

**National Tax Association**

**Communications and Electronic  
Commerce Tax Project**

**Final Report**

**Approved by Vote of the Project Steering Committee**

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Washington, D.C.**

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## Executive Summary

Electronic commerce — the use of computer networks to facilitate commercial transactions involving the production, distribution, and sale of goods, services, and intangible property — has significant implications for state and local taxation as it does for just about everything else. The advent of electronic commerce raises a number of questions as to whether and how state and local taxes, particularly state and local sales and use taxes, should be applied to such commerce.

The National Tax Association Communications and Electronic Commerce Tax Project (the "Project") was organized to bring together representatives of the business community, state and local governments, professional organizations, and academia who share an interest in identifying possible solutions to the state and local tax issues raised by electronic commerce. The purpose of the Project was "to develop a broadly available public report that identifies and explores the issues involved in applying state and local taxes and fees to electronic commerce and that makes recommendations to state and local officials regarding the application of such taxes." This Report is the product of the Project.

### Prefatory Caveat

One working assumption underlay all the work of the Project, to wit: ***“Nothing is agreed to until everything is agreed to.”*** Consequently, the Project Steering Committee wishes to emphasize at the outset that it would seriously misrepresent the work of the Project to pluck any of its tentative and preliminary conclusions, including specifically those it reached by a formal vote, out of context and represent them as the conclusion of the Project.

### Sales and Use Tax Rates

At the present time, local governments in 34 states are authorized to impose local sales taxes. There are about 7,600 jurisdictions across the country that have chosen to impose a local sales tax; this number could grow significantly if local governments that have the authority to

impose a tax, but have chosen not to, reverse course and choose to impose the levy. This myriad of tax rates imposes significant administrative burdens on multistate sellers, particularly smaller sellers whose ability to sell nationally and internationally is enhanced by the advent of electronic commerce.

As part of the discussion of a simplified sales tax system and subject to the “Prefatory Caveat,” the Project arrived at the following recommendation:<sup>1</sup>

*There should be one tax rate per state which would apply to all commerce involving goods or services that are taxable in that state. Provision must be made to ensure protection and equitable distribution of revenues to local jurisdictions. The details of how to encourage or require states, local governments, and businesses to participate in this new system need further study.*

The Project also examined other options that could be used to simplify state and local sales and use tax structures as well as to simplify the administration of such rates for sellers.

### **Duty to Collect Sales and Use Taxes and Other Taxing Jurisdiction Issues**

The Project held general discussions on the possibility of expanding the duty of some remote sellers to collect sales and use taxes. Several proposals were discussed, but these discussions did not yield a substantive agreement. Participants were concerned with a variety of issues, including the lack of details concerning sales tax simplification and a potential “spillover” effect on other taxes.

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<sup>1</sup> Readers are reminded of the Prefatory Caveat in connection with all resolutions discussed throughout this report. The agreements reflected in any of the resolutions in this report were tentative only and must be considered in light of the overarching principle that nothing is agreed to unless everything is agreed to.

## **Sales and Use Tax Base Issues**

The current sales and use tax system gives states (and some localities) broad powers to determine whether goods and services are fully taxable, taxable at a special rate or fully exempt. The taxable or exempt status of a transaction may depend on the specific product or service, how a product or service will be used, who is purchasing the product or service, and/or whether the product or service will be resold. This diversity of state and local tax base provisions adds significant complexity for multistate sellers trying to comply with sales and use taxes.

As part of its overall effort, the Project examined sales and use tax base complexity and options for base simplification and uniformity.

*Uniform Tax Base* — Proposals to require states to adopt a uniform tax base were rejected. In light of the general agreement that state authority to determine taxability or exemption of goods and services should be preserved, the Project unanimously adopted the following resolution concerning tax base issues:

*The Project’s work should not be viewed as recommending or determining what products or services should or should not be taxed in any state.*

*Uniform “Menu” Defining Goods and Services* — One problem facing multistate sellers is that an identical product sold in multiple states may be defined differently by some or all of those states. It was generally accepted that the development of a uniform “menu” that all states would use to define products and services for sales and tax purposes, while retaining the authority to determine whether or not to tax them, would be desirable for purposes of constructing state tax bases. Such a menu would need to contain sufficient detail to enable it to be capable of representing the states’ current tax bases. This would simplify the development of software that would enable sellers to determine, for each state, whether their product or service was taxable in the customer’s state. Several possible models for such a “menu” were explored, and the Project identified the new United Nations Central Product Classification system as a possible model. The Project did not endorse a specific classification system.

*Uniform Treatment of Business Purchases* — To avoid pyramiding or cascading (imposition of a tax on a tax), many states provide sales and use tax exemptions for certain business purchases. This adds complexity for sellers who must determine whether a purchaser's exemption certificate is legitimate. The Project explored several options for mitigating this complexity, but made no specific recommendation. One option explored was the development of model business purchase definitions for several common transactions, including: (1) sales for resale; (2) products that become components of another product; (3) items used or consumed in the manufacturing process; and (4) agricultural equipment and supplies. Such model definitions would allow, and possibly encourage, states to standardize their treatment of business purchases.

