

Proposed Findings and Recommendations of the Remote Sales Tax Collection Study Committee

Pursuant to House Joint Resolution No. 176

Submitted by Steve DelBianco, Citizen Member

Background:

Virginia's General Assembly is considering whether the Commonwealth should support the creation of a multi-state tax compact designed to increase collection of sales and use taxes on interstate, or remote, retail sales. This compact is the product of the Streamlined Sales Tax Project, or SSTP. SSTP is supported by many states who have adopted, to varying degrees, the Streamlined Sales & Use Tax Agreement, or SSUTA. The SSTP has a clear mission: to simplify the burdens of collecting remote sales taxes in order to persuade the Congress to force sellers in every state to collect and remit sales tax to any state that complies with SSUTA.

Virginia is currently a "Participating State" in the SSTP. The SSTP has not convened its ultimate governing body, since no states have yet achieved compliance with the SSUTA. Instead, the project created an interim committee of "conforming states" whose laws and rules are substantially in conformance with SSUTA. Virginia continues to participate in SSTP and can influence SSUTA policies to benefit Virginia's economic interests.

In its authorizing legislation, this committee was charged to address three questions surrounding Virginia's consideration of whether to adopt the SSUTA:

In conducting its study, the joint subcommittee shall determine the amount of revenue the Commonwealth would generate and the impact on small businesses within the Commonwealth if the Commonwealth collected taxes on remote sales; and the ability to use the lack of a requirement to collect remote sales as a marketing tool.

Below are proposed Findings and Recommendations for this committee.

Findings:

Sales & Use Tax Compliance:

The scope of sales and use tax compliance today – or how much additional compliance might be achieved through a national, mandatory system – must be carefully analyzed. Particularly in the case of e-commerce, there are important distinctions that help determine whether Virginia should transform its tax laws, surrender some control over its tax policy to an interstate governing body of un-elected tax administrators, and potentially lose competitive advantages to reach for additional sales tax revenues.

1. According to the widely-cited July 2004 study by the University of Tennessee, 1.3 trillion dollars of e-commerce was conducted in the United States in 2003. 93% of this e-commerce was in business-to-business (B2B) transactions. Of this B2B e-commerce, the study reports that 43% is exempt from sales tax, and 73% of the rest *is already fully taxed* since businesses already have a high compliance rate for use taxes. The bottom line here is that 9 of every 10 dollars in e-commerce is business-to-business, where there is little in incremental collections to justify a dramatic transformation of Virginia's sales tax system.

2. The remaining one-tenth of e-commerce is business-to-consumer (B2C) transactions. The latest University of Tennessee study estimates that 20% of B2C e-commerce is tax-exempt (e.g., Virginia does not impose sales tax on online services, content, and software). The study concludes that sales tax is already collected on 40% of the taxable B2C sales, largely by online retailers who already have to collect wherever they also have a physical presence (also by businesses like Dell, who voluntarily collect Virginia sales taxes so they can sell computers to the Commonwealth). The University of Tennessee figure agrees with an informal survey of 300 major online/catalog retailers conducted by the Virginia Tax Department, where approximately 40% of the major remote retailers were already collecting Virginia sales tax on their sales to Virginia consumers.

The National Retail Federation and Virginia Retail Merchants Association presented survey results from Forrester and shop.org that showed dramatic growth in this “multi-channel” variant of online retail. Nearly 75% of online sales in 2003 were by retailers with both online and physical presence in multiple states. The growth in multi-channel retail reveals the evolution of hybrid business models in response to consumer demand for in-store pickups and returns. These online sellers must therefore collect sales tax for any state where they have a physical presence—whether or not SSUTA is ever enacted.

3. Of all e-commerce in 2003, the Tennessee study estimates that just 3% is potentially taxable but not yet collected. Of that amount, sales by small retailers would not be subject to collection requirements under federal SSUTA legislation currently pending in Congress. (i.e., businesses that sell less than \$5 million annually in remote, taxable sales qualify for a small business exemption). Thus, were Virginia to change its sales tax system in an effort to tap interstate B2C electronic commerce, it would do so to reach a small fraction of e-commerce. This conclusion must be considered in any cost-benefit analysis.
4. Virginia Department of Tax Administration representatives presented data that may indicate compliance gaps in payment of use tax by Virginia businesses. Compliance by Virginia’s businesses appears to be much lower than national compliance averages given by the University of Tennessee and others. Considering that B2B remote sales are ten times as large as B2C remote sales, Virginia could generate significant additional revenue with greater use tax compliance by businesses, notwithstanding a federal mandate for the SSUTA.

