with the statutory requirement. As Mr. Dronenburg states in his July 14, 2003, letter to Ms. Charlotte Paliani, "The problems associated with using a historical average are that the price changes and ancillary charges are not factored into that number."

#### 4. Proposal Contrary to Current Board Practice

At the June 27, 2003 interested parties meeting, a comparison was made between Deloitte's proposed methodology for reporting transportation charges and the Board audit staff's use of prior audit percentages of error as a means to determine understated taxable measure in a current audit. Mr. Dronenburg also stated in his letters dated July 14, 2003 and August 25, 2003, that the Deloitte proposal's "approach is identical to the methodology applied to the examination of exempt transportation charges during the course of a sales and use tax audit." Audit Manual Section 0405.33 discusses when it is appropriate to use "prior audit percentages of error" in current audits. Before using a prior audit percentage of error, the Audit Manual requires that the auditor analyze the base to which the percentage is applied to assure no changes to the business have occurred since the prior audit. Such testing should include an examination of source documents for changes in processing procedures since the last audit. Other changes to look for include:

- The nature of the business,
- Accounting procedures,
- Key personnel changes,
- Laws or regulations affecting the business, and
- Significant increases in the population being sampled.

These considerations are used to determine if there have been changes to the business that would make the percentages of error from prior audit periods non-representative for a current audit. However, under Deloitte's proposal it is extremely difficult to determine whether past transactions would be representative of future transactions, and there are no provisions to recompute the liability or recoup underestimated taxes if the projections of future transactions turn out to be incorrect.

Furthermore, while Audit Manual Section 0405.33 forbids the use of a prior audit percentage of error in consecutive audits, Deloitte's proposal would permit use of a prior percentage of error in

Issue Paper Number: 03 - 011

consecutive periods without Board approval if the results of a “retest” are within a plus or minus 5% variance of the previous period.

#### 5. Proposed Language Vague

Under item (2) of the proposed alternative reporting method, Deloitte provides that if there are “material changes” in the transportation charges base from the facts and circumstances surrounding the base tested, retesting would be required for succeeding quarters. However, Deloitte’s proposal provides examples of material changes rather than a definition of the term. The two examples of “material changes” that Deloitte provides in its proposal are: (1) an exceptionally large increase (25%) in the charge made by the common carrier and (2) an exceptionally large increase (25%) in the charge made by the retailer for freight. These examples leave a lot of room for taxpayers and staff to disagree on a reasonable definition of “material changes.”

Although not included in the language proposed for subdivision (d) of the regulation, Deloitte recently proposed that the AMRUT guidelines be used to determine when there has been a material change and as a course of action to follow in such instances. The AMRUT guidelines have been approved by Board management and are provided to taxpayers availing themselves of this process (See Exhibit 5). However, while the AMRUT guidelines deal with significant business changes, the examples provided in Deloitte’s proposed regulatory language are limited to changes in carrier charges and changes in retailer freight charges, and lack any details concerning what would and would not be a material change.

Current Board practice (pursuant to RTC section 6012(c)(7)) requires proof of actual cost of transportation charges, a bright line test. Deloitte’s proposal creates a new area for potential disagreement, what are “material changes” to “the facts and circumstances surrounding the base tested.” The proposal substitutes estimates projected into the future (when all the facts are not yet known) for the current standard of actual costs (facts that are known/available).

Further vague language in the proposed wording follows the statement in subdivision (d)(1). The last sentence of proposed subdivision (d)(1) says that the test of amounts charged for transportation, which must be done annually, must follow a method acceptable to the Board. After this sentence is a reference in parentheses, “(Chapter 13 of the Audit Manual title[d] *Statistical Sampling*).” Without clarification, the reader does not know what this reference means or how it applies to “follow[ing] a method acceptable to the Board.”

#### 6. Barring of Refunds Problematic

It is questionable whether the provision in Deloitte’s proposal that a taxpayer would be barred from filing a claim for refund would be valid without statutory language to support it. Regulations are valid only to the extent they are consistent with statutes. There is no statutory basis to require that a taxpayer pay more tax than is legally due, nor that permits a taxpayer to be required to forego applying for a refund. Accordingly, this aspect of Deloitte’s proposal is most likely unenforceable. As such, the proposal would result in a reporting method that guarantees that the liability could not exceed what was reported and yet would allow the taxpayer the option of filing a claim for refund in the event the tax is over-reported. This would create a “no lose” situation for the taxpayer, yet it offers no such guarantee to the State of California.

Issue Paper Number: 03 - 011

### 7. Currently Available Alternative Exists to Report Transportation Charges

Staff believes that Deloitte has not considered an alternative that is allowed under existing statutes. Under Deloitte's current proposal, Deloitte limits the use of its method to those transactions, subject to sales tax, upon which the retailer does not collect sales tax reimbursement. That same retailer could choose to report his or her liability on an actual basis rather than a test basis. The complication, Deloitte contends, is that the actual cost of the transportation charge may not be known, and therefore the total tax liability may not be known at the time of sale. It is staff's understanding, however, that calculating the transportation charge at the time of sale is possible to do, although it may require substantial effort by the taxpayer. For example, review of the United Parcel Service (UPS) website shows that UPS offers free software for calculating such charges. In addition, the UPS website has various weight/distance tables that can be used to calculate freight charges in advance. Research has shown that other software programs also apparently are available to immediately calculate actual transportation charges. Once the cost of transportation is determined, a retailer may compute the actual transportation charge excluded from tax and, therefore, report and pay the actual tax liability.

