

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: January 21, 2005

Decision: MTHO #208

Tax Collector: City of Tucson

Hearing Date: December 2, 2004

DISCUSSION

Introduction

On September 10, 2004, *Taxpayer 1*, *Taxpayer 2*, *Taxpayer 3*, *Taxpayer 4*, and *Taxpayer 5* (Collectively, referred to as "Taxpayer") filed a protest of a tax assessment made by the City of Tucson ("City"). After review, the City concluded on September 13, 2004 that the protest was timely and in the proper form. On September 18, 2004, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to provide a response to the protest on or before November 2, 2004. On October 5, 2004, the City filed a response to the protest. On October 18, 2004, the Hearing Officer ordered the Taxpayer to file any reply on or before November 8, 2004. On October 22, 2004, a Notice of Tax Hearing ("Notice") was issued setting the matter for hearing commencing on December 2, 2004. Both parties appeared at the December 2, 2004 hearing (the Taxpayer requested and was granted permission to appear telephonically) and presented evidence. Subsequent to the hearing, the City provided copies of four cases on December 10, 2004 in support of their position. On December 16, 2004 the Taxpayer filed email comments to the cases. On December 21, 2004, the City filed an email response to the Taxpayer. On December 21, 2004, the Taxpayer filed an email reply. On December 24, 2004, the Hearing Officer indicated the record was closed and a written decision would be issued on or before February 7, 2005.

City Position

The City conducted an audit of the Taxpayer for the period January 2000 through December 2003. The Taxpayer consisted of several different corporations, some of which had physical stores located in the City while *Taxpayer 2* ("*Taxpayer 2*"), *Taxpayer 5* ("*Taxpayer 5*"), and *Taxpayer 3* ("*Taxpayer 3*") sold over the internet and did not have physical stores located in the City. According to the City, the Taxpayer had a policy during the audit period which permitted online customers to return merchandise to the Taxpayer stores located in the City. The City argued that pursuant to City Regulation 19-100.3 ("Regulation 100.3"), *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* would be considered retailers subject to the City privilege tax. Regulation 100.3 provides as follows:

When in the opinion of the tax collector it is necessary for efficient administration of this article, he may regard any salesman, representative,

peddler, canvasser or agent of any dealer, distributor, supervisor or employer under whom he operates or from whom he obtains tangible personal property for sale, rental, lease or license as a retailer for the purposes of this article, irrespective of whether he is making sales, rentals, leases or license on his own behalf or on behalf of others. The tax collector may also regard such dealer, distributor, supervisor or employer as a retailer for the purposes of this article.

The City argued that the issue in this case is whether the Taxpayer's internet and mail order businesses establish nexus with the City sufficient to allow the City to impose a transaction privilege tax on gross revenues during the audit period. The City asserted there was sufficient nexus since the Taxpayer maintained a physical presence through retail stores in the City and at least during part of the audit period allowed customers to return items purchased through the mail or internet to the stores located in the City. For the audit period, the City assessed *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* for privilege taxes in the amount of \$13,197.67, \$5,601.98, and \$4,986.12, respectively for unreported internet sales.

Taxpayer Position

The Taxpayer asserted the focus of the audit was on internet sales prior to July 31, 2003, during which time, the City did not have a use tax statute. The Taxpayer agreed that its businesses which had stores physically located in the City were taxable. The Taxpayer argued that sales made by *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* were internet sales and not taxable by the City prior to July 31, 2003. According to the Taxpayer: the execution of all online sales agreements occurred in Ohio, the online inventory was located in Ohio; and, title and possession occurred in Ohio. While the Taxpayer argued there was no evidence of any online sales purchases being returned to stores located in the City, the Taxpayer did acknowledge they have had a policy that would permit such returns. Even if there had been such returns, the Taxpayer argued that would not affect the proper tax type of the sale (i.e. sales vs. use tax). The Taxpayer asserted there is no legal basis which would allow the City to apply the sales tax statute against sales made in the stream of interstate commerce. According to the Taxpayer, the main issue in this case is the imposition of the proper tax type (i.e. sales vs. use).

