

## Evaluating Some Options For Sales Tax Reform

At its January 16, 2015 meeting the League’s Revenue and Taxation Policy Committee heard a presentation on the sales and use tax and directed staff to return with specific ideas for reform. The presentation followed a year-long study by a League Task force on the sales and use tax. The Task Force examined the issues including:

- the accelerating decline and concentration of local sales tax revenues,
- changes in demographics, purchasing behavior, and technology;
- tax rates and application to various categories of goods and services in other states;
- the use of tax rebates,
- tax sourcing rules (definition of the location of sale for purposes of determining tax rate and distribution)
- the distribution of pooled revenues.

The group also discussed a number of ideas for reform related to these issues and gathered input from technical experts in the field of municipal taxation including staff at Muniservices LLC and HdL Companies.

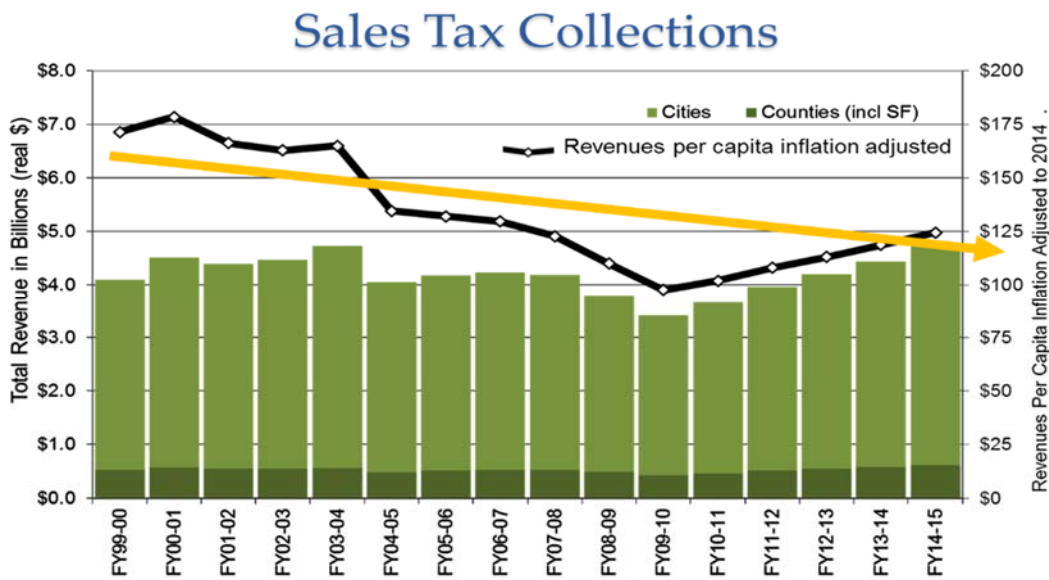
This report summarizes the issues, describes pertinent policies and principles to guide decisions on possible reforms, and examines various reform ideas in light of these principles.

### I. The Problems

#### A. Weak Growth In Revenues, Below The Pace of Population Growth and Inflation

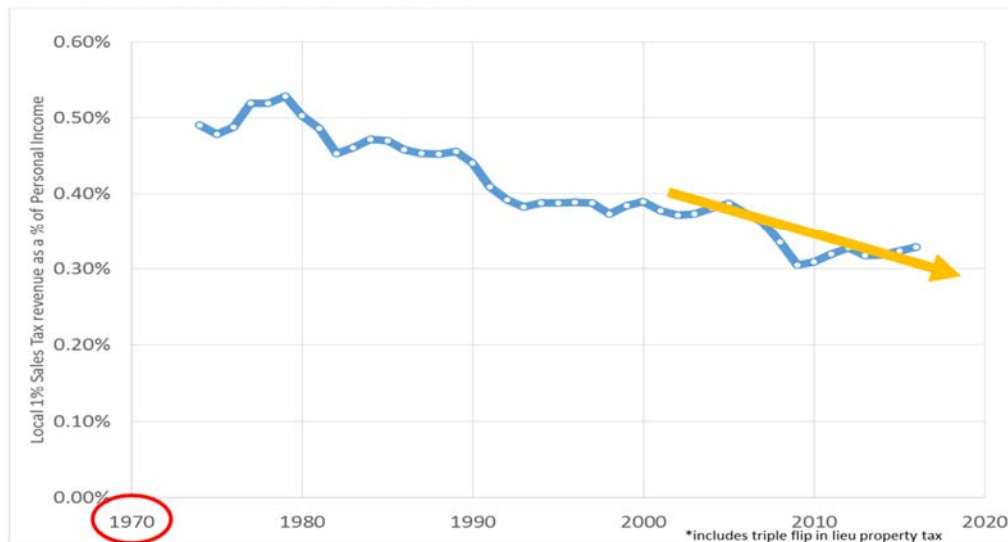
Sales and use tax (SUT) revenue collections do not keep pace with growth in the economy or with inflation and population growth. This is largely due to two things:

- 1) Growth in the economy and consumer spending has been stronger in areas which are generally not taxed in California. The cost of services, which are generally not taxed, has generally increased at a higher rate over time than the cost of goods.



