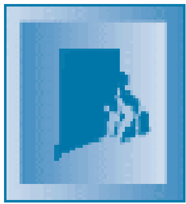

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Comments on Your Government

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The Streamlined Sales Tax Project -- Its Impact on Rhode Island

In May 2000 RIPEC's report, "A System Out of Balance – Rhode Island's State and Local Tax System" urged that the Governor, General Assembly and private sector support the efforts of the National Governors' Association and others to streamline collections for state sales and use taxes in order to simplify the system and maintain revenues received from this tax by applying it to remote transactions.

In 2002, forty-two of the 45 states that impose a sales and use tax system, including Rhode Island, approved an agreement to modernize sales tax collections and administration. Article 30 in the FY 2007 State Budget (see H-7120 Substitute A) brought Rhode Island sales tax statutes into conformity with the streamlined sales tax agreement statutes, including definitions of taxable items, limits on the rates and payments for processing. This RIPEC report, prepared by Mary F. Bernard, CPA, Principal and Inez M. Mello, Director of State and Local Tax Group of Kahn, Litwin, Renza and Co., Ltd. overviews the Streamlined Sales Tax Agreement and its impact for Rhode Island. RIPEC takes responsibility for the analysis and comments presented in the report.

SALES TAX OVERVIEW

Recently enacted legislation in Rhode Island could have a significant impact on the way many industries treat sales and use tax.

Rhode Island will soon require sales tax compliance with the regulations approved by the Streamlined Sales Tax Project (SSTP). This initiative began in 2000 under the auspices of the Federation of Tax Administrators, the National Conference of State Legislatures, and the National Association of Governors. The purpose of the Project is to "simplify and modernize the sales and use tax administration in states in order to substantially reduce the burden of sales tax administration for all sellers and all types of commerce." In order to level the playing field, the goal of the simplification is to require remote sellers (i.e., internet and catalog sellers) to collect sales tax on par with a "bricks and mortar" business.

Nexus

State sales tax issues are of little concern unless one concept is present – nexus. This defines some minimal presence within a taxing state. If this minimal presence exists, the state is legally allowed to impose their particular tax laws upon the out-of-state business entity. The critical question in the area of nexus involves the definition of "minimal connection" and "substantial nexus."

The first important Supreme Court case involving nexus issues was *National Bellas Hess, Inc. v Illinois Department of Revenue* in 1967. The Missouri corporation in this case sent mail order catalogs into Illinois generating sales as a remote vendor. The Supreme Court ruled that remote sellers would have a tremendous burden placed on them if they essentially had to collect sales tax on every type of sale made in every state and local tax jurisdiction regardless or whether or not they

were physically present in the state and regardless of the presence of substantial nexus.

About 25 years after Hess, in 1992, the Supreme Court case Quill Corp. v North Dakota, became the landmark case in the area of nexus. The facts in Quill mirrored Hess with the additional factor of the presence of floppy disks sent into the state along with sales catalogs. The Court's interpretation in this case concluded that in addition to any minimum connection within a state (Due Process Clause), a business must have substantial physical presence (Commerce Clause) before the state had the power to impose sales and use tax collection requirements. The presence of floppy disks in the state satisfied the minimal connection requirement but not the substantial physical presence requirement.

Constitutional Basis for Sales Tax

Two constitutional provisions that are generally invoked by a business refuting the imposition of sales and use tax nexus include the Commerce Clause and the Due Process Clause.

The Commerce Clause reserves to Congress the power to regulate commerce among the states. It prohibits the states from enacting laws that might unduly burden or inhibit the free flow of trade among the states. The United States Supreme Court has interpreted the Commerce Clause as prohibiting a state from taxing an out-of-state corporation unless that company has "substantial nexus" in the state. Nexus for sales tax purposes is established with any "warm body" or physical presence within a state. Anytime an employee, agent, or representative is conducting business on behalf of a taxpayer, nexus is generally established.

The Due Process Clause states that no state shall "deprive any person of life, liberty, or property, without due process of law." The United States Supreme Court has interpreted this clause as prohibiting a state from taxing an out-of-state corporation unless there is a "minimal connection" between the company's interstate activities and the taxing state.

In general, a state cannot impose a tax obligation on an out-of-state corporation unless the "minimal connection" of the Due Process Clause and the "substantial nexus requirements" of the Commerce Clause are satisfied.

STREAMLINED SALES TAX PROJECT

The growth of internet sales, which did not exist when Quill was decided, has threatened to overtake catalog sales. The prohibition on states imposing a tax collection obligation on sellers without a physical presence applies to internet sales as well as catalog sales. The University of Tennessee has estimated that state and local tax revenues lost by internet sales will be $24.2 billion in 2006!!

Therefore, the roots of the movement to streamline the sales and use tax system are in the challenge posed to that system by the proliferation of remote sales including catalog and internet sales. The Supreme Court indicated in Quill that the issue of state taxation of catalog sales would be better determined by Congress through its authority to control commerce among the states. To date, Congress has taken no steps to address this issue.

The lack of congressional action was largely due to the theory that taxation of internet sales could slow innovation and growth in the economy. In 1988, President Clinton signed the Internet Tax Freedom Act which prohibited state and local authorities from imposing taxes on internet access, except for taxes already in force prior to enactment. Several states had already begun taxing internet access prior to 1988. Since enactment, this temporary restriction has been renewed twice, currently extended until November 1, 2007.

