OCTOBER 2018

Bringing Sales Tax into the 21st Century

A REPORT ON REMOTE SALES TAX

Government Finance Officers Association

INTRODUCTION

Since the mid-1900's, state and local governments have struggled with the issue of taxing remote sales. For decades, the primary method of remote sales was in the form of mail-order businesses. In 1967, the U.S. Supreme Court ruled in *Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), that a state could not require sellers to collect use taxes if the only connection with customers in the state is through materials sent by common carrier or mail.

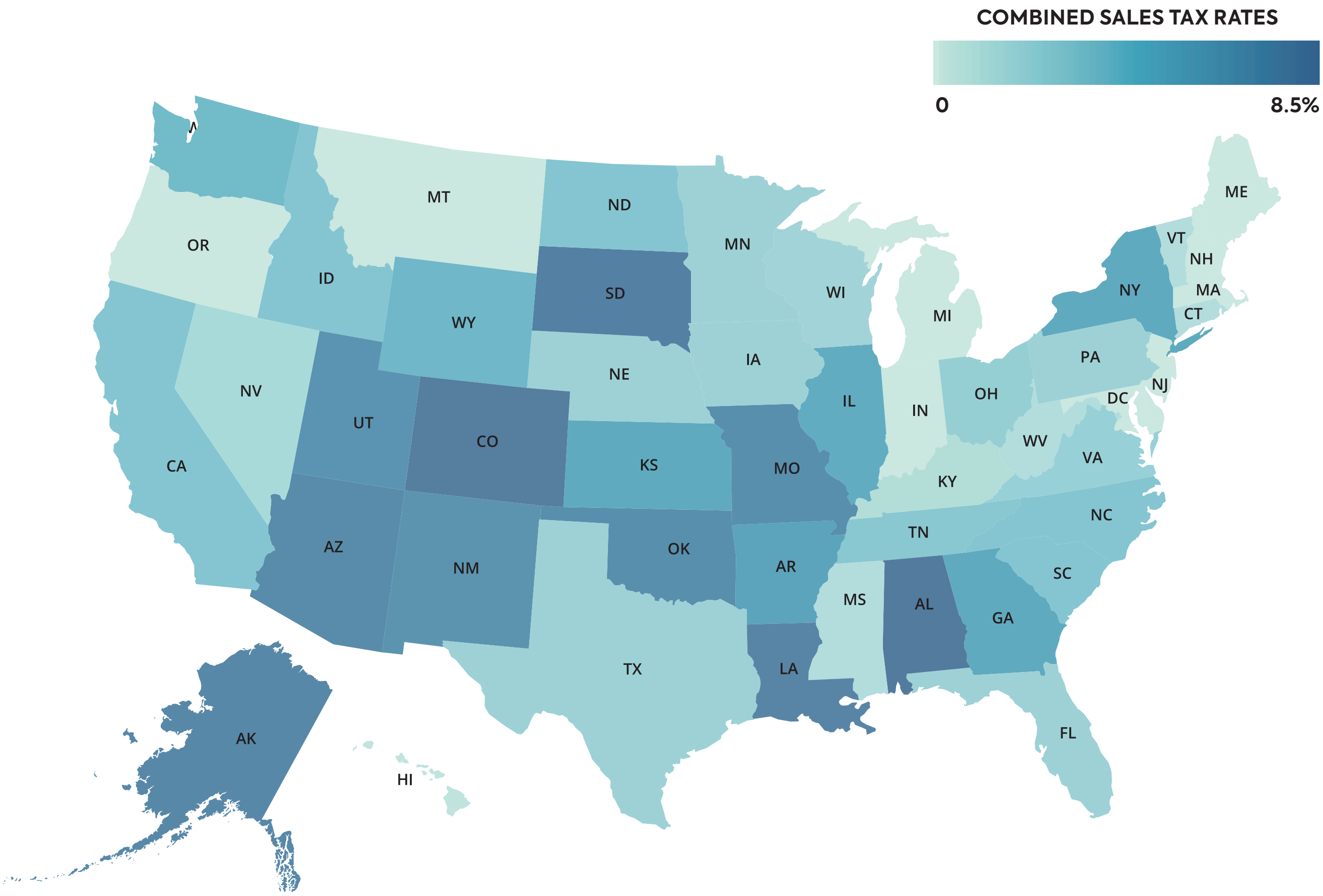
Then in 1992, the Supreme Court upheld the standard in *Bellas Hess* in *Quill v. North Dakota*, 504 U.S. 298 (1992), holding that a state can only require a business to collect and remit sales tax if the business has substantial presence (i.e. nexus) in that state. Both decisions, however, occurred well before the Internet forever changed the way consumers shopped and transformed the retail marketplace into the billion-dollar global platform we know today.

As a result of these decisions, state and local governments faced growing numbers of uncollected sales taxes over the past several decades. In an attempt to remedy this, there have been efforts at the federal level to enact legislation that would establish a framework of sales tax simplification and administration. The intent of the framework is to bring sales tax laws into the 21st century and grant state and local governments the ability to enforce existing sales tax laws on remote sales, while also minimizing the burden of collection on retailers. The billions of dollars state and local governments forego each year is much needed revenue that could support vital services in communities across the country like infrastructure, public safety, and education.

