



STATE BOARD OF EQUALIZATION

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November 8, 2004

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Dear Interested Party :

Enclosed is the Status Report for the topic, *Place of Sale When Sales Orders are Accepted and Processed Electronically*. This issue had been placed on the Business Taxes Committee's November 4, 2004 agenda and was subsequently removed with the Committee Chair's approval.

I thank you for your interest in this issue, and encourage you to participate in other issues before the Committee in which you may have an interest. Should you have any questions, please feel free to contact Mr. Geoffrey E. Lyle, Supervisor, Business Taxes Committee and Training Section, at (916) 322-0849.

Sincerely,

Jeffrey L. McGuire
Tax Policy Manager
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JLM: ca

cc: Honorable Carole Migden, Chairwoman
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BOARD OF EQUALIZATION
STATUS REPORT

- Board Members
- Business Taxes Committee
- Customer Services Committee
- Legislative Committee
- Property Tax Committee
- Technology & Administration Committee

Topic: Should the method by which electronic commerce is conducted determine the manner in which retailers report local sales tax?

Background:

At its meeting on April 13, 2004, the Board directed the Business Taxes Committee to review and discuss the “place of sale” for local sales tax purposes, under the Bradley-Burns Uniform Local Sales and Use Tax Law, when sales orders are placed, received and processed¹ electronically. Exhibit 1 provides information on (1) determining if a transaction is subject to sales or use tax, (2) the place of sale for local tax allocation purposes and (3) the history of the local tax. Interested parties meetings were held to discuss the allocation of local tax when sales are made electronically and to discuss the desirability of new or additional rules for electronic commerce transactions. Exhibit 2 provides eight examples of electronic commerce that were discussed at the interested parties meetings.

Interested Parties Meetings

Interested parties meetings were held on June 17, 2004 and on August 5, 2004. Prior to each of the meetings, a discussion paper and invitation to attend the meetings were sent to over 40 major retailers and over 500 city financial managers. Two retailers attended the meetings and the remaining parties represented local cities and counties. The Board also received written submissions from 27 Interested Parties on this matter, some of whom also attended one or both of the meetings. A list of interested parties who wrote timely submissions, and their position on this issue is provided in Exhibit 3.

Results of Meetings:

1. Server Location. Board Staff and all interested parties agreed that the location of the server on which the web site that took the order and any other server that processed the order, in and of itself, should not be considered the place of sale.²

2. Place of Negotiation of Sales. There were two general opinions regarding where the allocation should take place.

¹ For purposes of this Status Report, “processed” means performing one or more of the following activities or functions in connection with an order related to the sale of tangible personal property: checking inventory; checking the purchaser’s credit; checking the “ship to” address; and transmitting the order information to a warehouse for fulfillment of the order. This list of activities is intended to be illustrative and not exhaustive.

² Throughout this BTC topic, at the meetings and in the submissions, for simplicity’s sake, the assumption was made that a retailer’s electronic transactions would involve processing by only one server. Today’s complex business operations may, however, entail multiple steps; each performed by a separate server, thus adding to the complexity of the question.

a. One set of interested parties' opinions was that local tax should be allocated to the location of the retailer's employees who are responsible for maintaining, supervising, and updating the server and the software that processes the orders. Often, this would be the retailer's headquarters location. However, if this activity occurs out of state and the retailer has an in-state warehouse, most agreed that the tax should be allocated on a situs basis to the location of the in-state warehouse. There was, however, no agreement on where to allocate the local sales tax if there is more than one headquarters location with differing operations functions. To complicate matters, there seemed to be no agreement on exactly who the employees under discussion were — the programmers who designed and updated the web site, the marketing people who created the advertising information that would go on the web site, the sales personnel who determined what products would be available for sale and at what price, or someone else. One suggestion was to handle these situations on a case-by-case basis.

b. Another set of interested parties' opinions was that local tax should be allocated to the location where the first physical human contact takes place. Often, with the use of multiple servers that handle customer orders, this would be the location of the retailer's warehouse. These interested parties assert that human processing should take qualitative precedence over electronic processing. This is how the staff currently handles the transactions that have so far arisen in this context. (Annots. 710.0013.600 (12/30/97) & 710.0150 (8/18/99).)

