

**Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations,
Title 18, Section 1698, *Records*, and Section 4901, *Records***

SPECIFIC PURPOSES, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFITS

Current Law

Sales and Use Tax

The State Board of Equalization (Board) administers California's sales and use taxes. The Board's Sales and Use Tax Department is responsible for administering the Board's sales and use tax programs, including performing audits to ensure that sales and use taxes are reported properly.

There are two statutes related to the retention and examination of records for sales and use tax purposes. Revenue and Taxation Code (RTC) section 7053 provides that "[e]very seller, every retailer as defined in subdivision (b) of section 6015, and every person storing, using, or otherwise consuming in this State tangible personal property purchased from a retailer shall keep such records, receipts, invoices, and other pertinent papers in such form as the [B]oard may require."

RTC section 7054 specifies that the Board, or any person authorized in writing by it, "may examine the books, papers, records, and equipment of any person selling tangible personal property and any person liable for the use tax." It further specifies that the Board "may investigate the character of the business of the person in order to verify the accuracy of any return made" or "if no return is made by the person, to ascertain and determine the amount required to be paid."

The Board adopted California Code of Regulations, title 18, section (Regulation) 1698, *Records*, to implement, interpret, and make specific RTC sections 7053 and 7054 by specifying the types of records that must be maintained and made available for examination on request by the Board for sales and use tax purposes. The regulation currently allows records to be maintained and made available in hardcopy or electronic format. The regulation also generally requires all records to be preserved for a period of not less than four years, except for records for reporting periods beginning before January 1, 2003, that are subject to the extended ten year statute of limitations contained in RTC section 7073(d), which the regulation requires to be preserved for a period of not less than ten years. The Board made amendments that substantially updated Regulation 1698 in 1997, and added the provisions regarding records for reporting periods beginning before January 1, 2003, in 2005. However, Regulation 1698 has not been substantially updated since 1997.

As relevant here, Regulation 1698 currently defines the terms “database management system,” “electronic data interchange” or “EDI Technology,” “hardcopy,” and “machine-sensible record.” It explains that machine-sensible records do not include hardcopy records “stored in or by a storage-only imaging system such as microfilm or microfiche.” It also provides the requirements for hardcopy records to be converted to “storage-only imaging media, such as microfilm and microfiche.”

Special Taxes and Fees

The Board also administers a number of special taxes and fees, in addition to the sales and use taxes. As relevant here, those special taxes and fees are administered under the Motor Vehicle Fuel Tax Law (RTC § 7301 et seq.), the Use Fuel Tax Law (RTC § 8601 et seq.), the Cigarette and Tobacco Products Tax Law (RTC § 30001 et seq.), the Alcoholic Beverage Tax Law (RTC § 32001 et seq.), the Energy Resources Surcharge Law (RTC § 40001 et seq.), the Emergency Telephone Users Surcharge Law (RTC § 41001 et seq.), the Hazardous Substances Tax Law (RTC § 43001 et seq.), the Integrated Waste Management Fee Law (RTC § 45001 et seq.), the Oil Spill Response, Prevention, and Administration Fees Law (RTC § 46001 et seq.), the Underground Storage Tank Maintenance Fee Law (RTC § 50101 et seq.), the Fee Collection Procedures Law (FCPL) (RTC § 55001 et seq.), and the Diesel Fuel Tax Law (RTC § 60001 et seq.) (hereafter, collectively referred to as special tax and fee laws).

As relevant here, the Covered Electronic Waste Recycling Fee imposed by Public Resources Code (PRC) section 42464 is administered under the FCPL pursuant to PRC section 42464.2. The California Tire Fee imposed by PRC section 42885 is administered under the FCPL pursuant to PRC section 42882. The Lumber Products Assessment imposed by PRC section 4629.5 is administered under the FCPL pursuant to PRC section 4629.5. The Marine Invasive Species Fee imposed by PRC section 42885 is administered under the FCPL pursuant to RTC sections 44002 and 44003. The Natural Gas Surcharge imposed by Public Utilities Code (PUC) section 890 is administered under the FCPL pursuant to PUC section 893. The Prepaid Mobile Telephony Services Surcharge imposed by RTC section 42010 and Local Charges as defined in RTC section 42101 that are required to be collected by sellers other than direct sellers are administered under the FCPL pursuant to RTC sections 42020 and 42103. And, the Water Rights Fee imposed by Water Code sections 1525 and 13160.1 is administered under the FCPL pursuant to Water Code section 1552.