But 2018 proved to be a landmark year for the issue of remote sales tax. In June, the U.S. Supreme Court reversed those two pivotal cases by finally removing the antiquated physical presence requirement that has burdened state and local sales and use tax laws. This report will take a brief look at the importance of these taxes and how sales tax administration could be one step closer to 21st century modernization.


The billions of dollars state and local governments forego each year is much needed revenue that could support vital services in communities across the country like infrastructure, public safety, and education.

Figure 1. Combined state and local sales tax rates



A BRIEF OVERVIEW OF STATE AND LOCAL SALES TAXES

Forty-five states and the District of Columbia impose sales tax to many goods and services, although exemptions exist and vary from state to state.[1] Out of that number, thirty-eight states (including Alaska which does not have a state sales tax) allow for a local sales tax on top of the state sales tax.[2] Further, states in many cases levy separate taxes on other goods like tobacco and alcohol.

The five states without a general state sales tax are Alaska, Delaware, Montana, New Hampshire, and Oregon. The rates for the remaining states are varied and range as high as over 7 percent and as low as less than 3 percent.

What do sales taxes fund?

Just as sales tax rates vary at the state and local level, the use of the funds also vary. While sales taxes are not always the sole source of all state and local government revenues, they do flow into the general fund in most cases. The general fund typically serves as the primary source of revenue for public services. According to the Urban Institute, in fiscal year 2015, the bulk of spending by state and local governments was for K-12 spending.[3] Further, in addition to K-12 spending, most state and local expenditures go towards higher education, public welfare, health and hospitals, police and corrections, and highways and roads.

Figure 2. State and local general spending by functional category, fiscal year 2015

In fiscal year 2015, the bulk of spending by state and local governments was for **K-12 spending**.

Source: US Bureau of the Census, Survey of State and Local Government Finance, 2015.

Note: Excludes spending on government-run liquor stores, utilities, and insurance trusts. Medicaid spending is divided between the public welfare and health and hospitals functional categories, with the majority allocated to the former.

Figure 3. Percentage of general funds attributed to sales taxes

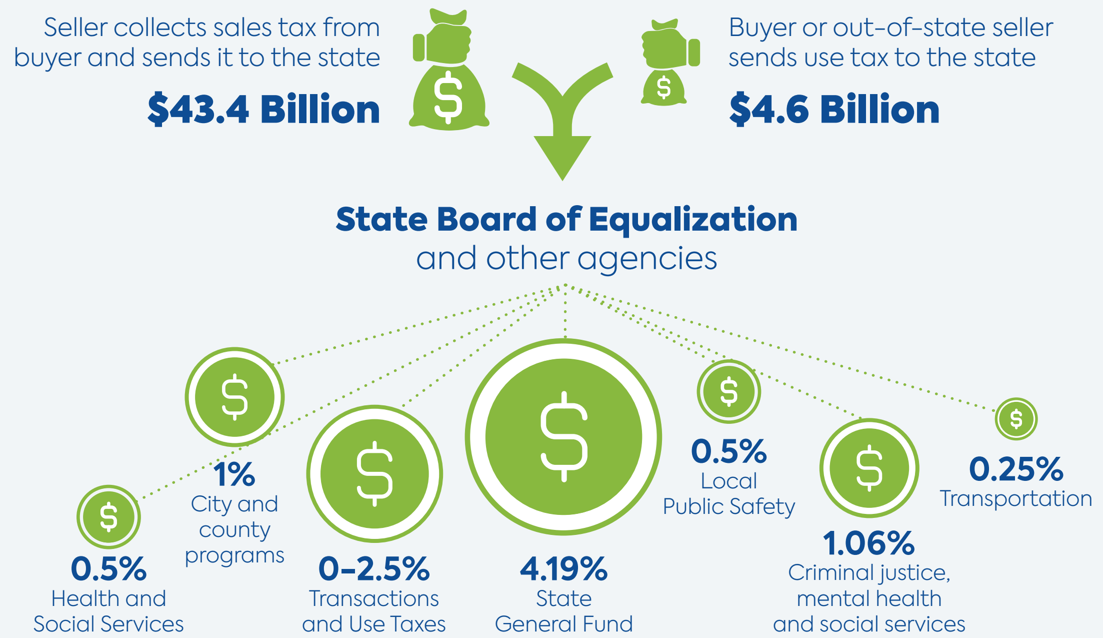
While general funds are not fully comprised of sales tax revenue, in some states **nearly a quarter** of total revenues are from sales taxes.

