CALIFORNIA TAX FOUNDATION

POLICY BRIEF

January 30, 2023

HOW CALIFORNIA DISTRIBUTES SALES TAX FROM ONLINE SALES

California uses "mixed sourcing" rules to ensure that local governments receive substantial sales tax revenue from online sales, regardless of the locations of the retailer or purchaser.

WHAT IS 'SALES AND USE TAX SOURCING?'

California's sales and use tax applies to the purchase price of tangible personal property – electronics, furniture, cooked food products, and many other things – used or consumed in the state.

Sales tax is imposed on retailers for the privilege of selling tangible personal property within California.

Use tax is typically imposed on consumers for purchases of tangible personal property from out-of-state retailers, for use in California. Generally, the sales tax and the use tax have the same base and exemptions. Common consumer purchases subject to the use tax include purchases from out-of-state internet sites, mail-order catalogs, and television shopping networks.

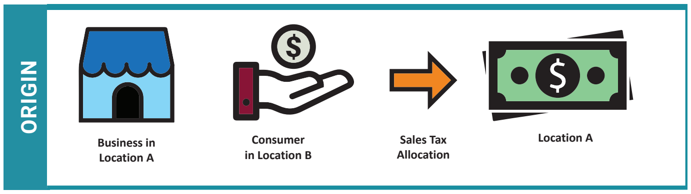
The base sales and use tax rate is 7.25 percent – with 6 percent directed to the state and 1.25 percent benefitting localities, pursuant to the Bradley-Burns Local Sales Tax Law. A number of cities, counties, and special districts impose additional transactions and use taxes that bring the rate to 9.25 percent, and while a state law caps these add-on taxes at 2 percent, some localities have received authorization to exceed the cap. As of January 30, 2023, the rate has reached 10.75 percent in some areas.

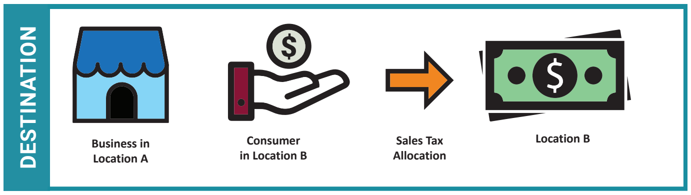
"Sales tax sourcing" is used to determine the location where a sale is taxed, to ensure that local jurisdictions receive a portion of the revenue. Sales tax sourcing is applicable only to remote sales, where the purchaser and retailer are in different locations.

Sales and use taxes generally are sourced using origin sourcing, destination sourcing, or a combination of both methods.

Origin sourcing is a method of apportioning sales tax revenue to the location of the seller's place of business. When the sale is made to an out-of-state destination, the sale generally is exempt from sales and use tax.

Destination sourcing is a method of apportioning sales tax revenue to the location of the consumer (the individual or business purchasing the product). Destination sourcing is the most common method of apportioning sales tax.





HOW SALES TAXES ARE SOURCED IN CALIFORNIA

California uses "mixed-sourcing" rules when apportioning sales tax revenue to local jurisdictions.

For California's state (including the general fund, public safety fund, local revenue fund, and local revenue realignment fund) and local Bradley-Burns (county transportation and city/county general operations) tax rate, sales taxes are sourced using an origin method.

If tangible personal property is shipped to a city, county, or special district that imposes a transactions and use tax – in addition to the combined 7.25 percent state and local Bradley-Burns sales tax – that portion of the sales tax is subject to destination sourcing.

For example, if a chair is shipped from Los Angeles to Sacramento, the state and local Bradley-Burns tax rate is apportioned to Los Angeles, while the 1.5 percent transactions and use tax imposed in Sacramento is apportioned to the destination.

SUPREME COURT DECISIONS AFFECTING SOURCING

The rise in online sales has necessitated the federal government to provide clarity on how sales and use taxes are sourced. The U.S. Supreme Court has issued several decisions regarding remote sales. These cases include:

