STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**03/03/11**	Bill No:	**Assembly Bill 155**
Tax Program:	**Use Tax**	Author:	**Calderon**
Sponsor:	**Author**	Code Sections:	**RTC 6203**
Related Bills:	**AB 153 (Skinner)** **SB 86 (Ch. 14, 2011)** **SB 234 (Hancock)** **SB 655 (Steinberg)**	Effective Date:	**01/01/12**

BILL SUMMARY

This bill would:

- Specify that a retailer that is a member of a commonly-controlled group and a member of a combined control group that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer performs services in this state in connection with tangible personal property to be sold by the retailer, as specified, is a "retailer engaged in business in this state," and
- Delete the statutory provision that would, upon an act of Congress, impose a use tax collection obligation on any retailer soliciting orders of tangible personal property by mail if the solicitations are substantial and recurring and if other specified conditions are met.

Summary of Amendments

Since the previous analysis, this bill was amended to (1) delete the "long arm nexus" provision (which would have extended nexus to the extent the U.S. Commerce Clause and federal law permit), (2) delete the proposed requirements for out-of-state retailers that do not have a use tax collection obligation to provide use tax information on their Internet websites and retail catalogs, and (3) delete the provisions that would have required such retailers to furnish annually to their California customers, and to the BOE, specified information about those sales.

ANALYSIS

CURRENT LAW

Under federal law, Article I, Section 8, Clause 3 of the United States Constitution, known as the Commerce Clause, states that Congress has the exclusive authority to manage trade activities between the states, with foreign nations, and Indian tribes. The "Dormant" Commerce Clause, also known as the "Negative" Commerce Clause, is a legal doctrine that courts in the United States have implied from the Commerce Clause. The idea behind the Dormant Commerce Clause is that this grant of power implies a negative converse — a restriction prohibiting a state from passing legislation that improperly burdens or discriminates against interstate commerce. The question of to what extent states can legally compel remote retailers to collect the tax, however, has been a subject of extensive disagreement.

Under California's Sales and Use Tax Law, Chapter 3 (commencing with Section 6201) of Part 1 of Division 2 of the Revenue and Taxation Code, a use tax is imposed 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 that purchaser pays the use tax to a retailer registered to collect the California use tax, the purchaser is liable for the tax, unless the use of that property is specifically exempted or excluded from tax. The use tax is the same rate as the sales tax and is generally required to be remitted to the BOE on or before the last day of the month following the quarterly period in which the purchase was made, or a purchaser may report the tax on the purchaser's state income tax return (if that purchaser is not registered with the BOE).

Section 6203 of the Sales and Use Tax Law describes various activities that constitute "engaging in business in this state" for purposes of determining whether an out-of-state retailer has sufficient business presence (also known as "nexus") in California such that the state will impose a use tax collection responsibility on sales made to California consumers. If a retailer has sufficient nexus within the terms of Section 6203, that retailer is required to register with the BOE pursuant to Section 6226 and collect the applicable use tax on all taxable sales to California consumers.

PROPOSED LAW

This bill would amend Revenue and Taxation Code Section 6203 to do the following:

- Specify that a retailer that is a member of a commonly-controlled group and a member of a combined control group that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer performs services in this state in connection with tangible personal property to be sold by the retailer, as specified, is a "retailer engaged in business in this state," and
- Delete the provision that would become operative upon a specified congressional act that specifies that any retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any banking, financing, debt collection, telecommunication or marketing activities occurring in this state or benefits from the location in this state of authorized installation, servicing, or repair facilities.

These provisions would become operative on January 1, 2012.

BACKGROUND

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to impose a use tax collection responsibility on out-of-state retailers for the sale of goods shipped into the taxing state. Such transactions are generally conducted either through mail order, telephone orders, or via the Internet.

A December 2010 BOE estimate of uncollected use tax reveals that about $1.145 billion goes unpaid annually ($795 million in uncollected use tax from California consumers; $350 million from businesses). The estimate indicates that the unpaid use tax liability owed by the average California household is $61 per year and $102 per year for each California business.

Under constitutional law, states lack jurisdiction to require out-of-state retailers to collect a sales or use tax when the retailer has no "physical presence" in the taxing state. In 1992 the Supreme Court issued an opinion in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298 and held that satisfying due process concerns does not require a physical presence, but rather requires only minimum contacts with the taxing state. Thus, when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit the state’s requiring the retailer to collect the state’s use tax. However, the Court further held that physical presence in the state was required for a business to have a “substantial nexus” with the taxing state for purposes of the Commerce Clause. The Court therefore affirmed that in order to survive a Commerce Clause challenge, a retailer must have substantial nexus in the taxing state before that state can require the retailer to collect its use tax.