Costs & Burdens Of Sales Tax Collections Imposed Upon Virginia Businesses:

1. The National Retail Federation and the Direct Marketing Association endorsed the results of a study, “*Masters of Complexity and Bearers of Great Burden: The Sales Tax System And Compliance Cost for Multistate Retailers*” by Ernst & Young (R. Cline, T. Neubig, 1999) The E&Y study estimates collection and remittance costs borne by retailers who collect sales tax for single and multiple states.
2. The E&Y study showed that small businesses collecting for one state incur a compliance cost equal to 7% of sales taxes collected. For large retailers, the cost of compliance is 1% of each dollar of tax collected.
3. Virginia currently compensates small retailers (\$0-\$62,500 in monthly sales) at an effective rate of 2.4% of each dollar of sales tax collected (4% vendor discount calculated on the first 3% of Virginia’s 5% sales tax rate). For large retailers (\$208,001 in monthly sales), Virginia compensates at an effective rate of 1.2% of tax collected (2% vendor discount calculated on the first 3% of Virginia’s 5% sales tax rate). Va. Code § 58.1-622.

4. The E&Y study estimated that small businesses, if forced to collect for all 46 sales tax states, would incur collection costs reaching 87% of sales taxes collected. For large retailers, the cost would be 14% of each dollar of tax collected.
5. The National Retail Federation advocated that states should compensate sellers for 100% of all actual costs incurred to collect and remit sales taxes.
6. According to the Direct Marketing Association, Virginia electronics retailer Crutchfield, which operates in several Virginia communities and sells via the Internet and catalogues, commented that costs of multi-state tax collection would be so expensive as to endanger their business model. This conclusion was shared by a small online and catalogue retailer in Lexington, Virginia, Virginia Born & Bred. Committee member Bill Frischling echoed those same concerns with respect to his own online consumer electronics business.
7. Virginia's current sales tax regime is an origin-based system. SSUTA, however, requires destination-based sourcing, even for in-state shipments. This would impose new tax and administrative costs and burdens on Virginia retailers shipping to Virginia customers. This will have distinct impacts upon retailers of large items typically shipped to the customer's location, including furniture, appliances and building supplies. Destination sourcing would add significant complexity to Virginia's relatively simple sales tax system. Destination sourcing also would cause transfer of tax revenues from jurisdictions where shippers are located (e.g., Greenfronts Furniture in Farmville, Virginia) to jurisdictions where customers are located.
8. In the 2004 legislative session, the Virginia General Assembly considered adopting SSUTA *without* the destination-based sourcing, but that is not in compliance with the Agreement and would therefore not meet requirements of the proposed federal mandate legislation.
9. One proposal under consideration is to require origin-based taxation for intrastate sales and destination-based taxation for interstate sales. Such a dual system would discriminate against interstate sellers by requiring them to operate two different compliance and collection schemes. Such a dual system also would introduce confusion into a multi-state tax collection system, particularly in the case of multi-channel retailers and transactions conducted by a mix of online and physical contacts.
10. Virginia's current sales tax system is one of the simplest in the nation: centralized state administration, one rate (5%) in all localities, a uniform tax base in all localities, origin-based sourcing, and broad exemptions for all online downloads of software, content, data, Internet access and services. Virginia's sales tax system was characterized as significantly more simple and uniform than the system proposed under SSUTA (multiple rates per state, multiple audits, destination-based sourcing, and taxability of online downloads and services). In short, the SSUTA system introduces additional complexity and burdens for Virginia businesses selling to customers outside Virginia.
11. Under proposed federal SSUTA legislation, retailers collecting and remitting Virginia sales tax would be compensated for tax processing costs for two years, although it is unlikely that significant costs of systems integration would be reimbursed.

Increase in Taxes Collected from Virginia Consumers:

All agree that should SSUTA become a mandatory system by act of Congress, Virginia's participation in the SSUTA would result in increased sales tax collections from Virginia consumers. Precisely how much is not known. Estimates vary widely.

