# STATE BOARD OF EQUALIZATION
# STAFF LEGISLATIVE BILL ANALYSIS

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| Date Amended: | **04/06/10** | Bill No: | **AB 2676** |
| Tax: | **Sales and Use**<br>**Special Taxes and Fees** | Author: | **Ma** |
| Related Bills: | | Position: | **Support as Sponsor** |

## BILL SUMMARY

This Board of Equalization (BOE)-sponsored bill would do the following*:*

1. Allow the BOE to register certain persons that regularly incur a use tax liability, as specified, who are not otherwise required to be registered. *(Revenue and Taxation Code Section 6225.1)*
2. Eliminate the January 1, 2009 sunset date with respect to the provisions that provide for the separate line on the Franchise Tax Board (FTB) income tax returns for use tax reporting. *(Revenue and Taxation Code Sections 6452.1, 6453, 6487.3, and 18510)*
3. Make several changes to the provision in the Sales and Use Tax Law relating to the imposition of personal liability on responsible persons of corporations and other business entities, and add similar provisions to certain BOE-administered Special Taxes and Fees programs where circumstances would warrant the imposition of personal liability on an officer, partner, member, manager, or other responsible person, as specified. (*Revenue and Taxation Code Sections 6829, 7984, 9034, 43448.6, 45609.6, 46465, 55210, and 60494)*
4. Allow the BOE to use the new employee registry information maintained by the Employment Development Department (EDD) for tax enforcement purposes. *(Unemployment Insurance Code Section 1088.5)*

## ANALYSIS

### USE TAX REGISTRATION

*Revenue and Taxation Code Section 6225.1*

#### 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, unless the use of that property is specifically exempted or excluded from tax. 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. The use tax is the same rate as the sales tax and is required to be remitted to the BOE on or before the last day of the month following the quarterly period in which the purchase was made (except as noted below).

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 BOE to collect the California use tax. The largest area of noncompliance in the BOE's sales and use tax program is the reporting of use tax.

During the Fourth Extraordinary Session of the 2009 Legislative Session, ABx4 18 (Ch. 16) was signed into law to increase compliance with California's use tax laws. This bill requires businesses that are not already registered with the BOE that receive more than $100,000 annually in gross receipts from their business operations to register with the BOE and file annual use tax returns by April 15. The first returns under this new law are due April 15, 2010.

## PROPOSED LAW

This bill would add Section 6225.1 to the Sales and Use Tax Law to require every person who regularly incurs a use tax liability ($1,000 or more in use tax liability each year consecutively over a three-year period) to register with the BOE and file an annual use tax return.

The bill would specify that the first return due under this section shall be filed on or before April 15, 2011.

## BACKGROUND

Use tax is the complement to the state's sales tax and was enacted in 1935 to ensure California merchants are not operating at a competitive disadvantage to their out-of-state competitors with low sales tax rates or no sales tax. Today, with the convenience of Internet shopping, and the states' inability to require a use tax collection requirement on many out-of-state retailers, the competitive disadvantage many California retailers experience is exacerbated.

ABx4 18 was enacted in an effort to minimize this competitive disadvantage and to increase the collection of use taxes owed by the larger California businesses that do not make sales of tangible personal property but that may be incurring a use tax liability (such as real estate firms, law and accounting firms, and medical and dental offices). Use tax is the largest area of noncompliance under the BOE's sales and use tax program, and businesses that are not already registered with the BOE share the largest portion of the use tax gap.

The provisions of ABx4 18 that incorporate the $100,000 annual gross receipt requirement were added at the suggestion of BOE staff. Staff was concerned that, without this limitation, the BOE would incur significant administrative expenses related to registering approximately 1.3 million additional businesses and processing returns for many businesses that may have little or no use tax liability. By limiting the bill to mandatory registration only for those businesses that have at least $100,000 in annual gross receipts, staff estimated that the number of businesses that would require registration would be reduced to about 200,000, which would capture the majority of the use tax gap of businesses.

