



California Tax Policy And the Internet

Background

- ❖ The Internet and its associated “e-commerce” activities have been evolving at a rapid pace, raising many important issues for policymakers at all levels of government.
- ❖ One key issue involves Internet tax policy, including how to allow the Internet to continue to evolve and develop while ensuring tax fairness and considering its potential impact on state and local government tax bases. Moratoria at the federal level and in California have temporarily frozen tax actions to facilitate resolution of these issues.

LAO Findings

- ❖ The two main Internet-related tax issues are related to the sales and use tax (SUT) and involve (1) tax inequities involving the treatment of taxpayers and consumers, and (2) potential revenue losses. These issues relate to collecting taxes on out-of-state sales, and the conversion of tangible taxable goods into nontaxable, “digitized” intangible forms.
- ❖ The SUT-related revenue losses, while currently small relative to the tax base, could grow significantly in the future and materially erode the base.
- ❖ Other tax issues involve the appropriateness of current telecommunications taxes and determining the income taxes of multistate and multinational corporations.
- ❖ Regarding the SUT, immediate tax law actions are not necessarily needed, given the current nature and magnitude of the problems. However, the Legislature should (1) pursue multistate agreements, and (2) consider undertaking a comprehensive review of the SUT with respect to its long-term viability and basic fairness.

Legislative Considerations

- ❖ The Legislature also should undertake a comprehensive review of California’s different telecommunications levies, to ensure that their rationales and current provisions make sense in light of Internet-related and other telecommunications developments. The results of this study could be used to assess the need for any extension of the current California Internet Tax Freedom Act.



INTRODUCTION

The rapid development and growth of the Internet in recent years has resulted in fundamental changes in the manner in which communications and transactions occur between and among businesses and individuals. These changes will continue to occur—and probably accelerate—as the Internet evolves and its use becomes more widespread throughout society. Such Internet-induced changes take a variety of forms. For example:

- ◆ The *manner* in which goods and services are exchanged has been changing, as transactions previously conducted by telephone, mail, or face-to-face contact can now occur directly through the use of computers and telecommunication lines. Consumers, for instance, can purchase clothing and other items simply by connecting to a seller’s web page and conducting the transaction over the Internet. Business transactions are also facilitated by the Internet.
- ◆ The *form* in which goods are exchanged also has been changing, as Internet technology has facilitated the transformation of certain goods from tangible into digitized intangible forms—as with books, movies, and musical recordings.

- ◆ Finally, *modes* of communication have been altered due, in part, to the Internet. While telephone, television, radio, and wireless communications all developed as separate and distinct technologies, the Internet and related developments have resulted in a convergence of these different technologies. As a result, they are no longer isolated from one other. Internet connections, for instance, currently can be made through both telephone lines and cable television connections, and will soon be widely available through wireless technology. Conversely, telephone service can now be obtained through Internet connections, as can radio service.

The above changes have a number of important public policy implications—including in the areas of economic growth and labor productivity, information security and privacy, and the structure of industry and the manner in which businesses operate. Of special interest, however, are the implications of the Internet for state and local tax policy.

This report, prepared at the request of Senator John Vasconcellos, focuses on tax-related issues, including the options available to the California Legislature for addressing them. The report is accompanied by a series of supplements, which are cited throughout the text and are available on our web site or upon request.

WHAT IS THE INTERNET?

The Internet is a worldwide network of computers and connections that uses a common communications language. This communications language provides a common link that enables individual computer systems to interact with one another. Individual computers are linked to Internet service providers (ISPs)—such as America Online—by a combination of wired (telephone, local area network [LAN], or cable) and/or wireless technology. These ISPs, in turn, connect to the Internet “backbone”—a large-capacity, high-speed, telecommunications network. A small percentage of the Internet-linked computers provide content via worldwide web sites that are available to other computers connected to the Internet.

Early History

The Internet began in the late 1960s as part of a Department of Defense project aimed at developing a computer-related communications system linking government agencies, university research facilities, and high-tech defense contractors. As the original system evolved, it expanded beyond the original participating institutions, and included broader industry and government participation, as well as encompassing commercial, nonprofit, and individual users. In the 1990s, much of the Internet system was turned over to private industry.

Basic Structure

The basic “layout” of the Internet is shown in Figure 1 (see page 4). It consists of (1) individual users who connect to ISPs, most often through

dial-up telephone lines or cable; and (2) institutional users—such as universities, governments, and large commercial entities—which generally connect to ISPs using dedicated wiring such as LANs or leased telephone lines. The ISPs are then linked to a regional or mid-level network which, together with other regional networks, connect to a “major point of presence” (MPOP). These MPOPs are linked at very high speeds to create the Internet backbone. The U.S. Internet backbone connects to other backbones around the world. Links to web sites, e-mail to individuals, sales transactions, and other uses of the Internet go through these networks and commercial service providers.

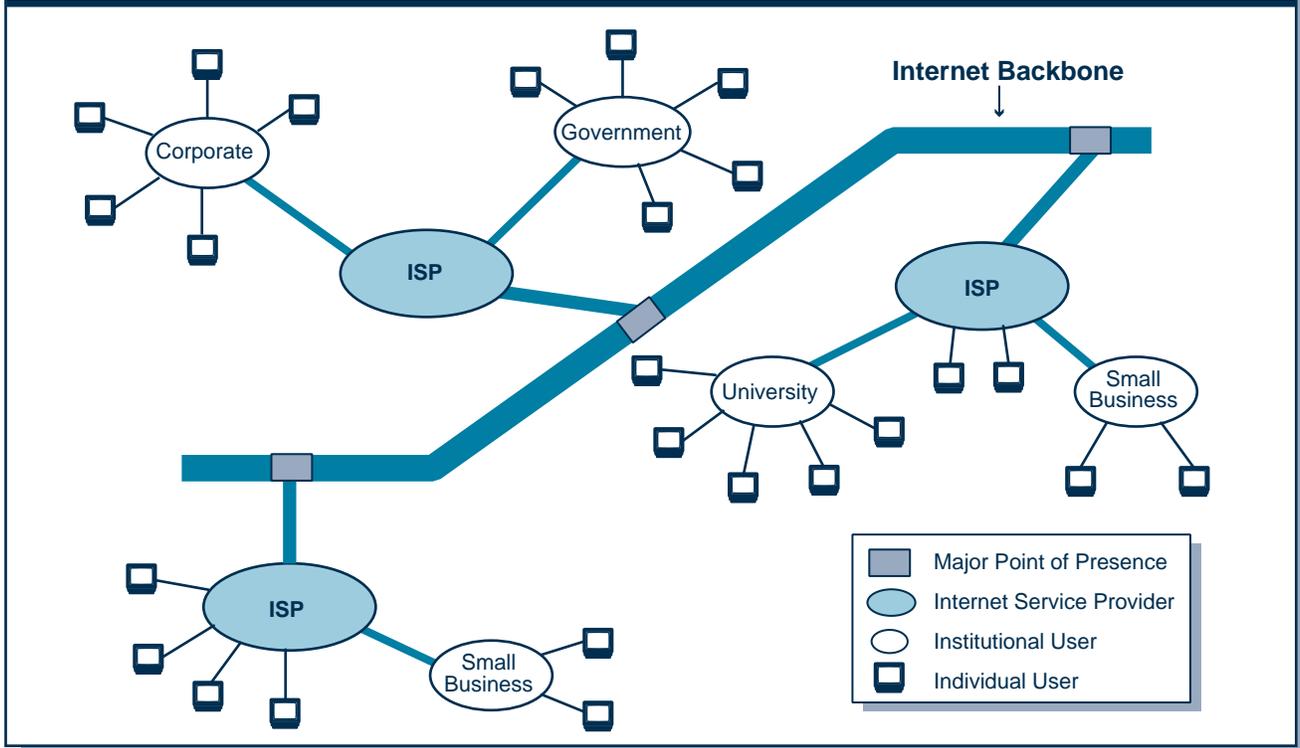
Scope of the Internet and E-Commerce Activity