### 8. Workload Issues

The proposal will require additional Board auditor time spent verifying and approving the taxpayer's test when requested to do so by a taxpayer. Under normal circumstances, taxpayers are eligible for audit every three years. Under Deloitte's proposal, Board audit staff would be required (if requested by the taxpayer) to conduct a "mini-audit" every year. This "mini-audit" would (in addition to verification of the transportation charges) require auditors to examine sales that are claimed exempt or excluded from the measure of tax, because if a sale is not subject to tax, the transportation charges for the tangible personal property sold are not subject to tax either, whether or not they are separately stated or reflect the actual cost of transportation. For example, to verify that the transportation charge on a claimed sale for resale was not taxable, the auditor would have to review a resale certificate. If the resale certificate was not available, or not in proper form, the auditor could either (1) assume the sale was taxable or (2) try to verify that the sale was in fact an exempt sale for resale, perhaps by contacting the customer. This would be a very time consuming process. During this time of anticipated current and future budget cutbacks, this could cause substantial staffing problems.

The Board is working with taxpayers that have applied for the Alternative Method for Reporting Use Tax Purchases (AMRUT). Currently, there is a considerable amount of time between when the taxpayer applies to the program and when his or her proposed reporting method is approved. This is due to the fact that both taxpayers and Board staff must expend substantial resources in order to meet the program requirements. A similar time lag could be expected for requests for approval of alternate reporting methods for transportation costs. This could create difficulties because there would be no written RTC section 6596 advice to the retailer if the retailer were using the taxable percentage to report before staff had a chance to audit the calculations.

### 9. Local and District Tax Issues

The proposed language does not address local and district tax reporting issues. The proposed reporting method contains no provision for ensuring that local tax is correctly allocated and that any applicable district taxes are correctly calculated and paid to the proper district.

Issue Paper Number: **03 - 011**

10. “Gaming” the Regulation

At the June 27, 2003 interested parties meeting, an interested party asked if the proposed method could allow a taxpayer to “game the system.” The answer is yes. For example, a dishonest taxpayer could calculate the percentage of taxable transportation charges and have the calculation approved by staff. This would be done in the first quarter. Then, starting in the second quarter, the taxpayer could intentionally increase the amount charged to its customers for shipping by, say, 24% (just under the 25% threshold for a “material change”). This would result in the taxpayer being able to exclude from tax a larger portion of its gross receipts.

Furthermore, since Deloitte’s proposal only permits RTC section 6596 advice to be revoked in instances of fraud, a dishonest retailer might change the facts or circumstances to the retailer’s advantage without the retailer’s action rising to the level of fraud. In such an instance, the retailer could continue to rely upon the prior written advice even though facts or circumstances have changed, and “game” the protection of RTC section 6596. RTC section 6596 provides that written advice is given based upon specific facts and circumstances of an activity or transaction. A change in those facts or circumstances would generally result in the person to whom RTC section 6596 written advice was given no longer being able to rely upon the written advice. Yet under Deloitte’s proposal, the RTC section 6596 advice could only be revoked if fraud was involved.

**B. Pros of the Staff Recommendation**

- Is consistent with statutory law.
- Does not require legislative or regulatory change.
- Will not require additional audit staff resources.
- Will not have a fiscal impact on the Board.

**C. Cons of the Staff Recommendation**

- Does not give retailers another method of reporting.
- Retailers may continue to collect excess tax reimbursement from consumers.
- Does not give retailers RTC section 6596 written advice to guarantee no additional taxes, interest, and penalties are due if the retailer overstates its deduction for transportation charges.

**D. Statutory or Regulatory Change**

None.

**E. Administrative Impact**

None. See Revenue Estimate (Exhibit 1).

Issue Paper Number: **03 - 011**

**F. Fiscal Impact**

**1. Cost Impact**

None.

**2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1).

**G. Taxpayer/Customer Impact**

None.

**H. Critical Time Frames**

None.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: October 1, 2003

**REVENUE ESTIMATE**

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION



---

**Proposed Regulatory Change Regarding Reporting Tax on Transportation Charges Based on an Alternate Method - Regulation 1628, *Transportation Charges***

**Recommendation and Alternatives**

**Staff Recommendation:**

Make no change to Regulation 1628.

**Alternative 1:**

Ernest J. Dronenburg, Jr. of Deloitte and Touche (Deloitte) proposes to amend Regulation 1628 by adding subdivision (d), which would provide retailers the option to report future transportation charges by third party carriers, such as United States mail, common carriers and contract carriers, using an estimate of the transportation charges developed from a test of the past charges. The proposal would require the Board to issue written advice under Revenue and Taxation Code (RTC) section 6596 authorizing the reporting of tax that is based upon estimates, if the proposed methodology is followed.

**Background, Methodology, and Assumptions**

**Staff Recommendation:**

Staff recommends no change to Regulation 1628. Therefore, keeping the regulation intact has no revenue impact since the regulation will continue to operate as it has to this date.

**Alternative 1:**

Alternative 1 would amend Regulation 1628 by adding subdivision (d), which would provide retailers the option to report future transportation charges by third party carriers using an estimate of the transportation charges developed from a test of past charges. The taxable

percentage developed by the test of past charges, drawn within one quarter, would be applied against the amount of recorded transportation charges for the following four quarters. After one year a retest is required. If the new test has a variance within plus or minus 5% from the previous number, the new taxable percentage may be used without Board approval. A retest is also required for a succeeding quarter when material changes (an increase of 25%) in common carrier or retail freight charges occurs.

