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Taxing e-commerce and other remote sales: Choices for Texas

The growth of electronic commerce (e-commerce) conducted over the Internet has accelerated states' efforts to collect taxes on remote sales — transactions between a state's taxpayers and businesses located outside the state. If ongoing efforts to streamline sales-tax laws produce a multistate agreement acceptable to Congress or the U.S. Supreme Court, decades of legal precedent could give way to a new era in sales-tax policy.

At the heart of the issue is how states treat taxable sales when technological innovations are changing the way retailers, wholesalers, and suppliers do business. At stake are billions of dollars in potential tax revenue and perhaps the future of e-commerce.

Congress recently reinstated the 1998 federal moratorium on new state or federal taxes on Internet access and on multiple and discriminatory taxes on e-commerce. While the moratorium does not prevent states from taxing most Internet transactions, U.S. Supreme Court decisions interpreting the Commerce and Due Process clauses of the U.S. Constitution — along with the lack of uniformity in how states administer sales and use taxes — have restricted the taxation of remote sales.

Texas and more than two dozen other states have enacted legislation committing themselves to simplifying sales-tax administration to make taxation of remote sales feasible. The new moratorium gives these states less than two years to design a multistate tax system that can both accommodate the digital economy and pass constitutional muster. When the current moratorium expires, Congress could extend it or make it permanent, declare the Internet tax-free, or establish its own uniform standards for state taxation of remote interstate sales.

The 78th Legislature could face a vote on a multistate agreement aimed at simplifying tax administration to make it feasible to collect taxes on remote sales.

The 78th Texas Legislature could face a vote on implementing a multistate agreement to facilitate taxation of remote sales. Specific issues could include limiting sales-tax exemptions, such as the “back-to-school” sales-tax holiday; categorizing food sales and defining computer software and digitized goods; and changing to “destination-based” sourcing of local sales taxes.

Because the Supreme Court has limited taxation of remote interstate sales, any authority for states to mandate sales-tax collection across their borders must come from Congress or the Supreme Court. Otherwise, any new system would be voluntary, presumably with incentives for vendors to participate in collecting taxes on remote sales.

Sales taxes accounted for about 33 percent of states’ total tax revenues in fiscal 2000, second only to personal income taxes.

Sales and use taxes

Sales and use taxes, a mainstay of state government finance, originated during the Great Depression, when the U.S. economy was based on agriculture and heavy industry. Mississippi, facing massive property devaluations, enacted the first sales tax in 1930. At that time, almost all transactions involved goods bought and sold face-to-face at physical places of business.

The *sales tax* is levied mainly on the sale of tangible personal property but also on some services. Unlike Texas, some states apply different sales-tax rates to different items. Businesses operating within a state collect tax on the total price paid by the customer and remit the revenue to the state. Sellers usually receive a discount as compensation for the cost of collecting the tax — in Texas, one-half of 1 percent of the tax due.

The *use tax*, usually equivalent to the sales tax, is levied on transactions via telephone, mail order, or the Internet in which the buyer and seller are not located in the same state. Sellers who have established a physical connection or “nexus” with distant states must collect and remit those states’ use taxes. Customers of out-of-state vendors without nexus are supposed to self-assess the tax on their usage of goods or services bought from those vendors and remit the taxes to the customers’ home states. Auditing capabilities allow states to monitor and enforce compliance to some extent on businesses and on expensive purchases. However, individual customers

rarely pay the use tax, and enforcement and collection are not feasible because of the difficulty and expense of tracking buyers without information from sellers.

All but five states — Alaska, Delaware, Montana, New Hampshire, and Oregon — levy a state sales tax. In fiscal 2000, states collected more than \$174 billion in general sales and gross receipts taxes (\$621 per capita), according to the U.S. Census Bureau. Sales taxes comprised about 33 percent of states’ total tax revenues — second only to personal income taxes at 36 percent — and about 11 percent of local tax revenues. In fiscal 2000, Texas collected more than \$14 billion in sales taxes (\$672 per capita), 51 percent of its total tax revenue. In only five states (Florida, Nevada, South Dakota, Tennessee, and Washington) did the sales tax account for a higher percentage of total tax revenue.

Texas enacted a 2 percent limited sales tax in 1961 (Tax Code, chapter 151). The Legislature has increased the rate seven times; the most recent hike was in 1990, from 6 percent to the current 6.25 percent. Five states have higher state sales-tax rates, the highest being Mississippi and Rhode Island at 7 percent. Local taxing jurisdictions in Texas may levy up to an additional 2 percent, for a maximum combined rate of 8.25 percent. Nine states have higher maximum combined rates, led by Oklahoma at 9.78 percent. Although many Texas communities have reached the maximum combined rate, the statewide average combined rate is 7.8 percent, according to the Sales Tax Clearinghouse.

