An Update On The Streamlined Sales And Use Tax Project

By: Mary Ann Hofmann, Megan Y. McSwain, and **Dwayne McSwain**

Abstract

Sales and use taxes represent the largest source of tax revenue for most states, according to the U.S. Census Bureau in 2012. Forty-five states and the District of Columbia impose sales and use taxes (William F. Fox, LeAnn Luna, and Matthew N. Murray, "The STTP and Technology: Implications for the Future of the Sales Tax," National Tax Journal, vol. 61, no. 4 part 2, 2008, pp. 823–841), including more than 7,500 local jurisdictions (Ian J. Redpath, Eric M. Redpath, and Kathleen Ryan, "Sales and Use Taxation in E-Commerce: Where We Are and What Needs to be Done," Information Systems Management, vol. 24, 2007, pp. 239–245). With so many different taxing jurisdictions and rates, compliance with all applicable sales tax laws can be quite complex.

Mary Ann Hofmann, PhD, CMA, and Megan Y. McSwain, and **Dwayne N. McSwain**, PhD, CPA (2013). "An Update on the Streamlined Sales and Use Tax Project," *The CPA Journal*, November 2013, pages 46-51. Publisher version of record available at: https://www.nysscpa.org/news/publications/the-cpa-journal/article-preview?ArticleID=11180#sthash.K0o4IZYK.dpbs

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Sales and use taxes represent the largest source of tax revenue for most states, according to the U.S. Census Bureau in 2012. Forty-five states and the District of Columbia impose sales and use taxes (William F. Fox, LeAnn Luna, and Matthew N. Murray, "The STTP and Technology: Implications for the Future of the Sales Tax," *National Tax Journal*, vol. 61, no. 4 part 2, 2008, pp. 823–841), including more than 7,500 local jurisdictions (Ian J. Redpath, Eric M. Redpath, and Kathleen Ryan, "Sales and Use Taxation in E-Commerce: Where We Are and What Needs to be Done," *Information Systems Management*, vol. 24, 2007, pp. 239–245). With so many different taxing jurisdictions and rates, compliance with all applicable sales tax laws can be quite complex.

A Complex System

By law, retailers with nexus in a jurisdiction are required to collect and remit sales tax to the states and to municipalities that impose a sales tax; however, no such burden is placed upon retailers without nexus (i.e., remote sellers), and consumers are responsible for remitting use tax to their state of residence for remote purchases on which no sales tax was paid. In a multistate sales transaction, the seller must consider where the sale actually takes place, which might depend upon the method of delivery (e.g., common carrier, seller- or buyer-owned vehicle, drop-shipment from the manufacturer); whether the seller has nexus (some minimal physical presence) in the destination state; and, if so, whether the items sold are taxable in the destination state. Sellers must also verify exemption certificates provided by buyers who claim exemption from sales tax (because they are buying the goods for resale, because they are a nonprofit organization, or for some other reason); this requires a working knowledge of other states' laws. In addition, buyers must consider whether they are being charged the appropriate amount of sales tax and whether they are required to remit use tax on the items purchased (Sharon R. Paxton, "Collecting and Remitting PA Sales Tax on Multistate Sales Transactions," 2012, http://www.jdsupra.com/legalnews/collecting-and-remitting-pa-sales-tax-on-57121/).

The current sales and use tax system is further complicated by the differences among taxing jurisdictions in administrative and filing requirements, the taxable status of products and services, tax exemptions, and tax holidays. For example, Louisiana recently issued a ruling that the sales tax exclusion for items of tangible personal property sold for the purpose of lease or rental does not apply to repair parts or materials purchased and necessary for the repair or maintenance of lease or rental equipment that is covered by the exclusion, regardless of whether the items are purchased and installed by the owner of the lease or rental equipment or installed as a repair service that is billed separately by a third party (*CCH State Tax Review Headlines*, Commerce Clearing House, vol. 74, no. 11, 2013).

These systemic complexities, coupled with the limited resources of many small retailers, have created an unequal playing field between small and large retailers. Small businesses often lack the in-house accounting expertise needed to comply with the requirements for multiple taxing jurisdictions and cannot afford to outsource this task, which geographically limits their sales market.

The Streamlined Sales Tax Project

In an effort to increase sales and use tax collections and to decrease compliance and administration costs, 39 states and the District of Columbia formed the Streamlined Sales Tax Project (SSTP) in March 2000 (Phil Harper and Dwayne N. McSwain, "Streamlined Sales Tax: An Update for Small Businesses," *Journal of Business & Entrepreneurship*, vol. 20, no. 1, 2008, pp. 72–80).

