California Tax Board Provides Guidance on the Broadened Definition of 'Retailer Engaged in Business in This State'

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On May 30, 2012, the State Board of Equalization ("SBE"), approved proposed amendments to the California Code of Regulations, Title 18, section 1684 ("Proposed Regulation"). The Proposed Regulation attempts to provide guidance as to the meaning of the broadened statutory definition of "retailers engaged in business in this state." The statutory definition now includes retailers who are members of "commonly controlled groups," as well as retailers who enter into agreements with "a person or persons in this state" who meet certain minimum thresholds.

Background and History

The Proposed Regulation attempts to provide guidance to retailers who may be subject to the use tax collection requirements under California Revenue and Taxation Code ("CRTC") section 6203, as amended by Assembly Bill 155 ("AB 155").[1] California law requires every "retailer engaged in business" in California

[1] AB 155 was approved by the Governor and filed with the Secretary of State on September 23, 2011. AB 155 took effect immediately. However, its operative date was deferred pending the enactment of federal legislation. AB 155 provides that if federal law is enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller, and the state does not, on or before September 14, 2012, elect to implement that law, AB 155 will become operative on January 1, 2013. If federal law is not enacted on or before July 31, 2012, AB 155 will become operative on September 15, 2012. The Proposed Regulation shall become operative on the same date as AB 155.

While there are other bills pending in Congress, the U.S. House Judiciary Committee will likely hold a hearing next month to discuss H.R. 3179, which would authorize states to require remote sellers to collect taxes. However, it is not anticipated that any such bill will be enacted by Congress by the July 31, 2012 deadline in AB 155.

that sells tangible personal property for storage, use, or other consumption in the state to collect use tax from the purchaser.[2]

CRTC section 6203 defines "retailers engaged in business in this state" as "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty."[3] The definition now encompasses retailers who are members of "commonly controlled groups," as well as retailers who enter into agreements with "a person or persons in this state" who meet certain minimum thresholds.[4]

Much of the debate regarding the new legislation revolves around the State's ability to impose use tax collection obligations on out-of-state retailers under the Commerce Clause. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court held that a state lacks jurisdiction to require out-of-state retailers to collect a sales or use tax when the retailer has no physical presence in that state. The Court held that physical presence was required for a business to have "substantial nexus" with the taxing state.

Moreover, in *Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (1994), the California Court of Appeal held that a retailer does not have the requisite physical presence solely because of its parent company's presence in the taxing state. In *Current*, prior to the retailer being acquired, its only connection with the State was through common carrier or U.S. mail. Thus, the Court held that mere corporate affiliation, where neither company is an agent for the other, is not sufficient to establish substantial nexus with the State.[5]

Proposed Regulatory Language

Broadened Definition of "Retailer Engaged in Business in This State"

CRTC section 6203 broadly defines the term "retailer engaged in business in this state" as "any retailer that has substantial nexus with this state for purposes of the Commerce Clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty."[6]

Under the Proposed Regulation, a retailer is presumed to be engaged in business in California if it has "any physical presence in California."[7] The presumption is rebuttable if "the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer."[8]

Commonly Controlled Groups

Under CRTC section 6203, a "retailer engaged in business in this state" specifically includes any retailer that is a member of a "commonly controlled group" and a "combined reporting group" that "includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal

[2] CRTC section 6203(a).

[3] CRTC section 6203(c).

[4] CRTC section 6203(c)(4), (5).

[5] *Current*, 24 Cal. App. 4th at 391.

[6] CRTC section 6203(c).

[7] Proposed Regulation ("Prop. Reg.") 1684(b)(2).

[8] *Id*.

property to be sold by the retailer."[9] Such services include "design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer."[10] The terms "commonly controlled group" and "combined reporting group," as taken from the Corporation Tax Law, are defined in CRTC section 25105, and Title 18, section 25106.5(b)(3) of the California Code of Regulations, respectively.[11]

The Proposed Regulation provides that services are "performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property."[12] Services are "performed in cooperation with a retailer if the retailer and the member of the retailer's commonly controlled group performing the services are working or acting together for a common purpose or benefit."[13]

Affiliate Nexus

CRTC section 6203 provides that a "retailer engaged in business in this state" is "any retailer entering into an agreement or agreements under which a person or persons in this state, for a commission or other consideration, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet Web site, or otherwise."[14] However, the foregoing only applies when two conditions are met.

First, "the total cumulative sales price from all of the retailer's sales, within the preceding 12 months, of tangible personal property to purchasers in this state that are referred pursuant to all of those agreements with a person or persons in California, is in excess of ten thousand dollars ($10,000)."[15] Second, within the preceding 12 months, the retailer must have "total cumulative sales of tangible personal property to purchasers in California in excess of one million dollars ($1,000,000)."[16] In determining whether the sales thresholds in CRTC section 6203(c)(5)(A) are met, the total cumulative sales in the preceding 12 months are to be calculated at the end of each calendar quarter.[17]

For purposes of the aforementioned "agreements," the Proposed Regulation provides that "a person that is an individual is in this state when the person is physically present within the boundaries of California."[18]

[9] CRTC section 6203(c)(4).

[10] *Id*.

