

PROPOSAL TO AMEND THE AUTHORITATIVE FRAMEWORK REGARDING DIRECT-PAYMENT PERMITS

**CALIFORNIA LAWYERS ASSOCIATION¹
TAXATION SECTION
2025 SACRAMENTO DELEGATION PAPER**

This proposal was prepared by Erica Love, Principal in the Sales and Use Tax Practice of Ryan, LLC, and Gina Rodriguez, Principal in the Advocacy Services Practice of Ryan, LLC.

Contact Information:

Erica Love
Ryan, LLC
13155 Noel Rd., Ste. 100
Dallas, TX 75240
(972) 934-0022

Gina Rodriguez
Ryan, LLC
500 Capitol Mall, Ste. 2080
Sacramento, CA 95814
(279) 600-3261

EXECUTIVE SUMMARY

A direct-payment permit is an authorization from a state tax agency that allows a qualified business to pay sales and use tax directly to the state, rather than paying the tax to its vendors. Instead of collecting tax at the point of sale, a permit holder issues an exemption certificate to its suppliers. Direct-payment permits are most often used in other states by businesses and tax-exempt entities that make a high volume of purchases, some of which may be exempt from sales or use tax. The permit allows the entity to self-assess and remit the appropriate tax to the state on a single return, simplifying their process and reducing the administrative burden on the transacting parties.

¹ The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association or of the Taxation Section.

The California Department of Tax and Fee Administration (“CDTFA”) is statutorily authorized to issue direct-payment sales tax and use tax permits.² This proposal recommends amending the existing statutory framework for applying and obtaining a direct-payment sales and use tax permit, and that regulatory constraints limiting the eligibility for such permits reflect the statutory authorizations.³

The proposed amendments would modernize and simplify existing law and regulations by expressly authorizing a purchaser holding a direct-payment permit to shift the point of sales and use tax collection from the retailer or vendor to the permit holder, thereby enhancing administrative efficiency, compliance clarity, and accuracy in tax reporting.

Direct-payment permits reduce errors in tax application and compliance, relieving vendors of the burden of determining the taxability of each sale—a process that is prone to error, and can either result in over-collection (tax charged on exempt transactions) or under-collection (tax not charged due to complexity of analysis or reliance on erroneous exemption certificates).

Presently, direct-payment permits are underutilized. In spite of their authorization nearly four decades ago, it is evident that (a) the statutes have not achieved their intended purpose, and (b) California, as a leading economy, is behind in their use. Specifically, pursuant to a Public Records Act request by the author, the CDTFA produced records showing that, since the authorizing statutes were enacted in 1985:

- **No direct-payment sales tax permits have been issued; and**
- **Only three direct-payment use tax permits have been issued.**

The author has concluded, as discussed below, that the reason for the low use of these permits is not statutory authorization, but rather regulatory limits to their issuance. Thus, rather than producing more accurate tax determinations and reducing the number of refund and deficiency cases, the framework has failed in producing administrative efficiencies and the precision it was meant to deliver.

The current regulations do not provide an opportunity for taxpayers to qualify for direct-payment permits, a concern that was foreseen and raised during the 1987 regulatory process (as discussed below). Over time, continued technological advancement and economic evolution have only

² Revenue and Taxation Code (“Rev. & Tax. Code”) Sections 7051-7099.1 are incorporated in Part 1 (Sales and Use Tax Law) of Division 2 (Other Taxes). Section 7051 provides the CDTFA with broad authority to “prescribe, adopt and enforce rules and regulations” relating to administration and enforcement of Part 1. **Direct-payment sales tax permits:** Rev. & Tax. Code Sections 7051.1 (“Section 7051.1”) and 7051.2 and 18 Code Reg., tit. 18 Section 1699.5 (“Reg. Sec. 1699.5”) (Direct Payment Permits) authorize the CDTFA to issue the permits and prescribe rules. **Direct-payment use tax permits:** Section 7051.3 and Reg. Section 1699.6 (Use Tax Direct Payment Permits) authorize the CDTFA to issue the permits and prescribe rules for issuance. Related regulations include Reg. Sections 1684 (Collection of Use Tax by Retailers), 1684.5 (Marketplace Sales), and 1685 (Payment of Tax by Purchasers).

