ADDRESSING THE TAX GAP

Fiscal Years
2007-2008
through
2009-2010

California State Board of Equalization

Revision 1 – 4/13/07

Addressing the Sales and Use Tax Gap

Executive Summary

The Board of Equalization's mission is to serve the public through fair, effective, and efficient tax administration. As stated in its Strategic Plan, the Board is committed to improving taxpayers' knowledge of the legal requirements for doing business in California. This includes providing new ways for them to understand and voluntarily comply with the tax and fee laws we administer.

California's tax system is based on the premise that each taxpayer will correctly determine the amount of taxes owed and will faithfully remit those taxes. Voluntary compliance is the most effective and efficient method of collecting tax, and it is improved by showing that tax administration is fair, equitable, and committed to ensuring compliance.

The "tax gap" – or the difference between taxes owed and taxes paid – does not consist solely of tax evasion. Much of the unpaid tax, such as use tax, is never reported because taxpayers are not aware of their liabilities. The Board will look to improve taxpayers' understanding of state laws, and provide new means for them to satisfy their tax obligations. This could include improved education and outreach and reducing the burden of complex filing and reporting requirements.

The Board's primary focus to date in addressing the tax gap is its compliance efforts and audit activities. Examples of the Board's efforts include the Retail Licensing program which involves visits to retail establishments focusing on unregistered taxpayers, and the U.S. Customs program which looks for potential use tax liabilities on purchases from out-of-state. The Board also supported legislation to reduce the tax gap, for example the prepayment of sales tax on gasoline and diesel fuel.

This plan involves Identifying areas of non-compliance, and then using both new and traditional approaches to address those areas. These approaches will include looking to industries that normally do not interact with the Board, utilizing enforcement tools to compliment discovery efforts, and maintaining a physical presence in the marketplace.

It will look outside the agency – to state and federal departments and public entities – to ensure that information sharing agreements are working properly and determine whether new channels of information need to be established.

The Board will also look at its own operations to make sure audit selection and collection methods are performing as efficiently as possible. The plan calls for the Board to find the best tools for collection efforts and to find innovative ways to use existing resources such as alternative auditing and collection practices.

In order to implement this multi-year plan and limit the tax gap in a sustainable manner, the Board will need additional resources to create new programs and processes to assist these compliance efforts. Implicit in this plan is the need to recruit and retain highly qualified staff to carry out the Board's efforts.

Leveling the playing field by improving sales and use tax compliance will insure that California retailers are not at a competitive disadvantage compared to out-of-state sellers. The actions described in this plan will result in the Board collecting unpaid taxes. The increase in revenue due to both enhanced enforcement efforts and improved voluntary compliance could be as much as $400 million annually.

The Tax Gap

The Board of Equalization administers 25 tax and fee programs that produce revenues of about $50 billion annually. The Sales and Use Tax is the largest tax program comprising over 88% of the total revenues. This report focuses on the Sales and Use Tax gap.

The Board of Equalization administers the sales and use tax, which produced revenues of about $44 billion in fiscal year 2005-06. We have estimated that these payments amount to about 96% of the total taxes owed. The tax gap, the difference between the amount owed and the amount paid, is estimated to be about 4% or approximately $2.0 billion.

The percentages of taxes owed are shown in the following chart.

