



# The Bradley-Burns Tax and Local Transportation Funds

Changing the Allocation Structure for the  
Bradley-Burns Tax Would Result in a More Equitable  
Distribution of Local Transportation Funding

Report 2017-106

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November 30, 2017

2017-106

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning how the Bradley-Burns Uniform Local Sales and Use Tax (tax) is assessed, collected, allocated, and distributed to local transportation funds (LTFs). The tax charges 1.25 percent on the retail sale or use of tangible personal property in the State, of which 1 percent is allocated to counties or incorporated cities to use at their discretion and the other 0.25 percent is allocated to county LTFs. This report concludes that changing the allocation structure for the tax would result in a more equitable distribution of local transportation funding.

Revenue from the tax is generally allocated to the city or county that served as the place of sale for a transaction. However, retailers that make Internet sales or ship goods to customers across jurisdictional borders may identify the place of sale as one of their warehouses, which concentrates the tax's revenue into those warehouses' jurisdictions. Consequently, counties with relatively large numbers of warehouses generally receive disproportionately larger amounts of the tax's revenue and therefore LTF funding. The State could make the distribution of the tax more equitable by amending the Bradley-Burns tax law so that revenues derived from Internet sales are allocated based on the destination of sold goods rather than their place of sale.

Further, the State does not regularly review the costs and benefits of its tax exclusions, tax exemptions, preferential tax rates, tax credits, and other tax provisions (tax expenditures), which reduce the amount of revenue the State collects. By not routinely reviewing tax expenditures, the Legislature is missing an opportunity to exert budgetary control over a significant portion of the State's potential spending. Removing certain tax exemptions, taxing digital goods, and taxing services could increase revenue for both LTFs and the State generally.

We also found that the California Department of Tax and Fee Administration (Tax Administration) has adequately administered the tax. However, to help address California's e-commerce tax gap and ensure out-of-state retailers' compliance with state law, Tax Administration should implement a two-year pilot of its authorized, but never funded, reward program for information resulting in the identification of unreported sales and use taxes.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

## Selected Abbreviations Used in This Report

Bradley-Burns tax	Bradley-Burns Uniform Local Sales and Use Tax
IRIS	Integrated Revenue Information System
LTF	local transportation fund
Tax Administration	California Department of Tax and Fee Administration

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## Summary

### Results in Brief

Since 1956 the Bradley-Burns Uniform Local Sales and Use Tax Law has imposed a tax (Bradley-Burns tax) on the retail sale of merchandise or goods within the State. The State collects the Bradley-Burns tax on behalf of cities and counties, and distributes the revenue to those local governments. The statewide rate is 1.25 percent; the State allocates 1 percent of the 1.25 percent tax to counties or incorporated cities to use at their discretion, and the other 0.25 percent to counties to support transportation programs. Since 1972 the 0.25 percent has been distributed to local transportation funds (LTFs) in each county. Counties use these LTFs to operate their local transportation programs. We found that Bradley-Burns tax distributions to LTFs steadily increased over the last five years. However, it is important to note that LTFs are not necessarily the most significant factor in local transit funding. Other sources of revenue, including district sales and use taxes, can play a larger role in counties' transit budgets.

Moreover, some counties may benefit disproportionately from the Bradley-Burns tax because of the way state law currently directs the allocation of the funds. Retailers generally allocate Bradley-Burns tax revenue based on the *place of sale*, which they identify according to their business structure. However, retailers that make sales over the Internet may allocate sales to various locations, including their warehouses, distribution center, or sales offices. This approach tends to concentrate Bradley-Burns tax revenue into the warehouses' or sales offices' respective jurisdictions. Consequently, counties with a relatively large amount of industrial space may receive disproportionately larger amounts of Bradley-Burns tax, and therefore LTF, revenue. The State could make its distribution of Bradley-Burns tax revenue derived from online sales more equitable if it based allocations of the tax on the destinations to which goods are shipped rather than on place of sale.

In addition, e-commerce is growing and is a significant factor in California's tax gap, which affects the amount of Bradley-Burns tax revenue that local jurisdictions receive. *Tax gap* refers to the difference between the amount of tax individuals and retailers owe versus the amount they remit to the State. The California Department of Tax and Fee Administration (Tax Administration) reported that California retail sales and use tax revenue totaled more than \$54 billion in fiscal year 2015–16, and it estimated the fiscal year 2009–10 tax gap was about \$2.3 billion. Because state law does not require e-commerce retailers without a California connection, or nexus, to remit California sales tax, e-commerce contributes significantly to California's tax gap. If the State were able to eliminate

### Audit Highlights . . .

*Our review of the Bradley-Burns tax and LTFs revealed the following:*

- » *The amount of Bradley-Burns tax revenue that county LTFs receive has steadily increased over the past five years.*
- » *Some counties may benefit disproportionately from the Bradley-Burns tax because state law currently allocates the tax's revenue based on place of sale rather than place of use or shipping destination.*
- » *The rapid growth of e-commerce is likely to further increase disparities in the distribution of future Bradley-Burns tax revenue.*
- » *The State could potentially increase its revenue, including LTF funding, by routinely reviewing tax expenditures and other tax provisions that reduce the amount of tax revenue the State collects.*
- » *The State could also increase both LTF funding and other sales and use tax revenue by removing certain tax exemptions, taxing digital goods, or taxing services.*
- » *Tax Administration has adequately administered the Bradley-Burns tax and has made reasonable efforts to increase out-of-state retailers' compliance with registration requirements for sales and use taxes.*

the e-commerce tax gap, it could have collected at least an additional \$50 million in LTF funding, or about \$864,000 per county, in fiscal year 2016–17.

The State could also increase its revenue—including LTF funding—by routinely reviewing *tax expenditures*, which are tax exclusions, tax exemptions, preferential tax rates, tax credits, and other tax provisions that reduce the amount of tax revenue the State collects. Tax expenditures decrease the amount of available state revenue in much the same way as direct spending. According to the Center on Budget and Policy Priorities, most tax expenditures are written into statute and continue indefinitely unless repealed. Nonetheless, neither the Legislature, Tax Administration, nor any other state entity currently reviews the costs and benefits of tax expenditures to ensure that they are in the State’s continued best interest. By not routinely reviewing exemptions, exclusions, and other tax expenditures, the Legislature has missed an opportunity to exert budgetary control over a significant portion of the State’s potential spending.

The State could increase both LTF funding and other sales and use tax revenue by removing certain tax exemptions, taxing digital goods, and taxing services. However, each option would require careful study as it would constitute a major shift in the State’s tax policy. Based on Tax Administration’s figures, we calculated that sales and use tax exemptions alone are worth about \$22.5 billion annually—an amount equal to 12 percent of the State’s fiscal year 2017–18 budget. Although the removal of exemptions for basic necessities such as food products is unlikely, removing exemptions for items such as candy, snack foods, custom computer programs, the lease of motion picture and television film and tapes, and the rental of linen supplies together could generate more than \$1.6 billion in annual tax revenue and over \$104 million in LTF funding. Similarly, taxing digital goods—such as e-books, downloadable software, and online products—could also increase the amount of Bradley-Burns tax the State collects. The largest increase to the tax base would involve taxing services. However, defining what services should be subject to tax is difficult. Other states have considered taxing nonmedical personal services, home repair services, funeral services, computer maintenance services, and more; but as of June 2017, none had enacted such changes.

Finally, our review found that Tax Administration has adequately administered the Bradley-Burns tax. Specifically, it has made reasonable efforts to close the tax gap by increasing out-of-state retailers’ compliance with registration requirements for sales and use taxes. It has also appropriately assessed, collected, and distributed LTF revenues to counties. Although there are inherent limitations to Tax Administration’s ability to verify the amount of Bradley-Burns tax owed by retailers, Tax Administration asserts that it routinely

conducts audits of large businesses to ensure that they file accurate tax returns. Lastly, Tax Administration has the authority to operate a reward program for information resulting in the identification of unreported sales and use taxes, but has never implemented it due to concerns about whether its benefits would outweigh its costs.

## **Key Recommendations**

### ***Legislature***

To ensure that Bradley-Burns tax revenue is more evenly distributed, the Legislature should amend the Bradley-Burns tax law to allocate revenues from Internet sales based on the destination of sold goods rather than their place of sale.

To increase budgetary control and ensure it has the information necessary to make decisions that reflect the State's best interests, the Legislature should regularly review and evaluate tax expenditures, including exemptions and exclusions to the Bradley-Burns tax and general sales and use taxes, by:

- Performing annual reviews of existing tax expenditures and eliminating those that no longer serve their intended purposes.
- Reviewing tax expenditures that have no stated legislative purpose and either adding clarifying language to those statutes or eliminating them.

To increase the tax bases for the general sales and use taxes and the Bradley-Burns tax, the Legislature should amend state law to specify that digital goods are taxable.

### ***California Department of Tax and Fee Administration***

To address California's e-commerce tax gap and further ensure out-of-state retailers' compliance with state law regarding nexus—meaning a retailer's tax relationship with California—Tax Administration should implement a two-year pilot of its authorized reward program for information resulting in the identification of unreported sales and use taxes.

**Agency Comments**

Tax Administration said in its response that it appreciates our recommendation to implement a pilot of its authorized reward program and will explore the feasibility of doing so.

