STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/02/03**	Bill No:	**SB 103**
Tax:	**Sales and Use**	Author:	**Alpert**
Board Position:		Related Bills:	**AB 2412 (2000)** **AB 81 (2001)**

BILL SUMMARY

This bill would do the following:

- Specify 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.

- 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.

- State legislative intent is that the above amendments are prospectively a clarification of existing law and that it is not the intent to, in any way, extend or broaden the definition of retailer engaged in business in the state.

Summary of Amendments

The amendments to this bill since the previous version address technical concerns regarding the inconsistent use of the term "doing business in this state" and the apparent rebuttable presumption language contained in the earlier version of the bill.

ANALYSIS

Current Law

Servicing and Repairing

Revenue and Taxation Code Section 6203(c)(2)

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.

With respect to activities such as repair and servicing work performed by in-state agents or independent contractors operating under the authority of the out-of-state retailer, the Board's Regulation 1684, *Collection of Use Tax by Retailers,* clarifies that a retailer is *not* engaged in business in this state based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services on property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar.

Thus, an out-of-state retailer whose sole presence in California is through its use of employees who travel to California to do warranty work, even if only minimally, is regarded as engaged in business in California and is required to collect the California use tax on all its sales to California consumers. However, if an out-of-state retailer whose sole presence in California is through a third party independent contractor performing repair work on property sold by the retailer, that out-of-state retailer is not regarded as engaged in business in California and is not required to collect use tax on sales made to California consumers.

Retailer Selling Similar Line of Products

Revenue and Taxation Code Section 6203 (g)

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 (Deluxe) 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 former subdivision (g) based on the *Current* decision.

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 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 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 a physical presence in the taxing state before that state can require the retailer to collect its use tax.

In 1999, a group of local booksellers argued that the Board was not enforcing the provisions of Section 6203 against online sellers such as Borders Online. The booksellers took their concerns to the Legislature, and Assemblywomen Carole Migden and Dion Aroner introduced AB 2412 in 2000.

The Legislature passed the bill; however, the Governor 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.
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> "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.
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> "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.
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> "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. Two specific cases on this issue have come before the Board, as discussed below.

Borders Online. Borders Online had a notice on its web site stating that if customers wanted to return merchandise purchased from Borders Online, the customers had several choices, including returning the merchandise to a local Borders store. When Borders Online was advised that this was sufficient to bring it within the definition of "retailer engaged in business in this state," it removed the notice from its web site. It did not, however, change its policy. Borders stores would take returns from anyone (presumably if the returned goods were in like-new condition) and would provide a store credit. Borders would even accept returns on this basis from its competitors. When it did so, it clearly was doing so on its own behalf (good will, bringing customers in, etc.), and not on behalf of its competitors. Just like a purchaser of a book from any other retailer, a person purchasing a book from Borders Online could return it to any Borders store for a store credit. However, Borders provided preferential returns, not offered to customers of any other retailer, for its own customers and for customers of Borders Online. Customers from either Borders entity could, with a proper receipt, obtain a cash refund of the purchase price.

The Board concluded that this preferential treatment for the customers of Borders Online was done to further the market of Borders Online, and that Borders did so as the representative of Borders Online in this state. The Board further held that this is a selling activity coming within subdivision (c)(2) of section 6203, and that imposing a use tax collection duty under that provision satisfied the requirements of the United States

Constitution. Borders Online has filed lawsuits in both the counties of Los Angeles and San Francisco over this issue.

Barnes and Noble.com. Another case before the Board involved Barnes and Noble.com, a separate and distinct legal entity from Barnes & Noble Booksellers, Inc. – the traditional “bricks and mortar” stores in California. The local stores were regarded as the authorized representative in this state for the purpose of distributing coupons.

In mid-November 1999, the local stores began distributing discount coupons in California for purchases made through Barnes and Noble.com’s web site. The customers received the coupons as an insert in the shopping bags into which their purchases from the store were placed by the local stores’ employees. The coupons offered a $5 discount on a purchase from Barnes and Noble.com of $25 or more, with certain restrictions. The coupons expired on January 31, 2000. Barnes and Noble.com paid the costs both for printing coupons and for stuffing the coupons into the promotional shopping bags. Employees in California handed customers shopping bags that contained Barnes and Noble.com’s logo and that contained the coupons. This conduct served evidence that the local stores had the authority to distribute the coupons on the dot-com company’s behalf. Because the distribution of the coupons occurred, among other places, in California, the Board determined that the in-state store’s authorized coupon distribution in this state constituted a “selling” activity on Barnes and Noble.com’s behalf under subdivision (c)(2) of Section 6203. As of the date of this analysis, Barnes and Noble.com has not filed suit on this issue.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. According to 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 April 2, 2003 amendments address technical concerns raised in the Board’s previous analysis.** These amendments 1) revise the language so that it is consistent with the rest of the statute, and 2) removes the rebuttable presumption language that was contained in the bill.

3. **The March 18, 2003 amendments delete legislative intent language related to the Streamlined Sales and Use Tax Agreement.** This language specified that it was the intent to implement the provisions of the Agreement.

4. **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.

5. **Who would be affected by enactment of this measure?** The proposed subdivision (g) of Section 6203 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, such as in the Borders Online case, 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.

