



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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November 4, 2005

Dear Interested Party :

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the November 15, 2005 Business Taxes Committee meeting. This meeting will address the proposed amendments to Regulation 1699, *Permits*.

Action 1 concerns whether subdivision (h) should be revised to clarify when a seller's permit should be issued to a buying company.

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 **November 15, 2005** in Room 121 at the address shown above.

Sincerely,

Randie L. Henry, Deputy Director
Sales and Use Tax Department

RLH: lw

Enclosures

E-file now, find out how . . . www.boe.ca.gov



cc: (all with enclosures)

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Mr. John Waid (MIC 82)
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Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Steve Ryan (MIC 85)
Mr. Rey Obligacion (via e-mail)
Mr. Todd Gilman (MIC 70)
Mr. Kenneth Topper (via e-mail)
Mr. Dave Hayes (MIC 67)
Ms. Freda Orendt (via e-mail)
Mr. Stephen Rudd (via e-mail)
Mr. Joseph Young (via e-mail)
Mr. Jeffrey L. McGuire (MIC 92 and via e-mail)
Mr. Vic Anderson (MIC 44 and via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Leila Khabbaz (MIC 50)
Ms. Lynn Whitaker (MIC 50)
Mr. Charles E. Arana Jr. (MIC 50)

**AGENDA —November 15, 2005 Business Taxes Committee Meeting
Regulation 1699, Permits – Buying Companies**

Action 1 — Regulation 1669(h), Buying Companies – General.

Issue Paper Alternative 1 - Staff Recommendation

Issue Paper Alternative 2

Issue Paper Alternative 3

Adopt one of the five following alternatives:

1) Staff’s recommendation to

- Revise subdivision (h)(1) through (2) of Regulation 1699 to clarify the definition of a buying company and when it is entitled to hold a permit.
- Add subdivision (h)(3) to provide that beginning September 1, 2006, a buying company demonstrates a separate identity by adding a markup; issuing an invoice; and maintaining separate employees, accounting records, facilities, and equipment. A buying company may obtain services, facilities, or equipment from a related entity as long as any dealings with such entity are conducted at arm’s-length. If the company does not meet these criteria, it may still show that it maintains a separate existence based on the facts and circumstances of the business operations.

OR

2) The County and City of San Francisco’s recommendation to

- Replace “sole purpose” language with “primary purpose.”
- Delete the final sentence of subdivision (h).
- Require evidence of business purpose other than redirecting local sales tax.
- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction measured by the local sales tax generated by the buying company.

OR

3) The County of San Mateo’s recommendation to

- Exclude retailers that primarily sell jet fuel to a related entity or primarily sell a single good or service to a related entity from the provisions of subdivision (h).
- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction.

AGENDA — November 15, 2005 Business Taxes Committee Meeting
Regulation 1699, Permits – Buying Companies

<p>Issue Paper Alternative 4</p> <p>Issue Paper Alternative 5</p>	<ul style="list-style-type: none"> • Require evidence that a buying company exists for economic reasons. <p align="center">OR</p> <p>4) Repeal subdivision (h) as petitioned by San Mateo and San Francisco in December 2004.</p> <p align="center">OR</p> <p>5) Do not amend subdivision (h) of Regulation 1699. Recommended by the City of Long Beach, the City of Oakland, Mr. Robert Cendejas, the Air Transport Association, and the City of Rancho Mirage.</p>
<p>Action 2 – Authorization to Publish</p>	<p>Recommend publication of amendments to Regulation 1699 as adopted in the above action.</p> <p>Operative Date: Staff’s proposal: September 1, 2006. All other alternatives: No operative dates.</p> <p>Implementation: 30 days following OAL approval.</p>

AGENDA — November 15, 2005 Business Taxes Committee Meeting
Regulation 1699, Permits – Buying Companies

Action Item	Alternative 1 -Regulatory Language Proposed by Staff	Alternative 2 - Regulatory Language Proposed by San Francisco	Alternative 3 - Regulatory Language Proposed by San Mateo
<p>Action 1 – Regulation 1669(h), <i>Buying Companies – General</i></p>	<p>(h) BUYING COMPANIES - GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is maintains a separate <u>existence</u> from another legal entity that owns, controls, or is otherwise related to; the buying company, and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. <u>A buying company, as defined above, shall be issued a seller’s permit and will be regarded as the seller of tangible personal property it sells or leases.</u> A buying company formed, however, A legal entity formed for the sole primary purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company does not maintain a separate existence from the legal entity that owns, controls, or is otherwise related to it and shall will not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s</p>	<p>(h) BUYING COMPANIES - GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to; the buying company, and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the sole primary purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company shall not be issued a seller’s permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying</p>	<p>(h) BUYING COMPANIES – GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to; the buying company, and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the sole primary purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. <u>And, it is presumed that the buying company is formed for the primary purpose of re-directing local tax if it has an economic incentive agreement with a local jurisdiction.</u> Such a buying company shall not be issued a seller’s</p>

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	<p>permit. Such a buying company <u>an entity</u> shall not be issued a seller's permit, and sales. Sales of tangible personal property by <u>to</u> third parties to such entity will be regarded as having been made by <u>to</u> the entity owning, controlling, or otherwise related to the buying company <u>such entity</u>. A buying company that is not formed for the sole purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. <u>For the period June 15, 2002, to August 31, 2006, a legal entity is recognized as a buying company if it satisfies one or more of the following elements: A buying company is not formed for the sole purpose of re-directing local sales tax if it has one or more of the following elements:</u></p>	<p>company. <u>It is presumed that the buying company is formed for the primary purpose of re-directing local tax if the legal entity that owns, controls, or is otherwise related to the buying company, receives an economic incentive from the local jurisdiction measured by the local sales tax generated by the buying company.</u> A buying company that is not formed for the sole <u>primary</u> purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. A <u>The buying company must demonstrate that it intends to actively engage in or conduct business as a seller of tangible personal property independent of the legal entity that owns, controls, or is otherwise related to it. The presence of any of the following factors shall indicate that a buying company is not formed for the sole primary purpose of re-directing local sales tax if it has one or more of the following elements:</u></p>	<p>permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the sole <u>primary</u> purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. <u>A buying company shall be deemed formed for the primary purpose of re-directing local sales, is shall not be recognized as a separate legal entity and shall not be issued a seller's permit unless the buying company does each of the following: formed for the sole purpose of re-directing local sales tax if it has one or more of the following elements:</u></p>

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Regulation 1699, Permits – Buying Companies

Action Item	Alternative 1 -Regulatory Language Proposed by Staff	Alternative 2 - Regulatory Language Proposed by San Francisco	Alternative 3 - Regulatory Language Proposed by San Mateo
	<p>(A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.</p> <p>(B) Issues an invoice or otherwise accounts for the transaction.</p>	<p>(A) <u>The buying company does not add</u> Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses;</p> <p>(B) <u>The buying company does not issue</u> Issues an invoice or otherwise account for the transactions.</p> <p>(C) <u>The buying company and the entity that owns, controls, or is otherwise related to it do not maintain distinct corporate identities, for example, they share office space, have common insurance policies, and/or share one payroll/employee benefits department;</u></p> <p>(D) <u>The buying company and the entity that owns, controls, or is otherwise related to it do not have independent business purposes;</u></p> <p>(E) <u>Less than 50% of the sales made by the buying company are sales to companies other than an entity that owns, controls, or is otherwise related to it;</u></p> <p>(F) <u>The buying company or the entity that owns, controls, or is otherwise related to the buying company receives revenue from the local</u></p>	<p>(A) <u>Establishes that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation</u> Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.;</p> <p>(B) <u>Issues an invoice or otherwise accounts for its the transactions.;</u> and</p> <p>(C) <u>Maintains a separate identity with respect to the use of employees, accounting systems, facilities, equipment and bank accounts.</u></p>

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Regulation 1699, Permits – Buying Companies

Action Item	Alternative 1 -Regulatory Language Proposed by Staff	Alternative 2 - Regulatory Language Proposed by San Francisco	Alternative 3 - Regulatory Language Proposed by San Mateo
	<p>The absence of any of these elements is not indicative of a <u>sole primary purpose to redirect local sales tax or a failure to maintain a separate existence.</u></p> <p><u>(h) (3) DEMONSTRATING A SEPARATE IDENTITY. Beginning September 1, 2006, a legal entity satisfying the following five elements will be recognized as a buying company because it maintains a separate existence from its related entity and is not formed for the primary purpose of re-directing local sales tax:</u></p> <p><u>(A) Adding a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses, unless the company is otherwise prohibited by law;</u></p> <p><u>(B) Issuing an invoice or otherwise accounting for the transaction as provided in Regulation 1698, Records;</u></p>	<p><u>jurisdiction where the buying company is located, which is based upon or tied to an increase in tax collected on sales made by the buying company;</u></p> <p><u>(G) The buying company or the entity that owns, controls, or is otherwise related to it has stated publicly or in writing that the buying company was formed in order to re-direct sales tax revenue.</u></p> <p>The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.</p>	<p>The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.</p> <p><u>(h) (3) EXCLUSIONS. In no event shall a seller's permit be issued to a buying company:</u></p> <p><u>(A) Created for the primary purpose of purchasing jet fuel for a related entity; or</u></p> <p><u>(B) Created primarily for the purpose of purchasing a single good or service for a related entity.</u></p>

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	<p><u>(C) Hiring or leasing and firing its own employees. A buying company may “lease” employees from a related entity as long as any dealings with such entity are conducted at arm’s-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity);</u></p> <p><u>(D) Maintaining separate accounting records (e.g., accounting for cash receipts and disbursements). A buying company may obtain accounting services from a related entity as long as any dealings with such entity are conducted at arm’s-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity); and</u></p> <p><u>(E) Owning or leasing its own facilities and equipment. A buying company may lease its facilities and equipment from a related entity as long as any dealings with such entity are conducted at arm’s-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity).</u></p> <p><u>A legal entity that does not satisfy all of these elements may still establish that it maintains a separate existence from its related entity and should hold a seller’s permit based on all the facts</u></p>		

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	<p><u>and circumstances of the business operations. In determining whether a legal entity maintains a separate existence under all of the facts and circumstances, the Board will consider all relevant factors related to the business, including the existence of an economic incentive agreement with a local jurisdiction, a stated intent to re-direct local sales tax, and the absence of sales to unrelated entities.</u></p>		

Issue Paper Number **05 - 010**



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

I. Issue

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

II. Alternative 1 - Staff Recommendation

To better identify and issue seller’s permits to buying companies that are formed and operate as separate business entities from their parents or affiliates, staff proposes:

- Revising subdivision (h)(1) through (2) of Regulation 1699 to clarify the definition of a buying company and when it is entitled to hold a permit.
- Adding subdivision (h)(3) to provide that beginning September 1, 2006, a buying company demonstrates a separate identity by adding a markup; issuing an invoice; and maintaining separate employees, accounting records, facilities, and equipment. A buying company may obtain services, facilities, or equipment from a related entity as long as any dealings with such entity are conducted at arm’s length. If the company does not meet these criteria, it may still show that it maintains a separate existence based on the facts and circumstances of the business operations.

Staff’s proposed amendments to subdivision (h) of Regulation 1699 are attached as Exhibit 3.