# Introduction

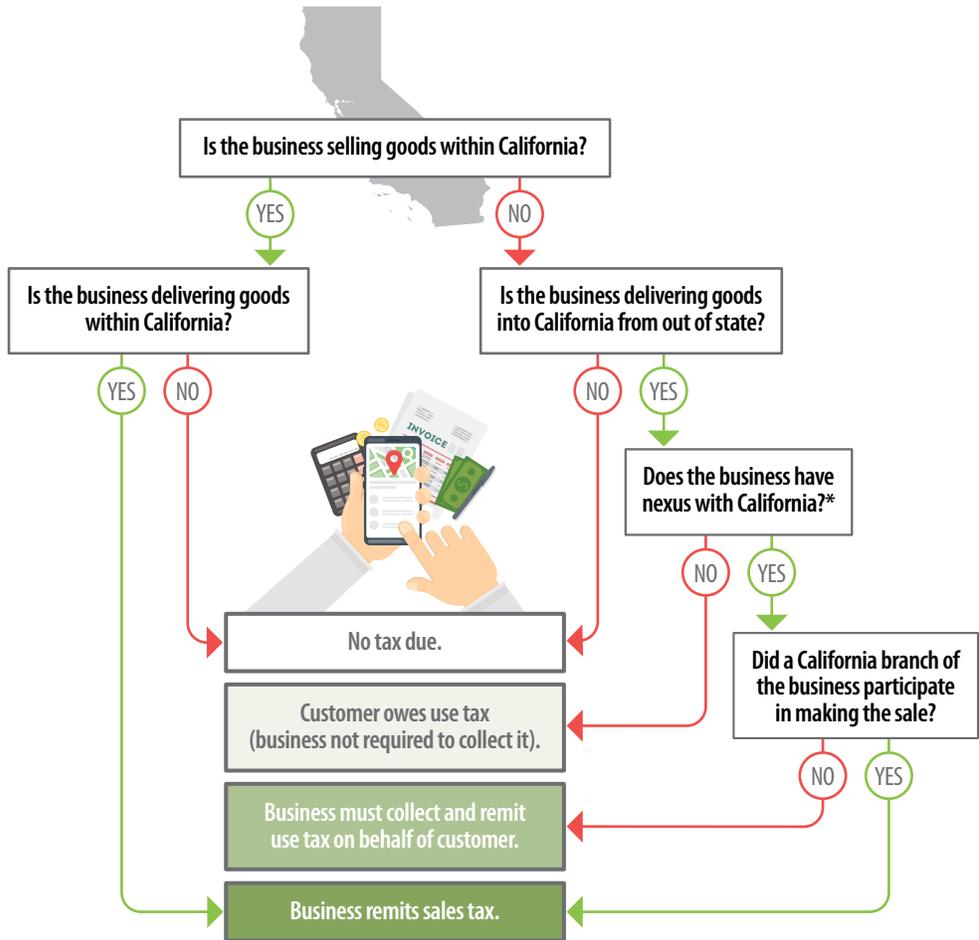
## Background

Since 1956 the Bradley-Burns Uniform Local Sales and Use Tax Law has imposed a tax (Bradley-Burns tax) on the retail sale of merchandise or goods and on the use, storage, or other consumption of tangible personal property when sales tax is not applicable. Its original intent was to tax the sale or use of tangible personal property. The State collects Bradley-Burns tax on behalf of cities and counties and distributes the revenue to those local governments. The statewide rate is 1.25 percent, of which 1 percent is allocated by the State to counties or incorporated cities to use at their discretion, and 0.25 percent is allocated to county local transportation funds (LTFs) to support transportation projects. As we discuss in greater detail beginning on page 15, Bradley-Burns tax revenue is generally allocated to the city or county that served as the *place of sale* for a transaction. Revenue from sales that occur within a city's limits is allocated to that city, and revenue from sales within a county's unincorporated area is allocated to that county. Figure 1 on the following page illustrates how the State assesses Bradley-Burns tax based on where and how goods are sold.

## The State Board of Equalization and California Department of Tax and Fee Administration

The Legislature established the State Board of Equalization (Equalization) in 1879 to ensure that county property tax assessment practices were equal and uniform throughout the State. In 1933 Equalization assumed responsibility for administering the statewide general sales tax, and in 1956 it began administering the Bradley-Burns tax. On July 1, 2017, the Taxpayer Transparency and Fairness Act of 2017 restructured Equalization into three separate entities: Equalization, the California Department of Tax and Fee Administration (Tax Administration), and the Office of Tax Appeals. Equalization is an independent agency that continues to administer property, alcoholic beverage, and insurance taxes. Tax Administration is a new department housed within the California Government Operations Agency and administers most of the taxes and fees previously collected by Equalization, including the Bradley-Burns tax. The Office of Tax Appeals is an independent agency that will begin full operation and appeals hearings regarding taxes and fees administered by Tax Administration as of January 1, 2018.

**Figure 1**  
Assessment of Bradley-Burns Tax Depends on Several Factors



Source: California State Auditor’s analysis of sales and use tax laws and regulations.

Note: This flowchart applies to most sales transactions; however, exceptions exist for certain sales to commercial airlines.

\* A business has nexus with California if it is considered to be engaged in business in the State, as defined by Revenue and Taxation Code section 6203.

### Sales and Use Taxes in California

Subject to a number of exceptions, California imposes sales and use taxes on the retail sale or use of tangible personal property in the State. *Tangible personal property* means goods (not real estate) that can be seen, weighed, measured, felt, touched, or otherwise perceived by the human senses. As of January 1, 2017, the statewide sales and use tax rate is 7.25 percent. State law allocates 6 percent of this rate to the State and the remaining 1.25 percent—the Bradley-Burns tax—to local governments. In almost every case in

which state sales or use tax is applicable, the Bradley-Burns tax is also applicable. In addition, local jurisdictions such as cities and counties can levy their own sales and use taxes, known as district taxes. Under state law, local jurisdictions may impose a rate of up to 2 percent in district taxes without requiring additional legislative approval.

When retailers sell merchandise in California, even temporarily, state law generally requires them to register with Tax Administration and remit tax on their sales. As the text box explains, retailers who have *nexus* with the State must remit sales tax on applicable sales. Businesses that have nexus with a local jurisdiction that levies a district tax must also collect that tax in addition to the statewide sales tax. Tax Administration reported that as of June 30, 2016, more than 949,000 retailers representing about 1.3 million business locations had registered to remit California’s sales and use taxes. In fiscal year 2015–16, California retail sales and use tax revenue totaled \$54.1 billion. This included \$39 billion from the state sales and use taxes, \$6.2 billion from district taxes, and \$7.1 billion from the Bradley-Burns tax. About \$1.6 billion in Bradley-Burns tax revenue went to county LTFs in the same year. Figure 2 on the following page shows how Tax Administration distributes California’s sales and use taxes.

In 2011 Assembly Bill 155 (AB 155) amended the general sales and use tax law to expand the definition of nexus to include more Internet retailers, like Amazon. As a result, Internet sales of tangible personal property are generally taxable in California. Sales and use taxes, and therefore the Bradley-Burns tax, apply to Internet sales in much the same way as they apply to sales made at retail locations, through sales representatives, over the telephone, or by mail order. As with traditional sales, the amount of tax due on Internet sales varies. If goods are delivered to a local jurisdiction with an additional district tax, then the total tax owed is the statewide rate of 7.25 percent plus the amount of the district tax.

### Who Has “Nexus”?

#### *Before passage of AB 155 (Chapter 313, Statutes of 2011)*

Under state law, anyone engaged in business in California was responsible for collecting and remitting sales or use tax on all applicable sales of tangible personal property. The following were among the activities that constituted being engaged in business in—otherwise known as having nexus with—California:

- Maintaining, occupying, or using any type of office, sales room, warehouse, or other place of business in the State. This includes use that is temporary, indirect, or through an agent or other representative.
- Having any kind of representative operating in the State for the purpose of taking orders for, making sales or deliveries of, installing, or assembling tangible personal property.
- Deriving rental income from a lease of tangible personal property located in California.

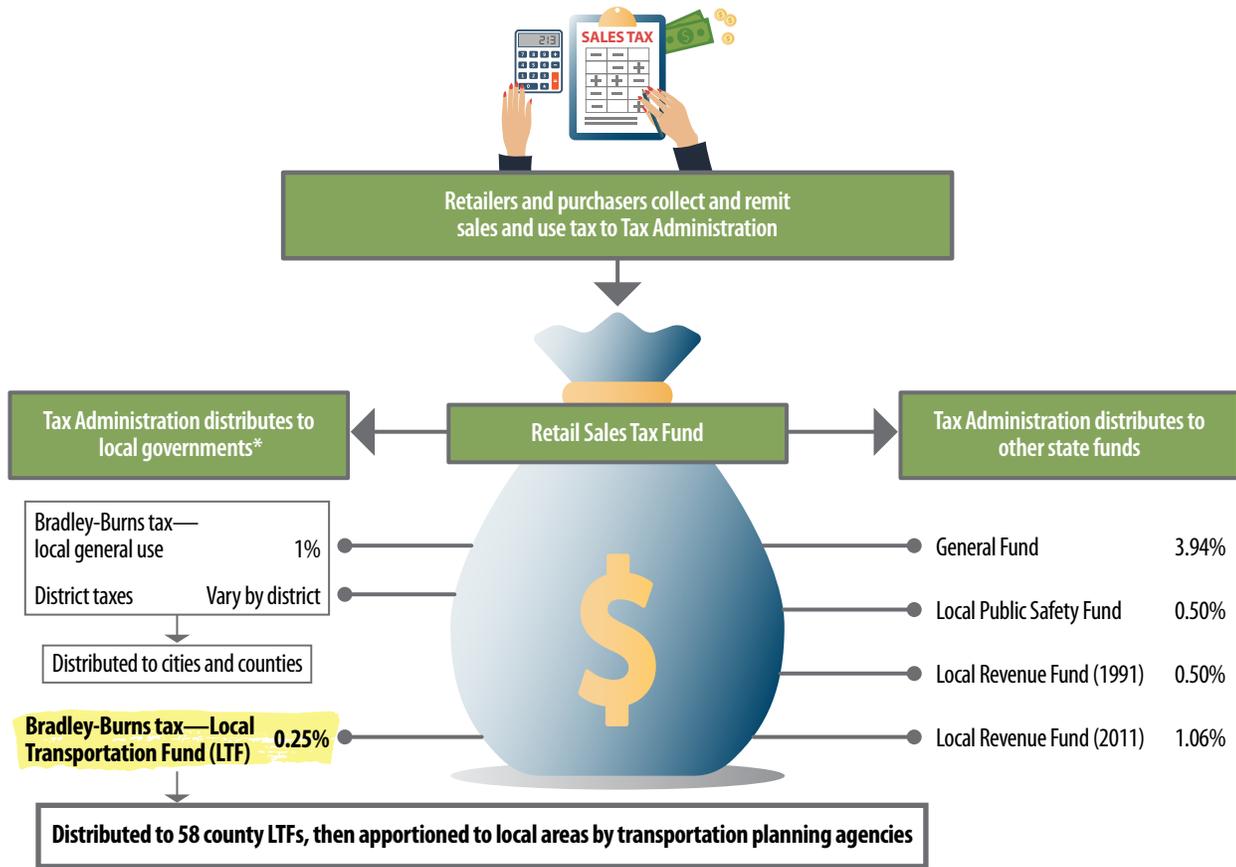
#### *After passage of AB 155*

As of September 15, 2012, any retailer who meets the following additional criteria also has nexus with California and must therefore register with Tax Administration and collect and remit California sales taxes:

- Is a member of a group of corporations that are commonly controlled and have business income that is reported in a combined report, and a member of that group performs services for the retailer in California that help the retailer to establish or maintain a California market for sales of tangible personal property.
- Has an affiliate operating in California that refers potential customers to the retailer through an Internet-based link, Internet website, or other specified means.