More than 7,400 state and local jurisdictions levy some form of sales tax, and many more have the authority to adopt it. According to the Streamlined Sales Tax Project, the permutations include 10 states and Washington, D.C., with a single sales- and use-tax rate and no local-option sales/use taxes; two states with single-rate local-option sales/use taxes; six states with a single use-tax rate and multiple local-option sales-tax rates; 21 states, including Texas, with single-rate state sales taxes; and 29 states, including Texas, with multiple local-option sales/use tax rates. Alaska has local sales taxes but no state sales tax.

The National Conference of State Legislatures cites three trends diminishing the impact of the sales

tax. First, the U.S. economy is shifting from producing tangible goods to providing services, which are less likely to be taxed. For example, Texas imposes the sales tax on few professional services. Second, legislatures are exempting more and more specific goods and services from the tax. For example, Texas does not tax groceries or drugs and is among several states that grant a sales-tax holiday. Third, increases in cross-state sales by telemarketing, mail-order, and online companies not required to collect and remit use taxes are enabling more purchases to elude taxation.

Estimates of tax losses

The spectacular growth of e-commerce has refocused states' concerns about sales-tax revenue lost to remote sellers. Complaints about lost revenue and competitive disadvantage from untaxed sales by mail-order houses and catalog companies have given way to calls for state and federal legislation that would "level the playing field" for taxing sales by electronic and conventional "brick-and-mortar" retailers.

Supporters of taxing remote sales maintain that sales taxes should be collected on all taxable goods and services, regardless of how they are purchased. Out-of-state Internet or mail-order sales should not have a competitive advantage over sales by brick-and-mortar merchants, proponents say. They argue that remote sellers should have to collect use taxes in exchange for access to states' markets, since those taxes are legally due. Opponents warn, however, that taxation could stifle the growth of e-commerce and place its economic benefits in jeopardy. They claim that online merchants incur costs that "Main Street" stores do not, such as shipping and handling. They contend that a state should not collect sales taxes from businesses located outside its borders. Typically, they advocate tax-free Internet access as well.

E-commerce, though still in its early stages, is gaining importance as an engine of economic activity. The Center for Research in Electronic Commerce at the University of Texas at Austin monitors the growth of what it calls the Internet economy, defined as including infrastructure (hardware and networks), applications (software and

services), electronic intermediaries (brokers and portals), and online sellers. The fourth layer, the domain of e-commerce, includes online retailing, pay-to-use content, and business-to-business (B2B) transactions. B2B accounts for the bulk of e-commerce activity. The center's 2000 study, quoted in the House Ways and Means Committee's interim report to the 77th Legislature, estimated that e-commerce revenues jumped 72 percent in 1999, to about \$172 billion.

While e-commerce can be an economic boon to states, its borderless nature makes it something of a fiscal bane because of states' inability to tax remote sales — or even to measure their tax losses. In 2000, the Federation of Tax Administrators told *Congressional Quarterly* it was unaware of any reliable measure of taxes owed on Internet sales. A [June 2000 report by the U.S. General Accounting Office \(GAO\)](#), "Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain," noted the absence of comprehensive data on purchasers' compliance with use taxes (although the consensus was that compliance is low). "Even with better data, the rapid and fundamental nature of innovations in e-commerce means that policymaking regarding the tax treatment of Internet sales will be done in an environment of significant uncertainty," the report stated.

Not surprisingly, estimates of the size of potential tax losses vary widely. Nationally, the GAO projected tax losses related to e-commerce at between \$300 million and \$3.8 billion in 2000, depending on different sets of assumptions. The higher figure represents less than 2 percent of aggregate general sales-tax revenues (less than 5 percent for all remote sales). For 2003, the GAO projected losses of \$1 billion to \$12.4 billion.

For Texas, the GAO's loss estimates ranged from \$26 million to \$342 million in 2000 and from \$96 million to \$1.1 billion in 2003. The Comptroller's Office estimates that Texas lost \$350 million of state use taxes on taxable remote sales (mail-order and Internet) in fiscal 2001 and will lose \$370 million in fiscal 2002. Online sales are growing faster than sales in the overall sales-tax base, according to the Comptroller's Office.

Two University of Tennessee researchers have estimated total state and local tax losses on Internet

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sales. They increased their previous estimate for 2001 by 41 percent to \$13.3 billion and projected losses of \$45.2 billion by 2006. The study estimated Texas' losses at \$1.2 billion in 2001 and \$3.9 billion in 2006. Texas ranked first in projected losses as a percentage of total tax revenue: 3.8 percent in 2001 and 10.3 percent in 2006.

Utah Gov. Michael Leavitt, past president of the National Governors Association, advocates a voluntary, incentive-based e-commerce sales-tax collection system embraced by the Streamlined Sales Tax Project (see below). This approach, the so-called "zero-burden system," would rely on private companies to collect sales taxes for states through Internet-based automation. The idea is to create a mechanism to capture remote sales-tax revenue while relieving businesses of the burden of collecting the taxes.

