

California Use Tax Exemption for Foreign Purchases Should Be Repealed

by Annette Nellen



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In this article, Nellen argues that the California use tax exemption for foreign purchases should be repealed as a matter of fairness and administrative efficiency.

Repeal of California's use tax exemption on some foreign purchases under Revenue and Taxation Code section 6405 would foster equity and fairness, help taxpayers avoid misleading conformity, and provide an administrative benefit. Additional reasons to eliminate this tax break include the improved administrative ease of collection since the exemption's enactment, increased awareness of the use tax, and the fact that the sales tax is not like a federal duty.

To make the case, this article explains the California use tax exemption for some foreign purchases, provides the basics of the U.S. customs duty rules on foreign purchases to which the California exemption relates, and notes how some states treat foreign purchases under their sales and use tax laws. Suggestions for repealing the use tax exemption are provided.

I. Tax Exemption for Foreign Purchases

California Revenue and Taxation Code section 6405 allows a use tax exemption up to \$800 of taxable goods purchased in a foreign country and brought back to the United States. That exemption may be used every 30 days.¹

¹This exemption is provided in Calif. Rev. & Tax. Code section 6405, which reads: "Notwithstanding Section 6246, the storage, use, or other consumption in this state of the first eight hundred dollars (\$800) of tangible personal property purchased in a foreign country by

(Footnote continued in next column.)

Enacted in 1990,² Revenue and Taxation Code section 6405 was intended as an administrative and compliance simplification by aligning state use tax with a \$400 federal duty exemption (section 6405 was increased to \$800 in 2007³ after the federal duty exemption was increased to \$800).⁴

The 1990 enacting legislation was a response to a State Board of Equalization program started that year when it first received customs declarations from the U.S. Customs office.⁵ Per the BOE's analysis of AB 1748 in 2007⁶:

As a result of the 1984 Tax Penalty Amnesty Bill (Ch. 1490, Stats. 1984), the Board created the U.S. Customs Program for the purpose of collecting unpaid use tax from consumers. The Board is granted authorization from the U.S. Customs Service to access passenger declarations filed at various ports of entry throughout California. That information is used to generate use tax returns.

A Legislative Analyst's Office (LAO) tax expenditure report from February 1999 offers two reasons for the exemption: tax relief for Californians traveling outside the United States and administrative relief for the BOE. The LAO described the rationale for the section 6405 exemption as follows⁷:

This program provides tax relief to California residents returning from overseas with purchases that

an individual from a retailer and personally hand-carried into this state from the foreign country within any 30-day period is exempt from the use tax. This section shall not apply to property sent or shipped to this state." See also, Regulation 1620.

²Chapter 1533, Statutes of 1990 (SB 2455).

³Chapter 342, Statutes of 2007 (AB 1748).

⁴See California State Board of Equalization, "Legislative Bulletin Sales Tax Legislation 2007," at 6; the federal duty exemption was increased to \$800 on November 4, 2002.

⁵In *California's Tax Machine — A History of Taxing and Spending in the Golden State* (2000), author David R. Doerr observes that the BOE expected to collect \$9 million by billing about 58,000 travelers annually (p. 231).

⁶See BOE, Staff Legislative Bill Enrolled Analysis, AB 1748, at 3.

⁷Legislative Analyst's Office, "California's Tax Expenditure Programs," (Feb. 1999).

otherwise would be subject to the use tax. The exemption originally was enacted as part of a new state program which seeks to collect use taxes on foreign purchases. Such taxes generally had not been collected prior to 1990 due to administrative difficulties.

The program is largely rationalized on administrative grounds. The exemption recognizes that the state's efforts to collect the use tax on foreign purchases is dependent on the federal government's duty collection procedures. The U.S. Customs Service recently began to provide the state with customs declarations filed by returning Californians. The U.S. Customs Service does not require payment of duties on the first \$400 of foreign purchases and keeps no useable records of travelers entering the state with purchases of less than \$400. Consequently, the state has no cost-effective means at present to collect use tax from travelers declaring less than \$400 of foreign purchases.

Although the state could attempt to collect the use tax on the first \$400 of purchases brought into the state by travelers who are subject to customs duties, the administrative costs would be prohibitive.

The California Department of Finance measures the cost of sales tax exemptions to obtain an estimate of the amount of revenue that is not collected by exempting some items. The section 6405 exemption is not in the report, indicating that the annual cost is under \$5 million.⁸

II. Tax on Foreign Purchases in Other States

The section 6405 foreign goods exemption appears to be unique among states. A search using RIA Checkpoint and Google did not lead the author to a similar exemption in other states. It does appear from information found on state tax agency websites that some states have no foreign goods exemption. Some websites highlight that use tax is owed on foreign purchases.

A. Florida

The Florida Department of Revenue website about who owes use tax includes the following:

Is there a credit for any tax paid at the time of purchase?

Yes. If you paid 6% or more sales tax to the seller at the time of purchase, no tax is due. However, if the seller charged less than 6% tax, you must pay "use tax" equal to the difference between what you paid in tax and the 6% tax imposed by Florida. You cannot use any sales tax paid in another country as a credit against the Florida tax due.

The implication is that even if tax is paid in the foreign country of purchase, use tax is still owed in Florida.

B. Illinois

The state's website on use tax for individuals includes an example of when use tax is owed: "items purchased while you were . . . in a foreign country." The website also notes that Illinois "is aggressively focusing upon collecting this tax" and "gathers information on overseas purchases from the U.S. Customs Service." Also, the website notes that "you are not allowed credit for any taxes paid to foreign governments. These purchases are subject to the full Illinois tax rate. . . . Use tax is due whether or not an item has to be declared or is subject to a duty tax."

C. Massachusetts

The Massachusetts Department of Revenue has a webpage titled: "Should You Be Paying Use Tax on Foreign Purchases?" The page includes the following:

If no Massachusetts sales/use tax was paid at the time of purchase, then a use tax is due when:

Taxable goods are purchased from an out-of-state or out-of-country vendor for personal use in Massachusetts. The total purchase price is subject to "use tax."

The page notes that a credit of up to 6.25 percent is available if sales or use tax was paid to another state or U.S. territory, but does not mention any tax paid to a foreign country or a purchase in a foreign country.

D. Michigan

According to this state's use tax explanation, a 6 percent use tax "must be paid on the total price (including shipping and handling charges) of all taxable items brought into Michigan or purchases by mail from out-of-state retailers. It applies to purchases made in foreign countries as well as other states."

E. Minnesota

"Sales Tax Fact Sheet 156" notes that a credit is allowed for sales or use tax legally required to be paid to another state, limited to the Minnesota tax rate. There is no mention about credit for tax paid on a purchase from outside the United States. The fact sheet also notes that the state "receives information about international purchases directly from the United States Customs Service."⁹

F. New Jersey

Per Publication ANJ-7, *Use Tax in New Jersey*:

Purchases Made in a Foreign Country. When taxable goods and services are purchased in a foreign country, no credit is allowed for sales tax paid to the foreign country, regardless of whether the purchaser

⁸Department of Finance, "Tax Expenditure Report 2013-2014," at 10.

⁹Minnesota DOR, "Use Tax for Individuals," Sales Tax Fact Sheet 156.

takes possession of the items there or has them delivered to New Jersey. Use tax is due at the rate of 7% of the purchase price, including delivery charges.¹⁰

G. North Carolina

Per the state's FAQs on the use tax:

If I make purchases of tangible personal property or certain digital property while in another state, do I owe North Carolina use tax on these purchases?

If the items are purchased for storage, use, or consumption in North Carolina, they are subject to the North Carolina use tax whether the purchases are delivered to you in another state or shipped to you in North Carolina. If you paid another state's sales or use tax on the out-of-state purchases, credit for the tax paid is allowed against the North Carolina use tax due. You may not claim a credit for sales tax or value added tax paid in another country.

III. Basics of the U.S. Customs Duty

The U.S. Department of Homeland Security defines a customs duty as “a tariff or tax imposed on goods when transported across international borders.” It further explains that the purpose of duty is “to protect each country's economy, residents, jobs, environment, etc., by controlling the flow of goods, especially restrictive and prohibited goods, into and out of the country.”

The duty rate is imposed on the value of the item and may vary by type of item. The U.S. Customs and Border Protection (CBP) uses the Harmonized Tariff Schedule of the United States Code Annotated to determine the rate for any item. The rate can vary depending not only on the item but the country of purchase. The total amount owed by a traveler also depends on any exemption he may claim. Some purchases beyond a specified quantity will not be eligible for an exemption (such as for purchases of tobacco and alcohol). Thus, even if a traveler has not reached her duty exemption (generally \$800), she may still owe duty on alcohol and tobacco if she brings back a quantity in excess of the exemption rule for those products. The CBP provides the following example:

Your exemption is \$800 and you bring back three liters of wine and nothing else, two of those liters will be dutiable and IR [Internal Revenue] taxed.

IV. Reasons to Repeal Section 6405

There are six reasons to repeal the section 6405 use tax exemption for foreign goods hand-carried into the state —

¹⁰New Jersey Division of Taxation, Publication ANJ-7, “Use Tax In New Jersey.”

including increased public awareness of the use tax and the administrative and compliance procedures implemented since its enactment in 1990.

A. Equity and Fairness

The Revenue and Taxation Code section 6405 use tax exemption violates the tax principle of equity and fairness in that it causes similarly situated taxpayers to be treated differently. For example, a Californian who buys an \$800 jacket in France and hand-carries it back into the country owes no use tax, while a Californian who buys an \$800 jacket online or at any store in the United States owes sales or use tax.

Inequity also exists based on how the taxable item purchased outside the United States enters California. For example, Henry and Sam each buy identical \$200 jackets while vacationing in France. Henry brings his jacket home with him on the plane, while Sam ships his jacket to his home in California. Assuming Henry is within his \$800 exemption amount, he does not owe use tax on his jacket, but Sam does. The result exists even though both Henry and Sam owe no customs duty on their jackets — Henry because of the \$800 exemption for goods hand-carried into the United States (accompanied baggage) and Sam because of the \$200 mailing exemption.¹¹

Code section 6405 can potentially exempt up to \$9,600 of goods annually (\$800 of goods every 30 days). That contrasts with consumers buying goods in the United States who owe sales or use tax regardless of the dollar value of the purchases. Those violations of the tax principles of equity and fairness can lead to disrespect for the tax system and lower use tax compliance.

A consumer visiting the BOE's website on use tax basics — where a tab labeled “Foreign Purchases” notes the exemption — can easily find information about the foreign goods exemption.¹² The information is also accessible in the instructions to Form 540.¹³

¹¹CBP.gov, “Types of Exemptions” (Aug. 21, 2009).

¹²See BOE, “California Use Tax Information.” The website on foreign purchases first notes: “Generally, use tax applies to foreign purchases of tangible personal property brought into this state for storage, use, or other consumption. The Board of Equalization has the authority under Revenue and Taxation Code section 7054 to audit duty declarations which you fill out and report to U.S. Customs for property first entering into the United States. However, there are some tax exceptions allowed in the law, subject to verification.” The first exception noted is the section 6405 exemption.

¹³For example, the instructions to the 2013 Form 540, p. 13, states: generally use tax is due on the purchase price of the goods you listed on your U.S. Customs Declaration less the \$800 per-person exemption. For the hand carried items, you should report the amount of purchases in excess of the \$800 per person exemption. This \$800 exemption does not apply to goods sent or shipped to California by mail or other common carrier. For goods sent or shipped, you should report the entire amount of the purchases.

A possible counterargument to the fairness violation is that the consumer purchasing goods outside the country, such as in the European Union, might be charged VAT on the purchase. Thus, imposition of use tax would be double taxation. However, this is incorrect for several reasons:

- The traveler may be able to obtain a refund of the VAT.¹⁴
- The traveler may not have been charged VAT on the item. VAT rules vary by country.
- The exemption only applies to goods hand-carried back to California and only on up to \$800 of such goods every 30 days. Thus, the system does not address the double taxation situation when a traveler pays both VAT and California use tax because the items were shipped back to California or goods were purchased beyond the \$800 use tax exemption amount.
- There is no requirement for California to forgo a state level use tax due to tax paid to a foreign country.

Repeal of section 6405 would make California's sales and use tax system fairer, more equitable, and more logical. It would also result in a simpler rule that use tax is owed when a person buys taxable goods outside the state and brings them to California.¹⁵

B. Ease of Collection Today Versus 1990

As noted, the LAO in 1999 described the section 6405 exemption as necessary because "administrative costs would be prohibitive" and said it was "rationalized on administrative grounds."¹⁶ In 1990 the BOE was using the U.S. Customs declarations to "generate use tax returns."¹⁷ And as noted by the LAO, there was no effective way to collect use tax from travelers returning with goods valued below the \$400 federal duty exemption amount.¹⁸

Today, there is no need for the BOE to "generate use tax returns" because systems are in place to enable consumers to compute and pay their use tax on their own. Consumers can learn about their use tax obligations when completing their state income tax return, and information is readily available on the BOE's website that explains how to comply.

Because the California income tax form has included a line to report use tax since 2003, there is no need for consumers to file (or the BOE to prepare) a separate form. And since 2007,¹⁹ record keeping has been eased through an optional lookup table, which allows consumers to determine their use tax liability based on their income level. For

¹⁴See, e.g., the HM Revenue & Customs website on how a visitor can obtain a VAT refund.

¹⁵California allows a credit for sales tax paid to another state to avoid double taxation (section 6406). There is no need to allow a credit for VAT or similar tax paid in a foreign country, as the tax is different and some countries allow the traveler to obtain a refund of the VAT.

¹⁶See *supra* note 7.

¹⁷See BOE, "Legislative Bulletin Sales Tax Legislation 2007," at 6.

¹⁸*Supra* note 7.

¹⁹Chapter 14, Statutes of 2011 (SB 86).

any item that costs \$1,000 or more, use tax on the item is added to the table amount. Thus, consumers have the option of only keeping track of taxable goods purchased for \$1,000 or more. Consumers are not required to use the lookup table; they can instead keep track of their purchases for which use tax is owed.

Given today's use tax assessment tools available to consumers, the section 6405 exemption can no longer be justified as necessary to alleviate the BOE's enforcement burden. Also, numerous differences between the federal duty exemption and the section 6405 exemption create compliance and administrative challenges that would be eliminated with repeal of the exemption.

C. Administrative Benefit of Removing the Exemption

The exemption is also questionable from a tax policy perspective because there is an administrative structure already in place via the U.S. Customs Office to make tax compliance simple. The federal declaration includes the dollar amount of the goods. As noted on the BOE website, staff has authority under section 7054 to audit the duty declarations.²⁰

Repeal of the section 6405 exemption would reduce the BOE's administrative burden in that it would not have to monitor the dollar value of goods hand-carried into California by residents during any 30-day period to ensure that use tax on the amount in excess of \$800 is paid. It would also mean that travelers would only have to figure out the federal duty rules and not whether California law conforms to any of them. With repeal of the section 6405 exemption, the consumer would only deal with the regular sales and use tax rules.

D. Increased Relevance and Awareness of the Use Tax

In contrast to the section 6405 exemption, in recent years California has enacted legislation and the BOE has pursued educational efforts to improve use tax collection, regardless of the amount owed by a consumer. For example, in 2011 California enacted so-called affiliate nexus legislation to improve sales tax collection on goods purchased from vendors with only an affiliation with some in-state persons in California.²¹

Unlike the apparent sentiment in 1990 that led to the enactment of the section 6405 exemption for "tax relief,"²² today the message is to pay your use tax regardless of the amount. For example, before Cyber Monday in November 2013, the BOE issued a press release to remind consumers about their use tax obligations. The news release included a link to a pictogram that stressed the importance of people meeting their use tax obligation.

²⁰The information on the foreign purchase use tax exemption is on the same BOE website as other information on use tax compliance.

²¹Chapter 7, Statutes of 2011 (ABX1 28).

²²*Supra* note 17.

Federal Duty Exemptions	Rev. & Tax. Code Section 6405 Exemption
Generally, \$800 exemption available every 30 days.	Same. ^a
\$1,600 exemption if the goods are brought back from a U.S. insular possession (such as the U.S. Virgin Islands).	\$800 exemption only. ^b
\$200 exemption if out of the country less than 48 hours.	\$800 exemption within a 30-day period.
If out of the country for less than 48 hours and bring back over \$200 of goods, the entire amount is subject to duty.	\$800 exemption applies within a 30-day period.
\$200 exemption for items mailed to the United States.	No exemption unless the items are not of the type subject to California sales tax.
Fine art of any value is exempt. ^c	Only up to \$800 value is exempt.
Quantity limits apply for alcohol and tobacco products.	Exempt up to a total of \$800 value (even if duty was paid).
<p>^aIf the traveler brings back goods valued at more than \$800, use tax might not be owed because some of the items, such as food, might not be subject to sales tax; thus, the Rev. & Tax. Code section 6405 exemption is not needed for such items (because the items are already nontaxable). This assumes that the food exemption is applied before the section 6405 exemption.</p> <p>^b<i>Supra</i> note a.</p> <p>^cThe duty exemption for fine art includes that it must be an original work. Additional rules exist regarding frames, artist qualifications, architectural hand drawings, country of purchase, and more. See U.S. Customs and Border Protection, <i>Importing personal and commercial original works of art, paintings, drawings, pastels, collages, decorative plaques, lithographs, original prints and sculptures</i>, as well as a 29-page book published by the Customs and Border Protection — <i>What Every Member of the Trade Community Should Know About: Works of Art, Collector's Pieces, Antiques, and Other Cultural Property</i>, May 2006.</p>	

Today, instead of suggesting tax relief for people who shop online, legislative and administrative actions aim to increase sales and use tax compliance and collection on purchases of all dollar amounts. That focus makes the section 6405 exemption outdated, as well as incompatible with efforts to convince taxpayers that the tax is important.

E. Avoiding Misleading Conformity

The Revenue and Taxation Code section 6405 exemption does not match the multifaceted federal customs duty rules. That results in situations when the federal duty might be owed, but California use tax is not owed, or vice versa.

The CBP brochure for travelers (“Know Before You Go”) states: “In most cases, the personal exemption is \$800, but there are some exceptions to this rule.” It then describes three dollar amount exemptions: \$200, \$800, and \$1,600. The applicable personal exemption will depend on various factors, including how long the person was outside the United States, what he or she purchased (special rules exist for tobacco, alcohol, and fine art), where he or she traveled, and whether he or she traveled with family.²³ Unlike the section 6405 exemption, federal law provides a \$200 exemption for items mailed back to the United States.

The following chart shows some of the differences between the section 6405 exemption and the federal customs duty exemption.²⁴ Note that in some situations, duty is owed, but not use tax, and vice versa.

As indicated by the table’s sample of differences, the section 6405 exemption does not match the duty exemption other than when the \$800 duty exemption applies. Thus, it

is inaccurate to suggest that the section 6405 exemption is needed to conform to the federal duty.

Repeal of the section 6405 exemption should make it easier to comply with the use tax on items brought back to California, as there would be no need to consider the federal duty rule because the consumer would just apply the sales tax rules to know what is subject to use tax and what is not.

