

M e m o r a n d u m**702.0175**

To: Mr. Clay Cowan
Local Tax Section

Date: June 10, 1992

From: John L. Waid
Tax Counsel

Subject: [C]
S- -- XX-XXXXXX
Date of Knowledge of Improper Local Tax Allocation
(S 7209)

In your February 19, 1992, memorandum to me on the above taxpayer, you have asked for our opinion regarding the proper interpretation of Revenue and Tax Code Section 7209, relating to reallocation of Bradley-Burns revenue between cities and counties, as it applies to the above taxpayer. (Unless otherwise state, all statutory references are to the Revenue and Taxation Code.) Specifically, you have asked what generally constitutes "knowledge of improper distribution" and what is the date of such knowledge in this case? You attached to your memorandum a Chronology of Events regarding the original audit of [C] and the correspondence with [M] and others on this matter. Included also was a copy of Senior Tax Counsel John Abbott's memorandum of February 14, 1990, to Local Tax Unit Supervisor Larry Micheli (regarding another taxpayer) discussing this issue.

Opinion

The problem here is [C]'s allocation of local tax revenues from the sale of supplies for which orders are taken by telephone at the [city] telemarketing center. You attached to your memorandum several documents bearing on the matter. One was a Chronology of Events which listed the communications which Board offices received and their responses.

Section 7209 provides as follows:

"7209, Limitations, redistributions. The Board may redistribute tax, penalty and interest distributed to a county or city other than the county or city entitled thereto but such redistribution shall not be made as to amounts originally distributed earlier than two quarterly periods prior to the quarterly period in which the Board obtains knowledge of the improper distribution."

In 1959, the year section 7209 was enacted, the Board staff issued its standards for determining the date of knowledge and what constitutes "knowledge of improper allocation" as follows:

“2. WHAT CONSTITUTES KNOWLEDGE OF IMPROPER DISTRIBUTION

“The Board of Equalization will be considered to have knowledge of an improper distribution when an employee of the Board has such knowledge. To constitute knowledge of an erroneous local tax allocation, there must be a factual basis sufficient to indicate the probability that local tax has been erroneously allocated. The facts may come to the attention of the Board through a field audit or investigation, review of a return, a letter from the taxpayer or his representative, a conversation with the taxpayer or his representative, or in some other manner.

“To constitute knowledge of the Board, it is not necessary that the employee of the Board obtaining the knowledge be absolutely certain that the local tax allocation was erroneous. For example, the employee may refer the information upon which the decision is based to the supervisor or to Headquarters for final decision, or the employee may secure additional information from the taxpayer. It is not necessary to know the specific amount of tax or tax measure involved at the time knowledge of an improper distribution is first obtained. This may be determined later.

“If a taxpayer or other person writes a letter to the Board questioning the correctness of an allocation and setting forth facts which indicate the probability of an improper distribution, and such reported allocation is later found to be erroneous, the Board will be considered to have knowledge of the erroneous allocation when the letter is received, even though the letter is not read immediately or field investigation is delayed.

“In other cases, however, where the facts are in the records of the Board, the Board will not be considered to have knowledge of the erroneous allocation until an employee of the Board has examined the documentation and questioned the tax allocation.

“In other words, facts actually in possession of the Board do not constitute knowledge of an erroneous tax allocation unless the taxpayer, an employee of the Board, or some other person questions the correctness of the local tax allocation.

“3. WRITTEN EVIDENCE THAT THE BOARD HAS KNOWLEDGE

There should be written evidence establishing the date on which the Board obtained knowledge of an improper distribution.”

* * * *

Communications in which the writer recounts facts allegedly demonstrating a misallocation of local tax revenues usually come from a city or its representatives. (See, § 7056(b).) Where the Board staff performs an investigation in response and determines that the writer was right, the question of the date of knowledge under Section 7209 is simple – the date of the letter. (BTGB 59-12, #2.) However, where, as here, as a result of the staff’s initial investigation it notifies the writer that the questioned allocation was proper, a different problem presents itself. The writer may then write back offering new facts upon investigation of which the staff determines that the allocation was in fact incorrect. The question then becomes the date of receipt of which of these missives constitutes the date of knowledge – the first or second. At our conference on May 14, Messrs. [V] and [A] pressed the position that, where the city or consultant responds to the initial investigation within a prescribed time period, the investigation remains open and the period in which the first letter was received is the date of knowledge. (Note that we assume for the purposes of this memorandum that the first and final letters are received in different quarters.)

Mr Abbott discussed this very issue in his memorandum in the context of the initial letter coming from a city as follows:

“If the Board staff conducted an insufficient investigation of [the taxpayer] after receiving specific factual information from the City regarding claimed misallocations, in my opinion the Board could not successfully assert that it did not obtain knowledge of the improper distribution when the City first informed us of the specific facts. I do not believe the Board can disregard the original date of knowledge merely by conducting an inquiry, however brief, of the taxpayer’s sales operations. On the other hand, if the Board staff conducted an investigation in which the taxpayer provided the Board with specific factual (but erroneous) information that no sales persons operated out of the [office at issue] the correct date of knowledge would be [the date of the second letter]. The Board is not required to resolve factual disputes or ensure against erroneous information if the Board obtains facts directly from the taxpayer which indicate the taxpayer is allocating local tax correctly.