Since the late 1990s, online shopping has taken off as an increasing number of businesses and consumers purchase increasingly diversified products on the Internet. That, combined with the states’ inability to require a use tax collection requirement on many out-of-state retailers, has prompted many states to seek new ways to enforce their use tax laws (every state that has a sales tax imposes the use tax). In California, for example, ABx4 18 was enacted in 2009 to require all businesses that have gross receipts from business operations of at least $100,000 annually and that are not already required to be registered with the BOE to register and file an annual use tax return to report and pay the applicable use tax on their untaxed purchases.

Past related legislative efforts. In the 2007-08 Legislative Session, two bills contained changes to Section 6203(c) to extend nexus to the extent allowed under the U.S. Constitution and federal law: AB 1840 (Calderon) and ABx3 2 (Calderon). AB 1840 failed passage on the Assembly floor and ABx3 2 was never heard in committee.

During the 2009-10 Session, Assembly Member Calderon introduced a measure that would have imposed an information reporting requirement on out-of-state retailers without California nexus, without the imposition of any penalty. That measure, AB 2078, was subsequently amended to delete the information reporting requirement, and simply require out-of-state retailers without California nexus, to post information on their Internet websites and catalogs about use tax, and with only that provision remaining, died on the Senate Floor.

Also during the 2009-10 Legislative Session and various extraordinary sessions during that period, seven other bills were introduced containing “click through nexus” provisions (where retailers would be considered “engaged in business” in this state when they enter into agreements with California affiliates under which the affiliate, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link or an Internet Web site or otherwise, to the retailers, under specified conditions). Only one passed the Legislature – SBx3 17 (Ducheney). However, SBx3 17 also contained several other provisions related to tax enforcement and tax administration, and was vetoed by Governor Schwarzenegger. His veto message related to the bill as a whole, and not specifically to this particular provision.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the author to enable California to reduce the over one billion dollar use tax gap. This bill is intended to impose a use tax collection obligation on out-of-state retailers that have presence in California through their relationships with their in-state sister companies that are providing services to products sold by the out-of-state retailers.

2. **Bill would impose a use tax collection obligation on retailers such as Amazon.com LLC, the on-line retailer and others.** This bill would impose a use tax collection obligation on out-of-state retailers who have certain sister companies in California that perform services in cooperation with the out-of-state retailer, as described. Amazon.com LLC (the on-line retailer), for example, and any other similarly organized out-of-state retailer, would fit within this provision. Amazon.com Inc. is a Seattle-based corporation. The on-line retailer, Amazon.com LLC, is a member of Amazon.com Inc.'s commonly controlled group and a member of Amazon.com Inc.'s combined reporting group under California's Corporation Tax Law. Amazon.com LLC's commonly controlled group has other California-based members that perform various services in this state in connection with items sold by Amazon.com LLC. For example, A9.com is a California-based wholly-owned subsidiary of Amazon.com, Inc., with about 131 California employees (as reported in September, 2010 to the Employment Development Department), and provides product and visual search technologies for items displayed on Amazon.com LLC's website. Another California wholly-owned subsidiary, Lab 126, (with about 370 California employees) performs design and development activities associated with Amazon's Kindle and other electronic reading devices. This change to Section 6203 would specify that such described out-of-state retailers are engaged in business in California, based on the activities of their other members of their combined reporting group, and are required to collect California use tax on their taxable sales to California consumers. This specific form of nexus has not been reviewed by the U.S. Supreme Court, but it does raise a question regarding whether it would be consistent with the "physical presence" test affirmed in *Quill*. Ultimately, the physical presence requirement for nexus may have to be reexamined by the court to reflect today's marketplace.

3. **Critics of this provision believe controlled group nexus already has been found unconstitutional.** They cite that the California Court of Appeal in *Current, Inc. v. State Board of Equalization (1994) 24 Cal.App.4th 382*, as well as other Federal court decisions and state court decisions in other states have already addressed this issue.