Beginning July 1, 2008 (before enactment of ABx4 18), the BOE began a program to enforce the use tax law by identifying businesses in the service industry that have a high potential for making purchases subject to use tax. Once identified, letters along with use tax returns were sent to those businesses informing them of the use tax requirements and instructing them to report their purchases subject to use tax over the last three-year period.

Through this program, staff has identified nearly 4,300 California businesses that have incurred substantial amounts of use tax. Most of these businesses will be required to register pursuant to the provisions of ABx4 18. However, staff has estimated that about 165 of those accounts will not be required to register under ABx4 18, as they do not meet the minimum $100,000 annual gross receipts requirement. However, staff determined that these 165 accounts are likely to regularly incur use tax of at least $1,000 each year over a three-year period.

### COMMENT

This provision is intended to capture a portion of the use tax gap that is not already captured under the provisions of ABx4 18, by requiring the registration of qualifying purchasers that regularly incur a substantial amount of use tax liability.

## SUNSET DATE - USE TAX LINE

*Revenue and Taxation Code Sections 6452.1, 6453, 6487.3, and 18510*

### CURRENT LAW

In an effort to increase the public's awareness of the use tax and to encourage voluntary compliance in reporting the use tax, legislation enacted in 2003 (SB 1009, Ch. 718) required the FTB to revise the personal income tax and corporation tax returns to add a separate line for use tax reporting and accompanying instructions in the booklet. This legislation allowed consumers and businesses that are not required to be registered with the BOE to report use tax on their state income tax returns for purchases made on or after January 1, 2003, and through December 31, 2009, as an alternative to reporting the tax to the BOE (businesses and certain consumers already registered with the BOE, however, may not use this alternative).

### PROPOSED LAW

This bill would amend Sections 6452.1, 6453, 6487.3, and 18510 of the Revenue and Taxation Code to eliminate the January 1, 2009 sunset date for the provisions that provide for the separate line on the FTB income tax returns for use tax reporting.

The bill would become effective on January 1, 2011, and would apply to taxable purchases made during the calendar year 2010 for which use tax was not paid to the BOE.

### BACKGROUND

During the past three Legislative Sessions, the BOE has sponsored legislation to not only eliminate the sunset date of these provisions, but to also *require* consumers who have failed to report use tax to the BOE 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. However, none of these attempts was successful. The first and third attempts (AB 969, 2007, Eng and AB 469, 2009, Eng) were vetoed by the Governor, and the second attempt (AB 1957, 2008, Eng) failed passage in the Senate Revenue and Taxation Committee. Rather than jeopardizing the use tax reporting option with the state income tax return with the *requirement* that the tax be reported on the income tax returns if a person failed to report the tax to the BOE (as all three failed measures proposed), this bill is limited to simply removing the program's sunset date.

### COMMENTS

The use tax line on the state income tax returns provides a simple means to both educate taxpayers and tax preparers as well as enable purchasers to report their use tax obligations.

Use tax reported under these provisions has increased each year since this section was enacted. In 2004, use tax of $2.8 million was reported, in 2005, $4.6 million, in

2006 and 2007, approximately $5.5 million was collected, in 2008, $9 million was reported, and in 2009, $10 million was reported. Surprisingly, individuals report a much greater proportion of the tax than businesses (in 2009, for example, businesses only reported $1.7 million of the total $10 million), yet businesses contribute a greater share of the use tax gap.

Prior to the inclusion of the use tax line on the income tax returns, individuals had to read far into the Form 540 instruction booklet for information regarding the use tax. In 2002, for example, use tax instructions were on page 60 in a 68-page book. Typically, individuals consult the 540 instruction booklet only if they have a question about a particular line on the return. Because there was no line provided for use tax reporting, individuals had little reason to look to the instruction booklet for use tax information.

If these sections become inoperative, use tax which might otherwise have been reported on the state income tax return may never be collected, resulting in losses to both state and local governments.