III. Other Alternatives Considered

Alternative 2: Revise subdivision (h) of Regulation 1699 as recommended by the City and County of San Francisco:

- Replace “sole purpose” language with “primary purpose.”
- Delete the final sentence of subdivision (h).
- Require evidence of business purpose other than redirecting local sales tax.
- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction.

San Francisco recommends these revisions be retroactive. (Exhibit 4.)

Alternative 3: Revise subdivision (h) of Regulation 1699 as recommended by the County of San Mateo:

- Exclude retailers that primarily sell jet fuel from the provisions of subdivision (h).
- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction.
- Require evidence that a buying company exists for economic reasons.

San Mateo recommends these revisions be retroactive. (Exhibit 5.)

Alternative 4: Repeal subdivision (h) as petitioned by San Mateo and San Francisco in December 2004.

Alternative 5: Do not amend subdivision (h) of Regulation 1699 as recommended by the City of Long Beach, the City of Oakland, Mr. Robert Cendejas, the Air Transport Assoc., and the City of Rancho Mirage. (Exhibits 6-10.)

A comparison of staff’s and interested parties’ proposed language is attached as Exhibit 2.

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IV. Background

The Business Taxes Committee (BTC) first considered the buying company issue in 2001. Staff wrote discussion papers, met with interested parties, and presented an issue paper to the Board at the October 24, 2001, BTC meeting. At that meeting, the Board approved language that had been submitted by an interested party the day before the meeting. Neither staff nor other interested parties had an opportunity to review or comment on the submission before it was approved for the public hearing process.

The current subdivision (h) of Regulation 1699, *Permits*, provides guidelines for distinguishing between buying companies that are established for the sole purpose of redirecting local tax and those that are not. The regulation defines a buying company as a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services for the other legal entity. The regulation goes on to provide that a buying company formed for the sole purpose of redirecting local tax shall not be recognized as a separate entity for the purpose of issuing a seller's permit. Subdivision (h) describes when a buying company is not formed for the "sole purpose" of redirecting local tax, as follows:

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

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

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

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

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

The San Francisco and San Mateo petitions stem from the issuance of a sub-permit to United Aviation Fuels Company (UAFC), a jet fuel buying company for United Airlines, Inc. (United) for a City of Oakland (Oakland) location. The issuance of this permit had the effect of redirecting local sales tax from San Francisco and San Mateo to Oakland.

The Board heard the San Mateo and San Francisco petitions at the March 22, 2005 Board meeting. Following the presentation by the petitioners, a motion was made to repeal subdivision (h) of Regulation 1699 and begin the interested parties process. The motion did not pass. Discussion followed regarding jet fuel and alternative ways of handling the issue. The first alternative suggested was to ask staff to draft language for the Board's consideration that would amend Regulation 1699 to address jet fuel. That suggestion did not develop into a motion for vote. The second alternative was to send the overall issue to the BTC. That suggestion was made into a motion and approved by the Board.

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Local Tax in General

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

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

Local tax allocation for jet fuel changes January 1, 2008

Assembly Bill (AB) 451 (Stats. 2005, Ch. 391, effective January 1, 2008) amends RTC sections 7204.03 and 7205 to change the way local sales tax is allocated on sales of jet fuel. Currently, to allocate local sales tax to the place where the jet fuel is delivered to the aircraft, the principal negotiations for the sale must be conducted in California, and the retailer of the jet fuel must have more than one place of business in California. Thus, because the United buying company UAFC has only one business location in California, it is not subject to the special rules for allocating local sales tax from jet fuel sales under RTC sections 7204.03 and 7205. Instead, it remains subject to the general local tax rules, which allocate local sales tax based on the location of the sales office of the buying company, regardless of where the jet fuel is delivered. (See Reg. 1802(a).)

Beginning January 1, 2008, local sales tax will be allocated to the place where the jet fuel is delivered to the aircraft.² Accordingly, the local sales tax from jet fuel sales by UAFC will no longer be allocated solely to the City of Oakland. Instead, local sales tax will be allocated to where the jet fuel is delivered to the aircraft. For jet fuel delivered to aircraft at the San Francisco International Airport, the local sales tax will be split evenly between San Francisco and San Mateo.

AB 451 does not affect buying companies that do not sell jet fuel.

V. Discussion

Businesses form buying companies for many reasons; for example, centralized procurement may be more efficient, particularly when the ultimate destination of the goods is not known at the time they are purchased. A buying company may also be able to take advantage of trade discounts not available to the parent company because suppliers frequently offer lower pricing levels to wholesale customers than to retail customers. Since a company also benefits if they receive economic incentive payments from a city

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

² Exceptions for multijurisdictional airports, including San Francisco and Ontario, remain in the law. Multijurisdictional airports are airports where the airport is located in a different local jurisdiction than the jurisdiction that owns or operates the airport. Local jurisdictions with these airports share the local tax revenue from jet fuel sales.

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as a result of locating their buying company in that city, it is reasonable to conclude that the receipt of these incentives would also be a reason for a business to form a buying company.

Economic Incentives from Local Jurisdictions

In general, local sales taxes are allocated to the city where the seller is located (i.e., where the sales negotiations take place). For example, when a company purchases supplies from vendors throughout California, the local sales tax revenue associated with those sales is distributed throughout California based on the location of the vendors, not the location of the purchaser. In contrast, when a parent company purchases the same supplies through a centralized buying company, the buying company purchases the supplies free of tax for resale and then resells those items to the parent company or other related entity. Since local sales tax is allocated to the place of sale, the city where the buying company is located will receive the local sales tax revenue. Attracted by this source of revenue, cities may offer businesses economic incentives to establish buying companies in their jurisdiction.

San Mateo and San Francisco recommend that subdivision (h) of Regulation 1699 be revised to create a presumption that a buying company is created for the primary purpose of redirecting local tax if the buying company receives economic incentive payments from a local jurisdiction. The buying company would have to overcome this presumption before the Board would issue the company a permit. As San Francisco explains, “It has been suggested that this is not a problem of statewide concern, but merely an argument between San Francisco, San Mateo and Oakland over jet fuel. That is far from the truth. The diversion of local sales tax revenue is the manifestation of a growing problem, wherein financially distressed local jurisdictions are persuaded to enter into deals with private industry, in order to increase local sales tax revenues. The lack of criteria in the current regulation has the unintended result of permitting the diversion of local sales tax revenue from public to private purposes, which was specifically prohibited in the regulation. The manipulation of local sales tax in this manner results in a loss of public funds, impedes the implementation of good planning, encourages unfair competition between local agencies, and does not result in a public benefit.” (See Exhibit 4).

San Mateo further supports this position by stating, “Opponents of such a proposal have argued that the Board has no authority to discourage these incentives. They are wrong. The Bradley-Burns Bill of Rights provides the authority, which the Board clearly recognized when it made discouraging redirection the express purpose of Regulation 1699(h). But more important, Buying Companies are a creature of the Board. In other words, if the Board can recognize them, it certainly has authority to limit the scope of its recognition. Finally, the Board is not discouraging incentives, generally. Public entities can still offer incentives to legitimate businesses. What the Board would be discouraging would be schemes that allow short-sighted public entities from creating incentives, not with their own tax base, but with other public entities’ tax base through redirection schemes.” (See Exhibit 5).

Although staff understands San Francisco’s and San Mateo’s arguments, staff does not recommend adding this presumption to the regulation. The obvious question is what does a business have to do to overcome this presumption? Staff believes that if a taxpayer meets the criteria for establishing themselves as sellers, the Board is obligated to issue that taxpayer a seller’s permit and that to condition its issuance of a seller’s permit solely on the existence or non-existence, or terms of an economic incentive agreement, would require statutory change giving the Board that authority.

Exclusion of Jet Fuel Sellers

San Mateo recommends excluding retailers that primarily sell jet fuel from the provisions of subdivision (h) of Regulation 1699. San Mateo points out that again, if the Board has authority to recognize buying companies, it certainly has the authority to limit that recognition. Staff disagrees.

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

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

Retroactivity

Under RTC section 7051, if the Board does not specifically limit the retroactive effect of a regulatory action, it is retroactive to the limits of the applicable statute of limitations, usually three years. (RTC § 6487.) If the Board repeals subdivision (h) of Regulation 1699, the effect would be retroactive. Similarly, unless an operative date is provided in the body of the regulation, any amendment would also be retroactive.

If the Board amends subdivision (h) of Regulation 1699 retroactively to clarify the standards the Board uses when determining whether permits should be issued to buying companies, it is reasonable to assume that some companies will not meet those revised standards. Similarly, if the Board repealed subdivision (h) of Regulation 1699, it is reasonable to assume that some buying companies could not show that they should hold a seller's permit under the general provisions of subdivision (a) of Regulation 1699. The result of either of these actions would be the Board revoking a buying company's permit retroactively and reallocating local tax as allowed under the statute of limitation (e.g., three years from the effective date of the regulation change). In essence, this means that the buying company was not entitled to hold a seller's permit and its sales should be disregarded. In such a case, staff believes the appropriate way to handle these transactions would be to reallocate based on vendor information in the purchasing records of the buying company. Staff does not recommend retroactively disallowing a resale certificate accepted by a vendor in good faith at the time that vendor's sale was made.

A full retroactive treatment could mean a multi-year impact on the city hosting the buying company. Using the United/U AFC buying company as an example, U AFC began reporting sales in Oakland in the 4th Quarter of 2003. If U AFC's permit for the Oakland office was revoked, a retroactive application back to 4th Quarter 2003 would mean millions of dollars reallocated from Oakland.

Reallocation, in the particular case of United/U AFC, would be comparatively easy to calculate because of the relatively few suppliers and transactions involved. However, most buying companies buy goods from many different suppliers located in many different jurisdictions. For a buying company that did not charge its parent or affiliate the same markup on all transactions, and made thousands of purchases from perhaps hundreds of suppliers inside and outside the state, an accurate reallocation would be much more difficult to calculate.

San Francisco and San Mateo are recommending a retroactive application – either through their proposed amendments or through repeal of the subdivision. San Mateo explains that the only buying

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companies that would be affected by retroactivity are those that, like UAFC, should never have been recognized in the first instance. San Mateo further explains, “These schemes are so inherently wrong, that no multi-national corporation advised by a Big Four accounting firm could have possibly formed a buying company without knowing the risk that it would be invalidated. Had Oakland and United not foreseen the risk, they would not have included numerous clauses to address it in their contract.” San Mateo comments that if revisions cannot be made fully retroactive, then staff should consider partial retroactivity. Buying companies were effectively put on notice when San Mateo and San Francisco filed their petitions to repeal the subdivision in 2004.

Staff disagrees with San Mateo and San Francisco and recommends prospective application of any revisions. In addition to the complexity of determining whose permit would be revoked and how the local tax should be reallocated, staff believes it would be an unfair burden on buying companies and cities that have relied on the current provisions of subdivision (h) of Regulation 1699. Although they oppose amending subdivision (h), the City of Long Beach, Oakland, and the Air Transport Association agree with staff that if the regulation is revised, all revisions should be handled prospectively.