Over time, the estimated taxable transportation charges derived from the application of the taxable percentage, developed by the test, may or may not equal the actual taxable transportation charges. Additionally, there will be variances from one period to another.

### **Revenue Summary**

The staff recommendation has no revenue effect.

The alternative proposal could have a revenue impact. However, it is not possible to calculate the size of any such impact.

### **Preparation**

Bill Benson, Jr., Research and Statistics Section prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section and Ms. Charlotte Paliani, Program Planning Manager, Sales and Use Tax Department reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of October 1, 2003.

Revenue and Taxation Code Section

6012(c) “Gross receipts” do not include any of the following:

...

- (7) Separately stated charges for transportation from the retailer’s place of business or other point from which shipment is made directly to the purchaser, but the exclusion shall not exceed a reasonable charge for transportation by facilities of the retailer or the cost to the retailer of transportation by other than facilities of the retailer. However, if the transportation is by facilities of the retailer, or the property is sold for a delivered price, this exclusion shall be applicable solely with respect to transportation which occurs after the sale of the property is made to the purchaser.

...

**Regulation 1628. TRANSPORTATION CHARGES.**

**(a) TRANSPORTATION BY CARRIER.** Except as provided in paragraph (c) below, in the case of a sale, whether by lease or otherwise, tax does not apply to "separately stated" charges for transportation of property from the retailer's place of business or other point from which shipment is made "directly to the purchaser," provided the transportation is by other than facilities of the retailer, i.e., by United States mail, independent contract or common carrier. The place where the sale occurs, i.e., title passes to the customer or the lease begins, is immaterial, except when the property is sold for a delivered price or the transportation is by facilities of the retailer, as explained in (b) below. The amount of transportation charges excluded from the measure of tax shall not exceed the cost of the transportation to the retailer.

Transportation charges will be regarded as "separately stated" only if they are separately set forth in the contract for sale or in a document reflecting that contract, issued contemporaneously with the sale, such as the retailer's invoice. The fact that the transportation charges can be computed from the information contained on the face of the invoice or other document will not suffice as a separate statement. If a separately stated charge is made designated "postage and handling" or "shipping and handling", only that portion of the charge which represents actual postage or actual shipment may be excluded from the measure of tax. Such amounts may be excluded from the measure of tax even though such amounts are not affixed to, or noted on, the package. A separately stated charge designated "handling" or "handling charge" is not a separate statement of transportation charges. Tax applies to such charges, notwithstanding the fact that postage or shipment charges may or may not be affixed to or noted on the package.

Property will not be considered delivered "directly to the purchaser" if it is shipped to the retailer, to the retailer's agent or representative, or to anyone else acting in the retailer's behalf. Any separately stated charges by the retailer for the transportation of property to, rather than from, the retailer's place of business, or to another point from which the property will then be "delivered directly to the purchaser," are included in the measure of tax. Such charges represent incoming freight and are taxable as part of the cost of the property sold by the retailer.

**(b) TRANSPORTATION BY RETAILER'S FACILITIES OR PROPERTY SOLD FOR DELIVERED PRICE.**

(1) DEFINITION. "Delivered Price." Property is sold for a delivered price when the price agreed upon in the contract for sale includes whatever cost or charge may be made for transportation of the property directly to the purchaser. A sale for a "guaranteed price" including a separately stated amount for transportation is a sale for a "delivered price." Property is not sold for a delivered price when the price is agreed upon and to this price is added a separately stated amount representing the cost or charge for transportation of the property directly to the purchaser and any increase or decrease in the actual cost of transportation is borne by or credited to the purchaser.

(2) IN GENERAL. Except as provided in paragraph (c) below, when transportation is by facilities of the retailer or the property is sold for a delivered price, tax applies to charges for transportation to the purchaser, unless (A) the transportation charges are separately stated, (B) are for transportation from the retailer's place of business or other point from which shipment is made directly to the purchaser, and (C) the transportation occurs after the sale of the property is made to the purchaser. When the sale occurs before the transportation to the purchaser commences, the tax does not apply to separately stated charges for the transportation. The amount that may be excluded from the measure of the tax cannot exceed a reasonable charge for transportation by facilities of the retailer or the cost of transportation by other than facilities of the retailer.

(3) DETERMINATION OF WHEN SALE OCCURS.

(A) Security Agreements. When a sale is made pursuant to a security agreement in which the retailer retains the title as security for the payment of the price, the sale occurs when possession of the property is transferred by the retailer to the purchaser or other person at the purchaser's direction.

(B) Leases. When the sale is by lease, the sale occurs upon the transfer of possession or granting of the right of possession of the property by the lessor to the lessee or other person at his direction.

(C) Sale on Approval. When the sale is on approval, the sale does not occur until the purchaser accepts the property.

(D) Other Sales. Unless explicitly agreed that title is to pass at a prior time, the sale occurs at the time and place at which the retailer completes his performance with reference to the physical delivery of the property, even though a document of title is to be delivered at a different time or place. If the contract requires or authorizes the retailer to send the property to the purchaser but does not require him to deliver it at destination, the retailer completes his performance with reference to the physical delivery of the property at the time and place of shipment, e.g., delivery of the property to a carrier for delivery by the carrier to the purchaser; but if the contract expressly requires delivery at destination, including cases where one of the terms of the contract is F.O.B. place of destination, the retailer completes his performance with reference to the physical delivery of the property on tender to the purchaser there. When delivery of the property is by facilities of the retailer, title passes when the property is delivered to the purchaser at the destination unless there is an explicit written agreement executed prior to the delivery that title is to pass at some other time.

