

**Report Card  
on the  
Streamlined Sales Tax  
Implementing States'  
Agreement**

**October 11, 2002**

**Prepared by**

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## Framing the Question

The delegates to the Streamlined Sales Tax Implementing States (SSTIS) have spent the last year reviewing the recommendations of the Streamlined Sales Tax Project (SSTP) and have developed an Agreement which will be voted on by the SSTIS during its November 2002 meeting. This Agreement, if legislatively adopted by the states, will define the manner in which businesses collect and pay sales and use tax throughout the country. In some states the Agreement will require minor changes; in others, radical modifications of the sales and use tax law will be necessary for compliance. In all states the Agreement would represent a major step towards a uniform and simpler sales and use tax structure. The question arises then whether the sales tax structure under the Agreement is sufficiently simple and uniform to justify congressional action permitting conforming states to require remote vendors to collect their sales and use tax. If so, it is essential that Congress simultaneously act to protect remote businesses from states' overreaching imposition of business activity taxes.

The Council On State Taxation (COST) issued its first report card on the SSTP's recommendations in November, 2001. That report card identified COST's standard for requiring remote vendors to collect sales and use tax and evaluated each of the SSTP's proposals against the standard. Since November 2001, the SSTIS has made many modifications to the proposals. COST is now reissuing its report card to indicate whether the SSTIS Agreement meets the standard of radical simplification, to identify areas of concern that remain, and discuss the relationship between business activity tax nexus standards and sales tax collection by remote vendors.

**Sales Tax Simplification**—While the sales tax should be nondiscriminatory – i.e., imposed on similarly situated vendors and goods, the remote vendors must not be subject to the burden imposed by thousands of taxing jurisdictions with thousands of disparate rules. Only if states have a truly simple, uniform system can remote vendors be required to collect their taxes. Radical simplification of the current sales tax is therefore required before Congress should consider removing existing limitations on the authority of states to require remote vendors to collect sales and use tax. The SSTIS Agreement defines the level of simplification and uniformity required of states in a voluntary collection system.<sup>1</sup> Should Congress consider making this system mandatory it must require states to meet the radical simplification standard and must uphold the standard over time by imposing an independent review of state compliance. The report card therefore indicates the necessity for federal oversight of state compliance with and governance of the Agreement should Congress require remote vendors to collect sales and use tax.

The report card compares the SSTIS Agreement with COST's Policy Statement on Simplification of the State and Local Sales and Use Tax System. The report card judges whether the requirements of the Agreement provide radical simplification of the current sales and use tax structure. In some instances the report card indicates that work is still being performed or that the assigned grade would change pending methods chosen to implement the requirement.

**Radical Simplification**— The word "radical" is used throughout this document because it conveys the level of change necessary to simplify the extraordinarily complex sales tax system we have today. As noted by Utah Governor Michael Leavitt, "The existing system is a mess...[and] it needs to be radically simplified."<sup>2</sup> According to Webster, "radical" means: fundamental; marked by a considerable departure from the usual or traditional; tending or disposed to make extreme changes in existing institutions.

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<sup>1</sup> The current Agreement anticipates that remote vendors will voluntarily collect sales and use tax for each member state if that state's laws are consistent with the Agreement and the state provides a reasonable level of vendor compensation.

<sup>2</sup> Congressional Advisory Commission on Electronic Commerce, September 15, 1999.



**The Relevance of Business Activity Tax Nexus Standards**—Should Congress act to remove existing limitations on the authority of states to require remote vendors to collect sales and use tax, it is essential that it also formally recognize that a State has no right to impose a business activity tax on any business that does not have a physical presence in that jurisdiction. Businesses are concerned that the elimination of current protections for sales tax collection would encourage and abet the already inappropriate state efforts to impose business activity taxes on out-of-state companies with no physical presence in the state. To prevent overreaching by states, Congress should specifically recognize that states may not impose a business activity tax on a business unless that company has substantial nexus as a result of physical presence in the State (i.e., when the company is receiving the benefits and protections offered by the state). Sales tax simplification and the propriety of requiring remote vendors to collect sales tax cannot be evaluated in a vacuum. Should Congress choose to address sales tax collection responsibility, it must consider and address the implications for business activity tax nexus. This report card does not seek to evaluate current proposals for business activity tax nexus clarification; it simply articulates the need for congressional resolution of the business activity tax nexus issue along with sales tax collection responsibility.