As yet, no official U.S. data on Internet usage or e-commerce are available, and, as a consequence, the exact magnitude of Internet activities is not currently known. However, there is no question that Internet activity and e-commerce are extensive and rapidly expanding. For example, the number of worldwide users of the Internet is currently estimated at some 200 million, up from an estimated 3 million in 1993. In the United States, it is estimated that the number of Internet users grew from fewer than 1 million in 1993 to over 80 million by 1999. Internet penetration has reached nearly 40 percent in the United States, the largest population share among all nations.



Figure 1

Structure of the Internet



Similarly, e-commerce has been exploding. Annual U.S. business-to-business volume is estimated to reach between \$1.3 trillion and \$2 trillion by 2003, up from an estimated volume of approximately \$100 billion to \$150 billion in 1999. Internet business-to-consumer transactions, which were estimated at less than \$10 billion in 1998, are estimated to have grown to \$20 billion in 1999—with some estimates in excess of \$35 billion. Retail e-commerce is expected to reach between \$100 billion and \$200 billion by 2003.

Regardless of its exact magnitude, Internet and e-commerce activity is extensive and rapidly growing, with similar trends expected for the future as this new technology continues to evolve and expand in scope.

(Supplement A provides additional detail regarding the Internet’s structure, technical characteristics, economic advantages, and usage, as well as further information concerning e-commerce activity.)

TAX POLICY AND THE INTERNET— A GENERAL OVERVIEW

The dramatic evolution of Internet technology raises numerous issues with respect to state and local taxes. These issues—which generally relate to the basic fairness and equity of the tax systems involved and the potential erosion of state and local tax bases—have been the subject of considerable discussion and debate for several years at both the national and state levels. Yet, they remain largely unresolved. Figure 2 summarizes key Internet-related tax issues. These issues are briefly described below, and more fully analyzed in the following section.

SALES AND USE TAX ISSUES

The Main Issue—Tax Treatment of Remote Sales. The issue that has received by far the greatest attention in the Internet tax policy debate is the fact that often the SUT may not be paid on out-of-state sales. This occurs because Internet technology facilitates the ability of businesses to conduct commerce on a “remote” (that is, out-of-

state) basis. As discussed later in this analysis, California has limited ability to require companies located out-of-state to collect the SUT on sales to its own residents that are conducted over the Internet. As a consequence, in many cases taxes go uncollected on sales of goods to Californians

Figure 2

Key Internet-Related Tax Policy Issues

Sales and Use Tax (SUT)

- ✓ Current limitations on the application of the SUT to out-of-state sales can result in unequal treatment of different businesses and consumers.
- ✓ Internet activity can result in revenue losses to state and local governments under current tax collection procedures.
- ✓ Increasing conversion of tangible goods into intangible goods has adverse implications for the SUT base and raises issues regarding the consistency of the tax.

Telecommunications Taxes

- ✓ There currently are many inconsistencies and inequities associated with these taxes.
- ✓ Technological changes in the industry and the “convergence” of various technologies raise many tax and regulatory issues.
- ✓ Changes in the competitive environment of telecommunications industries—including the Internet—make it especially difficult to apply existing taxes in an equitable and consistent manner.

Corporate Income Taxes

- ✓ Internet activity such as e-commerce raise significant issues regarding the definition of nexus and how to apportion the income of multistate and multinational corporations for tax purposes.



shipped from out-of-state. The same collection issues arise for the 44 other states which levy sales taxes. While this issue of SUT collection is not new, state and local officials recognize that as the Internet grows and this type of commerce—termed “remote sales”—increases, there will be a steady erosion of the SUT base.

How Extensive Are Internet Sales? Figure 3 presents estimates of e-commerce as a factor of various economic measures. E-commerce activity in the United States is estimated to represent three-quarters to four-fifths of the worldwide total. It does not appear as though Internet sales *currently* comprise a substantial proportion of total retail sales in our nation. This perspective is generally confirmed by a wide variety of studies and sources. Such sales do not, therefore, represent a significant loss of state and local SUT revenues *at this time*. Nevertheless, because of the ongoing rapid evolution and expansion of e-commerce and Internet activity generally, this relatively small impact certainly may not hold *in the future*.

The growth of Internet activity, coupled with substantial reliance on SUT revenues by state and local governments, poses a legitimate cause for concern on the part of public offi-

cial in California and other states regarding revenue impacts. As shown in Figure 4, many states are reliant to a substantial degree on revenues from the SUT. In addition to this potential Internet-related revenue loss, the distinction between remote sellers and traditional businesses identified above creates tax inequities. As a result of this tax differentiation, some businesses get an unfair competitive advantage over others, and some consumers get tax-related “price breaks” while others do not.

