

## Streamlined Sales Tax Project Update

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At the National Association of Counties (NACo) annual conference in Milwaukee on July 15<sup>th</sup>, 2003, Diane Hardt updated county officials on the progress being made with the Streamlined Sales Tax Project (SSTP).<sup>1</sup> The SSTP involves much more than simply collecting sales tax on remote sales, such as Internet and catalog sales. It is a comprehensive overhaul of sales tax systems across the country. It modernizes sales and use tax regulations, improves administrative efficiency, reduces the burden of tax collection, and encourages simplification and uniformity among all states. To better understand the project, it helps to know about some of the events surrounding its inception.

### History

The underlying need for what has become the SSTP is *Quill Corp. v. North Dakota*, a 1992 Supreme Court case that prohibited states from requiring remote sellers to collect sales or use tax from their customers. Remote sellers are defined as those businesses that do not have a ‘physical presence’ within a state in which they conduct business. Quill Corporation sells office equipment and supplies, and does so primarily through catalogs, magazine advertisements, and phone calls. In 1992, it sold about \$1 million worth of products to about 3,000 customers in North Dakota. Because it had no physical presence in the state, Quill did not collect sales or use tax from its North Dakota customers. It is reasonable to assume that very few consumers, if any, voluntarily paid the tax – as they were legally required to do – to then North Dakota Tax Commissioner Heidi Heitkamp.

In 1987, North Dakota had changed its sales/use tax law to define ‘retailer’ as “every person who engages in regular or systematic solicitation of a consumer market in the state.”<sup>2</sup> That meant that anyone who annually sends three or more advertisements or solicitations to North Dakota consumers would be considered a retailer and would be compelled to collect sales and use tax and remit it to the state. Basing its argument on that law change, the state sued to require Quill Corporation to pay taxes, penalties, and interest on all sales made after July 1, 1987.

The trial court ruled against the state, following the “bright line” test established in *Bellas Hess*, a 1967 Supreme Court decision that first established the ‘physical presence’ requirement. The court accepted Quill’s argument that because it lacked a ‘physical presence’ in North Dakota (it had no retail outlets, personnel or property in the state), the state “does not have the power to compel it to collect a use tax from its North Dakota customers.” The State Supreme Court reversed the ruling, saying that “wholesale changes in both the economy and the law made it inappropriate to follow *Bellas Hess* today.” In other words, because catalog and mail-order sales had become commonplace by 1992 (as is true with Internet sales today), the ‘physical presence’ test should no longer hold. The State Court ordered Quill to pay

the taxes due.

The United States Supreme Court eventually reversed the State Supreme Court, upholding *Bellas Hess*, but not without an important concession. Earlier decisions regarding interstate commerce rested on two constitutional clauses – the Due Process Clause and the Commerce Clause. “Due process centrally concerns the fundamental fairness of governmental activity.” It asks “whether an individual’s connections with a state are substantial enough to legitimate the state’s exercise of power over him.” In deciding that the connection between Quill Corporation and North Dakota was indeed substantial, *Quill* marked the first time that the court upheld a state’s power to compel remote sellers to collect sales and use tax *under the Due Process Clause*.

The court, however, rejected that power under the Commerce Clause. While the Commerce Clause explicitly authorizes Congress to “regulate commerce with foreign nations, and among the several states,” the Court interprets the clause to have a ‘negative’ or ‘dormant’ meaning as well. In addition to granting power to Congress, the clause “prohibits certain state actions that interfere with interstate commerce.” Because the court deemed North Dakota’s definition of ‘retailer’ to do just that, it struck down the law as unconstitutional. Quill Corporation, and other retailers, was not required to collect a state tax unless it established a physical presence in the state. Not yet, anyway. However, the court’s decision invited Congress to take advantage of the power it is granted by the Commerce Clause to “regulate commerce among the...states.” Indeed, the court wrote that because taxing remote sellers no longer violates the Due Process Clause, “Congress is now free to decide whether, when, and to what extent the states may burden interstate mail order concerns with a duty to collect taxes.” Those words were written over 11 years ago, and the term “mail order” would now be more broadly defined to include Internet sales as well. Enter the Streamlined Sales Tax Project.