## PERSONAL LIABILITY CORPORATE OFFICERS

*Revenue and Taxation Code Sections 6829, 7984, 9034, 43448.6, 45609.6, 46465, 55210, and 60494*

### CURRENT LAW

Except for the Sales and Use Tax Law (Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code), the laws related to the other tax and fee programs administered by the BOE do not allow for the imposition of personal liability against corporate officers, shareholders, or other responsible persons of terminated or suspended corporations or other business entities for the entities' failure to pay its tax or fee obligations to the Board.

Since 1982, the Sales and Use Tax Law, in Section 6829, has authorized the BOE to impose personal liability on the officers, partners, members, managers, and other persons who control or supervise, or who are charged with the responsibility for the filing of returns or the payment of sales or use tax, or who are under a duty to act for a corporation, limited liability company (LLC), or various other business entities that have been terminated, dissolved, or abandoned. In order for the BOE to impose personal liability on such persons, the law contains two conditions: (1) that the BOE establish that the person willfully failed to pay or to cause to be paid any sales or use taxes due from the business entity, and (2) that the business entity actually collected sales tax reimbursement or use tax from its customers on its sales, or made purchases subject to use tax, and failed to report and pay the tax to the BOE.

In addition, in 2000, the BOE promulgated Sales and Use Tax Regulation 1702.6, which sets forth the personal liability of an officer or shareholder who has control over the operations or management of a *closely held corporation* during the time in which the corporation's powers, rights, and privileges are suspended and on any responsible person who fails to pay or to cause to be paid any sales and use taxes due from the closely held corporation while it is suspended, regardless of the basis of the suspension. Regulation 1702.6 also requires the BOE to establish that the corporation collected sales tax reimbursement or use tax and failed to report and pay the tax to the BOE, or purchased tangible personal property for its own use and failed to pay the applicable tax either to the seller or the BOE. Under the BOE's interpretation of the Sales and Use Tax Law, as reflected by Regulation 1702.6, a subsequent reviving of the suspended corporation cannot negate or cancel the liability of the responsible persons for the period of suspension under any circumstances. Regulation 1702.6 also does not provide for the imposition of personal liability of a member of a *closely held LLC* who failed to pay sales or use tax to the seller or the BOE.

Under existing law, two powers have the authority to suspend and revive a corporation or an LLC: the Secretary of State (SOS) and the FTB (pursuant to Corporations Code Sections 2205 and 17654 and Revenue and Taxation Code Sections 23301 and 23305.5, respectively). The SOS may suspend a corporation or LLC if it fails to file the annual "Statement of Information," and the FTB may suspend a corporation or LLC if it fails to file tax returns or pay any taxes that are owed.

## PROPOSED LAW

This bill would amend Section 6829 of the Sales and Use Tax Law to codify provisions contained in the BOE's Regulation 1702.6 regarding the imposition of personal liability of an officer or shareholder during the period of a closely held corporation's suspension, and it would add additional provisions as follows:

1. Impose personal liability on a member of a closely held LLC during the period of the LLC's suspension that has control over operations or management of the entity, if the LLC collected sales tax reimbursement or use tax and failed to report and pay the tax to the BOE, or purchased tangible personal property for its own use and failed to pay the applicable tax either to the seller or the BOE,
2. Relieve the officers, shareholders, or members of a closely held, suspended corporation or closely held suspended LLC of personal liability of sales and use tax deficiencies if they take all actions necessary to revive the corporation or LLC within 60 days of the imposition of the suspension, and
3. Specify an express limitations period with which the BOE may issue a determination against an officer, shareholder, or member of a closely held corporation or closely held LLC.

In addition, this bill would add to certain special tax and fee programs administered by the BOE Sections 7984, 9034, 43448.6, 45609.6, 46465, 55210, and 60494 to incorporate a provision comparable to Section 6829 of the Sales and Use Tax Law, as amended, with all of the provisions specified above.

## COMMENTS

These changes would encourage a responsible officer or shareholder of a closely held corporation, or responsible member of a closely held LLC, to take the necessary steps to resolve the issues that caused the suspension. The availability of such relief would promote greater overall compliance with the law by encouraging responsible persons to be vigilant in curing violations that resulted in the suspension of the entity's powers, rights and privileges.

