



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	06/24/10	Bill No:	AB 2078
Tax:	Sales and Use	Author:	Calderon
Related Bills:	AB 178 (Skinner) AB 193 (Budget Committee) ABx3 19 (Evans) ABx3 27 (Calderon) SBx3 17 (Ducheny) SBx8 8 (Budget Committee)		

BILL SUMMARY

This bill would do the following:

- Provide a rebuttable presumption that any retailer is engaged in business in this state if the retailer is part of a controlled group of corporations that has a component member that is a retailer engaged in business in this state.
- Require each retailer that is not required to collect use tax to provide notification on its retail Internet Web site or catalogue that tax is imposed on the storage, use, or other consumption in this state of the tangible personal property purchased from the retailer that is not exempt, and is required to be paid by the purchaser, unless a statutory exemption applies.

SUMMARY OF AMENDMENTS

The amendments to this bill since our last analysis (1) added back and then again deleted the provision that would have required larger retailers not required to register with the Board who sell tangible personal property subject to use tax to file a report with the Board regarding those sales, and (2) added the rebuttable presumption relating to retailers that are part of a controlled group of corporations (this provision was in the introduced version of the bill).

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 California's Sales and Use Tax 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

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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 generally 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 taxable sales to California consumers.

Under subdivision (c) of 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:

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. As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state.
4. Any retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any banking, financing, debt collection, telecommunication, or marketing activities occurring in this state or benefits from the location in this state of authorized installation, servicing, or repair facilities. (This paragraph will become operative only when Congress authorizes states to compel the collection of state sales and use taxes by out-of-state retailers.)

PROPOSED LAW

This bill would amend Sales and Use Tax Law Section 6203 to provide a rebuttable presumption that any retailer that is part of a controlled group of corporations, as defined, and that controlled group of corporations has a component member that is a retailer engaged in business in this state, as described, is presumed to be a retailer engaged in business in this state. The bill provides that this presumption may be rebutted by evidence that during the calendar year at issue the component member that is a retailer engaged in business in this state did not engage in any of the activities described in paragraphs (1), (2), (3), or (4) of subdivision (c) of Section 6203 on behalf of the retailer.

The bill would also add Section 6208 to the Sales and Use Tax Law to require each retailer that is not required to collect use tax to provide notification on its retail Internet Web site or catalogue that tax is imposed on the storage, use, or other consumption in this state of the tangible personal property purchased from the retailer that is not exempt, and is required to be paid by the purchaser, as provided.

The provisions of the bill would become effective on January 1, 2011.

BACKGROUND

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to impose a use tax collection responsibility on out-of-state retailers for the sale of goods shipped into the taxing state. Such transactions are generally conducted either through mail order, telephone orders, or via 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 an opinion 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.

Courts have relied on the United States Supreme Court's decisions in *Scripto, Inc. v. Carson*, 362 U.S. 207, 213 (U.S. 1960) and *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232, 249 (U.S. 1987) (quoting the Washington Supreme Court decision on appeal, *Tyler Pipe Indus. v. Dep't of Revenue*, 715 P.2d 123, 125 (Wash. 1986)) that an out-of-state seller has nexus by attribution of a third party's in-state activities when: 1) the third party is acting "on behalf of" the out-of-state seller, and 2) the third party's activities are "significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Tyler Pipe*, 483 U.S. at 247-48.

"Nexus by attribution of a third party's in-state activities" has been demonstrated in cases such as *Scholastic Book Clubs, Inc. and Borders Online*. In the Scholastic case, its use of teachers and school librarians to solicit sales from students constituted sufficient nexus to require Scholastic, an out-of-state retailer, to collect use taxes imposed on the students' purchases. Once the teachers and librarians undertook to solicit orders, they were acting under Scholastic's authority as its representatives and Scholastic owed the use tax. *Scholastic Book Clubs, Inc. v. State Board of Equalization* (1989) 207 Cal.App.3d 734.

In the *Borders Online* case, *Borders Online*, an out-of-state retailer, was required to collect California use tax arising from its sales, where representatives of its separately owned and operated *Borders* bookstores located throughout California were permitted to accept returns from *Borders Online* customers. The in-state representative was authorized to take the returns, and the taking of returns is regarded as part of promoting sales. *Borders Online, LLC v. State Board of Equalization* (2005) 129 Cal.App.4th 1179.

Since the late 1990s, online shopping has taken off as an increasing number of businesses and consumers purchase increasingly diversified products on the Internet. That, combined with the states' inability to require a use tax collection requirement on many out-of-state retailers, has prompted many states to seek new ways to enforce their use tax laws (every state that has a sales tax imposes the use tax). Recently, the states of New York and Colorado have enacted laws with different approaches. In 2008, New York revised its statutes to create a presumption that a retailer "solicits" business in the state if an in-state entity (commonly referred to as an affiliate) is compensated for referring customers directly or indirectly to the retailer. This change in law required the larger Internet retailers that have affiliate programs, such as Amazon.com and Overstock.com, to begin collecting the tax on sales to New York purchasers (both retailers have filed suit, and the New York Supreme Court dismissed those suits; however, the matters are currently on appeal).

