Commission on the 21ST Century Economy

MEMORANDUM

January 29, 2009

TO: Commissioners

FROM: Mark Ibele
Staff Director

SUBJECT: Commissioner Information Requests

At the first meeting, Commissioners had several specific questions of staff related to the material that was presented. Responses to those questions are provided below. We are continuing to work on additional subject matter areas that were of interest—taxation of capital gains, the use of a reserve fund, and what changes require a 2/3 vote of the Legislature—and will follow up with those at a later date.

Information Requests

1. **Composition of California state-local revenues.** Information on state and local revenues provided to the Commission in the overview presentation was based on data from the U.S. Department of Commerce, Bureau of the Census. Please see attachment 1 for an example of what those revenues include.

2. **New York court case concerning sales tax collection by on-line retailers.** On June 1, 2008, New York Tax Law §1101[b][8][i][C] took effect. It contains a "commission-agreement" provision which subjects transactions by online retailers to state sales tax if the retailers use independent contractors in New York to solicit sales on the Internet or otherwise in excess of $10,000 from New York residents. Amazon operates a Web-link referral program with commission-paid "associates" in New York whose referrals resulted in more than $10,000. Amazon sued New York based on constitutional grounds including alleged Commerce Clause violations.

   On January 12, 2009, a New York trial court judge granted the state's motion to dismiss. The court held that the statute meets the constitutional requirement that an online retailer engage in a substantial amount of business in New York before it can be forced to collect and remit state sales tax. The court explained that the law requires a substantial nexus between an out-of-state seller and New York through a contract to pay commissions for referrals to a New York resident along with realization of more than $10,000 of revenue from New York sales earned through the arrangement.

   Amazon argued that the new tax law violates the Commerce Clause of the U.S. Constitution because a substantial nexus is not established between Amazon and New York through its associate program. Amazon did not detail its New York sales in court filings. While Amazon argued that the Web links through its associates amount to nothing more than advertising, state tax officials contended they demonstrate the necessary nexus between the company and New York to make the company liable for collecting sales taxes on everything it sells in New York -- whether through the associates or directly through Amazon.

Citing Scripto v. Carson (1960) 362 U.S. 207, the court rejected Amazon's arguments. The court explained that the commission-agreement provision imposes the sales tax only where there is a substantial constitutional nexus. It further noted that the law provides that a seller would not have to collect sales tax if it could prove that its New York contractors did not engage in any solicitation in New York. The court concluded, "The Commission-Agreement Provision is carefully crafted to ensure that there is a sufficient basis for requiring collection of New York taxes and, if such a basis does not exist, it gives the seller an out."

The primary distinction between the New York law and California's Sales and Use Tax Law relates to the burden of proof to show that the actions of independent contractors create federal Commerce Clause nexus. The New York commission-agreement provision creates a rebuttable presumption that if the in-state independent contractor is responsible for referring more than $10,000 in sales, then the independent contractor engaged in conduct on the out-of-state retailer's behalf that is sufficient to sustain a use tax collection obligation under the federal Commerce Clause. California law, however, creates no such presumption. In California, the existence of a link on an affiliate's Web site as part of a referral-commission agreement does not, on its own, presumptively create nexus.

3. **Tax expenditure information.** Reports on tax expenditures are available from the Board of Equalization, Franchise Tax Board, and Department of Finance. These reports provide a description of each provision, the statutory authorization for the provision, and an estimate of the revenue loss. Links to these reports are now listed on the Commission's web site (http://www.cotce.ca.gov/).

4. **Taxation of services.** The results of a Federation of Tax Administrators' (FTA) survey of states showing which services are taxed in each states is included in attachment 2. In addition, FTA has an online searchable database at http://www.taxadmin.org/fta/pub/services/services.html .

5. **Capital gains.** Attachment 3 provides a chart showing the volatility of capital gains, including the Department of Finance forecast for the next two years. Also, a chart showing the percentage of personal income tax revenue that was attributable to capital gains for the last 10 years is included as attachment 4.

6. **Personal income tax returns with at least $1 million of income.** A chart showing the number of returns with $1 million or more of adjusted gross income is attachment 5.

7. **Effectiveness of California's research tax credit.** The Legislative Analyst's Office did an analysis of the state's research credit a few years ago. Their report is available at the following link: http://www.lao.ca.gov/2003/randd_credit/113003_research_development.pdf

8. **Property tax as a percent of personal income.** Attachment 6 is a chart showing property tax as a percent of personal income from the 1960s to the present.