- 2) A growing portion of previously taxable goods are now being provided digitally and in that form are generally not taxed. Examples include music, videos and computer software.

### Local 1% Sales Tax Revenue as a Percent of Personal Income



## B. Concentration of Revenues and Leakage Through Rebate Agreements

There has been and alarming increase in arrangements to encourage certain land use development with rebates and incentives which exploit California's odd origin sales tax sourcing rules. This has resulted in the concentration of sales tax revenues in a few jurisdictions at the expense of many many others. It has resulted in the diversion of sales tax revenues away from the provision of important public services in amounts far in excess of any conceivable economic benefit.

In the typical arrangement, a city provides tax rebates to a company that agrees to move or expand their operations in the jurisdiction of the city. The expansion may be little more than an order desk. Under such an arrangement, the company generally agrees to make a specified amount of capital investment and create a specific number of jobs over a period of years in exchange for specified tax breaks, often property tax abatement or some sort of tax credit. In some cases, this has simply taken the form of a sales office, while customers and warehouses and the related economic activity are disbursed elsewhere in the state. In some cases the development takes the form of warehouses, in which the sales inventory, owned by the company, is housed.

Current sales tax incentive agreements in California rebate amounts ranging from 50% to 85% of sales tax revenues back to the corporations. Today, experts familiar with the industry believe that between 15% to 20% of local Bradley-Burns sales taxes paid by California consumers is diverted from local general funds back to corporations; over \$1 billion per year.<sup>1</sup>

<sup>1</sup> There is no comprehensive list of sales tax rebate agreements, but this estimate is based on the close understanding of current rebate agreements consultants involved with sales tax collection analysis for local governments. Twenty percent of the current \$6 billion annual 1% local Bradley Burns rate is \$1.2 billion.

## C. Revenues Reported to County Pools Are Not Fully Allocated On The Situs of Transactions From Which They Come

Sales tax revenues in a countywide pool are allocated among the local agencies in that county in proportion to other taxable sales. That is, regardless of the particular jurisdiction in a county where a taxable product is received or used, the revenues are distributed among all based on the proportion of other taxable sales. Why do we do it this way? Historically, for ease of administration for the BOE and taxpayers. But this method does not reflect the true economic activity or public service impacts associated with the use of the product, a fact implicitly recognized in existing regulations which provide that revenues from purchases in excess of \$500,000 in value be sourced to the location of first use. Today, technology is vastly more sophisticated than twenty or thirty years ago such that the administrative ease justification seems weak.

## II. Guiding Principles

### A. League of California Cities' Policies and Guiding Principles

The League's Policies and Guiding Principles<sup>2</sup> provide us a framework for evaluation as we consider these and other ideas. Pertinent to this issue are the following:

- 1) Revenue from new regional or state taxes or from increased sales tax rates should be **distributed in a way that reduces competition for situs-based revenue**. (Revenue from the existing sales tax rate and base, including future growth from increased sales or the opening of new retail centers, should continue to be returned to the point of sale.)
- 2) The existing situs-based sales tax under the Bradley Burns 1% baseline should be preserved and protected. Restrictions should be implemented and enforced to **prohibit the expansion of questionable businesses formed to circumvent the principle of situs-based sales and used to divert sales tax revenues** from other regions in return for favorable treatment.
- 3) Cities and the League should continue to emphasize efficiency and effectiveness, **encouraging and assisting cities to achieve the best possible use of city resources**.
- 4) Revenues should be logically **linked to traditional and emerging responsibilities**.
- 5) To preserve local authority and accountability for cities, state policies must ... **ensure the integrity of existing city revenue sources for all cities**, including the city share and situs allocation, where applicable, of property tax, sales tax, vehicle license fees, etc.

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<sup>2</sup> See "League of California Cities, Summary of Existing Policy and Guiding Principles" Revenue and Taxation section.

## B. Guiding Principles from Other Local Government Fiscal Reform Efforts

In my review of prior reform issues and efforts in the area of local and state government finance in California, I offer four broad principles to guide proposed solutions:<sup>3</sup>

- seek greater fiscal stability and local choice;
- better match local government revenues with local public service costs;
- improve transparency and simplicity to residents, taxpayers and customers;
- avoid harmful effects on individual agencies and groups.

I offer one more, a paraphrase of an aphorism attributed to Voltaire:

- “Don’t let the perfect be the enemy of the good.”

## III. Some Reform Ideas

### A. Expand Taxable Sales to Include Areas Commonly Taxed In Other States

Mazeroff (2009) offers the following benefits to expanding the sales tax base to include services:

- ✓ **Taxing additional services can generate substantial new sales tax revenue.** Broadening the tax base could substantially increase revenues.