Observation: The fact that Revenue and Taxation Code section 6405 does not conform to all of the federal duty exemption provisions should not be addressed by revenue and taxation changes to make it conform. That would exacerbate the exemption’s equity issues. For example, it would allow individuals to hand-carry expensive artwork from a foreign country to California without paying tax, whereas purchases made in the United States would be subject to sales and use tax. It would also violate the neutrality principle by favoring purchases made outside the country that are hand-carried back over purchases made in the United States.

F. A Sales Tax Is Not Like a Federal Duty

The federal government imposes duties on some items brought into the United States to protect the economy and jobs. Federal lawmakers make decisions about exemptions to the duty rules based on whether there would be an adverse effect on the purpose of the duty to allow an exemption. In contrast, the purpose of the use tax is to make the sales tax system fairer and more neutral. Goods used by consumers in the state should be subject to the same tax regardless of whether they are purchased from an in-state vendor or one out of state. Purchase decisions should not be swayed by whether or not sales tax is charged.

The use tax complements the sales tax, but it can only fully serve that purpose when it applies to all taxable items purchased from a vendor who is not required to collect California sales tax. When some purchases from outside the United States are exempt from use tax, the purpose of the

²³CBP, “Know Before You Go — Regulations for International Travel by U.S. Residents” (2009), at 14 et seq.

²⁴The federal duty rules are based on the descriptions in CBP, “Know Before You Go — Regulations for International Travel by U.S. Residents,” *supra* note 23.

use tax is not served and no state purpose is achieved similar to the purpose the federal government has for its duty system. For all of those reasons, there is no need for the section 6405 exemption.

Observation: Revenue is not listed as a reason to repeal section 6405 because, as noted earlier, the cost of that exemption is negligible (at least less than \$5 million annually). However, the exemption's negligible negative effect on state revenue should not be used as a justification for keeping it.²⁵ The exemption runs counter to efforts to improve use tax collection and can create disrespect for the system — thereby undermining use tax collection.

V. How to Repeal

While the repeal of Revenue and Taxation Code section 6405 could be accomplished by stand-alone legislation requiring a two-thirds vote, it is probably more appropriate to include it in a bill with other sales and use tax changes. For example, if the federal government enacts the Marketplace Fairness Act (MFA) of 2013,²⁶ California would likely make the required simplification changes to its sales tax rules so that it could collect sales tax from out-of-state vendors that do not meet the MFA's de minimis threshold. That type of legislation would be an ideal vehicle for repealing section 6405 because if California is able to take advantage of the

²⁵Any argument that an exemption should not be repealed because it has a negligible effect on revenue could also support adding more negligible exemptions to the sales tax. Clearly, those actions would add up to a non-negligible effect on revenue, as well as violate principles of good tax policy.

²⁶*See, e.g.*, S. 743.

MFA, more Californians would be paying sales tax because it would be on their invoices for many online purchases. With more people paying sales tax, sympathy for tax relief²⁷ for individuals shopping abroad will likely be nil.

MFA proposals include a de minimis rule to exempt small vendors from collection in states where they do not have a physical presence. That means that consumers will still have use tax obligations even if the MFA is enacted. If the MFA is enacted and the section 6405 exemption is repealed, Californians would owe use tax on:

- taxable items purchased from U.S. vendors subject to the MFA de minimis rule; and
- all taxable items purchased from outside the United States regardless of how they arrive in California (hand-carried or shipped).

Any bill that broadens the sales tax base — such as expanding it to personal services and digital goods — would also be an appropriate vehicle for repealing section 6405.

Repeal of a long-standing use tax exemption will certainly not be popular, even if it is one used by a small number of Californians. The six reasons for its elimination, particularly the equity and fairness rationale, may garner support by the public. Also, with greater awareness of use tax today relative to 1990, as well as more situations in which it is owed, many consumers are likely unable to articulate convincing reasons for keeping the Revenue and Taxation Code section 6405 exemption. ☆

²⁷Recall that the rationale provided by the LAO in 1999 for the section 6405 use tax exemption included providing “tax relief” to Californians shopping while traveling abroad.