### Description

The SSTP has two components at the state level. The first is a relatively benign piece of legislation states are required to pass, the Uniform Sales and Use Tax Administration Act. The act allows the state to enter into an agreement with other states in an effort to modernize and simplify the sales tax system. This part of the project requires no modifications to a state’s existing sales and use tax laws. Forty states and the District of Columbia have passed this type of legislation, allowing them to become participating states in the Streamlined Sales and Use Tax Agreement.<sup>3</sup>

The second component of the project is the agreement itself. Iowa is one of only 17 states that have enacted legislation substantially similar to the model agreement legislation proposed by the SSTP. This part of the project is more difficult to achieve

than the first, because in some states it requires significant changes to existing sales and use tax laws. To be compliant with the agreement, a state's laws must be "substantially compliant" with each requirement of the agreement. The agreement has at least 18 broadly defined requirements, each of which contains more narrow requirements; achieving "substantial compliance" is quite a chore in some states and will require at least minimal legislative changes in every state.

Because of the legislative changes it requires, the SSTP affects all businesses to some degree. Without question, however, it affects remote sellers to a greater extent than anyone else. Last year, a total of \$26 billion in potential tax revenue went uncollected because of remote sales. That number is expected to increase by 45% over the next few years. Federal enactment of SSTP legislation would require, or allow states to require, remote sellers to collect sales and use tax. This would be a financial boom to state and local governments, and would also level the playing field between online mega-retailers and smaller local businesses. But while the desire to collect sales and use tax on Internet, catalog and other remote purchases is certainly a motivating factor behind the SSTP, it is not *the* motivating factor. Of equal weight is the desire to simplify and modernize the sales tax systems in each state.

The SSTP imposes a number of standardizations that will make it easier for businesses to voluntarily collect sales and use tax on all purchases, regardless of their location or the location of their customer. (While the ultimate goal of the project is to require mandatory compliance in all 45 states that collect sales tax, voluntary compliance is necessary until a federal law implementing the SSTP takes effect.)

The most important standardizations created by the SSTP include:

- State level administration of all taxes, even the local share; Only the four so-called "home-rule" states (Alabama, Arizona, Colorado and Louisiana) are not doing this already. Those states allow local jurisdictions to set their own tax base, develop their own returns and filing forms, and audit their own taxes. The variety and sheer mass of administrative functions has proven very costly to businesses that operate in these states.
- Allowing only one state rate and one rate per local jurisdiction; Originally, businesses wanted to require only one rate per state, and allow each state to pass on revenue to local governments as it saw fit. That proposal was abandoned because of the increasing reliance of local governments on sales tax revenue, and because of the available technology that allows businesses to deal with local rates relatively easily.
- Establishing a common state and local tax base by 2006; Again, this problem is particularly prevalent in the home-rule states that allow local jurisdictions to

set their own tax base. Multistate businesses call multiple tax bases the "single most difficult issue in sales tax administration." Accordingly, the project seeks to remove them by 2006, with a few exceptions.

- Eliminating caps and thresholds by 2006, except in the case of sales tax holidays; Iowa's sales tax holiday involves the use of a threshold. Qualifying clothing sales of under \$100 are not taxable during the holiday; however, a tax is applied to the entire purchase amount for all goods over the \$100 threshold. Other states apply thresholds year-round. Caps can be in the form of rate caps or dollar caps, both of which are ceilings on the tax that can be charged against a particular sale.
- Standardized exemption auditing procedures; This includes holding harmless sellers that accept exemption certificates, and instead auditing consumers who claim the exemption. The project will develop a uniform electronic exemption certificate so that it can be used for remote sales, in addition to uniform paper certificates used for local sales.
- Requiring destination-based sourcing on all sales; Sourcing refers to determining for which state and local jurisdiction, if any, tax is to be collected. Destination-based sourcing means that sales tax is applied according to the rate of the jurisdiction in which the goods or services are actually exchanged (the seller's business location for over-the-counter transactions and the customer's shipping address for others). For industries that have unique situations, such as telecommunications services, direct mail, and florist services, individualized sourcing procedures are being developed.
- Creating and maintaining an updated central database; The project will create a website at which businesses can find the sales tax rates in every jurisdiction in the country, and which will be updated as boundaries change. The database will keep track of the current rate in each nine-digit ZIP code area.
- Establishing uniform definitions of property classes; Common definitions will mean that "prepared food" in Iowa means the same as it does in California. State legislatures would still be free to determine which classes of goods and services would be taxable and which would be exempt in each state. However, they would agree to use the uniform definitions adopted by the project.

