California's Use Tax Gap: A Brief Overview

I. California's Use Tax

Since 1933, the state has imposed a sales tax on California retailers for the privilege of selling tangible personal property (TPP), absent a specific exemption. The tax is based upon the retailer's gross receipts from TPP sales in this state. In 1935, California adopted a complementary "use tax" on the storage, use, or other consumption of TPP purchased out-of-state and brought into California. The use tax was designed to protect California merchants who would otherwise be at a competitive disadvantage when out-of-state retailers sell to California customers without charging tax.

Unlike the sales tax, the use tax is imposed on the *purchaser* and not the retailer. Unless the purchaser pays the use tax to an out-of-state retailer registered to collect California's use tax, the purchaser remains liable for the tax. The use tax is set at the same rate as the state's sales tax and must be remitted to the State Board of Equalization (BOE).

II. Impediments to Collection

The most practical way for a state to enforce its use tax is to have retailers collect the tax at the time of sale. However, there is considerable ambiguity regarding the circumstances under which a state may legally compel an out-of-state retailer to collect use tax on its behalf. This ambiguity has its origins in the commerce clause of the United States (U.S.) Constitution, which charges Congress with regulating commerce among the several states. The U.S. Supreme Court has held that, by implication, the commerce clause also prohibits *states* from enacting laws that unduly burden interstate commerce.

In Quill Corp. v. North Dakota (1992), 504 U.S. 298, the U.S. Supreme Court was asked to decide the constitutionality of a North Dakota law that imposed a use tax collection obligation on out-of-state retailers that advertised in the state three or more times in a single year. The Court invalidated the law, holding that, under the negative commerce

clause, a retailer must have a "physical presence" in a state before that state can require the retailer to collect its use tax.

The "physical presence" test affirmed in Quill has complicated California's efforts to collect its use tax. For example, when a California consumer purchases a coat from an out-of-state retailer through its catalog or online store, the consumer's use of the coat in California triggers a use tax liability. If the out-of-state retailer lacks a "physical presence" in California, however, California is constitutionally prohibited from requiring the retailer to collect the tax. If the consumer fails to remit the tax, the purchase completely escapes taxation. It is estimated that this gap in California's sales and use tax (SUT) system costs the state over $1.1 billion in revenues each year.

III. Current Efforts Being Taken to Close the Gap

In recent years, California has taken steps to increase use tax compliance. Chief among these efforts are the mandatory use tax registration program and the permanent inclusion of a use tax line on the state's income tax returns. Each is discussed briefly below.

a. Mandatory Use Tax Registration for Service Enterprises

In 2009, California enacted Revenue and Taxation Code Section 6225 seeking to increase use tax compliance among California businesses that purchase TPP from out-of-state. Specifically, Section 6225 requires "qualified purchasers" to register with BOE for annual use tax reporting. A qualified purchaser is defined as a person that:

i. Receives at least $100,000 in gross receipts from business operations per calendar year;

ii. Is not required to hold a seller's permit or certificate of registration for use tax;

iii. Does not hold a use tax direct payment permit; and,

iv. Is not otherwise registered with BOE to report use tax.

At the time of Section 6225's passage, BOE estimated that the mandatory use tax registration program would increase General Fund collections by $26 million in fiscal year (FY) 2009-10, and by $123 million in FY 2010-11.

b. Permanent Inclusion of Use Tax Line on Income Tax Returns

In 2010, Governor Schwarzenegger signed SB 858 (Committee on Budget and Fiscal Review) into law as part of the FY 2010-11 Budget Agreement. Among other things, SB

858 provided for the permanent inclusion of a use tax line on the state's income tax returns, thereby allowing income tax filers to fill-in the amount of use tax due on their returns. BOE staff estimated that this provision would increase General Fund collections by roughly $9.2 million annually.

IV. Additional Proposals for Increasing Use Tax Collections

States have also employed a host of different methods for closing the use tax gap. Most notable are the "Amazon" approach first adopted by New York, and the approach taken more recently by the State of Colorado.

a. The "Amazon" Approach

Revenue and Taxation Code Section 6203 specifies those retailers considered to be engaged in business in this state – in other words, it lists those retailers that are considered to have a "physical presence" sufficient to impose a use tax collection obligation. In 2009, Assembly Members Nancy Skinner and Charles Calderon jointly introduced AB 178, which would have added to this statutory list certain "out-of-state" retailers that use California residents, often referred to as "affiliates," to promote business. The bill was modeled after the so-called "Amazon" legislation passed in New York. New York, and other states that have enacted similar bills, argue that if a remote vendor (like Amazon) uses an affiliate marketing program, the vendor's in-state activities satisfy Quill's physical presence requirements and thus create SUT nexus for the vendor. Specifically, this argument is based on the theory of "attributional" nexus, as established in Scripto, Inc. v. Carson (1960) 362 U.S. 207 and Tyler Pipe Indus. v. Washington State Dep't of Revenue (1987) 483 U.S. 232, which hold that if a retailer has in-state agents that sell on the retailer's behalf, the in-state agents may establish nexus on behalf of the out-of-state retailer.

Proponents of the Amazon approach note that many out-of-state retailers use California residents to drive business, and take full advantage of California's consumer base, but refuse to collect California's use tax. This, in turn, places these companies at a competitive advantage vis-à-vis California-based businesses, which must collect and remit sales tax.

Opponents of the Amazon approach argue that such legislation would cause out-of-state retailers to terminate their affiliate relationships with California residents. This, they argue, would place the jobs of California affiliates at risk in an already troubled economic climate. In addition, critics argue that affiliates operate far differently from the sales force "actively engaged" on behalf of Scripto, Inc. Specifically, they note that the work of most affiliates is passive and that affiliates do not call on customers or directly solicit orders.