## **Simplification of the State and Local Sales and Use Tax System**

### **Policy Position of 2001-2002**

**Position:** *A sales and use tax should be easily administered by both vendors and taxing authorities, widely understood by consumers, and nondiscriminatory between similarly situated vendors and goods. State governments relying on a sales and use tax should make it a priority to ensure these criteria are met.*

**Explanation:** The existing state and local sales and use tax system is widely recognized as unnecessarily complex and burdensome by representatives of state and local government and business. This unnecessary complexity imposes real costs on vendors, states, and consumers. A simple sales tax system offers the potential to increase state revenue, reduce tax rates for consumers, reduce administrative burdens for both business and the states, and increase voluntary compliance.

A simple sales and use tax system would have the following characteristics:

- **Neutrality** – Taxability should be independent of the method of commerce used in a transaction.
- **Efficiency** – Administrative costs should be minimized for both business and government.
- **Certainty and Simplicity** – Tax rules should be clear and simple.
- **Effectiveness and Fairness** – Taxation systems should minimize the possibility of evasion.
- **Flexibility** – Taxation systems should keep pace with changes in the economy.

A simple sales and use tax system would incorporate the following elements\*:

- **Uniform Tax Base Definitions** – A uniform set of simple definitions from which individual states would determine their tax base.
- **Uniform Exemption Rules** – Removal of the good faith requirement for a vendor accepting an exemption certificate and allowance of a uniform, electronic exemption certificate.
- **Uniform and Centralized Administration** – A centralized, multistate vendor registration system; uniform tax returns and remittance forms; filing dates timed to allow collection of all relevant information; adequate notice of changes in law (at least 90 days); uniform audit procedures; uniform refund forms and procedures; and state administration of all local taxes.
- **One Rate and Base Per State** – Substantial rate simplification—preferably one rate per state—and a single tax base per state (including local taxes) that applies to taxable transactions in the state.
- **Uniform Sourcing Rules** – Uniform, simple rules sourcing transactions, with certain exceptions, on a destination/delivery basis. Where the destination/delivery location is unknown, sourcing rules should be based on information available to the vendor through its regular business activities with the consumer.
- **Bad Debt Deduction/Refund** – Uniform rules allowing a bad debt deduction/refund to vendors, assignees, or other third parties.
- **Uniform Direct Pay Permits and Registration Requirements.**
- **Technology Certification** – Uniform and technology-neutral procedures for certification of software that vendors may rely upon to determine their sales and use tax obligations.
- **Hold Harmless** – Elimination of liability for over or under collection of tax for vendors relying on state data or state-certified software.
- **Vendor Allowance** – Reasonable compensation to all vendors for their actual collection costs, to be determined by a study designed jointly by business and the States.

*\*This policy addresses the sales and use tax system as it impacts typical vendors selling consumer goods to individuals for personal use or consumption. Elements different from these may be useful or necessary in the context of business purchases.*



## **Jurisdiction to Tax—Constitutional**

### **Policy Position of 2001-2002**

**Position:** *In order for a State to impose a business activity tax on a business, that business must have a physical presence in that State.*

**Explanation:** There currently is a great amount of discussion and debate throughout the tax community, in the Congress, and elsewhere regarding the appropriate extent of state and local tax jurisdiction. This issue has become increasingly important in recent years due to the significant changes in the economy brought about by electronic commerce.<sup>1</sup>

Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens—economic as well as administrative—only on businesses that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means that businesses that are not present in a jurisdiction and are therefore not receiving any benefits or protections from the jurisdiction, should not be required to pay tax to that jurisdiction.

In the area of sales and use tax, the U.S. Supreme Court has ruled that substantial nexus requires physical presence. Although the Court has not made any similar ruling in the area of business activity taxes, numerous state courts at all levels have affirmed that the nexus standard for business activity taxes can be no less than the standard for sales and use tax.

Governments and taxpayers should work together to enact bright line nexus rules explaining both constitutional and practical nexus guidelines.

“Business activity tax” refers a to tax imposed directly on businesses and not generally passed directly on to consumers, such as corporate income taxes, franchise taxes, single business taxes, capital stock taxes, net worth taxes, gross receipts taxes, and business and occupation taxes.

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<sup>1</sup> The appropriate extent of state and local tax jurisdiction was discussed at length during the proceedings of both the National Tax Association’s Communications and Electronic Commerce Tax Project (1997-99) and the federal Advisory Commission on Electronic Commerce (1999-2000).