Washington	23.50%	Mississippi	13.30%	New York	10.07%
Nevada	22.52%	Colorado	13.25%	District of Columbia	10.03%
Hawaii	21.23%	Missouri	13.21%	Minnesota	9.96%
South Dakota	20.32%	Idaho	13.01%	New Jersey	9.57%
Tennessee	19.94%	Nebraska	12.58%	Pennsylvania	9.39%
Arizona	19.91%	Alabama	12.42%	Kentucky	9.29%
Texas	19.58%	North Carolina	12.14%	Rhode Island	9.10%
Louisiana	18.76%	California	11.92%	Massachusetts	7.99%
Arkansas	18.06%	Utah	11.75%	West Virginia	7.98%
Florida	16.59%	Wyoming	11.64%	Virginia	7.44%
Kansas	16.47%	Illinois	11.15%	Maryland	7.43%
Oklahoma	15.81%	Maine	11.12%	Vermont	5.41%
New Mexico	15.03%	Iowa	10.99%	Alaska	2.24%
North Dakota	14.55%	Michigan	10.97%	Delaware	0.00%
Indiana	14.06%	Wisconsin	10.95%	Montana	0.00%
Ohio	14.03%	Connecticut	10.40%	New Hampshire	0.00%
Georgia	13.68%	South Carolina	10.32%	Oregon	0.00%

HOW DOES THE MONEY FLOW TO LOCAL GOVERNMENT?

These examples are only two out of many local examples that demonstrate how varied sales tax collection and distribution can be from state to state. States vary in their methods of distribution. In California, for example, the State Board of Equalization has systematized a method using specific formulas for distribution to local governments.

Figure 5. California Board of Equalization



Source: https://lao.ca.gov/reports/2015/finance/sales-tax/understanding-sales-tax-050615.aspx

Figure 4. Oklahoma City, OK sales tax distribution

Due to the inseparable relationship between funding and the provision of essential public services, any impact is particularly acute at the local level.

Source: https://www.okc.gov/departments/finance/taxes

Remaining sales tax collected in OKC (4.5 cents in OK County) goes to the state & county.

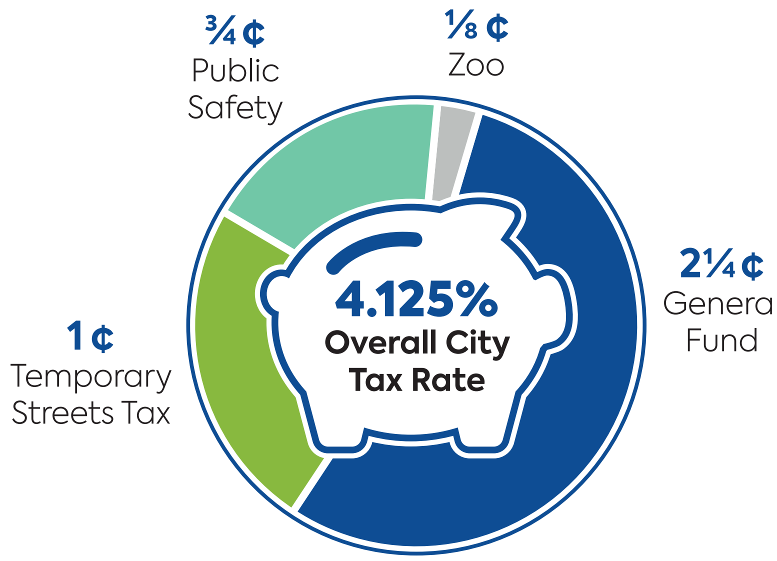
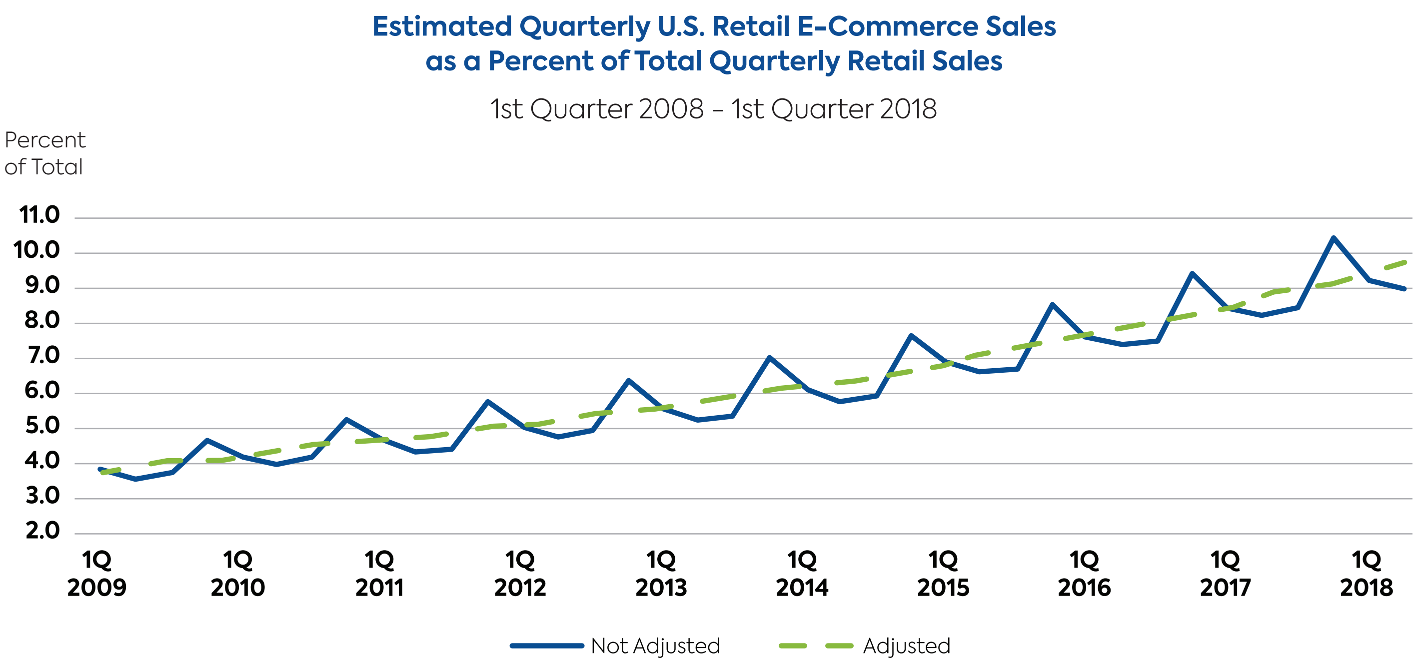