### **Sourcing Transactions for Sales and Use Tax Purposes**

Developing effective and practical recommendations for sourcing transactions in an electronic environment requires the balancing of often competing and conflicting interests and objectives. These include avoiding undue burdens on electronic commerce vendors, enabling governmental units to tax consumption occurring within their borders should they choose to do so, recognizing the unique characteristics of electronic commerce, avoiding confusion on the part of consumers and intrusions into their privacy rights, and attempting to promote neutrality in the tax treatment of similar transactions achieved through different marketing mechanisms.

The Project approved the following resolution reflecting the consensus of the Project regarding the sourcing of transactions:<sup>2</sup>

*For sourcing of transactions for sales and use tax purposes, the following principles should be followed:*

- *Transactions should be sourced only to the state level; sourcing to a sub-state level should not be required.*

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<sup>2</sup> Readers are reminded of the Prefatory Caveat in connection with all resolutions discussed throughout this report. The agreements reflected in any of the resolutions in this report were tentative only and must be considered in light of the overarching principle that nothing is agreed to unless everything is agreed to.

- *Transactions should be sourced to the state of use or destination to the extent that adequate information is available in a practical, unobtrusive and efficient manner. Transactions for which such information is not available should be subject to one or more default rules, to be developed.*
- *Procedures should be developed dealing with audits and recordkeeping.*

Some Project members, however, expressed concern about sourcing only to the state level and argued that insufficient information would be available for allocating sales tax revenues to the substate jurisdiction in which the consumption occurs. Some other Project members expressed the view that sourcing to the seller's state, rather than to the state of destination or use, (especially in the case of digital products and services) would be easier to administer.

In addition to its general recommendation, the Project examined the information that could be expected to be available during various types of electronic commerce transactions and developed several possible conventions that could be used to address practical questions of implementing the general recommendation. It also developed a series of potential "safe harbors" that could be used to protect sellers from additional liability if they rely on information provided by customers in making sourcing decisions and that information is subsequently found to be erroneous. Finally, the Project discussed various alternative default rules that could be applied when insufficient sourcing information is available; participants, however, were not able to agree on a recommendation regarding a specific default rule.

Developing workable rules for electronic commerce requires the balancing of competing and conflicting interests, commonly requiring a trade-off between sourcing with geographic precision on the one hand and practicality and seller burden on the other.

## **Simplification of State and Local Sales and Use Tax Administration**

Nearly all observers of state and local sales taxes and their administration agree that the current system is complex. The burden of this complexity is most keenly felt by the multistate seller that must comply with the varying laws of the states and must contend with the differing administrative requirements imposed by each jurisdiction. One of the key attributes of electronic commerce is its ability to enable many new, small retailers to sell on an interstate and international basis, thus accentuating the burden imposed by the diversity in sales tax requirements among states. As a consequence, nearly any examination of the tax issues associated with electronic commerce should eventually address sales tax complexity.

The Project discussed various approaches to simplification. The discussion centered on issues most commonly identified by retailers as imposing significant administrative burdens and the steps that could be taken to simplify various aspects of sales tax administration and to improve the degree of uniformity exhibited by the states in the administration of the sales tax. The Project did not adopt a formal recommendation concerning specific proposals for administrative simplification. The discussions did, however, yield a number of simplification suggestions that could reasonably seem to be implemented and make a significant reduction in the burden of sales tax administration if implemented. These have been termed “working premises” and should not be construed to constitute a specific recommendation by the Project.

At the outset, the Project discussed three overall approaches to simplification:

- “*Base State Tax Administration*” under which a multistate seller would be responsible for dealing on most matters of tax administration (*e.g.*, registration, return filing, tax remittance and audit) with only one state -- its base state;
- “*Real Time Tax Administration*” in which the electronic technology through which the purchase and payment is being made also administers the sales and use tax; and
- *Improving the current system* by making substantive and procedural improvements to the current basic structure in which an interstate seller interacts with each state in which it collects tax and each state is responsible for administration of its own tax.



The Project chose to focus its efforts on improvements to the current system. Among the types of simplifications examined were:

- Uniform vendor registration form;
- Uniform sales and use tax return, increasing the ability to electronically file such returns and decreasing the frequency with which such returns are filed;
- Uniform state laws for bad debt deductions and use of direct pay permits;
- Uniform exemption certificates and other simplifications in the administration of exemptions; and
- Simplified audit, assessment and appeal procedures for multistate sellers.

Simplification of the current sales and use tax administration is critical, regardless of whether consideration is given to extending the duty to collect tax to certain remote sellers. The work of the Project indicates there are a number of avenues that can provide meaningful simplifications in pursuit of that goal.

### **Telecommunications Tax Issues**

The Project approved the inclusion of telecommunication taxes in its scope for two principal reasons: First, the Project's Organizing Document states that "[t]he first focus of the project will be issues concerning state and local sales and use taxation of *communications* and electronic commerce, including gross receipts taxes that are functionally equivalent to sales and use taxes." Second, since telecommunications constitutes much of the "backbone" of the Internet and electronic commerce, a tax structure which impedes the growth of a competitive telecommunications industry may impede the development of an efficient and competitive Internet and electronic commerce marketplace.

The Project addressed two primary issues: (1) how can "telecommunications" be defined to ensure competitive neutrality among competing firms and services without regard to historical

industry classifications that may be no longer relevant for tax purposes; and (2) how can state and local jurisdictions reform existing taxes to reduce the tax and compliance costs faced by some firms.