VI. Alternative 1 - Staff Recommendation

A. Description of the Staff Recommendation

Proposed revisions to subdivision (h)(1) of Regulation 1699

Staff proposes revising subdivision (h)(1) of Regulation 1699 to clarify the subdivision by specifying that a buying company is entitled to hold a seller’s permit when (1) the entity is a retailer of tangible personal property within the meaning of RTC sections 6014, 6015, and 6066; and (2) a sufficient separation exists between the buying company and its controlling or related entity such that they are separate persons for purposes of RTC section 6094.5. (Section 6094.5 addresses improper use of a resale certificate.) Staff’s proposed revisions provide that a legal entity formed for the primary purpose of redirecting local sales tax does not maintain a separate existence from its controlling or related entity and will not be issued a seller’s permit. Staff believes that these revisions, together with the proposed addition of subdivision (h)(3) of Regulation 1699, Demonstrating a Separate Identity (explained below), provide better guidance and are less subjective than the current “purpose” language.

Proposed revisions to subdivision (h)(2) of Regulation 1699

As explained above in the Discussion section on retroactivity, staff recommends that revisions to subdivision (h) of Regulation 1699 be handled prospectively. To accomplish this, staff recommends revisions to subdivision (h)(2) of Regulation 1699 to correspond with the revised language in subdivision (h)(1) and to identify the period to which the current provisions apply. Thus, from the effective date of subdivision (h) to August 31, 2006, a buying company will be considered to maintain a separate existence and hold a seller’s permit if it has one or more of the following elements: (A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses, or (B) Issues an invoice or otherwise accounts for the transaction. In addition, the absence of either of these elements is not indicative of a primary purpose to redirect local tax or a failure to maintain a separate existence. That is, other facts and circumstances may be provided to establish that the company maintains a separate existence from its related entity.

So, if a buying company was issued a permit based on meeting the requirements of the current regulation, it will be able to maintain that permit until August 31, 2006, and thereafter by meeting the proposed requirements of subdivision (h)(3).

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Proposed new subdivision (h)(3) of Regulation 1699

The key to determining whether a buying company should be issued a permit is determining whether sufficient separation exists between the buying company and its parent or affiliates such that they are separate persons under RTC section 6005. Staff believes the current language of Regulation 1699 does not clearly explain the criteria for establishing a separate identity.

Staff proposes adding new subdivision (h)(3)(A) – (E) to prospectively provide that a business demonstrates that it maintains a separate existence and is not formed for the primary purpose of redirecting local tax if it:

- Adds a markup sufficient to cover its operating and overhead expenses (unless the company is otherwise prohibited by law),
- Issues an invoice or otherwise accounts for the transaction,
- Hires and fires its own employees,
- Maintains separate accounting records, and
- Owns or leases its own facilities and equipment.

In response to concerns by interested parties regarding the fact that it is common for related entities to share employees and accounting systems, staff’s proposed language clarifies that a buying company may procure, by lease or otherwise, services, facilities, and equipment from a related entity provided that any transaction is conducted at arm’s length and pursuant to a contractual service agreement.

Staff believes the requirements listed in subdivision (h)(3)(A) – (E) identify the basic criteria for establishing that a buying company has a separate existence from its parent or affiliate. However, if the company does not meet that criteria, the final paragraph of subdivision (h)(3) indicates the Board will examine the business operations as a whole to determine if a permit should nevertheless be issued. In effect, the proposed revisions create a safe harbor for businesses meeting the criteria listed in (A) - (E), and an alternative method for businesses to establish that they should be issued a permit even when not meeting the listed criteria.

Staff believes these proposed revisions will provide better guidance to taxpayers and Board staff regarding the Board’s authority to issue seller’s permits to buying companies. In addition, although the enactment of AB 451 will resolve the buying company issue with respect to jet fuel retailers as of January 1, 2008, staff believes the above revisions will clarify the guidelines that apply to all buying companies.

B. Pros of the Staff Recommendation

- Clarifies the minimum criteria for maintaining a separate existence and a requirement for issuing a seller’s permit.
- Prospective treatment allows companies time to achieve compliance.
- Prospective treatment does not harm companies or cities that relied in good faith on the current provisions of subdivision (h) of Regulation 1699.

C. Cons of the Staff Recommendation

- San Mateo and San Francisco contend that staff’s revisions do not go far enough to prevent the issuance of seller’s permits to buying companies formed primarily to re-direct local tax.

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- May require additional effort and expense of existing buying companies that will need to change their business practices to meet the criteria listed in subdivision (h)(3).

D. Statutory or Regulatory Change

No statutory change needed. However, the recommendation will require amendment of Regulation 1699.

E. Administrative Impact

- Requires notification of Board staff of the criteria for issuing seller's permits to buying companies.
- Staff will notify taxpayers of the amendments through an article in the Tax Information Bulletin (TIB).
- Staff will need to evaluate the practices of known buying companies to see if they should continue to hold a permit under the revised regulation.

F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and TIB article is considered routine and any corresponding cost would be absorbed within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Buying companies will need to review their business operations to see if they comply with the criteria of subdivision (h)(3)(A) – (E). If the companies do not meet that criteria, they will need to make necessary changes, or rely on their belief that they should still hold a permit based on all the facts and circumstances of their business operations.

H. Critical Time Frames

An operative date of September 1, 2006 is recommended. The regulation will become effective 30 days after approval by the Office of Administrative Law.

VII. Alternative 2

A. Description of the Alternative

San Francisco believes that the proposed revisions do not go far enough to prohibit schemes to redirect local tax. San Francisco recommends amending subdivision (h) of Regulation 1699 to:

- Replace the "sole purpose" language with "primary purpose" throughout subdivision (h) to allow the Board to examine the overall function and operation of a buying company in order to determine if the company is a separate entity in the business of selling tangible personal property.
- Delete the final sentence of subdivision (h) that states, "The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax." This sentence nullifies the preceding

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criteria, rendering the regulation ambiguous and ineffective. Deleting the sentence will improve the Board's ability to enforce the law regarding the issuance of seller's permits.

- Require evidence of business purpose other than redirecting local sales tax. The current elements of adding a markup, issuing an invoice, or otherwise accounting for the transaction are mere book entries and not meaningful. San Francisco suggests that criteria should be adopted that will allow the Board to examine and evaluate the economic purpose of the purported seller.
- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction. (See discussion on economic incentives from local jurisdictions for more on San Francisco's reasons for recommending this change, page 4.)

As explained in the Discussion section on retroactivity, San Francisco recommends that revisions to subdivision (h) be handled retroactively. See Exhibit 4 for San Francisco's submission.

B. Pros of the Alternative

- San Francisco believes its proposed revisions will prevent unfair diversions of local sales tax revenue to private businesses.
- Retroactive effect means that a buying company's seller's permit could be revoked thereby requiring local tax to be reallocated retroactively. This would be a benefit to the city that receives the reallocated revenue.

C. Cons of the Alternative

- Retroactive effect means that a buying company's seller's permit could be revoked thereby requiring local tax to be reallocated retroactively. This would be detrimental to the city that relied on those revenues.
- Staff believes the Board lacks the authority to condition the issuance of a seller's permit solely on the existence or terms of an economic incentive agreement between a buying company and a local jurisdiction.

D. Statutory or Regulatory Change

No statutory change needed. However, the recommendation will require amendment of Regulation 1699.

E. Administrative Impact

- Requires notification of Board staff of the criteria for issuing seller's permits to buying companies.
- Staff will need to evaluate the practices of known buying companies to see if they should continue to hold a permit under the revised regulation.
- Staff will need to notify taxpayers of the amendments through an article in the TIB.

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F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and TIB article is considered routine and any corresponding cost would be absorbed within the Board's existing budget.

2. Revenue Impact

See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

If a buying company could not show that the business should continue to hold a permit under the revised provisions of subdivision (h), its seller's permit would be retroactively revoked. The effect of retroactively revoking permits is discussed beginning on page 5.

H. Critical Time Frames

None. The amended regulation will become effective 30 days after approval by the Office of Administrative Law.

VIII. Alternative 3

A. Description of the Alternative

San Mateo believes that the proposed revisions do not go far enough to prohibit schemes to redirect local tax. San Mateo recommends amending subdivision (h) of Regulation 1699 to:

- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction. (See discussion on economic incentives from local jurisdictions for more on San Mateo's reasons for recommending this change, page 4.)
- Require evidence of a legitimate business purpose. San Mateo believes that the requirement that the buying company add a markup to its cost of goods sold does not go far enough to ensure that the buying company is actually a viable business. When a buying company is a wholly owned subsidiary, a parent could simply sell to the subsidiary with a markup and then take out the "profit." San Mateo proposes that buying companies be required to establish that the additional price discounts and other business advantage to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation.
- Exclude retailers that primarily sell jet fuel from the provisions of Regulation 1699(h). (See discussion on exclusion of jet fuel sellers, page 4.)

As explained in the Discussion section on retroactivity, San Mateo recommends that revisions to subdivision (h) be handled retroactively. See Exhibit 5 for San Mateo's submission.

B. Pros of the Alternative

- San Mateo believes its proposed revisions will prohibit schemes to redirect local tax.
- Retroactive effect means that a buying company's seller's permit could be revoked thereby requiring local tax to be reallocated retroactively. Since this proposal excludes jet fuel sellers

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from the provisions of subdivision (h), the permit for UAFC would be revoked. This action would be a benefit to the city that receives the reallocated revenue.

C. Cons of the Alternative

- Retroactive effect means that a buying company's seller's permit could be revoked thereby requiring local tax to be reallocated retroactively. Since this proposal excludes jet fuel sellers from the provisions of subdivision (h), the permit for UAFC would be revoked. This action would be detrimental to the city that relied on those revenues.
- Staff believes the Board lacks the authority to condition the issuance of a seller's permit solely on the existence or terms of an economic incentive agreement between a buying company and a local jurisdiction.
- Staff believes the Board lacks the authority to exclude jet fuel retailers from the provisions of subdivision (h).

D. Statutory or Regulatory Change

No statutory change needed. However, the recommendation will require amendment of Regulation 1699.

E. Administrative Impact

- Requires notification of Board staff of the criteria for issuing seller's permits to buying companies.
- Staff will need to evaluate the practices of known buying companies to see if they should continue to hold a permit under the revised regulation.
- Staff will need to notify taxpayers of the amendments through an article in the TIB.

F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and TIB article is considered routine and any corresponding cost would be absorbed within the Board's existing budget.

2. Revenue Impact

See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

If a buying company could not show that the business should continue to hold a permit under the revised provisions of subdivision (h), its seller's permit would be retroactively revoked. Since this proposal excludes jet fuel sellers from the provisions of subdivision (h), the permit for UAFC would be revoked. The effect of retroactively revoking permits is discussed beginning on page 5.

H. Critical Time Frames

None. The amended regulation will become effective 30 days after approval by the Office of Administrative Law.

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IX. Alternative 4

A. Description of the Alternative

Repeal subdivision (h) of Regulation 1699. Although San Mateo and San Francisco have submitted proposals to amend subdivision (h), they ask that in the alternative, the Board repeal subdivision 1699(h).

Repealing the subdivision would return staff and taxpayers to the situation that existed prior to June 2002. This would mean that companies who relied on subdivision (h) when forming their buying companies would have to show that their businesses should have held a permit under the general rules of subdivision (a). That is, the Board would not revoke a seller's permit as long as the taxpayer is engaged in business as a seller of tangible personal property to a separate person. If the taxpayer cannot show it meets that criteria, the Board would revoke the seller's permit.

