

Taxing E-Commerce Will Blunt State's High-Tech Edge

Internet Taxation Threatens California Technology Sector Jobs, Small Businesses

As online shopping becomes more popular and digital delivery of entertainment and software continues to expand, so too does concern by some lawmakers that the current tax system does not sufficiently capture tax revenues from e-commerce transactions. A growing number of efforts to increase taxation of e-commerce have taken shape in two primary forms:

- proposals to tax sales of intangible or digital products; and
- proposals to require out-of-state retailers to collect California sales taxes on online purchases.

One of the common justifications for these proposals is the tax structure needs to be updated to more accurately reflect today's economy. The reasoning is that when the sales tax was established in the 1930s, intangible goods and the Internet did not exist.

Although e-commerce is growing, it is still a fledgling industry. E-commerce currently represents just less than 4 percent of total U.S. commerce, and has grown only 3 percent in the last decade, according to the U.S. Census Bureau. There is ample room for growth in the e-commerce arena, and California policymakers should not distinguish California as a state with the most barriers to e-commerce enterprise.

On the contrary, California should take aggressive measures to incubate and foster e-commerce jobs and enterprise in California. E-commerce companies contribute millions toward California tax revenues in the form of income taxes. In its search for more sales tax revenues, California must take care not to undermine its opportunity to be the leader in e-commerce job creation and investments.

CalChamber Position

The California Chamber of Commerce is generally opposed to taxation policies that could stifle California's national and global competitiveness and leadership role in e-commerce.

Leadership in Technology Sector/E-Commerce Growth

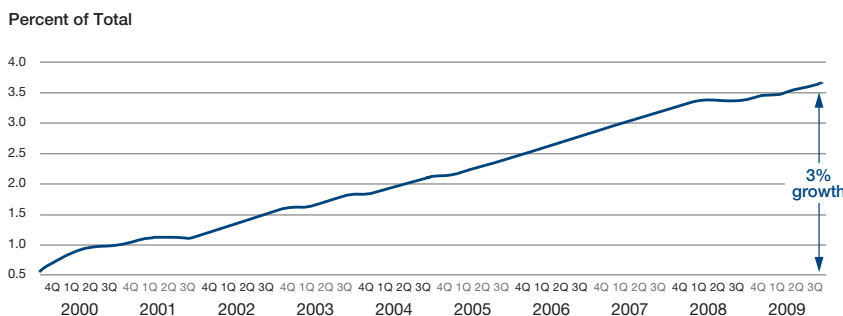
E-commerce brings high-paying technology-sector jobs, major economic benefits and significant tax revenue to the Golden State. Erecting fences on the Internet could chill needed growth of one of California's best economic engines.

California has far more to lose than most other states from proposals that harm e-commerce. By way of comparison, California's technology sector footprint is approaching two to three times the size of New York's, often cited for its recent efforts to more aggressively tax e-commerce.

E-commerce enables thousands of California entrepreneurs to get their start. It is estimated more than 50,000 websites are launched per week. Many small companies are 100 percent web-based, which enables them to have low overhead costs.

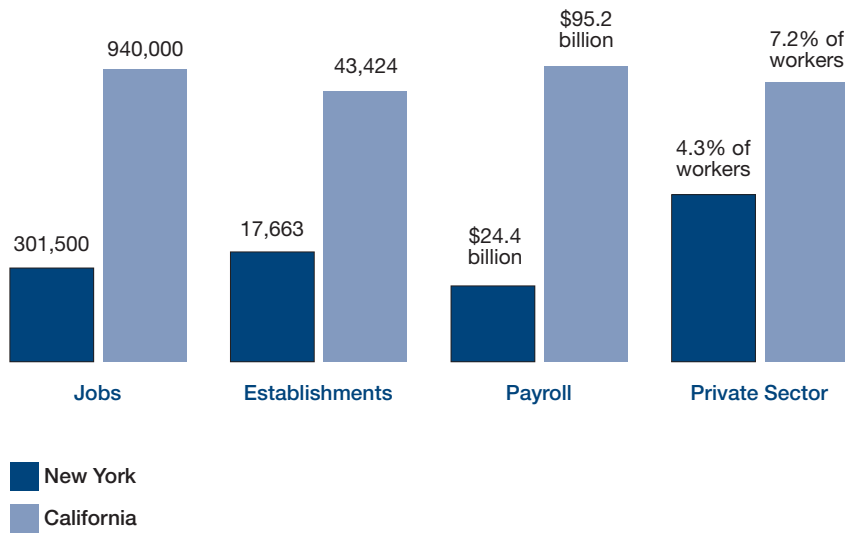
In addition, the Internet helps small

E-Commerce Sales as Percent of Total U.S. Retail Sales (1999–2009)



Source: U.S. Census Bureau

Technology Sector: New York vs. California



Sources: U.S. Bureau of Labor Statistics, U.S. Bureau of the Census, U.S. National Science Foundation

California companies compete with big companies. Small businesses, such as independent booksellers, benefit from being able to sell products online to an expansive customer base, both national and global. This helps them to compete with large chain stores on a scale never before possible.