³ The CDTFA was established on July 1, 2017, by The Taxpayer Transparency and Fairness Act of 2017 (Assembly Bill 102, Statutes 2017, Chapter 16) taking over most of the duties of the Board of Equalization (“BOE”), including sales and use tax administration. For ease of reference, all mentions of the CDTFA in this paper are intended to include its predecessor agency, the BOE.

amplified the regulatory shortcomings. California’s statutory and regulatory framework should be modernized to better align with contemporary business practices and tax administration realities.

Note: While the issues discussed in this paper apply to *both* direct-payment sales and use tax permits, for brevity, the general focus is on direct-payment sales tax permits. The rules, however, are somewhat similar and both sets of rules need to be amended.

DISCUSSION

I. BACKGROUND

As California’s economy grew in the 1980’s, transactions subject to sales and use tax became voluminous and more complex. Direct-payment permits were statutorily established to address the needs of specialized and/or large-scale entities with complex purchasing and sales operations, particularly those with significant taxable and nontaxable transactions across multiple jurisdictions.

In 1985, the Legislature enacted Senate Bill 427 (Statutes of 1985, Chapter 1343), adding Sections 7051.1, 7051.2 and 7051.3, which took effect on January 1, 1986 (“SB 427”). The measure was part of California Governor Deukmejian’s broader initiative to modernize tax administration and streamline compliance, and was consistent with the policy direction established by his executive order.⁴ In its four-decade history, Section 7051.1, authorizing the CDTFA to issue direct-payment sales tax permits has never been amended.

Direct-Payment Permits for Sales Tax

Revenue and Taxation Code Section 7051.1 (“Section 7051.1”) grants the CDTFA broad authority to provide guidance relating to administration of direct-payment sales tax permits, and states, in part:

The board may adopt rules and regulations which provide for the issuance of a permit to a person who holds a valid seller's permit which allows the purchase of tangible personal property without payment by the retailer of the tax imposed under this part and any reimbursement of the sales tax to the retailer by that person....

In addition, Section 7051.1 requires that all of the following conditions be satisfied to effectuate the issuance of a permit:

- 1) The permit applicant must hold a valid seller’s permit.
- 2) The permit applicant must agree to report and remit the vendor’s tax liability directly to the CDTFA.

⁴ See [Cal. Exec. Order No. D-36-84](https://www.library.ca.gov/wp-content/uploads/GovernmentPublications/transcripts/2020-2021.txt) (Deukmejian, June 14, 1984) [found at <https://www.library.ca.gov/wp-content/uploads/GovernmentPublications/transcripts/2020-2021.txt>]

- 3) The CDTFA must determine that the permit will facilitate efficient the collection of the tax.
- 4) The CDTFA must determine that the issuance of the permit is for the mutual convenience of the CDTFA, the applicant and the vendor.
- 5) The CDTFA may accelerate by no more than 10 days to ensure that the permit will not result in any loss of tax revenue, wither in total or on a cash flow basis; and
- 6) Permit holders must attach to their tax returns a district tax allocation schedule.

Unlike applications for direct-payment permits for use tax, the CDTFA does not appear to offer an application form for taxpayers seeking a direct-payment sales tax permit; it appears an applicant must submit a written request by letter.

Relatedly, Revenue and Taxation Code Section 7051.2 pertains to penalties for failure by the direct-payment sales tax permit hold to pay sales tax, including a proper allocation of district taxes.⁵

Direct-Payment Permits for Use Tax

Revenue and Taxation Code Section 7051.3 (“Section 7051.3”) grants authority to the CDTFA to issue direct-payment use tax permits and sets forth rules for issuance. Pursuant to Section 7051.3, the permit allows purchasers and lessees of tangible personal property (other than lessees of motor vehicles, the lease of which is subject to the terms of Rev. & Tax. Code Section 7205.1) to:

- 1) Self-assess and pay use taxes directly to CDTFA instead of to the vendor or lessor from whom the property is purchased or leased.
- 2) Issue to vendors and lessors their Use Tax Direct Payment Exemption Certificate provided by the CDTFA when they purchase tangible personal property subject to use tax or make qualified leases of tangible personal property. Vendors who timely take the certificate in good faith from a permit holder are relieved of the duty to collect use taxes on the sales for which the certificate was issued.
- 3) Self-assess and report the use taxes directly to CDTFA on their tax returns and allocate the local taxes to the county, city, city and county, or redevelopment agency in which the property is first used.