(4) PLACE OF SALE. For the purposes of the State Sales and Use Tax Law (but not for the purposes of the Bradley-Burns Uniform Local Sales and Use Tax Law nor for the purposes of the Transactions and Use Tax Law) the place of the sale or purchase of tangible personal property is the place where the property is physically located at the time the act constituting the sale or purchase takes place.

(c) **TRANSPORTATION OF LANDFILL MATERIAL.** Operative January 1, 1989, tax does not apply to separately stated charges for transportation of landfill material, e.g., sand, dirt or gravel, removed from the ground and transported from the excavation site to a landfill site specified by the purchaser if:

(1) the amount of transportation charges excluded from the measure of tax does not exceed a reasonable charge for transportation by facilities of the retailer or the cost of the transportation by other than facilities of the retailer, or

(2) the consideration received is solely for the purpose of transporting the material to a specified site and the material is transferred without charge. If such transportation charges are in excess of a reasonable charge for transportation by facilities of the retailer or in excess of the cost of the transportation by other than facilities of the retailer, the provisions of this paragraph will not apply.

For purposes of this paragraph, it is immaterial when title passes to the purchaser of the landfill material.

**(d) TESTING METHOD FOR REPORTING TAXABLE TRANSPORTATION CHARGES.** The following optional method of reporting taxable transportation charges is available only in regard to transactions subject to sales tax and where no sales tax reimbursement is added for the transportation charge. The process is as follows:

(1) Develop a taxable percentage from a test of the amounts charged for transportation. This is a transaction by transaction test with no offsets for charges where the retailer's charge is for less than the actual cost. The amounts charged by the retailer which exceed the actual cost of the transportation to the retailer, being considered taxable, over the total recorded transportation charges for the test period. This test, which would be done annually, must follow a method acceptable to the Board. (Chapter 13 of the Audit Manual (titled Statistical Sampling))

(2) The succeeding quarterly period bases are then evaluated to determine if there are any expected material changes in the transportation charges base from the facts and circumstances surrounding the base tested. Examples of a material change are; (1) an exceptionally large increase (25%) in the charge made by the common carriers, or (2) an exceptionally large increase (25%) in the charge made by the retailer for freight. In the case of a material change retesting would be required for the succeeding quarters.

(3) Then the taxable percentage, as determined in (1) above, is applied against the amount of recorded transportation charges and the product is reported as taxable sales or reduction from excludable transportation charges. The parameters of the population base used to determine the taxable amount to be reported must be consistent with the test population base. The test sample will be drawn from within one quarter's transactions and applied to the following four quarters. After a period of one year a retest must be done. If the results of the test are within a plus or minus 5% variance of the previous number, the new amount may be used without the Board approval. After the third year the Board must once again review the taxpayer's process and test and issue a new approval letter.

(4) The Board shall verify the methods used and the amounts reported in the normal audit cycle. At the retailer's request the Board will review the test procedure prior to or at the time the test is undertaken. If the test procedures and supporting documentation are consistent with the Board audit standards Sec. 6596 protection will be available to the retailer. The protection under Sec. 6596 will apply on test-by-test basis.

This process is a final process and no claims for refund would subsequently be allowed and no audit liabilities could be levied, without the proof of fraud, for the period covered by the section 6596 letter. Without the 6596 letter the taxpayer who reports per the method described above is at the same risk as any other taxpayer under audit.

#### APPENDIX

##### (a) EXAMPLES OF CONTRACT FOR DELIVERED PRICE.

- (1) The contract for sale provides for the sale of property for \$100 per unit delivered to the purchaser.
- (2) The contract for sale provides for the sale of property for \$100 per unit "which includes cost of delivery at \$10 per unit."
- (3) The contract for sale provides for the sale of property for \$100 per unit delivered, freight prepaid.
- (4) The contract for sale provides for the sale of property for \$100 per unit freight collect and allowed.
- (5) The contract for sale calls for the sale of property for a guaranteed price of \$100 consisting of \$90 plus \$10 freight.

##### (b) EXAMPLES OF CONTRACTS WHICH ARE NOT FOR A DELIVERED PRICE.

- (1) The contract for sale provides for the sale of property for \$100 per unit freight collect.
- (2) The contract for sale provides for the sale of property for \$100 per unit actual freight prepaid and added to the sales price.

**(c) EXAMPLES OF APPLICATION OF TAX.** All deliveries are by independent carrier. All billings are in accordance with the terms of the contract.

- (1) The contract for sale provides for the sale of property for \$100 per unit delivered to the purchaser with freight prepaid.

Tax applies to sales price of \$100 per unit with no deduction for freight charge since the freight charges are not separately stated. The contract is for a delivered price and requires delivery to the purchaser. Title does not pass to the purchaser prior to delivery.

- (2) Contract for sale provides for the sale of property for \$100 per unit. The retailer is required to ship the property to the purchaser freight collect.

Tax applies to \$100 per unit since the responsibility for the payment of the freight is upon the purchaser, and the seller makes no charge for freight. Since the carrier will bill the purchaser for the actual freight charge, there will be a separate statement of the freight. The property is not sold for a delivered price.

