



## Cal-Tax Analysis: Use Tax Nexus Dilemma

- **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 use tax collection duty on out-of-state businesses doing business in the state.
- **What is use tax?** 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 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 to impose a use tax collection duty. This "physical presence" may include the presence of sales representatives on a retailer's behalf, which help the retailer establish and maintain a market in the state. In contrast, advertising alone is insufficient to establish nexus.
- **Why don't we tax companies, like Amazon, in California?** Amazon is a Washington-based business that has a virtual presence, but no physical presence, in this state. Because Amazon is a Washington-based company, sales from their website are subject to use tax imposed on the consumer, rather than sales tax. California law provides a safe harbor for presence on a computer server in California. That means that the state cannot impose a use tax collection duty on Amazon, rather, the duty to pay the tax lies with the consumer.
- **Why don't we just repeal the safe harbor for computer servers under California law?** The safe harbor gives out-of-state retailers who do business on California web hosts certainty that selling their wares on California websites will not lead to a duty to collect use tax from their customers. Moreover, were the safe harbor removed, it is uncertain whether federal law would permit the state to impose a use 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 use tax nexus.

- **Why shouldn't California just enact a law that requires out-of-state retailers that access California consumers on the Internet to collect use tax from their customers?** Mail order catalogue sellers are not subject to a use tax collection duty without a physical presence in the state. Why should it be any different for Internet retailers? As many as 23 other states have computer server safe harbors. Retailers currently using California web hosts could simply choose to use a web host in one of the safe harbor states, causing California web hosts to lose a substantial amount of business, and possibly even leading those web hosts to stream their websites through non-California servers. In New York, a law was enacted to force out-of-state retailers with New York affiliates to collect use tax, despite no "physical presence" other than a web-based presence. That law is currently under challenge in the New York courts. In addition, at least one very well-known retailer, Overstock.com, chose to drop its New York affiliates.