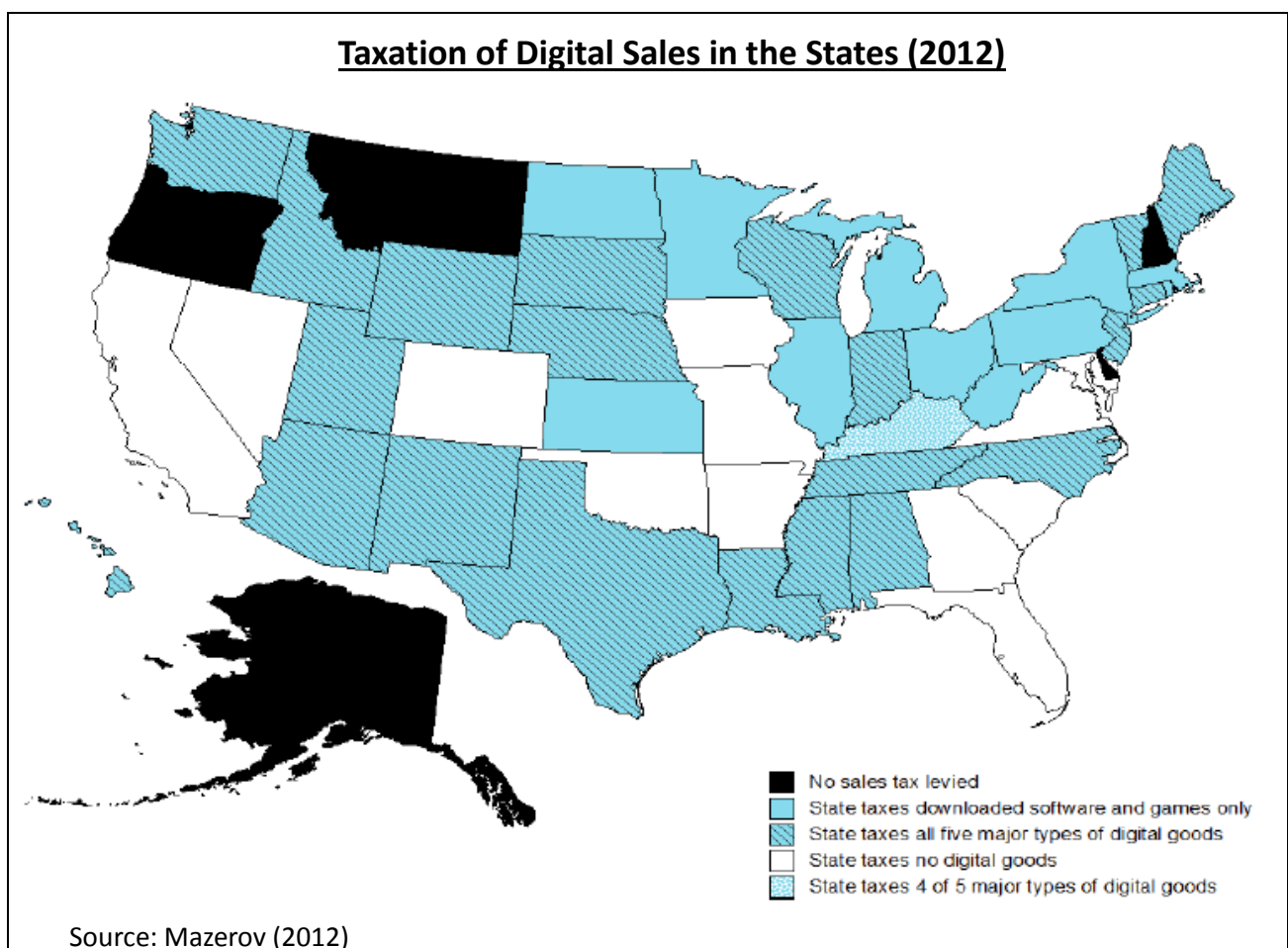
Estimated Sales and Use Tax Revenues	State GeneralFund	Counties Realignment	Local BradleyBurns	CoTransp ¼% +Prop172 ½%	Local Add-on TrUTax	(millions)
	3.9375%	1.5625%	1.0%	0.75%	various	Total
Amusement Parks	\$56.7	\$22.5	\$14.4	\$10.8	\$11.8	\$116.2
Sporting Events	\$47.3	\$18.8	\$12.0	\$9.0	\$9.8	\$96.8
Appliance/Furniture Repair	\$49.6	\$19.7	\$12.6	\$9.4	\$10.3	\$101.6
Golf	\$64.7	\$25.7	\$16.4	\$12.3	\$13.4	\$132.6
Vehicle Repair	\$641.0	\$254.3	\$162.8	\$122.1	\$133.1	\$1,313.3

SOURCE: Based on a memorandum from California State Board of Equalization Member Judy Chu April 2008

- ✓ **Taxing services broadly is essential if the long-run revenue adequacy of the sales tax is to be maintained.** Household spending has been shifting from goods to services for decades. Largely to compensate for this trend, states have increased sales tax rates.
- ✓ **Bringing services into the sales tax base may reduce the year-to-year volatility of sales tax collections.** Research suggests that including more services in the sales tax base could moderate the volatility of sales tax revenues over the course of the business cycle.