- (3) The contract for sale provides for the sale of property for \$100 per unit freight collect and allowed. The measure of tax is \$100 per unit less the amount of the freight paid to the carrier and shown on the payment voucher sent to the retailer by the purchaser.

The sale is for a delivered price. Separately stated transportation charges are excludable from the measure of tax since the transportation occurred after the sale of the property. If the contract for sale explicitly provided for passage of title upon delivery to the destination, then the measure of tax would be \$100 per unit since the sale was for a delivered price and title did not pass prior to transportation.

- (4) The contract for sale provides for the sale of property for \$100 per unit plus actual freight of \$10 per unit. Any increase or decrease in the freight is for the account of the buyer.

Tax applies to \$100 per unit since the contract is not for a delivered price and shipment is by independent carrier.

(5) The contract for sale provides for the sale of property for \$100 plus freight of \$10, and the seller guarantees the price will not exceed \$110.

Tax applies to \$100 because the sale is for a delivered price and there is no showing that title was to pass upon delivery at the destination. A contract will be construed as a shipment contract unless it expressly requires delivery at destination point. If the contract for sale explicitly provided for passage of title upon delivery to the destination, then the measure of tax would be \$110 since the sale was for a delivered price and title did not pass prior to transportation.

(6) The contract for sale provides for the sale of property for \$100 per unit freight equalized with x city. The invoice shows 10 units at \$100 per unit, \$1,000, freight from x city \$100, total \$1,100.

Under these circumstances, tax applies to \$1,000 since the only separate statement of freight is the freight equalized with x city in the amount of \$100. If the actual freight paid to the carrier for the transportation of the property from the retailer's place of business or other point from which shipment is made directly to the purchaser is less than \$100, the exclusion will be limited to the amount paid to the carrier.

(7) Assuming the same facts as above, except the invoice shows 10 units at \$100 per unit, \$1,000, freight equalized with x city \$100, total \$1,100. The invoice also shows the notation, "Actual freight prepaid from point of shipment to destination is \$200."

The sale is not for a delivered price. On the basis of the above billing, a separate statement of freight is made in the amount of \$200. Accordingly, the measure of tax is \$1,100 minus \$200, or \$900.

Draft

**Wall Street Journal, August 12, 2003  
Shippers Deliver Hidden Fee Increases**

SAN DIEGO, OKLAHOMA City and Miami Beach aren't on most people's list of out-of-the-way destinations. But the Airborne Inc. deliveryman is apparently having some trouble reaching these cities. In a drive to restore some of the revenue lost amid the downturn, delivery companies have introduced or increased more than a dozen fees over the past few years, for everything from proof of delivery to a missing account number. This strategy lets package companies boost revenue without having to announce huge rate increases. The latest twist is that carriers are slapping on a surcharge for off-the-beaten-track deliveries—mostly packages sent to homes—that aren't off the beaten track at all.

In addition to charging extra for packages bound for parts of San Diego, Oklahoma City and Miami Beach, Airborne adds a hard to-reach surcharge for certain ZIP Codes in Phoenix, Cincinnati and El Paso, Texas. United Parcel Service Inc. now charges extra for shipments to some homes in Santa Clarita, Calif., which was California's sixth-fastest-growing city during the 1990s; about 161,000 people live there. FedEx Corp., meanwhile, applies the markup to deliveries to two ZIP Codes in suburban Atlanta.

The surcharges are supposed to be for places that are difficult to get to. Package companies have different descriptions for these destinations—Airborne calls them "outlying" or "remote," while UPS says they are "less populated" or "less accessible." Most of the names on these lists are burbs like Chug-water, Wyo. (pop. 244) and Embarrass, Wis. (pop. 399).

But the number of ZIP Codes the carriers consider remote is swelling, even as America is growing more urban. UPS added 59 ZIP Codes to its list in January, bringing its total to 24,555. Overall, the big-three delivery companies—UPS, FedEx and Airborne, which control 80% of the market—now impose such fees on at least some shipments to more than 60% of all U.S. ZIP Codes, according to AFMS Transportation Management Group.

The various delivery surcharges individually don't amount to a lot of money. But they are rising faster than basic shipping rates, and all told can end up doubling the cost of sending a package. The surcharge to out-of-the-way locations (known as the "delivery area surcharge") first appeared four years ago. This year, it jumped 17%, to \$1.75.

Package companies say the new and higher fees help pay for deliveries that are costlier to make. Residential deliveries, for example, take more time than commercial ones—because homes are more scattered than office buildings, and the driver must make a return visit if the recipient isn't home. So customers now pay a premium to send packages to someone's house. Using the same inefficiency argument, FedEx and UPS tack on an extra \$12.50 to packages delivered on Saturday, up from \$10 last year.

The fees have irked some customers. "Miami Beach is hard to get to?" says Angelique Bird, who owns a surfboard shop there that uses FedEx and UPS. "I've never heard of such a thing."

The package companies say a place may be considered remote for any number of reasons. It could be that the ZIP Code is some distance from the company's nearest dispatch facility, or that the package company doesn't make as many deliveries to that

**Wall Street Journal, August 12, 2003  
Shippers Deliver Hidden Fee Increases**

particular area as it would like.

Airborne, for instance, levies extra fees on packages headed for one ZIP code in Miami Beach because it includes an island that can be reached only by ferry, says an Airborne spokesman. But the fee also covers areas closer to the center of Miami Beach and connected to the mainland by causeways.