Permit holders who fail to properly pay any use taxes that are due on property for which an exemption certificate was given are subject to interest and penalties assessments in addition to their tax liability.

To qualify for a direct-payment use tax permit, Section 7051.3 requires the applicant to:

- 1) Be pre-qualified by holding an existing California seller’s permit or a consumer use tax account.

⁵ Taxpayers seeking a direct-payment use tax permit must complete [Form CDTFA-400-DP, Appoication for Use Tax Direct Payment Permit](https://cdtfa.ca.gov/formspubs/cdtfa400dp.pdf) [found at <https://cdtfa.ca.gov/formspubs/cdtfa400dp.pdf>]

- 2) Agree to self-assess and pay directly to CDTFA any use tax which is due on property for which a use tax direct payment exemption certificate was given; and
- 3) Certify to the CDTFA either of the following:
 - a. The applicant has purchased or leased for its own use tangible personal property subject to use tax which cost \$500,000 or more in the aggregate, during the calendar year immediately preceding the application for the permit; or
 - b. The applicant is a county, city, city and county, or redevelopment agency.

The permit remains in effect until revised or withdrawn by the permit holder of the permit or until the retailer or seller has received actual notice that the permit has been revoked by the CDTFA.

Unlike an application for a direct-payment sales tax permit, the CDTFA publishes an application form.⁶

Corresponding 18 Cal. Code Reg. Sec. 1699.5 (Direct-Payment Sales Tax Permits)

California Code of Regulations, Title 18, Section 1699.5 (“Reg. 1699.5”) was adopted December 15, 1988, and effective January 14, 1989. It attempts to implement Section 7051.1 by establishing additional qualifying conditions, conditions that are not in the statute, and may, in fact, be an illegal underground regulation.

Such an administrative framework imposes significant burdens and prohibitive thresholds that effectively preclude businesses from obtaining a direct-payment sales tax permit. In fact, CDTFA records indicate that no direct-payment sales tax permits have ever been issued since statute was enacted four decades ago.

One example of prohibitive language to qualify for a direct-payment sales tax permit in Reg. 1699.5(b)(4) states:

(4) The board [CDTFA] determines that issuance of the direct payment permit is to the mutual convenience of the board, the applicant, and the retailers whose tax liability will be reported and paid by the applicant. Issuance of the permit will not be deemed to be to the convenience of the board if the applicant is a government entity or if the applicant has had gross receipts from sales of tangible personal property of less than \$75,000,000 and purchases of tangible personal property subject to sales or use tax of less than \$75,000,000 in any calendar quarter during the twelve months immediately preceding the application for the permit. [emphasis added]

Other prohibitive language in Reg. 16599.5(h) states:

(h) Exemption Certificates. A holder of a direct payment permit may issue a direct payment exemption certificate to any retailer. The certificate shall be in

⁶ *Id.*

*substantially the following form and **shall be valid only with respect to the calendar year for which it is issued.** [emphasis added]*

In fact, these two burdensome parts of the regulation were pointed out to the CDTFA during the Administrative Procedures Act (“APA”) proceedings. In a letter dated October 6, 1987, Kaiser Permanente Counsel Fonda Karelitz stated:

*It is our understanding that the intent of this [\$75 million] requirement is to assure that direct payment permit holders are financially able to remit any and all tax liability transferred from retailers to the permit holder. While we understand the importance of the Board's concern, **the proposed requirement will, as a practical matter, preclude service organizations such as Kaiser Permanente from applying for direct payment permits, not because they are not financially strong organizations, but because their product is service rather than the sale of tangible personal property.** The proposed requirement would restrict the issuance of direct payment permits to a limited number of large manufacturing concerns. The revenues of these concerns are primarily from the sale of goods. The proposed requirement would not provide the same opportunity to similarly situated service organizations, whose revenues are primarily from the sale of services.*

We believe that as long as an applicant for a direct payment permit has a level of revenue acceptable to the Board, the source of that revenue, i.e., whether from the sale of services or tangible personal property, is not critical to the Board's decision of whether to issue a permit to a particular applicant. We recommend, therefore, that the proposed amendment be modified to require applicants to have total revenues of not less than \$75,000,000 in any calendar quarter for the year immediately preceding the date of application for a permit, rather than the proposed requirement of \$75,000,000 in gross receipts from sales for any such period.

