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CITY ATTORNEY

MEMORANDUM OF LAW

DATE: July 29, 2011
TO: Russ Gibbon, Economic Growth Services
FROM: City Attorney
SUBJECT: Proposed Agreement from HD Supply for a Sales Tax Rebate

INTRODUCTION

According to its website, HD Supply Facilities Maintenance, Ltd. (HD Supply) is a leading supplier of maintenance, repair and operations (MRO) products to owners and managers of multifamily, hospitality, educational, and commercial properties; healthcare providers; and municipal and government facilities. They are also “experts in interior upgrade and renovation projects” and “number one in the market for Multifamily MRO distribution.” HD Supply has “the largest professional sales force in the industry and provides free, next-day delivery on thousands of in-stock products from a vast network of warehouses nationwide.” HD Supply has thirty-six distribution centers and five call centers throughout the United States. Four distribution centers are located in California in the cities of San Diego, Hayward, Industry, and West Sacramento, and one of the five call centers is located in San Diego, California.

HD Supply has presented the City of San Diego with a proposed Business Cooperation Agreement to take effect on June 1, 2011.¹ The Agreement states that HD Supply had “approximately \$280 million in California sales subject to the Bradley-Burns Tax” in 2009, “out of which only a small portion was sourced to San Diego, approximately \$24 million.” HD Supply offers to “undertake significant cost and expense to change its business practices, including modification of the Company’s SAE software, in order to assure [sic] all principal negotiations of its California sales take place” in the City of San Diego in exchange for a rebate of “fifty percent of the Bradley-Burns Tax Revenues reported by the Company and allocated to the City by the BOE (State Board of Equalization) in excess of \$240,000 (City’s approximate Bradley-Burns Tax Revenues).” HD Supply’s change in business practices would not involve the

¹ Staff has informed us that the proposed agreement has not been executed.

closure of any California distribution centers. You have asked our Office to review the proposed agreement.

QUESTION PRESENTED

Can the City of San Diego (City) enter into a Business Cooperation Agreement where HD Supply would “undertake significant cost and expense to change its business practices, including modification of the Company’s SAE software, in order to ensure all principal negotiations of its California sales take place in the City of San Diego, in exchange for a rebate of fifty percent of the Bradley-Burns local tax revenue reported by HD Supply and allocated to the City by the State Board of Equalization (BOE) in excess of \$240,000?”

SHORT ANSWER

The City is prohibited by California Government Code section 53084.5 from entering into the proposed agreement because the cities of Hayward, Industry, and West Sacramento, none of which would close as a result of the proposed agreement, would no longer receive sales tax proceeds from California sales unless a purchaser’s call was routed to a call center outside of California and a warehouse in Hayward, Industry, and West Sacramento filled the order.

ANALYSIS

A. BRADLEY-BURNS ACT

The Bradley-Burns Uniform Local Sales and Use Tax Law (the “Act”) allows counties to raise revenue by imposing up to a 1.25% sales tax on retail sales of “all tangible personal property” sold in the county and a 1.25% use tax on “tangible personal property purchased from any retailer for storage, use or other consumption in the county.” Cal. Rev. & Tax. Code §§ 7202-7203. Sales tax is distributed on a ‘situs’ basis to the retailer’s place of business.² Cal. Rev. & Tax. Code § 7205. Generally, the situs is where the business transaction takes place. The Act does not confer any taxing power on cities, but does authorize cities to impose a sale and use tax of one percent or less. This tax amount is then credited against the county’s tax. Cal. Rev. & Tax. Code § 7202(h).

B. STATUTORY RESTRICTIONS ON SALES TAX REBATES

We are informed that most of HD Supply’s California sales originate through a call center in New Braunfels, Texas. HD Supply may “automatically” route calls received from California purchasers at the Texas call center to the San Diego call center. If, however, California sales personnel are unavailable to take the call, the call would be routed to New

² Different rules apply to the retail sales of jet fuel.

Braunfels, Texas. HD Supply would not close any call or distribution centers as a result of the proposed agreement.

Title 18, section 1802(a) of the California Code of Regulations, describes the allocation of local sales tax, in pertinent part, as follows:

§ 1802. Place of Sale and Use for Purposes of Bradley-Burns Uniform Local Sales and Use Taxes.