The SSTP developed the Streamlined Sales and Use Tax Agreement (SSUTA) in 2002 and has amended it as needed in order to further simplify the tax system and attract more full-member states. This monumental undertaking focuses on reducing the burden of collecting and administering state and local taxes for both private companies and public agencies by simplifying the nationwide sales and use tax system. Currently, retailers must collect sales tax only in states where they have a physical presence (nexus), and consumers (taxpayers) are responsible for paying a use tax on all other interstate purchases they make; however, compliance with use tax laws is probably minimal at best, resulting in an estimated $23 billion of lost revenues for state and local governments (Scott Peterson, "Streamlined Sales Tax," presentation, North Eastern States Tax Officials Association [NESTOA] Conference, Wilmington, Delaware, 2011).

The SSUTA is not the only effort to simplify tax collection and administration; the Main Street Fairness Act, introduced in July 2011, advocates states' ability to enforce current sales tax laws on every seller—whether brick-and-mortar or online businesses—in their state. But the SSUTA is the only one to create a simplified system that states have already begun to adopt. The act has grown to include 44 states (at various levels of participation) and the District of Columbia, but many still consider it to be in the design phase—due to the many complexities involved, the massive scope of the project, and the slow pace of progress thus far. This discussion's examination of the SSUTA can help taxpayers and their advisors better understand the act and its future.

Background

In the 1930s, many states looking for alternative revenue sources started taxing sales transactions within their jurisdictions. Since then, such states have sought to collect sales taxes from out-of-state retailers who sell to customers within their states in an effort to minimize lost sales tax revenues. But in *National Bellas Hess v. Department of Revenue of the State of Illinois* (386 U.S. 753, 87 S.Ct. 1389 [1967]) and *Quill v. North Dakota* (504 U.S. 298, 112 S.Ct. 1904 [1992]), the U.S. Supreme Court ruled that requiring out-of-state retailers to collect sales tax in states in which the retailer did not have a physical presence (e.g., having a store, warehouse, distribution center) would be unconstitutional. The Court suggested that such a requirement would violate the Commerce Clause by placing an undue burden on interstate commerce.

As states continued to seek ways to tax all interstate sales transactions, the National Tax Association (NTA) launched its Communications and Electronic Commerce Tax Project in 1997 to help find viable solutions for the U.S. sales tax system, which was struggling to keep up with the dramatic increase in electronic commerce (e-commerce). In 1998, however, the U.S. Congress responded by passing the Internet Tax Freedom Act (ITFA), set to expire on November 1, 2014, which limits the states' power to tax Internet access and e-commerce. Although the ITFA did not prohibit states from taxing sales made via the Internet, it did effectively reinforce the nexus requirement. Citing its inability to reach a sustainable agreement, the NTA abandoned its Communications and Electronic Commerce Tax Project in 1999.

By the end of 1999, both the National Governors Association and the National Conference of State Legislatures had asked tax administrators to develop a less complex tax system that would not only be less burdensome for all retailers, but would also help states collect more revenues from sales and use taxes imposed but not collected. The SSTP was created in early 2000 as a response to that request. Supported by hundreds of businesses, the purpose of the project is to establish a more uniform and simplified sales and use tax system. By developing such a system, the process of collecting, remitting, and administering sales and use taxes should prove to be less expensive for businesses and state and local governments. According to its governing board and other supporters, the SSUTA offers a way to place both large and small remote sellers on a more equal playing field.

As a direct result of the SSTP, the Streamlined Sales Tax Implementing States

(SSTIS) adopted the initial SSUTA by November 2002. Provisions of this agreement call for simplification of the sales tax system and for systemic uniformity in cases where simplification is not possible. The SSUTA aims to balance states' interest in sovereignty with their interest in simplifying the tax system; it also seeks to ease the tax collection burden on retailers and states by leveraging the use of technology.

The SSUTA, which first became effective October 1, 2005, is under the governance of the Streamlined Sales Tax Governing Board. The agreement has been amended at least annually to implement further simplification, provide clarity, and increase participation among stakeholders (primarily remote sellers and additional states). As of January 1, 2010, the SSUTA is fully effective in states that have adopted it.