6. **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, or who use its own employees to perform repair or servicing activities in this state, 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 1) based solely on the fact that 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 2) based solely on its use of an independent third party contractor acting under the authority of the retailer in repairing or servicing property sold by the retailer, 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.

   The legislative findings and declarations specify that the changes to Section 6203 "prospectively clarify" the law. However, since it is Board staff's belief that the bill would broaden the Board's current interpretation of Section 6203 to some extent, this language raises concern, and could lead to disputes, especially with respect to past unpaid use tax obligations.

COST ESTIMATE

Some administrative costs would be incurred in notifying affected retailers. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Representatives and Independent Contractors. Out-of-state retailers that directly service or repair tangible personal property they sold to California customers are currently considered to be engaged in business in this state. However, the Board's Regulation 1684 specifically states that a retailer is not engaged in business in this state based solely on its use of a representative or an independent contractor for servicing or repairs, provided that the representative or independent contractor is not in a similar business.

While representatives and independent contractors may be used to service any equipment, it is likely that specialized industrial machinery would probably need to be serviced directly by the seller in most cases. However, many personal computers and related devices are generic enough that they can be serviced by independent contractors who repair various brands. We believe that independent contractors servicing personal computers and related devices to be the most commonly used equipment that would be subject to the nexus provisions of this bill.

Customer service personnel can often diagnose problems on equipment such as computers over the phone, without using an independent contractor. In many cases, parts can be exchanged directly with out-of-state sellers. Using these two means of customer service would not imply California nexus. However, some out-of-state sellers also provide service by use of independent contractors located in California near customers' homes or offices. Continued use of such independent contractors would constitute nexus under this bill. However, it is possible for out-of-state sellers to change their business practices. For example, they could discontinue the use of such independent contractors and instead provide all their services to customers directly, through customer phone support and shipping parts and equipment. We have no way of estimating the extent to which out-of-state vendors would change their business practices in response to this bill.

A reasonable upper limit to the potential revenues that could be subject to nexus would be those related to the total sales of computers and related devices to both households and businesses from out-of-state vendors without California nexus. Last year we estimated that the total use tax revenue loss related to remote sales (mail order and electronic commerce sales) from out-of-state vendors to California households was $456 million ($309 million in mail order sales and $147 in electronic commerce sales). We also estimated the electronic commerce use tax revenue loss to be $783 million from out-of-state businesses to California businesses. None of the companies making these sales to California households and businesses have California nexus. (These revenue estimates are documented in a revenue estimate for "Electronic Commerce and Mail Order Sales," April 12, 2002.) A portion of these revenues are derived from sales of computers and related devices, and a portion of those would be from companies that would be made subject to nexus under the bill.

Data from a U.S. Department of Commerce report shows that 28.4 percent of remote sales to U.S. households were computer hardware. The Commerce report also states that 10 percent of electronic commerce sales to businesses were computers and related products. Applying these percentages to California use tax estimates implies that a total of about $208 million in revenues could potentially be subject to nexus if this bill becomes law [(0.284 x 456) + (0.10 x 783) = 208].

Related Dot-Com Businesses. There is no national or state data that provides an estimate of the total number of firms meeting the specified criteria of this bill regarding related subsidiaries. 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 to register with the Board or not. 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, they are not required to register with the Board and collect the use tax.

The Board's Out-of-State district provided us with several lists of unregistered or closed out accounts of "dot-com" companies selling taxable goods. These lists were 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.

Information on the unregistered companies is sketchy, and needed to be culled from three different sources, depending on the information available. The first source is a list of closed out accounts from the district. Some of this information was incomplete, with firms reporting for less than four quarters. Furthermore, since only a small number of accounts were closed out, we needed outside sources to glean information from the other companies.

The second source is the latest company annual report (10 K report) found in the Securities and Exchange Commission web site. The third source is Standard & Poor's Stock Reports, December 2002. Both of these sources only provided total sales of dot-com subsidiaries; they did not specify California sales. To estimate California sales, we assume the state has a 12 percent share of U.S. sales. Using all three sources of information, we made California sales estimates for less than 20 firms. The total combined estimate of California sales from these companies was approximately $275 million.

Given all the unknown information associated with making such a revenue estimate, we believes 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 7.92 percent, these sales represent $21.8 million in state and local sales and use tax revenue.

Revenue Summary

The state, local, and transit district revenue gain associated with this bill is estimated to be at least:

State Impact (5.0%)	$13.8 million
Local Impact (2.25%)	6.2 million
Special Taxing Jurisdictions Impact (0.67%)	1.8 million
Total	$21.8 million

Qualifying Remarks

Independent Contractors. As discussed previously, we cannot accurately forecast potential changes in out-of-state vendors' business practices regarding their choice of using independent contractors for providing service. Potentially, use tax revenues could increase by up to $208 million if none of the current out-of-state computer vendors changes their business practices. This is an upper limit, and was not included in the revenue estimate.

Related Dot-Com Businesses. As discussed, there are many uncertain factors involved in making estimates of the revenue impact of Internet sales. A key factor is that we only have data for a very small subset of the total, but unknown, number of firms that could meet the criteria specified in this 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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