## Obligation to Collect State and Local Sales and Use Taxes

### Policy Position of 2001-2002

**Position:** *If Congress chooses to remove existing federal limitations on the authority of States to compel remote vendors to collect sales and use tax, Congress should also: (1) require the States to radically simplify and reform the sales and use tax system for all vendors; and (2) formally recognize that a State has no right to impose a business activity tax on any business that does not have a physical presence in that jurisdiction.*

**Explanation:** There has been a tremendous amount of rhetoric and misinformation in the popular press about whether sales over the Internet are subject to state and local sales and use tax. The current law is succinct: vendors having a physical presence ("substantial nexus" as defined in *Quill*<sup>1</sup>) in a state must collect and remit sales tax on all taxable sales in that state, and consumers are required to pay a use tax on all taxable purchases on which no tax was collected by the vendor. The law makes no distinction in tax application based on method of sale, whether in a store, through a catalogue, or over the Internet.

Remote vendors—vendors that do not have such physical presence in a state—are not required to collect sales or use tax for that state. States cannot compel remote vendors to collect sales or use tax on their behalf, in part, because the existing sales and use tax system is sufficiently complex as to constitute an unreasonable burden upon interstate commerce and, in part, because existing law has engendered substantial reliance by taxpayers.

The Congress has the authority to remove this existing limitation and allow states to compel remote vendors to collect and remit use tax. If Congress chooses to exercise such authority, it is appropriate for Congress to address the other issues raised in the *Quill* decision. First, Congress should require the states to radically simplify the sales and use tax system for all vendors, thus removing the existing unreasonable burden upon interstate commerce.<sup>3</sup> Second, Congress should formally recognize that a State has no right to impose a business activity tax on any business that does not have substantial nexus with that jurisdiction.<sup>4</sup>

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<sup>1</sup> *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

<sup>3</sup> Please see *Simplification of the State and Local Sales and Use Tax System*, COST Policy Position of 2001-2002.

<sup>4</sup> Please see *Jurisdiction to Tax—Constitutional*, COST Policy Position of 2001-2002.



## **COST Report Card on the Streamlined Sales Tax Implementing States' Agreement**

*October 11, 2002*

COST commends the state government executive branch officials participating in the Streamlined Sales Tax Project (SSTP) and the delegates to the Streamlined Sales Tax Implementing States (SSTIS). This simplification effort has gone further and made a more sincere effort to simplify our complex sales and use tax system than have all previous groups that have grappled with this issue. State officials have listened to COST's concerns and have modified many of their proposals as a result of these comments. We recognize the genuine effort that state participants have made and applaud it.

The following report card evaluates the difficult substantive and administrative issues that must be addressed to realize a truly simple and uniform sales and use tax system. The tax simplification proposals included in the SSTIS version of the Agreement, which will be voted on during the November 2002 meeting, are compared against COST's policy position on state and local sales and use tax simplification. The provisions of the Agreement which govern the interstate compact aspect of this effort are analyzed based on COST's experience and understanding of similar multistate efforts, both tax and non-tax.

We have graded the various elements within each category on an A-F scale. The following is a description of the meaning behind each grade:

- A—Radical simplification
- B—Significant simplification
- C—Some simplification
- D—Insignificant simplification
- F—Not addressed by the Agreement, no simplification, or new complexity
- INC—Addressed by the Agreement, but too early to grade

What constitutes an acceptable grade? From the standpoint of simplification alone, any grade better than "D" indicates an improvement over the current system and thus ought to receive consideration. Thus, under a voluntary system, COST would support any real state effort to reduce complexity in the sales tax arena. If the context is not simplification for its own sake but instead Congressional legislation to permit states to impose a sales tax collection obligation on remote sellers, then a grade of B+ or better—meaning radical simplification—is necessary.



Category	COST Policy Statement	Previous Grade	Current Grade	Comments on Current SSTIS Agreement
Uniform Tax Base Definitions	A uniform set of simple definitions from which individual states would determine their tax base.	INC	B	The Agreement includes product definitions for items typically sold at retail for final consumption. Although the definitions result in occasionally ludicrous results (i.e., candy does not include licorice), they provide bright-line guidance necessary for retailers to make taxability decisions. The Agreement requires that member states develop and provide retailers with a taxability matrix, which, if used, will hold them harmless. The Agreement however does not require that states adopt definitions by statute and requires only that each states' law use <i>substantially</i> the same language as that adopted by the SSTIS. Numerous definitions, including "digital goods," are still under development. This grade would change from B to F if these definitions are overbroad. The Agreement also fails to adequately discourage states from using simplification as a justification for expanding their tax base.
Uniform Exemption Rules	Removal of the good faith requirement for a vendor accepting an exemption certificate and allowance of a uniform, electronic exemption certificate.	A	A	The Agreement provides radical simplification of exemption administration by eliminating the good faith requirement, shifting the burden to the states to monitor improper claims of exemption. This grade would change from A to F if the states implement the new exemption system by requiring vendors to keep, electronically, line-item detail on every exempt purchase.
Uniform and Centralized Administration	A centralized, multistate vendor registration system; uniform tax returns and remittance forms; filing dates timed to allow collection of all relevant information; adequate notice of changes in law (at least 90 days); uniform	A-	B / INC	The Agreement provides significant simplification of sales tax administration. While many of the implementing details have not been resolved, the Agreement provides a basic framework for administration that could significantly ease the burden on multistate sellers. Our grade would change from B to F based on the quality of implementation



