



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

DRAFT

Date Introduced:	01/24/08	Bill No:	AB 1840
Tax:	Sales and Use	Author:	Calderon
Related Bills:	AB 2c (Calderon)		

BILL SUMMARY

This bill would specify that a “retailer engaged in business in this state” means any retailer that has substantial 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.

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 whether such a negative implication should be recognized, and how far it should extend, 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 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 to warrant 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 a retailer is *not* engaged in business in this state based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services on property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar.

Thus, an out-of-state retailer whose sole presence in California is through its use of employees who travel to California to do warranty work, even if only minimally, is regarded as engaged in business in California and is required to collect the California use tax on all its sales to California consumers. However, if an out-of-state retailer whose sole presence in California is through a third party independent contractor performing repair work on property sold by the retailer, that out-of-state retailer is not regarded as engaged in business in California and is not required to collect use tax on sales made to California consumers.

Regulation 1684 further clarifies 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" means any retailer that has substantial 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.

The bill would make other nonsubstantive changes to Section 6203.

The bill would take effect on January 1, 2009.

BACKGROUND

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to impose sales or use taxes 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, this creates a tax gap. 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.

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. 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, the Governor 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.

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“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.

Throughout this same period, the Board considered appeals from these online retailers that had been assessed use tax on their sales to California consumers.

Borders Online. Borders Online (Online) had a notice on its web site stating that if customers wanted to return merchandise purchased from Online, the customers had several choices, including returning the merchandise to a local Borders store (Borders). When Online was advised that this was sufficient to bring it within the definition of “retailer engaged in business in this state,” it removed the notice from its web site. It did not, however, change its policy. Borders would take returns from anyone (presumably if the returned goods were in like-new condition) and would provide a store credit. Borders would even accept returns on this basis from its competitors. When it did so, it clearly was doing so on its own behalf (good will, bringing customers in, etc.), and not on behalf of its competitors. Just like a purchaser of a book from any other retailer, a person purchasing a book from Online could return it to any Borders for a store credit. Borders also provided preferential returns, not offered to customers of any other retailer, for its own customers and for customers of Borders Online. Customers from either Borders entity could, with a proper receipt, obtain a cash refund of the purchase price.

The Board concluded that Borders was authorized to act for Online in accepting returns and that Borders did so as the representative of Online in this state. The Board further held that accepting returns on behalf of an out-of-state retailer is a selling activity coming within subdivision (c)(2) of Section 6203, and that imposing a use tax collection duty under that provision satisfied the requirements of the United States Constitution. Litigation ensued and the California Court of Appeal held that Borders acted as Online’s representative in California for purposes of accepting returns from Online’s California purchasers and that the acceptance of returns for Online was a selling activity under Section 6203. This Court further held that Online had substantial nexus with California,

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and that requiring Online to collect and remit the use tax does not violate the commerce clause of the United States Constitution. (*Borders Online, LLC v. State Board of Equalization* (2005) 129 Cal.App.4th 1179.)

Barnes and Noble.com. Another case that came before the Board and that is currently in litigation involved Barnes and Noble.com (bn.com), a separate and distinct legal entity from Barnes & Noble Booksellers, Inc. (Booksellers) – the traditional “bricks-and-mortar” stores in California. The local stores were regarded as the authorized representative in this state for the purpose of distributing coupons.

In mid-November 1999, the local stores began distributing discount coupons in California for purchases made through bn.com’s web site. The customers received the coupons as an insert in the shopping bags into which their purchases from the store were placed by the local stores’ employees. The coupons offered a \$5 discount on a purchase from bn.com of \$25 or more, with certain restrictions. The coupons expired on January 31, 2000. As to this joint marketing campaign, bn.com paid the costs both for printing coupons and for stuffing the coupons into the promotional shopping bags. Employees in California handed customers shopping bags that contained both bn.com’s and Bookseller’s logos and that contained the coupons. This conduct served as evidence that the local stores had the authority to distribute the coupons on the dot-com company’s behalf. Because the distribution of the coupons occurred, among other places, in California, the Board determined that the in-state store’s authorized coupon distribution in this state constituted a “selling” activity on bn.com’s behalf under subdivision (c)(2) of Section 6203. The trial court ruled in favor of bn.com and the Board has filed a notice of appeal. No final decision has been issued.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author in order to increase use tax revenues by imposing a use tax collection duty on out-of-state retailers to the extent the Commerce Clause and federal law allow.
2. **What impact would enactment of this bill have on California?** Different courts have interpreted *Quill* in different ways, reaching divergent conclusions about physical presence in cases with similar facts. The language of this measure would essentially require the Board to decide the meaning of “substantial nexus” as it applies to California’s use tax provisions and extend the obligation to collect the use tax to those retailers that are deemed to be engaged in business in this state as provided by federal law. Since the Court ruled in *Quill*, considerable debate has revolved around, for example, how much physical presence is sufficient to create substantial nexus, and whether nexus can be attributed to the out-of-state retailer through the physical presence of that retailer’s agent or affiliate, through a server, or through an independent contractor performing non-selling activities in a taxing state. This bill would enable California to enforce California’s use tax law to the fullest extent allowed under the federal constitution.
3. **Related legislation.** AB 2c (Calderon) is identical to this bill.

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.

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REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

In our updated June 7, 2007 e-commerce and mail order estimate, we summarized that the annual state and local revenue loss from unreported use tax associated with out-of-state Internet and mail order sales amounted to \$1.091 billion per year. This measure could expand the Board’s ability to include out-of-state Internet and mail order retailers that are currently not considered as having nexus under current Section 6203, and require them to register and collect use tax from California consumers. It is unclear to what extent this bill would expand California’s ability to impose a use tax collection duty on these retailers. However, if this measure expands nexus to some of those out-of-state retailers not currently required to collect the use tax, the amount of additional revenue could result in between 1% and 5% (\$11 million to \$55 million) of the \$1.1 billion in lost state and local revenue from Internet and mail order sales as follows:

REVENUE SUMMARY

The state, local, and special district revenue impacts associated with this bill are estimated to be at least:

	Possible Revenue	
	(in millions)	
	From	To
	1%	5%
State (5.00%)	\$ 6.9	\$ 34.6
Fiscal Recover Fund (0.25%)	.3	1.7
Local (2.00%)	2.8	13.8
Special District (0.70%)	1.0	4.9
Total Revenue Gain	\$ 11.0	\$ 55.0

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