3. Place of Delivery. Finally, the City of San Dimas suggested that the point of sale be the location of the purchaser or end user. This would often be the location of delivery. To implement this suggestion would require statutory change. This would be the result if California implements the Streamlined Sales Tax Program. (See Exhibit 1, footnote 3).

Conclusion:

Determining the proper allocation of local sales tax is becoming more complex due to the manner in which retailers conduct business today. The Business Taxes Committee has conducted two meetings to discuss how to allocate local sales tax when sales orders are placed, accepted, or processed electronically. Most of the submissions recommended making no changes to the regulations at this time but advocated that the Board interpret existing regulations to favor one of the other positions discussed above. For the regulation to be interpreted any differently than as it is currently interpreted, however, the regulation would have to be amended. While a number of cities supported the general idea of allocating local sales tax revenue to a location where employees are responsible for maintaining, supervising, and updating the server and the software that processes the orders, generally, the retailer's headquarters location, there was no agreement regarding the allocation of the local sales tax revenue when these functions were spread out over more than one headquarters location. Other cities supported the current staff practice of allocating local sales tax revenue to the location where the first human contact takes place.³

Accordingly, staff recommends no changes be made to current regulations at this time. In the meantime, disagreements regarding local tax allocation issues arising from sales in electronic commerce will of necessity continue to be handled on a case-by-case basis based on the location where the retailer's employees first process the order, which, as noted above, is current practice.

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

Current as of: November 3, 2004

³ Staff notes that the fact situations that have so far arisen have all involved employees of the retailer first coming in contact with the orders being located at the retailer's warehouse. As a result, staff has determined that the local sales tax in those situations was properly allocated to the location of the warehouse. The analytical framework, however, does not require that the local sales tax revenue go to a warehouse in all cases. That has simply been the result in recent cases.

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Introduction

Commerce in the 21st Century is changing significantly as retailers incorporate new technologies into the ways that they perform their transactions. Many retailers in today's markets have Internet web sites on servers,¹ that may or may not be owned by the retailer, where consumers place orders electronically from computers. The retailer's computers process the order transmitted to it from the web site (this processing is done through servers which can be located anywhere), and the order information is then transmitted to the retailer's or wholesaler's server(s) (which could be in or out of California and owned or not owned by the retailer or wholesaler) for order fulfillment from a warehouse. Such processing and fulfilling may occur in any state, and at locations that may not be owned or operated by the retailer. In many of these cases, there is no human involvement on the part of the retailer making the sale until the order is fulfilled at the retailer's warehouse. If the retailer does not own inventory, the retailer apparently has no human involvement at all in the sale. Thus, the person-to-person interaction at the order stage, on which the Board has historically based its analysis of the local sales tax consequences of a sale, is not present. In some cases, especially in business-to-business orders, even the purchaser's order may be placed by a computer that tracks inventory, resulting in no human involvement on the purchaser's side as well. These changes in sales methods have raised the issue of where to allocate the local sales tax when the transaction takes place electronically through the Internet².

Resolution of this issue requires an understanding of the retailer's operations in the state, as well as the circumstances of its transactions. Determining the answers to the following questions will assist in resolving the local sales tax allocation issues arising from electronic commerce transactions.

1. Is the transaction subject to sales tax or use tax?
2. If a transaction is subject to sales tax, what is the place of sale for local sales tax purposes?³

Is the Transaction Subject to Sales Tax or Use Tax?

Under the California Sales and Use Tax Law, sales tax is imposed on retailers for the privilege of

¹ "Servers are [computer] systems, often with multiple microprocessors working together, that house large amounts of data, direct traffic, perform complex transactions and control central functions in local and wide area networks and on the Internet." (2003 Intel Annual Report, p. 2 <<http://www.intel.com/intl/annual03ar03.pdf>>.)

² Because local use tax is allocated to the place where the property is first functionally used (Reg. 1802(c)) electronic commerce transactions subject to local use tax do not have "place of sale" issues as local sales tax transactions do.

³ Staff notes that the place-of-sale concept is not the only possible method of allocating local sales tax. For example, the Streamlined Sales Tax Program (SSTP) contemplates the allocation of local sales tax using a place-of-use orientation similar to district taxes. The SSTP is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. RTC sections 6026 - 6031 create a Board of Governance and direct the Board of Governance to represent California as a voting member of the SSTP. See <http://www.streamlinedsalestax.org/>.