Conversion of Tangibles to Intangibles Also Is Occurring. In addition to the restricted ability of state governments to require that out-of-state companies collect the SUT, the technology of the Internet is increasing the rate at which certain types of products are no longer even subject to

Figure 3

Worldwide E-Commerce Is Expanding at a Rapid Rate

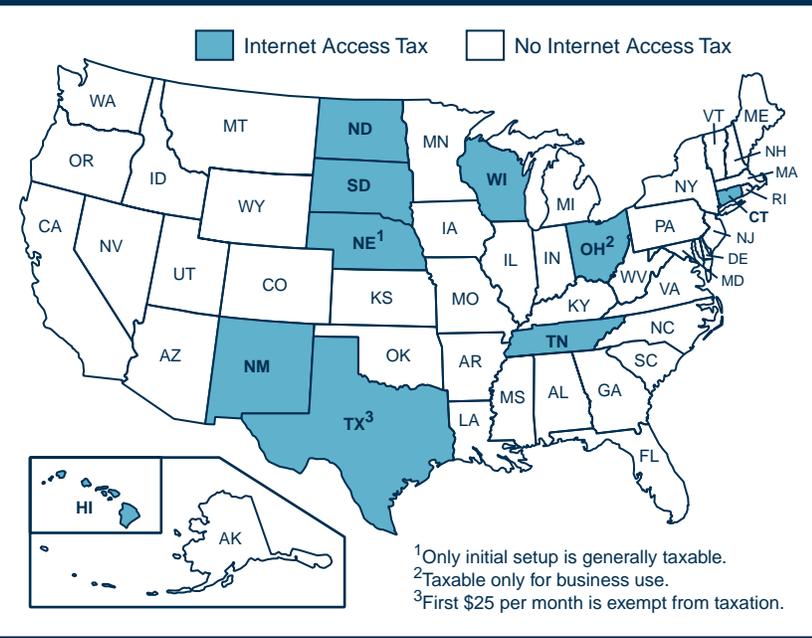
- ✓ Currently, e-commerce is estimated to be approximately one-third of U.S. catalog sales, but is expected to increase to eight times catalog sales by 2003.
- ✓ It is estimated that e-commerce currently comprises roughly 3 percent of U.S. credit card sales, a figure that is expected to expand to one-half of all credit card sales by 2003.
- ✓ Current estimates suggest that e-commerce sales account for approximately 1 percent to 2 percent of total retail sales. By 2003, this is expected to rise to an estimated 15 percent.
- ✓ As a percent of direct marketing, e-commerce is expected to grow from the current 2 percent of the total to over 40 percent by 2003.

Source: Organisation for Economic Cooperation and Development.



Figure 5

States That Currently Tax Internet Access



in the competitive structure of the industry have added additional complexity to the issue.

CORPORATE INCOME TAXES

The main issue posed by Internet activity with respect to corporate income taxes occurs because, for multistate and multinational corporations in most states, they are based on the geographic apportionment of income. In California, this apportionment is in turn based on a formula which incorporates property values, employment levels, and sales volumes. With respect to the sales component, Internet activity raises certain questions about how sales should be attributed to different states, and thus how the amount of income earned by a particular corporation should be allocated amongst such states. In addition,

Internet activity raises issues regarding “nexus” (that is, degree of presence) rules for corporate income tax purposes.

WHERE DO THINGS CURRENTLY STAND ON THESE TAX ISSUES?

Resolution of the above Internet-related tax issues has not yet occurred. In fact, due to the significant debate at both the national and state levels regarding them, temporary moratoria have been passed to preclude tax decisions from being made until some consensus has been reached. Such consensus will presumably attempt to balance

concerns regarding: (1) the fiscal issues the Internet poses for state and local governments; (2) tax inequities, complexities, and inconsistencies; and (3) constraints on the healthy growth and evolution of the Internet-based economic subsector.

To aid in this process, several advisory groups have been formed or are involved. Some of the most prominent groups are the federal Advisory Commission on Electronic Commerce (ACEC), National Tax Association, Electronic Commerce Advisory Council, Joint Venture: Silicon Valley Network, and Organisation for Economic Cooperation and Development. (The activities of these entities, some of the findings and recommendations of which have yet to be released, are summarized in Supplement B.)

Internet Tax Moratoria

The federal Internet Tax Freedom Act. The federal Internet Tax Freedom Act (ITFA), was signed into law on October 21, 1998. It provides for a three-year prohibition against states and local governments levying taxes on Internet access, unless such a tax already was imposed prior to October 1998. It also prohibits both "multiple" taxes and "discriminatory" taxes on Internet activity. (These are described in more detail in Supplement C.)

The federal ITFA also established the ACEC, which is to study Internet tax policy issues and report to Congress as to whether e-commerce should be taxed and, if so, what the appropriate taxation method would be. The ACEC is comprised of three federal officials, eight state and local government representatives, and eight representatives from the e-commerce industry, telecommunications carriers, local retail businesses, and consumer groups. By April 2000, ACEC is to deliver its report to Congress on various tax-related matters. (Again, see Supplement C for more detail.)

The California ITFA. Prior to the passage of the federal ITFA, California passed its own version of the measure. The California ITFA—Chapter 351,

Statutes of 1998 (AB 1614 [Lempert])—was signed into law by Governor Wilson on August 24, 1998. The California ITFA imposes a three-year moratorium on specifically identified new or discriminatory taxes, including taxes on Internet access or online computer services, "bit" or bandwidth taxes, or any discriminatory tax on online computer services or Internet access. Discriminatory taxes are defined as those that result in either a tax rate on online computer services or Internet access that is higher than the rate on other businesses, or results in taxes that are applied only to online computer services or Internet access.

The California ITFA does *not* preclude new or existing taxes of general application that are imposed in a uniform and nondiscriminatory manner. Thus, the collection of SUT, utility user charges (such as on basic cable television and telephone and cellular phone service, even if the lines are used for Internet access) or (under current federal law) franchise fees continues to occur under the act. The California ITFA also allows cities and counties to continue to collect business license taxes and the state to collect telecommunication taxes.

We now turn to a more detailed discussion of these issues on a tax-by-tax basis.



SALES AND USE TAX ISSUES

As noted earlier, currently the most discussed, visible, and potentially important Internet-related tax policy issues for California involve the state's SUT. One frequently voiced concern involves the tax inequities that result when some transactions trigger the collection of a sales tax, whereas other similar types of transactions do not. A second, interrelated concern involves the potential loss of SUT tax collections because through Internet activity certain types of transactions become not taxable. In addressing these concerns, one should keep in mind an important tax administration issue—namely, that the SUT's administrative and compliance costs for businesses are significant and can substantially differ for in-state versus out-of-state transactions.

The SUT issues have long existed involving tax-base erosion, inequities between different taxpayers and different transaction modes, and administrative and compliance cost differentials. The Internet, however, has exacerbated these concerns, as well as put some new issues "on the table." In this section, we discuss these issues and their policy implications. (Supplement D provides additional information on SUT issues.)

BACKGROUND ON THE SUT

Importance of the SUT

The SUT is one of California's largest sources of government revenue. In 1999-00, it is projected to raise revenues of approximately \$32.1 billion, including \$24.4 billion by the state (General Fund

plus special funds) and \$7.7 billion by localities. The SUT is the state government's second largest source of General Fund revenue, accounting for approximately one-third of the total. The tax is also important for local governments. Statewide, it provides about one-third of total city tax revenues. For counties it is an important source of funding for certain programs (criminal justice, transportation, and particular health programs).

Tax Base and Rates

What Is Taxed? California's SUT is imposed on the retail price of *tangible personal property* sold to final purchasers (unless specifically exempt). It does not apply to either real property (for example, houses) or intangible personal property (such as stocks or items sold in digital form). Services are also generally exempt from direct SUT taxation, although they can be indirectly taxed to the extent that their value is incorporated into the final value of the tangible products they help produce. The SUT is typically collected and remitted by sellers to the administering state agency—the California State Board of Equalization (BOE). When collecting the SUT, sellers generally apply the tax rate in effect where the transaction occurs.

Tax Rates. Figure 6 shows that there are both state and local SUT rates. The basic combined rate is 7.25 percent, including an overall state rate of 6 percent and a local one of 1.25 percent. In addition, localities can impose an added tax rate which generally can not exceed 1.5 percent. The

state rate includes 5 percent for the General Fund, plus two half-cent levies earmarked for localities in the Local Public Safety Fund and the Local Revenue Fund.

Sales Taxes Versus Use Taxes

The SUT is actually comprised of two separate levies. The first is the *sales* tax, which is applied to items which are both purchased and to be consumed *within* California. In contrast, the companion *use* tax is levied on goods purchased *outside* of the state for use *within* the state. These two taxes are similar in that they are both imposed on sales of goods to be used in California and are levied at the same rate. However, their proceeds going to local governments are distributed somewhat differently, and the Internet-related administrative and tax-collection issues associated with them are quite different (as more fully described in Supplement D).

It is the latter characteristic of the use tax which makes it of special interest to this report.

Revenue Trends

Recently, SUT collections have displayed strong performance. Taxable sales, for example, grew by over 8 percent in 1999—reflecting the state’s extremely robust economic performance and booming expenditures for both consumer durables and business investments. However, SUT performance often did not keep pace with the economy during the 1980s, as evidenced by the past declines in the ratio of taxable sales to personal income and the failure of this ratio to materially rebound during economic expansions (see Figure 7, page 12).

This decline appears to reflect a variety of factors, including increased spending on nontaxable services, reduced levels of residential building activity since the mid-1970s, increased catalogue sales from out-of-state sellers, and transformations of certain products from tangible (taxable) to intangible (nontaxable) form. (See Supplements D-2 and D-5.) Although its performance has been strong recently, the possibility of further SUT base erosion—including from Internet-related activities—has been of special concern to many state and local officials.

PROBLEMS RAISED FOR THE SUT BY THE INTERNET AND E-COMMERCE

The two problem areas for the SUT posed by the Internet and its associated e-commerce activity are (1) tax inequities and (2) potential base erosion. Below, we examine each of these issues in turn, and then discuss why they occur.

Figure 6

Sales and Use Tax Rates in California

	Current Rate
State	
General Fund	5.00%
Local Revenue Fund	0.50
Local Public Safety Fund	0.50
Subtotal	(6.00%)
Local	
Uniform Local Taxes	1.25%
Optional Local Taxes ^a	1.50
Subtotal	(2.75%)
Combined Maximum Rate	8.75%

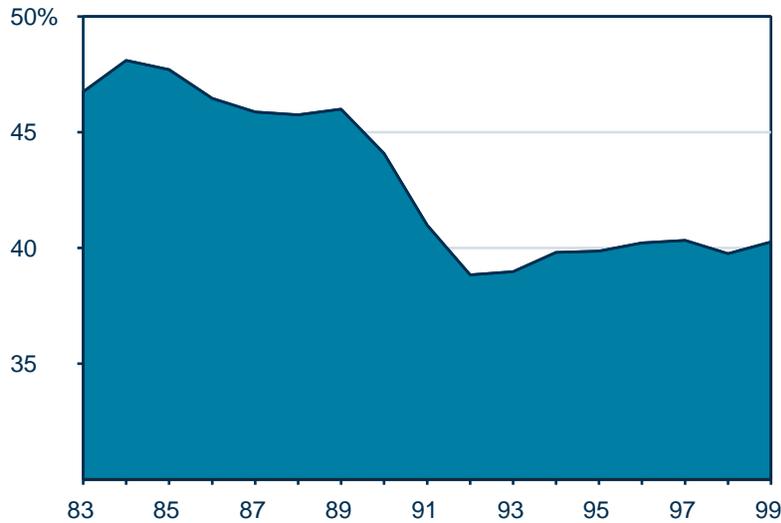
^a Maximum allowable rate except for City and County of San Francisco (1.75 percent) and San Mateo County (2 percent).



Figure 7

Taxable Sales Have Dropped as a Percent of Personal Income

1983 Through 1999



Inequities Related to the Application of the SUT

Currently, California generally collects the SUT only on sales where the seller has a *physical presence* in the state. This means that in many cases, the purchase of a tangible item—a book or item of clothing, for example—through the Internet (or other remote sales method) will not result in the payment of the SUT (as discussed below). If this same transaction were to occur instead through a traditional “bricks and mortar” business in California, the SUT would be applied by the seller to the purchase. This differential treatment in SUT responsibilities based solely on the transaction method results in unequal treatment of both sellers (based on their sales method) and consum-

ers (based on their means of purchase). In addition, if lack of Internet access is more predominant among those in lower-income households than the population as a whole, this could result in a somewhat increased share of the existing SUT burden towards the lower end of the income spectrum, especially as the Internet continues to expand.

Potential Base Erosion

The SUT base erosion associated with the Internet involves both remote sales and the conversion of goods from tangible into intangible form.

Remote Sales. It is not clear exactly what the current volume of e-commerce sales activity is, let alone the portion subject to California’s SUT and the share of this portion that is currently not collected. Making an accurate estimate of lost revenue is complicated both by a lack of reliable comprehensive information on current Internet and e-commerce activity, and the fact that not all such activities result in California SUT revenue losses. Nevertheless, as detailed in Supplement D-3, it appears that California retail e-commerce currently could be as much as several billion dollars annually.

In order to estimate SUT revenue losses due to Internet sales, this amount would be reduced by taking into account: (1) sales of exempt consumer

items, (2) displaced catalogue and telephone sales on which the SUT is not presently being paid, and (3) sales that result in the collection of the SUT by businesses with nexus in the state. Based on these adjustments, current total SUT revenue losses would appear to be in the high tens of millions of dollars to \$200 million annually. This figure would not include revenue losses due to nonpayment of use taxes by businesses which are not registered sellers, nor does it include SUT not collected on other remote sales. It should be noted that frequent revision of Internet and e-commerce activity occur and these revenue impacts constitute rough estimates.

The concern in this area is not so much related to *current* losses, but rather that this amount could grow substantially in the *future*, as the Internet and e-commerce continue to evolve. While the amount of estimated revenue losses is currently likely less than 1 percent of the SUT revenue base, Internet growth rates in the next three to five years equivalent to those experienced in the recent past could raise the magnitude of such losses. By 2003, such revenue losses could range into the mid- to high-hundreds of millions of dollars, constituting as much as 2 percent to 4 percent of state and local SUT revenues.

Conversion of Tangibles. One of the important and unique characteristics of Internet technology is its ability to transform vast quantities of information from physical into digital form. As a result, virtually any product which is based on information can be sold, transferred, or conveyed through the Internet. The process of reducing such items

to “pure information,” or “digitizing” them, transforms them from a tangible form (which generally *would* be subject to the SUT) into an intangible form (which is *not* subject to taxation). This occurs with respect to both interstate and intrastate sales.

This process of reducing goods to their pure informational form is not new. Previous telecommunications-based technologies also were used to transform information from physical to digital form (see Supplement D-5). For example, facsimile machines can be used to deliver or sell certain types of information, including reports, renderings, or similar items. However, the development and continued improvement in Internet technology has vastly expanded—in terms of both volume, variety, and complexity—the ability to engage in such digital exchanges. Examples of this process include the digitization of music, computer software, graphics programs, books, movies, and data bases.

The revenue losses stemming from the transformation of tangible goods into intangible form are unknown and difficult to estimate. At present, they are probably not all that significant relative to the SUT's base, given the technology's age and state of development. Future losses, however, are likely to be considerably more significant, as the technology used to convert information to digital form evolves and becomes more refined and widespread. This evolution also will increasingly raise tax administration issues regarding how to apply the SUT to a world where the line between tangibles and intangibles becomes more and more blurred, and the destination or place of delivery of



such intangibles may be both unknown and unknowable (see Supplement D-7).

Sales and Use Tax Collections Problems— What Underlies Them?

The collections-related problems associated with the Internet and e-commerce relate primarily to the issue of nexus as it pertains to the use tax and the related administrative and legal barriers to collecting the SUT. These issues are discussed below. With respect to the conversion of taxable tangible goods to nontaxable intangible goods, this issue cannot be addressed without fundamentally altering the SUT tax base.

The Concept of Nexus. In simple terms, nexus refers to the degree of presence or connection between things. For state tax purposes, it refers to the degree of contact or connection required between a state and a taxpayer before the state has the legal authority to impose and/or require the collection of a tax by a taxpayer. In the case of California, nexus must be established before the state can require the seller to collect the use tax component of the SUT. Although states normally define nexus in statute, it still may be subject to judicial review for such purposes as determining its constitutionality. Specifically, the courts have overturned nexus statutes if they violate the due process clause or commerce clause of the U.S. Constitution (see Supplement D-4).

Nexus Rules for Out-of-State Remote Sales. Legal issues involving state tax nexus have a history which predates the appearance of Internet technology and e-commerce. In particular, catalog

sales and telephone order sales both raise the same or similar issues regarding SUT nexus as do Internet sales. All such activities can be characterized as involving remote sales—that is, sales where the seller is located out-of-state but the buyer and user of the purchased item is located in-state. The legal guidelines for whether a state can require companies to collect the SUT on Internet sales were established by a series of previous Supreme Court cases dealing with non-Internet remote sales (see Supplement D-4).

The general rule is that states cannot require the collection of the SUT by out-of-state sellers without them having a sufficient physical presence in the state. Many Internet sellers do not have such a presence. As a result, states like California cannot require such retailers to collect the SUT. Many states have sought and continue to try to broaden the definition of nexus, such that more companies and transactions will meet the “physical presence” test. However, the current “bottom line” is that, short of Congressional action, it is not possible for states to require collection of the use tax component of the SUT on many Internet sales by out-of-state parties.

Does the SUT Still Have to Be Paid? California law *does* provide that *purchasers* of remote-sale taxable items are themselves liable for the use tax even if it is not collected and remitted by the seller. However, as a practical matter, the BOE reports that the SUT is routinely paid by purchasers on such out-of-state sales only in cases that involve (1) items purchased by taxpayers which are registered sellers and whose transaction

records are reviewed by the BOE during the normal course of its auditing activities; and (2) items that have legal registration requirements, such as cars, trucks, and boats. Otherwise, the tax goes unpaid except for those individuals and businesses who voluntarily report it. According to the BOE, there are few such voluntary payments made.

WHAT SHOULD BE DONE?

What, if anything, should the Legislature do about the above problems the Internet and e-commerce pose for the SUT? Unfortunately, no simple answer exists. However, in considering this question, there are several tax policy criteria that should guide the Legislature's thinking. These include the principles of tax efficiency, tax neutrality, tax equity, revenue sufficiency, and administrative cost and feasibility. (Supplement D-6 describes these principles in more detail.)

What Should the Focus Be?

Because the major SUT issues the Internet raises are not new but rather are generic to the SUT and only highlighted and exacerbated by the Internet, it is important that the Legislature decide at the outset how broad an approach it wishes to use in addressing this issue. For example:

- ◆ One alternative is to choose to do absolutely nothing and let the current SUT system operate as it presently does.
- ◆ At the opposite end of the spectrum, the state could decide to "stand back" and take this opportunity to review the entire

SUT system, including the problems and issues posed by services and other intangibles (see Supplement D-7). The thrust of this approach could include broadening the SUT's base so as to reduce tax rates, to looking at how SUT revenues are distributed to localities, to replacing the SUT with a broad-based consumption or value-added tax.

- ◆ It could instead take a "middle ground" approach of viewing the basic SUT system already in law as a "given," and attempt to apply and administer it to Internet-related activities as fairly as possible.