	audit procedures; uniform refund forms/procedures; and state administration of all local taxes.			of the administrative provisions; specifically, the Agreement lacks current funding for administrative processes and standards are not yet developed for audits, returns, and centralized registration. The Agreement protects sellers from imposition of business activity taxes based on the sellers' registration, but not their <i>activities</i> during registration, under the Agreement. Congress should not require remote collection if the states fail to adequately fund and implement the administrative simplifications.
One Rate Per State	Substantial rate simplification--preferably one rate per state (including local taxes)--that applies to taxable transactions in the state.	C+	B-	The Agreement limits local taxing jurisdictions to a single tax rate, constrains their ability to change rates without proper notice, and eliminates all caps and thresholds unless their burden is borne by the consumer (except under sales tax holidays). The Agreement limits states to a single sales tax rate on tangible personal property and allows states to have a second rate only on food or drugs. While a single rate per state is preferable, it is unlikely that some of the larger states could participate if such a rule were adopted. The Agreement provides for a uniform rounding rule and makes tax boundaries coincident with nine-digit zip code boundaries. These simplifications could be improved by restricting state rate changes similar to local rate changes, mandating five-digit zip code jurisdictional boundaries or mandating a single tax rate per state (including local taxes). Congress should not require remote collection until the states have developed address-based jurisdictional databases and after the phase-out on caps and thresholds is complete.
One Base Per State	A single tax base per state (including local taxes) that applies to taxable transactions in the state.	B	B / INC	The Agreement requires state and local tax bases to be identical by 2006. While such a phase-in may be necessary in a voluntary agreement, Congress should



	to determine their sales and use tax obligations.			sales tax responsibility. Unfortunately, the software certification standards remain undefined. Reasonable vendor compensation (see below) must still be addressed to compensate vendors who have invested in such systems.
Hold Harmless	Elimination of liability for over or under collection of tax for vendors relying on state data or state-certified software.	B-	A-	The Agreement protects vendors from liability for under-collected tax and now provides a remedy for customers who have been over-charged sales or use tax, requiring customers to utilize a specific procedure to seek a return of the tax before filing a class-action suit against the seller. In addition, the Agreement creates a presumption that a vendor's use of a certified system constitutes a reasonable business practice, making it more difficult for consumers to bring frivolous class-action suits. In summary, the Agreement radically simplifies the burden on vendors by holding them harmless from under-collection and providing protection for vendors who have inadvertently over-collected tax. The Agreement could be improved by requiring member states to allow customers the right to obtain a refund from the state.
Vendor Allowance	Reasonable compensation to all vendors for their actual collection costs, to be determined by a study designed jointly by business and the States.	INC	F / INC	The Agreement fails to explicitly mandate reasonable vendor allowance for all vendors based on the findings of the Joint Collection Cost Study (JCCS). Were it not for the SSTP's participation in the JCCS, this category would receive a straight F. Congress should not require remote collection without requiring that vendors receive a reasonable allowance. The cost of credit card processing alone is at least 2.5% - 3% and could be adopted today as a minimum base for vendor compensation. Because any vendor allowance should also be based on the complexity of the sales tax system, a mandated allowance should provide a built-in incentive to further reduce residual complexity.



				not require remote collection until the phase-in is complete. States should also be prohibited from moving complexity out of the sales tax to transaction taxes not covered by the Agreement. Congress should not require remote collection if the states simply shift the complexity to new taxes. Rules for bundling, allocation of discounts, shipping and handling, and treatment of returns are not complete. Congress should not require remote collection until these issues are resolved.
Uniform Sourcing Rules	Uniform, simple rules sourcing transactions, with certain exceptions, on a destination/delivery basis. Where the destination/delivery location is unknown, sourcing rules should be based on information available to the vendor through its regular business activities with the consumer.	B+	B+	The sourcing rules in the Agreement represent a significant advance over current practice by providing uniformity in a critical area. These rules would benefit from clarifying any due diligence standards relating to the maintenance of addresses in general business records; and clarifying that payment processors and other third party participants in a transaction are not required to provide information to the vendor for sourcing purposes.
Bad Debt Deduction/Refund	Uniform rules allowing a bad debt deduction/refund to vendors, assignees, or other third parties.	B	B	Uniform provisions for bad debts are a necessary part of simplification, and the Project worked closely with industry to find the least objectionable language possible. As a matter of policy, though, the bad debt provisions remain inequitable in that they do not require bad debt assigned to a third party to be treated in the same way as debt held by the original vendor.
Uniform Direct Pay Permits and Registration Requirements	Uniform direct pay permits and centralized registration should be required.	INC	A	The Agreement requires member states to allow businesses to direct pay their sales tax liability on their own purchases. The Agreement also provides for a single point of registration. Each of these requirements constitutes radical simplification.
Technology Certification	Uniform and technology-neutral procedures for certification of software that vendors may rely upon	C	B / INC	The Agreement allows for certification of proprietary software in addition to certification of third party service providers who can administer a vendor's