Figure 6. Growth of E-commerce sales



Source: https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf

CHANGES IN RETAIL BEHAVIOR

While the origins of the Internet dates back to the 1950s, the Internet as many of us know it now emerged in the late 80s and early 90s. But it was not until the 2000s that the Internet's true capability to serve as a significant retail platform really began to evolve. According to the U.S. Census Bureau, the total amount of sales online as a percentage of all retail sales has grown year over year.[4]

The trend is expected to increase as retail technology continues to advance. A prime example of this trend is retail data on Black Friday, the traditional start of the holiday shopping season. For years, Black Friday was marked by customers lined up outside of retail locations eager to score an early-bird special. But as more customers flocked online, the numbers painted a very different picture. For Black Friday 2017, shoppers spent a record $5 billion online, marking an almost 17 percent increase in sales over the same 24-hour period in 2016.[5]

Why buying locally matters

It is a common misconception within this debate that state and local governments simply want to tax the Internet. But given the trends over the last decade or more, the primary objective is to help existing sales and use tax laws reflect and keep pace with evolving technology. This would level the retail playing field, ensuring updated tax policies apply to all retailers, whether they are online or in a brick-and-mortar location.

While the *Quill* physical presence standard was in place, online-only retailers were able to enjoy a 5-10 percent competitive advantage because they did not have to collect sales taxes. Not only did local businesses suffer, the communities they supported suffered as well.

Figure 7. Hypothetical impact of remote sales on local communities

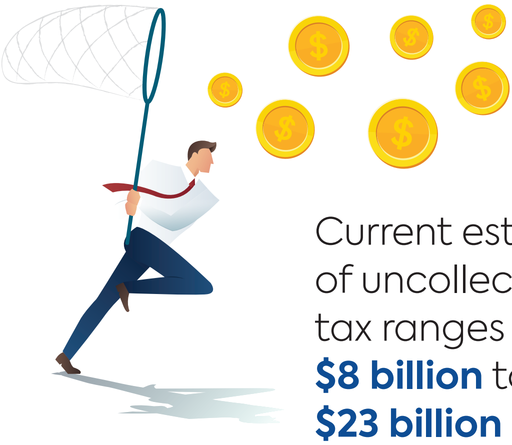
Source: https://www.amiba.net/resources/multiplier-effect

SALES AND USE TAX COLLECTION

Why the Uncollected Sales Taxes Matter

An important focus of advocates across the country is the scope and magnitude of uncollected sales taxes. Although studies have varied on total aggregate value, what does not vary is the importance of the tax to states and local communities across the country.

To view this in more relative terms using public service occupations with which we are all familiar, this report weighs revenue forgone to the average salaries of police officers, teachers, and firefighters. This is only for illustrative purposes because, as referenced above, sales tax revenue is used by state and local governments for a wide array of public services.



Current estimates of uncollected sales tax ranges from **$8 billion** to over **$23 billion** a year.[6]