The Board’s Special Taxes and Fee Department is responsible for administering the Board’s special taxes and fees programs under the special tax and fee laws.

The Board adopted Regulation 4901, *Records*, in 2003 to implement, interpret, and make specific the statutes related to the retention and examination of records under the special tax and fee laws, which are similar to RTC sections 7053 and 7054 (discussed above). (RTC §§ 8301, 8302, 8303, 8304, 9253, 9254, 30453, 30454, 32551, 32453, 40172, 40173, 40174, 40175, 41056, 41073, 41129.30, 43502, 45852, 46602, 46603, 50153, 55302, 60604, 60605, and 60606.) As relevant here, Regulation 4901 contains a list of “Applicable Tax Laws” and prescribes the types of records that must be maintained and made available for examination on request by the Board to determine taxpayers’ and fee payers’ correct liabilities under the

applicable tax laws. Regulation 4901 generally mirrors the provisions of Regulation 1698, except that it provides the requirements for hardcopy records to be converted to “storage-only imaging media, such as *microfilm, microfiche or other media used in electronic imaging.*” (Italics added.)

Regulation 4901 was amended in 2010 to clarify that it applies to the Water Rights Fee (enacted in 2003) and Cover Electronic Waste Recycling Fee (enacted in 2004). However, Regulation 4901 has not been substantially updated since it was adopted in 2003 and does not currently refer to the Lumber Products Assessment and the Prepaid Mobile Telephony Services Surcharge, which were enacted, or Local Charges, which the Board was first required to administer under the FCPL, after the regulation was last amended.

Electronic Cash Registers

Cash registers have existed for many years. They offer business owners an organized place to ring up sales and store money from their sales transactions. Electronic cash registers have also been in use for some time and now include a wide range of devices, such as integrated point-of-sale (POS) systems.

POS systems are sophisticated computer systems that use commercially available operating systems to record each sale when it happens. In recent years, POS systems have become more popular than traditional cash registers with business owners because of their user-friendly interface, data tracking capabilities, and increased affordability. These systems are also popular because they can be integrated with third-party accounting software, online ordering, and credit and debit card processors.

The Legislature added RTC section 7153.6 to the Sales and Use Tax Law (RTC § 6001 et seq.) and RTC section 55363.5 to the FCPL, effective January 1, 2014. (Stats. 2013, ch. 532.) As relevant here, both statutes define the term “electronic cash register” to mean “a device that keeps a register or supporting documents through the means of an electronic device or computer system designed to record transaction data for the purpose of computing, compiling, or processing retail sales transaction data in whatever manner” and both statutes indicate that electronic cash registers include POS systems.

Proposed Amendments

Need to Update Regulation 1698

As new technologies and business practices emerge, the Board must adapt to the new technologies and keep taxpayers informed with relevant guidance using the current terminology in the industry. Board staff determined that there was an issue (or problem within the meaning of Gov. Code, § 11346.2, subd. (b)(1)) because Regulation 1698 currently defines the outdated term “machines-sensible record” and generally uses the term to refer to information in an “electronic format,” which is now simply referred to as “electronic records.” Staff determined that there was an issue (or problem) with Regulation 1698 because it does not define the commonly used term electronic cash register or refer to POS systems. Staff also determined that

there was an issue with Regulation 1698 because it did not provide guidance to business owners with POS systems that overwrite data after a period of time about how to maintain their data before it is overwritten.

Interested Parties Process

As a result, the Board's Business Taxes Committee (BTC) staff prepared draft amendments to update Regulation 1698 and address the issues described above, and a discussion paper explaining the draft amendments. Both were provided to interested parties.

Staff's draft amendments to Regulations 1698:

- Defined the term "electronic cash register" and explained that the term includes integrated POS systems.
- Replaced the term "machine-sensible record" with "electronic record" and explained that electronic records included records recorded and maintained by electronic cash registers.
- Changed the format of the example provided in subdivision (c)(2)(A).
- Added an example to subdivision (i) to further explain how business owners should maintain their data if they have POS systems that overwrite data after a period of time.