Americans for Tax Reform (ATR), which opposes tax increases, ridiculed the Leavitt proposal for being based on unrealistic assumptions of growth in business-to-consumer e-commerce. ATR President Grover Norquist stated that sales-tax revenues nationwide grew 50 percent during the 1990s. "The idea that states are losing money to the Internet doesn't fly," he said.

Federal initiatives

As more states sought to tax Internet access and online sales, Congress exercised its authority over interstate commerce (see box, pages 6-7) in response to concerns that taxation would hinder the Internet's growth.

The Internet Tax Freedom Act (ITFA) of 1998 (P.L. 105-277, Title XI) imposed a three-year moratorium on new state or local taxes on Internet access, grandfathering existing taxes in about 10 states, including Texas. The act also prohibited multiple and discriminatory state or local taxes on e-commerce; for example, two states could not tax the same remote e-commerce sale without providing a credit. Only one state could tax an e-commerce transaction involving more than two taxing jurisdictions. Furthermore, electronic transactions had to be taxed in the same manner as similar "brick-and-mortar" transactions. In other words, states could not single out e-commerce for taxes not applicable to other sales activities, nor could they tax e-commerce at higher rates. Goods and services exclusively available online were exempt from new taxes.

Under ITFA, Internet access charges, such as a subscription to America Online, cannot be taxed except in the grandfathered states. The federal moratorium does not preclude state taxation of e-commerce, such as buying clothes online from Land's End, provided that the state can establish nexus with the seller.

According to David Hardesty, publisher of *E-Commerce Tax News*, ITFA has had little impact on taxation of Internet sales of tangible products. It is conceivable that states could implement new e-commerce taxes that meet the law's criteria. However, no state has changed its tax treatment of e-commerce substantively since the federal moratorium first took effect in October 1998, according to the Electronic Commerce Association.

Texas first imposed sales and use taxes on information services in 1987 and on data processing services in 1988. The comptroller later interpreted these tax-base changes to include Internet access services. In 1999, the Legislature separately defined Internet access services and partially exempted them from sales/use taxes. The \$25 exemption is prorated monthly, regardless of the billing period or whether access is bundled with other services. In fiscal 2001, Texas collected about \$39 million from this tax but gave up almost \$11.5 million to the \$25-per-month exemption, according to the comptroller's estimates. Texas also taxes other data processing and information services but exempts 20 percent of the total charges. Tax is due on the sale, lease, license, or installation of computer software, but not on the contracted customization of a computer program. These provisions appear in the Tax Code, chapter 151, and under Title 34 of the Texas Administrative Code.

Some have advocated a permanent ban on all taxes related to the Internet or on the sale of "digitized" goods — data, voice, video, music, images, or text converted to a digital format. Others have favored an extension of the tax moratorium, accompanied by details on what states must do to obtain interstate taxing authority. Some governors have urged Congress not to extend the ban.

In November 2001, Congress approved the Internet Tax Nondiscrimination Act (P.L. 107-75), renewing the moratorium contained in ITFA until November 1, 2003. An amendment failed that would have mandated congressional action allowing states to require multistate sellers to collect remote sales taxes if and when 20 states adopted a uniform, simplified sales-tax system.

The 1998 law also created the Advisory Commission on Electronic Commerce (ACEC) to study Internet and e-commerce tax issues. The 19-member panel of public officials and e-commerce industry executives included then-Dallas Mayor Ron Kirk and then-Virginia Gov. Jim Gilmore, an advocate of a tax-free Internet, as well as Leavitt and Norquist.

ACEC submitted a report to Congress in April 2000 but made few formal findings or recommendations because most of its votes did not produce the requisite two-thirds majority. Often splitting 11-1 with seven abstentions, ACEC representatives were divided largely along anti- and pro-Internet-tax lines. The majority favored ending taxes on all digitized goods and their non-digitized equivalents, permanently banning Internet access taxes, and broadening the amount and types of activities that e-commerce companies could conduct in a state without incurring tax liability. The minority argued that those policies would drain state revenues, harm conventional retailers, and penalize offline low-income consumers.

More than 125 academicians suggested that ACEC adhere to four tax principles for e-commerce:

- treat e-commerce identically to other commerce;
- tax remote sales by the state of destination, regardless of the vendor's physical presence;
- simplify tax laws and rules across states; and
- eliminate compliance burdens on small-volume sellers.

Multistate tax agreement

The Streamlined Sales Tax Project (SSTP) originated with proposals to ACEC by the National Conference of State Legislatures (NCSL), the National Governors Association, the Federation of Tax Administrators, and the Multistate Tax Commission, supported by other organizations representing state and local government. Disenchanted with ACEC's inability to produce workable solutions, these groups began recruiting states to join the SSTP. The project has grown to involve tax and revenue officials from about 40 states, including Texas.