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selling tangible personal property at retail in this state. (Revenue and Taxation Code (RTC) section 6051.) The use tax is complementary to the sales tax and is imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer for storage, use, or other consumption in this state. (RTC section 6201.) The obligation to pay use tax is on the consumer. (RTC section 6202(a).) However, if an out-of-state retailer is engaged in business in this state as defined in RTC section 6203, it is required to register with the Board (Certificate of Registration - Use Tax), collect the use tax from the consumer at the time of making the sale, and remit the tax to the Board, allocating local use tax to the place of first functional use. (Reg. 1803(c).)⁴

The sales tax and the use tax are at the same rate. The sales tax is measured by the retailer's gross receipts, and the use tax is measured by the sales price of the property purchased. (RTC sections 6011 & 6012.) The application of local sales tax and local use tax generally follows the application of state sales tax and state use tax, subject to various exclusions and exemptions from local tax. (Reg. 1803.) Retailers making sales subject to sales tax must obtain a seller's permit and a sub-permit for each location at which transactions related to sales are negotiated, and local sales tax is allocated to the place where the sale is deemed to take place. (RTC section 6066, Reg. 1699, 1802(c).)

Regulation 1620(a)(1) (*Interstate and Foreign Commerce*) provides in part that when a sale occurs in this state, the sales tax is not rendered inapplicable solely because the sale follows a movement of the property into this state from a point outside its borders. Such movements prevent application of the sales tax only when conditions exist under which the taxing of the sale is prohibited by the United States Constitution or there exists a statutory exemption. (Reg. 1620(a)(1).) Regulation 1620 defines the conditions when sales tax does and does not apply, as follows:

“Sales tax applies when the order for the property is sent by the purchaser to, or delivery of the property is made by, any local branch, office, outlet or other place of business of the retailer in this state... and the sale occurs in this state.... Participation in the transaction in any way by the local office, branch, outlet or other place of business is sufficient to sustain the tax.” (Reg. 1620(a)(2)(A).)

“Sales tax does not apply when the order is sent by the purchaser directly to the retailer at a point outside this state, or to an agent of the retailer in this state, and the property is shipped to the purchaser, pursuant to the contract of sale, from a point outside this state directly to the purchaser in this state... provided there is no participation whatever in the transaction by any local branch, office, outlet or other place of business of the retailer....” (Reg. 1620(a)(2)(B).)

If a Transaction is Subject to Sales Tax, What is the Place of Sale for Local Sales Tax Purposes?

Under the Bradley-Burns Uniform Sales and Use Tax Law (“Local Tax”), counties, cities and

⁴ The Sales and Use Tax regulations referenced in this paper can be viewed at <http://www.boe.ca.gov/sutax/staxregs.htm>

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some redevelopment agencies are authorized to impose a local sales and use tax in their jurisdictions in accordance with the provisions of this law. (RTC sections 7200 – 7212.) All participating jurisdictions are required to contract with the Board for the collection and administration of the local tax. (RTC 7202(d).) Local use tax generally is allocated to the place of first functional use, while local sales tax generally is allocated to the place where the sale is negotiated. (Reg. 1802.) Additionally, the legislature has provided specific local tax rules for sales of specific products, such as sales of jet fuel and leases of motor vehicles. (RTC sections 7204.03, 7205.1.)

For purposes of the state Sales and Use Tax Law, the place of the sale of tangible personal property is the place where the property is physically located at the time the act constituting the sale or purchase takes place. (RTC section 6010.5.) However, for purposes of the Local Tax Law, different rules apply. (Reg. 1628(b)(4).) For local tax purposes, retail sales are consummated at the retailer's place of business if the retailer has only one place of business in the state (RTC section 7205(a)); otherwise, if the retailer has no permanent place of business, or more than one place of business, sales are consummated as determined under rules and regulations of the Board (RTC section 7205(b)). As relevant here, Regulation 1802(a)⁵ interprets and implements the place of sale rules as follows:

“(1) **RETAILERS HAVING ONE PLACE OF BUSINESS.** For the purposes of the Bradley-Burns Uniform Local Sales and Use Tax Law, if a retailer has only one place of business in this state, all California retail sales of that retailer in which that place of business participates occur at that place of business unless the tangible personal property sold is delivered by the retailer or his or her agent to an out-of-state destination, or to a common carrier for delivery to an out-of-state destination.