The Project could not, however, agree on a definition of “telecommunications.” Some members suggested, as a starting point, using a broad definition that borrowed elements of current state definitions. Other members were concerned that a broad definition would incorporate non-traditional forms of electronic communications — not currently defined as telecommunications today — thereby subjecting these non-traditional forms of electronic communications to numerous state and local telecommunications taxes and fees. Without an agreement on the definition, the Project found it impossible to make progress on the broader issues of state and local telecommunications tax reform.

### **Implementation Issues**

The Project considered two basic approaches to implementing its recommendations--- federal legislation and cooperative state action. Because the Project did not agree on any specific substantive proposal, it was never compelled to specify a preferred means of implementing any particular proposal. The following points, however, emerged from the Project’s consideration of implementation issues.

Congress could require states to adhere to federally-determined substantive criteria when taxing specified activity that affects interstate commerce, either by directly imposing such requirements on the states or by forbidding the states from taxing specified activity unless they conformed to federally-determined guidelines. Congress could also impose additional limitations on state taxing authority for states not adopting the federally-determined substantive criteria, or it could simply remove the restraints on state taxation that have evolved as a result of judicial interpretation of the Commerce Clause. Those supporting a federal legislative approach to implementation believe federal legislation is the only effective way to ensure uniformity in the adoption of any proposals to modify existing state and local tax systems.

Cooperative state action offers an alternative to federal legislation as a means of implementing proposals to modify existing state and local tax systems. Such action could follow that pattern of the states' adoption of other uniform legislation (*e.g.*, the Uniform Commercial Code), or it could be effectuated through the adoption of a multistate compact. Those supporting a cooperative state approach to implementation believe that it will be more sensitive to state concerns than federal legislation. Proponents of voluntary state action recognize, however, that federal action (either legislative or judicial) would be necessary to expand the duty of remote sellers to collect use taxes beyond that permitted by current Commerce Clause jurisprudence.

A third or hybrid approach would blend both state and federal action. Interested states could develop a multistate tax compact creating a harmonized tax system, and Congress could remove potential constitutional objections to such a compact by approving it. States not enacting the harmonized system through the compact would continue to be subject to current constitutional limitations on their taxing authority. This approach would allow states to retain their historic authority over the details of their tax system while permitting Congress to act to encourage consistency and uniformity in state and local taxation.

The Project also identified, but did not explore, two other concerns relating to legislative modification of existing state and local sales and use tax regimes: the necessity that such legislation must satisfy (1) federal due process requirements and (2) internal state constitutional restraints on state taxation.

# **Introduction**

## **Genesis of the Project**

Electronic commerce — the use of computer networks to facilitate commercial transactions involving the production, distribution, and sale of goods, services, and intangible property — has significant implications for state and local taxation as it does for just about everything else. Electronic commerce provides the environment in which digital products or services are transferred and sold. These products and services include text, sound, video, and other content that can be expressed as series of ones and zeros. Electronic commerce also opens up new avenues for the marketing of traditional goods and services directly to consumers. It creates similar opportunities for business-to-business transactions involving both digital and nondigital products and services. Indeed, American companies currently make billions of dollars worth of sales to one another over the Internet, several times the consumer retail total, and it is estimated that business-to-business sales could exceed one trillion dollars in the near future. Unless virtually all predictions are wrong, the growth of electronic commerce will continue to produce a dramatic expansion of commercial transactions occurring through digital networks.

The advent of electronic commerce raises a number of questions as to whether and how state and local taxes, particularly state and local sales and use taxes, should be applied to such commerce. These questions include:

- whether the existing state and local sales and use tax system is compatible with an electronic commerce environment;
- whether electronic commerce should be taxed at all considering the difficulty of taxing such commerce;
- whether not imposing or collecting tax on electronic commerce will undermine the sales and use tax base and create inequalities between sales of equivalent goods and services depending on the form or mode of delivery;

- whether the multiplicity of and inconsistency among existing state and local use tax laws creates an undue burden on sellers and purchasers in an electronic commerce environment, and, if so, whether it is possible to create greater consistency in state and local sales and use tax laws to facilitate application and administration of such laws in an electronic environment; and
- whether, and under what circumstances, vendors should be required to collect sales and use taxes where they have no physical presence in the state in which their product or service is delivered, assuming a state of delivery can be identified, and that, in some circumstances, vendors may have little or no information regarding their customers' location.

The National Tax Association Communications and Electronic Commerce Tax Project (the "Project") was organized to bring together representatives of the business community, state and local governments, professional organizations, and academia who share an interest in identifying possible solutions to the state and local tax issues raised by electronic commerce. The purpose of the Project was "to develop a broadly available public report that identifies and explores the issues involved in applying state and local taxes and fees to electronic commerce and that makes recommendations to state and local officials regarding the application of such taxes."<sup>3</sup> This Report is the result of the Project.

### **Organization and Operation of the Project**

**The Boston Conference** — In November 1996, in conjunction with the Annual Conference of the National Tax Association in Boston, the Federation of Tax Administrators, the Multistate Tax Commission, the National Conference of State Legislatures, and the National Tax Association sponsored a Conference on Taxation of Telecommunications and Electronic Commerce. The Boston Conference was the first of its kind to bring together representatives of

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<sup>3</sup>NTA Project, "Description of the Organization and Operation of the Communications and Electronic Commerce Tax Project" (undated).

business, government, and academia to focus on the host of issues raised by taxation of telecommunications and electronic commerce at the federal, state, and local levels. The Boston Conference included wide ranging discussions from markedly different viewpoints of the impact of changes in telecommunications law and technology, and the development of the Internet, on the federal income tax, on state corporate income and sales taxes, and on local property taxes and franchise fees.

