

STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the July 27, 2011 Board Meeting

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- For Information  
 For Discussion  
 For Decision Making

BOARD OF EQUALIZATION  
INFORMAL ISSUE PAPER

**Discussion of proposed changes to the Qualified Purchaser Program**

**Issue**

Should BOE change the way it administers the Qualified Purchaser Program?

**Background**

Assembly Bill (AB) 418 (Stats. 2009, ch. 16) added Revenue and Taxation Code section 6225, which, effective January 1, 2010, requires that a "qualified purchaser" must register with the State Board of Equalization (BOE) and report and pay use tax directly to BOE. A "qualified purchaser" means a person that meets all the following conditions:

- The person is not required to hold a seller's permit or be registered pursuant to Revenue and Taxation Code section 6225 (Certificate of Registration – Use Tax);
- The person is not a holder of a use tax direct payment permit as described in Revenue and Taxation Code section 7051.3;
- The person receives at least \$100,000 in gross receipts from business operations per calendar year, and
- The person is not otherwise registered with the BOE to report use tax.

Unreported use tax is the largest area of noncompliance in California's sales and use tax program. BOE estimates the use tax gap – from unreported use tax purchases by both business and individual consumers - to be \$1.145 billion annually. Created by the Legislature, the Qualified Purchaser Program addresses the business-to-business component of the use tax gap.

**Administration of Qualified Purchaser Program**

**Outreach**

BOE informed taxpayers of the new program's requirements in a number of ways. In September 2009, BOE issued a press release, sent a Special Notice to all tax practitioners and certain service industry associations and government associations (54,000 notices), provided information in several tax professional seminars, and posted frequently asked questions on the BOE website. Since these initial outreach efforts, staff has added and clarified the information on our website. In addition, in March 2010, Publication 126, *Mandatory Use Tax Registration for Service Enterprises*, was developed to explain the program and answer taxpayer questions.

Implementation

Historically, BOE has had little contact with service businesses that are not also retailers. Consequently, prior to the Qualified Purchaser Program, staff had very little data about service business purchasing patterns and the potential for use tax liability within certain industry groups or by size of business. Using the statutory gross receipts threshold to drive our efforts, staff took the following steps to implement the Qualified Purchaser Program:

- Identified potential qualified purchasers based on income and payroll tax data. This data was matched against the account records in BOE's IRIS program to prevent duplicate registration of taxpayers.
- Beginning December 2009, staff sent weekly mailings of 10,000 letters explaining the new legislation. The letters notified taxpayers that they have been identified as a qualified purchaser. In order to simplify the registration process, notified taxpayers were also advised that BOE would be creating for them an account to report their use tax liability, and that once the account was created, they would be asked to report their use tax liabilities for the current year and two prior years (three years total). Although staff could have looked at an eight-year period, limiting reporting to three years made the Qualified Purchaser Program consistent with BOE's In-state Voluntary Disclosure Program for reporting use tax.
- Beginning February 2010, staff created accounts for approximately 180,000 identified qualified purchasers and mailed them instructions on how to efile their returns.
- In 2011, following the same process, BOE identified and registered approximately 350,000 additional qualified purchasers. These taxpayers were also provided instructions on how to efile their returns.

This simplified registration process allowed taxpayers to meet their registration requirements without completing an application or having to visit a BOE office to register.

**Program Results and Costs.** The data below is based on information through June 30, 2011:

January 2010 – June 2011					
Total Accounts Registered	Number of Returns Filed with Tax Due <sup>1</sup>	Total Revenue Reported	Average Revenue per Return Filed with Tax Due	Number of Accounts Filing Zero in the Last 3 Consecutive Years	Number of Delinquent Accounts
517,065	142,010	\$84,790,923	\$597	262,442	169,615

In the analysis for ABx4 18, BOE believed 200,000 businesses would be required to register under the program. Staff estimated 124 positions would be needed agency wide to implement the program, costing \$10.2 million in 2010-11. In the Sales and Use Tax Department's Use Tax Administration Section, 51 people currently work on the Qualified Purchaser Program, registering accounts and following up on delinquencies. Thirty of these staff were redirected from the In-State Service Business (ISS) Tax Gap Program (created in BOE's 2007 Tax Gap effort, the ISS program also focuses on use tax collection from service businesses).