ANALYSIS

It is clear that none of the internet sales for *Taxpayer 2*, *Taxpayer 5*, or *Taxpayer 3* would be subject to City use tax prior to July 31, 2003. The City has assessed the internet sales for *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* as retail sales pursuant to City Code Section 460 ("Section 460"). City Code Section 465 ("Section 465") exempts out-of-City sales from the Section 460 tax. Further, City Code Section 100 ("Section 100") defines out-of-City sales to occur when all of the following occur: (1) transfer of title and possession occur outside the City; (2) the stock from which the personal property was taken was not within the City; and, (3) the order is received at a permanent business location of the seller located outside the City. Based on the record in this case, the

internet sales of *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* were all exempt out-of-City sales pursuant to Sections 100 and 465. After review of the cases provided by the City, we concur that a privilege tax can be assessed when the business activities have a “substantial nexus” with the City. The City Argued because the Taxpayer had a policy, during at least a portion of the audit period, that allowed an online customer to return merchandise to a sister company with a physical store in the City resulted in sufficient nexus with the City to allow a transaction privilege tax on the gross revenues of the Taxpayer. We must disagree. While such a policy would provide the Taxpayer with some goodwill, we did not find evidence that it would significantly affect the Taxpayer’s ability to establish and maintain a market in the City. Accordingly, we do not find the Taxpayers’ activities establish a “substantial nexus” with the City. The internet sales of *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* were not subject to the City’s transaction privilege tax during the audit period.

FINDINGS OF FACT

1. On September 10, 2004, the Taxpayer filed a protest of a tax assessment made by the City.
2. After review, the City concluded on September 13, 2004 that the protest was timely and in the proper form.
3. On September 18, 2004, the Hearing Officer ordered the City to provide a response to the protest on or before November 2, 2004.
4. On October 5, 2004, the City filed a response to the protest.
5. On October 18, 2004, the Hearing Officer ordered the Taxpayer to file any reply on or before November 8, 2004.
6. On October 22, 2004, a Notice was issued setting the matter for hearing commencing on December 2, 2004.
7. Both parties appeared at the December 2, 2004 hearing and presented evidence.
8. Subsequent to the hearing, the City provided copies of four cases on December 10, 2004 in support of their position.
9. On December 16, 2004, the Taxpayer filed email comments to the cases.
10. On December 21, 2004, the City filed an email response to the Taxpayer.
11. On December 21, 2004, the Taxpayer filed an email reply.
12. On December 24, 2004, the Hearing Officer indicated the record was closed and a

written decision would be issued on or before February 7, 2005.

13. The City conducted an audit of the Taxpayer for the period of January 2000 through December 2003.
14. The Taxpayer consisted of several different corporations, some of which had physical stores located in the City while *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* sold over the internet and did not have physical stores located in the City.
15. The Taxpayer had a policy during the audit period which permitted online customers to return merchandise to the Taxpayer stores located in the City.
16. The execution of all online sales agreements occurred in Ohio; the online inventory was located in Ohio; and title and possession occurred in Ohio.
17. A policy that allowed an online customer to return merchandise to a sister company with a physical store in the City did not significantly affect the Taxpayer's ability to establish and maintain a market in the City.

CONCLUSIONS OF LAW

1. Pursuant to ARS Section 42-6056, the Municipal Tax Hearing Officer is to hear all reviews of petitions for hearing or redetermination under the Model City Tax Code.
2. During the audit period, the City assessed the internet sales for *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* as retail sales pursuant to Section 460.
3. Section 465 exempts out-of-City sales from the Section 460 tax.
4. Pursuant to Section 100, the internet sales for *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* were exempt out-of-City sales.
5. The internet sales of *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* did not establish a "substantial nexus" with the City.
6. The Taxpayer's protest of taxation of the internet sales for *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3* should be granted.

ORDER

It is therefore ordered that the September 10, 2004 protest of *Taxpayer 1*, *Taxpayer 2*, *Taxpayer 3*, *Taxpayer 4*, and *Taxpayer 5* of a tax assessment made by the City of Tucson is granted consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Tucson shall remove all privilege license taxes on internet sales of *Taxpayer 2*, *Taxpayer 5*, and *Taxpayer 3*

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer