# Activities of the 2000 and 2001 California Legislatures

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A review of Internet taxation bills introduced in the prior session of the California legislature may shed some light on what may be reintroduced in 2001/2002. AB 2412 (described below) has already been reintroduced as AB 81. Also, there may be some discussion of the Streamlined Sales Tax Project and extension of the California Internet Tax Freedom Act which expires in 2001.

**AJR 41** (Pacheco) – resolves that the President and 106th Congress should act favorably on legislation to make the Internet Tax Freedom Act moratorium permanent. AJR 41 makes reference to S. 1611 as an example for making the ITFA permanent. However, S. 1611 does more than make the current moratorium permanent, it would also expand it to include sales and use taxes on domestic or foreign goods or services acquired through e-commerce. AJR 41 also supports a permanent global ban on tariffs on e-commerce and special or multiple taxes on e-commerce and the Internet.

**SB 1377** (Haynes) – would add a sales and use tax exemption for any tangible personal property ordered over the Internet. Despite R&T Section 2230, there would be no state reimbursement to counties and cities for revenue losses caused by this proposed new exemption.

**SB 1556** (Brulte) – would create a sales tax exemption for tangible personal property used to provide broadband services for use by certain persons in conducting an Internet service business, or to upgrade cable TV facilities for the provision of advanced digital communications services, or similar services The exemption would not apply for local sales and use taxes.

**SB 1933** (Vasconcellos) – calls for formation of a temporary commission - the California Commission on Tax Policy in the New Economy, to examine the impact of the Internet and e-commerce on sales and use taxes, income taxes, telecommunication taxes and other taxes. In addition to nine voting members representing local government, academia, the private sector, and public interest groups, there would be non-voting members from various tax agencies and the legislature. The commission can establish technical assistance groups and is to hold public hearings. The commission is to make recommendations and issue a preliminary report within 12 months of its first meeting and a final report within 24 months.

Status: Governor Davis signed this bill in September 2000 (Chapter 619, 9/24/00). In vetoing AB 2412 (discussed later), Davis noted that the subject matter of AB 2412 warranted review, such as through the California Commission on Tax Policy in the New Economy, to be formed under SB 1933.

**SB 1949** (Costa and Chesbro) – would direct the Governor to enter into discussions with other states "regarding the development of a multistate, voluntary, streamlined system for sales and use tax collection and administration."

Status: Governor Davis vetoed this bill on September 25, 2000 because he deemed it unnecessary. He noted that California already participates in such forums as the Multistate Tax Commission and National Governor's Association that work on tax simplification activities.

**AB 1784** (Lempert, Honda and Cunneen) – would extend the California Internet Tax Freedom Act for three more years (through December 31, 2004).

Status: Governor Davis signed this bill on September 25, 2000. However, it will not take effect because he did not also sign AB 2412 (see later discussion). The bills had been "tied together" when sent to the Governor.

**AB 2188** (Baldwin) - would add a use tax exemption for any tangible personal property purchased from a retailer not engaged in business in California provided the purchaser is not a seller or retailer. Despite R&T Section 2230, there would be no state reimbursement to counties and cities for revenue losses caused by this proposed new exemption.

**AB 2367** (Leonard) – would reduce the state sales and use tax rate by .25% annually until it reaches a specified level. It would not reduce the tax for local sales and use taxes or transactions and use taxes. “It is the intent of this act to phase out the current California state share of sales and use taxes in order to make the total taxes paid by consumers at California retail stores closer to the price of a purchase on the Internet.”

**AB 2412** (Migden and Aroner) – would clarify the sales and use tax rules to provide that a retailer is responsible to collect sales tax if engaged in business in the state who processes orders electronically (by fax, via Internet, etc.). AB 2412 would also “prospectively clarify” that “a retailer is presumed to have an agent within the state,” if it meets both of the following conditions. “(A) The retailer holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in California or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof; and (B) The retailer sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to California purchasers”. Thus, a company with an affiliate, subsidiary or related entity in the state would have the same nexus as the related entity if they sell the same type of products and there is a substantial ownership interest. A substantial ownership interest is defined by reference to federal law under Title 15, §78p (federal securities law) which refers to an ownership level in excess of 10%.

*Commentary on AB 2412:*

The apparent goal is to address the sponsor’s concern that some bricks and mortar stores have established separate legal entities for their e-commerce activities which do not have a physical presence in California and are therefore not required to collect sales tax from customers. However, case law supports the view that a separate legal entity does not have nexus of a related entity attributed to it. For example, in *Current, Inc. v. SBE*, 24 Cal. App 4th 382, 29 Cal Rptr.2d 407 (Ct. Appeal 1994), the court held that a remote seller could not be treated as having nexus due to the physical presence of a parent corporation where the corporations were separate and distinct entities, did not have integrated operations and did not act as the alter ego or agent of the other for any purpose. The court noted that in similar cases, courts have "relied upon the fundamental principle of corporate law that the parent corporation and its subsidiary are to be treated as separate and distinct legal persons in the absence of a showing that corporate assets have been intermingled, that the formalities of separate corporate procedure have been ignored, or where the corporation is inadequately financed."

In the *Current* case, the court found that R&T §6203(g) (as it existed then) was unconstitutional under the commerce clause. This provision imposed a tax collection responsibility upon “any retailer owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business in this state.” The language found to be unconstitutional in the *Current* case is quite similar to the proposed language of AB 2412.

Similarly, see *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (SCt Ohio 1995), and *Bloomingdale's v. Dept. of Revenue*, 567 A.2d 773 (1989), aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992).

In *Bloomingdale's, supra*, Pennsylvania tried to get Bloomingdale's By Mail, Ltd. (By Mail) to collect use tax from catalog sales delivered into the state. By Mail was formed as a wholly-owned subsidiary of Federated Department Stores, Inc. Federated is a Delaware corporation with headquarters in Ohio and with stores (Bloomingdale's) in Pennsylvania. By Mail is a New York corporation with officers and directors in New York, Ohio, and Connecticut. It operates its nationwide mail order business from Virginia and a fulfillment center in Connecticut. Customer orders are received at one of these locations and shipped to the customer by U.S. mail or common carrier. By Mail customers may pay by various credit cards including a Bloomingdale's card. Customers wanting do return merchandise, do so to By Mail. By Mail had customers in Pennsylvania but did not collect use tax from them because By Mail did not have a physical presence in that state.

The Pennsylvania Department of Revenue argued that By Mail had sufficient nexus with the state to enable the state to impose use tax collection obligations. State arguments included: i) there were at least two instances where By Mail customers were allowed to return merchandise to a Bloomingdale's department store, ii) By Mail and Bloomingdale's use the same advertising themes and motifs, and iii) By Mail's separate corporate existence from Bloomingdale's department stores is a mere legal formality which should not control constitutional considerations, but should be treated as an agency relationship, such as in *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960). The court discredited each of these arguments as follows: i) the two merchandise returns were "aberrations from normal

practice," ii) similar advertising themes is not enough to constitute nexus, and iii) By Mail does not have agents acting on its behalf in Pennsylvania, as Scripto did by using independent contractors to solicit sales for the company.

In contrast, in *The Reader's Digest Association, Inc. v. Mahin*, 255 N.E.2d 458 (S Ct Ill 1970), cert denied 399 U.S. 919 (1970), the presence of subsidiaries in Illinois was attributed to the parent corporation. One of the subsidiaries solicited advertising for the parent corporation's magazine, thus acting as the parent's agent.

The difference between the approach of AB 2412 and existing law is that AB 2412 would label two corporations as being in an agency relationship without looking at what the one does for the other to indicate an agency relationship. Ownership and similar business activities do not create an agency relationship. In the *Reader's Digest* case, the subsidiary solicited advertising on behalf of the parent corporation, creating an agency relationship. In the other cases cited above, the situation was similar to that laid out in AB 2412 and attribution of one corporation's presence to another corporation was found to be unconstitutional. Rather than describing an agency relationship, AB 2412 seems to be taking the approach that two legal entities are deemed to be just one entity if a substantial ownership relationship exists and they sell the same products or assist in advertising. This ignores many years of case law that treat separate legal entities as separate taxpayers unless there is a basis for piercing the corporate veil due to insufficient financing or independence.

This bill would attempt to have Borders.com and BarnesandNoble.com collect California sales tax, but would have no impact on Amazon.com. Thus, consumers could buy books from Amazon without a sales tax charge, but not from the other two booksellers (although Amazon customers are technically required to self assess use tax).

Supporters of the bill included many local governments, the California League of Cities, the California Teachers Association and a few independent bookstores. Opposition to the bill came from a much smaller list consisting of the Silicon Valley Software Industry Coalition and Dean Andal, Chair of the State Board of Equalization. In a letter from Dean Andal to Senator John Burton dated June 15, 2000, urging defeat of AB 2412, Dean Andal also notes another constitutional issue with AB 2412: "Since the bill would be an expansion of existing tax law, it should have received more than 53 votes in the Assembly to pass. Passage of the bill with only a majority vote violated the two-thirds legislative vote requirement of Article XIII A, Section 3 of the California Constitution." Mr. Andal's letter includes a copy of a letter from Timothy W. Boyer, Chief Counsel of the SBE stating that he does not view AB 2412 as just clarifying existing law.

Status: AB 2412 was passed in the Assembly on May 30, 2000 and in the Senate on August 30. Governor Davis vetoed the bill on September 25, 2000. Governor Davis stated, "In order for the Internet to reach its full potential as a marketing medium and job creator it must be given time to mature." At present, it is less than 10 years old. Imposing sales taxes on Internet transactions at this point in its young life would send the wrong signal about California's international role as the incubator of the dot-com community. … AB 2412 singles out companies that are conducting transactions electronically and attempts to impose tax collection obligations on them to which, according to California courts, they are not subject." [Office of the Governor, press release of 9/25/00]

Despite the implication from Governor Davis that AB 2412 imposes a new tax, the bill attempts to get certain Internet retailers to collect sales tax that should instead be a self-assessed use tax of customers.

**ACA 28** (Runner) – "This measure would prohibit the state and its political subdivisions from levying or collecting, as defined, a bandwidth tax, a bit tax, an electronic messaging tax, a tax upon, or a franchise fee with respect to the provision of, access to or the use of the Internet or online computer services, a sales or transactions and use tax upon a certain type of transaction involving an "off-site" electronic customer, or a sales or transactions and use tax at a rate in excess of total applicable sales or transactions and use tax rates as of a certain date."

To obtain the full text and status of the above bills, search for the particular bill at:

http://www.leginfo.ca.gov/bilinfo.html