



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Amended:	06/28/09	Bill No:	SBx3 17
Tax:	Sales and Use	Author:	Ducheny
Related Bills:	AB 469 (Eng)		

BILL SUMMARY

This budget trailer bill makes a number of revenue and taxation related changes necessary to implement the 2009-10 budget. This bill, among other things unrelated to the Board, does the following:

1. Specifies 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. (*Section 6203*)
2. Requires a qualified purchaser, as defined, to register with the Board and report and pay by April 15, commencing with April 15, 2010, the use tax owed for the previous calendar year. (*Section 6225*)

ANALYSIS

Retailer Engaged in Business in this State (<i>Section 6203</i>)
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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 Board 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 Board).

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board’s formal position.

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 Board pursuant to Section 6226 and collect the applicable use tax on all sales to California consumers.

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 Board’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 provision would amend Section 6203 of the Sales and Use Tax Law to specify that a “retailer engaged in business in this state” includes any retailer entering into an agreement under which a person or persons in this state for a commission or other consideration, directly or indirectly refers potential purchasers of tangible personal property to the retailer, whether by a link or an Internet Web site or otherwise, if the cumulative sales price from all of the retailers’ sales of tangible personal property to purchasers in this state that are referred pursuant to all of those agreements is in excess of \$10,000 within the preceding 12 months.

The bill clarifies, however, that these provisions shall not apply if the retailer can demonstrate that the person in this state with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution. It also provides that an agreement under which a retailer purchases advertisements from a person in this state to be delivered on television, radio, in print, on the Internet, or by any other medium is not an agreement under the provisions of this bill, unless the

advertisement revenue paid to persons in this state consists of commissions or other consideration that is based upon sales of tangible personal property.

This provision would take effect immediately.

BACKGROUND

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to a use tax collection responsibility on goods purchased from out-of-state retailers – either through mail order or over the Internet.

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 a ruling 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.

For example, when a California resident purchases a coat from L.L. Bean, Inc. through its web site, the purchaser's use of that coat in California is subject to California's use tax. The most practical means for the state to enforce the tax is to have L.L. Bean, Inc. collect the tax at the time of sale. Because L.L. Bean, Inc. does not have substantial nexus in California, however (e.g., it neither owns nor rents property in the state, hires no employees or independent contractors here, and delivers all of its merchandise into the state through common carriers), California is constitutionally prohibited from requiring L.L. Bean, Inc. to collect the tax. If the purchaser fails to remit the tax to California, and escapes sales or use taxation, a tax gap is created. It is estimated that this gap in California's sales and use tax system, costs the state nearly \$1.1 billion in state tax revenues.

New York, Amazon, and Overstock.com. The state of New York, as part of its budget, enacted legislation in 2008 entitled "the Commission-Agreement Provision" that presumes a retailer "solicits" business in the state if an in-state entity is compensated for directly or indirectly referring customers to the retailer – language that is substantially similar to this measure. Last April, Amazon sued New York's taxation department. Then, in May, Overstock suspended its relationships with any affiliates that had a New York address. And in June, the company joined Amazon in its suit, challenging the constitutionality of the tax law.

Both Amazon and Overstock contended that the law violates the Commerce Clause of the U.S. Constitution and the Due Process Clause of the Fourteenth Amendment to the Constitution and sought a permanent injunction prohibiting New York from enforcing the law.

Seattle-based Amazon argued that it did not have a sufficient nexus (physical presence) in the state to be compelled to collect use tax and basically contended that the new law intentionally targets Amazon. Additionally, Amazon said the law is vague

and overly broad because Amazon has no way of knowing whether its affiliates, who provide addresses in other states, are legal residents of New York.

