DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**06/01/09**	Bill No:	**AB 711**
Tax:	**Use Tax**	Author:	**Calderon**
Related Bills:	**AB 469 (Eng)** **SBx3 17 (Ducheny)**		

BILL SUMMARY

This bill would require a qualified purchaser, as defined, to register with the Board and report and pay by April 15, the use tax owed for the previous calendar year.

SUMMARY OF AMENDMENTS

Since the previous analysis, this bill has been amended to delete double joining language with AB 817.

ANALYSIS

CURRENT LAW

Under existing law, Chapter 3 (commencing with Section 6201) of Part 1 of Division 2 of the Revenue and Taxation Code imposes a use tax 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 on the purchaser's state income tax return filed with the Franchise Tax Board. Generally, a use tax liability occurs when a California consumer or business purchases tangible items for their own use from an out-of-state retailer that is not registered with the Board to collect the California use tax.

PROPOSED LAW

This bill would add Section 6225 to the Revenue and Taxation Code to require "qualified purchasers" to register with the Board and report and pay by April 15, the use tax owed for purchases made during the preceding calendar year. The bill would define "qualified purchaser" as a person that meets all of the following conditions:

(1) The person is required to hold a business license as required by the local ordinance of the city, county, or city and county in which the person conducts business.

(2) The person is not required to hold a seller's permit pursuant to this part.

(3) The person is not required to be registered pursuant to Section 6226.

(4) The person is not a holder of a use tax direct payment permit as described in Section 7051.3.

The bill would become operative July 1, 2010.

IN GENERAL

In 1933, California enacted its first retail sales tax. Within a few years of the adoption of the sales tax, California retailers believed they were facing unfavorable competition from retailers in states that had not adopted a sales tax. Customers could choose to go to a neighboring state without a sales tax and avoid paying the tax on their purchases. California responded to this challenge in 1935 by adopting a use tax. The use tax is virtually identical to the sales tax, except it is imposed on the storage, use or consumption of the goods; and the tax is imposed on the sales price of the good. The intent of a use tax is to offset the incentive to purchase from retailers in other states with low sales tax rates or no sales tax.

Although the use tax is now generally imposed by every state that has a sales tax, there has been limited success in collecting the use tax. Unlike the retail sales tax which requires in-state retailers to remit the sales tax, states have been unable to impose a similar compliance and collection requirement on out-of-state retailers for the use tax (an out-of-state retailer is required to have physical presence in a state in order to require that retailer to collect the use tax).

Therefore, California must rely on purchasers to report their use tax obligations on their out-of-state purchases, such as those made over the Internet or through mail order. And, even though a separate line is currently on the state income tax return with accompanying instructions in the booklet for use tax reporting, the compliance rate remains very low. Unreported use tax is the largest area of noncompliance in California's sales and use tax program - an estimated $1.2 billion annually is attributable to unreported California use tax by both businesses and individual consumers. For 2008, the Franchise Tax Board processed over 18.5 million returns, yet only 44,114 state income tax returns had use tax reported, yielding only $9 million in state and local use tax revenues.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author in order to increase revenues to the state by requiring larger businesses that are not already registered, to register with the Board and remit use tax on their untaxed purchases from out-of-state retailers.
2. **The June 1, 2009 amendments** delete the double joining provisions to AB 819. **The May 4, 2009 amendments,** among other things, added an operative date of July 1, 2010.
3. **The majority of taxpayers affected by this measure would be small businesses that would likely have little or no use tax liability.** We examined codes for service enterprises using the North American Industry Classification System against the Internal Revenue Service corporate and Schedule C data for calendar year 2007. About 1.3 million taxpayers not holding a seller's permit were identified. Of these, more than 800,000 taxpayers reported annual gross receipts of less than $20,000. Board staff has estimated that taxpayers with gross receipts of over $100,000 annually would incur approximately 95% of the use tax liability. Considering the administrative expense related to registering 1.3 million taxpayers and processing returns for many taxpayers that have little to no use tax liability (see cost estimate on page 4), the author may wish to amend the bill to require registration for only those taxpayers with annual gross receipts from business operations in excess of $100,000.

4. **Not all local jurisdictions require business licenses; and not all businesses are required to hold such licenses.** The bill would require only those taxpayers required to hold a local business license to register. However, a random sampling of local jurisdictions disclosed that business licenses are not required of all businesses. For example, Santa Clara County does not require businesses located within the unincorporated area of the county to hold a business license. Sacramento County does not require financial institutions, residential facilities, churches, libraries, and certain agricultural industries to hold a business license. It is therefore recommended that this condition be stricken from the bill.

5. **Some taxpayers currently report use tax voluntarily and should be excluded.** Currently, the Board has about 4,800 taxpayers that voluntarily report their use tax obligations to the Board, and some do so on a quarterly basis. In order to not disrupt the reporting habits of these taxpayers, it is suggested that they be excluded from this bill. The following language is suggested on page 2, after paragraph (4) of proposed subdivision (c):

   (5) The person is not otherwise registered with the board to report use tax.

6. **Related Legislation.** AB 469 (Eng), sponsored by the Board, would *require* consumers (including businesses not already registered with the Board, such as those affected by this measure) who have failed to report use tax to the Board on their taxable purchases for the preceding year to report the use tax on the income tax returns for the taxable year in which the liability for the qualified use tax was incurred, as specified.

   SBx3 17 (Ducheny), a budget trailer bill that contains a number of revenue and taxation provisions, also contains provisions similar to this bill, except that measure would limit registration to purchasers with at least one hundred thousand dollars ($100,000) in gross receipts from business operations per calendar year.