UPS won't say why it still treats parts of fast-growing Gilbert, Ariz. (pop. 135,000), 8 miles southeast of Phoenix, like it is in the middle of nowhere. The company, based in Atlanta, says it plans to sift through its list next year to see if there are ZIP Codes that shouldn't be on it.

The higher fees are partly a response to the economic slump, which has badly bruised delivery companies. At UPS, the number of packages carried on the average day rose in the second quarter for the first time in more than two years (compared with the year-earlier period).

One way you can sometimes skirt the "remote" surcharge is to send the package to a person's office instead of their home—UPS and FedEx slap the fee only on residential shipments. (That also helps avoid a separate add-on fee of \$1.15 to \$1.40 on some home deliveries.) Another option is to go with the U.S. Postal Service, which doesn't levy fees for out-of-the-way addresses—and has fewer extra charges in general.

To find out if a ZIP Code is considered remote, check the shippers' Web sites. Go to <http://www.ups.com/using/software/currentrates/rate-pdf/xarea.pdf>, or [http://www.fedex.com/us/services/pdf/Zipcodes\\_DAS.txt](http://www.fedex.com/us/services/pdf/Zipcodes_DAS.txt). The fee is listed as a separate line in online rate calculators on those Web sites. Airborne says its list of places where the extra fee is charged must be searched by individual ZIP Code at [www.airborne.com](http://www.airborne.com).

It pays to read this fine print closely. While UPS, FedEx and Airborne tend to move in lockstep on rates, they don't always agree on what is or isn't rural. Airborne is the only carrier that regards parts of San Diego as hard to reach, while only FedEx considers Kennesaw, Ga., to be in that category.

Then there's Gilbert, Ariz. It was the fastest-growing city with at least 100,000 residents between April 2000 and July 2002, according to the U.S. Census Bureau. The town's population has mushroomed as subdivisions sprout from old farmland.

But package carriers still treat Gilbert like it is a cow town. UPS tacks on an extra fee for every residential shipment to the town's newest ZIP Code. Airborne charges extra to deliver to any home or business there.

"We are definitely not remote," says Kathy Langdon, president and chief executive officer of the Gilbert Chamber of Commerce.

## **ALTERNATIVE METHOD OF REPORTING USE TAX (AMRUT) PROGRAM GUIDELINES**

### **DEFINITION:**

The **Alternative Method for Reporting Use Tax (AMRUT) Program** is a process whereby a taxpayer can write to the California State Board of Equalization (Board) and propose a prospective use tax reporting method for qualified purchases subject to use tax. The alternative reporting method would replace the usual reporting method of reporting use tax on a transaction-by-transaction basis. The alternative reporting method will not allow a taxpayer to issue resale or exemption certificates to vendors solely for the purpose of directly reporting the use tax under this AMRUT program. The taxpayer's proposal must address the following matters:

- The use tax will be remitted directly to the Board on certain mutually agreed-upon categories of purchases.
- The tax will be determined by applying a mutually agreed-upon taxable percentage to the taxpayer's total purchases for these categories.

In general, audits of purchases in these categories for periods covered by this Board-approved reporting method will not ascertain whether tax was overpaid or underpaid on a transaction-by-transaction basis. Instead, the review will determine whether the taxpayer complied with the criteria specified in the Board's approval of the percentage-based reporting method.

If the Board concludes the proposed reporting method accurately reflects the taxpayer's use tax liability for the defined population, then the Board will write to the taxpayer and approve (subject to certain conditions) the use of the proposed reporting method.

### **ELIGIBLE PARTICIPANTS:**

The Board encourages participation in this program and will not restrict eligibility to any particular taxpayer, regardless of the size or type of their business. In order to be eligible to participate in the program, the taxpayer must be in good standing and maintain acceptable accounting records and internal controls. Taxpayers requesting approval must provide the necessary accounting records in a timely manner. When records are maintained electronically, the taxpayer shall provide data files requested by the Board's Computer Audit Specialist (CAS) or other Board staff in a timely and cooperative manner.

Prime candidates for this program are taxpayers with large volumes of recurring purchases subject to use tax. The taxpayer's business should be stable and the taxpayer's purchasing practices must be consistent. Also, prime candidates are those taxpayers

routinely audited by the Board and, although not required, those taxpayers that have been audited at least once by the Board.

### **CRITERIA FOR APPROVAL:**

#### Electronic Records:

It is anticipated most taxpayers desiring to report use tax using this reporting method will maintain their accounting records in electronic format. The Board's CAS staff will be involved in the analysis of these records during the approval and review processes. The taxpayer will be required to provide a data download of the electronic accounting records, including control totals, to the CAS staff. The CAS staff will participate in determining the specific file layout and format.

#### Base Period Selection:

It is essential to select a mutually acceptable base period and scope of purchases covered by this reporting method. Typically, the base period is a current audit period. However, the taxpayer and Board staff may select transactions occurring over some other period. At a minimum, 12 months of detailed accounting records, which includes the most recent reporting period, must be used to calculate the taxable percentage. When this minimum is used, summary accounting records from the two preceding years must be provided for comparison purposes.

When selecting a base period, it is essential the tested purchases are representative of the taxpayer's normal purchasing activity and anticipated activity in future filing periods. If the taxpayer is currently under audit, the audit period should be used to avoid duplication of work by the Board and taxpayer.