The SSTP has been meeting since early 2000. Its goals are to find ways to enhance tax compliance and increase revenue by making tax collection easier on businesses, especially national firms physically located in only a few states but having customers in many states. Local government and the private sector have input but no vote.

In May 2000, the SSTP launched a pilot project to test automated compliance systems, the centerpiece of its approach. Using specially designed software, three companies are under contract to calculate, bill, collect, report, and remit sales taxes from participating retailers in Kansas, Michigan, North Carolina, and Wisconsin (see box, page 11).

The project also has drafted model legislation adopted by several states, including Texas, as well as a model multistate agreement. The legislation essentially commits states to the interstate compact, outlines tax-policy principles, and delineates basic elements of the envisioned compact. The multistate agreement contains the details of tax treatment that member states would have to implement by law before signing the compact. The SSTP opted to put tax-policy changes in a separate document to accommodate variations in states' tax laws.

The SSTP adopted the model agreement in December 2000 for legislative consideration. However, NCSL was concerned that some controversial provisions might hinder enactment. In January 2001, NCSL adopted an amended version that omitted several major sections. Shortly thereafter, the SSTP amended its version of the agreement to reflect many of NCSL's changes. At least four states have enacted some version of the agreement, but most have yet to consider it.

Twenty-seven states and the District of Columbia have enacted legislation — either drafted by the SSTP or NCSL or modified by their legislatures — authorizing their formal participation in the formation of an interstate sales-tax compact. They have organized themselves as the Streamlined Sales Tax Implementing States (SSTIS) for the purpose of finalizing an agreement leading to the compact. The SSTP continues to formulate proposals

In November, Congress renewed the federal moratorium on new taxes on Internet access and on multiple and discriminatory taxes on e-commerce.

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Nexus: A Moving Legal Target

Because sellers collect most sales and use taxes, the system generally works efficiently when buyers and sellers are in the same state. When sellers are out of state, however, their connections to taxing states, whether by their presence or activities, may be unclear or even nonexistent under the law. This concept of connection, or *nexus*, is the crux of constitutional restrictions on taxation of remote sales, whether they occur through e-commerce, catalogs and mail order, or telemarketing.

The U.S. Constitution, Art. 1, sec. 3, clause 3 — the so-called Commerce Clause — gives Congress exclusive jurisdiction over interstate commerce. The U.S. Supreme Court has construed this provision to mean that state laws cannot restrict interstate commerce, absent congressional authority. State tax laws also are subject to the Constitution's due-process and (to a lesser extent) equal-protection provisions of the 14th Amendment. The Due Process Clause prohibits states from depriving persons of property without due process of law. For tax policy purposes, the Commerce Clause relates to a tax's effect on interstate commerce and the national economy, whereas the Due Process Clause relates to the fairness of a tax's burden.

On the basis of due-process principles, the Supreme Court has established a "safe harbor" for remote vendors, in that state and local governments may not tax businesses that do not have nexus — "some definite link, some minimum connection" — with the taxing jurisdictions (*Miller Bros. Co. v. State of Maryland*, 347 U.S. 340 (1954)).

Three Supreme Court decisions have set the parameters within which states levying sales and use taxes and companies engaging in interstate commerce must operate. In *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967), the court struck down an Illinois law requiring a Missouri mail-order company to collect Illinois' use tax from its Illinois customers. Because its only presence in Illinois consisted of catalogs and advertising, either mailed or delivered to residents,

National Bellas Hess was found not to have sufficient nexus, as required by both the Commerce and Due Process clauses, for Illinois to compel the company to collect the state's use tax. The high court also held that the sheer complexity of state and local sales taxation would interfere with interstate commerce. Writing for the majority, Justice Potter Stewart stated:

The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government." The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.

The court reaffirmed states' right to tax interstate commerce in *Complete Auto Transit, Inc. v. Brady, Chairman, Mississippi Tax Commission*, 430 U.S. 274 (1977). In so doing, the court invoked a four-part test for the validity of state taxes under the Commerce Clause: (1) the interstate activity being taxed must have "a substantial nexus with the taxing state"; (2) the tax itself must not discriminate against interstate commerce; and the tax must be (3) fairly apportioned and (4) fairly related to services provided by the state.

The *Complete Auto* ruling formed the basis of a subsequent challenge to *National Bellas Hess*. North Dakota pursued a use-tax collection case against Quill Corp., a Delaware vendor of office equipment and supplies doing business in the state via mail order, catalogs, and telephone. The North Dakota Supreme Court interpreted *Complete Auto* as no longer mandating a company's physical presence for use-tax collection. The court also found that *Complete Auto*'s four-part test included the due-process requirement of minimal connection to establish nexus. North Dakota's economic climate and the vendor's economic presence there

generated sufficient nexus for the state to require collection of the use tax, according to the court.