“(2) **RETAILERS HAVING MORE THAN ONE PLACE OF BUSINESS.**

“(A) If a retailer has more than one place of business in this state but only one place of business participates in the sale, the sale occurs at that place of business.

“(B) If a retailer has more than one place of business in this state which participate in the sale, the sale occurs at the place of business where the principal negotiations are carried on. If this place is the place where the order is taken, it is immaterial that the order must be forwarded elsewhere for acceptance, approval of credit, shipment, or billing. For the purposes of this regulation, an employee's activities will be attributed to the place of business out of which he or she works.”

Regulation 1802(c) further provides that local sales tax is allocated to the place where the sale is deemed to take place under rules of Regulation 1802(a) and (b).⁶

A business location is not considered “a place of business” of the retailer under Regulation 1802 unless that location can be issued a seller's permit or sub-permit: persons who desire to engage in

⁵ Subdivision (b) sets forth local sales tax allocation rules for specific sellers, and is therefore generally not a factor in this discussion. The rules contained in subdivision (a) cover the vast majority of retailers.

⁶ Subdivision (b) of Regulation 1802 contains allocation rules for seven different types of retailers. This Discussion Topic concerns only the general rules under subdivisions (a) and (c).

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the business of selling tangible personal property in this state must obtain a seller's permit for each place of business at which transactions related to sales are customarily negotiated with their customers. (RTC section 6066(a), Reg. 1699.) Regulation 1699(a) states:

“Every person engaged in the business of selling ... 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.”

The regulation also specifies that:

“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.”

Thus, the place of sale is generally the retailer's registered place of business at which the sale is negotiated or the order taken. Local sales tax generally is allocated directly to the local jurisdiction of that location.⁷ Guidelines for allocating local tax are set forth in Exhibit 5 of Chapter 5 of the *Compliance Policy and Procedures Manual*. (<http://www.boe.ca.gov/pdf/cpm-05.pdf>.)

The challenges facing the Board, retailers and participating jurisdictions today deal with allocation issues in the Internet age, where retailers do not operate in traditional business locations involving face-to-face negotiations of sale.

Local Tax History

The existing allocation rules were developed when the local tax system was instituted in 1956 with Board staff working in concert with cities, counties, and retailers. The system balanced the needs and desires of the participating jurisdictions against the administrative burdens and expenses of the retailers, who would be preparing the local tax returns and schedules, and reporting and paying sales taxes or collecting use taxes. The system was based on the economic model then current: sales were primarily accomplished through face-to-face negotiations between the customer and a representative of the retailer.⁸ The predecessor to Regulation 1699,

⁷ When a retailer has only one place of business in this state that negotiates sales, local sales tax of those sales is automatically allocated to that location. If the retailer has more than place of business capable of being registered under the Board's rules and regulations, the permit is issued to the retailer's headquarters and sub-permits are issued to each selling location. The qualifications for a sub-permit are the same as for a seller's permit.

⁸ The word “negotiate” is defined identically in a standard Webster's dictionary and in Black's Law Dictionary, as meaning “to confer with another so as to come to terms or reach an agreement.” (Webster's II New Riverside University Dictionary (1994) p. 789, col. 1; Black's Law Dict. (5th ed. 1979) p. 934, col. 1; see, *Mason v. Mazel*

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Tax Ruling 79, adopted in 1939, limited issuance of seller's permits to locations where retailers customarily negotiated sales with customers. The Board recognized at the time, however, that some sales agents would travel from their home offices to make sales, so their sales activities were (and are) attributed to the offices out of which they work. (See former Tax Ruling 2202, now Reg. 1802(a)(2)(B).) Sales offices also tended to be fairly permanent locations, and the Board has required that, in order for local sales tax to be allocated to a city, the retailer must have a place of business there in which the retailer has a "proprietary interest," the retailer must have employees permanently stationed there, and those employees must be negotiating sales. (Reg. 1802(a); Annotations 710.0013 (7/18/91) and 710.0024 (8/5/83).)

