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# California's Use Tax

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LEGISLATIVE ANALYST'S OFFICE

Presented to:

Assembly Revenue and Taxation Committee

Hon. Henry T. Perea, Chair





## The Use Tax Has a Long History...

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- Almost All States Levy Sales and Use Taxes.*** The use tax is a companion to the sales tax. It is levied on tangible goods consumed in California even if the goods were purchased from an out-of-state seller. This levels the playing field between retailers with a physical presence in California (who generally are required to collect the sales tax) and some out-of-state retailers (who generally are not required to collect the tax).
  
- California Use Tax Was Enacted in 1935.*** This occurred less than two years after enactment of the state sales tax.
  
- Same Rate as the State Sales Tax.*** The current statewide sales and use tax rate is 8.25 percent, including the temporary 1 percent rate increase for the state General Fund that expires on June 30, 2011. Including local option tax rates, the average sales and use tax rate in California now is 9.1 percent.



## ...Yet, There Is Relatively Little Compliance With This Tax

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- No General Tax Exemption for Internet Sales.*** Many Californians are unaware that when they purchase physical products from an Internet or mail order vendor with no in-state presence, the products shipped to their California address generally are subject to the state's use tax.
- Difference in Collection Procedures Hampers Collection Efforts.*** Businesses generally collect sales taxes and remit them to the State Board of Equalization (BOE). By contrast, due to limits imposed by the federal courts, businesses without a physical presence in California typically cannot be forced to collect and remit use taxes to BOE. Consumers themselves are responsible for remitting the use tax.
- Over \$1 Billion in Unpaid Use Taxes.*** According to BOE estimates, about \$1.1 billion of use taxes related to remote electronic and mail sales from out-of-state vendors are unpaid. (Of this total, \$755 million is due the state's General Fund.) About three-fourths of this gap relates to business-to-consumer sales, with the rest relating to business-to-business sales. Based on use tax collections, there is only about 1 percent consumer compliance with use tax obligations.
- Use Tax Non-Compliance Creates Competitive Burden for Some Businesses.*** When a "brick-and-mortar" California business competes with an out-of-state online, mail, or other retailer that does not collect use taxes, the California business has a competitive disadvantage. Enhancing use tax compliance would tend to reduce this competitive disadvantage.



## What Prevents the State From Forcing Businesses to Collect Use Taxes?

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- ☑ ***Decades of U.S. Supreme Court Rulings.*** A series of decisions by the U.S. Supreme Court severely restrict the ability of states to force businesses without a physical presence to collect and remit sales and use taxes.
- ☑ ***The “Negative Commerce Clause.”*** The “negative,” or “dormant,” Commerce Clause of the U.S. Constitution prohibits certain state actions that interfere with interstate commerce in the absence of congressional approval for those actions.
- ☑ ***“Bright Line” Physical Presence Requirement.*** In *National Bellas Hess, Inc. v. Illinois Department of Revenue* (1967), the U.S. Supreme Court established a bright line physical presence requirement for sales and use taxes. This requirement has been upheld in subsequent cases despite there being no similar bright line for some other taxes.
- ☑ ***Court Explicitly Upheld Bright Line Requirement in 1992.*** In *Quill Corp. v. North Dakota* (1992), the court explicitly upheld the bright line test on sales and use taxes, noting—in the context of the mail order industry—that it encouraged “settled expectations and, in doing so, fosters investment by business and individuals.” The court said Congress is “free to decide whether, when, and to what extent the states may burden interstate mail order concerns with a duty to collect use taxes.”



## Recent State Efforts to Increase Use Tax Compliance

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- New York's "Amazon" Law.*** Amazon.com allows so-called "affiliates" (individuals or businesses with a website of their own, for instance) to link to its website and receive money when web viewers purchase through that link. New York enacted legislation to require use tax collections by companies with such affiliate relationships. (A similar 2009 California bill would have required retailers like Amazon that enter into direct or indirect referral agreements to register with BOE and remit use taxes. The BOE estimated this bill would have produced \$150 million of state and local sales and use taxes.)
  
- Courts Still Mulling the New York Law.*** In November 2010, a New York appellate court ruled for the state on certain challenges to that state's Amazon law under the Commerce and Due Process Clauses. The court said additional discovery was required at the trial court level to determine whether there was sufficient in-state activity by the affected taxpayers to create a nexus under the Commerce Clause.
  
- Colorado Disclosure Law.*** Colorado enacted a law requiring specified businesses to notify Colorado purchasers on invoices that use tax applies and must be paid. The law requires an annual report be provided to customers on all such purchases and requires the companies to file an annual report with the state with customer names, addresses, and total amounts of purchases. The law is being reviewed by the courts.



## Significant Uncertainty About Unilateral State Action

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- California Has Undertaken Limited Actions to Enhance Compliance.*** In recent years, California has taken several steps to modestly enhance use tax compliance by in-state retailers and consumers that we generally support. Both houses' recent budget plans also would require BOE to produce a simple "look up table" for assistance in determining the amount of use tax to pay with income tax returns.
- Same Reasoning Underlying Prior Court Rulings Still Applies.*** The same reasoning underlying the past Supreme Court decisions concerning the physical requirement for use tax collection requirements still applies. Just as the bright line physical presence test encouraged the growth of the mail order industry, so has it encouraged growth of the Internet retail industry.
- Congress Most Likely Venue for a Solution.*** Given the significant interstate commerce issues arising from use tax compliance, Congress is the most likely—and probably the most appropriate—venue for seeking a solution on the issue of use tax compliance. We doubt that statutory or regulatory actions by California—acting alone—will significantly increase use tax compliance. Such unilateral California efforts may not withstand court scrutiny *or* may result in companies altering their behavior or organization to evade collection efforts.
- State Should Encourage Congressional Action.*** State officials should encourage Congress to authorize states to impose use tax collection requirements—through the streamlined sales tax initiative or other actions. Such authorization would mitigate the competitive disadvantage facing brick-and-mortar California businesses that compete with out-of-state retailers.