STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Draft

Date Introduced:	**01/04/01**	Bill No:	**AB 81**
Tax:	**Sales and Use**	Author:	**Migden & Aroner**
Board Position:		Related Bills:	**AB 2412 (2000)**

BILL SUMMARY

This bill would specify that a retailer is presumed to have an agent within this state and is thus, “engaged in business in this state” for purposes of having the duty of collecting California use tax, if both of the following conditions exist:

1) The retailer holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in California or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof, and

2) The retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to the California purchasers.

ANALYSIS

Current Law

Under existing 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.

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 to warrant 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.

Among other activities, subdivision (c)(2) of Section 6203 defines a "retailer engaged in business in this state" to include 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. For a representative, agent, etc. to be deemed "under the authority of the retailer" for purposes of this provision, the Board's legal staff has opined that it is not necessary that the retailer supervise or control the specific details of the work of the representative, agent, etc. Instead, this phrase encompasses an out-of-state retailer's authorizing or instructing an in-state representative or agent to perform one of the specified activities on the out-of-state retailer's behalf. Thus, if an out-of-state company located solely outside California sells products through its website, with all orders being processed out of state and all the products being shipped directly to the customers from the retailer's out-of-state warehouse, this activity alone would not cause the retailer to be regarded as engaged in business in this state under Section 6203. However, if that retailer allows its customers to return unwanted merchandise previously ordered from the out-of-state retailer to a separate company's in-state stores, the in-state company is acting as the out-of-state company's representative or agent in this state for accepting returns of items sold by the out-of-state company. The return of property is regarded as an integral part of "selling." Therefore, the out-of-state company is regarded as having a representative in California operating under the "authority of the retailer" for purposes of selling and is required to collect the California applicable use tax from all its California purchasers.

Under the unitary method of taxation, Bank and Corporation Tax Law Section 25101 provides that when the income of a taxpayer is attributable to sources both within and outside California, the taxpayer is required to measure its franchise tax liability by its income attributable to sources within the state. The portion of the total income that is considered to be attributable to California is determined in accordance with unitary business principles. Under the unitary method, all of the activities comprising a single trade or business are viewed as a single unit, irrespective of whether those activities are conducted by divisions of a single corporation or by commonly owned or controlled corporations. The business income from all of the unitary business activities is combined into a single report. An apportionment formula is then applied to the combined business income to determine the portion attributable to California. The basic tests used to determine if corporations are "unitary" in nature are:

1. The three unities test: whether the corporations exhibit unity of ownership or control, unity of operation (as evidenced by central purchasing, advertising, accounting and management divisions), and unity of use in its centralized executive force and general system of operation (*Butler Brothers v. McColgan* (1941) 17 Ca.App.2d 664); and

2. The contribution or dependency test (*Edison California Stores v. McColgan* (1947) 30 Cal 2nd 472).

The Bank and Corporation Tax Law contains bright-line tests to determine unity of ownership. A group of corporations is considered commonly controlled under the following conditions:

- if the corporations are connected by more than 50% stock ownership to a common parent corporation;
- if the same individual or entity holds stock possessing more than 50% of the voting power of the corporations;
- if the corporations are legally tied or bound together ("stapled") entities, as defined; or
- if the corporations are held by members of the same family, as defined.

Satisfying the other tests used to determine whether a corporation is unitary requires a case-by-case analysis of the taxpayers' situation. Factors used to establish whether a unitary business is present between two or more corporations include: intercompany sales; centralized management, purchasing and advertising; financing (lending capital between companies); the transfer of information; common pension, employee benefit, and insurance plans; and the sharing of facilities, trade name, trade marks, patents and processes. The importance of each factor may vary depending on the particular case.

Proposed Law

This bill would add subdivision (g) to Section 6203 of the Sales and Use Tax Law to, among other things, specify that a retailer is presumed to have an agent within this state if 1) the retailer holds a "substantial ownership interest," as defined, either directly or through a subsidiary, in a retailer maintaining sales locations in California or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof, and 2) the retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to California purchasers.

The bill would define "substantial ownership interest" to mean that degree of ownership specified by Section 78p of Title 15 of the United States Code, or any successor to that statute, with respect to a person other than a director or officer (in essence, having an ownership interest of any equity security of more than 10 percent).

The bill would additionally state legislative findings and declarations that, among other things, specify that the amendments to Section 6203 are intended to prospectively clarify existing law and that it is not the intent to affect, in any way, any investigation, audit, or other enforcement action by the Board that has been initiated prior to January 1, 2001.

The bill would become effective January 1, 2002.

Background

In 1967, the Supreme Court ruled in *National Bellas Hess, Inc.* v. *Illinois Department of Revenue*, 386 U.S. 753 (1967), that a firm that has no link to a state except mailing catalogs to state residents and filling their orders by mail cannot be subject to that state's sales or use tax. The Court ruled that these mail order firms lacked substantial physical presence, or nexus, required by the Due Process Clause and the Commerce Clause of the United States Constitution.