The New York Supreme Court dismissed both the Amazon and Overstock suits, ruling that the Commission-Agreement Provision does not broadly tax any and all Internet sales to New York consumers in that it requires a substantial nexus between an out-of-state seller and New York through a contract to pay commissions for referrals with a New York resident along with realization of more than \$10,000 of revenue from New York sales earned through the arrangement. Further, the Court stated that the neutral statute simply obligates out-of-state sellers to shoulder their fair share of the tax collection burden when using New Yorkers to earn profit from other New Yorkers.

It is possible that both Amazon and Overstock will appeal these rulings. If they decide to, they would pursue the issue with the New York State Supreme Court Appellate Division, and if necessary, to the New York State Court of Appeals. Because it is a constitutional issue, that matter could in theory ultimately be pursued to the U.S. Supreme Court.

Although Overstock ended its affiliate program with New York residents because of this change in law, Amazon.com has continued its affiliate program in New York and is currently collecting the tax on its sales to New York consumers.

Past legislative efforts. In 1999, a group of local booksellers sought assistance from the Legislature to level the playing field for those Internet retailers who claim to be out-of-state remote sellers but who are, in reality, California brick-and-mortar businesses. Specifically, the 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, Assemblywomen Carole Migden and Dion Aroner introduced AB 2412 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:

“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.”

Early in 2001, Assemblywomen Migden and Aroner introduced AB 81, 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.

Also, during the 2003-04 Session, SB 103 (Alpert) was introduced to include similar provisions, and to also include a provision that would have 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. Both AB 1840 and ABx3 2 would have provided that a “retailer engaged in business in this state” means any 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. AB 1840 failed passage on the Assembly floor and ABx3 2 was never heard in committee.

COMMENTS

1. **Why just conform to New York’s statute?** Different courts have interpreted *Quill* in different ways, reaching divergent conclusions about physical presence in cases with similar facts. The defining line between slightest and substantial presence varies from state to state. It is not unusual to see dissenting opinions and higher courts disagree with lower courts. A business with similar operations in two states might find that it is required to collect sales or use tax in one but not the other.

In addition to specifying one type of activity that would require certain out-of-state retailers to collect California’s use tax as this bill is proposing, perhaps consideration should be given to broadening the nexus statute to include other activities that have passed constitutional muster in other states. For example, in over 20 states, including New York, Minnesota, and Louisiana, warranty services performed by third party independent contractors create nexus for out-of-state sellers.

2. What impact would this bill have on California's affiliate programs?

According to NetChoice, an internet advocacy group, when New York enacted its law, over 200 retailers simply stopped their affiliate programs in the state. Although Amazon.com, which runs one of the Web's largest affiliate programs, has continued its affiliate programs with New York affiliates and complies with New York's law by collecting and remitting the tax on sales to New York consumers, it has emailed its affiliates in North Carolina warning that their accounts will be terminated if the law goes into effect in that state (North Carolina has also added a similar provision as part of its omnibus budget bill that is expected to be sent to the Governor by the end of June). Amazon.com has also recently sent correspondence to California's legislative leaders and the Governor stating that it will "have little choice but to end its advertising relationships with California-based participants in the Amazon 'Associates Program.'"

Use Tax Registration <i>(Section 6225)</i>
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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 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 Board on or before the last day of the month following the quarterly period in which the purchase was made, or on the purchaser's state income tax return filed with the Franchise Tax Board. Generally, a use tax liability 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 Board to collect the California use tax.

PROPOSED LAW

This bill would add Section 6225 to the Revenue and Taxation Code to require "qualified purchasers" to register with the Board and report and pay by April 15, commencing with April 15, 2010, the use tax owed for purchases made during the calendar year. The bill would define "qualified purchaser" as a person that meets all of the following conditions:

- (1) The person is required to hold a business license as required by the local ordinance of the city, county, or city and county in which the person conducts business.
- (2) The person is not required to hold a seller's permit pursuant to this part.
- (3) The person is not required to be registered pursuant to Section 6226.
- (4) The person is not a holder of a use tax direct payment permit as described in Section 7051.3.
- (5) The person receives at least one hundred thousand dollars (\$100,000) in gross receipts from business operations per calendar year.