   In the Current case, Current was an out-of-state mail-order company whose only connection with customers in California was by common carrier or U.S. mail. Current was acquired by a corporation, Deluxe Corporation, who was a retailer engaged in business in California. The BOE regarded *Current* as a retailer engaged in business in California required to collect use tax under then subdivision (g) of Revenue and Taxation Code Section 6203. That subdivision (which has subsequently been deleted) specified that a "retailer engaged in business in this state," included "any retailer owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business in this state."

The court of appeal held that Current was immune from the duty to collect use tax under the Commerce Clause, and its acquisition by a company engaged in business in California did not render it liable for collecting the tax. Current and Deluxe Corporation did not have integrated operations or management, were organized and operated as separate and distinct corporate entities, and neither was the alter ego or agent of the other for any purpose. As such, the court ruled that Current did not have sufficient physical nexus with California to justify the imposition of the duty to collect use tax, and, as applied to Current, the statute was unconstitutional as violative of the Commerce Clause.

4. **Others may counter that the Current case involves a different set of facts.** Those who view this proposed legislation as constitutional suggest that it would depend on the facts and circumstances with regard to any controlled group (common officers, degree of corporate coordination between sibling companies with a common parent, etc.) as to whether the constitutional analysis in Current would serve as a bar to imposing a use tax collection obligation with respect to any particular retailer that is a member of such a controlled group.

5. **Critics also believe that this bill would result in an unintended consequence.** They point out the possibility that by theoretically treating separate corporate entities as divisions of the same corporate entity (by referring to the income tax structure), this bill would create an opportunity that intercompany sales between related corporate entities are no longer subject to sales tax (as the transfer of tangible personal property within the same corporate entity is not a taxable event).

   However, the BOE's legal staff does not view this bill as having this unintended consequence because the standard for two related corporations to be treated as one for sales tax purposes is exceedingly high. Essentially, one corporation would have to have no separate existence and no outside transactions except for its relationship with the affiliated corporation. This issue was addressed in *Mapo, Inc. v. State Bd. of Equalization [53 Cal. App. 3d 245]*. Mapo existed as a separate corporation in name only, in its six years it did nothing for its own account or for anyone except its corporate relatives. It acted solely on orders from its corporate grandparent, Walt Disney Productions (Productions). It owned no materials, kept no books, bore no liability for its operation, and recorded no profits. Its sole reason for existence was to make the fabrication of animated mechanical figures possible by reaching agreements with a single labor union that would be vertical, i.e., any person could work on any job and be classified and paid accordingly. Mapo appeared, simplified these union negotiations, acted as conduit for payment of salaries for certain Productions personnel, and disappeared without noticeable effect. Under this particular set of facts, the temporary, paperwork transactions which resulted from its existence did not justify the imposition of sales taxes intended for dealings between separate producers and consumers.

6. **Related legislation.** The following measures relate to the use tax gap:

   AB 153 (Skinner) would specify that a "retailer engaged in business in this state" includes a retailer entering into an agreement with a California resident under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link or an Internet Web site or otherwise, to the retailer, under specified conditions.

SB 234 (Hancock) and SB 655 (Steinberg) would also amend Section 6203 to specify that any out-of-state retailer that has substantial nexus with this state for purposes of the Commerce Clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty is a "retailer engaged in business in this state."

SB 86 (Ch. 14, Stats. 2011) was recently signed into law to allow eligible California purchasers to satisfy their use tax liabilities by using 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.

COST ESTIMATE

The BOE would incur costs to administer this bill. Enactment of this bill could have an increase in the BOE's workload attributable to identifying and notifying affected out-of-state retailers, registering retailers, amending the BOE's regulation, pursuing collection efforts, and perhaps increased costs related to appeals and litigation. An estimate of these costs is pending.

REVENUE ESTIMATE

As noted in Comment 2 on page 4, this bill is intended to impose a use tax collection obligation on specifically structured out-of-state retailers that have in-state sister companies performing services related to tangible personal property sold by the out-of-state retailer. This would apply to Amazon.com LLC (the on-line retailer) and any other similarly organized out-of-state retailers.

Assuming that Amazon or other companies do not change their corporate structure or discontinue their use of in-state companies, or otherwise have a change in behavior, the revenues associated with Amazon's sales to California consumers alone would amount to an estimated state and local use tax increase of $83 million annually. This amount was derived by using published Internet retailer transaction data.

We have no information that would reveal other out-of-state retailers that are similarly structured to determine any further revenue impact. However, this does not necessarily mean that there are not other companies that are similarly structured that could be impacted by this provision. In addition, there could be an unknown delay of revenues due to potential litigation.

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