Repealing the subdivision would also mean there would be no specific regulatory guidance for companies that are contemplating forming buying companies. Once again, staff would have to determine what "business purpose" the buying company accomplished, without having the guidance of specific criteria.³ Businesses would have to rely on their interpretation of the Revenue and Taxation Code to determine whether their buying company would be considered a separate entity requiring a seller's permit; a buying company's criteria for establishing business purpose is not examined by the Board at the time of registration. When a buying company registers, it is identified and coded as a retailer of whatever it is selling (e.g., a fuel supplier, or an office supply retailer); it is not identified or registered as a "buying company."

B. Pros of the Alternative

Buying companies would be determined based on the facts and circumstances of each case.

C. Cons of the Alternative

- Retroactive effect means that a buying company's seller's permit could be revoked thereby requiring local tax to be reallocated retroactively. This action would be detrimental to the city that relied on those revenues.
- Provides no guidelines for new buying companies.

D. Statutory or Regulatory Change

No statutory change needed. However, the recommendation will require amendment of Regulation 1699.

E. Administrative Impact

- Requires notification of Board staff that the subdivision has been repealed.
- Staff will need to evaluate the practices of known buying companies to see if they should continue to hold a permit under the provisions of subdivision (a).

³ Redirection of local tax is sometimes an unintended side effect. A few years ago, staff investigated a situation where a statewide hospital formed a buying company but continued to allocate local sales tax as if the buying company did not exist. On the other hand, staff has learned of a situation, again involving a hospital, where the "buying company" is little more than a folder in the hospital's procurement officer's desk.

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- Staff will need to notify taxpayers of the change through an article in the TIB.

F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and TIB article is considered routine and any corresponding cost would be absorbed within the Board's existing budget.

2. Revenue Impact

See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

If a buying company could not show that the business should have held a permit under the general provisions of subdivision (a), its seller's permit would be retroactively revoked. The effect of retroactively revoking permits is discussed beginning on page 5.

H. Critical Time Frames

None. The amended regulation will become effective 30 days after approval by the Office of Administrative Law.

X. Alternative 5

A. Description of the Alternative

Do not amend subdivision (h) of Regulation 1699. The City of Long Beach, the City of Oakland, Mr. Robert Cendejas, the Air Transport Association, and the City of Rancho Mirage support this alternative.

In their submissions, these interested parties maintain that it has not been established that the regulation needs revision. The current version of subdivision (h) was adopted only three years ago after public meetings. They contend that the subdivision clearly provides guidelines that businesses and cities have relied upon; and, since the subdivision was adopted, there has been only one request for revision. According to these parties, this request involves a unique or isolated conflict between Oakland, San Mateo, and San Francisco over the allocation of local sales tax from sales of jet fuel by the UAFC buying company and does not demonstrate a statewide problem with buying companies in general. The local sales tax issues in regard to sales of jet fuel were addressed legislatively with the enactment of AB 451. The controversy surrounding the UAFC buying company will be resolved when the provisions of AB 451 take effect January 1, 2008.

B. Pros of the Alternative

- No regulatory change is required.
- Companies that relied on the current provisions of subdivision (h) will not have to re-evaluate or change their business practices.

C. Cons of the Alternative

- The current regulation does not clearly explain the criteria for obtaining a seller's permit.

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- The current regulation does not prevent the issuance of seller's permits to buying companies formed primarily to re-direct local tax.

D. Statutory or Regulatory Change

None.

E. Administrative Impact

None.

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: Tax Policy Division, Sales and Use Tax Department

Current as of: October 31, 2005

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



**PROPOSED REGULATORY CHANGES REGARDING THE
ISSUANCE OF SELLER'S PERMITS TO "BUYING
COMPANIES" - REGULATION 1699, PERMITS**

Alternative 1 - Staff Recommendation

To better identify and issue seller's permits to buying companies that are formed and operate as separate business entities from their parents or affiliates, staff proposes:

- Revising subdivision (h)(1) through (2) of Regulation 1699 to clarify the definition of a buying company and when it is entitled to hold a permit.
- Adding subdivision (h)(3) to provide that beginning September 1, 2006, a buying company demonstrates a separate identity by adding a markup; issuing an invoice; and maintaining separate employees, accounting records, facilities, and equipment. A buying company may obtain services, facilities, or equipment from a related entity as long as any dealings with such entity are conducted at arm's length. If the company does not meet these criteria, it may still show that it maintains a separate existence based on the facts and circumstances of the business operations.

Other Alternative(s) Considered

Alternative 2: Revise subdivision (h) of Regulation 1699 as recommended by the City and County of San Francisco:

- Replace "sole purpose" language with "primary purpose."
- Delete the final sentence of subdivision (h).
- Require evidence of business purpose other than redirecting local sales tax.
- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction.

San Francisco recommends these revisions be retroactive.

Alternative 3: Revise subdivision (h) of Regulation 1699 as recommended by the County of San Mateo:

- Exclude retailers that primarily sell jet fuel from the provisions of subdivision (h).

- Include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction.
- Require evidence that a buying company exists for economic reasons.

San Mateo recommends these revisions be retroactive.

Alternative 4: Repeal subdivision (h) as petitioned by San Mateo and San Francisco in December 2004.

Alternative 5: Do not amend subdivision (h) of Regulation 1699 as recommended by the City of Long Beach, the City of Oakland, Mr. Robert Cendejas, the Air Transport Assoc., and the City of Rancho Mirage.

Background, Methodology, and Assumptions

Alternative 1 - Staff Recommendation:

The staff recommendation would revise Regulation 1699 to clarify the definition of a buying company and it provides criteria to establish when a buying company is entitled to hold a seller's permit. Staff's revision to Regulation 1699 would change the allocation of existing local sales and use tax revenue for jurisdictions with buying companies, operating within their jurisdiction, that do not meet the new criteria entitling them to a seller's permit and can not demonstrate that they maintain a separate existence based on the facts and circumstances of the business operations. It would not change the amount of sales and use tax revenue collected by the state or local jurisdictions. Therefore, staff recommendation does not have a revenue impact.

Alternative 2

In Alternative 2, the City and County of San Francisco believes that the proposed staff revisions do not go far enough to prohibit schemes to redirect local tax. They believe that the last sentence of subdivision (h) (2) "The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax," should be deleted. Alternative 2 would also require evidence for a business purpose other than redirecting local sales tax, and grant the Board authority to examine and evaluate the economic purpose of the purported seller. Alternative 2 recommends that the revisions be retroactively applied. Alternative 2 should not change the amount of sales and use tax revenue collected by state and local jurisdictions. However, theoretically the retroactive application could result in revenue loss if the sales between the buying company and parent company included a markup on all sales to the parent company of which the buying company would be entitled to a refund. This would occur if the Board determined that the two companies were in reality the same entity. However, there is no economic incentive on the part of the buying company to add a markup to the sales price of tangible personal property sold to the parent company. Therefore, we believe Alternative 2 would not have a revenue impact.

Alternative 3

In Alternative 3, the County of San Mateo believes that the proposed revisions do not go far enough to prohibit schemes to redirect local tax. They believe that the revision should include a presumption that a buying company is formed for the purpose of redirecting local tax if it receives an economic incentive from a local jurisdiction. Alternative 3 would require evidence of a legitimate business purpose to ensure that the buying company is actually a viable business. Alternative 3 would also exclude retailers that primarily sell jet fuel from the provisions of Regulation 1699(h) and would recommend that the revisions be retroactively applied. Alternative 3 should not change the amount of sales and use tax revenue collected by state and local jurisdictions. As noted above in Alternative 2, in theory the retroactive application of the revision could result in revenue loss if the sales between the buying company and parent company included a markup on all sales to the parent company of which the buying company would be entitled to a refund. However, as also noted above, there is no economic incentive on the part of the buying company to add a markup to the sales price of tangible personal property sold to the parent company. Therefore, we believe Alternative 3 would not have a revenue impact.

Alternative 4

Alternative 4 would repeal subdivision 1699(h) and thereby return staff and taxpayers to the situation that existed prior to June 2002. This would mean taxpayers who relied on subdivision 1699(h) when forming their buying companies would have to show that their business should have held a permit under the general rules of subdivision 1699(a). That is, the Board would not revoke a seller's permit as long as the taxpayer is engaged in business as a seller of tangible personal property to a separate person. If the taxpayer cannot show it meets those criteria, the Board would revoke the seller's permit. Repealing subdivision 1699(h) would not have a revenue impact.

Alternative 5

Alternative 5 recommends no change to the current regulation. Therefore, Alternative 5 does not have a revenue impact.

Revenue Summary

Alternative 1 - The staff recommendation does not have a revenue impact.

Alternative 2 should not have a revenue impact.

Alternative 3 should not have a revenue impact.

Alternative 4 does not have a revenue impact.

Alternative 5 does not have a revenue impact.

While there is no overall revenue impact for any of these alternatives, for Alternatives 1 - 4 there will be a shift in local tax revenue among the various jurisdictions.

Preparation

Bill Benson, Jr., Research and Statistics Section, Legislative Division, prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section, Legislative Division, and

Mr. Jeff McGuire, Tax Policy 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 27, 2005

Regulation 1699, Permits – Buying Company Issue
Comparison of Current and Proposed Language
 Current as of October 27, 2005

Action Item	Current Regulatory Language	Alternative 1: Regulatory Language Proposed by Staff	Alternative 2: Regulatory Language Proposed by San Francisco	Alternative 3: Regulatory Language Proposed by San Mateo	Summary Comments
ACTION 1 -					
Amend subdivision (h) to clarify the definition of a buying company and when a buying company is entitled to hold a permit.	<p>(h) BUYING COMPANIES - GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the sole purpose of purchasing tangible personal property</p>	<p>(h) BUYING COMPANIES - GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is <u>maintains a separate existence</u> from another legal entity that owns, controls, or is otherwise related to, the buying company, and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. <u>A buying company, as defined above, shall be issued a seller's permit and will be</u></p>	<p>(h) BUYING COMPANIES - GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company, and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the <u>sole primary</u> purpose of</p>	<p>(h) BUYING COMPANIES - GENERAL.</p> <p>(1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company, and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the <u>sole primary</u> purpose of</p>	San Francisco and San Mateo propose that it is presumed that a buying company is formed for the purposes of re-directing local tax if the buying company has an economic incentive agreement with a local jurisdiction.