Action-Step Recommendations

The approach we recommend depends in large part on the time frame under consideration. For the present—and in the immediate future—we recommend a cautious approach. Estimated revenue losses are not of sufficient size to warrant immediate remedial action. In addition, the tax inequities discussed here do not lend themselves to a short-term solution, given the current structure of the SUT.

However, in order to address the identified tax inequities and in view of the fact that future base erosion and potential revenue losses are expected to increase substantially, the state should begin to explore and evaluate means by which the SUT can be applied more effectively and fairly. The options California has in this regard involve both (1) taking independent "state specific" actions and (2) working in cooperation with other states. These options



are summarized in Figure 8 (and discussed in detail in Supplement D-8). In addition, we recommend that the Legislature consider undertaking a comprehensive assessment of the SUT, with a focus on its long-term viability.

State-Specific Actions. In terms of state-specific actions, we believe that the ability of California to unilaterally address Internet-related tax issues is inherently limited. The state-specific options shown in Figure 8 would either not be particularly effective in dealing with the underlying tax policy issues highlighted by Internet development, or would raise additional—perhaps more serious—problems. For example, pursuing a more aggressive enforcement of nexus would not address the fundamental legal issues involved and would likely entail extensive litigation. Likewise, encouraging use tax compliance would serve

Figure 8

Options for Dealing With Internet-Related Sales and Use Tax Issues

State-Specific

- ✓ **Lessen California Nexus Problems**
 - Expand the concept of nexus in California, so that it encompasses the full range of Internet transactions which would appear to be appropriately taxable under existing sales and use tax (SUT) law.
- ✓ **Encourage Increased Compliance**
 - Have California more rigorously enforce the use tax on purchases from out-of-state sellers.
 - This could be attempted in a number of ways, including providing increased information to the taxpaying public and conducting increased auditing.
- ✓ **Change the SUT's Application in California**
 - Change how the SUT is applied in California by switching from the current destination-based system to an origin-based system.
 - Under this approach, sellers would apply the tax rate at their location and not be required to determine the rate at the purchaser's location.
- ✓ **Have California Facilitate Tax Collections**
 - California could create a web-based tax application to allow for easier collection of the SUT.
 - For example, the state could act as an on-line collector of the SUT by establishing links between sellers' web sites and a state web site.

Cooperation With Other States

- ✓ **Federal SUT Collection**
 - Work with other states and the federal government to have the latter collect the SUT for states, and then distribute collections back to them.
- ✓ **Individual State Agreements**
 - Strike reciprocal agreements with individual states for the collection and remittance of the use tax on out-of-state sales.
- ✓ **Pursue Multistate Compact**
 - Work jointly with other states to develop collective approaches to applying the SUT to out-of-state sales. This approach could minimize foregone revenues, reduce tax inequities, and lessen administrative costs.

to educate taxpayers as to the use tax obligation, but it would be unlikely to have a measurable impact on SUT collections. With regard to shifting to an origin-based SUT, the disadvantage with this is that economic locational distortions could occur, since this approach essentially results in shifting the SUT from a consumption-type tax to a production-type tax.

The last option—that the state investigate the potential of a web-based tax calculation and collection system—would not directly address Internet-related tax issues; however, we believe that a web-based tax collection effort would at least alleviate some of the secondary issues stemming from Internet activity and remote sales. Among the advantages of this option is that it would facilitate use tax collections, avoid placing additional administrative costs on sellers, and could result in a fairer application of the SUT.

Cooperative Actions. With respect to the cooperative options, more potential exists, at least in the long term. Multistate compacts seem the most viable and appropriate of the options. This approach would focus on designing and implementing a simplified and streamlined SUT administration system, involving some or all of the following: (1) single or a reduced number of state rates, (2) standardized definitions of products and taxable items, (3) standardized and simplified tax calculation and collection procedures, and (4) exemptions for small sellers (see Supplement D-8). Key goals would be to reduce SUT variations among states and reduce the compliance burden for sellers, while achieving tax neutrality. California

has pursued multistate approaches in the past in the areas of corporate income taxes and fuel taxes.

One specific option of this type was developed jointly by the National Governor's Association (NGA) and National Conference of State Legislatures (NCSL) and endorsed by several other state and local government membership organizations. It was presented to the ACEC at its December 1999 meeting in San Francisco. This "zero burden" proposal would establish a voluntary system where a third party would determine the taxability of and tax rate on purchased items. The third party would also collect the tax and remit the proceeds to states.

We recommend that the Legislature explore the appropriateness of this option as well as other alternative joint efforts with other states. We note, however, that any cooperative approach would not at this time result in a *requirement* that remote sellers collect and remit the use tax for all sales. This is because absent Congressional action addressing the issues raised by various legal decisions, out-of-state sellers could only be required to collect the use tax if they had physical presence in the purchaser's state.

CONCLUSION REGARDING THE SUT

California is inherently limited regarding what it can do in dealing with the SUT-related issues raised by the Internet and e-commerce. However, some steps can be taken, and pursuing a two-tiered approach offers the best prospects for addressing Internet-related SUT issues. Specifically, we believe that California should (1) pursue



multistate agreements that facilitate collecting the use tax while minimizing administrative costs, such as by standardizing tax rates and adopting com-

mon definitions for taxed commodities; and (2) consider undertaking a comprehensive review of the SUT, focusing on its long-term viability.

ISSUES INVOLVING TELECOMMUNICATIONS TAXES

Internet-related tax policy issues involving telecommunications taxes, franchise fees, and utility user taxes are the result of two principal characteristics of the telecommunications industry (including the Internet)—namely, changes in industry technology and changes involving the industry’s competitive structure. These features of the telecommunications system raise two primary issues related to Internet telecommunications tax policy (1) equitable and technologically neutral treatment of taxpayers and (2) potential revenue implications for local governments and specific state programs. These issues are summarized in Figure 9, discussed below, and examined in greater detail in Supplement E.

Many levies on telecommunications activities were established for an industry that no longer exists in its original form, either in terms of technology or competitive characteristics. Furthermore, the levies involved

are outmoded and have neither changed sufficiently to “mesh” with current industry competitive structure, nor possess the flexibility to accommodate future changes in the telecommunications industry. Regarding the technology area, the basic modes of telecommunications (telephone, television, radio, and the Internet), while still distinct in many respects, are increasingly “converging” (blending and overlapping). This process has made many of the current tax distinctions between the

Figure 9

Internet-Related Telecommunications Tax Issues

- ✓ Current tax treatment was designed for a telecommunications industry that is rapidly being transformed in terms of its technology and competitive characteristics.
- ✓ Increasing competition and technological convergence in the industry have strained the state’s ability to apply the existing tax structure in an appropriate and fair manner.
- ✓ A confusing array of different taxes and charges are being applied to telecommunications activities, including local franchise fees, local utility user taxes, and state telecommunications charges.
- ✓ Existing taxes on telecommunications activities fund specific programs at the state level and are a discretionary source of local government revenues. However, significant issues exist regarding the rationales for many of these levies and their continued desirability.

different media difficult to justify in economic terms, resulting in inefficiencies and unfairness.