Despite the significant differences of opinion on many of the critical issues that were voiced at the Boston Conference, two themes emerged during the course of the presentations and discussions. First, many of the conference participants appeared to share the view that taxation of telecommunications and electronic commerce, particularly at the state and local levels, raised a series of significant problems that required a uniform, equitable, and administrable solution on a nationwide basis. Second, many of the conference participants likewise appeared to share the view that such a solution could be achieved if representatives of business and government worked with one another to resolve these problems. Indeed, the suggestion was made at the close of the Boston Conference that an effort be undertaken, with the cooperation of interested parties and academics, to forge a solution to the problems raised by state taxation of telecommunications and electronic commerce through the drafting of a uniform state statute.

**Organization of the Project**— Shortly after the Boston Conference, a series of preliminary meetings were held at which representatives of states, localities, and business groups, as well as several academics, convened to establish a structure within which efforts to address the problems raised by state taxation of telecommunications and electronic commerce might be pursued. Over the course of the next nine months, considerable attention was devoted to the precise framework in which these efforts would be undertaken, and, late in the summer of 1997, the group agreed on its form of organization and operation.

The National Tax Association (NTA), an organization with a long and distinguished history as a forum for the discussion and evaluation of tax policy and with a broad-based

membership from the business, government, and the academic communities, was chosen to be the neutral convener of the Communications and Electronic Commerce Tax Project. The governing body of the Project is the Steering Committee, which consists of 16 business representatives, 16 government representatives, and seven "other" representatives from independent professional associations and academia. As noted above, the purpose of the Project was to develop a report that identified and explored the issues raised by state taxation of communications and electronic commerce.

While the NTA provided the framework for discussions of alternative policies dealing with the tax issues raised by taxation of communications and electronic commerce, its Board of Directors did so with the explicit understanding that NTA does not take positions with regard to tax policy and that any recommendations of the Project do not represent those of the National Tax Association.

**The Work of the Project** — The Project was created to examine state and local tax issues related to communications and electronic commerce. The Project's work initially embraced all types of state and local taxes. However, the Project participants agreed that the first set of discussions should focus on sales, use, and telecommunications taxes, and the Project, in fact, up to this juncture, has focused primarily on such taxes and has not considered other types of taxes in significant detail. Early on in the Project, however, it was agreed that any recommendation made with respect to electronic commerce would also have to be considered in the context of other forms of commerce.

Beginning with the first meeting of the Project's Steering Committee in September 1997 and continuing through its most recent meeting in July 1999,<sup>4</sup> the Steering Committee considered a wide range of issues raised by state and local taxation of electronic commerce and telecommunications. While the initial efforts of the Project (and its drafting committee) were

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<sup>4</sup>The Steering Committee met nine times between September 1997 and July 1999: September 1997 (Washington, DC); November 1997 (Chicago, IL); February 1998 (San Diego, CA); April 1998 (Salt Lake City, UT); July 1998 (Las Vegas, NV); November 1998 (Washington, DC); January 1999 (Washington, DC); March 1999 (Washington, DC); and July 1999 (Salt Lake City, UT).

devoted to designing a statute that might resolve a number of the issues raised by sales and use taxation of electronic commerce, it immediately became clear that any effort to draft a statute was premature in light of the numerous areas of disagreement and uncertainty that were brought to light in the responses to the preliminary report of the initial drafting committee. Accordingly, the Steering Committee created the following six subcommittees to pursue the work of the Project: (1) scope; (2) situs and sourcing; (3) tax base; (4) tax rate; (5) filing; and (6) other administrative issues. The Steering Committee subsequently determined that there was a need to set up a seventh subcommittee to address telecommunications tax issues.

Much of the Project's work was carried out under the auspices of these subcommittees. The subcommittees undertook a substantial effort to gather information, conduct research, and, in frequent conference calls, to explore the issues with which they were charged.<sup>5</sup>

**The Project Report** — Despite the Project participants' significant investment in time and effort over the course of nearly two years in attempting to develop a consensus and a set of recommendations regarding the appropriate approach to state and local sales and use taxation of electronic commerce and communications, the Project was unable to reach agreement on many of the key issues it considered. As a consequence, the Steering Committee agreed that the Project's report would be an educational document to provide context for the work of the Project to date and, for each major issue on which the Project worked, a description of items of agreement and a neutral and balanced description of items not resolved. The balance of this introduction provides additional background discussion to assist readers in placing this Report in its appropriate context. The remainder of the Report describes the substance of the work of the Project and the areas of agreement and disagreement.

## **The Context of the Report**

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<sup>5</sup> Each of these Subcommittees developed background reports that were presented and discussed at Steering Committee meetings. The reports are available from the Project files and represent a valuable source of information. The Subcommittee reports were not "approved" by the Steering Committee, and they should not be construed to represent the official position of the Project. Where there are conflicts between Subcommittee reports and this Report, this Report controls.



The Project's Steering Committee believes that a full appreciation of the substantive discussion in the Report is possible only if the Report itself is understood in the context in which the Project was conducted and the Report was produced. The ensuing discussion is designed to shed further light on that context.