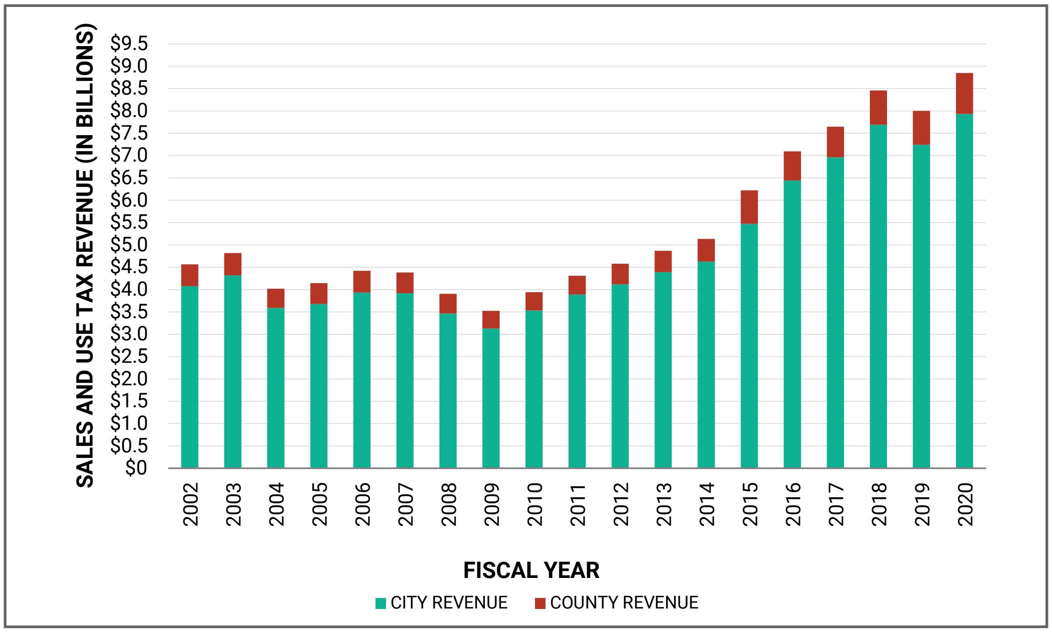
- ***National Bellas Hess v. Department of Revenue of Illinois (1967).*** National Bellas Hess was a mail-order company headquartered in Missouri. The company owned no tangible property in Illinois and had no representatives in the state, but mailed catalogs throughout the United States, including in Illinois. The Illinois Department of Revenue claimed that National Bellas Hess was required to remit use tax because the company was engaged in business in the state, even if it lacked a physical presence. The Supreme Court ruled that the Commerce Clause of the U.S. Constitution prevents a state from imposing use tax obligations on businesses without a physical presence in the state.

- ***Quill Corporation v. North Dakota (1992).*** Quill Corporation is an office supply retailer operating out of Delaware, with warehouses in Illinois, California, and Georgia. The corporation solicits business through catalogs that are mailed to individuals throughout the country. The North Dakota Tax Commissioner claimed that Quill Corporation was required to remit use tax because of state regulations targeting out-of-state mail-order companies engaged in business in the state. The Supreme Court ruled in Quill's favor and affirmed the physical presence and Commerce Clause justifications in *National Bellas Hess*.

- ***South Dakota v. Wayfair (2018).*** A 2016 South Dakota law required out-of-state retailers with gross revenue in excess of $100,000 – derived from South Dakota sources – to remit use tax to the state. Following the passage of the law, South Dakota notified Wayfair LLC, a home decoration retailer operating out of Massachusetts, that the company was liable for remittance of the state's use tax. Wayfair refused to comply and litigated the issue to the Supreme Court. The Supreme Court overruled the physical presence requirement established in *National Bellas Hess* and *Quill*, thus authorizing states to impose sales tax obligations on out-of-state retailers.

South Dakota v. Wayfair overturned 50 years of sales and use tax precedent, exposing retailers to significant tax liability. On April 25, 2019, California passed Assembly Bill 147 (Chapter 5, Statutes of 2019) in response to the Supreme Court's ruling in *Wayfair*. AB 147 requires sellers located outside California to register with the California Department of Tax and Fee Administration and collect use tax if, during the preceding or current calendar year, the total combined sales of tangible personal property for delivery in California by the retailer and all persons related to the retailer exceed $500,000. The California Department of Tax and Fee Administration reported that as of October 21, 2022, 15,800 taxpayers registered for a California permit as a result of the *Wayfair* decision and these taxpayers have reported $3.1 billion in tax due.

CITY AND COUNTY SALES AND USE TAX REVENUE



Source: State Controller's Office
Note: San Francisco is counted in the city column.

