STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Amended:	**Chapter 15**	Bill No:	**Senate Bill 86**
Tax Program:	**Sales and Use**	Author:	**Committee on Budget and Fiscal Review**
Sponsor:	**Author**	Code Sections:	**RTC 6452.1 and 18510**
Related Bills:	**AB 110 (Budget Committee)**	Effective Date:	**Upon enactment**

BILL SUMMARY

This bill would enact statutory changes related to the 2011 Budget Act to allow the use of a "look-up" table when eligible purchasers elect to report their use tax obligations on their state personal income or corporate or franchise income tax returns with respect to individual non-business purchases of less than $1,000.

The bill would also, among other things, require the Franchise Tax Board (FTB) to implement a financial institution records matching system, as provided.

ANALYSIS

CURRENT LAW

Under existing law, Chapter 3 (commencing with Section 6201) of Part 1 of Division 2 of the Revenue and Taxation Code imposes a use tax on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer. The use tax is imposed on the purchaser, and unless the tax has been paid to the state, or the purchaser has a receipt for payment of the use tax to a retailer registered to collect the California use tax, the purchaser is liable for the tax when the purchase of that tangible personal property is subject to tax.

The use tax is the same rate as the sales tax and generally is required to be remitted to the Board of Equalization (BOE) on or before the last day of the month following the quarterly period in which the purchase was made. A use tax liability typically occurs when a California consumer or business purchases tangible items for their own use from an out-of-state retailer that is not registered with the BOE to collect the California use tax. When a person is late in payment of his or her use tax obligations, the law imposes a 10 percent penalty, plus interest, currently at the rate of 7 percent per year.

As an alternative to reporting the use tax to the BOE, existing law allows eligible purchasers to report "qualified use tax" on their state personal income tax returns or their state corporation franchise or income tax returns (hereinafter referred to state income tax returns) for their taxable purchases. Eligible purchasers include those not required under the law to be registered with the BOE, and "qualified use tax" is defined to include the applicable state, local and district tax use tax imposed on the purchase. However, the law specifies that "qualified use tax" does not include the use tax imposed on specified mobile homes or commercial coaches, vehicles, vessels or aircraft, leases of tangible personal property, or cigarettes and tobacco products when the purchaser is registered as a cigarette and/or tobacco products

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consumer (collection of use tax on these transactions is already provided for under other programs).

Under the law, when an eligible purchaser timely reports his or her use tax obligations on a timely filed state income tax return, that payment of use tax is considered to be timely reported. However, the law does not preclude the BOE from making a determination for understatements of use tax against the purchaser, and the law specifies that any such determination be issued in accordance with the Sales and Use Tax Law (generally, within three years from the due date of the state income tax return).

Further, current law provides a longer period – six years from the due date of the state income tax return - with respect to the time in which the BOE may issue a deficiency determination to an eligible purchaser that made a "gross understatement" of use tax. Section 6487.3 of the Sales and Use Tax Law defines "gross understatement" as a deficiency that is in excess of 25 percent of the amount of qualified use tax reported on a person's state income tax return. In the case of fraud, however, a deficiency determination may be issued to a qualified purchaser at any time.

PROPOSED LAW

This bill would, among other things, amend Revenue and Taxation Code Sections 6452.1 and 18510 to *allow* eligible purchasers to use a "look-up" table when they elect to report their use tax obligations on their state income returns with respect to individual non-business purchases of less than $1,000.

Among its provisions, the bill would provide that "qualified use tax" means either of the following:

1) The state, local and district use tax that has not been paid to a retailer, as specified, or
2) For one or more single non-business purchases of individual items of tangible personal property with a sales price of less than $1,000, the estimated amount of use tax due based on the person's adjusted gross income as reflected in the use tax table shown in the accompanying instructions of the state income tax return.

The bill would require the BOE to annually calculate the estimated amount of use tax due according to a person's adjusted gross income and by July 30 of each calendar year make available to the Franchise Tax Board (FTB) such amounts in the form of a use tax table as part of the accompanying instructions of the acceptable tax return.

The FTB would be required to revise the accompanying instructions for filing state income tax returns in a form and manner approved by the BOE.

The bill would become effective immediately, and would apply to taxable purchases made during the calendar year 2011 for which use tax was not paid to the BOE.

BACKGROUND

With the increasing numbers of businesses and consumers shopping on-line, in the early 2000's the BOE and the Legislature began focusing on additional needed program or statutory changes necessary to encourage voluntary compliance, and to provide a cost-effective outreach and education effort to a wider audience of purchasers.

The BOE began working with the FTB to incorporate an actual use tax *return* inside the state personal income tax booklets. For the first time since enactment of the use tax law of 1935, 3.6 million booklets containing a use tax return were mailed to California households for the tax year 2002. Yet, only 322 of the 3.6 million returns were actually filed, yielding a mere $20,000 in use tax.

In an effort to further increase the public's awareness of the use tax and to encourage voluntary compliance in reporting the use tax, legislation enacted in 2003 (SB 1009, Ch. 718) required the FTB to revise the personal income tax and corporation franchise and income tax returns to add a separate line for use tax reporting. This legislation also required revisions to the accompanying instructions in the state income tax booklets to include additional information about the use tax.

This legislation allows consumers and businesses that are not required to be registered with the BOE to report use tax on their state income tax returns for purchases made on or after January 1, 2003, and through December 31, 2009, as an alternative to reporting the tax to the BOE (businesses and certain consumers already registered with the BOE, however, may not use this alternative). SB 858 (Ch. 721, 2010) eliminated the sunset date. With this use tax line, in the first year (2004) California purchasers remitted a total of $2.8 million as a direct result of that line. And, every year since, the amount remitted has increased. Last year, reported amounts on the use tax line amounted to $10.2 million.