TABLE 1 Sales tax funding power

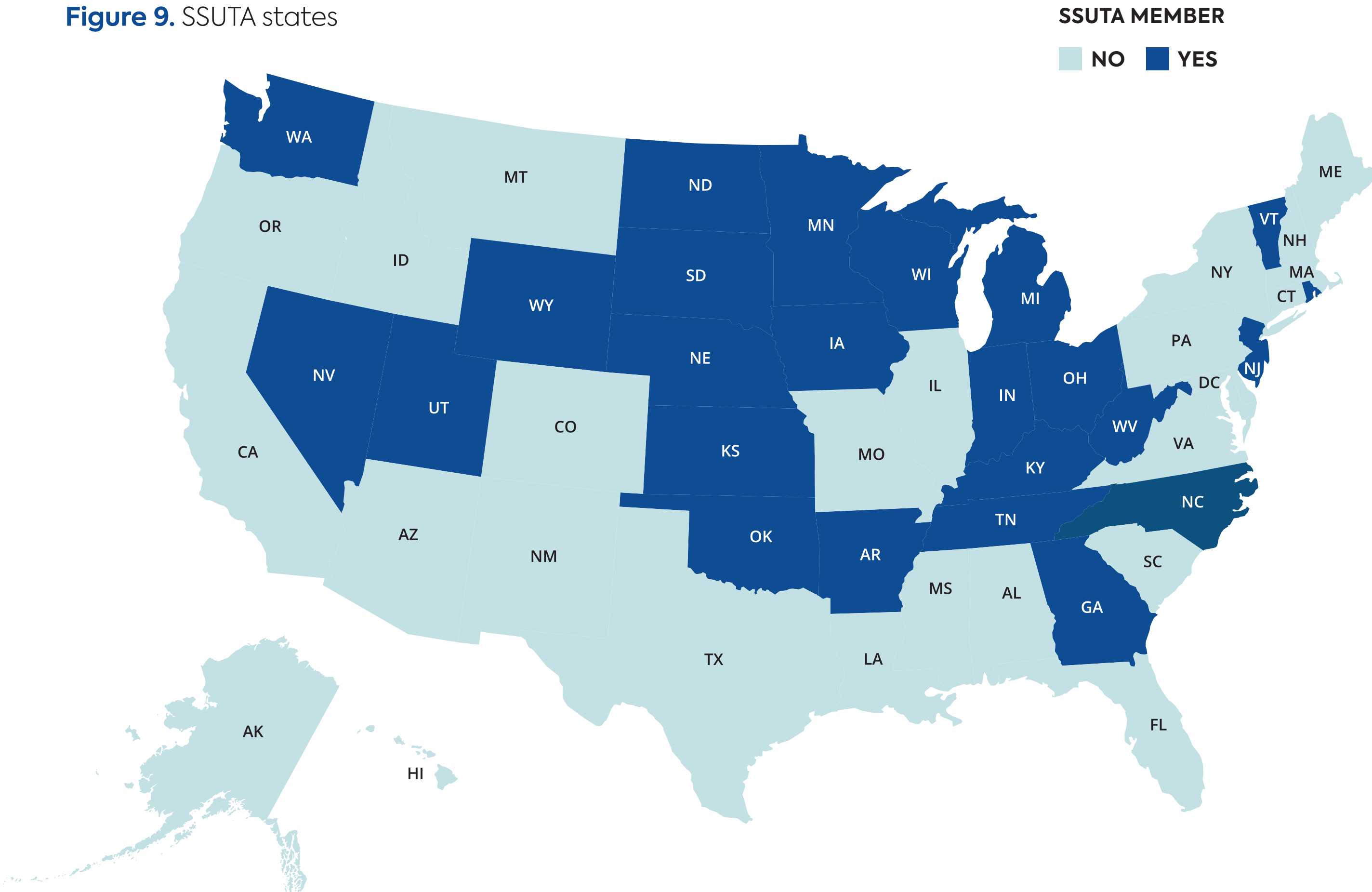
	Teachers	Police Officers	Firefighters
Total sales taxes collected FY2015 (local governments)	The numbers below reflect how many positions could be filled if **ALL sales taxes** were used to solely fund that particular occupation based on 2015 average salaries.		
Kenosha County, WI – $14M	268	258	412
Bakersfield, CA – $70M	950	752	1,036
Roanoke, VA – $10M	196	185	196
Salt Lake City, UT – $61M	1,303	1,248	1,737
Total sales taxes collected FY2015 (state governments)	The numbers below reflect how many positions could be filled if **ONE PERCENT of sales taxes** were used to fund that particular occupation based on 2015 average salaries.		
California – $50B	6,741	5,339	7,353
Kentucky – $3B	639	777	1,020
Texas – $41B	8,098	6,995	8,282
Utah – $2.6B	565	541	753
Virginia – $5B	1,001	956	1,012
Wisconsin – $5B	1,011	974	1,557

Streamlined Sales and Use Tax Agreement

During the Internet's development in the 1990's, leaders in every sector saw its potential use and ability to affect all aspects of everyday lives. While still in its nascent stages, Congress wanted to explore the impact of the Internet on society and whether policies were needed to encourage its growth. Through the temporarily established Advisory Commission on Electronic Commerce, various issues were examined, including tax policy and electronic commerce. It is because of this work that the Streamlined Sales and Use Tax Agreement (SSUTA) was established.[7]

Formally adopted in 2002, the SSUTA is a result of a collaborative effort between government and business to simplify sales and use tax collection and administration. Member states of the SSUTA must adhere to provisions that call for uniform tax definitions, uniform and simpler exemption administration, rate simplification, administration of sales taxes at the state level, uniform sourcing of taxable sales, and state funding of the administrative cost to business. The ultimate goal was to minimize the costs and potential administrative burdens on retailers that collect sales taxes, particularly those operating in multiple states. Currently, twenty-four states have adopted legislation to conform to the SSUTA.

Figure 9. SSUTA states



How SSUTA Could Be a Model for the New Retail Paradigm

What are the current collection/ distribution methods?

In traditional brick-and-mortar stores, not much has changed in how taxes are collected at the point of sale. Accounting systems have generally been designed to track sales and the amount of taxes that need to be sent to the appropriate tax authority. If anything has changed, it is the increased variety of payment methods available to shoppers other than using cash. But technology has not only allowed payment methods to evolve, technology has also enhanced modern accounting systems so that near real time collection and remittance of sales taxes can occur at the point-of-sale.