Source: Revenue and Taxation Code section 6203.

**Figure 2**  
California’s Sales and Use Taxes Are Distributed to a Variety of Funds



Source: California State Auditor’s synthesis of Tax Administration, Department of Finance, and California Department of Transportation guidance.

\* Less administrative costs.

Out-of-state retailers that do not have nexus are not required to register with Tax Administration or to remit tax on sales of taxable goods delivered to buyers in California.<sup>1</sup> In such cases, buyers are required to remit *use tax* to the State—specifically, to the Franchise Tax Board or Tax Administration for individuals, and to Tax Administration for businesses. Although buyers owe use tax to the State, they may not be aware of this obligation. Physical retailers charge applicable sales and use taxes at the time of sale, but online retailers do not always do so. In such cases, buyers may not understand that they are liable for paying use tax on their purchases when they submit their state tax returns, despite the State’s efforts to educate the public about their use tax liabilities.

<sup>1</sup> As we discuss later in the report, some out-of-state retailers voluntarily register and collect use tax from California buyers.

## Exemptions and Exclusions From Sales and Use Taxes

Since enactment of California's retail sales and use tax laws in the 1930s, the Legislature has granted many exemptions that remove the tax liability from sales of different types of property and by certain individuals or organizations. Other transactions are exempt because of the way in which the law defines what is taxable or because they do not involve the transfer of merchandise. The text box lists key exemptions and exclusions from California's general sales and use taxes, which also apply to the Bradley-Burns tax, and additional exemptions that are specific to the Bradley-Burns tax.

## Funding for Local Transportation in California

In 1971 the Legislature enacted the Mills-Alquist Deddeh Act, also known as the Transportation Development Act (Transportation Act), to improve existing public transportation services and encourage regional transportation coordination. The Transportation Act supports a wide variety of transportation programs, including planning and program activities, pedestrian and bicycle facilities, community transit services, and rail projects. Based on figures from Tax Administration and the State Controller's Office, we calculated that in fiscal year 2016–17, the Transportation Act generated nearly \$1.9 billion for public transportation in California.

In 1972 the Transportation Act also created an LTF in each county. LTF revenue is derived solely from the 0.25 percent portion of the 1.25 percent Bradley-Burns tax. However, as we discuss in the Audit Results, LTFs do not necessarily provide the majority of counties' total transit service dollars. Local transit operators also rely on numerous funding sources in addition to Bradley-Burns tax revenue, including passenger fares, other sales and use taxes, and other state and federal funding.

### Key Exemptions and Exclusions From California's Sales and Use Taxes:

- Necessities of life—such as food products, health-related products, and housing.
- Items and activities that provide general public benefits—such as alternative energy, museums, and nonprofit, religious, and educational organizations.
- Industry benefits—for groups related to transportation, entertainment, petroleum, leasing, and manufactured housing and buildings.
- Property and business activities defined in state law—such as admission charges, finance charges, lodging charges, real property sales, sales of securities, charges for travel accommodations, and—notably—services.

### Additional Exemptions Specific to the Bradley-Burns Tax:

- Sales of tangible personal property to commercial airlines.
- The storage, use, or other consumption of tangible personal property purchased by commercial airlines.

Sources: Tax Administration, *Sales and Use Taxes: Exemptions and Exclusions* and Uniform Local Sales and Use Tax Regulation 1805.

## Scope and Methodology

The Joint Legislative Audit Committee (Audit Committee) directed the California State Auditor to audit the California Department of Tax and Fee Administration's assessment and distribution of the LTF portion of the Bradley-Burns tax.<sup>2</sup> Table 1 lists the Audit Committee's objectives and the methods we used to address them.

**Table 1**  
**Audit Objectives and the Methods We Used to Address Them**

AUDIT OBJECTIVE	METHOD
1 Review and evaluate the laws, rules, and regulations significant to the audit objectives.	We reviewed relevant laws, rules, regulations, and policies and procedures for assessing, collecting, and distributing the Bradley-Burns tax.
2 Evaluate how the department assesses, collects, and distributes revenue derived from the Bradley-Burns tax and whether these processes comply with applicable laws. Also determine the following: <ul style="list-style-type: none"> <li data-bbox="159 1016 539 1108">a. What controls are in place to ensure the collection of the Bradley-Burns tax on Internet sales.</li> <li data-bbox="159 1108 539 1226">b. How the department assesses the Bradley-Burns tax on Internet sales, including whether the assessments differ for in-state and out-of-state sales.</li> <li data-bbox="159 1226 539 1323">c. How the assessment of Internet sales taxes under the Bradley-Burns tax compares to other Internet sales taxes within the State.</li> <li data-bbox="159 1323 539 1440">d. How California's rules related to the assessment of the Bradley-Burns tax compare to those of similar taxes in other states.</li> </ul>	<ul style="list-style-type: none"> <li data-bbox="555 869 1328 1029">• We interviewed relevant Tax Administration staff and conducted walk-throughs of its relevant processes. We reviewed how Tax Administration assesses and collects the Bradley-Burns tax; how it handles overpayments, underpayments, or failures to pay the Bradley-Burns tax; and how it distributes monthly LTF advance payments to counties and reconciles them to actual quarterly revenue. We also reviewed several programs Tax Administration has adopted to promote taxpayer compliance with out-of-state sales, including Internet sales.</li> <li data-bbox="555 1029 1328 1251">• We obtained Tax Administration's sales and use tax return data from its Integrated Revenue Information System (IRIS). From a sample of California Sales and Use Tax Returns we tested Tax Administration's assessment and collection of the Bradley-Burns tax, including its efforts to ensure retailers are collecting and remitting the Bradley-Burns tax to Tax Administration. We also tested whether Tax Administration accurately distributes the appropriate amount of LTF revenue to the correct counties. We analyzed Tax Administration's quarterly adjustment process to determine whether it accurately adjusts various counties' fund allocations to reflect actual revenue.</li> <li data-bbox="555 1251 1328 1390">• We examined how Tax Administration ensures that online-only retailers who have sales in California comply with Assembly Bill 155 (Chapter 313, Statutes of 2011), and identified how Tax Administration assesses the Bradley-Burns tax on Internet sales. We also analyzed how Tax Administration assesses sales and use tax, based on whether the sale or delivery of goods occurs in-state or out-of-state.</li> <li data-bbox="555 1390 1328 1453">• We researched how the law applies sales and use taxes, including the Bradley-Burns tax, to Internet sales and found that Internet sales are treated the same as traditional sales.</li> <li data-bbox="555 1453 1328 1591">• We researched how other states assess similar taxes. According to the Tax Foundation, only two other states besides California levy mandatory, statewide, local add-on sales taxes at the state level (Utah charges 1.25 percent and Virginia charges 1 percent). Both states' taxes on tangible personal property are primarily based on place of sale for sales taxes and on destination of goods for use taxes, which mirrors California's sales and use tax structures.</li> </ul>
3 Determine whether counties' LTF revenues have varied significantly over the last five fiscal years. Determine what factors are contributing to the variations in revenue and which counties have been most affected by the funding fluctuations. Identify any other factors affecting the availability of consistent revenue into counties' LTFs.	<ul style="list-style-type: none"> <li data-bbox="555 1610 1328 1694">• We analyzed LTF revenue that counties received during the last five fiscal years to determine whether it varied significantly over the period and to identify which counties were most affected by fluctuations.</li> <li data-bbox="555 1694 1328 1757">• We identified factors that contributed to variations by analyzing and comparing data on taxable sales, county population, industry-level sales, and adjustments to LTF allocations.</li> </ul>

<sup>2</sup> Formerly the State Board of Equalization (Equalization). During our audit state law created the California Department of Tax and Fee Administration (Tax Administration), which now handles most of the taxes and fees previously administered by Equalization, including the Bradley-Burns tax. Hereafter we use *Tax Administration* to refer to the audited agency.