In deciding *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court backed away from its requirement of physical presence to establish nexus under the Due Process Clause. The court retained its “minimum contacts” due-process test, provided that the vendor intentionally benefitted from a state’s economic market. The court agreed that Quill Corp. had a minimal connection to North Dakota by virtue of its business activities there and the benefits derived from its access to the state’s markets and services. However, the court reaffirmed physical presence as the relevant standard for the “substantial nexus” test required by the Commerce Clause, as set forth in *National Bellas Hess*. The near-unanimous opinion observed that the physical presence standard likely had contributed to the growth of the mail-order industry by creating a state use-tax exemption.

While acknowledging that case law on states’ authority to require collection of sales and use taxes was “something of a ‘quagmire,’” the high court noted that the removal of the due-process barrier allowed Congress to resolve the issue. Congress may not authorize violations of due process, the justices pointed out, but it may sanction laws that could affect interstate commerce adversely. “No matter how we evaluate the burdens that use taxes impose on interstate commerce,” Justice John Paul Stevens wrote, “Congress remains free to disagree with our conclusions.” The court noted past congressional efforts to overturn *National Bellas Hess* legislatively and invited Congress to do so again.

In response to the opening provided by *Quill*, Congress began considering legislation in 1994 to allow states to require remote sellers to collect use taxes under certain circumstances. Although *Quill* addressed mail-order sales, the implications for the fledgling digital economy were obvious.

Some identify the introduction of the Internet Tax Freedom Act in 1997 as the beginning of serious national debate about taxing the Internet and e-commerce. The resulting compromise was a three-year limited moratorium on state and local taxation of Internet access and on multiple and discriminatory sales and use taxes on

e-commerce. The act also created the Advisory Commission on Electronic Commerce (ACEC). While not barring state taxation of remote sales, Congress left intact the Supreme Court’s high legal hurdle of establishing “substantial nexus” before states can compel out-of-state vendors to collect use taxes on remote sales. ACEC’s failures, coupled with the potential created by *Quill* for changing sales-tax policy at the federal level, have provided much of the impetus for the current effort to simplify sales-tax administration.

The Supreme Court has not revisited nexus standards since *Quill*, nor has it clarified nexus requirements for e-commerce. Nexus remains a moving legal target because the precise level of physical presence required in the taxing state is unclear. For example, sporadic visits by employees or activity by agents have been deemed significant physical presence in some cases, while the presence of computer diskettes containing an out-of-state company’s software have not.

Texas law states that retailers are engaged in business in Texas if they earn rent from leasing tangible personal property located in the state (Tax Code, sec. 151.107(a)(3)). The state comptroller has determined that the presence of licensed software on computers located in Texas (and used by as few as 20 customers) is tantamount to a lease or rental of tangible personal property, resulting in nexus for sales and use tax purposes under Tax Code, sec. 151.009, and Texas Administrative Code, Title 34, sec. 3.308.

Some say that sales-tax simplification, if thorough enough, might be sufficient in itself to undo *Quill*. David Hardesty, publisher of *E-Commerce Tax News*, sees other legal possibilities. He believes that the “safe harbor” provided for business in *National Bellas Hess* was intended to apply only to companies with no physical presence whatsoever in a state. Hardesty also notes that the *Quill* court acknowledged that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.” That was 10 years ago, when the Internet was in its infancy.

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related to elements of the agreement, but in an advisory capacity to the SSTIS. Termed the “governing states” by NCSL, the SSTIS now controls the simplification process. Texas’ delegation comprises Sen. Troy Fraser, Rep. Dennis Bonnen, Legislative Budget Board Director John Keel, and Deputy Comptroller Billy Hamilton.

In 2001, the 77th Texas Legislature enacted HB 1845 by Oliveira (Van de Putte), NCSL’s version of the model act put forth by the SSTP. The law establishes a framework for a uniform sales-tax system and commits Texas to a set of principles on which it would be based. Twenty-six other states have approved the same or similar measures — Arkansas, Florida, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, Washington, Wisconsin, and Wyoming — as has the District of Columbia.

Specific provisions. In January 2002, the “governing states” tentatively approved a combined agreement on a uniform, simplified sales-tax administration system, containing provisions common to both the SSTP and NCSL versions. This established most of the proposed new system’s basic requirements, such as state-level tax administration and uniform registration, reporting, and filing. The preliminary document also includes the following major provisions:

- **Common local tax bases** through 2005 and identical state and local tax bases after 2005. In some states (relatively less so in Texas), the tax base varies among localities, or the state and local tax bases are different. Goods and services may or may not be taxable, or may be taxable at different rates, depending on where the sale occurs. Under the proposed agreement, local tax bases within a state initially would have to be identical to each other and eventually would have to mirror the state’s tax base. Uniformity of tax bases is considered essential to reducing complexity, but it can present fiscal and political problems among states that tax and exempt goods and services differently.