**Attributes of Electronic Commerce With Significant Implications for State and Local Taxation** — Electronic commerce increases the ability of sellers, including those who could not previously sell to a national and international market, to engage in interstate and international commerce through direct interaction with potential buyers. From the standpoint of state and local taxation, such direct interaction enables a wider range of vendors to make sales to purchasers and conduct other business activity in a state without establishing a physical presence there, since they communicate with their customers solely by electronic means.

Another key attribute of electronic commerce with important implications for state and local taxation is that, in principle at least, it allows for provision of digital products and services from remote locations and the receipt of such products and services at remote locations. Regardless of where digital products or services may be produced, they can be transmitted quickly from any location in the world. Such digital products or services can then be offered from that location to customers in any other location in the world that is capable of receiving and storing digital signals.

Electronic commerce also provides enhanced opportunities for engaging in anonymous transactions, *i.e.*, transactions that occur in a manner in which the seller does not know who the buyer is or where the buyer is located. Such transactions may involve the transfer of digital products or services with no verifiable individual or geographic identifiers. They may also involve the payment for such products or services with electronic cash, which likewise contains no verifiable individual or geographic identifier.

**Sales and Use Tax Issues Raised by Electronic Commerce** — We have alluded above to some of the key issues that electronic commerce raises for state and local sales and use taxes.

Many of these are variations on issues that have long existed with regard to the sales and use tax. The emergence of electronic commerce magnifies the impact of these issues, making them more significant.

*Collection Responsibility for State and Local Use Taxes* — The circumstances under which an out-of-state vendor may be required to collect a use tax that is due to the state from the customer (on products sold to customers within the state) has been the focus of legal and political controversy in the context of mail-order and other remote selling for over 30 years. If increasing amounts of economic activity will be conducted through electronic commerce by remote vendors, the question naturally arises as to which states, if any, would and/or should have jurisdiction to require collection of sales or use taxes associated with such activity. If states and localities are unable to collect sales or use taxes with respect to such activity, there could be substantial revenue implications for particular state and local governments. In addition, if such transactions effectuated through electronic commerce are not amenable to tax collection for legal or practical reasons, it raises the question of whether taxing the sale or use of equivalent products or services in conventional commerce is equitable. The answer to these questions may raise the fundamental issue posed at the outset of this introduction, namely, whether the existing state and local sales and use tax system is compatible with an electronic commerce environment.

*Complexity and Inconsistency of State and Local Sales and Use Tax Laws* — The complexity within states and the inconsistency among states in the existing state and local sales tax structure has been a major concern with respect to the ability of this structure to accommodate the world of electronic commerce. Although this is not a novel concern to state taxpayers and state tax administrators, it is one that is exacerbated in the context of electronic commerce because of the expectation that more vendors will be selling more products (digital and nondigital) into more states with less contact and less familiarity with the states and their tax systems than ever before. Consequently, the need for simplification of the sales and use tax system is apparent if it is to be a viable and administrable mechanism for raising revenue in the electronic environment.

*Sources of Complexity* — The principal sources of complexity that the Project identified in the existing sales and use tax structure, and to which a considerable portion of its efforts were directed, were tax rates, the tax base, and tax administration. With respect to rates, the essential problem is the existence of different rates in different localities within a state. These differences raise serious compliance concerns. With respect to base, the essential problems are: (1) the lack of consistent and uniform definitions of goods and services across states, thus complicating vendor efforts to determine taxable and nontaxable goods and services; and (2) lack of one information resource for what is taxable and not taxable in each state.<sup>6</sup> With respect to tax administration, the concerns relate to multiple and sometimes inconsistent requirements for registration, returns, remittances, exemption certificates, and audits.

*Telecommunications Tax Issues* — As the Project's title suggests, telecommunications taxation was a significant concern of the Project. Although many of the issues described under the rubric of "electronic commerce" are equally applicable to telecommunications, state and local taxation of telecommunications raises a number of special concerns. These concerns were the subject of considerable discussion in the course of the Project. The following issues were discussed: (1) whether state and local transaction taxes imposed on telecommunications providers and their customers should be applied uniformly, without regard to the regulatory status of the entity providing the service; (2) whether it is possible to arrive at a uniform definition of "telecommunications"; (3) whether the tax system should provide a mechanism for "unbundling" telecommunications from other services for tax purposes; and (4) whether administrative burdens on telecommunications taxation can be minimized, consistent with the legitimate concerns of local governments for revenue, by imposing a single state-wide transaction tax in lieu of various state and local telecommunications taxes.

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<sup>6</sup>The Project determined early on that it would not take any position on whether any particular goods or services should or should not be taxable. The Project's concern with "tax base" issues was limited to designing a system in which a state's freedom to determine its tax base would be preserved, but that, in determining what to tax or not to tax, the state would be required to adhere to uniform classifications and/or definitions of taxable or nontaxable products and services.

**The Course of the Project** — Against the foregoing background, the Project in many regards became an examination of sales and use tax issues that existed under old technology but were magnified by new ones. It also examined certain new tax issues presented by electronic commerce. As such, the Project explored the possibility of wholesale reform of state and local sales and use tax law and administration with an eye towards improving its workability in today's economy. The Project in the end was unable to reach an agreement that satisfied the concerns of both government and business representatives. The inability to reach agreement may be traced in part to the natural tension that exists in our federal system between state sovereignty and local authority on the one hand and the needs of a national marketplace for a tax regime that is simple, uniform and easily administered.