- (a) In General.
....
- (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 participates 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. . . .
- (c) Transactions Negotiated Out-of-State and Delivered from the Retailer's Stock of Tangible Personal Property in California. . . .
....
- (2) If a retailer has a permanent place of business in this state in addition to its stocks of tangible personal property, the place of sale, in cases where the sale is negotiated out-of-state and there is no participation by the retailer's permanent place of business in this state, city, county, or city and county from which delivery or shipment is made. Local tax collected by the Board for such sales will be distributed to the city, county, or city and county from which delivery or shipment is made.
....
- (d) Allocation of Sales Tax and Application of Use Tax. Local sales tax is allocated to the place where the sale is deemed to take place under the above rules. . . .

HD Supply has more than one place of business in the State of California: one call center in San Diego and four distribution centers in and outside of San Diego. Principal sales negotiations occur through the company's call centers and not through its distribution centers. Currently, the City of San Diego is entitled to local sales tax proceeds for sales made through a San Diego call center.

If a sales transaction is negotiated by one of HD Supply's out-of-state call centers, and the merchandise is delivered to the California purchaser from one of HD Supply's California distribution centers, the city that houses the distribution center from which the delivery or shipment is made (i.e., San Diego, Hayward, the City of Industry, or West Sacramento) is entitled to the local sales tax proceeds. Cal. Code Regs. title 18, §1802(a).

The proposed agreement would ensure that all sales to California purchasers are made *through the City of San Diego's call center*, unless the call is routed to Texas because San Diego is unable to process the call. As a result, the cities of Hayward, City of Industry, and West Sacramento would no longer receive local sales tax proceeds unless the call was routed to an out-of-state call center and the order was filled by a distribution center in Hayward, the City of Industry, or West Sacramento. This is problematic.

California law prohibits local governmental entities from luring business away from one another by offering financial incentives, such as local sales tax rebates, to businesses. Cal. Gov't Code §§ 53084, 53084.5. California Government Code³ section 53084(a) prohibits local agencies from furnishing any form of financial assistance to a vehicle dealer or big box retailer to relocate from one city or county to another. HD Supply's proposed agreement does not contemplate financial assistance to a big box retailer in exchange for relocation, nor would HD Supply close any of its distribution centers. Section 53084 is not applicable.

Similarly, section 53084.5, enacted in 2009⁴ as result of California Senate Bill 27 (2009-2010 Reg. Sess.) (SB 27), forbids a local agency from making *any* type of contract involving the transfer of any amount of local sales tax proceeds if the contract results in a loss of revenue by another local agency, and the retailer continues to maintain a physical presence within that other local agency's jurisdiction.

Section 53084.5 prohibits the arrangement proposed by HD Supply because the company would route calls from an out-of-state call center to the San Diego call center, thereby entitling the City to the local sales tax proceeds from such sales in exchange for a sales tax rebate. This would result in a loss of sales tax revenue to the cities of Hayward, Industry, and West Sacramento, who would continue to maintain a physical presence in these cities. Such cities would no longer receive sales tax proceeds unless a purchaser's call was routed to a call center

³ All references are to the California Government Code unless otherwise indicated.

⁴ SB 27 was introduced in response to a lawsuit by the Cities of Livermore, Industry, and San Diego against the City of Fillmore after it entered into a sales tax rebate agreement with several corporations that shifted local tax revenue from those cities to itself. SB 27 "makes these kinds of backroom deals illegal throughout the state." See, "Governor Signs Bill to Protect Cities from Sales Tax Scams," Am. Chron., June 6, 2009, available at <http://www.americanchronical.com/articles/view/105116>, note 6, quoting Senator Loni Hancock, author of SB 27.

outside of California and one of these warehouses filled the order. Cal. Code Regs. title 18, §1802(a)(2)(A). This is precisely the scenario section 53084.5 sought to avoid.

Section 53084.5 does not include the penalties or liabilities a city may incur if it violates this law. The Joint Reply Brief filed in the Fillmore case in November 2010 provides some guidance. 2010 WL 4929934 (Cal. App. 2d Dist.) The BOE claimed it did not have statutory authority to invalidate the sales tax rebate agreements or authority to award damages to the aggrieved cities because the request was made before section 53084.5 was codified. The cities therefore sued Fillmore.

