

California Fiscal Focus

A Monthly Report from State Controller Betty T. Yee

November 2018

Controller Reports State Revenue Missed Projections for October

State Controller Betty T. Yee reported the state received \$6.57 billion in revenue in October, falling short of assumptions in the 2018-19 fiscal year budget by 5.9 percent, or \$412.2 million.

This month, sales tax was the only major revenue source to come in higher than projected in the enacted budget. Personal income tax (PIT) and corporation tax — the two other revenue sources in the “big three” — were lower than assumed in the enacted budget.

Four months into FY 2018-19, revenues of \$35.28 billion are 3.0 percent (\$1.02 billion) higher than projected in the budget enacted at the end of June. Total revenues for FY 2018-19 thus far are 8.1 percent (\$2.63 billion) higher than through the first four months of FY 2017-18.

Sales tax receipts of \$1.03 billion for October were 8.2 percent (\$77.9 million) more than anticipated in the FY 2018-19 budget.

For October, PIT receipts of \$5.13 billion were 8.4 percent (\$472.0 million) less than expected in the FY 2018-19 Budget Act.

October corporation taxes of \$254.8 million were 10.9 percent (\$31.1 million) below FY 2018-19 Budget Act estimates.

For more details, read the [monthly cash report](#).



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California Works to Stem Loss of Use Tax Revenue

Retailers engaged in business in California pay the state’s sales tax. The tax applies to all retail sales of tangible personal property, except sales exempted by law. California’s use tax applies to the use, storage, or other consumption of tangible personal property in the state. Consumers in the state are required to pay use tax when they purchase items from out-of-state retailers that are not registered with the California Department of Tax and Fee Administration (CDTFA). The most common purchases that result in use tax liabilities are internet sales, mail orders, and items purchased from television shopping networks. Use tax was added to the Revenue and Taxation Code effective in 1935. The state sales tax and the use tax are “mutually exclusive,” meaning either sales tax or use tax applies to a single transaction, but not both.

Examining the Tax Gap

California’s tax system, including the payment of use taxes, is based on the premise that each taxpayer will correctly determine the amount of taxes owed and will remit those taxes. When the correct amount of taxes owed is not paid, there is a tax gap.

For sales and use taxes, the majority of the tax gap and the corresponding revenue loss is from the nonpayment of use taxes from business and household consumers. It has been estimated that the revenue losses are spread among 12.7 million households and 4 million businesses. The current estimate of unpaid use tax liabilities for each California household is \$60 per year, resulting from an

average of \$718 in taxable purchases per household. The unpaid use tax liability for California businesses is estimated at \$171 per year.

The lost revenue represents funds not provided to local governments and state-funded programs such as education, health and social services, and public safety.

Closing the Use Tax Shortfall

Over the years, policymakers and tax administrators have tried to close the use tax gap in a variety of ways. For example, individual consumers may report their use tax liabilities on personal income tax (PIT) returns instead of reporting the use tax on a one-time individual tax return. Since 2011, individuals may estimate their use tax liabilities based on their California adjusted gross income and continue to pay the tax on their PIT return.

For Fiscal Year 2011-12, use tax reported on PIT returns totaled \$16 million. The total increased to \$24 million for FY 2016-17.

Changes also were made in the use tax law to address the tax gap. AB 155 (Chapter 313, Statutes of 2011) expanded the definition of a retailer engaged in business in California. Under AB 155, an out-of-state retailer is engaged in business in California if the retailer has a substantial nexus with the state for purposes of the Commerce Clause of the United States Constitution or if federal law permits California to impose a use tax collection duty commonly known as California’s long-arm statute.

In addition, AB 155 provided that an out-of-state retailer is engaged in business in California if:

- The retailer sold more than \$1 million in tangible personal property to California consumers in the past 12 months and more than \$10,000 in sales to California customers through referral from California-based affiliates; or

Estimated CA Use Tax Revenue Loss			
Dollars in Millions			
Fiscal Year	Business to Household Consumers	Business to Business Consumers	Total
2016-17	\$769	\$685	\$1,454
2017-18	\$860	\$706	\$1,566
2018-19	\$963	\$728	\$1,691

Data Source: CDTFA

(See USE TAX, page 4)

Cannabis Act Implementation and Revenue Update



In November 2016, California voters approved Proposition 64, the *Control, Regulate, and Tax Adult Use of Marijuana Act*. Responsibility for administering the Act falls under the auspices of several different state agencies.