<sup>3</sup> See Multari, Coleman, Hampian and Statler, “Guide to Local Government Finance in California” 2012 Solano Press Books, Chapter 17, page 237.

- ✓ **Expanding the taxation of services will make the sales tax fairer.** The sales tax is intended to be a general tax on consumption. There is little reason to distinguish between consumption of goods and consumption of services, which in fact can be substitutes for one another. For example, it is not equitable — it violates the principle of “horizontal equity” — to tax the person who rents a videotape but not the person who watches a pay-per-view movie on cable TV.
- ✓ **Imposing a sales tax on services can improve the allocation of economic resources.** Taxing goods but not services creates an artificial incentive to purchase services rather than goods.
- ✓ **Expanding the taxation of services can simplify the process of administering and complying with the sales tax.** If all of a retailer’s sales, rather than just the non-labor portion, are subject to tax, many accounting burdens and disputes diminish or disappear.



### Specific reform ideas:

- ◆ Expand taxable sales to include **products delivered in digital form**. California's SUT laws were enacted in the 1950s and could not have contemplated the digital economy of today. Increasingly, products including books, music, games, movies and software are sold in digital form over the Internet. Unlike twenty-three other states including Texas, Idaho, Utah, and Washington, California has not updated its SUT law to cover goods and services sold and delivered digitally even though these states tax the sale of identical items sold in physical stores. The lost revenue is in excess of \$150 million per year and growing, including over \$130 million from the 7.5% base composite statewide rate. Bradley Burns 1% losses are about \$18 million per year.<sup>4</sup>

### Services Commonly Taxed in Other States ... But Not California

	Texas	Florida	Utah	#States*	
Professional sports (34), amusement parks (34), cultural events (29), circus/fairs (33), bowling alleys (26)	X	X	X	26-34	Amusement / entertainment / recreation
Private club memberships, golf	X	X	X	23	
Health clubs	X	-	-	21	
Marina services	X	X	X	15	Personal property repair / installation / maintenance
Laundry / dry cleaning	X	-	X	21	
Garment, shoe repair or alteration	X	X	X	19	
Automobile repair (20), washing (19), rustproofing (24)	-	X	X	19-24	Personal property repair / installation / maintenance
Appliance (incl TV) repair (23), installation (22)	X	X	X	22-23	
Carpet / upholstery cleaning	X	-	-	17	
Remodeling – Labor	X	-	X	14	Home repair / installation / maintenance
Exterminating	X	X	-	19	
Landscaping / lawncare	X	-	-	20	
Swimming pool cleaning	X	-	-	16	
Digital downloads	X	-	X	23	

Source: Mazerov "Expanding Sales Taxation of Services: Options and Issues, Center on Budget and Policy Priorities

\*States plus District of Columbia

- ◆ Expand taxable sales to **include recreation and entertainment**. Most other states that impose a sales tax include most sales of recreation and entertainment as taxable. In most cases, the vendors providing these services already have sales tax permits and are collecting and remitting sales and use tax revenues on taxable goods. This will help mitigate the administrative cost to the vendors and the BOE of such a change. The BOE costs would netted out of the state and local revenues they collect.

<sup>4</sup> Based on Mazerov's 2012 collection estimates for nine states, adjusting for rates and populations.

The foregone sales tax revenue in California from not taxing these categories exceeds \$300 million per year including nearly \$50 million to the local Bradley Burns 1% rate.<sup>5</sup>

#### **Recreation and Entertainment Not currently Taxed in California**

✓ Professional sports	✓ Circus / fairs	✓ Marina services
✓ Amusement parks	✓ Bowling alleys	✓ Health clubs
✓ Cultural events	✓ Video, billiards	✓ Private club memberships

- ◆ Expand taxable sales to cover **maintenance and repair services**. Repair and maintenance services are commonly defined as taxable sales in most other states that impose a sales tax. Providers of these services in California are typically already collecting and remitting sales and use tax revenues on taxable goods (e.g., parts, materials, etc.), but not on the labor portion of the transaction. The foregone sales tax revenue in California from not taxing these categories exceeds \$1.6 billion per year including over \$250 million to the local Bradley Burns 1% rate.<sup>6</sup>

#### **Maintenance and Repair Services Not Currently Taxed in California**

✓ Carpet and upholstery cleaning	✓ Automobile repair, installation, washing, rustproofing
✓ Extermination	✓ Appliance repair or installation (incl. TV, sound systems, kitchen appliances, etc.)
✓ Landscaping and yard care	✓ Garment or shoe repair or alteration,
✓ Swimming pool maintenance and cleaning	✓ Laundry/dry cleaning
✓ Building repair or remodeling (including plumbing, electrical, flooring, etc.)	