Technology, however, has marched on. As retailers began increasingly to use telephone banks to make sales rather than sales occurring face-to-face, the Board concluded that the location of the retailer's telephone bank where the retailer answered customers' telephone calls was the place where the sales negotiations occurred. (Annotations 710.0007 (5/19/92) and 710.0010 (11/14/91).) Again, the Board was responding to the instruction of Regulation 1699(a) to find the location which customers regularly contacted to negotiate sales with the retailer.

Mail-order catalog sales became increasingly common, and many retailers and the property they sold using this method of sale were located out of state. Consequently, the applicable tax was use tax, and the attention of the Legislature and Board was turned primarily to getting out-of-state retailers with nexus in California to collect and remit the use tax in these situations.

As the 1990's progressed, more and more sales began to be conducted on the Internet. Initially, servers mainly belonged to service providers, either Independent Internet Service Providers (ISP's), or national commercial on-line services like America On-Line. Upon consultation with industry, the Board concluded that a web site was a means to forward a buyer's order to the retailer through communications lines. Recognizing that if the server were located in California, a question of nexus on the part of an out-of-state on-line retailer could arise, the Board amended Regulation 1684(a) in 1997 to provide that the use of a computer server to create or maintain a web site on the Internet would not be considered in determining if a retailer has substantial nexus with California.⁹

As the millennium drew to a close, some California retailers established web sites on servers located in this state that customers could visit and on which they could place orders. Regarding whether web servers were places of sale, in 2001 the Board adopted subdivision (i) of Regulation

(1947) 82 Cal. App. 2d 769, 772.) Staff recognizes that in the case of typical over-the-counter sales there are no "negotiations" as that term is defined, but the bringing of goods to the counter has always been considered "negotiations" for the purpose of obtaining a seller's permit.

⁹ The third paragraph of subdivision (a) of Regulation 1684 states: "The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California. No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state."

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1699 as follows:

“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.”

This subdivision is consistent with the opinion set forth in Annotation 710.0013.600 (12/30/97), where, following the reasoning behind the 1997 amendment to Regulation 1684(a), the opinion concluded that when the order is placed through an Internet web site and forwarded through the site to a location in California where the retailer’s employees process the order, the place where the order is processed is the place of sale for local tax purposes. The rationale for this result is that RTC section 7205, Regulation 1699(a) and Regulation 1802(a) require the Board to determine where the retailer is exercising its privilege of selling, i.e., the place where persons customarily contact the retailer for the purpose of negotiating sales. Moreover, if a web server cannot provide nexus to require a retailer to collect use tax under Regulation 1684, it cannot support jurisdiction to make a retailer pay sales tax. Therefore, the location of electronic forwarding equipment, be it electronic telephone switching equipment or a web server, is not a place of sale, in and of itself.

In framing the analytical difficulties raised by the emergence of electronic commerce sales, staff was guided by two fundamental principles. The first is that both the local tax and the sales tax are limited in scope by the statutes and regulations of the Sales and Use Tax Law and the Bradley-Burns Uniform Local Sales and Use Tax Law. Unlike the business license tax that many cities impose, the sales tax does not tax the privilege of engaging in business in general but taxes only the privilege of selling. (See, e.g. *Carnation Co. v. City of Los Angeles* (1966) 65 Cal.2d 36, 39.) Therefore, to determine the proper allocation of local tax the Board may only look for locations where there are employees actively engaged in *selling* activities such as contacting customers and taking orders (e.g., Annots. 710.0009 (7/10/91) & 710.0012 (12/28/90)). Other non-selling business activities of the retailer, which might provide jurisdiction for a city to levy a business license tax measured by gross sales, would not be considered in determining where selling activities occur for purposes of imposing and allocating the local sales tax.

The second fundamental principle is that the location of the retailer’s employees for the purpose of making sales has been an essential factor in determining the place of sale from the beginning of the local tax system. In *City of Pomona v. State Board of Equalization* (1959) 53 Cal.2d 305, the boundary line between Pomona and Montclair bisected a Sears store. Pomona claimed that all of the local sales tax derived from the sales made at the store should go to Pomona, while Montclair and San Bernardino County claimed that an apportionment should be made. The trial court "apportioned the receipts of [the sales] departments on the basis of the percentage of total sales floor area of each such department (area in which merchandise is displayed and where customers and sales personnel customarily stand in negotiating the sale of merchandise) falling on either side of the [city] line." (*Id.* at p. 310.) The California Supreme Court concluded that the trial court’s decision was a reasonable method of determining where the principal negotiations occurred.