1. An updated report from the University of Tennessee forecast that Virginia consumers would pay an additional \$250 million in sales taxes collected under SSUTA (a 40% reduction from an earlier forecast from the same University of Tennessee researchers).
2. A report from the Direct Marketing Association forecasts that Virginia would realize increased collections of less than \$50 million under the SSUTA.
3. The National Retail Federation advocated a reduction in Virginia's overall sales tax rate of 5% to correspond proportionately to any increase in sales tax collections under SSUTA. In other words, Virginia should not adopt the SSUTA in order to increase taxes paid by Virginia retail consumers. Moreover, the Administration has represented that a sales tax increase adopted earlier this year, when combined with other tax increases and revenue surpluses generated by a recovering economy, was adequate to meet Virginia's spending needs. Since any increase in sales tax collections under a mandatory SSUTA system would mean Virginia consumers would be paying increased taxes, the Commonwealth would have to reduce its current sales tax rate in order to make the SSUTA a revenue-neutral proposition.
4. Any increase in tax collections would be reduced by reimbursements credited to retailers collecting the tax. At a minimum, any amounts collected would be reduced by Virginia's current effective reimbursement rates of 2.4% for small retailers and 1.2% for large retailers.

Preserving Virginia's Competitive Economic Position:

1. A study by the Progress & Freedom Foundation concluded that Virginia would gain significant economic development advantages by staying out of SSUTA, assuming that federal legislation authorizes a voluntary state compact instead of a national mandate imposed upon all states.
2. At the annual meeting of the National Conference of State Legislatures (NCSL) in July 2004, New Hampshire offered a voluntary participation amendment to SSUTA, but the amendment was overwhelmingly defeated by NCSL's sales tax task force. Both of the proposed federal SSUTA bills require mandatory collection by sellers in every state, even in states that elect not to confirm their laws to SSUTA.
3. Over the past decade, Virginia has competed vigorously to attract technology-based companies, particularly software providers, Internet access providers, and online content and service providers. One such policy was to exempt services, both on Main Street and online, from sales taxes. However, under SSUTA, Virginia services and online software and content would be taxable by other states. The Northern Virginia Technology Council believes that this tax policy is significant to maintaining Virginia's competitiveness in the technology sector. Thus, SSUTA would compromise a significant policy Virginia has used to build its technology industry, and expose Virginia's technology sector to new sales tax collection burdens, increasing their cost of doing business, and increasing the cost of Virginia exports of online services, software and content.
4. Virginia also implemented policies to incubate small online businesses and entrepreneurs. Among the policies cited is the Commonwealth's relatively simplified sales tax system. The Direct Marketing Association (DMA) reported that Virginia's tax policies have been successful in promoting a vibrant direct merchant sector in Virginia. The Virginia Employment Commission

estimates that Virginia's retail businesses have 400,000 direct employees, although the DMA demonstrated how secondary employment in businesses that serve direct market retailers brings the total employment in Virginia to over 400,000, including printing businesses from Lynchburg (e.g., Donnelly) and Southwest Virginia. Moreover, many direct merchants locate in Virginia and assume its sales tax collection responsibilities because of its attractive tax policies.

5. As for compensating businesses that locate in Virginia and assume the burdens of sales tax collection in Virginia, Virginia has implemented several policies to make Virginia an attractive state to locate a retail establishment. According to the Virginia Employment Commission, Virginia is home to 400,000 retail employees. Virginia provides retail establishments significant resources and benefits: education, fire, police, and transportation services; direct grants and significant tax breaks to locate or expand here; pro-business policies such as right-to-work, low corporate tax rates, and a simplified sales tax system.
6. A mandatory SSUTA interstate sales tax collection system would reduce significant competitive advantages that Virginia enjoys relative to other states. Virginia would be a net exporter of tax revenues to other states, and Virginia would become a net importer of tax collection burden compared to other states.

Important Unknowns About SSUTA:

SSUTA is a new concept with no demonstrated success at simplifying sales tax systems that the Supreme Court has ruled to be an unreasonable burden on interstate commerce. Critical facts and data needed for a comprehensive analysis of SSUTA's benefits and costs are not yet known. SSTP proponents should carry the burden of persuasion to show that SSUTA is in Virginia's best economic interests, and the following facts and data should be known before the policy is adopted.