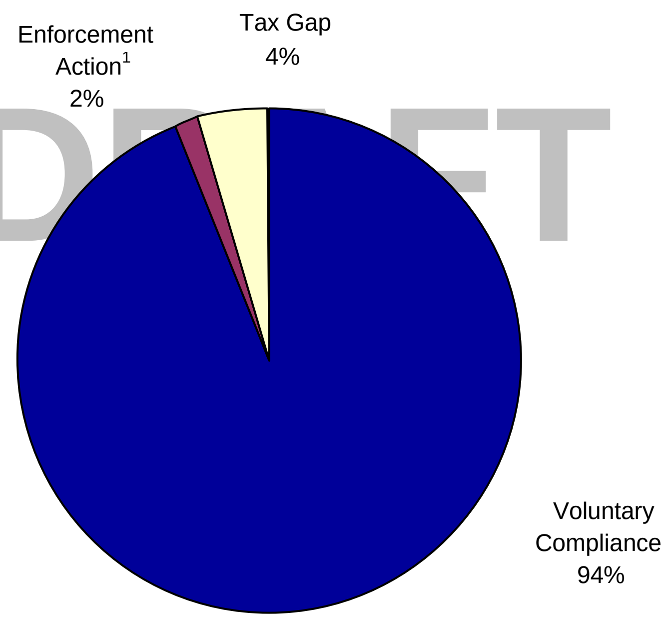

Table 1

Sales and Use Tax Gap Estimates

	STATE 5.25%	LOCAL 2.69%	TOTAL 7.94%[2]	PERCENT OF TOTAL
		(in millions of dollars)		
Total Sales and Use Tax Owed	$30,619	$15,688	$46,307	
Paid Voluntarily	28,742	14,727	43,469	93.9%
Enforcement Efforts[1]	551	282	833	1.8%
Sales and Use Tax Gap	$ 1,326	$ 679	$ 2,005	4.3%

[1] Enforcement efforts include normal audit and collection activities and special efforts such as the U.S. Customs program and the Retail Licensing Program.
[2] 7.94% is the average effective statewide tax rate.

There are three major components of the tax gap:

1. Use tax liabilities - businesses and individual consumers not required to be registered
2. Nonfilers/tax evasion
3. Registered taxpayers - under-reporting and non-payment

The percentage of the tax gap for each element is shown in the following chart.

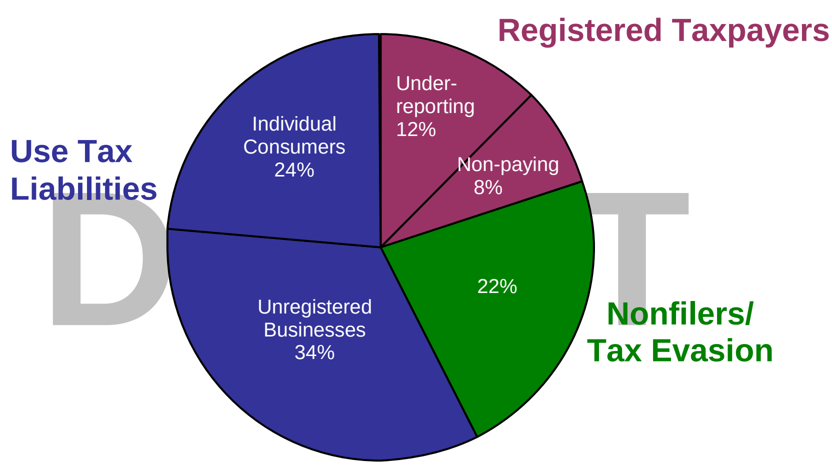

Table 2

Components of the Tax Gap

	STATE 5.25%	LOCAL 2.69%	TOTAL 7.94%*	PERCENT OF GAP
		(in millions of dollars)		
Use Tax Liabilities	$ 764	$ 361	$ 1,155	57.6%
Nonfilers/tax evasion	298	152	450	22.4%
Registered taxpayers	264	136	400	20.0%
Total	$ 1,326	$ 679	$ 2,005	

* 7.94% is the average effective statewide tax rate.

We will not be able to completely close the tax gap. A significant portion of the tax liability is spread among many taxpayers such that each individual liability is too small to justify collection efforts. For these liabilities, if the taxpayers do not voluntarily comply with the tax laws, it would not be cost effective to attempt to identify and collect the tax liability. In other cases, the tax liability may be identifiable, but is uncollectible because the taxpayer simply does not have the assets to pay it. While One hundred percent compliance is an admirable goal, it is not likely achievable. Rather, our efforts are directed towards narrowing the tax gap through cost-effective means of increasing compliance with the state's tax laws. In addition, we would note that our sales and use tax gap estimate does not include any taxes that should have been paid on sales relating to illegal activities.