On June 17, 2015, BTC staff conducted an interested parties meeting to discuss the draft amendments. Following the meeting, staff received a submission, dated July 1, 2015, from Mr. Robert Jones of Collins, Mason & Company LLP. Mr. Jones proposed that each occurrence of "microfilm or microfiche" in the regulation be replaced with "microfilm, microfiche, or pdf."

PDF or "portable document format" is a type of storage-only imaging format that is independent of software, hardware, or operating systems. Invented and developed by Adobe, PDF has become the most popular imaging format since 1994 when Adobe announced that it would provide its Adobe Reader software free online as an open file format. With increased availability and ease of use, PDF files have become the standard for document exchange, almost replacing microfilm or microfiche. Staff agreed with Mr. Jones that PDF is an acceptable record storage format, and as such agreed to add PDF to the regulation where it refers to microfilm and microfiche.

When preparing the second discussion paper and revising the draft amendments to Regulation 1698, BTC staff determined that Regulation 4901 generally mirrors Regulation 1698 (as discussed above). BTC staff also noticed that Regulation 4901 contains language in subdivision (h)(1) and (h)(2) that refers to "microfilm, microfiche or other media used in electronic imaging" (as discussed above). As such, staff revised its draft amendments to Regulation 1698, subdivisions (a)(4), (h)(1), and (h)(2) to replace each occurrence of "microfilm or microfiche" with "microfilm, microfiche, PDF files, or other media used in electronic imaging."

In addition, BTC staff prepared drafted amendments to update Regulation 4901 that mirrored the amendments to Regulation 1698, discussed above, including adding "PDF files" to subdivisions (a)(5), (h)(1), and (h)(2) of Regulation 4901 to ensure consistency between Regulations 1698 and 4901. Also, to further update Regulation 4901, staff drafted amendments to remove the

references to the Marine Invasive Species Fee, California Tire Fee, Natural Gas Surcharge, Covered Electronic Waste Recycling Fee, and Water Rights Fee from subdivision (a)(1)'s list of applicable tax laws and insert a reference to the FCPL to cover all the taxes and fees currently enacted and administered under the FCPL, as well as eliminate the need for further revisions to Regulation 4901 when new taxes and fees are enacted that are administered under the FCPL.

On August 11, 2015, BTC staff conducted a second interested parties meeting to discuss the draft amendments to Regulations 1698 and 4901. At the meeting, there was overall support for the proposed amendments. Also at the meeting, Mr. Marc Brandeis of Brandeis & Associates, LLC, requested that Excel worksheets and Access databases be included as acceptable forms of records in the regulations. Although staff did not receive a written submission for this request, staff did consider the suggestion. Staff determined that worksheets and database files are not necessarily source data and that they are often summaries or analyses of source data. Staff determined that worksheets and databases are already required to be maintained and made available to the Board under the provisions in subdivision (b)(1)(C) of both regulations, which refer to "schedules or working papers used in connection with the preparation of tax returns." Additionally, staff determined that it would be unnecessarily restrictive to revise the regulation to refer to specific proprietary software products, such as Excel and Access. For these reasons, BTC staff did not agree to incorporate Mr. Brandeis's suggestion into staff's draft amendments.

October 27, 2015, BTC Meeting

Subsequently, staff prepared Formal Issue Paper 15-011 and distributed it to the Board Members for consideration at the Board's October 27, 2015, BTC meeting. Formal Issue Paper 15-011 recommended that the Board propose to add a definition for "electronic cash register" to subdivision (a)(2) of Regulation 1698 and subdivision (a)(3) of Regulation 4901 to address the second issue (or problem) referred to above. The definitions in the regulations are in alphabetical order, therefore the issue paper recommended that the definition for "electronic cash register" be inserted alphabetically, and the remaining definitions be renumbered.

Subdivision (i) of both regulations explains that records must be kept for a period of not less than four years. The formal issue paper recommended that the Board propose to add an example to this subdivision to address the third issue (or problem) referred to above by explaining that if the taxpayer's POS system periodically overwrites stored data, the taxpayer should transfer and maintain a copy of all the data that would be overwritten or otherwise removed for the specified period.