**Discussion of the Issue**

With the Qualified Purchaser Program in operation for less than two years, staff does not yet have enough experience with the program to make a recommendation regarding the policy of whether changes to the statute should be considered. However, staff believes that, based on the data gathered to date, the program can be administered in a more cost effective and efficient manner within the current statute.

Accordingly, staff proposes a three-point approach to change how BOE registers and unregisters taxpayers by:

<sup>1</sup> The number of returns filed cannot be compared to the total number of accounts registered because the number of returns filed by taxpayers varies. Also, the total number of accounts registered includes accounts that have since been closed out.

1. Discontinuing the simplified convenience registration process based solely on the taxpayer meeting the criteria of the statute,
2. Allowing taxpayers to close their permit if their gross receipts drop below the \$100,000 threshold for the last two consecutive years, and
3. Automatically deregistering taxpayers that have filed zero returns for three consecutive years.

**Simplified convenience registration.** As staff has implemented the Qualified Purchaser Program, we have found that the original estimate of 200,000 affected businesses was significantly understated. In addition to the over 500,000 accounts registered in the first two years of the program, 300,000 new taxpayers have been identified that are not currently registered. In comparison, BOE currently administers approximately 850,000 sales and use tax accounts (excluding the Qualified Purchaser accounts).

As explained in the Background section, Revenue and Taxation Code section 6225 provides that qualified purchasers are required to register with BOE. To simplify the registration process, staff automated the registration of these taxpayers by creating accounts for them when they were identified as meeting the criteria of the statute. As previously explained, this simplified registration process allowed taxpayers to meet their registration requirements without completing an application or having to visit a BOE office to register. Although not previously done on a large scale, automated registration is not unique to the Qualified Purchaser Program. BOE's Consumer Use Tax Section will issue taxpayers account numbers when staff receives information that use tax may be due on the transfer of a vehicle, vessel, or aircraft.

This registration process also provided staff with a large amount of data that can now be analyzed and used to determine the population of taxpayers that are most likely to have purchases subject to use tax. In addition, sending notices to such a large number of service businesses also provided use tax information and education to a group of taxpayers that are generally not contacted by BOE. Staff believes that this outreach has also increased reporting of use tax on California income tax returns and on the BOE's use tax return (BOE-79-B).

Automated convenience registration has resulted in significant amount of revenue reported. However, it has also resulted in a significant amount of zero and unfiled (delinquent) returns. After considering all that has been learned since implementing the Qualified Purchaser Program, staff believes that the time spent registering this large number of accounts and following up on thousands of potential delinquencies would be better spent identifying and registering businesses that, because of the size and nature of their operations, are more likely to make purchases subject to use tax. Staff would continue to identify taxpayers that meet the requirements of the statute; however, instead of automatically registering all of these taxpayers, staff would send informational notices explaining the requirements under the program.

**Deregistration.** Under BOE's current administration of the Qualified Purchaser Program, a taxpayer remains registered unless they close the business or become registered with the BOE to report sales and use tax (e.g., becoming a retailer and obtaining a seller's permit). In either of these events, the taxpayer can close their qualified purchaser account by completing form BOE-345-QP, *Qualified Purchaser – Registration Update*.

This limited ability to close a permit was discussed at the Tax Gap stakeholder meetings with interested parties recommending that taxpayers be allowed to close their permit if their gross receipts dropped below the \$100,000 threshold for two consecutive years. Staff agrees with this recommendation. In addition, staff believes that it is not necessary for a taxpayer to hold a permit when the taxpayer consistently does not have any purchases subject to use tax to report. Staff recommends that BOE automatically deregister qualified purchasers after they file zero returns for three consecutive years. This action would be similar to the process BOE currently follows for seller's permit holders who report zero sales. Staff's proposal would include taxpayers that report three annual returns at one time (e.g., taxpayers contacted in 2009 were asked to complete returns for 2007, 2008, and 2009). Taxpayers would, however, have to file returns; staff would not consider three years of unfiled returns to be the same as reporting zero liability for three years.

**Other issues.** Unless required to report use tax directly to BOE, California businesses can report their use tax liability on their business income tax returns. Individuals can also report use tax liability on their personal income tax returns, and beginning 2012, individuals will have a look up table to estimate their use tax liability. At this time, however, there is no look-up table for businesses to estimate their use tax liability. Non-income tax filers can report use tax on BOE's use tax return (BOE-79-B).