Thus, the Internet's evolution as a retail marketplace is even more significant as businesses can easily reach customers thousands of miles away. This inserts a new dynamic into the traditional point-of-sale transaction because it is no longer confined to the brick-and-mortar setting. Nonetheless, technology is still the key to help businesses perform their tax functions regardless of where a sale is made.

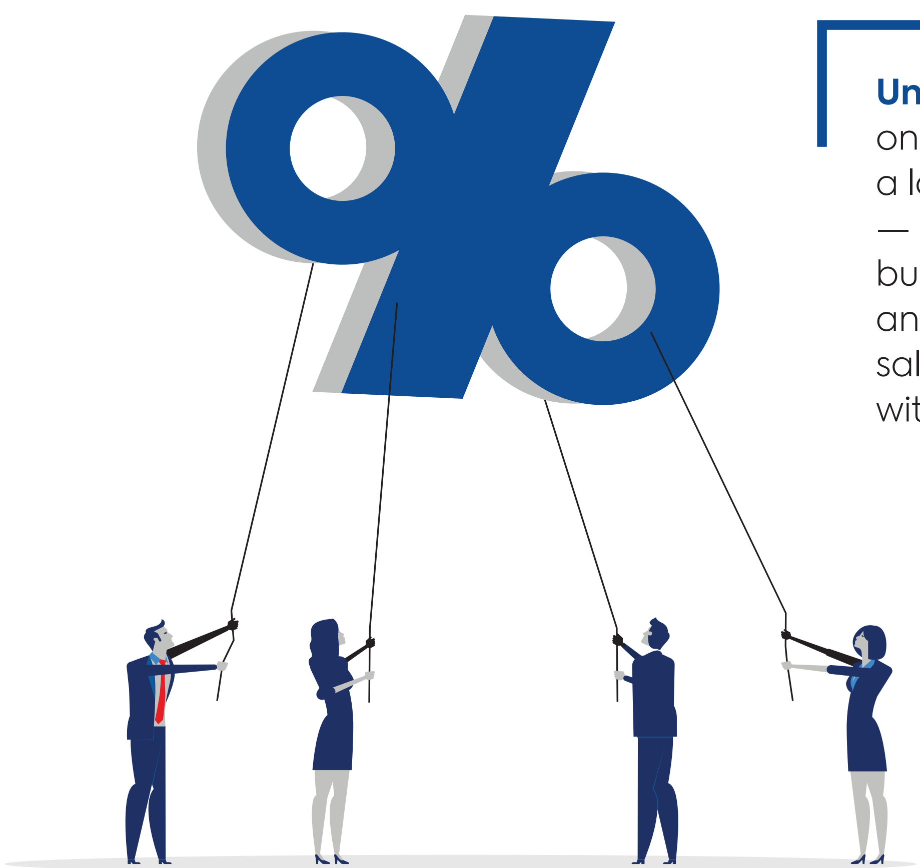
Under the SSUTA, technology is one of the primary tools to address a long-held concern of the retailers – the administrative burden of performing the sales and use tax functions for remote sales, especially when having to deal with different states. The SSUTA not only certifies the software retailers can use to assist in sales tax collection, the software is provided at no cost to the business. In conjunction with simplified tax laws and definitions, streamlined administration with states, the burden on business is substantially reduced.

Businesses registered under the SSUTA have two options available to them to assist with sales tax collection. The first is through a certified service provider (CSP) in which a business essentially outsources most of the sales tax administration responsibilities. The CSP acts as an agent of the business and utilizes software designed to communicate with the business's accounting system to carry out many administrative tasks, like determining the taxability of products and services, and then applying the appropriate tax rate. A CSP can also assist with preparing and filing required tax returns, as well as remitting the taxes collected to SSUTA member states. As alluded to earlier, SSUTA member states compensate CSPs who voluntarily provide their services to sellers.

The second way is through a certified automated system (CAS) which is software certified under the Streamlined Agreement that takes care of the tax calculations while leaving most of the administrative functions, like filing returns and remitting tax, up to the business. A CAS, like the CSP scenario, would communicate with the business's accounting system to carry out the tax calculations. If a seller chooses to utilize a CAS, they receive a collection allowance from states.

What about other general issues regarding sales tax administration?

For state and local governments, the general issue has always been about collection administration. Without the ability to require remote businesses to collect the tax at the time of sale, governments are essentially left with two choices. They can expend resources that would be diverted from other public services to find out which residents are making remote purchases and compel them to pay taxes on the purchases – a nearly impossible task as the daily shopping habits of residents would need to be tracked. Or, they can rely on their residents to self-report the purchases and remit the taxes. In the latter case, even though most states require residents to pay taxes on items purchased and later brought into the state, compliance is very low. That's why collection at the point of sale is the most efficient method.



Under the SSUTA, technology is one of the primary tools to relieve a long-held concern of retailers — lifting the administrative burden of performing the sales and use tax functions for remote sales, especially when dealing with different states.