The SSUTA's Basic Elements

The streamlining of sales tax collection and distribution involves many complex issues. Perhaps the most controversial issue is destination versus origin sourcing. The term "sourcing" describes which taxing authority has the right to tax a sales transaction. Originally, the SSUTA required states to use destination sourcing, which requires retailers to collect and remit sales tax based upon the destination of delivery or receipt by the consumer, in order to become full members. This has proven to be one of the major barriers to SSUTA adoption, because many states have traditionally used origin sourcing, where sales taxes are collected and remitted based upon the point of sale. In December 2008, the governing board amended the agreement to allow member states to use origin sourcing for tangible personal property and digital products delivered or mailed to intrastate purchasers (i.e., different taxing jurisdictions within the same state).

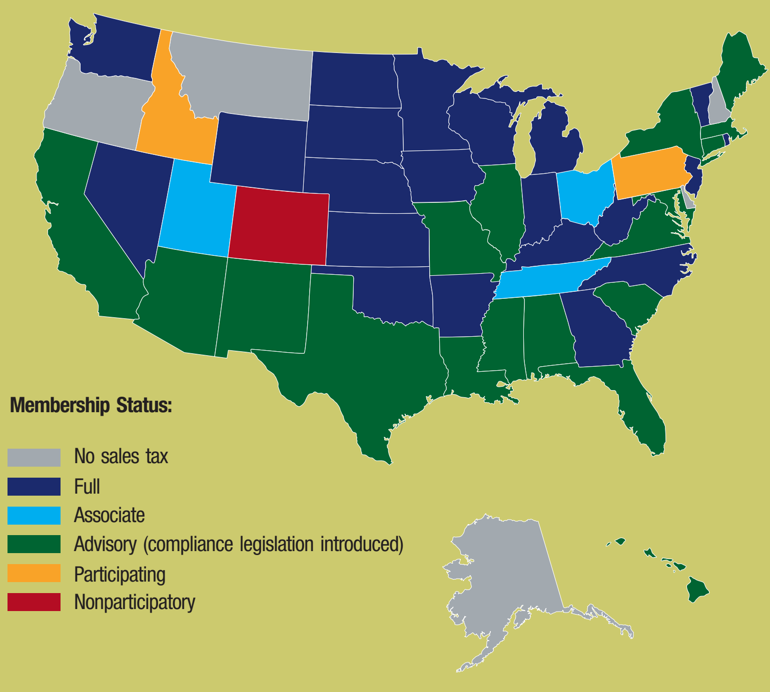
Although sourcing has been the most contentious issue, many other concerns must be addressed before successful implementation of the SSUTA, including the taxation of online sales and the unequal compliance burden placed on small businesses. The biggest roadblocks for taxing Internet sales are the Due Process and Commerce Clauses in the U.S. Constitution. The U.S. Supreme Court has repeatedly ruled that it is unconstitutional to require remote sellers to collect sales tax in states in which they have no physical nexus. The source of inequality between small and large retailers is twofold. First, conventional retailers without an online presence claim that the lack of sales tax for most online sales gives e-retailers the upper hand. Second, smaller brick-and-mortar stores lack the necessary resources to administer and account for sales taxes in a complex reporting system that involves multiple jurisdictions and rates.

The governing board and SSUTA members have worked diligently to address these issues. To date, the agreement includes the following basic elements:

- *Uniform definitions.* The SSUTA defines 106 administrative terms and outlines which items are taxable and which are exempt. Sellers do not have to investigate how SSUTA states define taxable items; they simply check whether the product or service being sold is taxable or exempt.
- *Simplified tax rates.* Each state is allowed only two tax rates—a general state rate and one local rate for items such as food and drugs. The local rate should apply to both sales and use tax (John Healy and Bruce Nelson, "The Streamlined Sales Tax Project," *Journal of State Taxation*, vol. 24, no. 3, 2006, pp. 9–12).
- *Uniform sourcing rules.* With limited exceptions, tax collection is determined by the tax rate of the state in which the item or service is being sold. For example, if someone in Georgia wants to buy an item from a seller in Michigan, the seller must collect the tax rate for Georgia.
- *Uniform exemption administration.* Sellers are not liable for failure to collect sales tax on a transaction in which the buyer incorrectly claims exemption from such tax. Instead, the buyer is responsible for paying any tax that is later assessed, as well as any interest and penalties.
- *State-level tax administration.* Sellers have to file only one sales tax return per state.
- *Uniform audit procedures.* Sellers who use sales tax administration software certified by the governing board are either not audited or have limited-scope audits.

