



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/09/11	Bill No:	<u>Senate Bill 234</u>
Tax Program:	Use Tax	Author:	Hancock
Sponsor:	BOE Member Betty Yee	Code Sections:	RTC 6203
Related Bills:	SB 655 (Steinberg) AB 153 (Skinner) AB 155 (Calderon)	Effective Date:	01/01/12

BILL SUMMARY

This bill would 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.”

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 existing state 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 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 which 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 business presence 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 sales to California consumers.

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Under Section 6203, the following retailers are considered “engaged in business in this state” and are required to collect the California use tax on sales made to California consumers:

- (1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.
- (2) Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property.
- (3) Any retailer deriving rentals from a lease of tangible personal property situated in this state.

The BOE’s Regulation 1684, *Collection of Use Tax by Retailers*, clarifies Section 6203 and specifies that the use of a computer server on the Internet to create or maintain a web page or site by an out-of-state retailer is not considered a factor in determining whether the retailer has a substantial nexus with California. The regulation further clarifies that an Internet service provider or other Internet access service provider, or World Wide Web hosting services shall not be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.

PROPOSED LAW

This bill would amend Revenue and Taxation Code 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.”

In addition, the bill would delete the following two provisions in Section 6203:

- The exclusion from the term “engaged in business in this state” related to the taking of orders from customers in this state through a computer telecommunications network located in this state, as specified, and
- The currently inoperative provision related to retailers soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from certain activities occurring in this state.

The bill would become operative January 1, 2012.

IN GENERAL

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

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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.

BACKGROUND

Past legislative efforts focused on imposing a use tax collection obligation on out-of-state retailers. The rapid development and growth of the Internet in the 1990's resulted in fundamental changes in the manner in which transactions occurred between and among businesses and individuals. As a result, various legislative proposals have been introduced over the past decade to broaden California's ability to impose a use tax collection requirement on out-of-state retailers. For example, in 1999, California brick-and-mortar book retailers began seeking assistance from the Legislature to level the playing field for those Internet book retailers who claim to be out-of-state remote sellers but who are, in reality, California brick-and-mortar businesses.

Specifically, at that time, local booksellers believed the Borders online and Barnes and Noble online stores should be required to collect the California use tax on their sales to California consumers just as their California "bricks-and-mortar" stores collect sales tax reimbursement. These out-of-state retailers had formed separate legal entities from their corporate affiliates to sell similar goods as in the bricks-and-mortar stores throughout the country, including California, and believed they were not required to collect the California use tax. In response AB 2412 (Migden and Aroner) was introduced in 2000 to clarify that a retailer is presumed to have an agent within the state if the retailer is related, as specified, to a retailer maintaining sales locations in this state, provided the retailer sells similar products under a similar name as the California retailer, or facilities or employees of the related California retailer are used to advertise or promote sales by the retailer to California.

The Legislature passed the bill; however, Governor Davis vetoed it, stating:

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“This bill would impose sales tax collection obligations on retailers who process orders electronically, by fax, telephone, the Internet, or other electronic ordering process, if the retailer is engaged in business in this state.

“In order for the Internet to reach its full potential as a marketing medium and job creator it must be given time to mature. At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California’s international role as the incubator of the dot-com community.

“Moreover, the Internet must be subject to a stable and non-discriminatory legal environment, particularly in the area of taxation. Unfortunately, AB 2412 does not provide such a stable environment: it singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject. Furthermore, AB 2412 re-enacts provisions that the Legislature has recently repealed due to court decisions.

“In the next 3 to 5 years, however, I believe we should review this matter. Therefore I am signing SB 1933, which creates the California Commission on Tax Policy in the New Economy. The Commission will examine sales tax issues in relation to technology and consumer behavior and make recommendations.”

(Throughout this same period, the BOE considered appeals from these online retailers that had been assessed use tax on their sales to California consumers. The BOE prevailed in Borders Online, LLC v. State Board of Equalization (2005) 129 Cal.App.4th 1179, and reached a settlement agreement with Barnes and Noble.com. Subsequently, both online retailers began collecting California use tax.)