To promote further uniformity and fairness, this bill would also extend the application of personal liability to closely held LLCs. Closely held LLCs are also subject to suspension by the SOS and FTB, and members should be held personally responsible when that LLC is suspended and failed to pay taxes or fees collected from customers or pay a use tax liability Additionally, the bill adds further clarity by providing an express statute of limitations provision for liabilities arising from suspension of closely held corporations or closely held LLCs.

Further, this bill would add a provision comparable to Section 6829, as amended, to certain special tax and fee programs administered by the BOE where the BOE currently lacks the authority to hold personally liable those persons responsible for misappropriating tax and fee amounts collected or received by business entities that have ceased business operations in California. In order to have effective tax and fee program administration, the BOE should have authority to impose such personal liability when the business entity's records reflect that a transaction included the tax or fee (even if the tax or fee was not separately stated on the receipt or invoice for the transaction), but the tax or fee amount in question was not remitted to the BOE. The BOE's current inability to impose personal liability where such misappropriation of tax or fee amounts has occurred permits the unjust enrichment of those persons responsible for the misappropriation and creates an unfair business advantage over other law-abiding California businesses.

The special tax and fee programs to which the responsible person liability provision is currently being added are: (1) the Motor Vehicle Fuel Tax Law; (2) the Use Fuel Tax Law; (3) the Hazardous Substances Tax Law (with respect to the disposal fee only); (4) the Integrated Waste Management Fee Law; (5) the Oil Spill Response, Prevention, and Administration Fees Law; (6) the Fee Collection Procedures Law (with respect to only the electronic waste recycling fee and the tire recycling fee); and (7) the Diesel Fuel Tax Law. Adding a provision comparable to Section 6829, as amended, to these programs, would also promote uniformity among the various tax and fee programs administered by the BOE with regard to the personal liability of a responsible person when a business entity is dissolved, terminated, or abandoned and during a period of suspension of a closely held corporation or closely held LLC, when a responsible person does not act promptly to revive the corporation or LLC.

## NEW EMPLOYEE REGISTRY DATA

*Unemployment Insurance Code Sections 1088.5*

### CURRENT LAW

Under existing law, Unemployment Insurance Code Section 1088.5 requires all employers to report information on newly hired or rehired employees who work in this state to the EDD within 20 days following the date the employee is hired. The information to be reported includes the employee's full name, address, social security number, and first date the employee worked. Employers are also required to report the business name and address, state employer identification number, and federal employer identification number. This EDD report is generally referenced as the "new employee registry."

Under Section 1088.5, the new employee registry information may only be used for programs administered by the EDD, FTB, public assistance programs, worker's compensation programs, and enforcement of child support obligations. Under current law, the BOE is *not* authorized to use the new employee registry.

### PROPOSED LAW

This bill would amend Unemployment Insurance Code Section 1088.5 to authorize the BOE to use information in the new employee registry for tax collection and enforcement purposes.

### BACKGROUND

In 1996, the federal Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) was signed into law. The primary purpose of PRWORA is to provide a strengthened child support enforcement program that locates non-custodial parents and enforces child support orders. One key provision of PRWORA related to child support orders is a requirement that all states have a program to report information about newly hired and rehired employees timely.

In 1997, pursuant to the federal PRWORA legislation, California enacted legislation (Ch. 606, AB 67, operative July 1, 1998) to establish a new employee registry. The purpose was to aid in the collection of debts of individuals who were able to avoid collection because the employer quarterly return information reported to EDD was received too late to be used as an effective collection information resource.

Also, because of the effectiveness of the new employee registry, in 2003, FTB sponsored legislation to use the registry for its non-tax debt collection programs. AB 1742 (Ch. 455, Stats. 2003, Committee on Revenue and Taxation) authorized FTB to use the registry when pursuing non-tax debt collection such as, vehicle registration dishonored check collection, delinquent fines imposed for labor law violations, and court-ordered debt collection.