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The push to standardize sales tax systems is the reason that the SSTP affects all businesses and not simply those that make remote sales. It is important to note that these standard rules are not merely the product of a brainstorming session by government tax experts. Throughout the process, and particularly in establishing uniform definitions of property classes, representatives from the private sector have been actively involved in crafting the model legislation for the SSTP.

Business and taxpayer groups will also have a continuing presence in the SSTP; they will form the membership of one of two advisory groups that will be created to advise the Governing Board of the Agreement on pertinent issues. (The other advisory group will consist of state and local government officials.) The Governing Board is comprised of up to four representatives from each participating state. Each state, no matter how many representatives it appoints, will have one vote. The Board will be responsible for approving new applicants to the Agreement, amending and interpreting the legislation as needed, and responding to definition requests and solving new issues as they are raised.

The SSTP has operated under a self-imposed guideline that the agreement will not go into effect until at least 10 states representing 20% of the population have enacted legislation to implement the Agreement. That goal has been achieved. As of July, 17 states have enacted conforming legislation and three others (Minnesota, Texas and Washington) are close to doing so. The expected effective date of the agreement is likely to be July 1, 2004. All participating states will go through an annual recertification process to ensure their continued compliance with the SSTP. This safeguard was imposed to prevent legislatures from tinkering with product definitions, which could lead to deviation from the standardized rules.

## Unresolved Issues

Even with all of the work that has been put into the agreement, there are many unresolved issues. As we come nearer to the effective date, the rush to solve these problems, as well as others that are sure to come up, will intensify. Some of the more prevalent issues as of yet unresolved are:

- Bundling – how the agreement will handle 2-for-1 deals, packages that include a product with a service, or those that include one taxable product and one exempt product;
- Digital property – defining digital property, and determining how to tax it, as it becomes more and more widespread in our society;
- Central database – identifying a cost efficient way to create and maintain a rate/jurisdiction database that is accessible to all businesses;
- Audits – adopting uniform audit standards and procedures;
- Tax holidays – determining common guidelines and rules for tax holidays.

The various parties involved in the SSTP have little time to solve these issues, but seem confident that they will do so. Then the quest will begin to fit the final piece of the puzzle: lobbying federal lawmakers to enact the SSTP legislation.

Some people have the mistaken impression that another piece of federal legislation, the Internet Tax Freedom Act (ITFA), which expires November 2003 but may be renewed, runs contrary to the SSTP. In fact, the two deal with separate issues. The ITFA prohibits states from taxing *Internet access*, e.g., AOL's \$19.95 monthly access charge. It was imposed, in part, because the telephone service underlying the Internet access is already subject to tax. The ITFA's goal is to prevent multiple or discriminatory taxation of Internet access; it is not concerned with Internet commerce.

## Iowa's Status

Iowa solidified its conformation to the agreement with the passage of HF 683 during the 2003 legislative session. The legislation included both components required by the SSTP, in that it authorized Iowa's entrance into a sales and use tax agreement, and also conformed to the Streamlined Sales and Use Tax Agreement. The Iowa bill, with an effective date of July 1, 2004, states: "It is the intent of the general assembly that entering into this Agreement will lead to simplification and modernization of the sales and use tax law and not to the imposition of new taxes or an increase or decrease in the existing number of exemptions, unless such a result is unavoidable under the terms of the agreement." Like all states, Iowa cannot force remote sellers to collect sales and use tax. It can only hope that by simplifying the process, retailers will voluntarily comply.

Iowa and 16 other states have already done their part to simplify and modernize sales and use tax laws. The list of conforming states will soon grow longer. federal legislation is in the process of being finalized and floor and committee debate on the project can begin as early as winter. The door is now open for Congress to allow states to start collecting taxes on remote sales. Some major retailers, like The Gap and Wal-Mart, have already begun doing so voluntarily. It is good to see that cooperation between business and government, even on a limited scale. But until all businesses are taxed evenly and fairly, which can only result from federal legislation, the goal of the Streamlined Sales Tax Project will have not been reached.

*Source: The Lawmaker's Guide to the Streamlined Sales Tax Project. Contact: Diane Hardt, Wisconsin Department of Revenue (Footnotes) <sup>1</sup> Ms. Hardt is Administrator of the Division of Income, Sales and Excise Taxes in the Wisconsin Department of Revenue and Co-Chair of the SSTP. <sup>2</sup> All quotations are from the U.S. Supreme Court's opinion in *Quill Corp v. North Dakota*; some may be the Court quoting from other cases or documents. <sup>3</sup> 45 states and the District of Columbia impose a sales tax at the state and/or local level.*