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Over-the-counter sales, such as those in the *Pomona* case, are relatively simple to allocate for local tax purposes. In a brick-and-mortar store, the customer visits the store and purchases from the retailer's employee, so that the "place of business" where the retailer "negotiates" with its customers is, of course, the store where the purchaser customarily contacts the retailer's employee. As technology has facilitated more remote contact, the Board has attempted to apply the same fundamental principle— where do persons customarily visit the retailer's employees for the purpose of making sales? With respect to orders placed over the telephone, customers call a telephone number, which is answered by the retailer's employee at the call center. The employee enters information from the caller into a computer at the call center, and the information is relayed electronically to a warehouse, where personnel act upon the information received from the call center.¹⁰ Under this analysis, the place of sale is not the location of the telephone switching equipment but that of the employee who actually answers the telephone (e.g., Annots. 710.0007 (5/19/92) & 710.0010 (11/14/91)).

However, with Internet or electronic commerce sales, one or more of the above factors may not be present. There may not be an individual directly involved in either the purchasing or the retailing end of the sale. The first time a human being comes in contact with the transaction may be when the order reaches the location of the retailer's stock of goods for processing for delivery. Or, the retailer may not own a stock of goods in this state, fulfilling its sales orders from one or more third-party suppliers in what are basically drop-shipment arrangements-- i.e., a third party fulfills the order and ships it to the customer. The retailer's only physical presence in California may be an administrative headquarters where no selling activities occur. This kind of business location does not qualify for a seller's permit under Revenue and Taxation Code section 6066 and Regulation 1699.

Some changes created by electronic commerce have been integrated relatively easily into the existing local tax system. For example, at many gas stations, a customer purchases gas directly at the pump by running a credit card through a reader on the pump, without interacting with the clerk inside the store. Some stores have systems where customers are given 'readers' with which they scan their purchases as they shop and then check out at a kiosk using a debit card, credit card, or check without going through a cash register. The Board considers these purchase methods to be substitutes for traditional cash register checkouts and instructs the retailers to allocate the local sales tax derived from such sales to the locations of the individual stores, just like other over-the-counter sales. However, transactions where the customer and the retailer interact entirely by computer raise issues which are more difficult to resolve concerning the determination of the place of sale and the allocation of local sales tax.

The Board, then, has been faced with determining where the retailer, with regard to its Internet sales, exercised its privilege of selling tangible personal property at retail—that is, where did the clients customarily visit the retailer's employees for the purpose of making sales and purchases over the internet? In the case of Internet sales, in the factual situations that have arisen so far, the location best fitting the criterion of Regulation 1699(a) has been the business facility where the

¹⁰This example assumes that the retailer owns and maintains the switching equipment, as well as the call center where the customers' calls are received and that the calls are received by the retailer's employees.

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retailer's employees first come into contact with the order (See Annotations 710.0013.600(12/30/97) and 710.0150 (8/18/99)).

ELECTRONIC COMMERCE EXAMPLES

The examples below were provided as a basis for a discussion by local government and retailers to discuss the desirability of new or additional rules for electronic commerce transactions. In each case, assume the retailer has a seller's permit and the California buyer places the order over the Internet.

Example 1: The retailer has its headquarters in a California city and a warehouse in another California city. The retailer's web site is hosted by an independent service provider located in another California city. All orders are electronically processed at the retailer's headquarters, e.g., electronically received, credit checked, acknowledged, and transmitted for fulfillment to the retailer's warehouse, where an employee receives and fills the order, and then ships the product to the California customer. The sale is subject to California sales tax because the buyer, the seller, and the property sold are all located in California at the time of the sale, but the determination of the retailer's place of sale is more difficult than a traditional over-the-counter sale. Just as with telephone sales where the location of the switching equipment was not the place of sale, here the place of sale is not the location of the server (the transmission equipment) nor of the employee who maintains the server. Furthermore, the local sales tax may not be allocated to the location of the web site, because the web site cannot be issued a permit under Regulation 1699(i), which explains:

“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.”