“But where a city or a consultant provides us only with a list of potential misallocation, and no specific information regarding the facts which lead them to believe there is a misallocation, then in my opinion such information does not constitute a date on which the Board obtains knowledge of the improper distribution. In the attachments with your memo, you included a letter ... from Mr. [A] of [M], in which he attached a list of hundreds of questioned accounts. He states that “for each business reported, we have established that sales people officing at the indicated locations are participating in retail sales of tangible personal property.” I do not believe that this is sufficient factual information regarding these hundreds of accounts to indicate that on this date, the Board obtained knowledge of any improper distributions. Accordingly, I agree that your [response] to Mr. [A] correctly states: ‘Also, the ... letter by itself is not sufficient

to establish a date of knowledge. Our standard for establishing a date of knowledge requires a factual basis sufficient to indicate the probability that local tax has been erroneously allocated. A mere listing of accounts with no further information would not fulfill this requirement.”

Your Chronology of Events indicated that in late 1989 an audit of [C] was completed for the period April 1, 1986, through June 30, 1989, and that it was decided that no adjustment should be made. In September of 1990, [M] inquired regarding modifications of the local tax allocations to several cities from sales of [C]' [city] location. These contacts were apparently by phone as you set forth no specific dates. Then on February 12, 1991, [M] wrote complaining that several cities were experiencing a decline in revenues attributable to sales by [C]. You attached a copy of that letter which included a chart listing the various [C] locations. This list merely stated that salesmen were operating out of these locations. As noted above, such general lists providing only conclusions can not provide knowledge of improper allocation.

Your Chronology then notes that Mr. [W] of [C] Corporation wrote Board member Ernest J. Dronenburg on July 2, 1991, describing [C]' telemarketing operation and asking how local tax revenues from that operation should be allocated. You note that he provided a materially different account of that operation than that which had been given our New York audit staff and which indicated that [C] telemarketing phone operators “may have been directly involved in negotiating sales from California locations.” You then show that Local Tax launched a new investigation with both the [city] and Out-of-State (New York) districts regarding these sales which came to the conclusion that local tax derived from them should be allocated to the California telemarketing offices. The remaining question is the date of such knowledge.

In these circumstances, we reject the position proffered by Messrs. [V] and [A]. Section 7209 is keyed to the period in which the Board acquires knowledge of the improper allocation. BTGB 59-12, issued the same year that the statute became law and presumably reflecting a contemporaneous understanding of the thinking that motivated it, advances the same principle. The date of knowledge is the date on which the Board receives a communication “facts which indicate the probability of an improper distribution, and such reported allocation is later found to be erroneous”. The bulletin does not key the date of knowledge to the date of receipt of a missive containing facts which are ultimately found to be correct after first being rejected but to the date on which facts are received which directly lead the staff to determine that the allocation is improper. Senior Tax Counsel Abbott's memorandum also sets forth the same rule: where, after a “sufficient” investigation, the staff receives information from the taxpayer indicating that the allocation is correct, it is up to the city or its representative to supply additional facts showing that the allocation is incorrect; it is the date of the follow-up contact containing those facts which provides the date of knowledge.

At our conference, Mr. [V] advanced the argument that this interpretation obviated the city's due process rights. We reiterate our assertion that I made at the time that due process is not an issue. The statute permits reallocation only from the period in which the facts are

received that cause the staff to determine the impropriety of the allocation. That can only be the date of the letter that contains those particular facts. The city retains all of its rights to have its case fully heard during this process.

From the facts that you have supplied, it appears that it was Mr. [W]'s letter which supplied the facts sufficient to indicate the probability that local tax had been erroneously allocated and which your investigation corroborated. Investigations of prior more sketchy allegations had led to the conclusion, based on facts supplied by [C], that the allocation was proper. In Mr. [W]'s letter, [C] supplied facts which led to the opposite conclusion. As noted above, the date of knowledge itself is the date on which the Board would have received Mr. [W]'s letter. The Chronology of Events does not give that date, the letter is dated July 2, 1992 [sic], and we would have received it shortly afterward. Either way, the date of receipt is in 3Q 1991. Thus, under Section 7209, Local Tax should re-allocate local taxes generated by [C]' [city] telemarketing office to [city] office for 1Q-3Q 1991 – the current quarter and two quarters back from the date of knowledge.

In his memorandum, John Abbott suggests that Local Tax develop a questionnaire to be answered by taxpayers regarding their allocations of local tax. At our conference, Mr. [A] agreed to submit a suggested questionnaire which we recently received and which I understand you are using as an aid to formulate an investigation guide of your own. No matter what you come up with, we reiterate Mr. Abbott's concern that some formalized guide for investigating allegations of improper local tax allocation must be developed. The arguments over the date of knowledge for this and other taxpayers demonstrate that Local Tax must be able to point to specific reasons why it makes the conclusions it does in a given case. It apparently has been the practice in the past, and here, to investigate these allegations by telephoning the taxpayer and relying upon its oral response. Such a process only engenders controversy and extends the process, resulting in a greater harm to the city from which local tax revenues will be reallocated.

A copy of BTGB 5912 is attached hereto for your convenience.

JLW:es

cc: Honorable Ernest J. Dronenburg, Jr.
Honorable Matthew K. Fong