



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Introduced:	<b>02/02/09</b>	Bill No:	<b><a href="#">AB 178</a></b>
Tax:	<b>Sales and Use</b>	Author:	<b>Skinner &amp; Calderon</b>
Related Bills:	<b>ABx3 27 (Calderon)</b>		

**BILL SUMMARY**

This bill would specify that a “retailer engaged in business in this state” includes a retailer entering into an agreement with a California resident under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link or an Internet Web site or otherwise, to the retailer, under specified conditions.

**ANALYSIS**

**CURRENT LAW**

Under federal law, Article I, Section 8, Clause 3 of the United States Constitution, known as the Commerce Clause, states that Congress has the exclusive authority to manage trade activities between the states, with foreign nations, and Indian tribes. The "Dormant" Commerce Clause, also known as the "Negative" Commerce Clause, is a legal doctrine that courts in the United States have implied from the Commerce Clause. The idea behind the Dormant Commerce Clause is that this grant of power implies a negative converse — a restriction prohibiting a state from passing legislation that improperly burdens or discriminates against interstate commerce. The question of to what extent states can legally compel remote retailers to collect the tax, however, has been a subject of extensive disagreement.

Under existing state 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 or a purchaser may report the tax on the purchaser’s state income tax return (if that purchaser is not registered with the Board).

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 such that the state will impose 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.

Under Section 6203, the following retailers are considered “engaged in business in this state” and are required to collect the California use tax on sales made to California consumers:

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- (1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.
- (2) 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.
- (3) Any retailer deriving rentals from a lease of tangible personal property situated in this state.

The Board's Regulation 1684, *Collection of Use Tax by Retailers*, clarifies Section 6203 and specifies that the use of a computer server on the Internet to create or maintain a web page or site by an out-of-state retailer is not considered a factor in determining whether the retailer has a substantial nexus with California. The regulation further clarifies that an Internet service provider or other Internet access service provider, or World Wide Web hosting services shall not be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.

#### **PROPOSED LAW**

This bill would amend Section 6203 of the Sales and Use Tax Law to specify that a "retailer engaged in business in this state" includes any retailer entering into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers of tangible personal property, whether by a link or an Internet Web site or otherwise, to the retailer, if the cumulative gross receipts or sales price from sales by the retailer to customers in this state who are referred pursuant to these agreements is in excess \$10,000 during the preceding four calendar quarterly periods.

The bill clarifies, however, that these provisions shall not apply if the retailer can demonstrate that the resident with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution during the four quarterly periods in question.

The bill would take effect January 1, 2010.

#### **BACKGROUND**

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to a use tax collection responsibility on goods purchased from out-of-state retailers – either through mail order or over the Internet.

Under constitutional law, states lack jurisdiction to require out-of-state retailers to collect a sales or use tax when the retailer has no "physical presence" in the taxing state. In 1992 the Supreme Court issued a ruling in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298 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 substantial nexus in the taxing state before that state can require the retailer to collect its use tax.

For example, when a California resident purchases a coat from L.L. Bean, Inc. through its web site, the purchaser's use of that coat in California is subject to California's use tax. The most practical means for the state to enforce the tax is to have L.L. Bean, Inc. collect the tax at the time of sale. Because L.L. Bean, Inc. does not have substantial nexus in California, however (e.g., it neither owns nor rents property in the state, hires no employees or independent contractors here, and delivers all of its merchandise into the state through common carriers), California is constitutionally prohibited from requiring L.L. Bean, Inc. to collect the tax. If the purchaser fails to remit the tax to California, and escapes sales or use taxation, a tax gap is created. It is estimated that this gap in California's sales and use tax system, costs the state nearly \$1.1 billion in state tax revenues.

**New York, Amazon, and Overstock.com.** The state of New York, as part of its budget, enacted legislation in 2008 entitled "the Commission-Agreement Provision" that presumes a retailer "solicits" business in the state if an in-state entity is compensated for directly or indirectly referring customers to the retailer – language that is substantially similar to this measure. Last April, Amazon sued New York's taxation department. Then, in May, Overstock suspended its relationships with any affiliates that had a New York address. And in June, the company joined Amazon in its suit, challenging the constitutionality of the tax law.