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(6) The person is not otherwise registered with the board to report use tax.

This provision would become effective immediately.

IN GENERAL

In 1933, California enacted its first retail sales tax. Within a few years of the adoption of the sales tax, California retailers believed they were facing unfavorable competition from retailers in states that had not adopted a sales tax. Customers could choose to go to a neighboring state without a sales tax and avoid paying the tax on their purchases. California responded to this challenge in 1935 by adopting a use tax. The use tax is virtually identical to the sales tax, except it is imposed on the storage, use or consumption of the goods; and the tax is imposed on the sales price of the good. The intent of a use tax is to offset the incentive to purchase from retailers in other states with low sales tax rates or no sales tax.

Although every state that has a sales tax imposes the use tax, there has been limited success in collecting the use tax. Unlike the retail sales tax that requires in-state retailers to collect the tax, states have been unable to impose a similar compliance and collection requirement on out-of-state retailers (an out-of-state retailer is required to have physical presence in a state in order to require that retailer to collect the use tax).

Therefore, California must rely on purchasers to report their use tax obligations on their out-of-state purchases, such as those made over the Internet or through mail order. And, even though a separate line is currently on the state income tax return with accompanying instructions in the booklet for use tax reporting, the compliance rate remains very low. Unreported use tax is the largest area of noncompliance in California's sales and use tax program - an estimated \$1.2 billion annually is attributable to unreported California use tax by both businesses and individual consumers. For 2008, the Franchise Tax Board processed over 18.5 million returns, yet only 44,114 state income tax returns had use tax reported yielding only \$9 million in state and local use tax revenues.

COMMENTS

- 1. Entities that would be affected.** Enactment of this bill would essentially apply to all businesses that are not already registered with the Board that have annual gross receipts from business operations in excess of \$100,000. We anticipate approximately 200,000 businesses would fall under this measure's parameters.
- 2. Bill would apply to purchases made during calendar year 2009.** Since the bill would become effective immediately, returns for the reporting of use tax on untaxed purchases made during calendar year 2009 would be due by April 15, 2010. Consequently, without any advance notice of this provision, some businesses may not have kept track of their purchases subject to use tax in their records. Those businesses may have difficulty in accurately determining their correct use tax liability.
- 3. Not all local jurisdictions require business licenses; and not all businesses are required to hold such licenses.** The bill would require only those taxpayers required to hold a local business license to register. However, a random sampling of local jurisdictions disclosed that business licenses are not required of all businesses. For example, Santa Clara County does not require businesses

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located within the unincorporated area of the county to hold a business license. Sacramento County does not require financial institutions, residential facilities, churches, libraries, and certain agricultural industries to hold a business license. It is therefore recommended that this condition be stricken from the bill.

4. **Related Legislation.** AB 469 (Eng), sponsored by the Board, would *require* consumers (including businesses not already registered with the Board, such as those described in this measure) who have failed to report use tax to the Board 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, as specified. Under the AB 469 provisions, however, those taxpayers that are required to be registered with the Board (such as the taxpayers subject to registration in this bill) would not be allowed to report their use tax liabilities on their state income tax returns.

COST ESTIMATE

Significant costs for these two provisions would be incurred if this bill were enacted. These costs would be attributable to identifying, notifying, and registering all affected businesses, processing an approximate 200,000 additional returns annually, auditing accounts and resolving appeals and legal issues. These costs are estimated as follows:

Year	Positions	Amount	Costs	
			General Fund	Local Reimb.
2009/10	127.6	\$14.3 million	\$10.1 million	\$4.1 million
2010/11	128.9	\$10.9 million	\$7.7 million	\$3.2 million
2011/12	130.4	\$10.7 million	\$7.6 million	\$3.1 million
2012/13 and ongoing	141.4	\$12.1 million	\$8.6 million	\$3.5 million

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Retailer engaged in business in this state. We do not have precise information on the specific e-commerce retailers that would be regarded as retailers engaged in business in this state under the provisions of the bill. However, we would expect that the same e-commerce retailers that have affiliate programs through California residents would be similar as those e-commerce retailers in New York.