On a closely related issue, the SSTP originally proposed that each state apply a single rate for its state sales and use taxes to all taxable items. In some states, eliminating multiple state rates, coupled with

harmonizing all tax bases, could be tantamount to creating new taxes or repealing existing taxes, where state and local tax policies vary significantly. An NCSL amendment would give states more flexibility within tax bases by allowing them to levy a lower rate than the uniform rate (even zero), mainly on food, clothing, electricity, and natural gas. Though not as simple as a single statewide rate, this approach aims to prevent large revenue swings in the event that state and local governments must reconcile differences in their tax bases.

- **Centralized administration.** States that authorize local sales taxes would be responsible for receiving and distributing local as well as state revenues (Texas already does this). States also would have to maintain databases of all local rates, coordinated initially by zip code until development of an address-based system. Multiple rates between equivalent jurisdictions within a zip-code area would default to the lowest rate. Such a system would simplify remittance by businesses but would curtail local governments’ control of sales-tax administration.
- **Limitations on rate changes.** Rate changes could occur no more often than quarterly, only on the first day of a calendar quarter, and only with advance notice (as in Texas). Lack of notice, however, would not absolve sellers of their liability for collecting taxes. These limitations would reduce adverse effects on remote sellers but also would reduce states’ flexibility. Not holding sellers harmless for lack of notice would protect states’ revenue streams but would negate some of the benefit to sellers of not having to scrutinize statutory and administrative changes so closely.
- **Uniform, streamlined exemption administration.** Sales-tax exemption claim forms would be standardized electronically with no requirement for the purchaser’s signature. Sellers following proper procedures would not be liable for taxes if exemptions proved invalid. This would eliminate duplication of efforts by vendors across states but would require creation of a nationwide exemption database and tracking system.

Also, businesses buying digital products or services to be used in multiple locations would be eligible for a new exemption. For most states (including Texas), the multiple-points-of-use (MPU) exemption would

relieve sellers from collecting taxes. Buyers would have to remit taxes to the various taxing jurisdictions where they used their purchases. This approach would tax large software purchases for multiple sites more equitably, but it might pose enforcement problems in cases of noncompliance.

- ***Seller classification.*** Sellers would be categorized by the method of automated tax collection used: third-party outsourcing, certified software, or in-house programs. Allowing third-party “certified service providers” (CSPs) to contract with states and vendors and accept responsibility for sellers’ sales-tax compliance would represent a major policy shift. It would relieve sellers of liability for collection and payment, absent fraud or misrepresentation, except for levies on their own taxable purchases. Allowing flexibility in collection methods would encourage innovation, but introducing third parties into the collection process could complicate enforcement and might raise concerns about protecting consumer privacy and proprietary business information.
- ***Participation incentives.*** Sellers volunteering for the program would receive amnesty for any sales tax owed prior to registration. Member states could not use seller participation to establish nexus for taxation purposes. Uncertainties about tax administration across states make these provisions important to multistate vendors. States would relinquish some measure of enforcement power in exchange for collecting more revenues from remote sellers.

Vendors also would receive monetary allowances for collection costs. Only about half of the taxing states (including Texas) now allow sellers any cost reimbursement. Any vendor compensation (which would extend to CSPs) would come out of tax collections, which states hope would increase with greater participation.

The size of the allowances remains undetermined pending the outcome of the Joint Cost of Collection Study. A government-business task force is overseeing this first-ever major effort to determine the costs of seller compliance and third-party collection as well as any savings from tax simplification.

- ***Destination-based sourcing.*** Sourcing rules determine which jurisdictions tax a transaction and, consequently, what tax rates sellers apply. The agreement initially

would require taxation of purchases at the location where goods and services were received, delivered, or shipped, regardless of type, or else at the buyers’ known addresses. Telecommunications services would be temporarily exempt.

Using a single sourcing method in all taxing jurisdictions would streamline the assignment of tax rates. It would treat all sales the same, minimizing competitive disadvantages and adverse effects on business location. The European Union has adopted destination-based sourcing for its value-added tax. However, origin-based sourcing is more manageable for vendors, requires less information about purchasers, and may create fewer problems for states in establishing nexus.

In general, these provisions are designed to reduce the amount of information, number of forms, and levels of bureaucracy with which vendors must contend in order to comply with sales-tax laws and regulations. These factors are exacerbated for multistate sellers, especially small businesses engaged primarily or exclusively in e-commerce. Allowing contracts with CSPs using largely existing software would move sales-tax collection toward nationwide automation. Destination-based sourcing and the MPU exemption are tailored for e-commerce, especially involving digital products.

