



Streamlined Sales and Use Tax System: Adoption of Landmark Multistate Agreement

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Introduction

The existing—and notoriously antiquated—state sales and use tax system has been widely recognized by state governments and businesses alike as overly complex and unduly burdensome:

- More than 7,500 separate state and local jurisdictions currently levy some form of sales and use tax.
 - The rates at which the tax is levied differ by jurisdiction and can vary within a particular jurisdiction depending on the type of product, the status of the taxpayer, and the manner of purchase. Of the 47 states that administer a sales or use tax (including the District of Columbia), there are currently 12 states with a single sales and use tax rate, 6 states with a single use tax rate and multiple sales tax rates, and 29 states with multiple sales and use tax rates ranging from 0.875 percent to 11 percent (including local add-on taxes). There are also 25 states that charge special tax rates for certain product categories or services (e.g., vending machines, telephone services).
 - Application of the proper sales or use tax rate to a particular item is complex because many of the taxing jurisdictions have different laws or definitions as to what is taxable. Thus, it is possible for the same item to be both exempt and taxable in one state simultaneously (for example, food for home consumption may be exempt at the state level but taxable by certain local jurisdictions within the state), or exempt in one state and taxable in another. Critics of the current sales and use tax system have cited orange juice and marshmallows as good examples of products that have been subject to inconsistent sales and use tax treatments: orange juice may be subject to sales tax in one state as a fruit but exempt in another as a beverage, while a marshmallow may be subject to sales tax in one state as a food item but exempt in another as a candy.
- The combination of multiple rates and varying sales tax bases makes the sales and use tax system difficult for multistate businesses to understand and comply with. In fact, the complexities of the existing sales and use tax system has created an entire industry dedicated to producing specialized sales and use tax compliance software.

Under current law, only vendors who are physically present in a state are required to collect and remit the tax on taxable sales in that state. As a result, states generally cannot compel “remote” vendors, such as telemarketing, mail-order and catalogue companies, to collect and remit these taxes so long as those vendors do not have any physical presence in the purchaser’s state. Accordingly, “remote” vendors (including online sellers) have remained relatively free of the state sales and use tax administration and compliance requirements imposed on more traditional retailers.

On November 12, 2002, thirty-three member states of the Streamlined Sales Tax Implementing States (“SSTIS”) approved the Streamlined Sales and Use Tax Agreement (the “Agreement”). If enacted into law in the various states, the Agreement would significantly simplify and modernize the existing sales and use tax rules and administrative systems by reducing the number of applicable tax rates, making the definitions of items in the tax base more uniform from state to state, and reducing the overall compliance burden on sellers. The Agreement will become binding, and the simplified system will go “live” in those states that have enacted implementing

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legislation, when at least ten member states comprising twenty percent of the total population of states imposing a sales and use tax enact legislation that substantially conforms to the Agreement. It is expected that a sufficient number of states will pass implementing legislation by June 2003 to make the Agreement binding.

The Agreement is based on the work of the Streamlined Sales Tax Project (“SSTP”), which was organized in March 2000 by state government representatives to develop and implement a simplified sales and use tax administration system. The SSTP gained considerable momentum following the issuance of a report to Congress by a majority of the Advisory Commission on Electronic Commerce that proposed extending the existing moratorium on new internet taxes introduced by the Internet Tax Freedom Act in 1998 pending the passage of more uniform sales and use tax rules by the various states. State and local governments viewed the moratorium on Internet sales taxation as harmful to their sales tax base because it would cost them billions of dollars in lost tax revenue annually. For their part, “bricks and mortar” retailers found the moratorium objectionable because it left undisturbed the existing inequity between local sellers and remote vendors. In December 2000, the SSTP produced a set of recommendations for provisions that would constitute the basis of an interstate agreement to streamline state and local sales and use tax collection systems and bring remote vendors and online sellers into the mainstream of state sales and use tax collection efforts. These recommendations were reviewed and ultimately finalized this November by the SSTIS as the Streamlined Sales and Use Tax Agreement.

Highlights of the Agreement

The Agreement proposes to streamline the existing sales and use tax system through several key provisions:

