

Use Tax Enforcement

More Information Can Encourage Compliance

Summary

Background

As online shopping becomes more popular, so too does concern by some lawmakers and in-state retailers that the current tax system does not sufficiently capture sales tax revenues from Internet transactions, or protect in-state “brick-and-mortar” businesses from unfair competition by Internet retailers based in other states. They argue the state’s tax structure no longer accurately reflects our economy because the Internet did not exist when the sales tax was established in the 1930s.

Use tax is the equivalent of sales tax, but is applied to out-of-state purchases and responsibility for remitting the tax currently is placed on individual purchasers. It was instituted in California in 1935 to help the state catch lost sales tax due on purchases Californians were making from out-of-state retailers through catalogues and while traveling outside of the state. Because of constitutional restrictions (discussed in more detail below), California could not require those retailers to collect its sales tax, so the state created an equivalent use tax obligation for individuals.

Today, however, many Californians still do not know they owe use tax on purchases they make out of state, assuming incorrectly that those purchases are tax-free. Others are merely willing to gamble that the Board of Equalization (BOE) will not audit their online purchases and so they never pay the tax. California also has made little effort to educate and collect use tax until recent years when budget troubles hit. In fact, there was not even a line for individuals to report and remit their use taxes on the personal income tax form in California until 2003.

Although e-commerce is more prevalent today than it used to be, and people are making more out-of-state purchases as a result, Internet sales still account for only about 4 percent of all U.S. retail sales, according to the U.S. Census Bureau. This suggests that, while the state is losing meaningful revenue when individuals do not pay their use tax, the tax system still is well-suited to collect the majority of the taxes it is owed.

These facts aside, there still is a legitimate argument to be made that if legislators can find a more effective way to collect taxes the state already is owed, and help in-state brick-and-mortar businesses at the same time, they should do so regardless of the amount of revenue that is being lost. Many argue that there simply is no reason Internet retailers based in other states cannot or should not have to collect tax on behalf of purchasers the same way in-state retailers do.

Unfortunately, federal law governing interstate commerce makes this type of solution far more complex, if not impossible, for states to craft than individual enforcement approaches. This is one of the primary reasons the California Chamber of Commerce continues to oppose efforts by the Legislature to require out-of-state retailers to collect use tax on behalf of individuals.

Current Law

The U.S. Constitution requires an out-of-state retailer to have a sufficient physical connection (nexus) to a state before the state can require that retailer to collect the state’s sales and use taxes. Out-of-state retailers selling products solely through the Internet can reach California consumers without having any physical presence in the state and, as a result, many do not collect these taxes on behalf of purchasers.

Because of the growing number of out-of-state retailers in the online marketplace, many states have become interested in finding 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 retailers to collect the state sales tax if they have performance-based marketing relationships with in-state affiliate-advertisers. New York claims those retailers have a physical presence in the state because the affiliate-advertisers act as a sales force for the out-of-state retailers.

Like New York, states that create laws to establish nexus in the e-commerce setting are vulnerable to lawsuits because the Supreme Court has not ruled on the constitutionality of such laws. The last guidance the U.S. Supreme Court provided on nexus was for mail orders rather than Internet purchases in the 1992 *Quill Corp. v. North Dakota* case. There it held that a retailer must have a physical presence in a state before it can be required to collect the state’s sales and use taxes. Another problem with New

York's approach is that in other states that have since enacted similar laws, Internet retailers have simply severed ties with affiliate-advertisers based in those states, eliminating nexus, but have continued to sell to individuals there through ads placed on websites based in other states.

In 2010, Colorado tried a different approach, attempting to establish nexus by using an out-of-state retailer's relationship with an in-state retailer owned by the same parent corporation. For retailers with no such in-state relationships, it required a notice be posted on the website or catalog indicating the consumer owed use tax for the purchase, and also required those retailers to send annual notices to individuals in Colorado and to the state tax collection agency about individual purchases to aid the state in its tax collection efforts. This law raises a host of constitutional issues aside from a likely U.S. Commerce Clause violation, and also threatens consumer privacy. Colorado is also now engaged in litigation, as are other states that borrowed portions of its law for themselves.

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, 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, both by Assemblyman Charles 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, they had the potential to 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.

The Legislature then shifted its focus to out-of-state retailers with "click-throughs" and banner ads located on California-based websites. Three bills in 2009, AB 178 (Skinner; D-Berkeley), ABX3 27 (C. Calderon; D-Montebello) and SBX3 17 (Ducheny; D-San Diego), and one in 2010, ABX8 8 (Committee on Budget), all proposed to establish, similar to New York's law, 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.

Although none of the bills became law, they posed a significant threat to many in-state advertisers and in-state e-marketplaces, whose businesses would be devastated if the law passed and out-of-state retailers severed their ties in California to avoid the tax collection burden. In addition, this approach is already the subject of litigation pending in several states, including New York, because it arguably violates the U.S. Commerce Clause. The New York appellate court decision was released on November 4, 2010, and essentially reinforces the current practice in California—in short, stating that out-of-state retailers can be forced to collect the state sales and use tax only if they have agents within the state that actively solicit sales for them.

Significantly, SBX3 17 made it through the Legislature, only to be vetoed by Governor Arnold Schwarzenegger. It is possible that a similar measure could be introduced in 2011 in hopes that the new Governor will view it more favorably.