The project explored--only in conceptual terms and not in detail--the potential for applying technology to tax administration as a means of addressing the issues raised above. The technology underlying electronic commerce is evolving rapidly and may ultimately provide ways of resolving certain of these issues.

In the final analysis, much was gained by exploring the critical issues raised by state and local taxation of communications and electronic commerce and, perhaps, in laying the groundwork for future resolution of these issues.

## Prefatory Caveat

One working assumption underlay all the work of the Project, to wit: “*Nothing is agreed to until everything is agreed to.*” Consequently, the Steering Committee wishes to emphasize at the outset that it would seriously misrepresent the work of the Project to pluck any of its tentative and preliminary conclusions, including specifically those it reached by a formal vote, out of context and to represent them as the conclusion of the Project.

As the Introduction reveals, the Project spent nearly two years exploring a broad array of issues in a continually evolving political context. These deliberations were ultimately unsuccessful in reaching a consensus on a set of recommendations regarding the appropriate approach to state and local sales and use taxation of electronic commerce and telecommunications. In light of the inextricable interrelationships between the various issues that the Project considered, the Steering Committee believes that this prefatory caveat is crucial to a proper understanding of the ensuing Report.

One example is particularly illustrative of the importance of this prefatory caveat to all parties. For the business representatives, one sales tax rate per state was the essential ingredient in any sales tax simplification package. For the government representatives, an expanded duty to collect sales and use tax on remote sales was the essential ingredient of any such package. Midway through its work, the Project endorsed the principle that there should be one sales tax rate per state for all goods and services subject to tax in the state. The Project, however, was never able to reach a consensus on expanding the duty to collect. Therefore, it would be incorrect to attribute to the Project an endorsement of the one-rate-per-state principle without an explanation that many who supported that principle did so only in the context of a simplified sales tax system with an expanded duty to collect.

In short, the Steering Committee urges in the strongest of possible terms that readers of the ensuing Report view it for what it is — a document that explores many controversial issues and reaches firm conclusions about none of them. Although the Report clearly reveals areas of

greater and lesser consensus, the bottom line is this: *Because there was no agreement on a package of recommendations, there was no agreement on any particular recommendation.*

# Sales and Use Tax Rates

## Introduction

At the present time, local governments in 34 states are authorized to impose local sales taxes. There are about 7,600 jurisdictions across the country that have chosen to impose a local sales tax; this number could grow significantly if local governments that have the authority to impose a tax, but have chosen not to, reverse course and choose to impose the levy. This myriad of tax rates imposes significant administrative burdens on multistate sellers, particularly smaller sellers whose ability to sell nationally and internationally is enhanced by the advent of electronic commerce. These administrative issues include:

- Obtaining the information necessary to identify the destination jurisdiction for the goods and services being sold;
- Purchasing and maintaining the software necessary to translate the jurisdiction to the appropriate tax rate;<sup>7</sup>
- Maintaining systems to ensure awareness of new taxes or tax rate changes;
- Confusion on the part of customers concerning the tax rate that should be applied, particularly if the customer is completing an order form and computing the tax on her/his own and/or purchasing items to be delivered to more than one location;
- Reporting the tax collected by individual local jurisdictions on sales and use tax returns; and
- Increased audit exposure and potential liability for incorrectly applied tax rates.

The current pattern of varying local tax rates particularly affects multistate sellers, especially smaller vendors that are now, from a practical standpoint, able to participate in the multistate market for the first time because of the Internet. Not inconsequentially, the current

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<sup>7</sup> Proper determination of tax rates generally requires obtaining the street address of the buyer and translating that to the appropriate taxing district, and then assigning a tax rate. Software to accomplish this has been designed, but its reliability varies depending on certain circumstances. In addition, multistate vendors consider the costs associated with such software significant, particularly in light of the obligation imposed on them to collect the tax by the government.

pattern of local tax rates also burdens state tax administration agencies because it complicates the audit process and creates additional requirements for processing and reconciling returns so that revenues can be distributed to local jurisdictions with some degree of accuracy.

During the discussions, government members insisted that any proposal to alter local option sales taxes should take into account the role and importance of such taxes in the local fiscal structure. They pointed to the fact that over the last three decades, states have reduced the role of property taxes and increased the role of sales taxes in financing local government projects and operations. Traditional local services such as police, fire protection and education depend increasingly on sales taxes. Local sales taxes also fund facilities that provide localized, rather than statewide benefits, such as educational and sports centers, cultural facilities and transportation projects, many of which have been funded with long-term debt backed by local-option taxes. Local-option sales taxes are often established through local referenda, while property taxes and local levies remain unpopular by comparison.

### **Project Recommendation**

The issue of tax rates was among the most difficult philosophical issues faced by the Project. Nearly all Project members agree that the current rate structure complicates sales tax administration in the areas of assigning appropriate tax rates, sourcing transactions, and filing tax returns. By the same token, virtually all Project members recognize the importance of local option sales taxes revenues in the fiscal system of many local governments. Any movement to constrain their use may substantially disrupt the fiscal systems of some local governments unless sales and use tax revenues are shared with them on an equitable basis by the states. Nonetheless, as part of the discussion of a simplified sales tax system and subject to the “Prefatory Caveat”, the Project arrived at the following recommendation:

*There should be one tax rate per state which would apply to all commerce involving goods or services that are taxable in that state. Provision must be made to ensure protection and equitable distribution of revenues to local jurisdictions.*



*The details of how to encourage or require states, local governments, and businesses to participate in this new system need further study.*

### **Alternatives to “One Rate per State”**

Some Project members believe there is considerable opportunity to simplify the system of tax rates without adopting single state-wide tax rates. Alternatives discussed, but not adopted, that may warrant further examination include:

- Conforming tax rate boundaries to some other known boundary (*e.g.*, Zip Codes or Zip + 4 boundaries);
- Holding sellers harmless (*i.e.*, eliminating audit risk) if they use approved software for establishing tax rates;
- Adopting GIS<sup>8</sup> coding to identify taxing districts; or
- Modifying the current rate structure to reduce the variability (*e.g.*, two rates – one for remote and a second for over the counter transactions).