However, data obtained from FTB indicated that professionally-prepared returns accounted for about two-thirds of the returns filed with FTB, yet individual-prepared returns were about three times more likely to report use tax. Also, we heard from some tax practitioners that they did not necessarily believe they had a fiduciary duty to their clients to inquire about their clients' use tax obligations when preparing their state income tax returns, since payment of use tax on the state income tax return was merely a voluntary option. In response, in 2007, 2008 and 2009, the BOE sponsored legislation to not only eliminate the sunset date of these provisions, but to also *require* businesses and consumers who have failed to report use tax to the BOE on their taxable purchases for the preceding year to report the use tax on the income tax returns for the taxable year in which the liability for the qualified use tax was incurred. However, none of these attempts was successful. The first and third attempts (AB 969, 2007, Eng and AB 469, 2009, Eng) were vetoed by the Governor, and the second attempt (AB 1957, 2008, Eng) failed passage in the Senate Revenue and Taxation Committee.

An additional measure to address the over $1 billion use tax gap was enacted during 2009's Fourth Extraordinary Session. ABx4 18 (Ch. 16) was enacted to impose a use tax registration and reporting obligation on larger businesses. Under this provision of law, businesses (except for those already registered to report sales or use tax) that have annual gross receipts from business operations of at least $100,000 annually, are required to register with the BOE and file an annual use tax return and report their purchases subject to use tax. Since its enactment, this bill has resulted in additional collections of $32 million in use tax, interest and penalties.

COMMENTS

1. **Purpose.** This bill is intended to make various changes to state laws regarding tax compliance and tax programs in order to implement provisions of the 2011-12 Budget agreement.

2. **Issue.** Although the use tax law has been in existence since 1935, many Californians are unaware that they incur a use tax liability when they make a purchase over the Internet or from a mail order catalog from an unregistered out-of-state retailer. Also, many Californians do not hold onto their receipts for their incidental purchases all year long to identify how much they spent, let alone whether they paid tax to the out-of-state retailer when they made the purchase. Providing California eligible purchasers a convenient way to satisfy their use tax liabilities by using a lookup table for their less costly purchases would enable them to comply with the law and improve overall use tax collections.

3. **The optional use tax table would provide simplicity.** A use tax table would make compliance with reporting use tax more convenient for taxpayers who know they have made untaxed purchases but have not kept receipts from those purchases. For individual purchases of less than $1,000, the table would reflect the amount of use tax due based on the person's California adjusted gross income as shown in the instructions in the state income tax booklet. For individual purchases of $1,000 or more, or for any business-related purchase, taxpayers would be required to report the actual amount of use tax due.

   Of the 45 states with sales and use taxes, 38 also have an individual income tax. Of these 38 states, 23 provide for taxpayers to report use tax obligations on the individual income tax return, and another seven, provide information about the use tax in the individual income tax booklets. Nine of those states incorporate a use tax table, and according to a June 2010 report prepared by the Research Department of the Minnesota House of Representatives, *Use Tax Collection on Income Tax Returns in Other States,* many of those states that allow purchasers to report their use tax obligations using the tables have higher participation rates. Although those states collect less use tax per return than do states without lookup tables, the greater participation rate in those states overwhelms the effect of lower average use tax reporting per return.

4. **What would the use tax table look like?** The bill does not incorporate a specific use tax table that eligible purchasers could use to determine their use tax liability if they opt to do so, but requires the BOE to calculate the estimated amount of use tax due according to a person's adjusted gross income by July 30th each year.

   The tables adopted by other states typically consist of two columns. Taxpayers find their income in the left column and read across to the right column to find their estimated use tax liability. There is some indication from the states first implementing lookup tables that their tables may have derived from amounts from federal tables used prior to 1987 for estimating sales tax liability of taxpayers claiming the itemized deduction for sales tax paid. The states that have subsequently added provisions for lookup tables appear to have modeled their tables on those used in other states. We expect that the table the BOE would establish would likely be similar to other states' tables, with appropriate adjustments relative to, among other things, California tax rates.

5. **An eligible purchaser's correct use of the look-up table would prevent future liability.** The bill would provide a safe harbor provision for those eligible purchasers who use the lookup table correctly, so that the BOE would be precluded from making any determination against those purchasers when the purchaser uses that table in accordance with the accompanying instructions.

6. **No new penalties would be imposed.** This measure would not impose any new penalties for a person's failure to pay the use tax on the FTB return or to the BOE. Current law already provides for a 10 percent penalty, as well as interest (and has done so since 1935), for a person's late payment of the use tax.
7. **Related legislation.** AB 110 (Budget Committee) contains similar provisions.

COST ESTIMATE

The BOE's costs associated with this measure would be commensurate with the number of additional returns that would be filed with FTB (currently the BOE incurs personnel costs for collecting the unpaid use tax reported on the FTB returns, refunding use tax reported in error, answering questions from taxpayers about the use tax, and allocating the local and district taxes included in the tax reported on the FTB returns). However, we anticipate that the additional revenue would substantially exceed the additional costs.

REVENUE ESTIMATE

This provision is estimated to result in additional use tax revenues of $10.6 million in 2011-12 and annually thereafter, $6.5 million of which is General Fund. This assumes the General Fund tax rate reverts back to 5 percent on July 1, 2011.

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