EXHIBIT

Streamlined Sales and Use Tax Agreement—2012 Status by State



Source: Adapted from Streamlined Sales Tax Governing Board Inc. (2012)

SSUTA Requirements

Audits. The SSUTA requires uniform audit procedures, including the use of statistical sampling techniques. Statistical sampling allows states to conduct more efficient audits and encourages states to keep their tax system up-to-date with the SSUTA requirements. Sellers who use certified software to collect and report taxes are either not audited or have limited-scope audits. Large businesses that make sales in multiple states can request to have a joint audit from all of the states in which they do business, rather than being audited by individual states.

Compliance. The SSUTA requires states to simplify their tax rates and administration. This means that administration of the sales tax system should be conducted at the state level, and the same tax rate should be used statewide, with no sales tax thresholds or caps. States must also reduce or eliminate sales and use tax holidays and standardize exemption certificates. These requirements allow sellers to submit just one sales tax return per state, as opposed to one return for each taxing jurisdiction within the state.

There is a checklist of approximately 44 items outlined in states' certificates of compliance. The items include seller registration, uniform administration, state and local tax rates, definitions (sourcing, administrative, product, and sales tax holiday), sourcing rules, amnesty rules, exemptions, and refund procedures. The governing board evaluates states by each of these parameters to determine compliance and their appropriate membership status.

Technology. Retailers may remit sales taxes using any one of three approved technology models, and the SSUTA requires states to help fund these three models. For collecting and remitting sales taxes to the states, retailers may choose to—

- use an approved third party to act on their behalf,
- use preapproved software to conduct the process themselves, or
- use their own state-approved proprietary software to conduct the process themselves.

In the first technology model, a certified service provider (CSP) essentially does everything for the seller. The CSP figures out the amount of tax due, pays the tax to the states, and files the returns. As compensation, the seller pays a transaction fee, a percentage of collected revenue, or a combination of the two. In the second model, a certified automated system (CAS) calculates how much tax is due for the seller. In the third model, a seller with a state-approved proprietary software system must process all sales using the system, meet the states' accuracy standards, agree to a methodology that determines whether the proprietary system meets the established standards, and allow the states to occasionally examine the system. Currently, the SSUTA website lists the following CSPs: Avalara, Automatic Data Processing, Accurate Tax, Exactor, Fed-Tax, and CCH ("Certified Service

Providers," Streamlined Sales Tax Governing Board Inc., http://www.streamlinedsalestax.org/index.php?page=Certified-Service-Providers).

Progress and Participation

Originally, only two SSUTA membership categories existed: participatory and nonparticipatory. The governing board has since broadened its membership categories to reflect the level of legislative interest in each state. Out of the 44 jurisdictions currently cooperating in the initiative, 25 have legislation complying with the agreement (i.e., full members). The remaining states have varying levels of membership, including associate, advisory, and participating. The current status of each state is depicted in the *Exhibit*.

Full members have made changes to their statutes, rules, and regulations that are currently in effect. Sellers in full-member states must collect sales and use tax from customers in their own state, other full-member states, and the associate-member states with which they choose to register. Associate members are 1) substantially in compliance with the SSUTA overall but do not meet every specific requirement or 2) have complying legislation that has yet to become effective. These states can become full members when they are found to be in full compliance and the changes to their statutes, rules, and regulations have taken effect. Associate-member states have the same rights and privileges as full-member states, with the following exceptions:

- They cannot vote on amendments or interpretations of the agreement.
- They cannot vote in deciding whether an applying state is in compliance with the agreement.
- They cannot have representatives serve on compliance review and interpretations committees.

Advisor members are any states that had an implementing state status before October 1, 2005, and have not become full or associate members. States with advisory status demonstrate an interest in establishing legislation in compliance with the SSUTA but are not officially committed to the initiative and therefore not eligible to vote on the governing board. These states have no voting power but can speak to any matter brought to the board. Participating states have demonstrated some amount of interest in the agreement.

The governing board recognizes states' legislative compliance with the agreement by issuing certificates of compliance, which states must renew annually. When a state becomes a full SSUTA member, sellers in that state are notified of their state's new status and guidelines for tax collection. By registering under the SSUTA, a seller is registered in each full-member state and the associate-member states of the seller's choosing. Full-member states can be sanctioned by other full-member states if they are found not to be in compliance with the agreement.