Regulation 1699, Permits – Buying Company Issue
Comparison of Current and Proposed Language
 Current as of October 17, 2005

Action Item	Current Regulatory Language	Alternative 1: Regulatory Language Proposed by Staff	Alternative 2: Regulatory Language Proposed by San Francisco	Alternative 3: Regulatory Language Proposed by San Mateo	Summary Comments
Action 1 – continued	<p>ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company shall not be issued a seller’s permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the sole purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for</p>	<p>regarded as the seller of tangible personal property it sells or leases. A buying company formed, however, A legal entity formed for the sole primary purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company does not maintain a separate existence from the legal entity that owns, controls, or is otherwise related to it and shall will not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company an entity shall not be issued a seller’s permit, and sales- Sales of tangible personal</p>	<p>purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company shall not be issued a seller’s permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. <u>It is presumed that the buying company is formed for the primary purpose of re-directing local tax if the legal entity</u></p>	<p>purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. <u>And, it is presumed that the buying company is formed for the primary purpose of re-directing local tax if it has an economic incentive agreement with a local jurisdiction.</u> Such a buying company shall not be issued a seller’s permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning,</p>	

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Action Item	Current Regulatory Language	Alternative 1: Regulatory Language Proposed by Staff	Alternative 2: Regulatory Language Proposed by San Francisco	Alternative 3: Regulatory Language Proposed by San Mateo	Summary Comments
Action 1 – continued	<p>purposes of issuing it a seller’s permit. Such a buying company shall be issued a seller’s permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. A buying company is not formed for the sole</p>	<p>property by to third parties to such entity will be regarded as having been made by to the entity owning, controlling, or otherwise related to the buying company such entity. A buying company that is not formed for the sole purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company shall be issued a seller’s permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. <u>For the period June 15, 2002, to August 31, 2006, a</u></p>	<p><u>that owns, controls, or is otherwise related to the buying company, receives an economic incentive from the local jurisdiction measured by the local sales tax generated by the buying company.</u> A buying company that is not formed for the <u>primary</u> purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company shall be issued a seller’s permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. <u>A The buying company must demonstrate that it</u></p>	<p>controlling, or otherwise related to the buying company. A buying company that is not formed for the sole <u>primary</u> purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller’s permit. Such a buying company shall be issued a seller’s permit and shall be regarded as the seller of tangible personal property it sells or leases.</p> <p>(h) (2) ELEMENTS. <u>A buying company shall be deemed formed for the</u></p>	<p>To achieve a consistent and prospective</p>

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Action 1 – continued	<p>purpose of re-directing local sales tax if it has one or more of the following elements:</p> <p>(A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.</p>	<p><u>legal entity is recognized as a buying company if it satisfies one or more of the following elements:</u> A buying company is not formed for the sole purpose of re-directing local sales tax if it has one or more of the following elements:</p> <p>(A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.</p>	<p><u>intends to actively engage in or conduct business as a seller of tangible personal property independent of the legal entity that owns, controls, or is otherwise related to it. The presence of any of the following factors shall indicate that a buying company is not formed for the sole primary purpose of re-directing local sales tax if it has one or more of the following elements:</u></p> <p>(A) <u>The buying company does not add</u> Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses;</p>	<p><u>primary purpose of re-directing local sales, is shall not be recognized as a separate legal entity and shall not be issued a seller’s permit unless the buying company does each of the following:</u> formed for the sole purpose of re-directing local sales tax if it has one or more of the following elements:</p> <p>(A) <u>Establishes that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation</u> Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.;</p>	<p>application, staff revised this section to correspond with the revised purpose language in 1699(h)(1).</p> <p>San Francisco and San Mateo both recommend a retroactive application.</p> <p>San Francisco and San Mateo propose their criteria for showing separate identity and business purpose in these subsections.</p>

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Action 1 – continued	(B) Issues an invoice or otherwise accounts for the transaction.	(B) Issues an invoice or otherwise accounts for the transaction.	<p>(B) <u>The buying company does not issue invoices or otherwise account for the transactions.</u></p> <p>(C) <u>The buying company and the entity that owns, controls, or is otherwise related to it do not maintain distinct corporate identities, for example, they share office space, have common insurance policies, and/or share one payroll/employee benefits department;</u></p> <p>(D) <u>The buying company and the entity that owns, controls, or is otherwise related to it do not have independent business purposes;</u></p> <p>(E) <u>Less than 50% of the sales made by the buying company are sales to companies other than an entity that owns, controls, or is otherwise related to</u></p>	<p>(B) <u>Issues an invoice or otherwise accounts for its transactions;</u> and</p> <p>(C) <u>Maintains a separate identity with respect to the use of employees, accounting systems, facilities, equipment and bank accounts.</u></p>	

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Action 1 – continued	The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.	The absence of any of these elements is not indicative of a sole <u>primary</u> purpose to redirect local sales tax <u>or a failure to maintain a separate existence.</u>	<p><u>it;</u></p> <p><u>(F) The buying company or the entity that owns, controls, or is otherwise related to the buying company receives revenue from the local jurisdiction where the buying company is located, which is based upon or tied to an increase in tax collected on sales made by the buying company;</u></p> <p><u>(G) The buying company or the entity that owns, controls, or is otherwise related to it has stated publicly or in writing that the buying company was formed in order to redirect sales tax revenue.</u></p> <p>The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.</p>	<p>The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax.</p>	

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Action 1 – continued		<p><u>(h) (3) DEMONSTRATING A SEPARATE IDENTITY. Beginning September 1, 2006, a legal entity satisfying the following five elements will be recognized as a buying company because it maintains a separate existence from its related entity and is not formed for the primary purpose of re-directing local sales tax:</u></p> <p><u>(A) Adding a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses, unless the company is otherwise prohibited by law;</u></p> <p><u>(B) Issuing an invoice or otherwise accounting for the transaction as provided in Regulation 1698, Records;</u></p> <p><u>(C) Hiring or leasing and firing its own employees. A buying company may</u></p>		<p><u>(h) (3) EXCLUSIONS. In no event shall a seller’s permit be issued to a buying company:</u></p> <p><u>(A) Created for the primary purpose of purchasing jet fuel for a related entity; or</u></p> <p><u>(B) Created primarily for the purpose of purchasing a single good or service for a related entity.</u></p>	<p>San Mateo proposes a new subdivision excluding certain seller’s from the provisions of 1699(h).</p> <p>Staff proposes adding a new subdivision listing the criteria for showing a separate existence. Staff’s new subsections (A) – (E) provide a safe harbor for buying companies meeting those criteria. The last paragraph of 1699(h)(3) provides an alternative method for establishing the</p>

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Action 1 – continued		<p><u>“lease” employees from a related entity as long as any dealings with such entity are conducted at arm’s-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity);</u></p> <p><u>(D) Maintaining separate accounting records (e.g., accounting for cash receipts and disbursements). A buying company may obtain accounting services from a related entity as long as any dealings with such entity are conducted at arm’s-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity); and</u></p> <p><u>(E) Owning or leasing its own facilities and equipment. A buying</u></p>			need for a permit if the company does not meet the (A) – (E) criteria.

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Action 1 – continued		<p><u>company may lease its facilities and equipment from a related entity as long as any dealings with such entity are conducted at arm’s-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity).</u></p> <p><u>A legal entity that does not satisfy all of these elements may still establish that it maintains a separate existence from its related entity and should hold a seller’s permit based on all the facts and circumstances of the business operations. In determining whether a legal entity maintains a separate existence under all of the facts and circumstances, the Board will consider all relevant factors related to the business, including the</u></p>			

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Action 1 – continued		<u>existence of an economic incentive agreement with a local jurisdiction, a stated intent to re-direct local sales tax, and the absence of sales to unrelated entities.</u>			

G:\BTC\BTC Topics - 2005\050304BTC – Buying Companies\Working Files\IP Exhibit 2 (comparison table)

Regulation 1699. PERMITS

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

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

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

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

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

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

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

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

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

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

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

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

- Deposits funds into a separate account.

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

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

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

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

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

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

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

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

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

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

Unless the permit holder who transfers the business notifies the Board of the transfer, or delivers the permit to the Board for cancellation, he or she will be liable for taxes, interest and penalties (excluding penalties for fraud or intent to evade the tax) incurred by his or her transferee who with the permit holder's actual or constructive knowledge uses the permit in any way; e.g., by displaying the permit in transferee's place of business, issuing any resale certificates

showing the number of the permit thereon, or filing returns in the name of the permit holder or his or her business name and under his or her permit number. Except in the case where, after the transfer, 80 percent or more of the real or ultimate ownership of the business transferred is held by the predecessor, the liability shall be limited to the quarter in which the business is transferred, and the three subsequent quarters.

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

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

(h) BUYING COMPANIES - GENERAL.

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

(2) ELEMENTS. ~~For the period June 15, 2002, to August 31, 2006, a legal entity is recognized as a buying company if it satisfies one or more of the following elements: A buying company is not formed for the sole purpose of re-directing local sales tax if it has one or more of the following elements:~~

- (A) Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.
- (B) Issues an invoice or otherwise accounts for the transaction.

The absence of any of these elements is not indicative of a sole primary purpose to redirect local sales tax or a failure to maintain a separate existence.

(3) DEMONSTRATING A SEPARATE IDENTITY. Beginning September 1, 2006, a legal entity satisfying the following five elements will be recognized as a buying company because it maintains a separate existence from its related entity and is not formed for the primary purpose of re-directing local sales tax:

(A) Adding a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses, unless the company is otherwise prohibited by law;

(B) Issuing an invoice or otherwise accounting for the transaction as provided in Regulation 1698, Records;

(C) Hiring or leasing and firing its own employees. A buying company may "lease" employees from a related entity as long as any dealings with such entity are conducted at arm's-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity);

(D) Maintaining separate accounting records (e.g., accounting for cash receipts and disbursements). A buying company may obtain accounting services from a related entity as long as any dealings with such entity are

conducted at arm's-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity); and

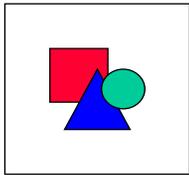
(E) Owning or leasing its own facilities and equipment. A buying company may lease its facilities and equipment from a related entity as long as any dealings with such entity are conducted at arm's-length pursuant to contractual service agreements (e.g., compensation reflects the fair market value for all services purchased from the related entity).

A legal entity that does not satisfy all of these elements may still establish that it maintains a separate existence from its related entity and should hold a seller's permit based on all the facts and circumstances of the business operations. In determining whether a legal entity maintains a separate existence under all of the facts and circumstances, the Board will consider all relevant factors related to the business, including the existence of an economic incentive agreement with a local jurisdiction, a stated intent to re-direct local sales tax, and the absence of sales to unrelated entities.

(i) WEB SITES. The location of a computer server on which a web site resides may not be issued a seller's permit for sales tax purposes except when the retailer has a proprietary interest in the server and the activities at that location otherwise qualify for a seller's permit under this regulation.

Draft

CITY AND COUNTY OF SAN FRANCISCO

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September 26, 2005

By E-Mail and Facsimile (916) 322-4530Jeffrey L. McGuire
Chief, Tax Policy Division
Sales and Use Tax Department
State Board of Equalization
450 N Street
Sacramento, CA 94279-0092

Re: Petition to Amend or Repeal Regulation 1699(h) Buying Companies

Dear Mr. McGuire:

At the request of the Controller of the City and County of San Francisco ("CCSF"), I am to submit comments regarding the proposed amendment of Regulation 1699(h), "Buying Companies". It is the City's position that, the current regulation exceeds statutory authority and lacks the standards necessary to prevent the unfair diversion of local sales tax revenue. Additionally, the regulation encourages manipulation and abuse of the sales tax law, by attributing sales to entities that may not be legally separate from the parent company that owns and controls them. CCSF's comments are as follows:

1. Regulation 1699(h) Fails To Achieve Its Stated Regulatory Purpose.

The intent of Regulation 1699(h) was to provide guidance in determining whether a "buying company" is a person engaged in the business of selling tangible personal property. It will not be recognized as a separate entity if it is created in order to redirect local sales tax from the location of the vendor to the location of the buying company. Unfortunately, the regulation is ineffective because it does not provide criteria that adequately address the issues of separate identity and the re-direction of local sale tax.

2. Change "Sole Purpose" To "Primary Purpose".

During the Interested Parties process, staff acknowledged problems in administering the current regulation and suggested revisions. Staff recommend that the Board replace the word "sole" with the word "primary" to achieve the intended objective of the regulation. CCSF appreciates and supports the staff recommendation. This recommendation allows the Board the ability to examine the overall function and operation of a buying company in order to determine if the company is a separate entity in the business of selling tangible

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personal property. We agree with staff that such an amendment would improve the effectiveness of the regulation.