#### Taxable Percentage Calculation:

The most important element of this reporting method is the calculation of the taxable percentage to be applied prospectively to purchases within the defined population. Under this method, the taxpayer will calculate (with Board staff involvement) a taxable percentage to be applied to purchases from specific categories of transactions. Percentages are calculated as follows:

- (1) Determine which of the covered purchases in the base period are subject to use tax.
- (2) Divide the resulting taxable purchases by total covered purchases in the base period.

The total purchases subject to use tax for the approved period is calculated by applying the taxable percentage to total purchases from the same specified categories of transactions.

The taxable percentage calculation may be based on statistical sampling, non-statistical sampling or a detailed review of the base period. However, both the taxpayer and Board

staff must agree on the sampling plan and procedures used to calculate the taxable percentage.

The taxable percentage calculation and application are limited to qualified purchases. This excludes specific categories of transactions such as fixed asset acquisitions and other accounts or transactions the taxpayer or Board staff believes are atypical (e.g., resale inventory withdrawals, inter-company purchases, etc.) and should not be included in the defined population. Fixed asset acquisitions are excluded since these purchases generally are nonrecurring transactions. Atypical purchases skew the taxable percentage calculation and negate the validity of the sample.

Ex-tax purchases subject to use tax are ultimately the tax liability of the purchaser storing, using or otherwise consuming the property in this state, and ex-tax purchases subject to transactions and use tax (district tax) are ultimately the liability of the purchaser when purchased for use in a district imposing such a tax and thereafter used there.

It may be necessary to calculate more than one taxable percentage to be applied to different categories of purchases. Computation of different percentages may be established by:

- Account number(s)
- Subsidiary
- Location
- Division
- Computer accounting system
- District tax
- Other criterion that makes business sense and produce a reliable and verifiable estimate of the taxpayer's use tax liability.

Sample Selection:

Sampling is an important issue in the calculation of the taxable percentage. To establish a prospective taxable percentage, a sample is drawn from transactions that occurred in prior periods. Whenever sampling techniques are used, an estimate is made instead of using the actual result from a detailed review of the population. Therefore, the sample must be representative of the population. It is expected that the sample results will approximate the use tax currently being reported on a transaction-by-transaction basis for qualified purchases after considering Board audit adjustments.

**Board staff must be involved in the sample selection process.** Prior to beginning the process, the taxpayer will complete a preliminary form *BOE-472 - Audit Sampling Plan*. Both the taxpayer and Board staff must agree to the sampling plan and then a final form *BOE-472* will be completed.

If statistical sampling techniques are used, the sample results will be statistically evaluated to determine how accurately the sample reflects the population. Statistical sampling techniques must be in accordance with Chapter 13 of the Audit Manual (titled *Statistical Sampling*).

Revenue & Taxation Code section 6406 credits and atypical transactions encountered during base period testing will be reviewed and evaluated by Board staff on a transaction-by-transaction basis.

Disputed Transactions:

The Board will not issue a letter approving a taxpayer's proposal if the taxpayer and Board staff cannot agree on a sampling plan or resolve disputes regarding individual sample transactions.

**NOTIFICATION REQUIREMENTS:**

The taxpayer is responsible for monitoring and advising the Board of activities that significantly affect the taxable percentage. These activities may lead to adjustments to the percentage. Circumstances that require notification of the Board include, but are not limited to:

- Changes in accounting policy – changes that affect the distribution of use tax transactions in the accounts covered under the AMRUT that would significantly affect the agreed-upon percentage.
- Changes in purchasing practices – changes in purchasing activities that would significantly affect the agreed-upon percentage.
- Other significant business changes, as discussed in more detail below.

**TERM:**

The taxpayer will be notified of the specific period for which the applicable percentage may be relied upon. Generally, this will be a 36-month period corresponding with the taxpayer's reporting basis.

**TERMINATION/CANCELATION:**

The Board may rescind its approval of the reporting method if the taxpayer fails to comply with any of the program's conditions. In addition, the written approval of the use tax reporting method is void and shall not be relied upon for the purposes of Revenue and Taxation Code section 6596 if the taxpayer files a claim for refund for tax that had been reported based upon this reporting method.

The Board's specific written advice shall be rescinded provided written notification is given to the taxpayer. The notification shall be effective as of a date specified by the Board. The written advice becomes invalid the first day of the subsequent quarterly filing period, but no less than thirty (30) days after the mailing date of the Board's notice.

At any time, the taxpayer may elect to discontinue reporting tax based upon this alternative reporting method. The taxpayer should notify the Board in writing of the election to discontinue the alternative reporting method within the quarterly filing period of the election.

**RENEWAL:**

The Board's written advice is not automatically renewable. However, nothing herein shall prohibit the Board from issuing specific written advice for subsequent time periods. The Board retains the right to audit the taxpayer's records to determine if the taxpayer's business practices or operations have changed.

**SIGNIFICANT BUSINESS CHANGES:**

This program does not relieve the taxpayer of his or her responsibility to report in accordance with changes in the California Sales and Use Tax Law and the accompanying regulations. Changes in laws may occur during the period when the Board's specific written advice is in effect. During the period the written advice is in effect, the taxpayer is responsible for monitoring its purchasing practices and the California Sales and Use Tax Law to ascertain any changes that may significantly affect the taxable percentage.

The Board must be notified within ninety (90) days of a significant business change. If the taxpayer fails to report a significant business change within the specified period, the Board-approved reporting method may be rescinded and the taxpayer may be liable for any unreported use tax due from the first day of the quarterly filing period following the date of the significant business change.