AUDIT OBJECTIVE	METHOD
<p>4 To the extent possible, identify trends and the likely future impact on transit services of the following:</p> <p>a. Internet sales versus sales at retail locations within the State.</p> <p>b. Sales of taxable goods and services versus nontaxable goods and services.</p>	<ul style="list-style-type: none"> <li>We analyzed data from the U.S. Census Bureau and Tax Administration. We used Census Bureau data to calculate national retail sales and e-commerce sales growth rates. Since no data specific to California were available, we assumed these national trends also held true for California. We did not perform data reliability procedures on the Census Bureau data, as U.S. Census data are considered to be reliable.</li> <li>We analyzed budgets and funding sources for a selection of large transportation planning agencies to determine their sensitivity to changes in Bradley-Burns tax revenues.</li> </ul>
<p>5 Identify all exemptions and exclusions to the Bradley-Burns 0.25 percent tax and determine whether these exemptions and exclusions have significantly affected the distribution of funds in specific areas of the State. Evaluate whether any of these exemptions and exclusions are affecting the original intent of the Bradley-Burns tax.</p>	<ul style="list-style-type: none"> <li>We researched the original legislative intent of the Bradley-Burns tax.</li> <li>We examined the Bradley-Burns tax and the general sales and use tax laws to identify all exemptions and exclusions to the taxes.</li> <li>We researched whether exemptions to the Bradley-Burns tax have affected specific areas of the State. Based on a lack of demonstrated harm (lawsuits), analyses, and relevant data, we are unable to conclude whether the two exemptions specific to the Bradley-Burns tax has a significant impact on the distribution of funds.</li> <li>We researched any changes to the general sales and use tax exemptions and exclusions within the last five years and did not identify any that significantly affected the distribution of Bradley-Burns tax revenue.</li> </ul>
<p>6 To the extent possible, determine whether increased Internet sales have benefited some areas of the State more than others.</p>	<ul style="list-style-type: none"> <li>In conjunction with the procedures we performed in Objectives 3 and 4, we analyzed how Internet sales affect the distribution of tax revenue to local jurisdictions.</li> <li>We reviewed 10 retailers that sell online to determine how their business structures affected their tax allocations.</li> </ul>
<p>7 Review and assess any other issues that are significant to the audit.</p>	<p>We researched whether any exemptions and exclusions to the Bradley-Burns tax have been amended within the last five years; whether they have an expiration, or sunset, date; and whether any body, legislative or otherwise, regularly revisits the appropriateness of exemptions and exclusions.</p>

Sources: California State Auditor’s analysis of the Audit Committee’s audit request number 2017-106, planning documents, and analysis of information and documentation identified in the table column titled *Method*.

### Assessment of Data Reliability

In performing this audit, we obtained electronic data files extracted from Tax Administration’s Integrated Revenue Information System (IRIS). The U.S. Government Accountability Office, whose standards we are statutorily required to follow, requires us to assess the sufficiency and appropriateness of computer-processed information that we use to support findings, conclusions, and recommendations. Tax Administration uses IRIS to administer its tax and fee programs. For a selection of counties, we used IRIS data to determine the source of taxable sales allocations for the Bradley-Burns tax and district taxes. We performed data set verification procedures and electronic testing of key data elements and did not identify any issues. We did not perform full accuracy and completeness testing of these data because they come from a fully paperless system, and thus, hard-copy source documentation was not available for review. Consequently, we found the IRIS data to be of undetermined reliability. Although these determinations may affect the precision of the numbers we present, sufficient evidence exists in total to support our audit findings, conclusions, and recommendations.

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## Audit Results

### **Although Bradley-Burns Tax Revenue Has Increased in Recent Years, Some Counties Have Benefited More Than Others**

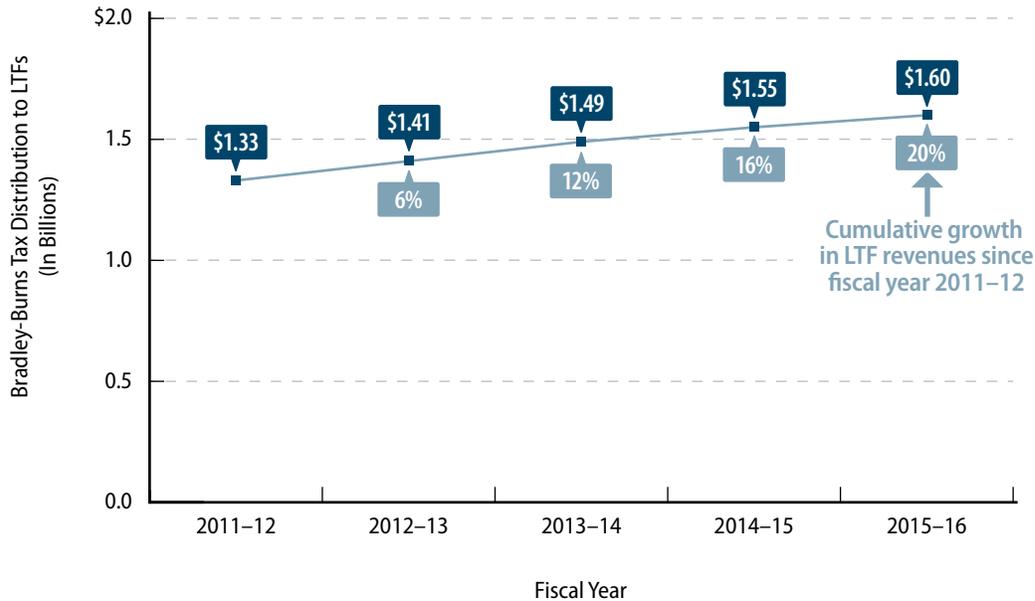
The amount of Bradley-Burns tax revenue that county local transportation funds (LTFs) receive has steadily increased over the past five years. However, because LTFs do not necessarily make up a large portion of transit funding, the increase in Bradley-Burns tax revenue may not have had a significant impact on counties' transit spending. In addition, because the State generally distributes the Bradley-Burns tax based on place of sale, some counties may receive LTF allocations that do not proportionately reflect their purchases. Specifically, Internet retailers may identify their warehouses or distribution centers as their places of sale when remitting Bradley-Burns tax, even though they may ship their taxable goods to locations across the State. As a result, local jurisdictions with relatively more warehouses or distribution centers receive Bradley-Burns tax allocations that are disproportionate to their purchases. This disparity is likely to increase in the future due to the rapid growth of e-commerce. Further, the growth of e-commerce has also amplified California's tax gap—the difference between the taxes individuals and retailers owe and the amount they pay—which has had a negative impact on Bradley-Burns tax revenue.

### ***Bradley-Burns Tax Distributions to LTFs Have Steadily Increased in Recent Years***

Bradley-Burns tax distributions to LTFs have generally risen over the past five fiscal years. Distributions to LTFs statewide grew by an average of over 20 percent from fiscal years 2011–12 through 2015–16, with an average annual growth rate of almost 5 percent. The consistent growth occurred irrespective of counties' population size or whether the counties were rural or urban. In fact, since 2011 LTF revenue in all but two counties has had positive five-year growth rates. In the most significant exception, Kern County, the decline in oil prices in 2014 significantly affected the county's oil industry, leading to job losses and a decrease in sales tax revenue. Figure 3 on the following page shows the general rise in counties' Bradley-Burns tax distributions to their LTFs over the last five fiscal years.

**Figure 3**

Statewide Bradley-Burns Tax Revenue Distributions to Counties' Local Transportation Funds Have Risen From Fiscal Years 2011–12 Through 2015–16



Source: Tax Administration, *Payments to County Transportation Funds From the 1/4% Local Sales and Use Tax*.

The consistent growth in Bradley-Burns tax distributions may not have significantly affected counties' overall transit spending, however. Specifically, LTF funding does not necessarily make up a large portion of counties' total transit service dollars; other sources, including district sales and use taxes, play a bigger role in some transit operators' budgets. Our review of five transit operators, which serve over 39 percent of California residents, found that LTF funding ranged from about 4 percent to 16 percent of the operators' total budgets. For example, in fiscal year 2016–17, the Los Angeles County Metropolitan Transportation Authority expected to receive about \$398 million in LTF funding. However, its total budget was \$5.6 billion, which included \$2.4 billion in other sales taxes, \$2.3 billion in grants and bond proceeds, and \$499 million in passenger fares and other operating revenues. LTF funding therefore made up only 7 percent of its total budget. As Table 2 shows, our findings for the other transit operators we examined were similar.

**Table 2**  
**Selected County Transit Operators Did Not Derive a Significant Portion of Their Funding From LTFs**

TRANSIT OPERATOR	TOTAL BUDGET FOR FISCAL YEAR 2016-17	PORTION OF BUDGET FROM LTF		PORTION OF BUDGET FROM ALL SALES TAX SOURCES*	
		PERCENTAGE	AMOUNT	PERCENTAGE	AMOUNT
Los Angeles County Metropolitan Transportation Authority	\$5,626,200,000	7.1%	\$397,900,000	50.4%	\$2,837,900,000
San Francisco Municipal Transportation Agency	1,181,900,000	3.5	41,230,662	10.5 <sup>†</sup>	123,950,662
Orange County Transportation Authority	1,161,500,000	13.9	161,000,000	42.4	492,500,000
Alameda-Contra Costa Transit District	398,345,000	15.6	62,086,000	44.5	177,199,000
Santa Cruz Metropolitan Transit District	51,427,144	12.4	6,377,491	55.8	28,686,661

Sources: California State Auditor's analysis of transit operators' annual reports.

\* Includes district taxes where applicable.

† Parking and traffic fees made up the category providing the largest amount of San Francisco Municipal Transportation Agency's funding (28 percent of its total budget).

***Because of the Way State Law Is Written, Some Local Governments Receive Disproportionate Distributions Related to Online Sales***

Differences in how businesses are structured can result in an uneven distribution of Bradley-Burns tax revenue, and therefore LTF funding, derived from the online sales of tangible goods. With the exception of retail sales of jet fuel, the State generally distributes Bradley-Burns tax revenue based on where a sale took place, known as a *situs-based system*. A retailer's physical place of business—such as a retail store, auto dealership, or restaurant—is generally the place of sale, since that is where most of its sales transactions occur.