It should be noted that out-of-state retailers have followed through on their threats to terminate affiliate contracts in states that have adopted Amazon legislation. After New York's enactment of its "Amazon" law, both North Carolina and Rhode Island followed suit. As a result, online giant Overstock.com cancelled its affiliate program in all three states, while Amazon.com cancelled its affiliate programs in both North Carolina and Rhode Island.

b. **The "Colorado" Approach**

In its effort to increase use tax collections, the State of Colorado has taken a different path from the one forged by New York. On February 24, 2010, Colorado Governor Bill Ritter signed into law HB 1193, which imposes a set of notice and reporting requirements on retailers that do not collect the state's use tax. Specifically, under HB 1193, non-collecting retailers must:

i. Notify consumers that SUT is due on certain purchases and that, under state law, the consumer must file a SUT return. Absent reasonable cause, failure to provide this notice will result in a penalty of $5 for each failure;

ii. Send consumers an annual notice showing the total amount of purchases made in the prior calendar year. In addition, the notice must inform consumers of their obligation to file appropriate SUT returns. The notice must be sent separately by first class mail with the marking, "Important Tax Document Enclosed." Absent reasonable cause, failure to provide this notice will result in a penalty of $10 for each failure; and,

iii. File an annual statement for each consumer with the state's Department of Revenue showing the total amount paid for purchases during the preceding calendar year. Absent reasonable cause, failure to file this annual statement will result in a penalty of $10 for each consumer that should have been included in the statement.

HB 1193 also provides that, if a non-collecting retailer is part of a controlled group of corporations with a component member that is a retailer with physical presence, the non-collecting retailer shall be presumed to be doing business in the state.

Critics of the Colorado approach argue that the law's reporting regime is tantamount to requiring use tax collection, because it includes features like audits and penalties for failure to comply. In addition, critics state, "Colorado's information reporting requirement is excessive – and perhaps results in a reporting regime that is ironically more burdensome than the tax collection obligation struck down in *Quill*." (Kranz, Smith, and Freeman, Colorado's End Run: Clever, Coercive, and Unconstitutional, Tax

Analysts, April 5, 2010.)

Despite the fact that HB 1193 does not attribute nexus based on the activity of in-state affiliates, Amazon.com terminated its Colorado affiliates on March 8, 2010. It is unclear whether this decision was motivated by a desire to avoid tax collection or was simply intended as a warning to other states considering similar legislation.

HB 1193's constitutionality was recently called into question by the United States District Court for the District of Colorado. On January 26, 2011, Judge Robert E. Blackburn issued a preliminary injunction barring Colorado's enforcement of the law. Specifically, Judge Blackburn found that the plaintiff had demonstrated a substantial likelihood that HB 1193 violates the commerce clause by imposing a burden on interstate commerce that is not imposed on in-state commerce. Judge Blackburn also concluded that the law likely violates the commerce clause by imposing an undue burden on interstate commerce.

There is also reason to believe that Colorado's approach may be challenged on First Amendment grounds. As noted above, HB 1193 requires non-collecting retailers to file an annual statement for each consumer with the state's Department of Revenue showing the total amount paid for purchases during the preceding calendar year. Many consumers prefer to make certain purchases online because they can do so with relative anonymity. Thus, HB 1193 could raise concerns by requiring out-of-state retailers to share private information and buying habits with a government tax agency.

V. Prior Legislative Efforts

In recent years, this Committee has heard a number of other proposals designed to increase use tax compliance. Two notable examples are discussed below.

a. "Long Arm" Nexus

As noted above, Revenue and Taxation Code Section 6203 currently lists those retailers that are considered to be engaged in business in this state and that, as such, are required to collect use tax on all sales to California consumers. In 2008, Assembly Member Charles Calderon introduced legislation (AB 1840) that would have retained this list, but, at the same time, made clear that it was not exhaustive. Specifically, AB 1840 specified that a "retailer engaged in business in this state" means any retailer with substantial nexus with this state for purposes of the commerce clause and any retailer upon whom federal law permits this state to impose a use tax collection duty. Thus, this "long arm" proposal simply allowed California to impose a use tax collection duty on "out-of-state" retailers to the maximum extent permitted by the U.S. Constitution and federal law. At the time, BOE estimated that AB 1840 would generate, at a minimum, between $11 and $55 million annually in state, local and special district revenues. There is reason to believe that this estimate was rather conservative. While AB 1840 passed

out of both the Assembly Committee on Revenue and Taxation and the Assembly Appropriations Committee, it failed passage on the Assembly Floor.

b. **Use Tax Tables**

In 2009, Assembly Member Mike Eng introduced legislation (AB 469) that would have allowed taxpayers to satisfy their use tax obligations on relatively small purchases by using a "lookup" table on their income tax returns. BOE, which sponsored the measure, noted the following in its analysis of the bill:

> A use tax table would make compliance with reporting use tax more convenient for taxpayers who know they have made untaxed purchases but have not kept receipts from those purchases. For individual purchases of less than $1,000, the table would reflect the amount of use tax due based on the person's California adjusted gross income as shown in the instructions in the state income tax booklet. For individual purchases of $1,000 or more, taxpayers would be required to report the actual amount of use tax due.

BOE also noted that, of the 38 states that impose both an income tax and a use tax, 21 states provide for individuals to report their use tax obligation on their income tax return. In addition, 9 of those states incorporate a use tax table. While states with lookup tables collect less use tax per return when compared to states without lookup tables, the increased participation rate actually results in increased collections.

Governor Schwarzenegger vetoed AB 469 noting, "This bill exposes individual taxpayers to additional recordkeeping and confusion about a tax that few Californians understand and even fewer track for tax purposes."