Use Tax Liabilities

The largest portion of the tax gap is use tax liabilities. Use tax liabilities are created when taxable items are purchased for use in California, and the sales tax has not been paid to the Board by the retailer. For the most part these are purchases made from out-of-state retailers either in person, by mail order, or over the Internet.

We estimate that the portion of the state sales and use tax gap associated with use tax liabilities amounts to $1.2 billion. The major portion of this amount is associated with purchases made by mail order or over the Internet. Below is a discussion of our estimate of these remote purchases.

Remote Sales

Taxable transactions that take place between an out-of-state seller and an in-state buyer create a use tax liability for the purchaser. If the out-of-state retailer is registered with the Board, it is required to collect and remit the use tax. If the in-state buyer is registered with the Board it is required to report and pay the use tax on its sales tax return. The difficulty occurs when neither the seller nor the purchaser is registered with the Board.

The majority of such purchases are made by mail order or over the Internet. For the most part, purchasers, especially individual consumers, are not aware that they have incurred a use tax liability. These remote sales transactions can be classified as being business-to-business sales or business-to-consumer sales. Our revenue estimate is:

Estimated Total California Electronic Commerce and Mail Order Revenue Impacts in 2005

	MILLIONS OF DOLLARS		
	B-TO-C	B-TO-B	TOTAL
State loss (5.25%)	$270	$451	$721
Local loss (2.00%)	103	172	275
District loss (0.69%)	36	59	95
Total	$409	$682	$1,091

Remote sales to unregistered businesses

It is important to note that these business-to-business sales include only those sales where there is an out-of-state retailer that is not registered with the Board and the purchaser is a California business not required to register with the Board. These California businesses are not required to register with the Board because they are not making taxable sales. The items are purchased for use rather than for sale.

Businesses registered with the Board are required to remit the use tax they owe on their sales and use tax returns and use tax is one of the areas that the Board looks at in audits. Unregistered businesses, however, are similar to individual consumers in that they pay the sales tax for tangible personal property to the retailer when they purchase items from in-state retailers. In order to comply with their use tax liability, they would also have to determine which transactions are taxable and keep track of those transactions for which the tax has been collected by the out-of-state retailer and those transactions for which the tax has not yet been paid.

There are currently about 2 million businesses in California that are not registered with the Board. We estimate that these 2 million businesses have a total use tax liability of $682 million. The average liability amounts to about $335 per business. With such a low average liability it would not be cost efficient to attempt to register and collect the use tax from all 2 million unregistered businesses. The challenge is to find those industries with the largest use tax liabilities so that we can focus our enforcement efforts in the most efficient manner.

Remote sales to individual consumers

Consumers purchasing tangible personal property either by mail order or over the Internet from out-of-state retailers incur a use tax liability. Some out-of-state retailers are engaged in business in California and are required to collect this use tax. If the retailer does not collect the use tax, the liability remains with the consumer. For the past few years the state has included a use tax line on the personal income tax form to allow consumers to report and pay this use tax liability. More than 31,000 personal income tax returns in 2006 reported $5.46 million in use tax.

The sales and use tax is normally collected and reported by the retailer. In those situations, the consumer, while aware of the tax, normally has no responsibility to determine or report his or her sales and use tax liability. The sales and use tax is a tax that is paid incrementally – with each purchase of tangible personal property. Most consumers simply pay the tax as determined by the retailer. Most consumers have no idea that they are incurring a use tax liability on purchases from out-of-state retailers. With some out-of-state retailers collecting the use tax and other not collecting it, the consumer would have to determine which purchases would be subject to the use tax (for example, a purchase of a music CD would be taxable while the purchase of the same music as an online download would not be taxable) and then determine whether or not the retailer has already collected the tax. They would have to do this for a year’s worth of purchases and then remit the tax either with a use tax return or with their income tax return.

Non-filers/Tax Evasion

The second largest component of the tax gap is comprised of individuals and businesses that conduct business transactions by word of mouth and cash payments to avoid scrutiny by government officials. For instance, there are some businesses which are located in California, making taxable sales and are not registered with the Board. Some of these are itinerant vendors, such as sellers at swap meets, Christmas tree retailers, street corner merchants, etc. There are also those who have stores and are not registered. There are also some individuals who are registered with the Board and misuse resale certificates, buying property without paying the tax and then using it for personal use rather than for resale.