CURRENT TELECOMMUNICATIONS TAXES

There are several types of taxes or fees in California that can be applied (directly or indirectly) to the Internet as it currently exists or which may affect it as it continues to evolve. These involve both flat-rate levies and gross receipts taxes, and include: (1) state surcharges levied on telephone service; (2) local taxes levied on utility use of telephone and cable service; (3) local franchise fees on cable service; and (4) various federally assessed surcharges, fees, and taxes. Although a few states impose Internet access taxes, California does not impose or allow state or local taxes on Internet access.

WHAT ARE THE BASIC ISSUES?

Equitable and Technologically Neutral Taxation

The Industry Has Markedly Changed. Changes in *technological convergence* and *market structure* make it increasingly possible to conduct similar activities using different means and, as a result, be treated differently for tax purposes. With respect to technological changes, for example, the blurring of the line between conventional telephones and Internet-based communications (voice and written) has raised issues related to tax fairness and neutrality. Voice communication using telephone providers is subject to direct telecommunications charges, yet similar voice communication using Internet telephony or written communication is not subject to such direct charges. Wireless

cable is not subject to either local taxes or fees or state telecommunications surcharges and fees.

With respect to market structure, telecommunications have evolved from an industry characterized by monopoly to one displaying an increasing degree of competition. Statewide monopoly franchises and rights-of-way access were awarded to telephone companies and, in exchange, companies provided common-carrier service and were subject to special tax treatment. Telephone surcharges and other fees were levied on monopoly telephone utilities partially in an effort to extend telephone service to high cost areas, provide low-cost telephone service, provide emergency service, and extend access to the disabled.

Do Current Levies Make Sense? The growth of competition in the telephone-service market has weakened the original justification for many of these taxes for long-distance telephone service and, increasingly, for local telephone service as well. Retaining the existing tax structure raises issues of tax equity, in that Internet activity may be subject to certain types of taxes and tax burdens using telephone access, a different tax treatment when cable access is used, and still another if wireless Internet connections are employed—even though the activity conducted may be identical. For utility user taxes and franchise fees, the change in competitive industry structure and technological convergence raises similar issues of tax fairness and equity.

Is the Industry Under-Taxed or Over-Taxed? In addition to the issues of tax equity discussed above, changes in telecommunications raise a



more fundamental question as to whether the tax burden on these services is too high with respect to other services, which may not be subject to the same level of taxes, fees, or charges. While this issue is beyond the scope of this report, the basic question is—*Should the existing system of telecommunications taxes, utility user taxes, and franchise fees be modified and, if so, in what ways given the current and evolving structure of the industry?* To the extent that any differential tax treatment between technologies persists, a situation may develop where activity moves to the lowest taxed area—based on the level of fees, taxes, and charges—instead of using the most efficient or appropriate means.

Potential Revenue Issues

Limited Revenue Loss May Be Occurring.

Changes in technology and market structure present a potential for revenue losses if telecommunications activities migrate to telecommunication modes that are not taxed, such as the Internet. Generally, these fiscal concerns are of less magnitude than those related to the SUT. For telephone surcharges and fees, the potential revenue losses are rather small and do not comprise a significant portion of state revenues (accounting for less than 1 percent of total revenues). Although these revenues are earmarked for particular programs, they could be rather easily replaced from other sources. In addition, there exist no particular policy reasons why the programs should be funded from specific excise taxes, rather than from general governmental revenues.

Similarly, the fiscal effects on utility user taxes and franchise fees for local governments are likely to be substantially less important than those associated with the SUT. While revenue losses could occur due to tax differentiation between technologies—for example, telecommunications activity could move from conventional telephone lines to cable-based service if overall taxes are lower for the latter—we believe that in the short to medium term the likely fiscal effects are quite small.

Local Concerns Should Be Addressed. Potential revenue losses are an issue that may be more cause for concern for local governments in the longer term. Utility user taxes and franchise fees account for a small proportion of local government discretionary revenues but are more important for certain selected localities. Although clearly not all of these revenues would be in jeopardy due to changes in tax policy, in view of their role in local finance, any long-term restructuring of the telecommunications tax area should explicitly account for any local fiscal effects.

WHAT ARE THE POLICY OPTIONS?

In addressing the above issues involving telecommunications taxes associated with the changing nature of the industry—including the impacts of the evolving Internet technology—California has two basic alternatives. First, it can adopt the status quo approach of leaving the basic telecommunications tax structure as it currently stands and focus simply on trying to “patch it” so as to make its application fairer. Or second, it could take direct action to address the many underlying problems with the basic system by moving toward its re-

structuring. A first step with respect to the latter approach would be a thorough study of all existing telecommunications taxes and an assessment of their rationales and overall desirability.

“Patching Up” the Existing Tax System

The main action to consider here would be to extend telecommunications taxes to all types of telephone or similar communications services. Doing this, including applying them to communications conducted over the Internet, would result in a removal of the tax-generated bias towards these alternative technologies. This approach would allow for equal treatment of similar activities. To the extent that this policy results in additional revenue due to base broadening, the Legislature can adopt a revenue neutral approach by reducing tax rates accordingly. This approach may, however, suffer from certain technical difficulties since Internet telephony signals are indistinguishable from other digital transmissions. Generally, options to patch up the existing system are—due to continuing technological shifts—likely to result in only a temporary resolution of the issue.

Basic Tax Restructuring

This policy strategy could include such steps as removing some or all of the various telecommunications and utility user taxes on telephone service and treating it similarly to other services. This would put telecommunications services on an “equal footing” with other services and address the uneven treatment of the industry with respect to other telecommunications technologies such as Internet telephony. This fundamental change

would necessitate alternative means of funding universal service and other similar state programs. In addition, given that such taxes are a discretionary revenue source for localities, basic restructuring would need to be sensitive to alternative funding sources for localities.