Governance	Not separately addressed by COST policy statement.	F	A-/ INC	The Agreement contains an acceptable governance mechanism, keeping in mind that the Agreement is currently a voluntary association of states and vendors. Congress should not require remote collection without providing for federal oversight of state compliance and governance of the Agreement. The current system allows taxpayers and interested government groups to have input into the decision making process; open meetings and public comment are required. While the current Agreement provides a solid, basic structure for governance, our grade would change from A- to F based on the quality of implementation. Without adequate state funding the governance mechanism will not work. Further, because the governance provisions are written for a voluntary Agreement, and should be rewritten if Congress mandates collection by remote vendors, we have indicated that the governance structure for a mandatory system is incomplete. Congress should not require remote collection without defining a governance model that provides for limited but meaningful federal oversight.
Interpretation	Not separately addressed by COST policy statement.	F	A-/ INC	The Agreement contains an acceptable mechanism for taxpayers to obtain interpretations of definitions or other provisions of the Agreement itself. Any person may request an interpretation or request that additional definitions be developed. While the current Agreement provides a solid, basic structure for issues of interpretation, our grade would change from A- to F based on the quality of implementation. Without adequate state funding the interpretation mechanism will not work. Further, because the interpretation provisions are written for a voluntary Agreement, and should be rewritten if Congress mandates collection by remote vendors, we have



				indicated that the interpretation structure for a mandatory system is incomplete. Congress should not require remote collection without defining an interpretation process that will resolve questions on a timely basis without drastically infringing on state sovereignty. Limited but meaningful federal oversight is necessary to ensure timely uniform application of interpretations.
Issue Resolution Process	Not separately addressed by COST policy statement.	NA	A-/ INC	Questions of state membership, matters of compliance, the possibility of sanctions, and issues of amendments and interpretation of the agreement, including differing interpretations among member states, can be brought by any person before an issue resolution process. This process includes independent review by a neutral third party or non-binding arbitration. While the current Agreement provides a solid, basic structure for issue resolution, our grade would change from A- to F based on the quality of implementation. Without adequate state funding the issue resolution process will not work. Further, because the issue resolution provisions are written for a voluntary Agreement, and should be rewritten if Congress mandates collection by remote vendors, we have indicated that the issue resolution procedures for a mandatory system are incomplete. Congress should not require remote collection without defining an issue resolution model that provides for limited but meaningful federal oversight.
Replacement Taxes	Not separately addressed by COST policy statement.	NA	F	The Agreement fails to discourage member states from shifting sales tax complexity into other transaction taxes. For example, Minnesota generally exempts clothing but taxes clothing made from fur. Because the Agreement does not provide a separate definition for clothing made from fur, Minnesota had



				to exempt such items from sales tax if it wanted to continue to exempt clothing. The State's "solution" was to create a separate "fur tax" identical to the previous sales tax. The Agreement also allows states to exclude certain sales taxes from coverage. Alabama has indicated that it will exclude its rental tax from the provisions of the Agreement. The result is additional complexity and the potential for double taxation. The Agreement fails to prohibit states from employing tactics so contrary to the goal of simplification.
Expansion of Tax Base	Not separately addressed by COST policy statement.	NA	C	The Agreement fails to discourage member states from using simplification as a reason for expanding their tax base. While the Agreement itself, and utilization of the uniform definitions required by the Agreement will undoubtedly have some minor revenue impact, and states are within their sovereign right to achieve revenue neutrality by increasing taxes or expanding the base, states should avoid the temptation to raise additional revenue by expanding their tax base as part of the simplification effort. The Agreement currently indicates that it is not the intent of the Agreement to indicate whether states should tax or exempt any particular product. This language should be strengthened to discourage states from expanding their tax base under the guise of simplification unless required incident to complying with the Agreement.