Another issue discussed at the Tax Gap stakeholders meetings was the recommendation by interested parties to change the due date of qualified purchaser returns from April 15 to the due date of the taxpayer's timely filed income tax return.

This would allow taxpayers to review their purchase records for use tax at the same time they are gathering records for the preparation of their income tax returns. Although staff wants to make reporting easy for taxpayers, staff believes it would be administratively impractical to implement such a change. BOE would not know when a particular taxpayer's income tax return was due (i.e., taxpayers reporting on a fiscal year, or filing an extension), and consequently, would not know when a return was filed late or when an account was delinquent. Staff does not recommend that the due date currently in the statute be changed.

As a final item, staff notes that the Qualified Purchaser Program will be available in the first phase of the electronic registration project. BOE's eRegistration is expected to be available by March 2012.

## Alternatives

### Alternative 1

Revenue and Taxation Code section 6225 provides that in order to facilitate the collection of use tax, qualified purchasers must register with BOE to report use tax. Staff believes the Qualified Purchaser Program would run more efficiently if BOE made the following changes to how it registers and deregisters taxpayers:

1. Allow taxpayers to close their account if their gross receipts drop below the \$100,000 threshold for the last two consecutive years. After closing the account, taxpayers would be advised to report future use tax purchases on their business or personal<sup>2</sup> income tax return. If the taxpayer meets the threshold requirements in a future year, they must re-register if they make purchases subject to use tax.
2. After three consecutive years of filing zero returns, BOE would automatically deregister the taxpayer's account. Upon deregistration, a notice to the taxpayer will explain:
  - BOE has the discretion to examine the taxpayer's records even after deregistration,
  - If the taxpayer meets the threshold requirements of the statute, they must re-register if they make purchases subject to use tax in the future, and
  - If the taxpayer no longer meets the threshold requirements, they should report future use tax purchases on their business or personal<sup>3</sup> income tax return.
3. BOE will no longer perform automated convenience registration of taxpayers solely because they met the \$100,000 gross receipt threshold. However, BOE will require registration of taxpayers that meet the threshold requirements, but using a more focused approach to identify taxpayers likely to make purchases subject to use tax based on industry type, gross receipts, or other available information.

### Pros

- Will substantially decrease the number of accounts BOE would register (300,000 accounts identified for the next campaign).
- Protects the current revenue received under the program.
- Will result in deregistering an estimated 262,000 accounts that have reported zero use tax in the last three consecutive years.
- Staff time currently spent on the automated convenience registration of all taxpayers meeting the requirements of Section 6225 can now be focused on identifying businesses that have a high potential for use tax liability. Staff believes that focusing registration on these accounts will result in greater revenue than what has been reported under the current process.
- Does not require legislative change; changes can be implemented immediately.
- Is consistent with the statutory intent to facilitate the collection of use tax.

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<sup>2</sup> Taxpayers reporting business income on Schedule C of their income tax returns would report use tax on their personal income tax returns.

<sup>3</sup> See footnote 2 above.

### **Cons**

- Will incur a workload to deregister and close out accounts.

### **Alternative 2**

Do not change current policy. Continue simplified convenience registration of qualified purchasers with gross receipts of \$100,000 from business operations and require that the business be registered until it ceases to exist or obtains a different permit to report use tax.

### **Pros**

- Current practices have resulted in significant revenue. Continuing BOE's current practice should continue to result in new use tax revenue.
- Does not require any legislative change.

### **Cons**

- BOE has identified an estimated 300,000 qualified purchasers requiring registration next year.
- Taxpayers that consistently report zero use tax liability will be required to maintain their accounts and file returns.
- Staff will continue to spend significant time registering thousands of accounts that report zero, and following up on potential delinquencies that may result in zero liability.

## **Recommendation**

Staff recommends the Board approve Alternative 1.

## **Critical Time Frames**

If BOE continues its current registration process, approximately 300,000 new taxpayers would be scheduled to receive registration notices beginning October 2011.

## **Preparation and Reviews**

Tax Policy Division, Sales and Use Tax Department

Current as of: July 12, 2011