Then, early in 2001, the authors introduced AB 81 (Migden and Aroner) which was substantially identical to AB 2412. Later in the session, the provisions in AB 81 related to the Sales and Use Tax Law were gutted, and replaced by unrelated property tax provisions.

During the 2003-04 Session, SB 103 (Alpert) was introduced to include provisions similar to AB 81 and AB 2412, but it also included a provision that specified that a retailer engaged in business in this state includes any retailer having, among others, any representative or independent contractor operating in this state under that retailer’s authority for the purpose of servicing or repairing tangible personal property. That measure was subsequently gutted and amended on the Assembly Floor with unrelated provisions.

During the 2007-08 Session, Assembly Member Calderon introduced two other measures that would have imposed a use tax collection duty on out-of-state retailers to the extent allowable under the law as this bill is proposing to do: AB 1840, which failed passage on the Assembly floor and ABx3 2, which was never heard in committee.

During the 2009-10 Legislative Session and various extraordinary sessions during that period, seven other bills containing provisions that were modeled after a New York law that imposed a use tax collection obligation on out-of-state retailers who had New York affiliates (sometimes referred to as “Amazon affiliate legislation” or “click through nexus”) were introduced. 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.

Recent legislative efforts focused on use tax collections from California purchasers. With the increasing numbers of businesses and consumers shopping on-line, in the early 2000's the BOE began focusing on additional needed legislative changes 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 Franchise Tax Board (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 tax returns to add a separate line for use tax reporting and accompanying instructions in the booklet. This legislation allowed 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, we saw an improvement in collections. The first year – in 2004 – we received a total of \$2.8 million as a direct result of that line. And, still today, the amount reported on the income tax forms continues to grow. In 2005, we received \$4.6 million, and in 2006 we got \$5.5 million, and in 2009, we received \$10.2 million.

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. And, we learned that many tax practitioners 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.

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 bill, 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. **Sponsor and Purpose.** This bill is sponsored by BOE Member Betty Yee in an effort to provide the BOE with the necessary tools to effectively administer the 75-year old use tax law, which would enable the BOE to narrow the widening use tax gap. With a use tax gap of over \$1.145 billion, California should assert its jurisdiction to require a use tax collection responsibility from out-of-state retailers to the fullest extent permitted under the United States Constitution and federal law.
2. **What does the bill accomplish?** This provision would enable California to impose a use tax collection obligation on any out-of-state retailer that has nexus in California when it makes taxable sales to California consumers. This would include other activities that have passed constitutional muster in other states, and would also eliminate any restrictions in the nexus provisions in current law. For example, in over 20 states, including New York, Minnesota, and Louisiana, repair or warranty services performed by third party independent contractors in connection with items sold by out-of-state retailers under certain circumstances create nexus for those out-of-state retailers. Also, some states impose a use tax obligation on out-of-state retailers that sell the same or substantially similar line of products as the retailer maintaining sales locations in the taxing state under the same or substantially similar business name. In addition, a 2008 change in New York's statutes that imposes a use tax collection obligation on out-of-state retailers that have affiliate programs with New York residents under specified circumstances has been reviewed by New York's appellate court and deemed constitutional on its face. As such, this "long-arm" nexus provision would provide California with the tools it needs to allow for use tax collection to the fullest extent federal law and the U.S. Constitution permit, and any limitations currently in the nexus statute would be eliminated.
3. **Some believe this proposed legislation provides no certainty for out of state retailers.** Because the proposed statute does not specifically identify the in-state activities that would give rise to the imposition of a use tax collection obligation on out-of-state retailers, some have expressed concerns that adding a "long-arm" provision places a level of uncertainty in California's law for out-of-state retailers making sales to California consumers. For example, some believe it is unclear whether the BOE will direct out-of-state retailers who have affiliate programs of a certain size in California to collect the California use tax, or whether the BOE would begin immediately to impose a use tax reporting obligation on out-of-state retailers based solely on their use of independent California-based repair shops performing warranty or repair services with respect to items sold by the retailer.
4. **Others note the competitive disadvantage California's retailers have.** The sales tax rate in California ranges from 8.25 percent to 10.75 percent. Observers note that many California retailers are finding it more difficult to compete with out-of-state retailers – particularly those with on-line sites - that currently don't have a California tax collection responsibility. To the extent California may impose a use tax collection obligation on these out-of-state retailers allowable under the U.S. Constitution's Commerce Clause and federal law, California retailers would be able to better compete in today's global market.