2023 SALES AND USE TAX RATES

TAX	HOW THE FUNDS ARE ALLOCATED	RATE	AUTHORITY	DESTINATION OR ORIGIN
STATE SALES AND USE TAX	State General Fund	3.6875%	RTC §6051 and RTC §6201	Origin
	State General Fund	0.25%	RTC §6051.3 and RTC §6201.3	Origin
	Local Public Safety Fund	0.50%	California Constitution Article XIII, §35	Origin
	Local Revenue Fund (Health and Social Services)	0.50%	RTC §6051.2 and RTC §6201.2	Origin
	Local Revenue Fund (2011 Realignment)	1.0625%	RTC §6051.15 and RTC §6201.15	Origin
TOTAL STATE SALES AND USE TAX RATE		6.00%		
BRADLEY-BURNS LOCAL SALES TAX	County Transportation Budgets	0.25%	RTC §7202	Origin
	City/County General Operations	1.00%	RTC §7203	Origin
TOTAL LOCAL SALES AND USE TAX		1.25%		
CITY AND COUNTY TRANSACTIONS AND USE TAX	Voter-approved taxes imposed by cities, counties and special districts for general or special purposes. Rates vary by jurisdiction, but generally cannot exceed 2 percent. State law authorizes some jurisdictions to exceed the 2 percent cap for special purposes. Levies can be in increments as small as 0.125 percent.	Rate Varies	RTC §7261	Destination

ONLINE SALES TAX SOURCING

To determine the source of an online sale, California follows a variety of rules outlined in California Department of Tax and Fee Administration regulations 1699 and 1802.

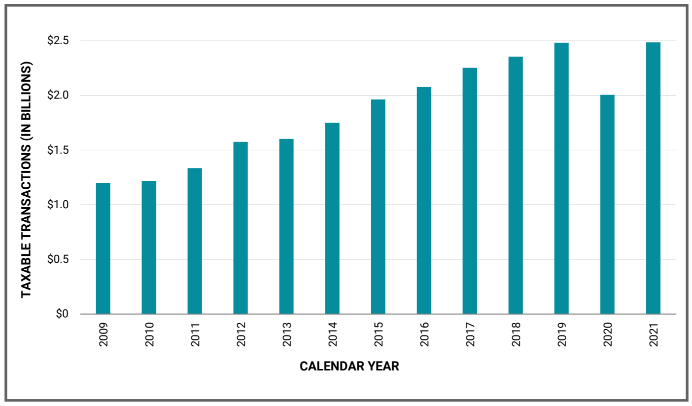
When an online retailer is located out of state, sells goods to a California consumer, and is not required to file tax statements under California's *Wayfair* guidelines, the purchaser is responsible for remitting use tax to the state. Because online purchases from out-of-state retailers often do not involve a permanent "place of sale," California implemented a pooling method to ensure that localities receive tax revenue. Under the pooling method, the Bradley-Burns portion of local tax is apportioned to the county where the sale took place and then is distributed to each locality in the county based on a pro rata share of taxable sales for each quarter.

Online retailers headquartered out of state with a physical presence in California are required to remit sales tax to the state. If a California consumer places an order and the online retailer has the goods shipped out of a warehouse located in the state, the Bradley-Burns portion of local tax is apportioned to the warehouse's location while the add-on transactions and use tax imposed by a city, county, or special district is apportioned to the purchaser's location.

If an online retailer headquartered out of state contracts with a third-party warehouse or fulfillment center located in California, the sales tax sourcing rules outlined above remain true – Bradley-Burns local tax is apportioned to the location of the third-party warehouse while the add-on transactions and use tax is apportioned to the purchaser's location.

In recent years, lawmakers have discussed restricting zoning for logistics facilities, including warehouses and fulfillment centers. California's sales and use tax sourcing rules ensure that local governments receive tax revenue from online sales and restricting the zoning of these facilities will have detrimental effects on revenue that local governments rely on to stabilize budgets, deliver critical services to residents, and provide infrastructure investments.

LOCAL REVENUE FROM WAREHOUSING ACTIVITIES



Source: California Department of Tax and Fee Administration

CONCLUSION

In the past, the vast majority of sales tax revenue was generated from over-the-counter transactions at shopping centers. Cities with shopping centers and malls received significant sales tax revenue, while cities without robust commercial activity did not.

With the increased popularity of online sales, California's sales and use tax sourcing rules ensure that localities receive their share of sales tax revenue based on the location of the retailer and purchaser. In 2020, cities and counties collected $8.8 billion in sales and use tax revenue, up from $4.5 billion in 2002. During the 2020-21 fiscal year, warehousing activities generated more than $2 billion in taxable transactions.