



Cal-Tax Analysis: Sales and Use Tax Nexus Dilemma

- **What is sales and use tax?** Sales tax is imposed on California retailers based on gross receipts from the sales of tangible goods. Use tax is imposed on California consumers who purchase goods from out-of-state retailers and use them in California. It is imposed at the same rate as that which the consumer would pay in sales tax if the consumer had purchased the goods in California, subject to certain exemptions. If the consumer paid sales tax in another state, the consumer would owe use tax in the amount of the difference between the California sales tax, and what the consumer already paid to the other state.
- **What is nexus?** Nexus is the level of connection with a state necessary under the U.S. Commerce Clause to permit the state to impose a tax or a sales tax collection duty on out-of-state businesses doing business in the state.
- **What is required to establish nexus?** Under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), out-of-state businesses must have a "physical presence" in the state for there to be "substantial nexus" sufficient under the Commerce Clause to impose a sales tax collection duty. This "physical presence" may include the presence of sales representatives that help the retailer establish and maintain a market in the state. In contrast, advertising alone is insufficient to establish nexus.
- **Why don't we impose the duty to collect sales tax on out-of-state website companies that sell goods into California?** These companies have no physical presence in this state as required by *Quill*. When a company has no physical presence in this state, sales from its website are subject to use tax imposed on the consumer, but no sales tax collection duty may be imposed on the out-of-state seller.
- **Why don't we just repeal the safe harbor for computer servers under California law?** As in two dozen other states, California law provides a safe harbor for presence of data on a computer server in California. That means that the state cannot impose a sales tax collection duty on an out-of-state website hosted in California. Rather, the duty to pay the tax lies with the

consumer. The safe harbor gives out-of-state retailers who use California web hosts certainty that doing so will not lead to a duty to collect sales tax from their customers. If the safe harbor were removed, web hosting in California would suffer relative to the states that keep the safe harbor. Moreover, were the safe harbor removed, it is very doubtful whether federal law would permit the state to impose a sales tax collection duty under the federal Commerce Clause. The Supreme Court has not yet addressed whether presence on a computer server is considered "physical presence" sufficient to establish sales tax nexus.

- **Why shouldn't California enact a law that would impose a duty to collect sales tax when an out-of-state retailer advertises or has a "click-through" on California-based websites?** Such a law would be unconstitutional because it would not meet the physical presence requirement of *Quill*. Moreover, it would result in problems similar to repeal of the computer server safe harbor. If providing a "click-through" or selling wares on a California-based website would result in California tax liability, remote sellers will choose not to advertise or sell goods using California-based websites. A similar law in New York is currently under constitutional challenge. It is important to note that at least one very well-known online retailer, Overstock.com, chose to drop its New York affiliates entirely as a result of this law. This is a lose/lose result. Not only did Overstock's New York affiliates lose revenue, Overstock is not collecting any tax for New York.
- **How would a law establishing nexus via California-based "click-throughs" or other advertising impact California-based web hosts?** A law that imposes such broad-based nexus on out-of-state online retailers would substantially diminish the client base of California web hosts. Instead of selling wares on California-based web hosts, out-of-state retailers instead will choose to sell their goods on websites in states that will not impose a duty to collect sales tax. As California web hosts lose business to other states, they will be forced to reduce payroll and investment in California, resulting in substantial job loss in California's technology sector, the shining star of the California economy.