In another letter dated September 3, 1987, with respect to the renewal date, Eastman Kodak Company Sales and Use Tax Manager Steven Wilkins, stated:

*Section (h) Exemption Certificates states in part **"The Certificate shall be valid only with respect to the calendar year for which it is issued."***

This puts an extra burden on the retailer to review and update all direct pay permits at the beginning of each year and/or the first time a sale is made to a customer in the new year. The administrative cost makes it unattractive to accept a direct pay permit from a customer.

This requirement creates an added burden on the retailer. As a result the retailer will likely require a resale certificate and not accept the direct payment exemption certificate from the customer.

This could create misunderstandings, poor customer relations, added burden for the holder of a direct payment exemption certificate, and defeat the purpose of a direct pay permit.

I would also like to point out that no other state issuing a direct pay permit has these requirements.

It does not appear that the CDTFA addressed any of the public comments expressed during the 1987 APA proceedings. The result: The regulations are overly restrictive, making them impractical and unworkable in practice, i.e., they create administrative barriers that undermine the statute.

Are the Direct-Payment Permit Regulations Valid?

A regulation is considered illegal or invalid in California when it exceeds the authority granted by statute, conflicts with legislative intent, or fails to comply with procedural requirements under the APA. The Legislature provided the CDTFA with broad statutory authority to adopt regulations for direct-payment sales tax permits by stating that the CDTFA “may adopt rules and regulations **which provide for the issuance of a permit**” and **provides the conditions that must be met**. The corresponding regulation, however, mandates additional, very restrictive, conditions that are not in the statute.⁷ The same holds true for the use-tax-direct-payment permit and its corresponding regulation.⁸

CDTFA’s direct-payment permit regulations for both sales tax and use tax restrict eligibility for direct-payment permits beyond what Section 7051-7051.3 intended, and could be deemed *ultra vires* — invalid because they exceed the statutory scope. To remedy this, the CDTFA could align the regulations with the statute or repeal the regulations and seek a statutory fix.

A regulation is illegal if an agency acts beyond the powers delegated by the Legislature. State agencies may only adopt regulations that are “consistent with and not in conflict with” the statute they implement. An agency cannot expand, alter, or limit statutory rights or duties unless the Legislature clearly authorized it.⁹

Again, the fact that not a single direct-payment sales tax permit has issued and only three direct-payment use tax permits have been issued in nearly four decades since the regulations took effect demonstrates that the current framework has been wholly ineffective in achieving its intended purpose.

The absence of CDTFA-issued direct-payment permits underscores that the existing process is ineffective in practice and fails to fulfill the purpose of the statutes and gubernatorial executive order. Addressed below are several specific deficiencies and administrative obstacles within the direct-payment permit regulatory framework under Reg. 1699.5 for sales tax. Note, however,

⁷ Section 7051.1 and 7051.2 and Reg. 1699.5

⁸ Section 7051.3 and Reg. 1699.6

⁹ Government Code Sections 11342.1 and 11342.2

that the regulations under Reg. 7051.3 contain similar deficiencies for direct-payment permits for use tax.

II. PROBLEMS WITH APPLICATION AND ISSUANCE PROCESS FOR DIRECT-PAYMENT PERMITS

A. Excessive Financial Thresholds

Under Reg. 1699.5(b)(4), applicants for a direct-payment sales tax permit must have *both* \$75 million or more in quarterly gross receipts from sales of tangible personal property *and* \$75 million or more in quarterly taxable purchases of tangible personal property. This dual threshold disqualifies most entities that may meet one but not both criteria, making qualification extremely difficult, if not impossible. These financial thresholds are not found in Section 7051.1.