[11] *Id*. Corporations are in a "commonly controlled group" if they are linked by stock ownership exceeding 50 percent. Moreover, corporations are included in the same "combined reporting group" if they satisfy the foregoing ownership requirement and are engaged in a single unitary business. Query: Who makes the determination whether a unitary group exists? Does the SBE follow a Franchise Tax Board ("FTB") determination? What if the FTB or a court of law has never made such a determination with respect to the retailer? Does the SBE then make its own determination? What if the retailer disagrees with the SBE, who makes the final determination regarding unity—the SBE or the FTB?

[12] Prop. Reg. 1684(c)(2)(B)(i).

[13] Prop. Reg. 1684(c)(2)(B)(ii).

[14] CRTC section 6203(c)(5)(A).

[15] CRTC section 6203(c)(5)(A)(i).

[16] CRTC section 6203(c)(5)(A)(ii).

[17] Prop. Reg. 1684(c)(3). Query: Given that the threshold calculations are performed on a quarterly basis, is a retailer's affiliate nexus determined each quarter? What if the retailer's sales fluctuate greatly from quarter to quarter, and thus it meets the minimum threshold one quarter based on the preceding 12 months, but not the next quarter, but again the following quarter? Could the retailer have affiliate nexus one quarter, but not the next, and then back again? Also, is there a concept of "lingering nexus," where the State may argue that the retailer still reaps the benefits of its nexus with the State from previous quarter(s) and thus should continue to collect use tax from in-state purchasers? If so, how long after the termination of the retailer's affiliate nexus does this "lingering nexus" apply?

[18] Prop. Reg. 1684(c)(5)(A).

Similarly, "a person other than an individual is in this state when there is at least one individual physically present in California on the person's behalf."[19]

Under the affiliate nexus provisions, the Proposed Regulation requires that an individual must "solicit[] potential customers under the agreement while the individual is physically present within the boundaries of California."[20] This includes an "individual who entered into the agreement directly with the retailer, an individual, such as an employee, who is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor."[21]

"Solicitation" is defined as a "direct or indirect communication to a specific person or persons done in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property from a specific retailer or retailers."[22]

Demonstrating Lack of Affiliate Nexus

CRTC section 6203(c)(5)(A) does not apply if the "retailer can demonstrate that the person in this state with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution."[23]

Under the Proposed Regulation, a retailer may demonstrate that a particular agreement did not amount to solicitation of potential customers in California by satisfying all of the following requirements.[24]

First, the retailer's agreement must "prohibit persons operating under the agreement from engaging in any solicitation activities in California that refer potential customers to the retailer."[25] Such activities include "distributing flyers, coupons, newsletters and other printed promotional materials or electronic equivalents, verbal soliciting (e.g., in-person referrals), initiating telephone calls, and sending e-mails."[26] If the retailer's agreement includes an "organization, such as a club or non-profit group, the agreement must also provide that the organization will maintain on its website, information alerting its members to the prohibition against each of the solicitation activities described above."[27]

Second, the person or persons operating under the agreement in California must "certify annually, under penalty of perjury, that they have not engaged in any prohibited solicitation activities in California at any time during the previous year."[28] Moreover, "if the person in California with whom the retailer has an agreement is an organization, the annual certification shall also include a statement from the organization certifying that its website includes information directed at its members alerting them to the prohibition against solicitation activities described above."[29]

[19] Prop. Reg. 1684(c)(5)(B).
[20] Prop. Reg. 1684(c)(6).
[21] *Id.*
[22] Prop. Reg. 1684(c)(8)(E).
[23] CRTC section 6203(c)(5)(E).
[24] Prop. Reg. 1684(c)(7).
[25] Prop. Reg. 1684(c)(7)(A)(i).
[26] *Id.*
[27] Prop. Reg. 1684(c)(7)(A)(ii).
[28] Prop. Reg. 1684(c)(7)(B).
[29] *Id.*

Lastly, the retailer must accept the certification in good faith, meaning the retailer does not know or have reason to know that the certification is false or fraudulent.[30]

Conclusion

There are several federal bills pending in Congress which would authorize states to require remote sellers to collect taxes. However, without a national nexus legislation, states' attempts, including California's, to impose such a collection requirement risk constitutional challenges. Indeed, affiliate nexus statutes similar to CRTC section 6203 have been successfully challenged in other states.[31] Therefore, CRTC section 6203 may also be susceptible to such legal challenges. Finally, as noted above, CRTC section 6203 and the Proposed Regulation, aside from the constitutional concerns, also leave unanswered questions relating to administrative and compliance issues.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

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[30] Prop. Reg. 1684(c)(7)(C). Query: Are the three listed requirements intended by the SBE to be exclusive means by which a retailer may demonstrate that the requirements of Commerce Clause have not been satisfied? If so, how does this square with Proposed Regulation 1684(b)(2), which provides that the presumption that a retailer is engaged in business in this State is rebuttable if "the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer." See footnote 8.

[31] See e.g., *Performance Marketing Association, Inc. v. Hamer*, Circuit Court, First Judicial Court , No. 2011 CH 26333, Order Granting Plaintiff's Motion for Summary Judgment entered May 7, 2012 (holding recently enacted nexus legislation violated the Commerce Clause of the U.S. Constitution); *Direct Marketing Association v. Huber*, U.S. District Court, D. Colorado, No. 10-cv-01546-REB-CBS, March 30, 2012 (enjoining the enforcement of nexus legislation, holding it unconstitutional because it discriminated against and imposed an undue burden on interstate commerce).