The formal issue paper recommended that the Board propose to update the term "machine-sensible records" to "electronic records" throughout the regulations to address the first issue (or problem) referred to above. "Machine-sensible records" is an outdated term, and "electronic records" is a current and readily understood term. Board staff also recommended that the Board propose to change the formatting of the regulations in subdivision (c)(2)(A) where they provide examples of what retained records should contain when a taxpayer uses electronic data interchange processes and technology. The recommended amendments reformatted the examples as numbered lists for easier reading and consistent formatting with other subdivisions in the regulations.

Additionally, the formal issue paper recommended that the Board revise Regulation 4901 to remove the references to the Marine Invasive Species Fee, California Tire Fee, Natural Gas Surcharge, Covered Electronic Waste Recycling Fee, and Water Rights Fee from the list of applicable tax laws under subdivision (a)(1) and insert a reference to the FCPL to cover all the taxes and fees currently enacted and administered under the FCPL, as well as eliminate the need for further revisions to Regulation 4901 when new taxes and fees are enacted that are administered under the FCPL. The recommended amendments to subdivision (a)(1) were also arranged in alphabetical order.

Furthermore, the formal issue paper recommended that the Board propose to amend Regulation 1698, subdivisions (a)(4), (h)(1), and (h)(2) to replace each occurrence of “microfilm or microfiche” with “microfilm, microfiche, PDF files, or other media used in electronic imaging” and propose to amend Regulation 4901 to add “PDF files” to subdivisions (a)(5), (h)(1), and (h)(2), to address Mr. Jones’s submission, which was included as Exhibit 4 to the formal issue paper.

At the conclusion of the Board’s discussion of Formal Issue Paper 15-011 during the October 27, 2015, BTC meeting, the Board Members unanimously voted to propose the amendments to Regulations 1698 and 4901 recommended in the formal issue paper. The Board determined that the proposed amendments are reasonably necessary for the specific purposes of clarifying and updating the regulations to address the issues (or problems) referred to above and respond to Mr. Jones’s submission.

The Board anticipates that the proposed amendments to Regulations 1698 and 4901 will benefit business owners that use electronic cash registers, including POS systems, and maintain records in electronic format by providing updated guidance about the electronic records they must maintain and make available to the Board. The Board also anticipates that the amendments to Regulation 4901, subdivision (a)(1), will benefit the Board by eliminating the need for further revisions to Regulation 4901 when new taxes and fees are enacted that are administered under the FCPL.

The proposed amendments to Regulations 1698 and 4901 were not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulations 1698 and 4901 or the proposed amendments to Regulations 1698 and 4901.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 15-011, the exhibits to the issue paper, and the comments made during the Board’s discussion of the issue paper during its October 27, 2015, BTC meeting in deciding to propose the amendments to Regulations 1698 and 4901 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulations 1698 and 4901 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments to Regulations 1698 and 4901 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulations 1698 and 4901 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2,
SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY
GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The proposed amendments to Regulation 1698 and 4901 update and clarify the terms currently used in the regulations, incorporate the statutory definition of electronic cash register, update the guidance currently provided in the regulations regarding storage-only imaging media so that it is clear that such media includes "PDF files" and other media used in electronic imaging, and provide a current example explaining how business owners should maintain their data if they have POS systems that overwrite data after a period of time. The proposed amendments to Regulation 4901 also change the way the regulation refers to taxes and fees administered under the FCPL. The proposed amendments do not mandate that individuals or businesses maintain or make available any records that they are not currently required to maintain or make available or do anything that is not already required by the Sales and Use Tax Law, the special tax and fee laws, or Regulations 1698 and 4901, and there is nothing in the proposed amendments that would significantly change how individuals and businesses would generally behave, in the absence of the proposed regulatory action, or that would impact revenue. Therefore, the Board estimates that the proposed amendments will not have a measurable economic impact on individuals and businesses. And, the Board has determined that the proposed amendments to Regulations 1698 and 4901 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed amendments will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period.

Further, based on these facts and all of the information in the rulemaking file, the Board has also determined that the adoption of the proposed amendments to Regulations 1698 and 4901 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

Furthermore, Regulations 1698 and 4901 do not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulations 1698 and 4901 will not affect the benefits of Regulations 1698 and 4901 to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulations 1698 and 4901 will not have a significant adverse economic impact on business.

The proposed amendments to Regulations 1698 and 4901 may affect small businesses.