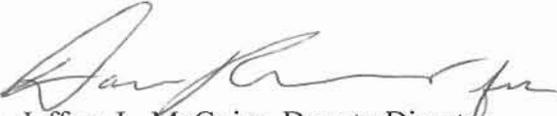


Memorandum

To : Ms. Kristine Cazadd
Interim Executive Director

Date: March 17, 2011

From : 
Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department

Subject : **Board Meeting, March 22-24, 2011**
Item P3- Sales and Use Tax Department's Deputy Director Report
Contract Over \$1 Million - Use Tax Gap Pilot Project

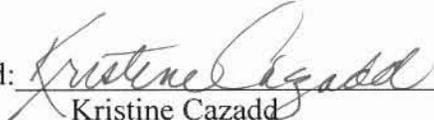
At the March 22-24, 2011 Board Meeting, we will be presenting information and requesting approval on a Use Tax Gap Pilot Proposal.

Please place this item on the March 22, 2011 Board Meeting agenda under P3.3.

JLM:sb

Attachment

cc: Ms. Diane Olson (MIC 80)

Approved: 

Kristine Cazadd
Interim Executive Director

Use Tax Gap Pilot Proposal

Issue

The Board's approval is requested to issue a Request for Proposal (RFP) on strategies and techniques to more effectively and efficiently address the use tax gap of \$1.145 billion; with respect to remote sales.

It is recommended that the RFP call for a performance-based, benefits funded proposal that provides a positive return to the State of California and focuses on increasing voluntary compliance with the law.

Background

Nationally, online sales are growing by leaps and bounds: Independent research firm Forrester estimates \$53 billion was spent online during the 2010 holiday season alone and projects consumers will spend roughly \$248 billion online – or 8% of all retail sales by 2014.

Based on calendar year 2010 data, the use tax gap in California, with respect to remote sales (electronic and traditional mail order sales) from out-of-state vendors is estimated at \$1.145 billion; of which, \$795 million is estimated to be owed by consumers.

In calendar year 2010, consumers reported \$10.2 million of the \$795 million in use tax due to the State of California via their Franchise Tax Board income tax return.

Historically, given the low dollar amount of each transaction, it has not been deemed productive to focus on the individual transactions for enforcement purposes. However, given the growth of online retail sales by out-of-state retailers and its impact on California's economy, we believe that through the use of improved data matching, mining, and warehousing capabilities it is now more productive than ever to enforce the law on major offenders.

While the legislature and others are currently debating whether it is productive to require out-of-state online retailers to register with the Board of Equalization (BOE) and report the use tax due to the State of California, most people acknowledge that pursuant to Section 6202 of the Revenue and Taxation code consumers are required to report use tax and it is the BOE's responsibility to enforce this provision of the law.

In fact, one of the largest online retailers, Amazon.com, and others have argued the BOE should collect the use tax from consumers.

Challenges

- Unregistered out-of-state sellers have an advantage over in-state, registered retailers that are complying with their sales tax reporting obligations.
- Consumers do not have a clear understanding of how use tax applies, which perpetuates their lack of voluntary compliance.

Use Tax Gap Pilot Proposal

- Identifying the point of diminishing return for education, enforcement, and collection efforts wherein it will be productive to enforce the law.
- Establishing an economical yet sustainable educational outreach program that capitalizes on existing medias, including but not limited to, current mailing of returns and other data, electronic notification during e-filing, BOE website, public service announcements, and through outreach partnerships with practitioners and professional associations.
- Identifying, processing, and obtaining public information for data matching efforts.
- Deciding how to effectively and efficiently focus educational and enforcement efforts based on limited resources in the most productive manner.

Objectives

- Fulfills the Board's statutory and fiduciary obligation to administer and enforce the law.
- Protects California consumers from unwarranted penalties and interest due to the failure of online retailers to voluntarily report the use tax.
- Encourages taxpayer voluntary compliance due to an increased awareness of use tax.
- Levels the playing field for California retailers.
- Promotes a cost effective method of obtaining small dollar taxes owed by a large number of taxpayers.
- Accelerates revenue to the State.
- Addresses a segment of the tax gap.

Purpose of Proposal

If approved to seek vendor proposals, BOE would ask vendors to perform two primary tasks on a pilot basis. These tasks include:

1. Create and conduct a targeted use tax educational and enforcement outreach campaign to encourage voluntary compliance, increase awareness of identifiable use tax liability, and serve as a notice of enforcement efforts.

This campaign would extend to California consumers as well as registered businesses and tax practitioners.

- I. For registered businesses, the intent of the education outreach would be determine if there is use tax activity warranting a permit, urge them to be diligent in their use tax reporting, and advise them of potential interest and penalties applicable to unreported use taxes.

Use Tax Gap Pilot Proposal

- II. With respect to current non-filers, the efforts would be focused on use tax education and reporting responsibilities, with an emphasis on the use of the Franchise Tax Board use tax line.
 - III. As it relates to tax practitioners, the goal of the campaign would be to appeal to their professional ethical obligation to advise their client of any and all potential tax liabilities including use tax. Further, we would seek to educate them on the law and reporting requirements.
2. Through the use of existing public information, identify internet purchases from unregistered out-of-state sellers and provide that data to BOE, either as a single data transfer or collected and stored in a data warehouse environment.
 - I. Since it would not be an efficient use of state resources to initiate investigations or billings on small dollar individual use tax purchases, we would ask for data that exceeds an aggregate \$5,000 (aggregate) annually per individual consumer.

Cost

Procure a performance-based, benefits funded contract with an expenditure range of \$7-10 million. A performance-based, benefits funded contract that provided that the vendor will only be paid based on the acceleration of revenue through self compliance or enforcement efforts resulting from their work.

Benefits

Revenues would begin to be collected under this pilot project in fiscal year 2011/12. While estimated revenues cannot be established until the initial data summaries are provided, we expect to obtain a 3 to 1 benefit to cost ratio.

Similar Efforts

In 2007, BOE sought to pursue an educational outreach campaign but was not successful in obtaining funding for such a campaign at that time. Given the recent law changes and the complexity of the law, an educational outreach campaign would expand BOE's current outreach and educational efforts to improve voluntary compliance by individuals reporting use tax. Knowledge is a key to voluntary compliance.

Additionally, data relative to reportable out-of-state purchases is apparently available. Vendors have approached BOE staff to offer the sale of data on purchase transactions between out-of-state retailers and California consumers. BOE has not pursued the purchase of this data because the vendors have not provided BOE with the opportunity to review a sample of the information available without a contractual arrangement. However, we do believe the data exists and may be useful in meeting our statutory and fiduciary obligations under the law.