Colorado's approach, portions of which are similar to this bill, became effective in March, 2010. Colorado's new law contains the rebuttable presumption regarding retailers that are part of a controlled group of corporations, as is in this bill. In addition, Colorado requires a reporting requirement for Internet sellers, including:

- Invoices to Colorado customers must note that use tax applies to taxable purchases and must be reported by the purchaser.
- An annual report must be provided to their Colorado customers on all purchases.
- An annual report must be filed with the Colorado Department of Revenue with customer names and addresses and total amount of purchases.

Colorado's law also provides for a penalty of \$5 per invoice without use tax information, and \$10 penalty per failure to provide annual customer reports. Colorado's emergency regulation related to these provisions specifies that out-of-state retailers that made total gross sales in the prior year of less than \$100,000 and reasonably expects sales in the current year will be less than \$100,000 shall be exempt from these requirements.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. It is patterned after Colorado's statute enacted in February 2010, and is intended to minimize the use tax gap by imposing a use tax notice obligation on those out-of-state retailers that are not regarded as "engaged in business" in California.
2. **The June 24, 2010 amendments** (1) delete the provision that would have required larger retailers not required to register with the Board who sell tangible personal property subject to use tax to file a report with the Board regarding those sales, and (2) add the rebuttable presumption related to retailers that are part of a controlled group of corporations (this provision was in the introduced version of the bill). The **June 16, 2010 amendments** added provisions that were also originally in the introduced version of this bill that require larger retailers not required to register with the Board who sell tangible personal property subject to use tax to file a report with the Board regarding those sales. **The April 27, 2010 amendments** deleted provisions that would have (1) created a rebuttable presumption that any retailer is engaged in business in this state if the retailer is part of a controlled group of corporations that has a component member that is a retailer engaged in business in this state, and (2) required larger retailers not required to register with the Board who

sell tangible personal property subject to use tax to file a report with the Board regarding those sales.

3. **The proposed amendments to Section 6203, while narrower than current application of Section 6203, could assist the Board in some situations.** In order for a retailer to be regarded as part of a “controlled group of corporations” under the Internal Revenue Code (IRC), as this bill requires, specific stock ownership and other requirements are necessary. However, under current interpretations of Section 6203, as upheld in such cases as the Scholastic Book Clubs and Borders Online cases previously explained, an out-of-state retailer is considered to have sufficient nexus, and is required to collect the California use tax, if the in-state retailer acts on the out-of-state retailer’s behalf under subdivision (c)(2) of Section 6203 (regardless of whether the relationship between the out-of-state and in-state retailer fits within the IRC definition of “controlled group of corporations”). One critical element of this determination is the out-of-state retailer’s sales return policies, such as in the Borders Online case. If the in-state retailer accepts returns of merchandise on behalf of the out-of-state retailer’s behalf, the Board regards the out-of-state retailer as a retailer engaged in business in this state who is required to register and collect the California use tax. However, these amendments may assist the Board in some circumstances to the extent that the out-of-state retailer would have the burden of showing that the in-state component member does not act on its behalf, whereas now the Board must discover evidence that the in-state retailer has acted on the out-of-state retailer’s behalf.
4. **What happens if an out-of-state retailer fails to comply with the notice requirements?** It is not certain whether the Board has the authority to enforce these tax obligation notices, due to the U.S. Supreme Court cases holding that a retailer must have a substantial nexus in the state in order to be required to collect use tax. It is unclear whether the notice mandate in the bill requires the same level of presence that a use tax collection obligation has. Also, the bill does not include any civil penalties or sanctions if an out-of-state retailer fails to comply with the Internet or catalog notification requirements.
5. **Related legislation.** During this 2009-10 Regular Session and extraordinary sessions, there have been several bills (i.e., AB 178, Skinner; ABx3 19, Evans, and ABx3 27, Calderon) introduced that would expand the definition of “retailer engaged in business in this state.” Unlike this bill, these other measures would have incorporated provisions in California law similar to New York’s described previously. Only one of these bills was approved by the Legislature; however, it was vetoed by the Governor (SBx3 17).

COST ESTIMATE

Absorbable costs would be incurred in notifying affected out-of-state retailers through press releases and notices, and updating the Board’s website and other publications.

REVENUE ESTIMATE

It is unknown how many out-of-state retailers would comply with the requirements of the bill, or how many California consumers would voluntarily report the use tax as a direct result of a retailer complying with the notice requirements in this bill. To the extent compliance with this bill is achieved, state and local revenues could increase.

Based on information released by the U.S. Census Bureau and other sources in 2009, we have updated our estimates of use tax losses associated with remote sales from out-of-state vendors. We now estimate annual revenue losses of \$1.085 billion in calendar year 2009 (to be remitted in fiscal year 2009-10). Of the total, \$600 million are owed by consumers and \$485 million were unpaid by businesses. We assume that the majority of business-to-business commerce does not occur through an internet site, and thus would not be impacted by this bill.

Anecdotal evidence suggests that perhaps 5 percent of the business-to-consumer sales would occur from firms that choose to comply with the provisions of this measure. In 2008, taxpayers voluntarily remitted use tax of about \$10 million using the use tax line on the state income tax returns (or roughly two percent of the estimated total). Assuming a similar compliance rate from people who make purchases from retailers who comply with this bill, we estimate a state and local revenue gain of about \$590,000 (\$590 million times 5 percent times 2 percent) from business-to-consumer sales. Any business-to-business sales conducted through the internet site of a retailer who complied with this bill would increase this revenue amount, but the total revenue gain would still likely be less than \$1 million.

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