- ◆ Eliminate the sales tax **exemption for candy, snacks and bottled water**. California, like most states, exempts food products from taxable sales. Unlike many other states, California also exempts, candy, confectionary and snack foods and bottled water. The BOE estimates this exemption results in the loss of \$1.3 billion annually in sales and use tax revenues to governments including \$120 million per year in city/county local Bradley Burns sales tax and over \$100 million in local add-on transactions and use taxes.
- ◆ Eliminate the sales tax **exemption for custom computer programs**. Customized computer programs are non-taxed service, unlike “off-the-shelf” computer programs if delivered in tangible form (i.e. not digital). The BOE estimates that governments in the California lose about \$400 million annually from this exemption, including about \$50 million per year in city/county local Bradley Burns sales tax and over \$42 million in local add-on transactions and use taxes.
- ◆ **Tax reduction offset**. The sales tax rate could be reduced to mitigate, all or in part, the initial revenue impact of expanding what activities are taxable. A 0.25% reduction is roughly equivalent to \$1.6 million annually at present. A 0.1% reduction is roughly equivalent to \$640 million. However, there are complications with this. The Legislature is constitutionally prohibited from reducing some components of the sales and use tax including: the 1% local Bradley Burns general rate,<sup>7</sup> the 0.25% Bradley Burns

<sup>5</sup> Based on Mazerov (2009), BOE (2010)

<sup>6</sup> Based on Mazerov (2009), BOE (2010)

<sup>7</sup> Proposition 1A, Cal Const Art XIII Sec 25.5 (a)(2)

county transportation rate,<sup>8</sup> the 0.5% Proposition 172 public safety rate,<sup>9</sup> the 0.5% and 1.0625% local realignment fund rates,<sup>10</sup> and any of the voter approved local transactions and use tax rates (add-on sales taxes).<sup>11</sup> Revenue gains from an expansion would occur for all of these rate categories, but an offsetting rate reduction could only be enacted on the 3.9375% state general fund rate. Consequently, a reduction that *fully* offsets the revenue increase would produce a revenue *decrease* to the state general fund.

## B. Strictly Limit or Eliminate New Sales Tax Rebate Agreements

- ◆ Eliminate SB27 loophole for impacts on **revenues from pools**. The last sentence of Government Code Section 53084.5 (a)(1) allows a rebate agreement even if it results in a reduction of revenues to other agencies if those reductions occur from a countywide pool. A retailer’s change from collecting and reporting use tax into county pools to sales tax does not justify a rebate agreement.
- ◆ Eliminate SB27 loophole for impacts on revenues where a **retailer is expanding operations**. The last sentence of Government Code Section 53084.5 (a)(2) allows a rebate agreement when there is an expansion of the retailer’s operations with the result that the retailer is conducting a comparable operation in both jurisdictions. Eliminating this loophole would of course not prevent such expansions but it would not allow this to enable rebate agreement.
- ◆ Eliminate SB27 loophole for impacts on revenues related to **reimbursement to a retailer for public works improvements**. Government Code Section 53084.5 (c). Eliminating this loophole would of course not prevent the reimbursement of retailers for public works improvements. But such reimbursement could not come in effect at the expense of other agencies via a rebate agreement.
- ◆ Eliminate SB27 loophole for impacts on revenues related to a **“buying company.”** Government Code Section 53084.5 (d) allows a rebate agreement when there is a buying company involved. Eliminating this loophole would of course not prevent the establishment or use of buying companies but it would not allow this a justification for a rebate agreement.
- ◆ Eliminate SB27 loophole for impacts on revenues in cases where there is a **use tax direct payment permit** involved. (Government Code Section 53084.5 (e)). Eliminating this loophole would of course not prevent these use tax direct payment permits but it would not allow a rebate agreement in such a circumstance.

## C. Reduce The Leakage of Local Sales Tax Revenue Under Existing Agreements

- ◆ Redefine sales tax sourcing rules to destination instead of origin. Under California’s current origin based sourcing rules, retail sales are generally sourced to the local jurisdiction of the retailer’s place of business and where the principal sales negotiations took place. Under destination based sourcing, sales are instead sourced to the jurisdiction where the purchaser receives the property, if the information is

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<sup>8</sup> Proposition 1A, Cal Const Art XIII Sec 25.5 (a)(2)

<sup>9</sup> Proposition 172, Cal Const Art XIII Sec 35

<sup>10</sup> Proposition 30

<sup>11</sup> Proposition 1A, Cal Const Art XIII Sec 25.5 (a)(6)



available to the retailer at the time of sale. If the location where the purchaser takes possession of the property is not known by the seller, alternative methods to source the tax include (in order):

- the location indicated by delivery instructions known to the seller,
- the location indicated by the address of the purchaser available in the seller's records,
- the location of the purchaser's payment instrument, or
- the location from which the property is shipped.

- ◆ Alternative: phase in destination rules over time to arrive at a split of the source between the origin and the destination locations. For example: on July 1, 2017, 25% destination and 75% origin; on July 1, 2020, 50% destination and 50% origin; and on July 1, 2023, 75% destination and 25% origin.