Figure 10. Example of sales and use tax reporting on state tax form

24. Tax Credit for Low-Income Individuals or Earned Income Credit from Sch. ADJ, Line 17 .... 24 . 00
25. Credit for Tax Paid to Another State from Schedule OSC, Line 21.
You must enclose Schedule OSC and a copy of all other state returns. .... 25 . 00
26. Reserved for future use. 26
27. Credits from **enclosed Schedule CR, Section 5, Part 1, Line 1A** .... 27 . 00
28. **Add Lines 20a through 27** .... 28 . 00
29. If Line 28 is less than Line 19, subtract Line 28 from Line 19. This is the Tax You Owe .... 29 . 00
30. If Line 19 is less than Line 28, subtract Line 19 from Line 28. This is Your Tax Overpayment .... 30 . 00
31. Amount of overpayment you want credited to next year's estimated tax .... 31 . 00
32. Virginia College Savings Plan Contributions from Schedule VAC, Section I, Line 6 .... 32 . 00
33. Other Voluntary Contributions from Schedule VAC, Section II, Line 14 .... 33 . 00
34. Addition to Tax, Penalty and Interest from enclosed Schedule ADJ, Line 21. .... 34 . 00
35. Sales and Use Tax is due on Internet, mail order, and out-of-state purchases (Consumer's Use Tax).
See instructions. .... FILL IN OVAL IF NO SALES AND USE TAX IS DUE. .... 35 . 00
36. **Add Lines 31 through 35** .... 36 . 00
37. If you owe tax on Line 29, add Lines 29 and 36. **OR** If Line 30 is less than Line 36, subtract Line 30 from Line 36. Enclose payment or pay at **www.tax.virginia.gov**. .... **AMOUNT YOU OWE** .... 37 . 00
FILL IN OVAL IF PAYING BY CREDIT OR DEBIT CARD - SEE INSTRUCTIONS
38. If Line 30 is greater than Line 36, subtract Line 36 from Line 30. .... **YOUR REFUND** .... 38 . 00
If the Direct Deposit section below is not completed, your refund will be issued by check.

DIRECT BANK DEPOSIT Bank Routing Transit Number Bank Account Number Checking Savings
Domestic Accounts Only.
No International Deposits.

I (We) authorize the Dept. of Taxation to discuss this return with my (our) preparer. I agree to obtain my Form 1099-G at **www.tax.virginia.gov**.

For businesses, the concerns generally revolve around the cost of compliance and liability. With respect to compliance burdens, all the simplification steps the SSUTA requires of member states are geared towards minimizing the administrative burdens on business. One example is requiring a central point of administration in each state which eliminates the need for a business to deal with every local government within a state, in addition to any state level entity. Another example is state and local governments are required to notify sellers of any changes in law, which substantially reduces the resources needed for a business to keep current on tax laws.

While the collection software and tax law simplification should fairly ensure businesses are collecting and remitting the correct taxes in each state, sellers also want to be sure they are not subject to multiple audits each year from different taxing jurisdictions. Under the SSUTA, sellers using the certified collection software are either not audited or have limited scope audits. Large multi-state businesses can request a joint audit from all the states rather than face audits from each state.

The bottom line is that the SSUTA demonstrates that business and government can come together to work through the issues on both sides of sales and use tax administration. This discussion is not limited to just states within the Agreement because the steps implemented to reduce the burden on business are also included within the potential federal legislative framework discussed in the next section.

2018: A SHIFT IN THE SALES TAX PARADIGM

For decades the issue of remote sales tax has floundered in the U.S. Congress with the only major milestone being the Senate's passage of remote sales tax legislation in 2013. Since then, several states have made efforts to enact state laws to address remote sales, setting the stage for dual tracks for resolving the issue.

Courts Weigh In

On June 21, 2018, the U.S. Supreme Court issued a decision that essentially clears the path for states to enact laws on taxing remote sales. The Court first expressed its opinion on the matter in 1967, albeit during times when the retail environment was much different.

In the 1967 *Bellas Hess* case, the Court struck down a state law requiring a remote seller to collect sales taxes, ruling that communicating to customers solely through the mail did not result in the seller receiving any benefits and services provided by the local government. Thus there was no foundation for the state to require the collection of the very taxes that fund the provision of the services or infrastructure that facilitated the delivery of goods to customers in the state.

Then in the 1992 *Quill v. North Dakota* case, the Court essentially continued the reasoning from *Bellas Hess* and established a physical presence standard that needed to be met for a state to require any business to collect sales taxes. In the decision, however, the Court explicitly stated that Congress could overrule this decision through legislation.

More recently, in 2015, the Court took up a sales tax case from Colorado where the state attempted to require remote sellers to report sales into the state, rather than collect sales taxes. This was one of several attempts by different states to tackle the issue due to the enormous growth of e-commerce in recent years. While the Court did not rule on the authority to collect taxes, Justice Anthony Kennedy wrote in

his concurrence that given the substantial evolution of the Internet, it was certainly time to reconsider the decision in *Quill*.

The first case to successfully reach the Supreme Court is *South Dakota v. Wayfair, Inc.* 585 U.S. ___ (2018). In this case, South Dakota enacted a law that requires all sellers making sales above a specific threshold into the state to collect sales taxes. The law was challenged and the case quickly worked its way through the system. In January 2018, the Court agreed to hear the case and issued a decision in late June.