Although reducing or eliminating various telecommunications taxes may be a reasonable approach, it should not be taken “in a vacuum.” Rather, it should only be undertaken as part of a comprehensive assessment of the overall tax burden on the telecommunications industry (including such levies as property and corporate income taxes). This will help ensure that the industry is not advantaged or disadvantaged by its tax treatment.

ACTION-STEP RECOMMENDATIONS

As in the case of the SUT, recommended state actions regarding taxes on telecommunications are dependent on the time frame involved. In the near term, the potential revenue loss resulting from Internet activity is not substantial and the tax fairness issues cannot be cured through any “quick fix.” Thus, there is relatively limited potential or need for action. In the short and medium term, any efforts undertaken should focus on applying the existing tax regime as fairly as possible—such as treating activities conducted over the Internet in a manner similar to activities conducted through other means. However, given that the Internet technology continues to evolve rapidly, any solution is likely to be short-lived.



Instead of expending substantial resources in patching the existing system, we recommend that the Legislature undertake a comprehensive study geared toward an overall evaluation of the telecommunications tax and regulatory area. The overall objective of this approach should be to examine the system and its rationales and address

issues of equitable tax treatment of the industry. As part of the process, careful consideration should be given to the impact of changes on state and local fiscal conditions. The results of this study could be used to inform the Legislature regarding the appropriateness of any extension of the Internet tax moratorium.

CORPORATE INCOME TAX ISSUES

Internet-related tax issues raised for the Bank and Corporation Tax (BCT) primarily involve (1) determination of nexus and (2) the geographic apportionment of income of multistate and multinational corporations. (Additional details are provided in Supplement F.) These issues principally affect the potential of base erosion of the BCT.

THE BCT ISSUES ARE HIGHLY TECHNICAL IN NATURE

Determination of Nexus. The determination of nexus for BCT purposes is less clear to begin with than for the SUT and the development of the Internet essentially lays an additional layer of complexity on this already difficult area. (This complexity is discussed further in Supplement F.) However, the bottom line is Internet development makes it *more* likely than in the past that businesses can conduct activity in the state while avoiding nexus. This is because they can conduct business on a remote basis, thereby minimizing contacts with the state. This situation could affect the state's collection of corporate income taxes in some cases.

Apportionment of Income. Regarding apportionment issues, these relate to how much of an interstate or international company's total income is subject to California's BCT. The income apportionment factor for California is based on a firm's average ratio of its corporate activity in California to its total corporate activity for three factors—property, payroll, and sales (the latter weighted twice). Sales of tangible goods to California businesses and individuals would result in California sales since these are attributed to the destination point.

Sales of intangible goods to California purchasers—such as those in a digitized form—would typically result in a California sale for tax purposes *only* if the state was the location of the greatest direct costs of production. As a consequence of these rules, even if nexus is established under current law, this may not necessarily result in a business having any California taxable income. Because the Internet may cause an increase in the sales of intangible goods relative to tangible goods, less income may be taxable.

CONSIDERATIONS FOR THE LEGISLATURE

Of the tax issues raised by Internet and e-commerce activity, those involving the BCT are among the least visible and perhaps most complex. While the issue of tax fairness—regarding the treatment of tangible versus intangible goods, for example—may be relevant, this issue is more directly related to the overall design of the tax rather than the effects of the Internet *per se*. Similarly, the potential revenue impacts of Internet activity are likely to be limited at this time and are unlikely to grow in importance as rapidly as for other taxes.

The fact that the current- and near-term impacts of the Internet on the BCT are not likely to be significant at this time, coupled with the inherent complexity of the issues involved, suggests that the Legislature need not take any immediate action in this area. Rather, the appropriate approach may be to wait and see how Internet-related business activity develops and how effective the existing tax system is in meeting the challenges posed. Pursuit of multistate tax compacts and agreements involving nexus and apportionment appears to be California's best means of eventually addressing these issues in the near term and for the future.

SUMMARY AND CONCLUSIONS

As summarized in Figure 10 (see page 24), the Internet and its associated e-commerce raises taxation issues for the Legislature in a number of areas, including tax administration challenges, tax-equity concerns, and potential revenue losses. No simple or obvious solution to these issues currently exists, as evidenced by the ongoing debate surrounding them. In addition, identifying action steps for addressing the issues is further complicated by the fact that Internet technology is still evolving. Thus, with regard to some of the issues involved, a wait and see attitude is the best policy for the present.

There are, however, certain steps that the Legislature should initiate now in light of the issues

raised by the Internet. In particular, it should pursue multistate SUT agreements to simplify, standardize, and collect the tax. Coupled with this, the Legislature should consider undertaking an overall assessment of the effectiveness and long-term viability of the SUT. We also recommend that the Legislature undertake a comprehensive review of the state's telecommunications-related tax policies in light of the issues the Internet raises in this area. The results of this study could be used to assess the need for any extension of the current Internet tax moratorium. Finally, it should pursue solutions to some of the technical issues related to the BCT raised by Internet activity by working through its affiliations with multistate organizations.



Figure 10

Key Findings and Considerations

Key Findings

- ✓ Internet-related sales and use tax (SUT) issues exist involving both tax inequities and revenue base erosion. These relate to collecting use taxes on out-of-state sales and converting goods from tangible into intangible form.
 - While currently limited, revenue losses are increasing and will continue to do so in the future.
- ✓ Concerning taxing Internet activity *itself*, telecommunications media such as telephones are already subject to taxation. However, tax policy in this area is full of inconsistencies and inequities, and the “lines” are blurring between different telecommunications modes.
- ✓ Tax nexus and income apportionment issues complicate the calculation of income tax liabilities for multistate and multinational corporations in California.

Considerations

- ✓ Given that current revenue effects are fairly minor relative to the tax base, immediate action in terms of fundamentally altering the SUT tax system is not required.
- ✓ Since medium- and long-term issues are likely to be more substantial, the Legislature should address Internet-related SUT issues by (1) pursuing multistate agreements to minimize foregone revenues, reduce tax inequities, and lessen administrative costs; and (2) considering a comprehensive analytical appraisal of the SUT, including its long-term viability.
- ✓ A comprehensive review of the state's telecommunications taxes and fees generally should be conducted. This review:
 - Should clarify the rationales for existing levies, and determine whether, and in what forms, such levies should exist in the future, including on the Internet.
 - Should be completed prior to taking any actions regarding taxation of Internet activity and access charges, and could be used to assess the need for any extension of the California Internet Tax Freedom Act.
- ✓ Multistate agreements should be explored to incorporate Internet-related considerations into the determination of nexus and the apportionment of corporate income for tax purposes.

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