#### **D. Reduce Pools, Send Revenues to Specific Location of Economic Activity**

- ◆ Redefine the sourcing rules for all use tax transactions to specify the location of product receipt (destination) is the specific jurisdiction, not the county, unless it is not reasonably possible to determine. Current Board of Equalization regulations provide that the use tax from taxable transactions of \$500,000 or more by out-of-state retailers who are engaged in business in California is allocated to the jurisdiction in which the first functional use of the property occurs. This is generally deemed to be the jurisdiction to which the goods are shipped. Use tax revenues from transactions below this threshold are reported to pools and then disbursed among jurisdictions based on the share of other taxable sales.
- ◆ Alternative: Reduce the pool threshold from \$500,000 to \$10,000 (or some amount).

**ADDENDUM: Excerpt from “Guide to Local Government Finance in California”****Principles of Local Government Fiscal Reform**

from Multari, Coleman, Hampian and Statler, “Guide to Local Government Finance in California”

**Enhance Fiscal Stability and Local Choice.** The efficient and effective delivery of public services requires reasonable durability and stability of fiscal resources. It also requires flexibility for local policy makers to make choices, including the reallocation of resources to meet changing needs. Improvements to the local fiscal system should:

- Increase “local control,” the ability of local governments to respond effectively and efficiently to local public service priorities and needs of their residents, property owners, businesses and civic institutions.
- Stabilize and protect local government revenues and prevent mandated responsibilities from capricious actions by the State.
- Improve the efficiency, effectiveness and responsiveness of local government by consolidating finances, roles and responsibilities and increasing the ability of cities and counties to decide the allocation of public revenues, and how and what municipal services they will provide.
- Provide sufficient fiscal resources to underfunded local governments.
- Enable and encourage intergovernmental cooperation, consolidation and improvement.
- Establish a local fiscal system that is sustainable, and that can respond to evolving economic conditions and local public service needs.

**Match Local Government Revenues with Local Public Service Costs.** When the demand for local public services expands due to development and population growth, local fiscal resources need to grow in tandem. Improvements to the fiscal system should:

- Provide a responsive palate of revenues that grows concomitantly with service demand so as to minimize the need for restructuring or tax increases except to enhance service levels.
- Provide sensible incentives for desired land uses that may not generate high revenues, such as affordable housing or open spaces.
- Avoid incentives that encourage cities and counties to overemphasize certain land uses, such as retail development, at the cost of well-balanced communities.
- Consider tax deductibility, so that the structure of state and local taxes causes the federal government to shoulder a greater share of public service costs and provide tax relief and/or service improvements.

**Improve Transparency and Simplicity to Residents, Taxpayers and Customers.** The local fiscal system is extremely complicated. Unnecessary complexity wastes resources and creates distrust. Improvements to the fiscal system should:

- Enhance the transparency of where taxes, fees and other funds are allocated and spent, making the system more understandable, accessible and less complicated.
- Minimize administrative bureaucracy and costs while providing sufficient systems to assure accountability and to measure the efficiency and effectiveness of public service delivery.

**Avoid Harmful Effects on Individual Agencies and Groups.** In almost any fundamental change to the local fiscal system there will be some agencies and individuals that will be better and some worse off. This is the “winners and losers” challenge of reform. Improvements to the fiscal system should endeavor to minimize or mitigate the impact of changes on institutions and individuals.

California communities and the public agencies that serve them are diverse in service needs, in philosophy, and in the structure of their finances. Changes to the system should allow for local flexibility and choice and avoid “one size fits all” solutions.

## ADDENDUM: Countywide and Statewide Pools in California

Under current California State Board of Equalization regulations, a substantial portion of local use tax collections are allocated through a countywide pool to the local jurisdictions in the county where the property is put to its first functional use. The state and county pools now constitute over 15% of local sales and use tax revenues. Under the pool system, the tax is reported by the taxpayer to the countywide pool of use and then distributed to each jurisdiction in that county on a pro-rata share of taxable sales. If the county of use cannot be identified, the revenues are distributed to the state pool for pro-rata distribution on a statewide basis.

BOE rules call for the use of these pools rather than sending the revenue to the jurisdiction of first use despite the fact that - in most cases now - transactions include a district tax component which is allocated not to any pool, but to the specific jurisdiction. For example, Amazon collected an 8% rate on my purchase of a book last week, the total rate in my hometown. This includes a 0.5 percent rate, the add-on transactions and use tax (district tax) allocated to my city. But the Bradley Burns one percent portion of the tax I paid goes into the county pool and is shared among all cities and the county. Under destination sourcing rules, that local one percent would be allocated to the city, a stronger move toward true situs allocation.

The largest components of these pools are from:

- Private party sales of vehicles, vessels and aircraft registered at the Department of Motor Vehicles, and mobile homes reported by the Department of Housing and Community Development.
- Private party sales of vessels (not required to register with the DMV) and aircraft purchases.
- Use tax paid by contractors who are considered consumers of materials purchased without tax, but used by the contractor in the improvement of real property, and whose job site is regarded as the place of business.
- Merchandise shipped directly to consumers by common carrier from inventory located outside the state with the title passing out of state.
- Long term leases of tangible personal property except long term leases of motor vehicles (see below).
- Catering trucks, itinerant vendors, vending machine operators and other permit holders who operate in more than one local jurisdiction and are unable to readily allocate taxable transactions to specific points of sale.
- Use tax on purchases consumed at non-selling facilities (research and development, for example.)
- Use tax on motor vehicle leases negotiated by out-of-state leasing companies.