Reg. 1699.5(b)(4) should be revised to allow for alternative financial demonstrations or cumulative annual metrics that better reflect the diversity of modern businesses.

B. Annual Reissue Burden

Reg. 1699.5(h) states that direct-payment permit exemption certificates are valid only for the calendar year in which they are issued. This creates a significant administrative burden for applicants, as they will need to track to whom a certificate has been issued, when it was issued, and then reissue one for the next calendar year. If this also implies that the permit itself must be renewed annually, it creates an entirely different administrative burden, both for the taxpayer and the CDTFA.

Reg. 1699.5(h) should be amended to either extend the validity of direct-payment permit exemption certificates with no sunset date, like other California certificates — such as resale — or implement a streamlined renewal process to reduce administrative burden.

C. Ambiguity in Operational Requirements

Reg. 1699.5(b)(3) requires applicants to have “sufficient information processing resources” without defining what qualifies. Similarly, Reg. 1699.5(e) refers to “such other information as the board may require” in returns, which introduces uncertainty and potential inconsistency in enforcement.

The operational standards in Reg. 1699.5(b)(3) and(e) should be clarified by defining what constitutes sufficient information processing capabilities and specifying the types of “other information” that may be required in returns.

D. Compliance Burdens

Retailers: Reg. 1699.5(i)(3) requires retailers to segregate the sales made under direct payment exemption certificates from sales made under non-direct-payment-exemption certificates, and to document these transactions clearly.

Also, Reg. 1699.5(g) requires retailers to provide information to the direct payment permit holder to determine where the sale took place for local tax allocation. This information is not readily available to purchasers and places an additional burden on retailers to provide it only for sales made under direct payment permit.

Applicants: Reg. 1699.5(e) requires direct-pay permit holders to file two different returns but does not describe what “form the board may prescribe,” nor does it describe “other information the board may require.” Further, the pre-payment due date is five days earlier than the normal pre-payment due date, which increases an applicant’s compliance cycle. This imposes additional compliance obligations on direct-pay permit holders.

Reg. 1699.5(i)(3) and 1699.5(e) are ambiguous and should be clarified for vendors regarding recordkeeping and documentation requirements.

The local tax allocation requirement in Reg. 1699.5(g) should be amended to allocate local tax based on where the permit application was executed. This approach would align with how local tax allocations are done for buying companies.

The regulation has not been updated since it became operative in 1989, despite significant changes in technology, tax administration, and business practices. This lack of modernization greatly hinders its effectiveness and relevance. Therefore, we respectfully request that the CDTFA modernize the regulation to reflect current technologies, business models, and administrative practices, ensuring it will not only be accessible to taxpayers but also effective.

III. RECOMMENDATIONS TO MODERNIZE DIRECT-PAYMENT PERMIT RULES

The direct-payment permit rules clearly need modernizing. What remains uncertain is how best to accomplish that goal.

While the statute grants the CDTFA broad authority to adopt rules and regulations, the existing regulatory framework is unworkable and may, in some respects, exceed the statutory authority. The stringent eligibility requirements and procedural barriers have effectively rendered the program inoperative.

There are three potential approaches to address these issues:

1. Amend the statute to establish clear and practical criteria for qualification and repeal the regulations;
2. Amend the regulations to align them more closely with legislative intent and make the program administratively feasible; or

3. Amend both the statute and regulations and align them to address a workable application and qualification process

Although both statutory and regulatory reform could improve the direct-payment permit framework, statutory amendment is the preferred approach.

Revising both Sections 7051.1 and 7051.3 would provide clear legislative direction and eliminate ambiguity allowed by the overly restrictive regulations. By codifying the basic eligibility criteria, application procedures, and administrative safeguards, the Legislature can ensure that the program operates as originally intended—facilitating accuracy, efficiency, and fairness in tax administration.

In tandem, the CDTFA should be directed to update its implementing regulations to conform to the amended statute, simplify administration, and promote broader access for qualified taxpayers. This dual strategy—clarifying the law while modernizing the regulations—would restore the effectiveness of California’s direct-payment permit framework and align it with contemporary business and technological realities.