While the same reasoning generally applies to orders placed through a web site as to orders placed through a telephone order center, with the Internet order, instead of an employee picking up the phone and receiving the order, a computer performs that task. Where, then, is the place that the retailer's customers “visit” or contact to place their orders? Staff has concluded that the place that best fits that criterion for local sales tax purposes for orders placed over the Internet is the jurisdiction where the employee who receives and processes the order is located. Since the first time an employee of the retailer is involved in the order in this example is when the order arrives at the retailer's warehouse where the retailer's employee fills the order from the warehouse inventory, staff would interpret current allocation rules to require the local tax to be allocated directly to the local jurisdiction of the warehouse¹. (Regulation 1802(a).)

¹ In the fact patterns that have so far arisen for resolution by staff, the place where the retailer's employees have first received and processed the orders has been at a warehouse. It is by no means, however, staff's position that the local sales tax revenue must go to the warehouse location in all cases. While that may be the typical case, the actual results would vary depending on where the retailer's employee first downloads the order from the server and processes it according to the retailer's normal business practices. Notwithstanding, the rule would be the same: find the first location where the retailer's employee receives and processes the order.

ELECTRONIC COMMERCE EXAMPLES

Example 2: Same as Example 1, except a third-party California supplier, not the retailer, fulfills the orders from its warehouse inventory. The retailer has no employee involved in processing the order, but the sale is still subject to sales tax because all activities take place in California. Under existing rules, there is no business location of the retailer that can be issued a sub-permit under Regulation 1699(a). Staff would interpret existing allocation rules to require the local sales tax to be allocated indirectly through the medium of the county-wide pool to the jurisdiction of the retailer's only business location in this state. (RTC section 7202; see also *City of San Joaquin v. State Board of Equalization* (1970) 9 Cal. App. 3d. 365, 375-376.)²

This example points out the difficulty of finding sales negotiations and a physical location of a retailer's place of sale when all activities relating to the sale occur electronically. This raises the issue of whether sales negotiations, as that term is commonly understood, take place at all when the customer and retailer solely interact by electronic transmissions. On the other hand, if negotiations do take place, do they take place in cyberspace, i.e., a place with no physical location to which a seller's permit or sub-permit may not be issued? To the extent the retailer's operations are consolidated in one location, a permit to that location might be a solution. What if, however, as in Annotation 710.0150 (8/18/99), the corporate headquarters and its server are in different places (see Example 4)? What if, in this day and age of "virtual corporations,"³ the retailer's various corporate functions are located in several different cities? Which function should be issued a permit? Should the permit be issued to the location of the retailer's server or to the location of the retailer's programmers who design and maintain the web page, or to that of the marketing and sales personnel who provide the programmers the necessary information regarding products, prices, promotions, or to somewhere else?⁴ Instead of searching for a place where the retailer has a place of sale, an argument could be made that, as the retailer is not engaged in the business of selling at any physical location in California, the place of sale is the California location of the stock of goods that fulfills the orders, with the local sales tax then allocated to the jurisdiction where the warehouse is located. Another alternative would be for the retailer to allocate the local sales tax through the medium of the statewide pool especially if the sales involve high-volume but low-per-unit-cost sales, which is where the statewide pool is typically used.

² The county-wide pool system is an accounting system used to allocate the local portion of the sales or use tax reported under certain circumstances. The pool system is used only when the applicable rules and regulations of the Board do not permit direct allocation and even then is involved only after the applicable tax and the place of sale or use have been determined under the rules and regulations of the Board. Retailers who report tax to the participating jurisdictions through the medium of the pool system generally do so on Schedule B (*Detailed Allocation by County of 1 Percent Uniform Local Sales and Use Tax*) with their returns. Schedule B lists each county within the State of California. Local sales tax is listed opposite the county wherein is located the place of sale; local use tax is entered opposite the county of first functional use. At the end of each reporting quarter, the county-wide pool totals are prorated among the unincorporated area and the cities and redevelopment agencies of each county using the proportion that the directly-reported tax for each city, redevelopment agency, and unincorporated area bears to the total direct-reported tax for the county as a whole.

³ Chutchian-Ferranti, Joyce, *Virtual Corporation*, Computerworld (9/13/99) <<http://highbeam.com>> (as of May 20, 2004).

⁴ The difficulties increase if these departments were themselves "virtual" with no one physical location.