3. Delete the Final Sentence of Regulation 1699(h).

CCSF and San Mateo County propose deleting the final sentence of Regulation 1699(h). The final sentence states, "The absence of any of these elements is not indicative of a sole purpose to redirect local sales tax." The problem with this sentence is apparent. It nullifies the preceding criteria, rendering the regulation ambiguous and ineffective. Staff agree that deleting this sentence will improve the Board's ability to enforce the law regarding the issuance of seller's permits.

4. Focus The Criteria On Separate Sales Activity.

A great deal of the discussion at the Interested Parties Meetings focused on the elements that the Board should examine to determine if a buying company is separate from its parent. There is no consensus on what elements should be included. CCSF's position is that the current elements, adding a mark-up, issuing an invoice or "otherwise accounting for the transaction" are not meaningful. They amount to mere book-entries. Industry argues that the elements suggested by CCSF would disqualify all buying companies. It is the intent of CCSF that the Board should adopt meaningful elements that prevent companies from re-directing local sales tax by circumventing the law. Staff have recommended several clarifications that would improve the regulation. CCSF urges staff to include additional elements in their proposal that would go further toward preventing abuse.

We support the suggestion that at a minimum, prior to issuing a seller's permit, the Board should require evidence of a business purpose other than re-directing local sales tax. Criteria should be adopted that will allow the Board to examine and evaluate the economic purpose of the purported seller.

5. Make Sure That Public Expenditures Serve A Public Purpose.

It has been suggested that this is not a problem of statewide concern, but merely an argument between San Francisco, San Mateo County and Oakland over jet fuel. That is far from the truth. The diversion of local sales tax revenue is the manifestation of a growing problem, wherein financially distressed local jurisdictions are persuaded to enter into deals with private industry, in order to increase local sales tax revenues. The lack of criteria in the current regulation has the unintended result of permitting the diversion of local sales tax revenue from public to private purposes, which was specifically prohibited in the regulation. The manipulation of local sales tax in this manner results in a loss of public funds, impedes the implementation of good planning, encourages unfair competition between local agencies, and does not result in a public benefit.

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Currently Regulation 1699(h) states, "It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related...." To prevent continued manipulation, the Board should amend the presumption to clarify that if a city offers incentives that are tantamount to a kick-back of sales tax revenue to a private business, that it shall be "presumed" that the company was established for the primary purpose of re-directing local sales tax revenue.

The City and County of San Francisco greatly appreciates the Board Member's and the Department's diligent efforts to resolve these complex issues.

Very truly yours,

DENNIS J. HERRERA
City Attorney

Jean H. Alexander
Deputy City Attorney

cc: Ed Harrington, Controller
Todd Rydstrom, Director of Budget & Analysis, Controller's Office
Noelle Simmons, Budget Director, Mayor's Office

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September 23, 2005

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Sales and Use Tax Department
State Board of Equalization
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450 "N" St.
Sacramento, CA 94279-0092

Re: Petition to Amend or Repeal Board of Equalization Regulation 1699(h)

Dear Mr. McGuire:

I write on behalf of the County of San Mateo to comment on the Second Discussion Paper and the September 8, 2005 Second Meeting With Interested Parties. In general, the County believes that Staff has made a number of excellent revisions—and clearly is on the right track. However, Staff's recommendations do not go quite far enough to effectuate the purposes of the Bradley-Burns Bill of Rights and Assembly Bill 66. A few important changes would provide public entities as well as small and medium-sized businesses the protection and uniformity required under the law.

I. PROVIDING REAL MEANING TO THE BOARD POLICY OF PROHIBITING TAX-REDIRECT SCHEMES.

As I explained at the Second Interested Parties meeting, the express purpose of the original Regulation 1699(h) was to ensure that large corporations did not form buying companies for the purpose of redirecting sales tax. This purpose effectuates Bradley-Burns Bill of Rights' promise of fair and uniform taxation. Only large corporations can engage in the type of kickback scheme exemplified by United Airlines-Oakland jet fuel deal and only they benefit. When large corporations fail to pay their fair share of sales taxes, they obtain unfair competitive advantage vis-à-vis other businesses and these schemes always result in a net loss to public entities that use sales tax proceeds to pay for the burdens imposed by the businesses. For example, the County of San Mateo used the sales tax proceeds from SFO to ensure public safety at the airport and the surrounding area. The burdens imposed by SFO did not disappear with the tax base.

Yet, the current Staff proposal does not include any language designed to effectuate the express purpose of the regulation—preventing tax redirection schemes.¹ Accordingly, the County asks that Staff consider an addition that would cure this omission. While there are numerous possibilities, one of which was included in the County’s original proposed revision (submitted on June 14, 2005), Staff should also consider adding language creating a *presumption* that a buying company is created with the primary purpose of redirecting sales tax if the buying company is paid an incentive agreement for locating in a particular jurisdiction.²

Opponents of such a proposal have argued that the Board has no authority to discourage these incentives. They are wrong. The Bradley Burns Bill of Rights provides the authority, which the Board clearly recognized when it made discouraging redirection the express purpose of Regulation 1699(h). But more important, Buying Companies are a creature of the Board. In other words, if the Board can recognize them, it certainly has authority to limit the scope of its recognition. Finally, the Board is not discouraging incentives, generally. Public entities can still offer incentives to legitimate businesses. What the Board would be discouraging would be schemes that allow short-sighted public entities from creating incentives, not with their own tax base, but with other public entities’ tax base through redirection schemes.

II. REQUIRING REAL EVIDENCE OF A LEGITIMATE BUSINESS PURPOSE

Staff has recommended keeping the “adds a markup” language of the current version of 1699(h). While this provision does prevent businesses from reselling products to itself at a loss to avoid taxation, it does nothing to ensure that the buying company is actually a viable business.³ When a buying company is a wholly-owned subsidiary, a parent could simply sell to the subsidiary with a markup and then take out the “profit”. Compare Second Discussion Paper at 8. Accordingly the County asks staff to reconsider adding a provision that requires some evidence that a buying company exists for economic reasons. The County already proposed language in its original submission.⁴

¹ Staff did recognize that “the existence of an incentive agreement is, however, evidence the buying company may have been formed for the purpose of re-directing local tax revenues.” It did not, however, incorporate this recognition into its proposal.

² The County suggested that the Board not issue sales permits to businesses that receive large kickbacks from public entities for locating buying companies in their jurisdiction. Staff has concluded that the Board lacks authority to limit these incentives. The County respectfully disagrees for the reasons described in the next paragraph. Staff has not explained why it concluded to the contrary and the County asks it to reconsider its position.

³ See Transcript of March 22, 2005 BOE Meeting at 30 (Board Chairman Chiang) (“I also warned those who started buying companies that somebody is going to test the margin, and that we’re going to get to this point one day because we’re going to get—somebody was going to test how much *economic activity* we have in the buying company.”) (emphasis added) *id.* at 33 (Board Chairman Chiang) (“I just have a real hard time with the *economic purpose*[.]”) (emphasis added).

⁴ The County has proposed that the Board of Equalization require that a buying company “establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation.” Staff has not explained why this provision would be unduly burdensome. It merely requires a showing that there is some sort of economic activity supporting the buying company’s existence.

III. ENSURING THAT JET FUEL TAX IS EXEMPT FROM THE BUYING COMPANY REGULATION

Staff has indicated its belief that there is no statutory authority for excluding jet fuel from Regulation 1699(h). The County asks staff to reconsider. At the time that AB 66 was enacted, Regulation 1699(h) did not exist.⁵ The Legislature had no way to know that a massive multi-national corporation like United could form a shell corporation that would allow it to redirect all of its jet fuel tax from more than a dozen public entities to Oakland—all without moving a single drop of jet fuel through, or conducting any of its negotiations (or even having a legitimate sales office) in Oakland. Promulgating a regulation that allows this scheme would render AB66 a practical nullity. It does not take a crystal ball to know that all the airlines will follow United's lead. As the Board knows, Southwest Airlines has already expressed great interest in the resolution of the County's Petition. Any Board regulation that has the effect of nullifying a properly enacted piece of legislation would clearly be void. In addition, Board Regulations (and the Legislature) already single out jet fuel for special treatment. *See* Regulation 1802(a)(7); *cf.* Second Discussion Paper at 6 ("Staff does not believe there is sufficient statutory authority to make such revisions").⁶ And again, if the Board has authority to recognize buying companies, it certainly has authority to limit that recognition.

IV. RETROACTIVITY

The County of San Mateo believes that it is important that the Board make any change to Regulation 1699(h) fully retroactive. The only "buying companies" that would be effected by retroactivity are those that, like the United buying company, should never have been recognized in the first instance. Because the only thing that would be required by the new regulation is that the buying company be a legitimate business, created for economic reasons, that maintains an identity separate from its parent.

Staff has indicated that it might recommend that any change to 1699(h) not be retroactive. Staff's primary concern is that such a change would be unfair to businesses that have relied on the earlier version. These schemes are so inherently wrong, that no multi-national corporation advised by a Big Four accounting firm could have possibly formed a buying company without knowing the risk that it would be invalidated. Had Oakland and United not foreseen the risk, they would not have included numerous clauses to address it in their contract.⁷

⁵ *See* Transcript of March 22, 2005 BOE Meeting at 30 (Boardmember Mandel) ("Well my sense was that...when this buying company regulation came up that...jet fuel...was not even thought of. And that if anything, that's almost an unintended consequence that the Board would not have...intended to override somehow the specific arrangements that were made on jet fuel"; *id.* at 41 (Boardmember Mandel) (suggesting a motion to draft specific language exempting jet fuel from Regulation 1699(h), but not precluding "interested parties [from looking at] the whole thing."). Ultimately the motion passed was a motion to reconsider the entirety of Regulation 1699(h). *Id.* at 42.

⁶ If Staff believes it more appropriate, it could always suggest a modification to 1802 rather than 1699 to prevent tax redirection schemes related to jet fuel.

⁷ *See, e.g.*, Economic Development Agreement Between the City of Oakland California and United Airlines (Attached as Exhibit I to the County's Petition) at 4 (terminating the responsibility of Oakland to pay economic incentives if there is "change of the law or California Board of Equalization Regulations" relating to jet fuel sales).

In addition, Staff has apparently not considered partial retroactivity. Even if large multi-national corporations had not foreseen the possibility of Board revision of 1699(h) in 2001, no entity can claim that it was not on notice after the County filed its Petition last year. At a minimum, Staff should consider recommending that any revision of 1699(h) be retroactive to 2004.⁸

V. CONCLUSION

Finally, there were a number of comments at the September 8th meeting from staff and others to the effect that perhaps the changes to 1699(h) would not foreclose the United Airlines kickback scheme. Whether it is through an exemption of jet fuel or through some other mechanism, any revision of 1699(h) must have the effect of eliminating the United Airlines kickback scheme because it so clearly exemplifies the problems with 1699(h). Any regulation that allows such a scheme would clearly be inconsistent with the Bradley-Burns Bill of Rights and AB66 as well as federal law.

The County appreciates the Board and Board Staff's time and consideration.