Events which may result in a significant business change that are likely to **affect the taxable percentage** include, but are not limited to the following:

- Change in the product line
- Change in purchasing procedures (i.e. implementation of cost containment programs)
- Merger or acquisition
- Discontinuation or start up of manufacturing or support facilities
- Change in law due to statutory change, regulatory change or a change in the application of the law due to a decision of the court
- Change in the financial or accounting system

When the taxpayer makes a change in business practices, procedures or operations, including but not limited to those described above, then the taxpayer must determine whether the event(s) results in a significant change to the agreed upon percentage. For purposes of audit, the taxpayer should retain the documentation he or she used to determine whether the event is significant.

If a change in business practices, procedures or operations occurs, the following thresholds will be used to determine whether the event is significant. A significant business change has occurred when, over a 12-month period:

1. An increase in purchases subject to use tax for the agreed-upon categories of purchases results in unreported purchases subject to use tax of \$50,000 or more in measure; and
2. For this same period, the taxable percentage calculation used to determine use tax reporting increases by ten (10) percent or more from the previously agreed-upon taxable percentage or the total unreported purchases subject to use tax for these agreed-upon categories of purchases is \$500,000 or more in measure, whichever is less.

For example, if the agreed-upon taxable percentage were determined to be 10 percent, and thereafter, over a 12-month period, based upon a change in vendors from an in-state vendor to an unregistered out-of-state vendor, the actual taxable percentage increased to 12 percent, this would be regarded as a significant business change that requires the taxpayer to notify the Board of the change. This change represents a 20 percent increase (2 percentage points difference between actual and agreed-upon taxable percentages divided by the agreed-upon taxable percentage) in the taxable percentage.

If the taxpayer anticipates that the reporting percentage is likely to fluctuate and is not likely to remain stable, then, as previously stated, this business may not be an appropriate candidate for this reporting process.

### **REVISED PERCENTAGES:**

The taxpayer must provide notification to the Board of a significant change in the facts and circumstances upon which the Board's approval is based. The notification must be provided within ninety (90) days of the significant change. Since a significant business change will terminate the prior written advice, when a significant business change occurs and the taxpayer wishes to use an alternative reporting method, the taxpayer is required to request approval to use the new reporting percentage. If a request is made, the new reporting percentage shall be subject to review and approval by Board staff, based upon the evaluation of the new information. The taxpayer will be allowed a reasonable period in which to provide documentation to support a revised percentage. Although the taxpayer may choose to report the tax liability using the revised percentages, the revised reporting percentage may not be relied upon for the purposes of Regulation 1705, which interprets and applies section 6596, until written approval is provided by the Board. Therefore, if appropriate, the Board will provide the taxpayer a new approval letter after reviewing the supporting documentation. The new reporting percentage shall become effective commencing the first day of the quarterly filing period following review and approval by the Board.

### **MECHANICS OF THE APPROVAL PROCESS:**

The taxpayer initiates the process by submitting a written request for participation in the program. Requests must include:

- The taxpayer's name, address and seller's permit number
- The period for which the request is being made
- An assurance that the taxpayer's accounting records and internal controls are acceptable for participation
- Identification of the records that are maintained electronically

The Board will not consider any written requests for participation if the taxpayer is not identified. Properly completed requests should be submitted directly to:

Program Planning Manager  
Program Planning Division (MIC 92)  
California State Board of Equalization  
P. O. Box 942879  
Sacramento, CA 94279-0092  
Fax: (916) 322-4530

Requests submitted to district offices will be forwarded to the Program Planning Manager for consideration. Once a request for participation is received, the Program Planning Manager will send an acknowledgment letter to the taxpayer providing information about the program, outlining the implementation process and soliciting additional information, if needed. The taxpayer will also be provided form *BOE-472 – Audit Sampling Plan* to complete prior to beginning the implementation process.

The taxpayer's request will be forwarded to the appropriate district office for completion of the implementation process. The implementation process includes establishing the agreed-upon categories of purchases and the agreed-upon taxable reporting percentage in coordination with the Board's CAS staff and/or district audit staff, when appropriate. This process should be completed within 90 days after the taxpayer's accounting records and internal controls are deemed acceptable for possible participation in the program, and electronic records are verified to be in the proper format.

After completion of the implementation process, district audit staff will forward the staff's recommendation to the Program Planning Manager. The taxpayer will be furnished a letter approving or denying their request.

**POST REVIEW AND EVALUATION:**

The taxpayer's records may be reviewed at or near the end of the approved term, or anytime during the program's term to monitor the integrity of the program or in conjunction with a routine sales and use tax audit.

The Board will verify the taxpayer is in compliance with the approved reporting method. This includes verifying the mechanical accuracy and appropriateness of accounting procedures for all applicable accounts within the defined population.

The taxpayer's records will be reviewed to determine if there has been an unreported change in business practices and/or operations during the applicable period. The review will determine if any unreported business changes have a significant impact on the agreed-upon percentage. This may include a comparison of vendors from the original test with the list of current vendors to determine if there has been a significant change in the in-state versus out-of-state vendor distribution.

The Board will only perform a detailed (transaction-by-transaction) test of purchases if it has previously established that one or more events have taken place that may have resulted in a significant business change. Prior to initiating a detailed test of purchases, the District Principal Auditor will review the preliminary step of determining a significant business change has occurred. If detailed testing is pursued, the method and scope must be mutually agreed upon with the taxpayer.

Last updated: June 1, 2001