Now that section 53084.5 specifically prohibits local agencies from entering into certain types of local sales tax rebate agreements, the BOE would have jurisdiction to process a written petition from a local agency requesting review of questionable or disputed local tax allocations.⁵

C. SAN DIEGO CITY COUNCIL POLICY 900-12, BUSINESS AND INDUSTRY INCENTIVE PROGRAM

If the proposed agreement can be amended so that section 53084.5 is not violated, the Mayor's office will seek authority from the City Council to enter into the proposed agreement unless the agreement is modified so that its terms fall within the Mayor's authority, as described in San Diego City Council Policy 900-12 (CP 900-12).

CP 900-12, entitled "Business and Industry Incentive Program," is intended to "attract and retain major revenue, job generating, and revitalization projects throughout the City, along with criteria and procedures to ensure that the Program is equitably and efficiently administered." It says that the City may "provide assistance" to projects or businesses that "promote the stability and growth of City taxes and other revenues," that are "consistent with the City's current adopted Community and Economic Development Strategy."

Both criteria established by this policy are met: the proposed agreement would significantly increase sales tax received by the City, and the arrangement is consistent with the City's Community and Economic Development Strategy.

The City Manager (Mayor) may approve "[a]n agreement that does not involve General Fund reimbursement of fees or rebate of taxes, or which authorizes reimbursement based on prior City Council authorization." CP 900-12. Further, the Mayor may enter into five types of business cooperation agreements without seeking City Council approval:

- a. The provision of assistance in securing required City permits and approvals;
- b. The provision of due diligence assistance in advance as a potentially valuable project is under consideration, and the provision of preliminary reviews;

⁵ The BOE will provide independent opinions on whether a particular transaction complies with § 53084.5. These opinions take approximately 30-60 days to receive.

- c. The expediting of required Development Review Department permits;
- d. Crediting up to 45 percent of sales or use taxes paid by the business against City business license taxes and/or development related fees, *or rebating up to 25% of sales or use taxes paid by the business, if such sales or use taxes constitute previously uncollectable revenue to the City and the business pays its sales, or use taxes to the State Board of Equalization properly reporting San Diego as the situs of sale or use, consistent with the provisions of the Business Cooperation Program (Resolution R-288034);*⁶ and/or
- e. Reducing water and sewer capacity charges by \$1,000 per equivalent dwelling unit (Resolution R-287543).

CP 900-12 (emphasis added)

The Mayor is otherwise required to seek City Council approval before offering financial incentives that would require general fund reimbursement of fees or rebate of taxes. In seeking City Council approval, the Mayor would submit a report that includes a cost/benefit analysis of the proposed incentive and a description of general fund obligations incurred as a result of the incentive agreement. The Annual Budget must include the impacts incurred by the City as a result of the incentive agreement.

The agreement proposed by HD Supply includes a sales tax rebate representing 50% of previously uncollectable sales tax over \$240,000. If section 53084.5 is addressed and such an agreement is contemplated, the Mayor must obtain City Council authorization. If, however, the proposed agreement is modified so that HD Supply would receive a local sales tax rebate of 25% of previously uncollectable sales tax over \$240,000, then the Mayor is authorized to proceed without City Council participation.

CONCLUSION

Section 53084.5 prohibits the City from entering into an agreement with HD Supply that would involve the loss of local sales tax proceeds by other local agencies where the retailer continues to maintain a physical presence within that other local agency's jurisdiction, as would be the case here.

City staff may also request that HD Supply perform the analysis contemplated by CP 900-12 which, to our knowledge, has not yet occurred. CP 900-12 states that an owner or authorized proponent of a business or project seeking assistance from the City of San Diego "shall submit information to the Mayor. . .detailing how the business or project meets the required criteria, the type of assistance requested, and how the assistance may affect the

⁶ Although R-288034 contemplated allowing a "cash rebate of half the amount of sales/use tax returned to the City as a result of a company's participation" in the City's Business Cooperation Program, and this resolution is cross-referenced in Council Policy, the City Council limited the sales tax rebate to 25%.

development decision.” The Mayor is charged with reviewing this information and determining if further information is needed before a decision can be made. The Mayor may “request additional information, may refer the request and supporting information to a City financial consultant, or may require the applicant to assume the costs of an independent consultant selected by the City.” The Mayor may, for instance, require HD Supply to hire a tax consultant or tax attorney selected by the City and paid for by HD Supply who would review the proposed agreement and determine whether options exist that would not violate section 53084.5.

JAN I. GOLDSMITH, CITY ATTORNEY

By 

Mara W. Elliott
Deputy City Attorney

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