Proposals to Tax Sales of Intangible or Digital Products

Current Law

California currently does not tax digital products. Its sales and use tax applies only to tangible property, and digital property is intangible. About half the states currently tax digital products. A number of those states have tax structures, populations and technology footprints that are vastly different than California's.

Recent Legislative Proposals

In 2008, AB 1956, ABX3 22 and ABX3 23 (C. Calderon; D-Montebello) proposed to impose the sales and use tax on digital downloads, including software, e-books, music, videos, cell phone ring tones, cable television and movies on demand. ABX3 22 proposed to do this through the regulatory process, while ABX3 23 proposed to do so through a statutory change. AB 1956 failed passage in the Assembly

Revenue and Taxation Committee, and the latter two bills did not move.

Although there were no such proposals in the 2009 legislative year, interest in taxation of digital downloads remains strong and more proposals are likely.

Policy Arguments

Proposals to tax intangible property and digital downloads overlook characteristics and challenges unique to e-commerce that could be counterproductive for both the state and industry and ultimately lead to fewer tax revenues, including the following:

- **Competitive disadvantage.**

Digital media industries are highly mobile and can reach California consumers from outside the state's borders as easily as from within. Thus, a digital tax could trigger an undesirable movement of high-paying, clean and green, technology sector jobs out of the state.

- **Has impact on many types of consumer purchases.** A digital tax would be a direct cost increase to California consumers who purchase digital media, including software, e-books, music, videos, cell phone ring tones, cable television and movies on demand. As many consumers are going through tough times—such as foreclosures, plummeting home values

and layoffs—imposing a new tax on digital purchases will further reduce disposable income. It could also lead to taxing of consumers' personal financial information and research data.

- **More digital piracy.** Increasing the cost of California digital purchases by a tax of 7 percent to 9.25 percent, depending on the applicable local sales tax rate, may encourage even more digital piracy. Digital media and its channels of delivery are especially vulnerable to theft due to increasingly faster computers. Moreover, Internet connections have made illegal downloads of software, movies, music and the like easier. Digital piracy leads to lost jobs, lost sales and lost tax revenue. In 2005, in the music industry alone, there were an estimated 20 billion illegal downloads globally and a loss to U.S. firms of more than \$2 billion.

- **Costly litigation.** A new digital tax could open up many potential areas of litigation due to the complexity and amorphous nature of digital and e-commerce transactions. This would mean costly litigation for the state of California, local governments and companies.

- **Digital media often more convenient and better for environment.** The state should encourage digital downloads. Consumers have the convenience of immediately receiving the product and saving money by not paying for packaging and extra costs associated with physical product. The environment benefits from less packaging waste in landfills and fewer car trips to stores.

Proposals to Require Out-of-State Retailers to Collect Sales Taxes on Online Purchases

Current Law

The U.S. Constitution requires a state to have a sufficient physical connection, or nexus, to an out-of-state company before it can require a company to collect the state's sales tax. Out-of-state companies selling products solely through the Internet can reach California consumers without having any physical presence in the state. California consumers making purchases from such out-of-state sellers are required to pay California use tax on these purchases, but there is a reportedly low compliance rate.

Because of the growing number of out-of-state sellers in the online marketplace, a number of states have become interested in exploring new ways to establish nexus with them.

For example, the state of New York has a lawsuit pending against it because of its recently adopted law requiring a large online retailer to collect the state sales tax on the basis that the retailer has “affiliates” with a physical presence in the state. New York claimed the retailer had physical presence because the affiliates had a click-through to the retailer on their websites.

States attempting such new ways to establish nexus in the e-commerce setting are vulnerable to lawsuits because the Supreme Court has not ruled whether they are constitutional. The last guidance the U.S. Supreme Court provided on nexus was for mail orders rather than Internet orders in the 1992 *Quill Corp. v. North Dakota* case.

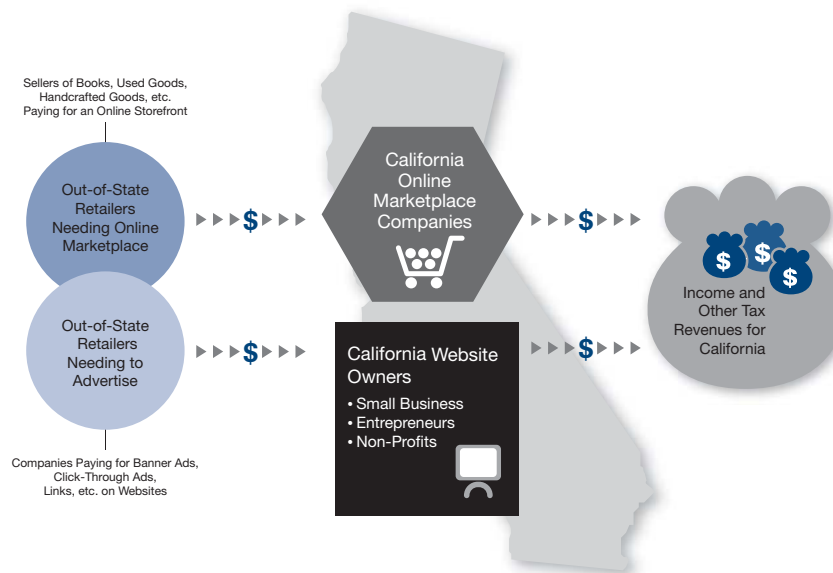
On the other end of the spectrum, some states, in an effort to protect and encourage e-commerce activity, have passed laws establishing safe harbors from nexus—laws explicitly setting forth activities the state has deemed do not establish nexus.