The law does not specify what types of locations are to be considered the place of sale for online sales; Tax Administration requires only that this location be one that the retailer owns or leases, uses to customarily negotiate sales or permanently station employees, or from which it stores and ships goods. As such, the place of sale can depend on a retailer's business model and the organization of its sales activities. For instance, warehouses or other places where goods are stocked can be used by retailers when they make online sales. Alternatively, retailers that do not have California nexus but voluntarily remit Bradley-Burns tax may identify the destination of the sold goods as the place of sale. In such cases, the county where the buyer takes delivery of the goods receives the related Bradley-Burns tax allocation.

The situs-based allocation structure of the Bradley-Burns tax creates incentives for local governments to bid against one another to attract commercial development—including warehouses or distribution centers—to their jurisdictions. The amount of

taxable sales that retailers allocate to a local government directly correlates with the amount of tax revenue the State distributes to it; as a result, cities and counties sometimes give subsidies or tax incentives to companies to encourage them to relocate into the cities' or counties' jurisdictions or change their sales structure. For example, since 1997 the city of Cupertino has given Apple Inc. (Apple) a substantial rebate on the sales tax it owes (this rebate was 50 percent; it has recently been renegotiated to 35 percent) in exchange for its assigning more of its sales to the city. This agreement allowed the city to benefit from increased tax revenue. However, it also cost the city half (now, about one-third) of the Apple-related sales tax revenue it would otherwise have received.

Although local governments may expect such new revenue generators to help finance infrastructure upgrades or provide new jobs for residents, a situs-based tax distribution system may help companies more than the public because of the benefits and subsidies local governments sometimes provide. A more equitable approach would be to allocate Bradley-Burns tax revenue based on the shipping destination rather than the retailer's place of business or principal negotiations. If the State's sales tax was destination-based rather than situs-based, cities would gain little from negotiating with retailers to concentrate sales in their jurisdictions.

***The current situs-based system for collecting and allocating sales tax has resulted in some local governments receiving a disproportionate share of Bradley-Burns tax revenue in relation to their purchases.***

Furthermore, we found that the current situs-based system for collecting and allocating sales tax has resulted in some local governments receiving a disproportionate share of Bradley-Burns tax revenue in relation to their purchases. We reviewed 10 retailers that sell online and filed tax returns in California in 2016, five of which sell exclusively online, to determine which local jurisdictions received the Bradley-Burns tax revenue the retailers remitted. These retailers were involved in a variety of industries, including children's goods, women's clothing, gardening supplies, office supplies, sports-related goods, and truck and four-wheel-drive accessories.

We looked specifically at two types of sales and use taxes the retailers remitted: the Bradley-Burns tax, which is generally situs-based, and district taxes, which are generally destination-based. By comparing the two, we were able to highlight the incongruence between the concentration of Bradley-Burns taxes in some jurisdictions versus those of district taxes. We found a notable difference in the ways in which the retailers allocated the two types of tax.

Specifically, five retailers based in California allocated their taxes in a way that concentrated a higher proportion of their Bradley-Burns tax than their district taxes to a particular jurisdiction. For example, for Bradley-Burns tax purposes, one retailer attributed 29 percent of its taxable sales to the part of the county where its headquarters

and a warehouse are located, but only 8 percent of its taxable sales to the same jurisdiction for district tax purposes. This structure thus provided significant Bradley-Burns tax revenue for the retailer's home jurisdiction, even though the company shipped products to locations throughout the State. On the other hand, two of the five retailers assessed relatively small amounts of taxable sales in total for district tax purposes as opposed to Bradley-Burns tax purposes. This may be because these retailers had six or fewer locations in the State and therefore rarely met the nexus requirement for remitting district taxes.

In contrast to the California retailers, we found that four of the five retailers based outside of California allocated their taxable sales for Bradley-Burns tax and district tax purposes in roughly the same proportions, reflecting a destination-based allocation structure. For example, one retailer ascribed \$71,700 in taxable sales for Bradley-Burns tax purposes and \$71,679 in taxable sales for district tax purposes to the city and county of San Francisco, demonstrating that some retailers already allocate their Bradley-Burns tax by destination. Allocating the tax by destination results in a distribution of tax revenue based on the value of purchases a jurisdiction receives rather than the sales it makes. The last retailer we reviewed that was based outside of California reported no district tax at all, and allocated its Bradley-Burns tax on a statewide level, which is permissible for some retailers. Despite the exceptions noted above, these examples demonstrate that differences in how the Bradley-Burns tax and district taxes are allocated can lead to a greater concentration of Bradley-Burns tax revenues for counties with retailers involved in online sales.

In addition to the online retailers previously discussed, we also reviewed six counties' taxable sales allocations. Our review supports the idea that the Bradley-Burns tax's situs-based allocation system has resulted in some counties receiving a disproportionate share of Bradley-Burns tax revenue. Specifically, counties with more taxable sales subject to the Bradley-Burns tax than to district taxes also had more industrial space located within their borders than did the other counties.

When retailers sell goods and ship them to buyers in another county, the Bradley-Burns tax assessed on those sales remains in the retailer's county, even though the buyers received those goods elsewhere. However, district sales and use taxes on those same goods are allocated to the jurisdictions to which goods were delivered. Consequently, the Bradley-Burns tax concentrates in counties from where many retailers store and ship goods. This tax revenue accumulates at the expense of counties that do not have many distribution centers, and therefore receive disproportionately less Bradley-Burns tax revenue for transportation services.

*The differences in how the Bradley-Burns tax and district taxes are allocated can lead to a greater concentration of Bradley-Burns tax revenues for counties with retailers involved in online sales.*

For example, in San Bernardino County during the second half of 2016, retailers allocated Bradley-Burns tax on more than \$4 billion in goods shipped out of the county. This was equal to nearly 21 percent of the county's total taxable sales. By comparison, in neighboring Riverside County, which does not have a similar concentration of industrial space, retailers allocated Bradley-Burns tax on only \$1.8 billion in goods that were shipped out of the county during the same period, just over 10 percent of its total taxable sales. As a result, San Bernardino County received disproportionately more Bradley-Burns tax revenue, and therefore more funding for local transportation services, than Riverside County—\$47.7 million versus \$44.3 million. This was the case even though nearly 200,000 more people reside in Riverside County. Alameda County and San Joaquin County, both of which have relatively large amounts of industrial space, also had higher percentages of their total taxable sales that related to out-of-county shipments: 19.6 percent and 16 percent, respectively, of total taxable sales. They consequently received more Bradley-Burns tax revenue than would otherwise have been expected.

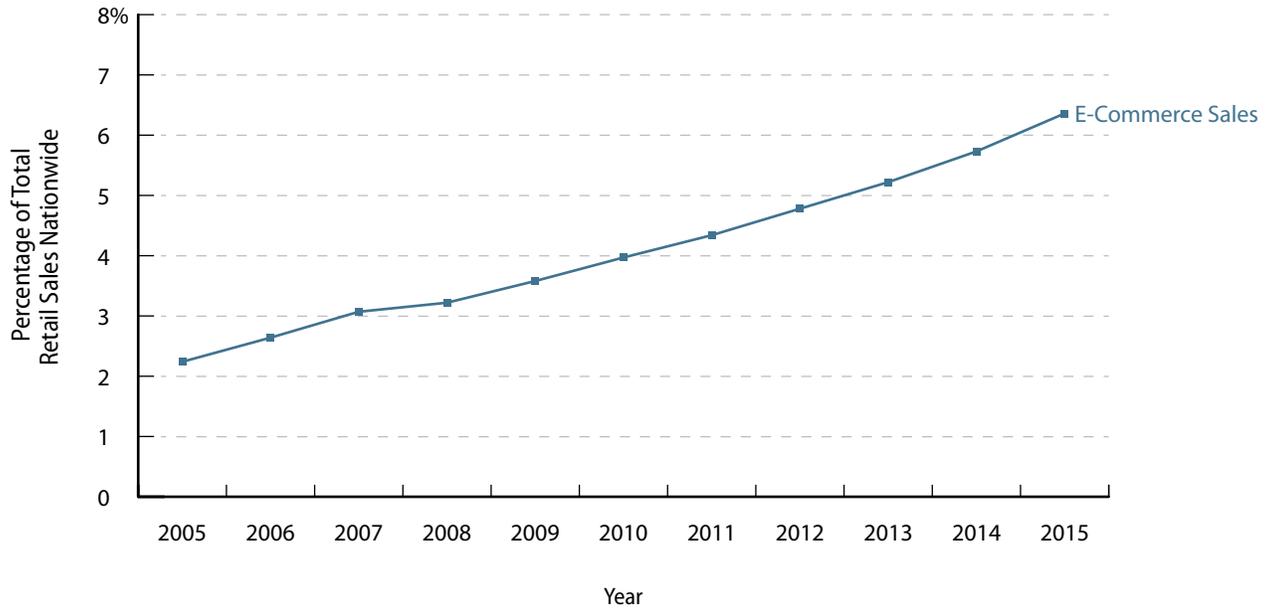
As we discussed previously, we found that LTFs can be a relatively small revenue source for public transit operators in California. However, amending the law so that the allocation system for Bradley-Burns tax revenue derived from online sales is destination-based, rather than situs-based, would eliminate situations in which Bradley-Burns tax revenue is disproportionately concentrated in counties with large numbers of warehouses and distribution centers. It would also reduce competition between local jurisdictions for such tax revenue. Without such a change, the distribution of Bradley-Burns tax revenue will likely become even more concentrated as online sales continue to grow.

*Without amending state law, the distribution of Bradley-Burns tax revenue will likely become even more concentrated as online sales continue to grow.*

### ***The Growth of E-Commerce Is a Significant Factor in California's Tax Gap***

E-commerce is quickly becoming a significant factor in today's economy, growing at a faster pace than sales at traditional brick-and-mortar stores. It is also a significant factor in California's tax gap and therefore adversely affects Bradley-Burns tax revenue. Traditionally, retailers sold goods at physical locations such as supermarkets or department stores. But since Internet access has become more available, buyers can now make purchases at both physical locations and via the Internet. In 2006 e-commerce sales accounted for about \$113 billion (2.6 percent) of the nation's nearly \$4.3 trillion in total retail sales. By 2015 e-commerce had increased to about \$340 billion (6.4 percent) of the nation's \$5.4 trillion total retail sales. The average annual growth rate of e-commerce over this period was 12 percent, while traditional sales grew by only about 2 percent annually. Although e-commerce sales still account for only a small fraction of the nation's total retail sales, the fraction these sales represent is continuing to increase, as Figure 4 illustrates.