In 2010, the Legislature also considered a proposal modeled on Colorado's new law in AB 2078 (C. Calderon; D-Montebello). This bill proposed to establish nexus for out-of-state retailers with the same parent corporation as an in-state retailer. In addition, it proposed to have out-of-state retailers without nexus post a notice on their websites to educate Californians about their use-tax obligation and to report detailed information about individual purchases by Californians on a quarterly basis to the state BOE. While AB 2078 was not identical to the Colorado law, many groups, including the BOE, testified that it raised numerous, serious constitutional and privacy issues, and would have been difficult to implement and enforce. The bill eventually was dropped, but it is still possible a modified version could be introduced in 2011, given the Legislature's persistence on the issue.

The 2010 Legislature approved additional funding for the BOE to hire more staff to help it better enforce and collect on existing debts. The Legislature also reinstated and made permanent the use tax reporting line on the personal income tax form, which had been allowed to expire at the end of 2009.

Finally, in late 2010, the BOE's legislative committee held a public hearing to discuss another possible proposal for the 2011 legislative session. This proposal, identical to AB 1840, which failed passage in 2008, eliminates the safe harbor for servers located in California and expands BOE's discretion to assess out-of-state retailers to the full extent allowed by the U.S. Constitution. Industry groups have expressed considerable concern with such an expansive proposal, which would eliminate all certainty regarding who will and will not be asked to collect the state's sales and use taxes going forward. It is also unclear what authority the bill would give the BOE that it does not have under the current, more specific statute, which has been narrowed over the years to reflect case law explaining the limit set by the U.S. Commerce Clause. It remains to be seen, however, whether the BOE will elect to move ahead and seek out an author in the Legislature.

Policy Concerns

As a threshold issue, the CalChamber opposes attempts by the Legislature to pass laws that threaten in-state employers and expose the state to costly litigation it could well lose, particularly when there are other means at its disposal to attack the same problem. Given the current uncertainty in the law and the array of cases already pending throughout the country that deal with various elements of both the New York and Colorado laws, it makes little sense for California to throw itself into the mix, and risk valuable taxpayer dollars and California jobs to defend a law that would likely be found unconstitutional.

Besides the constitutional concerns, there are other serious risks with the various proposals the California Legislature has considered in recent years. There are more than 25,000 online advertisers in California, many of which are small, entrepreneurial Web-based businesses. Their main source of income is advertising revenue from out-of-state retailers and together they pay more than \$125 million in income taxes each year. Many also offer beneficial Web services and online resources, such as health information, blogs, social networks and e-mail services for free, thanks to revenue from out-of-state advertisers. If California were to approve a New York-style law, all these businesses could be threatened with severe revenue losses should out-of-state retailers decide to sever their California ties to avoid the law.

Employers that offer online marketplaces also could be put at a significant disadvantage by passage of such a law because it would create a strong incentive for existing and potential out-of-state sellers to utilize out-of-state e-marketplaces to avoid the tax collection obligation.

A Colorado style-law also would impose enormous burdens on the BOE, which would have to process literally millions of extra documents each year if all out-of-state retailers complied with the reporting requirement. In addition, retailers would have to provide information about the nature of Internet purchases coupled with individual names to allow the BOE to know whether use tax was owed. This is because the state provides more than 200 exemptions to the sales and use tax law. Divulging this information, however, threatens consumer privacy and possibly violates the First Amendment of the U.S. Constitution. Finally, there is already California case law ruling that merely being related to an in-state retailer is insufficient to satisfy the U.S. Commerce Clause's nexus requirement, making it highly unlikely the state could prevail should a retailer challenge the law.

Lastly, in their search for more sales tax revenues, legislators should take care not to undermine the state's opportunity to be a leader in e-commerce jobs and investments. Focusing solely on one side of the revenue equation risks driving emerging e-commerce businesses to other states with more receptive laws and regulations.

E-commerce companies contribute millions of dollars in income tax revenues to California every year, an estimated \$124 million in 2009, and provide thousands of jobs for Californians, and there is still ample room for growth in the e-commerce arena. E-commerce also enables thousands of California entrepreneurs to get their start. It is estimated that more than 50,000 websites are launched per week and many small companies are 100 percent Web-based, which enables them to have low overhead costs. The Internet even helps small California companies compete with big companies by giving them cheap access to a global market, enabling them to compete with large chain stores on a scale never before possible.

**CalChamber
Position**

As an alternative, the CalChamber does not oppose approaches that focus on enforcement of the individual obligation to report use taxes to the state, such as the use tax registration requirement for businesses passed in 2009, which the BOE expects to raise approximately \$600 million annually by 2013. The CalChamber also encouraged legislators to reinstate the use tax reporting line on the personal income tax form, which was eliminated in 2009, but was reinstated permanently in 2010. The CalChamber is supportive of proposals to make the reporting line mandatory, while supplying individuals with an estimate table and a safe-harbor to encourage and simplify compliance. Such a proposal was vetoed in 2009, but might be revived with more success in 2011, given the change in leadership. The CalChamber also believes more can be done to educate individuals about their obligation to remit this tax.

**Reasons for
Position**

- Due to U.S. Commerce Clause issues, the only way to truly level the playing field for all retailers is through a federal solution.
- State approaches that focus on out-of-state retailers threaten California jobs, and will not bring in the anticipated revenue because out-of-state retailers can easily avoid collecting the tax without giving up access to California consumers.

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