1. The actual cost of all collection, remittance and compliance costs for all vendors under a mandatory SSUTA is unknown. The SSTP is preparing a study of current collection costs, but has not planned a study of collection and compliance costs under SSUTA.
2. The National Retail Federation explained that a significant cost and administrative burden which is not addressed by the SSUTA is the burden of integrating new tax-compliance software into the existing business systems of every vendor in America. While it may be trivial to perform a database lookup of zip code and product codes, the difficult part is implementing the lookup in sales systems and back-office software that handles shipments, inventories, partial orders, returns, exchanges, etc. Not enough is known about the initial and ongoing maintenance costs for systems integration, particularly for small businesses with proprietary or customized systems.
3. The Direct Marketing Association explained that no interstate tax collection software has thus far been offered by SSTP proponents. While the SSTP conducted a limited software pilot among several states and several retailers, there has been no public demonstration of a successful implementation.
4. It is unknown how much additional sales taxes Virginia consumers would pay under a mandatory SSUTA system. This is a fundamental fact that should be communicated to Virginia consumers before considering adoption of SSUTA.
5. It is unknown to what extent or for how long retailers would be reimbursed for tax collection costs under the SSUTA.
6. Not enough is known about the impact of destination-based sourcing upon re-allocation of tax revenue among Virginia's localities. Several SSUTA states delayed implementation of sourcing rules when vendors began to confront significant collection burdens and when cities realized they would lose tax revenue to surrounding jurisdictions.

7. It is not known whether the SSUTA is workable (or Constitutional) if states elect to use “dual” sourcing: origin-based for intrastate sales, and destination-based for interstate sales.

Recommendations:

1. Virginia’s Department of Taxation should sponsor a “True Cost of Collection” study by an independent vendor, asking Virginia’s retail industry to assess their actual costs of sales tax compliance for retailers of all sizes and types. Virginia should then adjust its vendor reimbursements to cover substantially all actual and reasonable sales tax compliance costs.
2. Virginia’s Department of Taxation should sponsor a study of “Costs and Revenue Re-allocation Arising from Destination-Based Sourcing”. The study should be conducted by an independent vendor and should involve localities potentially affected by sourcing changes. Funding should be adequate to include a survey of merchants potentially affected by sourcing changes. The Department of Taxation has requested that the General Assembly set the timing of these studies so that they can be done when the Legislature is not in session.
3. Virginia should continue to monitor and influence the SSUTA debate through its multiple roles—as a Participating State in the Streamlined Sales Tax Project, Governor Warner’s chairmanship of the National Governors Association, and many Virginia Legislators who participate in the National Conference of State Legislatures, including Senator Hanger’s leadership on NCSL’s task force on remote sales taxation.

Virginia representatives to these organizations should advance the Commonwealth’s interest in the SSUTA and in federal legislation by advocating the following policies:

- ☐ origin-based sourcing on all sales, with no discrimination between online and offline retailers or between interstate and intrastate commerce;
 - ☐ a broad prohibition against taxation of electronically delivered services, software downloads, online content, and Internet access services;
 - ☐ explicit protections for small businesses from disproportionate collection burdens;
 - ☐ compensation for all retailers to cover substantially all reasonable costs of collection as a condition of any state’s participation;
 - ☐ provisions for transparency in consumer tax burdens effected by any mandatory SSUTA collections (i.e., tell taxpayers about the additional sales taxes they’ll pay under SSUTA, and the corresponding reduction in sales tax rates to maintain current revenues);
 - ☐ explicit protections against multiple sales tax audits;
 - ☐ explicit protections for consumer privacy.
4. Virginia representatives to these organizations and Virginia’s federal delegation should push for changes to federal SSUTA legislation *to allow a voluntary interstate tax collection compact instead of a national mandate* in order to protect Virginia’s tax sovereignty and ability to compete for economic development prospects.
 5. It is not at all clear that the benefits of SSUTA justify the collection costs and lost opportunity to use tax policy to compete for economic development for Virginia. At this time, there is no compelling reason for Virginia to adopt SSUTA, and there are too many unanswered questions regarding collection costs and ameliorative provisions in SSUTA and proposed federal legislation. Therefore, Virginia’s General Assembly should not consider adoption of SSUTA in its 2004-2005 legislative session.