In the much-anticipated decision, the Court overturned the long-standing precedent established in *Bellas Hess* and *Quill*, essentially holding that the physical presence rule is unsound and incorrect given the substantial advancements in technology. The decision in *South Dakota* is certainly a victory, as it removed an outdated standard that restrained the ability of state and local governments to enforce existing sales taxes. But the decision did not necessarily prescribe how states should design their tax laws post-*Quill*. Rather the decision more or less pointed out that South Dakota's law was one way to do it. What remains to be seen is how other states will react and whether this development will motivate Congress to act and create a national framework for sales tax administration.

An Act of Congress

Over the last decade or more, several bills have been introduced in the U.S. Congress to establish a national framework to allow states and local governments to enforce existing sales tax laws and potentially recoup the billions in revenue lost every year. The farthest any proposal has advanced in Congress was in 2013, when the Senate passed the Marketplace Fairness Act in a strong bipartisan vote. Unfortunately, the House failed to capitalize on the momentum to advance the legislation to the President's desk. Since then, legislation has been reintroduced in each chamber. There are minor differences between the bills, but both largely follow the same approach to simplify sales tax administration.

MARKETPLACE FAIRNESS ACT OF 2017 (S. 976 – 115th U.S. Congress)

The Marketplace Fairness Act (MFA) would grant states and local governments the authority to compel remote sellers to collect taxes regardless of their location. The amount of tax would be based on the location of the buyer, i.e. destination-based sourcing. Under the legislation, sellers who have less than $1 million in annual remote gross receipts would be exempt from the requirement to collect. States would obtain the authority only after they have simplified their sales tax laws.

Simplification could be done in two ways:

Option 1: A state could participate in the Streamlined Sales and Use Tax Agreement (SSUTA). The twenty-four states that are already members of the SSUTA would essentially have the ability to collect once federal legislation is passed.

Option 2: If a state does not want to join the SSUTA, the authority to collect could still be attained by meeting five simplification mandates within the bill. States must agree to: notify retailers in advance of rate changes; designate a single state level entity for sales tax registrations, filings and audits; establish a uniform sales tax base throughout the state; use destination sourcing to determine sales tax rates for out-of-state purchases; provide tax compliance software to retailers for free.

REMOTE TRANSACTIONS PARITY ACT OF 2017 (H.R. 2193 – 115th U.S. Congress)

Similar to MFA, the Remote Transactions Parity Act (RTPA) would also grant states and local governments the authority to compel remote sellers to collect taxes regardless of their location provided states adopt minimum simplification requirements. Further, like MFA, RTPA utilizes destination-based sourcing to determine the tax amount and it provides two options for states to meet the simplification requirements. One of the major differences between RTPA and MFA is found in the small seller exception provision. During the first year following enactment of the RTPA, sellers with less than $10 million in annual remote gross receipts would be exempt from collection requirements. This threshold is lowered and ultimately phased out by the fourth year following enactment.

CONCLUSION

The next several months and years will certainly be indicative of how the sales and use tax landscape will evolve. With some states already implementing and others preparing to effectuate remote seller laws soon, the decision by the Supreme Court will undoubtedly play a major role. Given the state-by-state development of the laws, any state's law could potentially be challenged. But there is relief knowing the antiquated physical presence standard no longer stands in the way of developing laws to reflect the 21st century retail marketplace. Now that this hurdle has been removed, only time will tell how successful states will be in implementing the collection requirement on remote sellers. Further, the question remains whether Congress will ever decide to weigh in with federal legislation or will it simply let the states chart the course. Nonetheless, there is no question that technology will continue to improve and allow greater innovation in the retail market, as well as allow for greater strides in the administration and simplification of sales tax.

ENDNOTES

[1] https://taxfoundation.org/state-and-local-sales-tax-rates-2018

[2] *Id.*

[3] https://www.urban.org/policy-centers/cross-center-initiatives/state-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-expenditures

[4] https://www.census.gov/retail/index.html

[5] https://money.cnn.com/2017/11/25/news/black-friday-holiday-shopping-foot-traffic/index.html

[6] GFOA analysis of GAO and NCSL reports at https://www.gao.gov/assets/690/688437.pdf and http://www.efairness.org/files/Updated%20Sales%20Tax%20Loss%20Report.pdf

[7] https://www.streamlinedsalestax.org/index.php?page=frequently-asked-questions

METHODOLOGY

Figure 1: Collected state sales tax rates from Tax Foundation and created heat map of rates with Tableau. Scale for heat map interpretation provided in top right corner of map.

Figure 3: Data collected from the 2015 Census of Governments. Total general sales tax divided by total general revenue, and this calculation was used to create a heat map with Tableau. Scale for heat map interpretation provided in top right corner of the map.

Table 1: A recent Certified Annual Financial Report (CAFR) was collected for each locality and data on each revenue source collected. Then, the amount of sales tax data in $ was divided by the average 2015 annual salary for police (BLS Occupation Code 33-3051), firefighters (BLS Occupation Code 33-2011), and teachers (NEA Table Rankings & Estimates Table C-5). For state level figures, data was collected from the 2015 Census of Governments. Total general sales tax divided by total general revenue for specific states.