Online businesses. The interest in a uniform sales tax system among brick-and-mortar stores has also extended to online businesses. There has already been debate about the collection of online sales tax, with Amazon being one of the more high-profile companies of interest. If federal intervention occurs and *Quill* is overturned, it could require sellers to collect sales and use tax from customers in all states with which they do business, irrespective of their physical presence in those states. Thus, sellers that do business mostly online would be required to collect sales tax in all states. Although overturning this Supreme Court ruling might seem like a way to level the playing field between all businesses—big, small, online, brick-and-mortar—it might actually prove detrimental to online businesses, because it takes away a major competitive advantage, without having a positive effect in encouraging a fair and balanced environment among all sellers.

Problems and Limitations

Although the SSUTA offers a more simplified and uniform approach to tax law, it has several limitations. One of the major challenges facing the initiative is establishing uniform definitions for taxable and nontaxable goods that are acceptable in every state. All SSUTA states need to agree upon how they classify items such as food and drugs—for example, should potato chips be considered a food item or a candy item? Rather than determining their own definitions, states have to share the same definitions; in addition, SSUTA states need to agree upon taxable items and exempt items. Getting all SSUTA states to agree on uniform definitions can be difficult and time consuming. Some states believe they will be "boxed in" by uniform definitions (Diane L. Hardt, Douglas L. Lindholm, and Stephen P.B. Kranz, "A Lawmaker's Guide to the Streamlined Sales Tax SSTP," *Journal of State Taxation*, vol. 22, no. 2, 2003, pp. 1–29). Definitions must be detailed enough that sellers can accurately classify items and determine how they should be taxed; moreover, vague definitions might be confusing or difficult to apply in practice.

Another issue facing the SSUTA is the number of membership classifications. Sellers have to keep track of which states are full members, associate members, advisory members, participatory members, and nonmembers in order to determine how to collect sales and use tax from purchasers in those states. Unless all 50 states become full-member states, each state is responsible for knowing the statuses of other states and what those statuses mean.

Although the purpose of the SSUTA is to create tax neutrality among all businesses, it could have the opposite effect. For example, if the tax in each state is rendered the same for all businesses—brick-and-mortar, online, large, small—will it matter to a buyer if a toolbox comes from Home Depot, Hometown Hardware, or Tools.com? Buyers will have essentially no incentive to purchase from local or online sellers.

Although technology makes the tax system faster and simpler, it also creates concerns for the SSUTA. The certified software that sellers are required to use in order to comply with the agreement can be costly for small sellers. Although the SSUTA makes allowances for sellers that cannot afford to adopt any of the three models to continue calculating, paying, and reporting tax as they normally would, the burden of compliance that small businesses face is not entirely addressed (Hardt et al. 2003). In addition, technology in the form of software increases the possibilities for sellers to understate taxes or to fraudulently avoid taxing digital transactions (Fox et al. 2008).

Looking to the Future

The SSUTA might be the biggest overhaul of the state sales tax system in the United States since states began taxing sales in the 1930s. Although the SSUTA aims to provide a simple, uniform tax system, it faces several challenges that need to be addressed before it can be deemed a success. Possibly the biggest barrier to the agreement's success is the lag in state tax law changes. Creating a simpler, uniform tax system has been an issue for more than a decade, but it has yet to be fully realized.

Because the SSUTA is voluntary, the governing board cannot take compulsory measures to control its members. Each state's government must decide on the level of participation and compliance it is willing to support. According to Fox, Luna, and Murray, some states are "reluctant to go along with changes that are being developed by a group that legislators often view as simply state employees rather than as policymakers." This might be one reason why it has taken more than a decade for states to join the agreement and adopt its policies.

Although the future of the SSUTA remains unclear, two other pieces of legislation addressing tax fairness have been recently introduced in Congress—the Marketplace Equity Act (October 2011) and the Marketplace Fairness Act (November 2011). According to the SSUTA, federal intervention is necessary to ensure that a level playing field exists for small and local merchants because "only Congress has the authority to let states require collection of the billions of dollars in uncollected sales tax" ("Why Must There be a Federal Solution?," Streamlined Sales Tax Governing Board Inc., http://www.streamlinedsalestax.org/index.php?page=alias-19).

The possibility of federal intervention, however, is complicated by states' traditional desire to protect their sovereignty and reluctance to compromise with the federal government or other states on tax issues. The taxation of online sales is currently not uniform, and it remains unclear for all states. Unless all states join the SSUTA as full members and collectively agree on how online taxation should be handled—or the federal government intervenes by creating and enforcing legislation governing online taxation—sellers must keep abreast of SSUTA membership. Because SSUTA requirements are binding on member states only, the agreement arguably adds to the complexity of the tax laws it is attempting to simplify—at least until all states are on board. ❑

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