By its very nature, the number and receipts of these unregistered retailers are difficult to measure. However, based on preliminary results from the Board’s Retail Licensing Sweep program, we believe that these unregistered retailers are costing the state and local governments hundreds of millions of dollars in lost sales and use tax revenues annually.

Under-reporting and non-payment by registered businesses

This portion of the tax gap consists of sales and use taxes owed but not reported by businesses registered with the Board. The major areas of taxpayer noncompliance found in audits are:

1. Untaxed purchases from out-of-state vendors
2. Unsupported sales for resale
3. Differences between recorded and reported sales
4. Reported sales lower than markup on purchases
5. Withdrawal from resale inventory for own use without payment of tax

The Board has a solid and extensive audit program in place. With current resources, we are able to audit about 60 percent of the sales and use tax base. Our audit program discovers tax liabilities of approximately $360 million annually. Based on out current audit findings, we estimate that those businesses that we do not currently audit have an under-reported liability of $250 million.

There are liabilities either self-reported or discovered by the Board’s audit and compliance programs for which the taxpayer has not paid. The Board’s collection program deals with these non-payments by a variety of collection methods. The Board’s collections program is also successful in collecting revenue owed but not paid. During fiscal year 2005-06 our collections program collected more than $800 million in outstanding liabilities. However, a portion of this liability is still uncollected, and about $150 million is added to our outstanding accounts receivable balance each year. This plan is designed to address this growth.

Tax Gap Plan Goals

Goal 1: Develop new approaches and processes to address specific areas of non-compliance.

Tax administration in an ever-changing economic environment requires the application of new approaches and new processes to ensure the maximum level of voluntary compliance. The California economy is not static; new technology, new products in the marketplace and new methods of conducting business affect tax liabilities. Every year there are changes to either statutes or rules and regulations. Further, the demographics of California's diverse population are continually changing. All of these factors require the Board to constantly reassess its taxpayer education and public outreach responsibilities and to find new methods to address specific areas of non-compliance. Our strategies for accomplishing this goal include the following:

1. In the area of use tax liabilities for those businesses not required to register with the Board, we need to level the playing field for California business. Currently, those businesses that are registered with the Board are required to report use tax on any taxable purchases for which the sales or use tax was not collected. Those businesses that are not registered with the Board have the same liability regarding taxable purchases for which the sales or use tax has not been collected. We need to develop methods to inform these businesses of their use tax liabilities and find ways to determine and collect these liabilities.
2. We need to utilize effective enforcement tools to complement our efforts to discover tax liabilities.
3. The Board must maintain a physical presence in the marketplace so that taxpayers understand our commitment to full compliance by all taxpayers.

Goal 2: Increase information sharing with state agencies and other entities.

Information is the key to successful approaches to shrink the tax gap. There exists, at all levels of government, data that could be useful to the Board in its effort to collect revenues legally owed. The Board seeks to further develop the ability to access this data as well as the technology to efficiently analyze it.

1. In the area of use tax liabilities for California businesses not currently registered with the Board, we are looking at segments of the economy with which the Board has not historically dealt. The Board needs information from outside sources in order to focus our efforts.
2. The sharing of the information discovered by any of California's tax agencies will help the others in their pursuit of full compliance with all of California's tax laws.
3. We must collaborate with other governmental entities as well as our sister tax agencies to assist new taxpayers in determining which permits or licenses they are required to hold.

Goal 3: Improve audit and collection efficiencies.

The Board of Equalization is committed to developing ways to achieve the most efficient use of its resources. Currently the Board expends 68 cents for every $100 it collects. We realize however, that efficiency is a moving target, and we need to continue to look for ways to increase efficiency in our processes.

1. We must be sure that our audit selection methods are as effective as possible.
2. We must make sure that our compliance staff is given all the enforcement tools necessary to be successful.
3. We must be innovative in our uses of existing resources, utilizing alternative audit and collection methods.