ELECTRONIC COMMERCE EXAMPLES

Examples 3 and 4: Same as Examples 1 and 2, except that the retailer hosts its own web site on a server that may (Example 3) or may not (Example 4) be located in the same place as its administrative headquarters. Now that the retailer owns the server, the question is whether the retailer undertakes any activity at the location of the server that would qualify that location for a seller's permit under Regulation 1699(i). Staff has previously taken the position that merely the placing of an order on a web site is not "negotiation" in that the Internet order is like filling out an order form from a mail-order catalogue. (See Annotation 710.0151 (10/30/02).)

Examples 5 and 6: Same as Example 3 (the server is located at the retailer's headquarters), except the retailer also makes retail sales over the telephone, either at the headquarters location (Example 5) or at a remote location in this state (Example 6). Clearly, for the telephone sales, the telephone seller's location must obtain a seller's permit or sub-permit under Regulation 1699(a), and the local sales tax derived from the telephone sales would be allocated to the location of the telephone seller. (Reg. 1802(a)(1).) What, however, happens to the Internet sales? Resolution of this issue depends on the answers to the questions posed under Examples 3 and 4.

Example 7: Another example (really a variation of Examples 5 and 6) is a scenario regarding a large in-state retailer whose operations are located in various cities. Customers place their orders on the web site hosted by a server located in City A, which automatically forwards the orders to a warehouse in City D (northern California orders) or City E (southern California orders). The retailer's headquarters in City B is where the customer service team is located. That team answers questions about Internet orders and makes changes to orders. Problems with Internet orders are handled at yet another office in City C; and once the problems are corrected, the orders are forwarded to the warehouse in City D or City E. The warehouse employees fulfill the orders.

Example 8: Another example is a scenario regarding a large in-state retailer having multiple retail stores, where the order is received electronically at a web site hosted on a server located out of state and forwarded electronically to the closest registered retail outlet participating in the program (not all stores participate), where the order is fulfilled. Customers enter their zip codes when ordering to determine the nearest participating outlet. Customers also enter their credit information at that time. The local participating outlets also resolve any problems with the orders. The local retail outlet will deliver the goods, or the customer can pick them up there. Local sales tax is allocated to the location of the local retail outlet that fulfills the order and delivers the goods for the reasons explained in Example 1.

ELECTRONIC SALES SUBMISSIONS SUMMARY

No change to existing practice. Local tax should be allocated to the location where the first physical human contact takes place (generally warehouse).	Local tax should be allocated to the location of the retailer's employees who are responsible for maintaining, supervising, and updating the server and the software that processes the orders. Often, this would be the retailer's headquarters location.
Mr. Douglas R. Boyd, Sr., HdL Companies	Mr. Robert E. Cendejas
Mr. Dwight Stenbakken, League of California Cities	Mr. Grant D. Yee, City of Ontario
Mr. Allan Roeder, City of Costa Mesa	Ms. Linda A. Moxon, City of Santa Monica
Mr. Bruce E. Channing, City of Laguna Hills	Mr. Albin C. Koch, MBIA MuniServices Company
Ms.Carolynn Thomas, City of Eureka	Mr. Kenneth Farfsing and Mr. Dennis MacArthur, City of Signal Hill
Mr. R. W. Gittings, City of San Marcos	Mr. Michael A. Killebrew, City of Long Beach
Mr. Hubert Walsh, Jr., City of Merced	Mr. Steven Conway, Town of Los Gatos
Mr. Richard Torres, City of Montebello	Mr. David Hyman, Netflix
Ms. Marsha R. Ramos, City of Burbank	Ms. Carol A. Atwood, City of Cupertino
Mr. Richard C. Ambrose, City of Dublin	
Mr. Chris Jeffers, City of Monterey Park	
Mr. Steven M. Chapman, City of Moreno Valley	
Ms. June Overholt, City of Rialto	
Ms. Helen M. Allen, City of Concord	
Mr. Kevin N. Smith, Town of Apple Valley	
Mr. Scott Ochoa, City of Monrovia	

The following submissions did not fit either one of the above positions:

Mr. James L. Becklenberg, City of Fremont - Agreed with direct situs vs. the indirect pooling method of local sales tax allocation and not to location of the server in and of itself.

Mr. Blaine Michaelis, City of San Dimas – Preferred the local sales tax to go to the place of purchase or delivery.