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5. Related legislation. Three other bills have been introduced this session that address the use tax gap:

- SB 655 (Steinberg) is similar to this bill.
- AB 153 (Skinner) would impose a use tax collection obligation 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; and
- AB 155 (Calderon), as amended March 3, 2011, would impose a use tax obligation on an out-of-state retailer that is a member of a commonly-controlled group and a member of a combined reporting 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 sold by the retailer, as specified. It would also delete other provisions that exclude specified activities from the term, "engaged in business in this state."

COST ESTIMATE

Enactment of this bill could have an increase in the BOE's workload attributable to amending the BOE's regulation, identifying affected out-of-state retailers, and ensuring compliance by out-of-state retailers. A cost estimate is pending.

REVENUE ESTIMATE

In our updated December 2010 e-commerce and mail order estimate, we estimated that the annual state and local revenue loss from unreported use tax associated with out-of-state Internet and mail order sales amounted to \$1.145 billion per year. This measure could expand the BOE's ability to include out-of-state Internet and mail order retailers that are currently not considered as having nexus under current Section 6203, and require them to register and collect use tax from California consumers. To the extent this bill expands nexus to some of those out-of-state retailers not currently required to collect the use tax, we have estimated in previous analyses of similar bills that the amount of additional revenue could result in between 1% and 5% (\$11 million to \$57 million) of the lost state and local revenue from Internet and mail order sales by out-of-state retailers. As an example, this provision could include out-of-state retailers that use independent California contractors to perform warranty and repair work on products they sell, or those out-of-state retailers currently unregistered that sell the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name. However, to the extent the BOE makes a determination that other in-state activities conducted in connection with out-of-state retailers are sufficient to impose a use tax collection obligation on those out-of-state retailers, the estimated revenues associated with this provision could substantially increase.

For example, since a New York Appellate court ruled that the affiliate nexus provision is constitutional on its face, we include those related revenues to this estimate. However, some of the revenues associated with this provision could be included with the revenues identified in the previous paragraph. The extent of this overlap, if any, is unknown. Our static revenue estimation methodology for this component produces a

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state and local revenue increase of \$152 million in 2011-12 (a half-year effect) and \$317 million in 2012-13. These estimates are based on the combination of (1) the amount of revenues currently being collected in New York, adjusted for California's larger economy, and (2) increased revenues associated with out-of-state retailers that sell to California consumers on eBay that could have a use tax collection obligation under the provisions of this bill.

However, the State's likelihood of actually realizing the revenues described in the previous paragraph depends entirely on (1) Internet retailers' (such as Amazon and Overstock) willingness to continue their affiliate programs, and (2) other retailers' willingness to continue to sell on eBay and to fully comply with the added use tax collection obligations imposed by this bill. We have received direct confirmation from Amazon that it will terminate its relationship with its 10,000 California affiliates should this measure get enacted. We estimate that Amazon currently comprises roughly 50 percent of the Internet sales of large firms who currently do not have nexus in California. Consequently, the static revenue estimates cited in the previous paragraph, adjusted for Amazon's response, would drop to \$114 million in 2011-12 and \$234 million in 2012-13. If other firms were also to terminate their affiliate programs in response to the enactment of this bill, the revenue gain would be further diminished. Similarly, while we lack the data to determine to what extent out-of-state retailers would discontinue their use of eBay to sell to California consumers, any drop in such eBay usage would even further lower the revenue gain.

Thus, with respect to total revenues that we could anticipate from the bill's provisions, we estimate a potential gain for 2012-13 of \$374 million if (1) 5% of the use tax gap is closed, (2) full compliance with no behavioral changes by out-of-state retailers with in-state affiliate programs occur, and (3) there is no duplication or overlap with out-of-state retailers affected by (1) and (2).

Additionally, the termination of affiliate programs would have an adverse impact on state employment, which in turn would lead to lower revenues from sources such as the personal income tax and the corporation tax. The amount of these potential reductions is unknown.

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