This Act also created a temporary Advisory Commission on Electronic Commerce to study the impact of federal, state, local and international taxation and tariffs on transactions using the internet and internet access and to report their conclusions to Congress. This Act was also instrumental in the formation of the SSTP with a goal of designing and implementing a voluntary, nationwide sales and use tax system. The plan was to include uniform tax definitions and simplification of audit and administrative procedures.

The primary goal of the SSTP is to convince Congress to confer collection authority over remote sales on the states that enact the streamlined system with uniform tax definitions and simplification of audit and administrative procedures. The states would thereby generate additional revenues from sales that currently go untaxed. In general, this proposal is supported by "home town" brick and mortar retailers that are currently losing business to internet competitors. As an alternative, the federal courts could overturn the *Quill* decision and determine that the simplification is sufficient to remove undue burden on interstate commerce.

The SSTP is composed of three groups – a project group, the implementing states group, and the conforming states group. The ***project group*** consists of staff from tax agencies in the participating states that develop recommendations for coordination and simplification related to sales tax definitions, tax administration, and use of technology for sales tax collection.

The voting participants in the SSTP make up the ***implementing states group***. This group accepts, rejects or modifies the recommendations made by the project group. Provisions accepted by this group form the Streamlined Sales and Use Tax Agreement (SSTA).

The ***conforming states group*** consists of the 18 states that have passed conforming legislation and have been voted by the implementing states as most likely to conform with the SSTA.

How will it work?

- The SSTP will create uniform definitions that each state must adopt. **However, each state legislature will continue to determine what is taxable and what is exempt.** This will continue to vary state by state.
- Each state will only be permitted two tax rates – a general tax rate, and one for food and drugs. Each local jurisdiction will only be allowed one tax rate.
- State and local governments must use a common tax base, as only one sales tax return will be required to be filed with one central point of administration per state.
- Resale and exemption certificates will be standardized, with purchasers responsible for paying the tax, interest, and penalties for claiming incorrect exemptions.
- Each state must participate in an online sales and use tax registration process with registration in one state automatically registers taxpayer in all member states.
- The SSTP board will certify automated systems and service providers to assist with the administration of sales and use tax collection. Three methods of remittance are permitted:
  - Model 1: Seller selects a Certified Service Provider (CSP) as an agent to perform all the seller's sales tax functions at no cost to the seller.
  - Model 2: Seller selects a Certified Automated System (CAS) to calculate the amount of tax due on a transaction.
  - Model 3: Seller is a seller (or affiliated group of sellers) that has
    - Sales in at least five member states;
    - Total annual sales revenue of $500 million;

- Proprietary system that calculates the amount of tax due; and
- Systems certified as Certified Automated Systems.

Note: Participating sellers would not have to choose one of these technology models, but could continue under the current system for remittances, while still enjoying the benefits of the simplifications enacted. They will not, however, be afforded limited scope audit protection as sellers who choose one of the provided models.

Impact on Rhode Island

As noted, legislation has been enacted by the General Assembly and signed by the Governor that brings Rhode Island's sales tax statutes into conformity with the streamlined sales tax agreement. As a result, this will require changes to the existing sales tax regulations prior to the effective date of January 1, 2007. Now the state will have the opportunity to be proactive by becoming an implementing state while it is still a voluntary system. This is the time to closely scrutinize the sales tax regulations for compliance with the uniform definitions required of the SSTP. This legislation is expected to add $2.4 million in the FY 2007 State Budget due to newly required sales tax collections.

It is anticipated that most changes will occur in food and healthcare product definitions, which will impact grocery and convenience-type stores. For example, the SSTA will not allow the State to continue to exempt certain products such as medicated shampoos and soaps from the sales tax since they will no longer be considered an over-the-counter medicine. Also, beverages containing greater than fifty percent vegetable or fruit juice by volume will not be considered a soft drink subject to tax. Another example of a definition change is to the term "delivery charges" that will affect many retailers. Handling charges (presently taxed as part of the sale of goods under current law) will be exempt when the delivery charges are separately stated to the purchaser.

COMMENTS

By becoming an implementing State, the provisions of the Streamlined Sales Tax Agreement should permit Rhode Island to more effectively collect sales taxes on remote sales through collaboration with other states that are signatories to the agreement. However, tax reform of this magnitude may have a short-term impact on some types of businesses.

This project could substantially expand collection and remittance requirements for middle market businesses. Increased technology based investments may be required for compliance, placing an additional burden on small businesses. The additional filing requirements for all affected businesses may necessitate more sophisticated software systems and manpower.

Taxpayer education on this project has been extremely limited. Most small and mid-sized businesses have never heard of the SSTP, let alone understand the potential impact on their business.

Since the SSTA is a voluntary system, it means that two sales and use tax systems will run concurrently – individual state systems and those of the implementing SSTP states.

A key goal of the SSTP is to have Congress pass legislation requiring remote vendors to collect and remit sales tax for every state in which they have sales. Thus, encouraging further streamlining and simplification of the administration of the sales tax. This will only be accomplished by negating the decision established in the *Quill* case.