The Bureau of Cannabis Control is responsible for regulating commercial cannabis licenses. As of November 2, the Bureau issued more than 1,200 active temporary licenses. The types of licenses include:

- Retailers
- Distributors
- Testing laboratories
- Microbusinesses
- Cannabis event organizers

The Manufactured Cannabis Safety Branch, a division of the California Department of Public Health, is responsible for regulating and licensing the manufacturers of cannabis-infused edibles for both medical and nonmedical use.

CalCannabis Cultivation Licensing, a division of the California Department of Food and Agriculture, is responsible for licensing cultivators of medicinal and adult-use recreational cannabis and implementing a track-and-trace system to record the movement of cannabis through the distribution chain.

The California Department of Tax and Fee Administration (CDTFA) is responsible for administering the Sales and Use Tax Law and the Cannabis Tax Law. On January 1, two new cannabis taxes went into effect: a cultivation tax on all harvested cannabis that enters the commercial market; and a 15 percent excise tax on the purchase of cannabis and cannabis products.

In addition, cannabis and cannabis products are subject to state and local sales tax at the time of retail sale. CDTFA estimated total revenues related to Proposition 64 cannabis sales would be approximately \$1.73 billion in Fiscal Year 2018-19, the first full fiscal year for which Proposition 64 will be in effect. However, CDTFA reported \$135.1 million in total revenues from cultivation, excise, and sales tax on cannabis for the first two quarters of 2018.

CA 2018 Cannabis Tax Revenue by Quarter

Tax Type	1st Quarter	2nd Quarter
Cultivation	\$1.6 million	\$4.5 million
Excise	\$32.0 million	\$43.5 million
Sales	\$27.3 million	\$26.2 million
Total	\$60.9 million	\$74.2 million

Data Source: CDTFA

(USE TAX, continued from page 2)

- The out-of-state retailer is part of a related group of corporations, as defined, where one of those related corporations is engaged in business in California in a business activity that helps the out-of-state retailer establish or maintain a California market for sales of tangible personal property.

If one of these conditions is met, the retailer must register with CDTFA and has the duty to collect and remit use tax. For FY 2011-12, use tax reported by out-of-state retailers totaled nearly \$1.60 billion. In FY 2016-17, just over \$2.91 billion in use tax was reported by out-of-state retailers.

South Dakota v. Wayfair, Inc.

Although AB 155 expanded California's use tax collection, the bill did not and could not require an out-of-state retailer to collect use tax if the retailer did not have a physical presence in California. This is because the U.S. Supreme Court's 1992 decision in *Quill Corp. v. North Dakota* (Quill) held that the Commerce Clause prohibits a state from requiring a retailer to collect its sales or use tax unless the retailer has a substantial nexus with the state. It also held that a retailer does not have a substantial nexus with a state unless it has a physical presence there.

In June, the U.S. Supreme Court's *South Dakota v. Wayfair, Inc.* (Wayfair) decision overruled Quill's physical presence requirement.

In Wayfair, the Court found that the South Dakota law met the substantial nexus requirement established in *Complete Auto Transit v. Brady* (1977). The first prong of the Complete Auto test simply asks whether the tax applies to an activity with a substantial nexus with the taxing state. In Wayfair, the court concluded that "nexus is clearly sufficient," as the South Dakota law applies only to sellers who engage in a significant quantity of business in the state (\$100,000 in sales and 200 transactions), and the remote sellers are large, national companies that undoubtedly maintain an extensive virtual presence.

CDTFA is in the process of implementing the long-arm statute pursuant to the Wayfair decision. It says there is a compelling legal argument that an out-of-state retailer with \$100,000 in California sales and 200 transactions should be required to register with the agency and collect use tax. The registration and collection of tax will most likely start by the first quarter of 2019.

CDTFA argues that a change in law would be needed to raise the sales threshold higher than the precedent established by Wayfair. Given the magnitude of California's population and economy, consideration should be given to raising the sales threshold beyond that established by South Dakota with a population of less than a million people.

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