According to staff at the New York Department of Taxation and Finance, New York will collect \$68 million in state and local sales and use tax in fiscal year 2008-09, ending March 31, 2009. New York's state and local average tax rate is 8%. The estimated taxable sales from the revenue reported by New York amounts to \$850 million (\$68 million / 8%).

In order to determine the amount taxable sales for California for this measure, we compared New York's population to California's population and found that New York's population is 51.2% of California. Using this factor, we estimate that California's taxable sales would amount to \$1,661 million (\$850 million / 51.2%). The estimated state and local revenue gain in California from this provision would amount to \$149.5 million (\$1,661 million x 9%) annually.

Use tax registration. We examined codes for service enterprises using the North American Industry Classification System against IRS corporate and Schedule C data

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for calendar year 2007. 1.3 million taxpayers not holding a seller's permit were identified. Of these taxpayers, less than 30,000 reported gross receipts in excess of \$1 million annually and approximately 160,000 reported between \$100,000 and \$1 million. More than 800,000 taxpayers reported gross receipts of less than \$20,000. Accordingly, a potential of 200,000 accounts would be required to report use tax under the provisions of this bill, and we anticipate that these accounts would represent approximately 95% of the total California business-to-business use tax liability.

We also believe compliance with the provisions of this bill would progressively increase with the Board's outreach efforts, with about 25% compliance the first year, increasing to 80% compliance in the fourth year and thereafter. The estimate assumes a pattern of business-to-business sales for subsequent years that follows the forecasted percent change in national spending on business equipment and software, according to a leading national macroeconomic forecasting firm. For instance, that forecast assumes that business spending on equipment and structures in 2009-10 will decline by 18 percent, before rebounding (particularly in 2011-12 and 2012-13) as the economy recovers from the current recession.

Finally, the Board implemented the Instate Service Business component of the Tax Gap program in July of 2008. Initial efforts involved (1) sending letters to service industry firms identified as the most likely (based on information from EDD, FTB and other sources) to have a use tax liability and (2) providing the information resources so that they understand and may choose to comply voluntarily. In cases where voluntary compliance is not obtained, the BOE will implement an enforcement program similar to what currently exists under the sales and use tax program. Based on preliminary results of this program, we believe the Board will collect additional use tax revenue amounting to \$70 million annually, absent this provision.

REVENUE SUMMARY

Retailer engaged in business in this state.

The estimated annual revenue gain from this proposed change in the definition of a "retailer engaged in business in this state" would amount to \$149.5 million as follows:

State (6.00%)	\$ 99,700,000
Fiscal Recovery Fund (0.25%)	4,100,000
Local (2.00%)	33,200,000
Special District (0.75%)	<u>12,500,000</u>
	<u>\$ 149,500,000</u>

Use tax registration

	2009-10	2010-11	2011-12	2012-13	2013-14
<i>in</i> <i>millions</i>					
California Business-to-Business Purchases Subject to Use Tax	\$ 6,861	\$ 7,283	\$ 8,517	\$ 9,722	\$ 10,544
Percent Change from Previous Year	-18.4%	6.2%	16.9%	14.1%	8.5%
Compliance Rate Assumed	25%	40%	60%	80%	80%
Preliminary Use Tax Revenue	151	253	437	665	721
Less Amount Collected by BOE's Tax Gap Program	-70	-70	-70	-70	-70
Net Use Tax Revenue	<u>\$ 81</u>	<u>\$ 183</u>	<u>\$ 367</u>	<u>\$ 595</u>	<u>\$ 651</u>
State General Fund	54	122	245	397	434
State Fiscal Recovery Fund	2	5	10	17	18
Local Funds	25	56	112	182	199

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