Both Amazon and Overstock contended that the law violates the Commerce Clause of the U.S. Constitution and the Due Process Clause of the Fourteenth Amendment to the Constitution and sought a permanent injunction prohibiting New York from enforcing the law.

Seattle-based Amazon argued that it did not have a sufficient nexus (physical presence) in the state to be compelled to collect use tax and basically contended that the new law intentionally targets Amazon. Additionally, Amazon said the law is vague and overly broad because Amazon has no way of knowing whether its affiliates, who provide addresses in other states, are legal residents of New York.

The New York Supreme Court dismissed both the Amazon and Overstock suits, ruling that the Commission-Agreement Provision does not broadly tax any and all Internet sales to New York consumers in that it requires a substantial nexus between an out-of-state seller and New York through a contract to pay commissions for referrals with a New York resident along with realization of more than \$10,000 of revenue from New York sales earned through the arrangement. Further, the Court stated that the neutral statute simply obligates out-of-state sellers to shoulder their fair share of the tax collection burden when using New Yorkers to earn profit from other New Yorkers.

It is possible that both Amazon and Overstock will appeal these rulings. If they decide to, they would pursue the issue with the New York State Supreme Court Appellate Division, and if necessary, to the New York State Court of Appeals. Because it is a constitutional issue, that matter could in theory ultimately be pursued to the U.S. Supreme Court.

**Past legislative efforts.** In 1999, a group of local booksellers sought assistance from the Legislature to level the playing field for those Internet retailers who claim to be out-of-state remote sellers but who are, in reality, California brick-and-mortar businesses.

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Specifically, the local booksellers believed the Borders online and Barnes and Noble online stores should be required to collect the California use tax on their sales to California consumers just as their California “bricks-and-mortar” stores collect sales tax reimbursement. These out-of-state retailers had formed separate legal entities from their corporate affiliates to sell similar goods as in the “bricks-and-mortar” stores throughout the country, including California, and believed they were not required to collect the California use tax. In response, Assemblywomen Carole Migden and Dion Aroner introduced AB 2412 in 2000 to clarify that a retailer is presumed to have an agent within the state if the retailer is related, as specified, to a retailer maintaining sales locations in this state, provided the retailer sells similar products under a similar name as the California retailer, or facilities or employees of the related California retailer are used to advertise or promote sales by the retailer to California.

The Legislature passed the bill; however, Governor Davis 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.

“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.”

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.

Also, during the 2003-04 Session, SB 103 (Alpert) was introduced to include similar provisions, and to also include a provision that would have specified 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. That measure was subsequently gutted and amended on the Assembly Floor with unrelated provisions.

During the 2007-08 Session, Assembly Member Calderon introduced two other measures that would have imposed a use tax collection duty on out-of-state retailers to the extent allowable under the law. Both AB 1840 and ABx3 2 would have provided that a “retailer engaged in business in this state” means any retailer that has substantial

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nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty. AB 1840 failed passage on the Assembly floor and ABx3 2 was never heard in committee.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author in order to provide an even playing field so that on-line retailers making taxable sales to California consumers are treated similarly as California bricks and mortar stores are treated under California's sales and use tax system.
2. **Why just conform to New York's statute?** Different courts have interpreted *Quill* in different ways, reaching divergent conclusions about physical presence in cases with similar facts. The defining line between slightest and substantial presence varies from state to state. It is not unusual to see dissenting opinions and higher courts disagree with lower courts. A business with similar operations in two states might find that it is required to collect sales or use tax in one but not the other.

In addition to specifying one type of activity that would require certain out-of-state retailers to collect California's use tax as this bill is proposing, perhaps consideration should be given to broadening the nexus statute to include other activities that have passed constitutional muster in other states. For example, in over 20 states, including New York, Minnesota, and Louisiana, warranty services performed by third party independent contractors create nexus for out-of-state sellers.