Very truly yours,

THOMAS F. CASEY III, COUNTY COUNSEL

By: David Silberman
David A. Silberman, Deputy

TFC:DAS/cc

cc: Jean Alexander, CCSF
Members of the Board of Supervisors, CSM

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⁸ The County cannot help but point out the ironic implications on retroactivity of Opponents' main arguments against revising 1699(h), *i.e.*, "the United deal is an isolated incident and that there has been little other documented abuse of Buying Companies". The County disagrees, both because such schemes are very difficult to detect and because other businesses have made clear that they are waiting to see the resolution of the County's Petition to implement their own schemes. Nevertheless, if opponents are right, few businesses will be effected by the change and there should be little concern about retroactivity.



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October 12, 2005

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Sacramento, CA 94279-0092

Re: Petition to Amend or Repeal Board of Equalization Regulation 1699(h)

Dear Mr. McGuire:

I write at pursuant to Ms. Whitaker's recent request that the County of San Mateo provide the updated version of 1699(h) that it will ask the Board to approve. I have attached that version to this letter.

In addition, I have attached a newspaper article that the County will ask the Board to consider on the retroactivity issue. In that article Oakland Budget Director Marianna Marysheva is quoted as stating (in reference to the recent jet fuel legislation): "[w]e knew that this would probably happen, so we did not include that money in our budget... . We expected that this would go against us and planned our budget conservatively." As the County explained in its earlier correspondence, all relevant entities were aware of the risks of engaging in a tax redirection scheme.

Finally, the County notes that despite possessing the County's proposal for four months, no interested party has ever explained how a buying company that is formed for the sole purpose of purchasing a single good or service could provide business advantages other than improper tax savings. See [Proposed] Regulation 1699(h), subsection (3). The County asks Staff to consider including a provision like the County's proposed subsection (h)(3) in the version it provides the Board.

Jeffrey L. McGuire
October 12, 2005
Page 2

If I can provide any additional information, please feel free to contact me.

Very truly yours,

THOMAS F. CASEY III, COUNTY COUNSEL

By: David Silberman
David A. Silberman, Deputy

TFC:DAS/cc

cc: Jean Alexander, CCSF

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CALIFORNIA

SACRAMENTO

Governor vetoes bill to increase minimum wage

Thumbs down also to Gate bridge ban on tolls for walkers

By Christian Berthelsen
and Jim Herron Zamora
CHRONICLE STAFF WRITERS

SACRAMENTO — Gov. Arnold Schwarzenegger vetoed a bill Thursday to increase California's minimum wage, following through on a promise made by his aides at the end of the legislative session.

The governor, seeking to clear his desk of hundreds of pending bills before an Oct. 9 deadline, also vetoed a bill that would have prevented tolls from being imposed on pedestrians and bicyclists using the Golden Gate Bridge and a measure that would have banned schools from using the word "Redskins" for team names. He also signed a bill that changes how revenue from the

tax on jet fuel sales is distributed among cities and counties.

The minimum wage bill, AB48 by Assemblywoman Sally Lieber, D-Mountain View, would have increased the minimum wage by \$1 over two years and automatically tied future increases to the pace of inflation.

The bill was opposed by some of the governor's biggest allies, including the California Chamber of Commerce and the California Restaurant Association.

Schwarzenegger vetoed a bill last year to increase the minimum wage by \$1 over two years. This year, Schwarzenegger said he supported an increase in the minimum wage but wanted a bill that did not include the provision allowing for an automatic increase.

Lieber, speaking to reporters after the veto, called the governor's explanation "a political fig leaf."

"We tried for months to get a solid offer from the governor, but he and his staff did not come up

with one," she said. "The governor's veto was very unfortunate, because this was a very modest, small step toward self-sufficiency for many Californians."

Both Lieber and Art Pulaski, head of the California Labor Federation, accused Schwarzenegger of bowing to pressure from business interests.

"It was time for him to prove he was not in the pocket of the Chamber of Commerce and the big corporations, and he failed," said Pulaski.

Schwarzenegger signed a bill that re-allocates millions of dollars in jet fuel sales tax dollars from Oakland to cities and counties that host airports including San Francisco.

The bill, written by Assemblyman Leland Yee, D-San Francisco, is designed to close a loophole in a 1998 law that allows every community that hosts an airport to reap sales tax revenue every time a plane refuels there.

The loophole has been used by

United Airlines and the city of Oakland, siphoning millions of dollars in jet fuel sales tax revenue from airport communities throughout the state, Yee said.

Under a special deal cut by Oakland in 2002, United Aviation Fuels Corp., a wholly owned United subsidiary, can buy and sell all fuel used by the airline out of an office in Oakland.

If a United flight fuels in Los Angeles, San Diego or San Francisco, the airline pays sales tax only in Oakland — at a reduced rate. To draw the United subsidiary to Oakland, city officials agreed to rebate 65 percent of the sales tax to the airline, which is in bankruptcy, as a "business incentive" and keep the other 35 percent for its general fund.

Yee said his bill would end the special deal and raise as much as \$3 million for San Francisco and San Mateo counties, which jointly oversee San Francisco International Airport, and about \$4.8 million for Los Angeles as well as

smaller amounts for all the other state's airports.

Oakland officials have questioned Yee's numbers, saying the deal netted only \$1.4 million in the fiscal year ending June 30. The airline has declined to comment.

"We knew that this would probably happen, so we did not include that money in our budget," said Oakland Budget Director Marianna Marysheva. "We expected this would go against us and planned our budget conservatively."

Other bills vetoed by the governor include:

► A measure by Assemblywoman Lois Wolk, D-Davis, that would have prevented the Golden Gate Highway and Transportation District from imposing bridge tolls on bicyclists and pedestrians. Schwarzenegger said the bill, AB748, would inappropriately usurp control from the district's governing board.

► A bill that would regulate the

name of school team names, mascots and nicknames. AB13 by Assemblywoman Jackie Goldberg, D-Los Angeles, would have banned the use of "Redskins" in school team names, but Schwarzenegger said in his veto message that those types of decisions should be made at the local school board level.

► SB363 by Sen. Don Perata, D-Oakland, which would have required acute care hospitals to establish health care worker back injury prevention plans and implement "zero lift policies," which would have replaced manual lifting and transferring of patients with mechanical lifting devices or lift teams. Schwarzenegger said he was supportive of the bill's goals and would like to see hospitals voluntarily implement its measures before imposing a mandate.

Chronicle staff writers John Wildermuth and Lynda Gledhill contributed to this report.



CITY OF LONG BEACH

OFFICE OF THE CITY MANAGER

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GERALD R. MILLER
CITY MANAGER

September 23, 2005

Mr. Jeffrey L. McGuire, Tax Policy Manager
Sales and Use Tax Department
State Board of Equalization
450 N Street (MIC:92)
P.O. Box 942879
Sacramento, CA 94279-0092

RE: Oppose Revision or Repeal of Regulation 1699(h) - Buying Companies

Dear Mr. McGuire:

Thank you for the opportunity to attend the interested parties meeting on September 8, 2005 regarding proposed changes to Regulation 1699(h), concerning Buying Companies.

The City of Long Beach opposes any modification to the language contained in the existing Regulation 1699(h). We believe that the language changes proposed by staff will result in subjective interpretation by Board staff, and could result in penalizing legitimate buying companies by revoking their seller's permit. Such revocation would have a severe financial impact on those cities that have relied on the revenue generated by the buying companies in their jurisdiction.

Staff proposes revising "sole purpose" language to "primary purpose" throughout the Regulation, and changes the definition of "primary" to require that ALL elements listed in 1699(h)(2) be met. Further, staff proposes to expand 1699(h)(2) to include an element that requires the buying company to maintain a separate identity from the parent company. The proposed language defines "separate identity" to mean, in part, that the buying company maintain separate employee and accounting records and own or lease its own equipment.

The City has strong concerns that such proposed language change would require a legitimate buying company to incur more operational expenses, and thus operate less efficiently, than would a counterpart subsidiary that does not purchase goods for its parent entity. Legally and for all other tax purposes, both companies would be considered separate entities, even if they share employees or facilities/equipment with their parent corporation; yet for sales tax purposes, just because one entity purchases materials and equipment for its parent and associated subsidiaries, it would not be considered as a separate entity. There is no basis in law for distinguishing the two.

During the course of the interested parties meeting, the City of Long Beach pointed out that it is common practice for all types of subsidiary companies, including buying companies, to outsource, for consideration, their payroll and accounting functions to other companies, and often to their own parent corporations. The proposed language raises the question that if a buying company outsources such activities, for consideration, to its parent corporation,

would such outsourcing be considered by Board staff as 'not maintaining a separate identity'? Board staff acknowledged that, in such a situation, the buying company would still be considered as maintaining separate identity, as long as there was consideration paid to the parent company. However, Board staff disagreed with the City of Long Beach and Mr. Cendejas that clarifying language to that effect should be added to the proposed changes.

The City of Long Beach strongly requests that, should the Board decide to adopt the staff's proposed changes to Reg. 1699(h), clarifying language be added to 1699(h)(2)(c) that indicates outsourcing the listed elements to a parent company or related subsidiary would not negate the "separate identity" requirement for the buying company.

Some interested parties would like to see language added that would deny the seller's permit to a buying company if its agreement with the local government included economic incentives. The City of Long Beach strongly opposes any such language, and agrees with Board staff's position that the addition of such language has no statutory support, and therefore, would be beyond the Board's authority.

SUMMARY

The City of Long Beach opposes any change to the existing Regulation 1699(h) regarding Buying Companies.

However, should the Board decide to accept staff's proposed language changes, the City requests that the "sole purpose" language be maintained as is, inasmuch as "primary purpose" leaves the buying company open to subjective staff interpretation.

Further, the City strongly requests that language be added to clarify that outsourcing the elements listed in Reg. 1699(h)(2)(c) to a parent corporation would be acceptable in determining whether the buying company has maintained a separate identity.

Finally, the City opposes adding any language that would preclude economic incentives.

Thank you for the opportunity to respond to this very important issue.

Sincerely,



Gerald R. Miller
City Manager

cc: Honorable John Chiang, Chair
Honorable Claude Parrish, Vice Chairman
Ms. Betty T. Yee, Acting Board Member
Honorable Bill Leonard
Honorable Steve Westly
Ms. Marcy Jo Mandel, Deputy for Steve Westly
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September 26, 2005

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Dear Mr. McGuire,

Following is the response of the City of Oakland to the Second Discussion Paper on Proposed Regulatory Changes Regarding the Issuance of Sellers Permits to "Buying Companies" – Regulation 1699, Permits.

RECORD DOES NOT ESTABLISH NEED FOR CHANGE

The Discussion Papers and the Interested Parties Meeting on September 8, 2005 at Board of Equalization headquarters did not reveal any systemic problem with Regulation 1699(h). Rather, they showcased one local tax allocation dispute between three jurisdictions that is well on its way to legislative resolution. Regulation 1699(h) has been relied upon successfully innumerable times since adoption in February 2002, and should continue to provide guidance for companies in circumstances where operation of a buying company makes sound business sense.

Said guidance would be subject to confusion and subjective interpretation if the "sole purpose" test were replaced by some form of "primary purpose" language as suggested by Staff. What clearly seems "primary" to one person may not be to another.

The Board expends much time and effort on an ongoing basis clarifying and interpreting statutory and regulatory language. Its goal has always been to make guidance clear, and remove vague and confusing terminology. This proposal would take us in the opposite direction by replacing the clear and unambiguous term "sole purpose", with a vague term open to as many interpretations as there are business purposes.