In 2007, at the direction of the Legislature, the Legislative Analyst Office, in consultation with the Department of Finance, prepared a report on the challenges facing California's three tax agencies and the need to engage in information and data sharing to effectively and efficiently administer the overall tax system. This report titled, *A Report on Tax Agency Information and Data Exchange*, focuses on how increased cooperation and information sharing among the tax agencies can serve to improve tax compliance and enforcement activities.

The report points out how, recently, compliance and enforcement issues have become of increasing concern to California due to a number of different trends and factors. For example, the growth of the Internet and other forms of remote sales has led to the noncompliance with the state's use tax. These factors, coupled with other features of today's economy such as new and different business ownership structures and the large cash economy, have led to increased concern about the tax gap. The report goes on to say that the collection, sharing, and accessibility of tax-related information among agencies are seen as primary methods of dealing with the tax gap.

In addition, the report describes how the state's tax agencies currently exchange data and information. However, despite the information sharing that already occurs, each of the tax agencies have identified additional information now collected, but not shared, that would be useful for tax compliance purposes.

### COMMENTS

This provision would assist the BOE in locating missing taxpayers and possibly garnishing the wages of taxpayers that are delinquent in their payment of BOE-administered taxes or fees. Currently, the BOE uses the EDD's online wage and employment information which is based on quarterly employment returns filed by employers. Even though this information is available to the BOE shortly after the end of each quarter, this information is relatively old when compared to the new employee registry information (four to six months more current). According to the FTB, the new employee registry has been a valuable enforcement resource in allowing that agency to identify delinquent taxpayers and begin collection action shortly after those taxpayers have started a new job. The BOE believes this information could be valuable for its collection efforts as well.

## COST ESTIMATE

Except with respect to the provisions in the bill that would eliminate the sunset date for the use tax line on the state income tax return, the BOE's administrative costs would be absorbable. The BOE's administrative costs associated with use tax line are commensurate with the number of returns filed with FTB (currently the BOE incurs personnel costs for collecting the unpaid use tax reported on the FTB returns, refunding use tax reported in error, answering questions from taxpayers about the use tax, and allocating the local and district taxes included in the tax reported on the FTB returns). However, we anticipate that the additional revenue would substantially exceed the additional costs.

Since the line was incorporated into the FTB returns, the BOE has reimbursed FTB for associated costs, as shown below.

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|---|---|
| 2003-04 | $1,007,316 |
| 2004-05 | 237,038 |
| 2005-06 | 239,458 |
| 2006-07 | 198,649* |
| 2007-08 | 118,859* |

* This decrease is attributable to the FTB's cost of printing the tax information booklets that accompany the tax returns it mails. The BOE shares in that cost because the booklets contain information about use tax. The decrease in printing cost is due to the success of FTB's e-file program (printed tax booklets are not mailed for these filers).

## REVENUE ESTIMATE

The provisions of the bill related to **personal liability of responsible persons** and access to the **EDD's new employee registry** would assist the Board in enhancing the Board's ability to collect delinquent tax and fee obligations. The actual amount expected to be collected is difficult to measure.

The state and local sales and use tax revenue increase associated with the provisions related to **elimination of the sunset date of the use tax line** on the state income tax returns is estimated to be at least $10 million annually.

Finally, the **use tax registration** for persons regularly incurring a use tax liability of $1,000 or more is estimated to $165,000 annually.

### REVENUE SUMMARY

The combined annual revenue gain from keeping the use tax line on the FTB return and requiring persons who regularly incur a use tax liability of $1,000 or more to register with the BOE is estimated to be $10.165 million, as follows:

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|---|---|
| State General Fund (6%) | $ 6,776,667 |
| State Fiscal Recovery Fund (1/4%) | 282,361 |
| Local Revenue Fund (1/2%) | 564,722 |
| Local Public Safety Fund (1/2%) | 564,722 |
| Local and County (1%) | 1,129,444 |
| Special districts (.75%) | 847,084 |
| Total | $10,165,000 |

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***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.***