### Revenue from the Pool: An Example

A city generating 4% of all taxable sales in a given county receives 4% of the pool.

State law does provide special allocation procedures for use taxes collected on certain products. Generally, these special allocation rules allow use tax revenue that would otherwise be shared via the countywide and statewide pools to be directly allocated to the jurisdiction of use. These include:

- **Jet Fuel:** The sales tax on jet fuel generally goes to the jurisdiction where the fuel is pumped into the aircraft.
- **Long Term Leases of Motor Vehicles (greater than four months):** Sales tax from rentals of equipment and vehicles is allocated to the jurisdiction where the rental company is located. Rentals exceeding four months or longer are considered long term leases. When the leased vehicle is either purchased from a California dealer or leased by a California dealer-lessor, the tax is allocated to the place of business of the dealer or lessor. If the leased vehicle comes from an out-of-state source, the tax is allocated through the county-wide use tax allocation for the county in which the vehicle is registered.

- **Auctioneers** conducting auction events at locations other than their regular place of business when the taxable sales total \$500,000 or more: The local tax is to be allocated to the jurisdiction in which the auction occurs.
- **Construction Contracts equal or greater than \$5,000,000.** Construction contractors have the option to allocate use tax on materials consumed and fixtures furnished directly to the jurisdiction where the jobsite is located if the sales or purchase value exceeds \$5 Million. The Board of Equalization will not allocate to the jobsite if a sub permit for the location is not taken out prior to commencement of the project.
- **Sales and Purchases of \$500,000 or More Subject to Use Tax.** Use tax from transactions by out-of-state retailers who are engaged in business in California is allocated to the jurisdiction in which the first functional use of the property occurs. This generally is deemed to be the jurisdiction to which the goods are shipped.

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## ADDENDUM: Destination Sourcing<sup>12</sup>

A change from origin sourcing rules to destination sourcing rules for the local tax component of California’s sales tax would improve overall revenue collections and distribute these revenues more equitably among all of the areas involved in these transactions.

A change from origin based sourcing to destination based sourcing would have no effect on state tax collections. However, it would alter the distribution of local sales and use tax revenues among local agencies. Most retail transactions including dining, motor fuel purchases, and in-store purchases would not be affected. But in cases where the property is received by the purchaser in a different jurisdiction than where the sales agreement was negotiated, there would be a different distribution than under the current rules.

Under California’s current origin based sourcing rules, retail sales are generally sourced to the local jurisdiction of the retailer’s place of business and where the principal sales negotiations took place. Under destination based sourcing, sales are instead sourced to the jurisdiction where the purchaser receives the property, if the information is available to the retailer at the time of sale. If the location where the purchaser takes possession of the property is not known by the seller, alternative methods to source the tax include (in order):

- the location indicated by delivery instructions known to the seller,
- the location indicated by the address of the purchaser available in the seller’s records,
- the location of the purchaser’s payment instrument, or
- the location from which the property is shipped.

Moving to destination based sourcing rules will not reduce the amount of local tax collected (in fact it will INCREASE the overall amount of tax retained by cities and counties), but it would result in different distributions among local jurisdictions. These differences would occur in cases where a retailer ships or delivers the property sold to locations outside the local jurisdiction of the retailer’s place of business. Specifically, a different distribution would occur under destination sourcing if:

1. The sold property is delivered to the purchaser in another taxing jurisdiction, or
2. The purchaser receives the property at a retailer’s business location other than where the principal negotiations took place.

### The Source of Origin Based Sourcing Problems

Where other than over-the-counter sales are concerned origin sourcing often causes a concentration of large amounts of tax revenue in one location, despite the fact that the economic activity and service impacts are also occurring in other locations.

The large amounts of revenue concentrated in a few locations by California’s “warehouse rule” origin sourcing causes a concentration of revenue far in excess of the service costs associated with the development.

In order to lure jobs and tax revenues to their communities, some cities have entered into rebate agreements with corporations. This has grown to such a problem, that experts estimate 15% to 20% of total local taxes paid statewide are being rebated back to corporations rather than funding public services.

<sup>12</sup> The same issues that are of concern regarding the local sales tax do not apply to California’s Transactions and Use Taxes (“Add-on sales taxes”) as these transactions, when not over the counter, are generally allocated to the location of use or, as in the case of vehicles, product registration. There is no need to alter the sourcing rules for transactions and use taxes.

Cities and counties that are comprised of a large number of retailers that routinely sell property that is shipped or delivered to purchasers outside their local jurisdiction may see a reduction in tax revenues compared to the current origin based system. But cities and counties that are comprised of businesses with a significant amount of over-the counter sales and residences that receive property from outside their local jurisdiction, may see an increase in local revenues.