- *State-level administration of sales and use tax collections.* States will be responsible for the administration of all state and local sales and use taxes and the distribution of these taxes to the local government. A seller will no longer file tax returns with each local jurisdiction in which it conducts business, but rather will be required to register with, file returns with, and remit funds to a single designated state-level authority. Any sales and use tax audit of a registered seller will only be performed at the state level, either by a state agency itself or by some designated third-party agent. This change would significantly reduce the levels of bureaucracy and paperwork that multistate sellers must contend with in order to comply with sales and use tax laws. However, standards for audits conducted by authorized agents of each state remains an open issue.
- *Conform major tax base definitions.* While the Agreement provides that each state must use common definitions for key items in the tax base, there is no explicit requirement that the states generally adopt common definitions. Therefore, the final definitions for each item could potentially vary somewhat from state to state. Furthermore, each state will still be able to designate whether particular items will be taxable or not (e.g., food, prescription drugs, etc.), and will be required to make available a “taxability matrix” that vendors can rely upon in making sales into the state. Since the final definition of each item, and its classification as taxable or exempt, ultimately rests with each state, there is still the possibility that slight variances in the definition of an item and its treatment on a state by state basis could create confusion and compliance issues.
- *Uniform state and local tax bases.* The Agreement requires local jurisdictions that levy a sales and use tax to share a common tax base with their state by January 1, 2006. Conforming the tax base definitions of state- and local-level sales and use taxes would significantly reduce complexity, although it is not yet clear how the phase-in will be implemented. It is possible that forcing local jurisdictions to conform to a uniform state tax base may result in a proliferation of additional local transaction taxes as local jurisdictions seek to replace lost revenue.
- *Simplification of state and local tax rates.* The Agreement requires that states use a single sales and use tax rate for most kinds of personal property or services as of January 1, 2006 (although a second rate would be allowed for food, food ingredients and drugs). Similarly, each local jurisdiction will generally be allowed a single local sales and use tax rate. For purposes of determining applicable local sales and use tax rates, tax boundaries will coincide with the nine-digit ZIP code boundaries. To implement a single sales tax rate, states would have to develop databases assigning each zip code in the state to appropriate tax rates and jurisdictions. If

a given ZIP code area encompasses more than one local jurisdiction, the state would be required to apply the lowest combined rate, resulting in loss of revenue for the jurisdiction with higher rates. Altering the rate structure in this manner could affect sales tax revenues that have been earmarked by state and local governments to settle state and local bond covenants.

- *Uniform sourcing rules for all taxable transactions.* States will be required to conform to uniform rules relating to the sourcing of sales, leases and rental transactions. These uniform rules are destination-based and apply regardless of the characterization of a product as an item of tangible personal property, a digital good or a service, or telecommunications services. For direct-mail sellers that delegate the mailing of catalogues to their printers, customers may give the seller a direct-mail form (*i.e.*, a multiple point of use certificate) that will enable the seller to track where the catalogues go and determine the source of the tax. While the single-sourcing method will streamline the assignment of tax rates, this may result in revenue losses for jurisdictions that impose sales tax at the point of sale, such as regional shopping hubs. Nevertheless, the uniform sourcing rule clarifies that third party agents of sellers do not have to provide information to the sellers for tax sourcing purposes.
- *Simplified administration of use- and entity-based exemptions.* States will be required to adopt a uniform exemption certificate in both paper and electronic format, and will administer use-based and entity-based exemptions where practicable through direct-pay permits, exemption certificates or other means that do not burden sellers. Purchasers who claim incorrect exemptions will be responsible for paying any tax, interest and penalties, and sellers will generally have no liability. Since detailed rules for implementing this provision have not yet been developed, it remains to be seen whether shifting the burden from the sellers to the states to monitor sales tax exemptions will materially reduce sellers' recordkeeping requirements relating to exempt purchases.
- *Simplified tax returns.* Sellers will be required to file only one tax return for each tax period for each state and all the taxing jurisdictions located within

that state. This would significantly reduce the compliance burden for vendors selling into multiple state and local jurisdictions.

- *Simplification of tax remittances.* Sellers will be required to make a single tax payment for each filed return, regardless of how many local jurisdictions are covered by the return. In addition, the Agreement allows sellers to utilize certain state-sponsored third-party service providers to comply with their sales and use tax recordkeeping, filing and payment responsibilities. To reduce the costs of collection for sellers, states will provide sellers that voluntarily register to collect tax with monetary allowances and vendor discounts, including a percentage of the tax revenue generated for a member state. **Allowing third-party certified service providers to contract with states and vendors to accept responsibility for sales tax compliance, while encouraging flexibility and innovation, may complicate enforcement and raise concerns about consumer privacy and proprietary business information.** Moreover, the Agreement does not provide any set criteria for monetary allowances, and there is no guarantee that participating sellers will be reasonably compensated for actual collection costs.
- *Protection of consumer privacy.* Certified service providers that function as agents for a seller will be required to perform their tax calculation, remittance and reporting functions without retaining any information that would allow consumers to be personally identified. States may retain such information for purposes of determining the validity of an exemption claimed by the consumer by reason of status or intended use for the goods or services purchased. Once the exemption has been established, member states are required to discard the information. Information retained by the member state must be made reasonably accessible to the consumer. Member states that retain a consumer's information must make the information reasonably accessible to the consumer and inform the consumer if any unauthorized person seeks to obtain such information. While the Agreement grants enforcement authority of these privacy policies to member states' attorneys general or other government authorities, it also provides that the