### **Other Related Issues**

Another issue discussed was how a single rate per state would be established. Options considered by Project members included setting a single rate at the lowest rate currently levied within a state. Other options discussed included a blended rate reflecting a weighted average of existing rates, or the highest rate currently levied.<sup>9</sup>

Simplification of tax rates also requires consideration of the frequency of tax rate changes and the related issue of allowing sufficient lead-time to implement such changes. This issue requires balancing the flexibility required by those who levy sales taxes with the certainty required by those required to collect the taxes. An example cited was catalog sales, where

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<sup>8</sup> The Geographic Information System (“GIS”) locates facilities by the longitude and latitude coordinates. It can be used to map addresses to taxing districts.

<sup>9</sup> Each option raises issues such as revenue neutrality, equity between communities within the same state that currently levy different substate rates, and potential revenue windfalls or shortfalls.

printing deadlines may not be compatible with current notification practices employed by states. While the catalog sales example reflects a concern of remote sellers, the issue of lead time affects all commerce. Members expressed a preference for less frequent changes which would not only provide additional notice, but mitigate the burden of staying abreast of changing tax rates. Other members pointed to the varying fiscal years used by state and local governments and the significance of being able to adjust rates up or down quickly after a policy decision is made to raise or lower tax rates.

## **Conclusion**

Dealing with the current pattern of local government sales tax rates is one of the most important issues that must be addressed in any discussion of sales tax simplification and uniformity. Any resolution must address seriously competing views of the importance of local fiscal autonomy as well as of the actual complexities faced by vendors and consumers. It must also deal with potentially significant fiscal dislocations.

# **Duty to Collect Sales and Use Taxes and Other Taxing Jurisdiction Issues**

## **Introduction**

One of the issues addressed by the Project's Steering Committee concerned the possibility of expanding the obligation of some remote sellers to collect sales and use taxes. The Government representatives viewed an expanded duty to collect as necessary to improve the equity, stability and effectiveness of the sales tax and as a major motivation for them to discuss substantial sales and use tax simplification. Business representatives were concerned about the limited scope of tax simplification under consideration and that an agreed-to change in the jurisdictional standard for sales and use tax collection would lead to unintended consequences in the business activity tax nexus area.

## **Description of Discussions**

The general discussions focused on the extent of a seller's obligation to collect sales and use taxes. The options explored included: (1) supplementing or completely replacing the current nexus standards with a collection duty premised on sales volume within the United States (*i.e.*, a national sales threshold) and/or within a given state (*i.e.*, state sales threshold); (2) retaining the current constitutional nexus standards set by such cases as *Quill* and *Jefferson Lines*; and (3) clarifying the type and extent of an interstate marketer's physical presence within a state necessary to give rise to a collection duty.

Some participants advocated a sales and use tax collection duty incorporating a sales threshold standard because it would: (1) establish a bright line standard, simpler and clearer than current nexus standards; (2) substantially reduce or eliminate nexus disputes; (3) recognize the contributions of state and local governments to supporting commerce; and (4) foster a level playing field among competing retailers selling into the same market place. Further, the advocates of expanding the duty to collect sales and use taxes through sales threshold standards believe that

such a duty is reasonable in the context of greater uniformity and simplification of sales and use taxes and protections for certain sellers from being subject to other forms of taxation.

Retaining current constitutional nexus standards was advocated by some participants as (1) protecting interstate marketers and consumers from the myriad of unduly burdensome, inconsistent and confusing state and local tax obligations; (2) not submitting remote sellers to the jurisdiction of states where these companies receive no direct services or other benefits from state and local governments; and (3) constituting an appropriate reliance on nexus standards established by the Supreme Court in well-established case precedent.

Clarification of physical presence nexus standards was advocated by some participants as a means of reinforcing current Supreme Court precedent by describing, with greater precision, those business activities in which an interstate marketer may engage without being subject to state tax obligations that may arise from unclear and/or inconsistent application among the states of existing nexus standards.

### **Reasons for Lack of Agreement on an Expanded Duty to Collect**

While many participants understood the relevance of considering an expanded duty to collect sales and use taxes as part of a simplified tax environment, the discussions did not result in an agreement. Some Business representatives were unwilling to agree to an expanded duty to collect sales and use tax until after the main ingredients of sales and use tax simplification were identified, described and agreed to by the Steering Committee. Others felt that the current nexus standards applicable to sales and use tax collection are justified, regardless of the level of simplification achieved.