## **Moving to Destination Sourcing: Issues**

### ***1. Destination Sourcing Would Add Some Complexity for Some Sellers.***

For most transactions, including brick and mortar transactions and any transaction in which the seller delivers the product within the same jurisdiction, the seller's tracking and reporting would be no different under destination rules. However, for deliveries outside the jurisdiction in which the seller resides, destination sourcing requires more information tracking. Under origin-based sourcing, sellers generally only have to know the sales tax rates in effect where their place of business is located. Destination-based sourcing requires sellers to properly apply sales tax rates for all the jurisdictions into which they deliver taxable items.

However, California's transactions and use taxes (district taxes), now numbering over 121, require a seller to collect and remit the tax for a district if a delivery is made into that district AND the seller is "engaged in business" in that district. Large retailers with multiple locations are now, as a matter of practice, tracking collecting and remitting district tax rates. So the location of "receipt" is already being tracked and used for tax reporting. It seems no more difficult to apply this information to the sourcing of rest of the sales tax. In fact, it is arguably simpler and many large remote sellers are – for various reasons - already sourcing their transactions as "use tax" rather than sales tax.

A switch to destination sourcing would create a greater compliance burden for smaller sellers who do not currently use programs or databases to assist them in properly collect taxes. However, such programs are readily available.

### ***2. Destination Sourcing Would Increase City and County Revenues***

A switch to destination sourcing would increase city general fund revenues by over \$800 million to \$1+ billion per year. Substantial amounts of local revenue that are currently being rebated back to corporations through sharing agreements would instead allocated to receipt locations not affected by those agreements. This amounts to an increase in sales tax revenues for every city of \$25 to \$35 per resident per year on average.

### ***3. A Switch to Destination Sourcing would Alter Revenue Distributions Among Cities and Counties***

The greatest concern regarding the switch from origin-based to destination-based sourcing is the redistribution of local sales taxes from jurisdictions where taxable items are purchased to jurisdictions where the items are delivered.

A switch to destination sourcing would cause some shift in sales and use tax revenue distribution among cities and counties. Cities with less than average per resident taxable sales of products that are delivered to locations outside the jurisdiction will see an increase in revenues. Cities with a greater-than-average per resident amount of taxable sales of products delivered other locations will see some loss. In some cases, this loss will exceed the gain in revenues from the added amount of revenues to all cities (above).

**4. Destination Sourcing Rules Reduce the Incentive for Tax Rebate Agreements**

Add-on transactions and use taxes would not need to change. California's Transactions and use tax is already a form of destination sourcing. The exception is the special provisions for motor vehicles where the district tax is sourced to the location where the property is registered. A change in the sourcing method of the Bradley Burns rate would not require an alteration of these rules. In effect, taxes would be applied to auto sales just as they are now.

**5. Out of the Pool: Destination Sourcing Would Allocate Revenue to the True Locations of Economic Activity.**

As a part of the shift to destination based sourcing, most revenues currently allocated to pools would instead be allocated to the specific jurisdiction where the property is received. Statewide and countywide pools would only be used when it is too difficult for a retailer to identify and report tax to specific jurisdictions. In this way destination sourcing allocates these tax revenues more closely to the situs of the economic activity (the sales transaction).

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**ADDENDUM: Notes from a Meeting with BOE Staff**

In March, Dan Carrigg and Michael Coleman met with several members of the Board of Equalization's sales tax staff to discuss practices and issues regarding the collection and distribution of sales tax especially use tax pooling. BOE staff emphasize that they provide administration under state law and regulations adopted by the board, that they are "policy neutral." Their role is to provide needed information to support policy decisions and implementation. If instructed to do so, the staff can and will administer the taxes differently, but in order to do so, BOE may need additional resources and that may necessitate additional administrative charges to tax revenue recipients. BOE staff noted that the pools were implemented many decades ago, prior to the existence of computers as we know them, when remote sales consisted primarily of catalogue sales. They note that the largest component of countywide pools is third party automobile sales (i.e. non-dealer sales). In those early days, over 50 years ago, the pooling system was established to reduce administrative costs and burden on the taxpayers (58 locations rather than hundreds for taxpayers to identify in their returns).

Computers today are vastly more sophisticated and capable. But while it would appear that the technology to identify specific locations of delivery in order to get distributions out of pools and out fully to the jurisdictions of distribution (true situs), there is no agreed-upon adopted GIS system. The technology appears close, with 9-digit zip codes and sophisticated geo-mapping. But the 9-digit zip code is administered by the US Postal Service with no concern for tax zones. In some cases even these small 9-digit zip areas cross jurisdictions with different tax rates. In order to establish and maintain a central – agreed upon, master address to tax rate database, would require new systems and resources and an ongoing maintenance staff. The BOE is currently updating its data systems but the eventuality of a master central database for the determination of use tax apportionment by taxpayers as well as BOE has apparently not been explicitly anticipated.

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