COST ESTIMATE

Significant costs would be incurred if this bill were enacted to identify, notify, and register all affected businesses, and to process additional returns annually. These costs are estimated as follows:

Year	Positions	Amount	Costs
First	573.2	$50.8 million	G* $36.0 million; R** $14.8 million
Second	618.9	$44.0 million	G $31.2 million; R $12.8 million
Third	609.8	$42.4 million	G $30.1 million; R $12.3 million
Fourth and subsequent	619.9	$43.7 million	G $31.0 million; R $12.7 million

* G = General Fund
**R = Local Reimbursement

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

In June 2007, the Board released use tax revenue estimates associated with electronic commerce and mail order purchases.[1] The estimate of business-to-business (B-to-B) revenue losses in this publication was $682 million. The average statewide state and local sales and use tax rate used in calculating this estimate was 7.94 percent.

Earlier this year, legislation increased the sales and use tax rate by one percentage point effective April 1, 2009 [ABX3 3 (Chapter 18), Statutes of 2009]. As a result of this legislation and other local voter-approved measures, the average statewide state and local sales and use tax rate we now use for revenue estimation purposes for fiscal year 2009-10 is 9.00 percent.

The table below shows calculations made to update the 2007 B-to-B estimate to reflect an average statewide state and local sales and use tax rate of 9.00 percent instead of 7.94 percent. No other changes were made to the data or assumptions used in the 2007 calculations.

Business to Business Electronic Commerce Revenue Calculations		
U.S. Remote Sales		$896,510
California-Taxable Share	x	40.0%
Noncompliance Rate	x	20.0%
CA Share of U.S. Sales	x	12.0%
Use Tax Rate	x	9.00%
Sales and Use Tax Revenues	=	

Board data indicate that about 20 percent of registered taxpayers fail to pay use tax on purchases from out-of-state vendors. If we assume a 20 percent noncompliance rate for new taxpayers who register under this bill, this implies that the revenue increase will be 80 percent of $775 million, or about $620 million.

However, since our initial revenue estimate was prepared in April, newly-available preliminary data indicate that California taxable sales have declined sharply since 2007. This is corroborated by national data from the U.S. Department of Commerce. Our initial estimate used a 2007 figure for business-to-business (B to B) electronic commerce sales, and assumed no change thereafter. This revised version assumes a pattern of B to B sales for subsequent years that follows the forecasted percent change in national spending on business equipment and software, according to a leading national macroeconomic forecasting firm. For instance, that forecast assumes that business spending on equipment and structures in 2009-10 will decline by 18 percent, before rebounding (particularly in 2011-12 and 2012-13) as the economy recovers from the current recession.

[1] Revenue Estimate, "Electronic Commerce and Mail Order Sales," Board of Equalization, June 11, 2007.

The initial estimate assumed an 80 percent compliance figure for firms affected by these provisions, the same as for firms currently registered at the Board. This revised version assumes a lower initial compliance rate. In our initial estimate in April, we did not have subsequently available data indicating that the compliance rate for new firms should be lowered. This data includes revenue from the implementation of the Instate Service Business component of the Board's Tax Gap program that began in July 2008. Summary results indicate that achieving an initial compliance rate of 80% would be very difficult. In addition, we looked at the voluntary compliance rate from the use tax line on income tax returns administered by the Franchise Tax Board and found that the compliance rate was less than one percent. Therefore, based on these factors, we believe that to be prudent the initial compliance rate should be reduced to 25%. However, we feel that, over time, outreach efforts will produce a comparable 80 percent compliance rate for firms registering under this bill.

Further, we lowered the initial estimate to reflect the success of current use tax-related tax gap programs already in place. As noted above, the Board implemented the Instate Service Business component of the Tax Gap program in July of 2008. Initial efforts involved (1) sending letters to service industry firms identified as the most likely (based on information from EDD, FTB and other sources) to have a use tax liability and (2) providing the information resources so that they understand and may choose to comply voluntarily. In cases where voluntary compliance is not obtained, the BOE will implement an enforcement program similar to what currently exists under the sales and use tax program. Based on preliminary results of this program (which were not available in April), we believe the Board will collect additional use tax revenue amounting to $70 million if FY 2010-11, absent AB 711. However, beginning in FY 2011-12 the revenue from the Instate Service Business component of the Tax Gap program will be reduced to $66 million, then to $62 million annually thereafter because of the lower tax rate as explained below.

On July 1, 2011, ABX3 3 (Chapter 18, Statutes of 2009) will sunset, the state (General Fund) sales and use tax rate will decrease from 6.0% to 5.0%, and the statewide average tax rate will be reduced from the current rate of 9.0% to 8.0% (subject to changes in the local tax rates). The revenue estimate reflects the lower tax rates in the out years.

REVENUE SUMMARY

The revenue increase is estimated to be $94 million in FY 2010-11, increasing to $613 million in FY 2013-14. The details are shown in the table below.

	Revenue Gain			
	2010-11	2011-12	2012-13	2013-14
	(Revenue dollar amounts in millions)			
Business-to-Business Sales Subject to Use Tax	$ 7,283	$ 8,517	$ 9,722	$ 10,544
Percent Change from Previous Year	6.2%	16.9%	14.1%	8.5%
Compliance Rate Assumed	25%	40%	60%	80%
Preliminary Use Tax Revenue	164	290	467	675
Less Collections from BOE's Tax Gap Program	-70	- 66	-62	-62
Net Use Tax Revenue	$ 94	$ 223	$ 404	$ 613
State General Fund	63	145	253	383
State Fiscal Recovery Fund	3	7	13	19
Local Funds	29	72	139	211

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