In the 1977 case of *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274 {51 L.Ed.2d 326, 97 S.Ct. 1076} the court articulated that, in order to survive a Commerce Clause challenge, a tax must satisfy a four part test: 1) it must be applied to an activity with a substantial nexus with the taxing State, 2) it must be fairly apportioned, 3) it does not discriminate against interstate commerce, and 4) it must be fairly related to the services provided by the State.

North Dakota enacted anti-National Bellas Hess legislation with the expressed purpose of creating nexus with mail order firms selling to consumers in the state, in an attempt to compel out-of-state retailers to collect the use tax on mail order sales and test the continuing validity of the *National Bellas Hess* decision. That statute was challenged, and in 1992 the Supreme Court issued a ruling in *Quill Corporation* v. *North Dakota* (1992) 504 U.S. 298. The Court in *Quill* applied the *Complete Auto Transit* analysis 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 held further 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 a physical presence in the taxing state before that state can require the retailer to collect its use tax.

Under current law, a retailer is not regarded as having a physical presence in California based solely on the taking of orders from California customers via a computer telecommunications network that is physically located in California.

Section 6203 of the Sales and Use Tax Law has been amended over the years to clarify what is regarded as sufficient business presence in California to warrant use tax collection responsibilities of out-of-state retailers. Some provisions of Section 6203 have been under the scrutiny of judicial review and some have been held to be unconstitutional. The provision held to be unconstitutional that most closely relates to the provisions of this measure was a result of a 1994 decision in *Current, Inc*. v. *State Board of Equalization* 24 Cal.App.4th 382. In this case, the court held that subdivision (g) of Section 6203 - as it appeared then - was unconstitutional as it applied to *Current*, stating that it placed an impermissible burden on interstate commerce. At that time, this subdivision defined a "retailer engaged in business in this state" as "any retailer owned or controlled by the same interests which own or control any retailer engaged in business in the same or a similar line of business in this state."

Current was an out-of-state mail-order company whose principal place of business was in Colorado. Current had no employees, inventories, or facilities in California, and had no other contacts with California until it was acquired by Deluxe Corporation as a wholly owned subsidiary. Deluxe, who maintained its principal place of business in Minnesota, had a physical presence in California and held a California seller's permit.

Deluxe was engaged primarily in the manufacture and sale of checks at wholesale (nearly all its sales – 96.3% - were checks to financial institutions and their depositors; the remaining 3.7% of sales consisted of financial forms, pre-inked hand stamps and checkbook calculators). Current's principal product lines consisted of greeting cards, gift wrap and various other novelty items, including checks, with an emphasis placed on the creative design of Current's products. Although Current and Deluxe both produced checks, only 7.9% of Current's revenue was derived from check sales. However, neither company held itself out to customers or potential customers as being the same as, or an affiliate of, the other. Each had its own trade name, goodwill, marketing practices and customer lists and each marketed its products independently of the other. Neither exploited the trade name, corporate identification or goodwill of the other or purchased goods or services from the other. The companies did not have integrated operations or management, nor was either an alter ego or agent of the other for any purpose and both operated as separate and distinct corporate entities. The court held that Current did not have nexus with California sufficient to justify the imposition of a use tax collection duty.

The court also held that the minor overlap with regard to the sales of checks by both companies was not sufficient to render the two corporations in "the same or similar line of business." The court noted that the fact that the two companies' products were produced by printing was not a sufficient distinguishing characteristic; it was the uniqueness of the product itself, coupled with any distinctive marketing strategy, which was required to pass the test of similarity under the statute. Further, the development, design, production, and marketing of Current's various novelty products were substantially *dissimilar* from that of Deluxe, and consequently, there was no basis for application of subdivision (g) of Section 6203.

Subsequent to this decision, the Board sponsored legislation during the 1995 Session (SB 718, Ch. 555) to repeal subdivision (g) based on the *Current* decision.

During the 2000 Legislative Session, a bill substantially similar to AB 81, on which the Board took a "Neutral" position, was passed by the Legislature, but vetoed by the Governor (AB 2412, Migden & Aroner). The Governor's veto message states the following:

> "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."

COMMENTS

1. **Sponsor and purpose of the bill.** This bill is sponsored by the author. Its purpose is to clarify that a retailer engaged in business in California cannot be relieved of the use tax collection responsibilities through the use of an affiliate, subsidiary, or related company outside this state, the purpose of which is to engage in similar transactions through the processing of orders through electronic means. The bill is intended to eliminate the competitive advantage such retailers have over in-state retailers who are required to collect California sales taxes on all their sales.
2. **The bill would define "substantial ownership interest."** The bill would define that term by cross-referencing a statute in the United States Code relative to requirements imposed with respect to exchanges of securities. In essence, "substantial ownership interest" would mean having an ownership interest of any equity security of more than 10 percent.
3. **Who would be affected by enactment of this measure?** This measure is intended to require those retailers who form separate companies outside this state with a substantial ownership interest and sell similar products under essentially the same business name as the in-state parent company to collect the California use tax on sales to California consumers. Generally, under current interpretations of Section 6203, if a California retailer forms an out-of-state "dot-com" corporation that is operated separately from the "bricks and mortar" California corporation, the out-of-state dot-com corporation is not required to register with Board and collect the California use tax. However, that dot-com corporation will have sufficient nexus, and will be required to collect the California use tax, if the in-state company acts on its behalf under subdivision (c)(2) of Section 6203. One critical element of this determination is the dot-com retailer's sales return policies. If the bricks and mortar stores accept returns of merchandise on the dot-com's behalf, the Board regards