Agreement will not enlarge or limit the member states' authority to conduct audits or other reviews under the Agreement or state law, provide records to governmental agencies under the Freedom of Information Act (or similar state disclosure laws) and other regulations, prevent disclosures of confidential taxpayer information, or collect, disseminate or use anonymous data for governmental purposes. **The Agreement does not provide a definition for "personally identifiable information."** As a result, in implementing these provisions each state would look to its own particular privacy laws. States are also not restricted on their authority to use the information that is developed and maintained under the Agreement for sales and use tax purposes for other governmental purposes. It is unclear whether sellers performing their own sales and use tax compliance functions or through a certified automated software would be subject to the same privacy standards and be constrained from disseminating the information or customer lists to affiliates for marketing purposes.

- *Participating seller benefits.* Sellers that voluntarily register under the Agreement will be exempt from payment of any registration fees or other charges from member states and, subject to certain conditions, may obtain amnesty for prior uncollected or unpaid sales taxes, including immunity from penalty and interest assessments. Moreover, member states will provide participating sellers with monetary allowances, vendor discounts and, for the first 24 months, a percentage of the sales or use tax revenues collected to reduce the financial burdens of tax collection. **Prior period audit immunity could be particularly attractive to remote sellers who may arguably have had sufficient nexus in a given state (e.g., through affiliates or agents doing business in the state) to have been subject to sales and use tax collection requirements under current law.**

Perspective

While the Agreement may become binding for all member states in the near future, participation in the proposed streamlined sales and use tax system remains voluntary for remote sellers who otherwise do not have a physical presence within a state, unless Congress removes existing federal limitations on the authority of states to

require such sellers to collect and remit sales and use taxes. To date, however, Congress has resisted enacting such legislation. Whether or not the current Agreement gains enough critical mass and popular support for Congress to pass legislation favorable to the implementation of a simplified sales and use tax system by the states remains to be seen.

In the meantime, remote vendors and online sellers should carefully consider whether the benefits offered by the Agreement, such as the sales tax amnesty and monetary allowances for collection costs, outweigh the potential risks brought about by voluntary participation. In its current form, the Agreement transforms sellers into collection agents for the state, eligible for monetary compensation and vendor discounts for compliance costs associated with collecting and remitting sales and use taxes. The Agreement also seeks to encourage remote sellers that would not otherwise be subject to registration and collection requirements to participate in the program by offering such sellers a percentage of the tax revenue generated for that state within the first 24 months of registration.

While participation offers remote sellers some potentially significant advantages, there are some possible drawbacks as well. For example, a seller's voluntary participation in the Agreement may expose the seller to other business activity taxes in the state (e.g., excise or franchise tax). Sellers should take note that the Agreement itself only prohibits member states from using a seller's *registration* under the Agreement as a factor in determining whether that seller has nexus with that state for any tax at any time. The Agreement itself does not provide any explicit guarantees that all other activities of remote or online sellers participating under the Agreement will be exempt from any nexus-assertions by the member states for purposes of imposing other state taxes such as business activity taxes.

The Agreement also necessitates the development of information retrieval and database systems that would collect a staggering amount of customer information which will be shared by all member states for sales and use tax purposes. However, the Agreement's privacy policy fails to provide any clear definition of what constitutes "personally identifiable information" and "anonymous" information that may be retained, used, and disclosed by a member state to other governmental agencies of member states for other governmental purposes. There is no

uniform set of standards governing the collection, maintenance and use of such information once it is turned over to the member states for purposes of verifying sales and use tax exemptions claimed by any one particular customer.

The current state of the Agreement's privacy policy is troublesome because the Agreement only prevents the disclosure of customer information to third parties that are neither authorized agents nor government agencies of the member states. Governmental agencies of member states could potentially access customer information while the information is being retained by the member state for purposes of establishing the sales and use tax exemptions claimed by that particular customer. Because the government agency is not a third party, there is no obligation on the part of member states to inform customers that their information has been accessed or reviewed by another government agency, much less obtain

the customer's consent to do so. This risk is not insignificant given the fact that state authorities are already looking to internet sellers to identify taxpayers for potential audit (or even criminal prosecution) for violations of state laws. Since participation in the Agreement for remote and online sellers without physical nexus is voluntary, such sellers could potentially be held liable by customers that are singled out by state authorities for prosecution in this manner. Remote and online sellers should consider carefully whether the Agreement's privacy provision is sufficient to safeguard the rights of their customers.

Material Available On-Line

We have posted a copy of the November 12, 2002 [Streamlined Sales and Use Tax Agreement](#), which is also available via ftp at:

<ftp://pmstax.com/state/ssutAgmt.pdf> [291K].