PROPOSED ADDITIONAL CRITERIA NEED CLARIFICATION

Staff proposes that entities be required to meet multiple criteria before being recognized as a legitimate buying company. We have concerns that the separate identity requirement (proposed Reg. 1699(h)(2)(c)) could be interpreted in ways harmful to the efficient operation of the businesses in question.

It is a common practice for buying company employees to be paid by the parent company. What is the status of those employees in the Board's view? If the buying company pays their parent company for performance of the payroll function, would that suffice for maintaining a separate identity with respect to employees?

Many buying companies are staffed by one or two people. How would the hiring and firing provision operate from the Board's viewpoint? Is this provision really necessary to accomplish the Board's purposes?

Would leasing an office or warehouse facility from the parent company satisfy the separate identity requirement with regard to "its own facilities and equipment"? What types of equipment are intended to be covered by this provision?

FULL AND FAIR APPLICATION OF REGULATIONS

The City of Oakland strongly opposes any attempt to "pick and choose" products for discriminatory treatment. We agree with Staff that there is no statutory basis for exempting certain products from this Regulation. Calls for doing so by other jurisdictions involved in a local tax allocation dispute over one particular product, only underscore the parochial nature of this entire revision process. But for that one dispute, this review would not be occurring.

RETROACTIVITY

We agree with Staff that retroactivity in this matter would be fundamentally unfair to the many businesses and local jurisdictions that have relied on current Regulation 1699(h) for over three and one half years.

It is noted that the Board conducted hearings less than four years ago on the Regulation, and adopted it after widespread notice and opportunity to be heard by all interested parties. The Board's procedures ensure that changes to regulations are carefully considered. They are relied upon by millions of taxpayers as authoritative guidance, and great care is taken to conduct business operations in accordance with these laws.

To pull the rug out from under many parties who have detrimentally relied on it would be completely contrary to the Board's goal of fair tax administration.

The Board can be likened an umpire ensuring that everyone plays by a set of mutually agreed upon rules. The instant request is akin to asking for a rules change in the middle of a game because you don't like the outcome and want to "take points off the board".

ENSURING FLEXIBILITY IN DECISION MAKING

The revisions proposed by Staff to Regulation 1699(h) appear to establish an exclusive set of criteria for determining the legitimacy of a buying company, even where one of the proposed criteria is not met.

We recommend that language be inserted specifying that these criteria are not the exclusive method of determining whether a buying company is legitimate.

All buying companies meeting the final criteria would be deemed legitimate and issued a seller's permit. However, buying companies meeting a "facts and circumstances" test could also be deemed legitimate, even though they do not meet all of these criteria.

ECONOMIC INCENTIVES

We agree with Staff that the Board lacks authority to condition issuance of a seller's permit on the existence of, or the terms contained within, an economic incentive agreement.

This legitimate business tool has many advantages to local jurisdictions and their business constituents. Voluntary agreement between the parties is the proper vehicle for creation and modification of these agreements.

CONCLUSION

The City of Oakland believes the Discussion Papers and Interested Parties Meeting have not revealed a systemic problem in need of resolution. We therefore request that the Board not amend Regulation 1699(h).

If the Board chooses to amend, we suggest that it do so only to the extent necessary to satisfy itself that a separate identity is present.

Thank you for the opportunity to participate in this review process.

Sincerely,

Douglas R. Boyd Sr.

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September 26, 2005

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Chief, Tax Policy Division
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State Board of Equalization
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Sacramento, CA 94279-0092

**RE: BTC Concerning Buying Companies
Under Regulation 1699(h) - Oppose
Any Revision or Repeal**

Dear Mr. McGuire:

For the reasons stated in more detail below, I oppose any revision or the repeal of subsection (h) of Regulation 1699 concerning buying companies. In summary, the revisions are unnecessary and ill advised. Additionally, they lack statutory authority and have the potential to create many problems.

During the second interested party meeting on September 8, 2005, it was clear that there are three views. The first view, which is proposed by Board staff, is to amend the regulation to require that the primary purpose for forming a buying company not be to re-direct local sales tax. Additionally, the buying company must maintain a separate identity that includes but is not limited to hiring or leasing its own employees, maintaining separate accounting records and owning or leasing its own facilities and equipment.

There are several problems with this proposal. First, there is no statutory support for these requirements on buying companies. Second, these requirements are both vague and unlimited in their scope. Third, the requirements would invalidate buying companies that were not intended to be invalidated. Fourth, the requirements do not recognize that it is a very common practice for companies, especially large companies, to outsource these types of services and administrative functions to both the related and unrelated entities. Fifth, the requirements can easily be overcome, but increase the cost of doing business in

California. Finally, these requirements will not invalidate the United Airlines buying company.

The position of San Francisco and San Mateo County is to add even more and stronger requirements. In particular, they seek to add a requirement that prohibits or substantially restricts any incentive provided to buying companies. While I sympathize with them (see my prior letter to you dated June 20, 2005), I agree with Board staff and the Legal Department that there is no statutory support for restricting city and county incentives.

The remaining position seemed to be held by all the other parties participating in the meetings. The position is that the regulation should not be revised or repealed. There are several valid reasons for this position. First, this subsection was adopted less than three years ago after public meetings. Since then, there has been only one complaint about buying companies. This hardly seems sufficient to require an extensive revision of the regulation. Second, the current regulation is very clear and has been relied on by many cities. To change the requirements now would cause harsh and unfair budgetary problems for cities, which are now dependent on the revenue. Third, the proposed revisions are vague, open ended, without statutory support and ignore the fact that related entities share the cost of centralized administrative functions. The revisions would cause a multitude of foreseeable as well as unforeseeable problems. Fourth, the issue, as it relates to United Airlines buying company, has been addressed by the legislature. This is not only the appropriate place to resolve the issue; it seems inappropriate for the Board to now address it in a different manner than the legislature found appropriate. Finally, an attempt to indirectly change the allocation of local sales tax is still a change in the regulation for the purpose of changing local sales tax allocation. This is now prohibited under Proposition 1A.

In summary, I oppose the proposed revisions because they do not accomplish anything but instead create many problems, the issue has been addressed by the legislature, it is an obvious attempt to change the allocation of local sales tax by an indirect means that is prohibited by Proposition 1A and there is no statutory support for treating one entity differently than another entity merely because one is related to its customers.

I request that this letter be included in the materials that will be provided to the Board on November 4, 2005. Thank you for your assistance.

Very truly yours,

Robert E. Cendejas

Robert E. Cendejas

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August 15, 2005

Honorable John Chiang
Chairman, Business Taxes Committee
State Board of Equalization
450 N Street MIC:72
Sacramento, CA 95814

Re: Written Comments of the Air Transport Association (ATA)
on the Proposal to Amend Regulation 1699.

Dear Chairman Chiang:

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

The Proposed Amendments are Unnecessary.

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

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

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

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

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

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

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

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

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

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

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

The San Francisco and San Mateo Proposals are Unadministrable

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

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

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

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

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

The Proposals Lack Statutory Support

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

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

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

of a seller's sales are at wholesale.

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

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

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

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

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

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

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

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

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

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

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

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

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

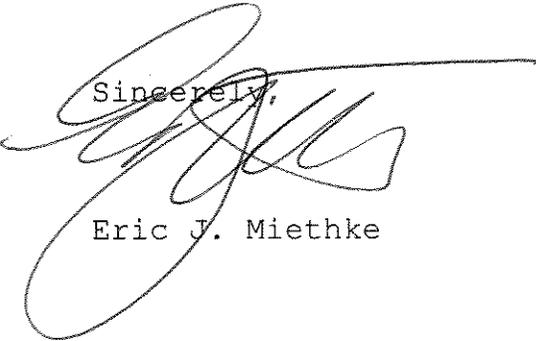
Any Actions by the Board Should Be Prospective Only.

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

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

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

Sincerely,



Eric J. Miethke

SUBMISSION FROM THE CITY OF RANCHO MIRAGE

Via Fax

September 26, 2005

Lynn Whitaker
CALIFORNIA STATE BOARD OF EQUALIZATION
450 N. Street
Sacramento, CA 94279-0092

PROPOSED AMENDMENTS TO REGULATION 1699(h)

Dear Ms. Whitaker:

The City of Rancho Mirage was recently informed of the proposed changes to Regulation 1699(h), stemming from petitions filed by the Cities of San Francisco and San Mateo, regarding the issuance of seller permits to Purchasing Corporations. Based on my research of the issue, the San Francisco and San Mateo petitions clearly stem from a local dispute with the City of Oakland over the allocation of local taxes from jet fuel sales. However, the consequences of these changes, if approved, would be far more reaching than this particular issue. By addressing a dispute between three cities through a change in an existing Regulation, hundreds of businesses and local jurisdictions would be negatively impacted.

Regulation 1699(h), as it exists today, creates a mutually beneficial relationship between local government and private enterprise. Purchasing corporations allow businesses the following:

- **Increased Purchase Power** – Corporations can obtain larger discounts by acting as a buying corporation for all of its divisions and subsidiaries
- **Improved Control over Administrative Costs** – Purchasing Corporations provide for greater efficiency by allowing for better control over costs and consolidating personnel, procedures and facilities
- **Deferral and Reduction of Sales, Use and Property Taxes** – Purchasing corporations allow for sales or use tax to be paid when the merchandise is taken out of inventory, rather than at the time of purchase, which can lead to the loss of the tax previously paid when inventory becomes obsolete prior to being used.
- **Increased Control over Sales Tax Administration** – With purchasing corporations, the sales tax responsibilities are clearly outlined and there is never a question of whether the

SUBMISSION FROM THE CITY OF RANCHO MIRAGE

tax was properly paid at the correct rate. Businesses without purchasing corporations have to rely on a variety of vendors to collect and remit the appropriate sales tax rate for the various states and counties in which they do business. This is problematic as many times the vendors will over-assess or not collect and remit the proper use tax.

An important component to the community of Rancho Mirage is Eisenhower Medical Center. Eisenhower Medical Center is a progressive medical campus that provides an enormous benefit to the City. The medical campus provides important services and research in a variety of medical areas. Doctors from around the world come to Rancho Mirage to take part in seminars and conventions at the facility. Eisenhower also plays an important role in the community through its involvement in various philanthropic endeavors.

The previously mentioned benefits of purchasing corporations allow Eisenhower to maintain an efficient and streamlined organization, while providing the City with sales tax revenue. The benefit of sales tax revenue for Rancho Mirage is crucial in maintaining an effective level of City services. As a low property tax city, Rancho Mirage relies heavily on sales tax to provide police, fire, parks, street maintenance and other services to the community. Please note that the City of Rancho Mirage provides no economic incentives to Eisenhower Medical Center.

Resolving a dispute over the distribution of jet fuel tax among three local jurisdictions by amending Regulation 1699(h) makes no sense, especially in light of the fact that the very issues that the amendments are proposing to resolve are already being addressed by Assembly Bill 451. Assembly Bill 451 specifically targets the allocation of sales tax derived from the sale of jet fuel. There is no logical justification for pursuing amendments to an existing Regulation that would have such disruptive implications throughout the state.

It is the City's opinion that the proposed amendments to Regulation 1699(h) are misguided and unwarranted. This regulatory overkill would most certainly do more harm than good. As a result, the City of Rancho Mirage respectfully requests that the proposed amendments to Regulation 1699(h) be denied.

Sincerely,
CITY OF RANCHO MIRAGE

Patrick Pratt
City Manager