The overarching goal of a simpler, more uniform system is to persuade all remote sellers to collect sales and use taxes voluntarily. Although e-commerce still comprises only a fraction of retail sales, its sustained growth and revenue potential have motivated states to pursue these new sales-tax policies. Consensus has developed relatively easily on the proposals discussed above, but not on others.

Taxing issues ahead

Before endorsing an amended version in 2001, NCSL removed several controversial elements from the SSTP’s model agreement. These include the provisions on uniform definitions, rounding rule, and bad-debt deductions, as well as limitations on state and local caps, thresholds, and sales-tax holidays. The simplification effort being led by the SSTIS governing states is focusing on these more contentious issues. The most difficult decisions lie ahead, and some will affect Texas directly.

Transaction sourcing. Texas sales-tax laws and rules appear to comply with most of the key provisions of the governing states' combined agreement. One exception is sourcing. Currently, city and county sales and use taxes in Texas are based on origin of sale. This method is easier for most businesses, even though destination-based sourcing is more common in other states. The gist of the SSTIS proposal is to tax transactions where customers first take control of their purchases. Usually this occurs at a place of business, but not if the goods or services are delivered, shipped, bought online, or downloaded.

Converting all transactions to destination-based sourcing would result in reallocating revenues among local jurisdictions, according to the Comptroller's Office. This could mean tax losses for large cities or for mid-sized cities that serve as regional shopping hubs. For example, if a Plano resident buys a couch at a Dallas mall and takes it home, he or she owes sales tax to the City of Dallas under both current law and destination-based sourcing. However, if the seller delivered the couch to Plano or shipped it to Waco, the buyer would owe tax to one of those cities, rather than to Dallas, under destination-based sourcing.

Tax base uniformity. For the most part, state and local tax bases in Texas are similar. Notable exceptions involve residential utility services, which the state does not tax but some cities do, and telecommunications services, which some local jurisdictions exempt. One of the simplified rate provisions in the SSTIS agreement could affect some local jurisdictions adversely.

Until an address-based rate-tracking system could be developed, states would have to use a system based on zip codes. They would have to develop databases assigning each five- or nine-digit zip code in the state to the appropriate tax rates and jurisdictions. In case of multiple rates within a zip-code area, the state would have to default to the lowest combined rate. Jurisdictions with higher rates would lose revenue. This approach is designed to facilitate destination-based sourcing by helping sellers pinpoint applicable rates.

Limiting exemptions. Another potential compliance issue for Texas is limiting and standardizing sales-tax caps, thresholds, and value-based exemptions. The purpose would be to reduce complexity and simplify tax collection across states. However, these provisions could require curtailing or eliminating the annual sales-

tax holidays that Texas and other states have allowed in recent years.

Since 1999, Texas consumers have paid no sales tax during the first weekend in August when buying most non-athletic apparel priced under \$100. The 2001 sales-tax holiday cost about \$38.6 million in tax revenue — \$30.5 million state and \$8.1 million local — according to the comptroller's estimates. No local jurisdictions exercised the law's opt-out provision in 2001.

During the SSTP's deliberations, Texas voted against eliminating the sales-tax holiday because of its popularity with retailers, who say it has attracted more customers. Several lawmakers and Comptroller Carole Keeton Rylander have proposed expanding the holiday. Some analysts believe that remote sellers may be able to handle sales-tax holidays under the new system if the agreement defines exempt items specifically. The SSTP also is proposing that SSTIS consider an alternative that would limit but not end the holidays.

Similar restrictions could affect the partial exemptions for taxes on data processing and information services and Internet access, as well as the phased-in tax reductions for timber operations (Tax Code, sec. 151.3162). Timber producers can take partial, graduated tax credits or refunds for operational expenses based on the value of the timber they produce; the expenses become fully exempt in 2008. If the proposed uniform limits were approved, Texas would have to tax these goods and services fully or else exempt them altogether.

Defining taxable goods and services. While states would retain discretion over the specific goods and services they tax and exempt, uniform definitions could affect state tax bases somewhat. For example, differences could arise between how the multistate agreement and Texas law categorize clothing, possibly affecting the sales-tax holiday, or how they define food or food sold for immediate consumption. Also, if the definition of software included contract customizing of computer programs, Texas would have to tax those services along with "canned" software.

Exemption administration. Allowing sellers to accept purchasers' sales-tax exemption claim forms electronically without signatures could require a change in the Texas statute regarding resale certificates (Tax Code, sec. 151.152). However, according to the Comptroller's Office, listing exempt entities and direct-pay permit holders

Going for the Gold

Rewriting two dozen states' tax codes is one thing; collecting all their sales and use taxes is another. The current multistate tax proposal hinges on the ability of third parties called certified service providers (CSPs) to design and operate computer systems that can handle businesses' in- and out-of-state transactions. The systems must be able to apply each state's tax base, rate, and sourcing regulations to each purchase, compute the correct amount of state and local taxes owed, and transfer the revenue to the appropriate state treasury or tax agency.