3. **This bill is slightly different from New York's statute.** New York's statute is clear that if the cumulative gross receipts from all the referrals by New York residents are over \$10,000 in the prior four quarterly reporting periods, the seller is presumed to be a vendor and required to be registered for use tax purposes and required to collect the tax on all of its taxable sales to New York consumers. This bill (on page 3, lines 10-14), isn't entirely clear that the phrase "pursuant to these agreements" is intended to refer to all the agreements made between the retailer and all the residents of California who enter into such agreements with the retailer. To clarify, it is recommended that on page 3, line 12, "pursuant to these agreements" be replaced by "to the retailer by all residents with these agreements with the seller."

Also, the New York statute provides that a seller that makes sales in the state of New York is *presumed* to be a vendor required to be registered for sales tax purposes and required to collect sales tax on all of its taxable sales in New York State Department when the specific requirements are met. This bill does not contain a presumption, but rather, amends the definition of "retailer engaged in business in this state" for purposes of imposing a use tax collection duty when the specific requirements are met.

4. **Related legislation.** ABx3 27 (Calderon) contains a provision similar to this bill, and also contains a provision that would further expand the definition of a "retailer engaging in business in this state" to include any retailer having a 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 *servicing or repairing* any tangible personal property.

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**COST ESTIMATE**

Enactment of this bill could have an increase in the Board's workload attributable to identifying and notifying affected out-of-state retailers, registering retailers, amending the Board's regulation, pursuing collection efforts, and perhaps increased costs related to appeals and litigation. An estimate of these costs is pending.

**REVENUE ESTIMATE****BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

Studies indicate that U.S. internet retail sales have increased by 16.6% in 2008 to \$204 billion. Amazon.com Inc. is America's top e-commerce retailer with sales volume of \$19.2 billion in 2008, including \$10.2 billion in North America. Overstock.com revenues totaled \$834 million in 2008. CSN Stores, another e-commerce company based in Massachusetts and founded in 2002, has grown to over 200 online stores. CSN stores also operate by using affiliate or associate programs in various states including New York and California. In 2008, CSN had \$202 million in revenue - nearly doubling its 2006 revenue of \$109 million. The company is expected to continue to grow in double digits. Amazon, Overstock, and CSN Stores as well as most large e-commerce merchants operate affiliate or associate programs.

These programs are intended to encourage other websites to send potential customers to the e-commerce sites by paying commissions or referral fees. For example, Amazon.com's "Associate Program" allows its "associates" to offer books and other products on their sites, through special links to Amazon. When a customer comes to the associate's site, he or she is transported to Amazon's site through a link. If the customer purchases something, Amazon commits to the "associate" a commission or referral fee, generally between 5 and 15 percent of the purchase price.

We do not have precise information on the specific e-commerce retailers that would be regarded as retailers engaged in business in this state under the provisions of the bill. However, we would expect that the same e-commerce retailers that have affiliate programs through California residents would be similar as those e-commerce retailers in New York.

According to staff at the New York Department of Taxation and Finance, New York will collect \$68 million in state and local sales and use tax in fiscal year 2008-09, ending March 31, 2009. New York's state and local average tax rate is 8%. The estimated taxable sales from the revenue reported by New York amounts to \$850 million (\$68 million / 8%).

In order to determine the amount taxable sales for California for this measure, we compared New York's population to California's population and found that New York's population is 51.2% of California. Using this factor, we estimate that California's taxable sales would amount to \$1,661 million (\$850 million / 51.2%). The estimated state and local revenue gain in California from this bill would amount to \$149.5 million (\$1,661 million x 9%).

**REVENUE SUMMARY**

The estimated annual revenue gain from this proposed change in the definition of a “retailer engaging in business in this state” would amount to \$149.5 million as follows:

	<u>Revenue Gain</u>
State (6.00%)	\$ 99,700,000
Fiscal Recover Fund (0.25%)	4,100,000
Local (2.00%)	33,200,000
Special District (0.75%)	<u>12,500,000</u>
	<u>\$ 149,500,000</u>

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