the dot-com corporation to be a retailer engaged in business in this state who is required to register and collect the California use tax. Firms vary in their stated return policies; some allow such returns and some do not. Since this is a relatively new commercial activity, many firms are still in the process of deciding on their return policies.

4. **Are the provisions consistent with the Board's administration of Section 6203?** To the extent that this measure would impose a use tax collection duty on an out-of-state retailer that uses in-state personnel or facilities to promote sales of the out-of-state retailer, this measure is consistent with the Board's administration of the law. However, with respect to imposing a use tax collection duty on an out-of-state retailer based solely on mere advertising done on its behalf in California, it is staff's opinion that this bill would not be consistent with the Board's administration of Section 6203, and thus, is not declaratory of existing law.

5. **Technical correction.** It is noted that in the legislative intent portion of the bill (page 5, line 13) the language specifies that it is not the intent of the Legislature in amending Section 6203 to affect any investigation, audit, etc. by the Board that has been initiated prior to *January 1, 2001.* This appears to be an oversight and should be changed to January 1, 2002 – the operative date of the bill.

COST ESTIMATE

Enactment of this measure would not materially affect the Board's administrative costs.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

There is no national or state data that provides an estimate of the total number of firms meeting the specified criteria of this bill. Consequently, there are no total U.S. or California sales figures for firms meeting the criteria.

Under current law, retailers who meet the criteria specified in the bill have considerable legal discretion as to whether or not to register with the Board. This freedom of choice makes it difficult to categorize firms and tabulate data for them. Generally, if the out-of-state "dot-com" corporation (separate entity) is operated separately from the "bricks and mortar" California corporation, and is not otherwise “engaged in business” in California, it is not required to register with the board and collect the use tax. While there are other criteria, a key determination of required registration is the dot-com retailer's sales return policies. If the dot-com retailer allows its bricks and mortar stores to accept returned merchandise, an agency relationship is established, and the Board can require the dot-com retailer to register. Firms vary in their stated return policies; some allow such returns and some do not. Since this is a relatively new commercial activity, many firms are still in the process of deciding on their return policies.

The Board's Out-of-State district office provided a list of "dot-com" companies making taxable sales that appear to meet the criteria specified in the bill. The list was developed based on taxpayer contacts, newspaper articles, and other similar sources, so only a small fraction of the total firms meeting the criteria specified in the legislation are included.

The registered "dot-com" firms on the list are assumed to already be collecting use tax associated with their sales. Estimates of 2000 U.S. (and worldwide) sales for some of the unregistered dot-com retailers were obtained from an outside source, Standard & Poor's Stock Reports, September 2000. We only had data from Standard and Poor's for a total of six firms. The electronic commerce sales estimates for these dot-com companies found for 2000 amounted to $724.2 million.

A reasonable estimate of total electronic sales for 2001 would be to double the 2000 estimate. If we assume such growth in sales, total U.S. and worldwide 2001 estimated sales of these firms would be $1,448 million (724.2 x 2 = 1,448.4). If we assume a California share of 15 percent of these sales, this implies a 2001 California sales estimate of approximately $217 million (0.15 x 1,448 = 217). Given all the unknown information associated with making such a revenue estimate, we believe that it would be reasonable to assume such a sales estimate as a lower bound. At an average statewide sales and use tax rate of 7.67 percent, these sales represent $16.7 million in state and local sales and use tax revenue.

To check the reasonableness of the estimate, we reviewed the revenue estimate we made last year for AB 2412, virtually identical legislation with respect to revenue implications. The estimate of revenue impacts for AB 2412 totaled $14.4 million in state and local tax revenues. Over the past year some dot-com subsidiaries of retail corporations registered with BOE, and are now paying sales and/or use taxes. This change in status reduced the revenue estimate from what it would have been otherwise.

Revenue Summary

The state, local, and transit district revenue impacts associated with AB 81 are estimated to be at least:

State Impact (4.75%)	$10.3 million
Local Impact (2.25%)	4.9 million
Transit Impact (0.67%)	1.5 million
Total	$16.7 million

Qualifying Remarks

As discussed, there are many uncertain factors involved in making these revenue estimates. A key factor is that we only have data for a very small subset of the total, but unknown is the number of firms that could meet the criteria specified in the proposed legislation. Given all the uncertainties in making this estimate, we reiterate that this revenue estimate should be considered as a lower bound.

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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.