In 2000, the Streamlined Sales Tax Project (SSTP) chose three companies to conduct a pilot project to collect sales and use taxes for four of the participating states. Taxware International of Salem, Mass. (subcontracting with Hewlett-Packard), was the first to launch its portion of the project. Since October 2001, the commercial tax software developer has calculated and remitted sales taxes to Kansas, Michigan, and North Carolina for one of its clients, Salt Lake City-based O.C. Tanner Co., which made the medals for the 2002 Winter Olympics.

Taxware is testing a configuration similar to the SSTP's third-party outsourcing concept for CSPs. The company links to Tanner's in-house software by means of a remote Internet server that receives all of Tanner's online sales transactions. A Taxware program segregates sales unique to the pilot project, calculates taxes due, relays the information back to Tanner's web site, and debits Tanner's account for the revenue sent to the pilot states. Taxware also files tax returns, generates reports,

and is subject to any tax audit. Tanner no longer has to obtain certificates from tax-exempt purchasers in pilot states because the requisite data are incorporated into Taxware's software and processed at time of purchase.

Taxware announced on March 7 that it had processed the first electronic sales-tax payments to Kansas, North Carolina, and Michigan. No stumbling blocks have arisen so far, according to Jon Abolins, Taxware's vice president of tax and government affairs, and SSTP Steering Committee Co-chair Diane Hardt of Wisconsin's Revenue Department. Abolins identified two main technological challenges facing automated collection: compatibility of operating systems (working with different platforms, such as Windows and Macintosh) and integration of third-party collection programs with retailers' software configurations.

The project is based on existing state sales-tax laws. Because any new automated collection system must incorporate all changes in sales-tax laws, Abolins said the true test will be scalability — moving from a handful of sellers to thousands. Coordination among vendors, CSPs, and taxing entities also will be paramount.

SSTP officials and governing states' delegations got their first glimpse of the brave new sales-tax world at a presentation during their mid-March meeting in Dallas. Taxware and two other contractors, esalestax.com and Pitney-Bowes, processed actual transactions in real time, reportedly with varying degrees of success.

(high-dollar buyers who remit sales taxes themselves) on the comptroller's web site could relieve sellers administratively of their legal responsibility to act in good faith when handling tax-exempt sales (Tax Code, sec. 151.054 and Texas Administrative Code, Rule 3.287). Verification of exemptions would be automated rather than based on sellers' obtaining certificates from buyers. Thus, a vendor no longer could be forced to pay sales taxes owed by a purchaser with an invalid certificate on the basis of an assertion that the seller knew or should have known it was invalid. This measure would lessen sellers' responsibilities related to tax collection and would remove their liability for uncollected taxes.

Outlook for an agreement

The governing states continue meeting this spring to adopt uniform definitions and rules. Some officials hope that a final vote on the multistate agreement could come as early as June. Final adoption requires a three-fifths majority vote.

In its present form, the agreement would take effect when five states certified their compliance with it and signed it. They would have to conform their existing tax laws and rules to the agreement's provisions and verify that the other states had done likewise. A three-fourths

majority vote of the initial states and subsequent member states would be required for admittance to the compact. The member states would organize themselves to govern compliance with and interpretation of the agreement.

In the meantime, the agreement remains a work in progress. In fact, hammering out its precise final language could take years. Also, subsequent court rulings could produce some variation in actual practices from state to state. The legislatures of all governing states must decide whether to make certain tradeoffs. The question is whether states' potential gains from collecting taxes on remote sales would outweigh any revenue they would lose by amending their sales-tax codes.

Under the U.S. Constitution, as most recently interpreted by the U.S. Supreme Court, states cannot force out-of-state sellers to collect their sales or use taxes without congressional authorization. Any multistate agreement would apply solely to states that pledged to conform their tax laws to its provisions and to cooperate with each other. The agreement itself would not affect directly any state's laws nor, for that matter, any vendors.

Member states would interpret and enforce the agreement. Individual states would continue to administer their own tax laws, subject to judicial review.

Some view the uniformity effort as an attempt to preempt federal legislation that might diminish states' taxation powers or mandate unfavorable tax policies. Congress might be less likely to preempt or restrict state taxation of remote interstate sales because, in the present form of the agreement, the program enacted by the governing states would be voluntary for vendors. Moreover, consensus by the taxing states on a multistate compact might persuade Congress to authorize states to mandate collection of sales taxes by remote sellers outside states' borders.

If states can resolve the remaining, and most complex, issues satisfactorily, they could realize significant revenue gains. Vendors could find sales-tax collection much easier and less costly, especially on Internet and mail-order sales. But the notion of a tax-free Internet could be lost in cyberspace.

— by *Patrick K. Graves*

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