One such safe harbor adopted by more than 20 states, including California, protects servers—the mere presence of a company’s products and information on a web server located within the state will not in and of itself trigger the obligation to collect the state’s sales or use tax. This acts as a safe harbor by providing companies certainty and predictability when choosing to give business to California web-service companies, such as online marketplaces or web hosts. Without the safe harbor, there is uncertainty because the U.S. Supreme Court has not ruled whether the presence of a company’s information and products on a server does or does not establish nexus.

Recent Legislative Proposals

In 2008, AB 1840 and ABX3 2 (C. Calderon; D-Montebello) proposed to change California’s current “nexus” standard under California’s sales and use tax law. Both bills proposed to eliminate California’s server safe harbor. Although the measures purported to target out-of-state sellers, the bills had the potential to

Internet Taxation Hurts California Companies/State Revenues



cause significant harm to California companies by undermining their ability to compete nationally and globally for customers. AB 1840 failed passage on the Assembly floor, while ABX3 2 failed to move.

In 2009, the focus of nexus legislation shifted to out-of-state retailers with “click-throughs” and banner ads located on California-based websites. The three bills were AB 178 (Skinner; D-Berkeley), which was dropped early this year; ABX3 27 (Calderon; D-Montebello), which died when the third extraordinary legislative session adjourned in late October 2009; and SBX3 17 (Ducheny; D-San Diego), which was vetoed. These bills proposed to establish that California nexus is created when any retailer enters into any referral agreement with a California resident in exchange for compensation or commission, such as by a link, website or otherwise that generates referrals in excess of \$10,000 in sales.

Policy Arguments

Although aimed at out-of-state companies, these nexus proposals could inflict significant harm on California companies in the following ways:

● Significant harm to small California businesses—“affiliate” companies.

There are more than 25,000 affiliates in the state of California, many of which are small, entrepreneurial web-based businesses. The main income source for these small companies is affiliate advertising—click throughs and banner advertisements for out-of-state retailers.

Affiliates are estimated to pay around \$123 million in income tax revenue each year from affiliate advertising. Many affiliates offer free web services and useful online resources, such as health information, blogs, social networks and e-mail.

Overstock.com immediately terminated its affiliates advertising program in New York when that state enacted a law similar to AB 178. Before Governor Arnold Schwarzenegger vetoed SBX3 17, Overstock.com had announced it also was canceling its Internet affiliate advertising program in California. After being contacted by the Governor’s administration, Overstock.com reinstated its California-based affiliates. Overstock.com estimates its Internet affiliate advertisers in California create millions of dollars in revenue.

- **Competitive disadvantage.**

Nexus proposals could place California companies that offer online marketplace and other web services at a competitive disadvantage by creating a strong disincentive for existing and potential out-of-state customers/retailers to instead utilize service providers in other states.

By using out-of-state competitor web-service companies, out-of-state retailers can lawfully avoid collecting California sales or use tax, while still reaching California consumers. Since only three states have adopted a similar nexus law, there still are many other states from which to choose if California adopts this law. In the e-commerce world, online marketplace companies in competitor states and countries, unheard of today, can quickly surge and become major companies overnight.

Following his veto of SBX3 17, the Governor said California cannot solve its budget deficit by raising taxes and driving businesses out of the state: “After passing the largest tax increase in California history, it makes absolutely no sense to go back to the taxpayers to solve the current shortfall—that’s why I vetoed the majority-vote tax increase passed by the Legislature.

With unemployment at an all-time high, we should be doing everything we can to keep jobs and create jobs in California.”

- **Reduces state tax revenue.**

The nexus proposals could result in behavioral changes that ultimately may reduce state tax revenue. The possibility of any new tax revenues resulting from these bills may be more than offset by the damage they could cause to California web-service companies whose customer bases could shrink or disappear, ultimately resulting in lost jobs and fewer tax revenues stemming from lost company revenue and lost jobs. Moreover, California web-service and online companies are uniquely positioned to move their operations to another state due to their highly mobile nature. California could also lose tax revenues as valuable highly mobile e-commerce jobs and operations are transferred to other states, simply by moving servers.

- **Could result in costly litigation.**

A state’s enactment of a new nexus standard does not mean that it is legal. The form of nexus that this proposal attempts to establish has not been decided as constitutional by the U.S. Supreme Court and thus could be subject to immediate court challenge

under the U.S. Commerce Clause. New York, which was sued immediately after adoption of its nexus law two years ago, is still in litigation with no end in sight. Such costly court challenges against California could last for years as they make their way through the trial and appellate courts, when California is suffering from budgetary challenges and a severe economic downturn.



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