**Figure 4**  
**E-Commerce Is a Growing Percentage of Retail Sales Nationwide**



Source: California State Auditor’s analysis of U.S. Census Bureau data.

The rise in e-commerce has contributed significantly to California’s tax gap. A tax gap is the difference between taxes owed and taxes actually paid. Tax gaps exist not only because of tax evasion, but also because of taxpayers who are unaware that they owe tax. In its most recent tax gap report, issued in 2011, Tax Administration estimated that in fiscal year 2009–10, California’s total tax gap was \$2.3 billion. It also estimated that in that year, use tax liabilities—which are owed by taxpayers on their online or mail order purchases from out-of-state retailers who do not have nexus with the State—amounted to \$1.2 billion, or 51 percent, of the State’s total tax gap. In addition, Tax Administration estimated that for fiscal year 2016–17, the State lost about \$1.45 billion in revenue due to unpaid taxes on e-commerce transactions. Spread among approximately 2.7 million households and 4 million businesses statewide, this amounts to each household and business owing an average of about \$87.

As we discussed in the Introduction, retailers that have nexus with California must remit sales tax on applicable sales. However, out-of-state retailers that do not have nexus with California are not required to register with Tax Administration or to remit tax on sales of goods they deliver to buyers in California. In such cases, the law requires buyers to remit use tax to the State. The amount of this use tax is the same as the amount of the sales tax the buyer

would have paid if the retailer had nexus with California. Although buyers owe use tax to the State, they may not be aware of this obligation. As a result, they may understate on their tax returns the amount of tax they owe to the State, thereby contributing to California's tax gap.

Because the average household and business tax gap is less than \$100, it would be cost-prohibitive for Tax Administration to pursue every taxpayer who has not remitted use tax. Nonetheless, based on Tax Administration's estimate of the e-commerce tax gap for fiscal year 2016–17, we calculate that the tax gap from e-commerce sales could have resulted in \$50.1 million in lost LTF revenue statewide for that year. On average, this represents about \$864,000 in lost LTF revenue per county in fiscal year 2016–17.

### **Routine Reviews of Sales and Use Tax Exemptions Could Help the State Identify Those That Are Outdated and Ineffective**

Neither the Legislature, Tax Administration, nor any other state entity routinely reviews tax expenditures, thereby forfeiting budgetary control over a large portion of the State's potential resources. *Tax expenditures* are tax exclusions, exemptions, preferential tax rates, credits, and other tax provisions that reduce the amount of revenue that would otherwise be collected from the basic tax structure. They include exemptions and exclusions to sales and use taxes and reduce state revenue in much the same way as direct program and other spending does. In addition, according to the Center on Budget and Policy Priorities, tax expenditures typically receive far less scrutiny than direct expenditures, such as those for schools, health care, or road construction. And because most tax expenditures are written into a state's tax code, they continue indefinitely unless repealed. Furthermore, in states such as California, abolishing a tax expenditure is considered a tax increase, which requires a legislative supermajority to pass. There are currently 160 exemptions and exclusions to California's general sales and use taxes, plus two exemptions specific to the Bradley-Burns tax. Tax Administration's publication, *Sales and Use Taxes: Exemptions and Exclusions*, describes each of the general sales and use tax exemptions and exclusions in detail.

***There are currently 160 exemptions and exclusions to California's general sales and use taxes, plus two exemptions specific to the Bradley-Burns tax.***

The Department of Finance (Finance) and the Franchise Tax Board produce annual reports on tax expenditures, but they are not comprehensive and contain only limited analyses. For example, Finance's *Tax Expenditure Report 2016–17* describes only 18 of the 160 sales and use tax exemptions. The report generally provides a short description of these exemptions, along with their statutory authority, sunset date, legislative intent, beneficiaries, number of affected taxpayers, comparable federal benefit, and amount of

revenue loss to the State's General Fund, its Fiscal Recovery Fund, and to local government. However, the report quantifies revenue losses for only 14 of those exemptions and does not offer any recommendations regarding the continuance of each one. Similarly, the Franchise Tax Board's *California Income Tax Expenditures: Compendium of Individual Provisions* does not contain any information about sales and use tax expenditures and includes only limited analyses. Quantification of revenue losses and recommendations regarding the continuance of expenditures are key pieces of information for legislative decision makers. In the absence of information on expenditures' costs and benefits, lawmakers cannot make informed decisions on whether continuing them is in the State's best interest.

Further, the laws enacting many tax expenditures do not include critical information that might help encourage consideration of an expenditure's efficacy. For example, when such a law includes a provision that automatically repeals the law on a specified date (a *sunset date*), the Legislature is more likely to evaluate the effectiveness of the expenditure. Although the Legislature has included sunset dates in some new tax expenditures, Finance's *Tax Expenditure Report 2016–17* lists sunset dates for only three of the 18 exemptions it discusses. Similarly, statements of legislative intent that are specified in law help clarify the purpose and rationale of individual tax expenditures; when an original purpose is unstated, the State may find it difficult to determine whether a tax expenditure is working as intended. However, Finance's *Tax Expenditure Report 2016–17* specifies legislative intent for only three exemptions.

By not routinely reviewing exemptions, exclusions, and other tax expenditures, the Legislature has missed an opportunity to exert budgetary control over more than \$22 billion related to the sales and use tax alone. This equates to 12 percent of the State's budget for fiscal year 2017–18. It is unclear why the State does not review tax expenditures as part of its regular budgeting process or have a standard process for reviewing the efficacy of tax expenditures and deciding whether to continue them. This issue has been raised before: In 2011 the now-defunct Senate Office of Oversight and Outcomes (oversight office) recommended that the State regularly review tax expenditures, as the text box shows. Similarly, in April 2016 we

#### The Oversight Office's 2011 Recommendations

- The Legislature should consider creating a commission charged with reviewing existing tax expenditures each year, as is now done in the state of Washington. The commission would select tax expenditures for review based on criteria established by the Legislature, such as the impact on state revenues, the number of years the statute has been on the books, or other factors. Individual analyses could be performed by legislative staff or experts at the State's tax boards or Finance.
- For tax expenditures with no stated legislative purpose, the Legislature should consider reviewing the preference and adding language to statute clarifying their goals. Tax preferences whose public purposes cannot be discerned or are no longer relevant should be referred to the commission for possible revocation.
- For major tax expenditures that result in forgone revenues above a certain threshold, analysts may want to revisit the use of a dynamic revenue model. Although such a model is costly and time-consuming, a pared-down version may be valuable in assessing the effect of reduced government spending or increased taxes and multiplier effects that may lead to secondary job creation and higher state tax revenues.
- The Legislature should require the Franchise Tax Board and Finance, in their annual reports, to list estimated costs of tax expenditures upon inception alongside figures for actual forgone revenue. The side-by-side comparison would give legislators and other policymakers a quick snapshot of which tax expenditures are costing more than envisioned, which may lead to investigations of the reasons and amended statutes to control unintended uses of tax preferences.

Source: California Senate Office of Oversight and Outcomes, *Bleeding Cash: Over a Decade, Ten Tax Breaks Cost California \$6.3 Billion More than Anticipated* (2011).

issued *Corporate Income Tax Expenditures: The State's Regular Evaluation of Corporate Income Tax Expenditures Would Improve Their Efficiency and Effectiveness*, Report 2015-127, in which we recommended that the Legislature identify goals, purposes, and objectives for all tax expenditures; require sunset dates for all new tax expenditures; and fund and task a state agency with conducting comprehensive evaluations of all tax expenditures, including recommending whether to continue, modify, or repeal each one.

### The State Could Increase Its Tax Base by Removing Exemptions, Taxing Digital Goods, and Taxing Services

If the Legislature wished to increase the State's tax base—which would in turn increase funding for local transit services—it could remove exemptions, tax digital goods, and tax services. As we discussed previously, a review of the State's tax expenditures could identify ways to expand the general sales and use tax base. The Legislature could also expand the tax base by taxing digital goods, such as software applications and e-books, and by taxing services, such as auto repair and cable television. However, each option would require careful study as it would constitute a major shift in the State's tax policy. Furthermore, because each option imposes a tax levy, it would require the approval of two-thirds of each legislative house to pass, potentially presenting a significant legislative hurdle.

#### Examples of Digital Goods

Digital goods are goods that exist in digital form and are delivered to the recipient electronically but not on tangible storage media. They include:

- Cloud-based applications and online games.
- Digital images.
- Digital subscriptions.
- Downloadable software and mobile applications.
- E-books.
- Electronically traded financial instruments.
- Fonts and graphics.
- Internet radio and television.
- Manuals in electronic formats.
- Movies, motion pictures, music videos, news and entertainment programs, and live-streamed events.
- Music files.
- Recordings of speeches and readings of books or other written materials.
- Ringtones.
- Video tutorials and webinars.
- Website templates.

Sources: Streamlined Sales Tax Governing Board, Webopedia, and Wikipedia.

As of February 2017, Tax Administration estimated that the State's sales and use tax exemptions were worth a total of more than \$22.5 billion annually. It is unlikely the Legislature would consider removing exemptions for basic necessities such as food products and prescription medications, which are worth about \$11.5 billion. However, removing other exemptions could still have a significant impact. For example, Tax Administration estimated that removing exemptions for candy, confectionery, snack foods, and bottled water would generate an additional \$1.1 billion in sales and use tax revenue; removing exemptions for custom computer programs would generate \$374 million; removing exemptions for the lease of motion picture and television film and tapes would generate \$63 million; and removing exemptions for the rental of linen supplies would generate almost \$60 million. Together, removing these exemptions could generate about \$1.6 billion annually for the State's General Fund and more than \$104 million in additional LTF funding—an average of more than \$1.8 million per county.

Taxing digital goods is another way to expand state revenue. Currently, California imposes its sales and use taxes, including the Bradley-Burns tax, on tangible personal property only. However, digital goods that are delivered electronically but not on tangible storage media, such as compact discs or DVDs, are not taxed, likely because the authors of the 1933 general sales and use tax law and those of the 1955 Bradley-Burns tax law did not envision the variety of goods available in today’s society. At the time the laws were enacted, most consumer spending was for merchandise that could be weighed, packaged, mailed, carried, or driven; no one pictured a society where products could be delivered in cyberspace. In order to tax digital goods, the State would need to define digital products and their taxability, which it does not currently do.

Other states have taken steps to incorporate digital goods into their tax laws. A study regarding taxation of digital goods, presented to the National Conference of State Legislatures in 2015 and updated in 2017, asserts that at least a third of the states tax digital products—including digital audio, digital audio-visual materials, and digital books delivered electronically—by statute, and a further 18 percent have interpreted their laws to include such products as taxable. Such actions can yield significant financial benefits: the New York City Independent Budget Office stated in 2015 that extending its sales tax base to include downloaded and streamed music, videos, and e-books would yield an additional \$38 million annually for the state of New York. The growth of the digital goods marketplace creates an opportunity for California to define the taxability of digital products, and thereby increase state revenue and consequently funding for local transit services or other purposes.

However, by far the biggest boost to the State’s tax base would involve taxing services. Tax Administration estimated the total receipts for services that are currently not taxed in California were \$1.5 trillion in 2015. In addition to resulting in significantly more general sales and use tax revenue, taxing such services would deliver an additional \$3.6 billion to LTFs statewide each year, or \$62.8 million per county LTF. Table 3 on the following page illustrates the magnitude of the impact that removing some exemptions or taxing services could have.

Although taxing services would be a major shift in tax policy, the State is not alone in contemplating this change: according to research from the Pew Charitable Trusts (Pew), 23 states, including California, considered legislation in 2017 that would have imposed taxes on at least some services. The text box lists some of the services states have considered taxing. As of June 2017, none of these measures

**Services That States Proposed Taxing in 2017**

- Auto repair and car washes.
- Cable television.
- Care for outdoor gardens.
- Computer maintenance.
- Cosmetology and barbering.
- Funeral services.
- Home repair.
- Lock rekeying.
- Nonmedical personal services.
- Repairs to air conditioning and heating systems.
- Service contracts.
- Snow removal.
- Telecommunications.
- Trash hauling.

Source: Pew Charitable Trusts, *Why States Are Struggling to Tax Services* (2017).

had passed. Pew notes that this is in part because trying to define what services should be subject to tax is difficult. Further, taxing services may disproportionately affect low-income residents or hurt small business owners, like plumbers and barbers.

**Table 3**  
The State Could Increase Revenue by Expanding the Sales and Use Tax Bases

	TAX RATE	EXAMPLE	OPTIONS TO EXPAND THE SALES AND USE TAX BASES	
			REMOVING CERTAIN EXEMPTIONS*	TAXING SERVICES
Sales revenue		\$10.00	\$41,715,736,000	\$1,456,000,000,000
<b>Components of the tax collected</b>				
General Fund	3.94%	\$0.39	\$1,642,557,000	\$57,330,000,000
Local Public Safety Fund	0.50	0.05	208,579,000	7,280,000,000
Local Revenue Fund (1991)	0.50	0.05	208,579,000	7,280,000,000
Local Revenue Fund (2011)	1.06	0.11	443,230,000	15,470,000,000
Cities and counties	1.00	0.10	417,157,000	14,560,000,000
<i>Local Transportation Funds</i>	<i>0.25</i>	<i>0.03</i>	<i>104,289,000</i>	<i>3,640,000,000</i>
<b>Total sales tax collected</b>	<b>7.25%</b>	<b>\$0.73</b>	<b>\$3,024,391,000</b>	<b>\$105,560,000,000</b>
<i>Average potential LTF funding per county</i>			<i>\$1,798,000</i>	<i>\$62,759,000</i>

Source: California State Auditor's analysis of 2015 Tax Administration estimates of potential revenue to be derived from taxing currently non-taxed items and services.

\* Exemptions include candy, confectionery, snack foods, and bottled water; custom computer programs; lease of motion picture and television film and tapes; and rental of linen supplies.

### Tax Administration Has Adequately Administered the Bradley-Burns Tax

Our review determined that Tax Administration has appropriately assessed, collected, and distributed the Bradley-Burns tax. Further, it has made reasonable efforts to increase out-of-state retailers' compliance with laws related to registering for and paying sales and use taxes. However, to further increase compliance with these laws, Tax Administration should develop a pilot program to determine the cost-effectiveness of providing monetary incentives to individuals who provide information about businesses with unpaid sales and use tax liabilities. Such a program was authorized by the Legislature in 1993, but Tax Administration has not requested funding for it because of uncertainties about program costs.

***Tax Administration Has Appropriately Assessed, Collected, and Distributed Bradley-Burns Tax Revenue***

We found that Tax Administration has properly assessed, collected, and distributed Bradley-Burns tax revenue. Specifically, we reviewed 29 randomly selected tax returns and five judgmentally selected tax returns that Tax Administration received between January 1, 2014 and June 2, 2017, and found that in all cases it properly assessed and collected the appropriate Bradley-Burns tax. In each case, Tax Administration also distributed the revenue to the correct local jurisdictions' LTFs.

Despite certain challenges, Tax Administration has several controls to ensure that retailers collect and remit the appropriate tax amounts. The Bradley-Burns tax is self-reported, which means businesses (taxpayers) must report how much Bradley-Burns tax they owe on their California Sales and Use Tax Returns (tax returns), and then remit those amounts to Tax Administration.<sup>3</sup> However, taxpayers may mistakenly or intentionally understate the amount of Bradley-Burns tax they owe, thereby reducing the revenue they remit to the State. Tax Administration faces inherent limitations to verifying the amount of Bradley-Burns tax owed and to the accuracy of approximately 2.3 million Sales and Use Tax Returns it receives annually: namely, it would be cost-prohibitive for Tax Administration to audit every return. To address this issue, Tax Administration reports that it routinely conducts audits of large businesses. According to Tax Administration, these audits generally review taxpayers' books and records for the prior three years to determine whether they reported all applicable sales, properly claimed deductions, and properly applied and allocated state and local taxes, among others. Tax Administration asserted that from fiscal years 2013–14 through 2015–16, it conducted an average of almost 17,000 audits a year and identified an average of \$511 million in tax deficiencies annually.

Tax Administration also relies on its Integrated Revenue Information System (IRIS) to ensure that taxpayers' calculations of their state, county, and local taxes are correct. IRIS automatically reviews tax returns and flags for further review those that have computational errors or include questionable items. Tax Administration staff then correct the computational errors and investigate questionable items, which may require contacting the taxpayers. For example, our review of 34 tax returns identified one taxpayer who was delinquent; however, Tax Administration had been communicating with the taxpayer through letters of deficiency and other reasonable methods to inform the business of its outstanding liability.

***Despite certain challenges, Tax Administration has several controls to ensure that retailers collect and remit the appropriate tax amounts.***

<sup>3</sup> California individuals are also responsible for reporting the use tax they owe. However, they must report this information on their individual income tax returns either to the Franchise Tax Board or to Tax Administration.

We also found that local jurisdictions' reviews serve as a strong control over the accuracy of Bradley-Burns tax distributions. Specifically, cities and counties receive Bradley-Burns tax revenue from Tax Administration on a monthly basis, based on the prior year's actual allocations. At the end of each quarter, Tax Administration reconciles the advance payments with the actual tax revenue taxpayers have remitted. It then provides each local jurisdiction with a report describing the taxpayers within their jurisdiction and the amount of Bradley-Burns tax revenue generated from each. Because local jurisdictions are able to estimate their future tax revenue based on historical reports, they are likely to query Tax Administration about any discrepancies between expected and actual revenue. For example, in the third quarter of 2016, the city of San Jose received about \$35.4 million in Bradley-Burns tax revenue, which was \$4.1 million (10 percent) less than it had received during the same quarter of the previous year. City staff queried Tax Administration to determine the reason for the decrease; Tax Administration researched the issue and informed the city that two major businesses had closed or relocated out of the city, resulting in the drop in revenue.

Tax Administration asserted that in the first three months of 2017 alone, it made over 1,100 telephone and email contacts with local jurisdictions related to their reviews of Bradley-Burns tax revenue. These reviews serve as a strong control because, like salaried employees who know how much to expect in their paychecks, local jurisdictions know how much tax revenue they expect to receive and may seek clarification from Tax Administration if actual distributions do not match their expectations.

### ***To Reduce the Tax Gap, Tax Administration Has Attempted to Increase Out-of-State Retailers' Compliance With California's Tax Laws***

As we discussed previously, Tax Administration estimated California's sales and use tax gap to be about \$2.3 billion in fiscal year 2009–10. This amount was the result not only of tax evasion, but also of taxpayers' failure to pay taxes because they were unaware of their liabilities. As part of its efforts to close the gap, Tax Administration relies on field audits, outreach, and voluntary compliance, among other strategies, to identify out-of-state retailers that deliver sold goods in California and to educate the public about their use tax liabilities.

According to Tax Administration, its field audits of out-of-state retailers garnered an average of \$233 million annually in additional revenue to the State from fiscal years 2013–14 through 2015–16. Tax Administration's Out-of-State District Office (office) conducts field audits of out-of-state retailers. The office is headquartered

***Tax Administration relies on field audits, outreach, and voluntary compliance to identify out-of-state retailers that deliver sold goods in California and to educate the public about their use tax liabilities.***

in Sacramento and has permanent field offices in New York, Chicago, and Houston. Staff from all four offices conduct onsite audits of retailers outside the State to ensure that they accurately report the amount of tax they owe to California. According to Tax Administration, the office conducted 3,610 audits during fiscal year 2015–16, which amounted to about 6 percent of the State’s total number of registered out-of-state businesses, and it assessed about \$194.7 million as a result of those audits. Table 4 lists the number of audits, percentage of registered businesses audited, and amount of revenue assessed and collected by the office in the last three fiscal years.

**Table 4**  
**Out-of-State District Office Audits Conducted and Revenue Assessed and Collected for Fiscal Years 2013–14 Through 2015–16**

	FISCAL YEAR		
	2013–14	2014–15	2015–16
Number of out-of-state audits	3,122	3,905	3,610
Percentage of registered out-of-state sellers audited	6.57%	7.30%	6.05%
Total tax revenue assessed	\$239,558,000	\$265,611,000	\$194,747,000
Total tax revenue collected to date	\$156,616,000	\$223,664,000	\$161,694,000

Source: Tax Administration (unaudited).

Another tool that Tax Administration uses to encourage retailers to remit taxes they owe to California is the office’s out-of-state compliance program, known as the 1032 Program. The 1032 Program identifies and registers out-of-state retailers that have nexus with California but have not yet registered with Tax Administration. As part of its efforts, the 1032 Program receives leads on unregistered retailers that may have California nexus, generally from other divisions within Tax Administration or from whistleblowers concerned about unregistered retailers. If program staff determine that a retailer has nexus with California, the retailer must register with Tax Administration and provide sales figures and report taxes going back to the date its California nexus began. Retailers that do not have nexus with California are not required to register or collect use tax, although Tax Administration encourages them to do so. If such retailers do not register, it is ultimately their customers’ responsibility to report and remit use tax to California, as we discussed in the Introduction. The 1032 Program also conducts outreach and compliance efforts related to AB 155, which became operative in 2012. As we also discussed in the Introduction, AB 155 amended state law to expand the types of out-of-state retailers considered to have nexus with California.

According to Tax Administration, the 1032 Program assessed an average of \$39.7 million in sales tax revenue per year from fiscal years 2013–14 through 2015–16, and it identified and registered an average of 293 new out-of-state businesses annually over the same period. Overall, about 18,000 new businesses registered with Tax Administration per year during those fiscal years. Table 5 lists the 1032 Program’s registrations and revenues assessed over the past three fiscal years.

**Table 5**  
**1032 Program Registrations and Revenue Assessed for**  
**Fiscal Years 2013–14 Through 2015–16**

	FISCAL YEAR		
	2013–14	2014–15	2015–16
Number of out-of-state registrations	293	283	304
Total 1032 Program revenue assessed*	\$34,250,000	\$30,386,000	\$54,572,000

Source: Tax Administration (unaudited).

\* 1032 Program revenue collected to date was unavailable. Tax Administration asserted that it discarded the reports showing the program’s collections for these fiscal years.

Finally, the office administers an Out-of-State Voluntary Disclosure Program (disclosure program) for retailers that have nexus with California and have not yet registered. Under the disclosure program, Tax Administration offers incentives to retailers if they voluntarily register before the department identifies them as unregistered and contacts them about their activities in California. For example, Tax Administration will limit its assessment of taxes owed to the prior three years, as opposed to the statutorily allowable eight years; waive late filing and payment penalties; and allow retailers to anonymously obtain written opinions from Tax Administration regarding whether it might approve their voluntary disclosure requests. To qualify for the disclosure program, retailers cannot have been previously contacted by Tax Administration regarding their activities in the State, among other conditions. Once Tax Administration contacts a retailer regarding an unreported use tax liability, the retailer not only is no longer eligible to participate in the disclosure program but also is subject to applicable fees and penalties. Table 6 lists the disclosure program’s registrations and revenues assessed for the past three fiscal years.

**Table 6**  
**Out-of-State Voluntary Disclosure Program Registrations and Revenue**  
**Assessed for Fiscal Years 2013–14 Through 2015–16**

	FISCAL YEAR		
	2013–14	2014–15	2015–16
Number of out-of-state voluntary disclosure registrations	70	67	88
Total out-of-state voluntary disclosure revenue assessed*	\$6,760,000	\$12,697,000	\$14,422,000

Source: Tax Administration (unaudited).

\* Disclosure program revenue collected to date was unavailable. Tax Administration asserted that it discarded the reports showing the program’s collections for these fiscal years.

***Tax Administration Has Not Implemented Its Authorized Reward Program***

In 1992 the Legislature authorized the State Board of Equalization (Equalization)—which at the time performed the functions now executed by Tax Administration—to implement a program that offers a reward for information resulting in the identification of unreported or underreported sales and use taxes. Under the program, individuals who provide the State with information that enables it to recover sales tax revenue would be entitled to a reward of up to 10 percent of the taxes collected. However, the program was never funded. Tax Administration’s current guidance directs staff, in lieu of providing compensation, to appeal to informants’ sense of fair play and civic responsibility.

In 2011 Equalization staff recommended to Equalization’s board that it request legislative funding for the reward program. However, the board referred the request to a committee for further investigation. According to current Tax Administration staff, the board dropped the idea by 2012 due to a lack of outside interest and uncertainty about program costs. Specifically, staff told board members at the time that they were unable to demonstrate how much revenue might be recovered because there were no operational data for the program; they therefore recommended that the board not move forward with the program. We recommend that Tax Administration revisit its efforts to implement a reward program. Specifically, Tax Administration should develop a two-year pilot reward program, which would enable it to determine the costs and benefits of compensating informants for their information, and thereby help to close California’s tax gap.

## Recommendations

### *Legislature*

To ensure that Bradley-Burns tax revenue is more evenly distributed and remove the incentive for local jurisdictions to vie for commercial development as a means to increase their tax revenue, the Legislature should amend the Bradley-Burns tax law to allocate revenues from Internet sales based on the destination of sold goods (a destination-based allocation structure) rather than their place of sale (situs-based).

To increase budgetary control and ensure it has the information necessary to make decisions that reflect the State's best interests, the Legislature should regularly review and evaluate tax expenditures, including exemptions and exclusions to the Bradley-Burns tax and general sales and use taxes, by:

- Performing annual reviews of existing tax expenditures and eliminating those that no longer serve their intended purposes.
- Reviewing tax expenditures that have no stated legislative purpose and either adding clarifying language to those statutes or eliminating them.
- Requiring the Franchise Tax Board and the Department of Finance to include in their annual reports on tax expenditures the estimated costs of those expenditures before implementation compared to actual forgone revenues to date.

To increase the tax bases for the general sales and use taxes and the Bradley-Burns tax, the Legislature should amend state law to specify that digital goods are taxable.

### *California Department of Tax and Fee Administration*

To help address California's e-commerce tax gap and further ensure out-of-state retailers' compliance with state law regarding nexus, Tax Administration should implement a two-year pilot of its authorized reward program for information resulting in the identification of unreported sales and use taxes.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Date: November 30, 2017

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For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

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CALIFORNIA GOVERNMENT OPERATIONS AGENCY

**EDMUND G. BROWN JR.**  
*Governor*

**MARYBEL BATJER**  
*Secretary*



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November 3, 2017

Elaine M. Howle, State Auditor  
California State Auditor  
621 Capitol Mall, Suite 1200  
Sacramento, CA 95814

**Re: CALIFORNIA STATE AUDITOR'S REPORT 2017-106 –  
BOARD OF EQUALIZATION – LOCAL TRANSPORTATION  
FUND ASSESSMENT AND DISTRIBUTION**

Pursuant to the above audit report, enclosed are the California Department of Tax and Fee Administration's comments pertaining to the results of the audit.

The Government Operations Agency would like to thank the state auditor for its comprehensive review. The results provide us with the opportunity to better serve our clients and protect the public.

Sincerely,

Marybel Batjer, Secretary  
Government Operations Agency

Enc



STATE OF CALIFORNIA

## CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

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EDMUND G. BROWN JR.  
Governor

MARYBEL BATJER  
Secretary, Government Operations Agency

NICOLAS MADUROS  
Director

November 3, 2017

Marybel Batjer, Secretary  
Government Operations Agency  
915 Capitol Mall, Suite 200  
Sacramento, CA 95814

Re: The Bradley-Burns Tax and Local Transportation Fund Review-November 2017

Dear Secretary Batjer:

The California Department of Tax and Fee Administration (CDTFA) received a draft report on the CSA's recent review of the Bradley-Burns Tax and Local Transportation Funds that requires a response by 5:00 PM Friday November 3, 2017. The report is comprised of two recommendations. The first recommendation is for the CDTFA the second recommendation is for the legislature.

We appreciate CSA's review of our records and the related positive review comments about our administration of the Bradley-Burns and Local Transportation Funds (LTF) that improve our efforts to close the tax gap by increasing out-of-state retailer's compliance. The recommendation for the CDTFA and related response is below:

Recommendation:

- CDTFA should implement a two-year pilot of its authorized reward program for information resulting in the identification of unreported sales and use tax.

Response:

- The CDTFA appreciates the recommendation made by the CSA and the related authority to operate a reward program. We are open to piloting a reward program and will explore the feasibility of a pilot program within our existing authority. Please note that the CDTFA currently has a mechanism for stakeholders to provide information of potential non-compliance with tax and fee laws. Since non-compliance results in unfair competition, we often receive such information from law abiding citizens who want to ensure a level playing field.

Sincerely,

Nick Maduros, Director

Cc: Ms. Katie Hagen  
Ms. Karen Caves  
Ms. Edna Murphy  
Ms. Julia Findley  
Ms. Sara Sheikholislam  
Ms. Susanne Buehler  
Ms. Karen Hughes  
Ms. Ester Cabrera-Diaz