Further, some representatives were concerned that an agreement on an expanded duty to collect sales and use taxes would affect nexus for other types of taxes. While there was some agreement to incorporate safeguards to ensure that nexus for business activity taxes (*e.g.*, franchise, corporate income, gross receipts, and similar taxes) would not be affected by changes in the sales and use tax area, the participants could not agree on a method to guard against this

“spillover” problem. Business representatives believe that a physical presence nexus test is the appropriate standard for business activity taxes. Other participants believe that measures of economic activity, not physical presence, are the appropriate standard for business activity tax nexus. These participants proposed that the "spillover" problem can be resolved by a law providing that registration to collect sales and use taxes under an expanded duty to collect requirement does not, by itself, create nexus for any other taxes. This proposal was rejected by some as not providing the appropriate nexus standard for business activity taxes that would otherwise guard against "spillover."

## **Conclusion**

Some members of the Project’s Steering Committee recognized the relevance of considering a revised standard for the duty to collect sales and use taxes. Because of the inability of the participants to agree on the related matters discussed above (*i.e.*, simplification and “spillover”), however, the Project’s participants could not agree on a new standard.

# **Sales and Use Tax Base Issues**

## **Introduction**

The current sales and use tax system gives states (and some localities) broad powers to determine whether goods and services are fully taxable, not taxable or taxable at a special rate. The taxable or exempt status of a transaction may depend on the specific product or service, how a product or service will be used, who is purchasing the product or service, and whether the product or service will be resold. This diversity of state and local tax base provisions adds significant complexity for multistate sellers trying to comply with sales and use taxes.

There was general agreement among the Project participants that the use of uniform definitions and/or classifications of products and services would be desirable for purposes of constructing state tax bases. There was also general agreement that once a uniform system of definitions/classifications is developed, each state would have the sovereignty to determine which components of the defined list would, or would not, be taxed. Business members stressed that the power to determine the tax base should reside only with the state, and that the base for any local government tax must conform to the state's tax base. This system was perceived as simplifying sales and use tax compliance and administration for multistate sellers.

The Project examined: (1) possible sources for a uniform system of definitions/classifications of products and services; and (2) certain tax policy questions related to the designation of the tax base.

## **Sources for Uniform Tax Base Definitions/Classifications**

Several potential sources for uniform definitions and classifications of products and services were identified; each is discussed briefly below. For reasons described below, the Project considered the United Nations Centralized Product Classification (CPC) Scheme to be the most likely starting point for developing uniform tax base definitions.

**United States Harmonized Tariff Schedule (Harmonized System)** — The United States Harmonized Tariff Schedule (the "Harmonized System") is derived from the Harmonized Commodity Description and Coding System, maintained by the World Customs Organization. The Harmonized System was designed to assist in the application of tariffs (*i.e.*, for tax purposes), and is international in nature; all major trading partners of the United States utilize an identical or nearly identical system (a bonus when dealing with cross-border electronic commerce).

The Harmonized System schedule has 22 major subdivisions or sections, each containing one or more chapters; in all, there are 99 chapters containing 8,500 tariff descriptions and corresponding tariff numbers at the eight-digit rate level. Theoretically, for any imaginable item there is only one tariff description that is legally the most correct. Corollary sources are required for proper classification, including six General Rules of Interpretation and four Additional U.S. Rules of Interpretation. The classification process is complex and time-consuming, but likely to yield an exact result.

While the system of classification is extensive, it is devoted solely to the identification/classification of goods and does not include services. In addition, the level of detail for classifying taxable goods is extensive and may be more than is required in most state tax systems.<sup>10</sup>

**North American Industrial Code System (NAICS)** — The NAICS system is designed to replace the Standard Industrial Code (SIC) system of 1987. It is currently being used by NAFTA countries. The NAICS system utilizes a 6-digit code (expanded from the SIC 4-digit

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<sup>10</sup> To review the Harmonized System, go to the following Web sites: (1) Alphabetized list of codes: <<http://www.customs.ustras.gov/imp-exp/rulings/harmoniz/hrm230.html#1>>. (2) List of codes by product classification, with search engine: <<http://www.customs.ustras.gov/imp-exp/rulings/harmoniz/index.htm>>. (3) General Web site: <[www.usitc.gov](http://www.usitc.gov)>.

codes) to categorize industries. The numbers refer to industry sectors and sub-sectors, by reference to a hierarchical production- or supply-based framework.<sup>11</sup>

Production-based classifications of goods and services may not be particularly helpful for sales/use tax base designation purposes because consumption/use is generally viewed as a more relevant criteria for tax policy purposes than is production. On the positive side, the NAICS codes now attempt to identify new and emerging industries, service industries<sup>12</sup> in general, and advanced technology industries.<sup>13</sup>

**Bureau of Labor Statistics Expense Categories** — The Bureau of Labor Statistics (BLS) prepares a listing of 450 or so discretionary expense categories, including goods and services. The BLS data reflect a survey conducted to determine how consumers spend their disposable dollars. Therefore, the survey classifications are *much* less detailed, and organized, than the NAICS or Harmonized System. On the other hand, they are more manageable in terms of the level of detail and number of classifications.<sup>14</sup>

**United Nations Central Products Classification (CPC) System** — The United Nations is sponsoring an effort to develop a Central Products Classification (CPC) system, "based on the

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11	XX	Industry Sector
	XXX	Industry Subsector
	XXXX	Industry Group
	XXXXX	NAICS Industry
	XXXXXX	National Industry
	21	Mining
	212	Mining, Except Oil and Gas
	2122	Metal Ore Mining
	21222	Gold and Silver Mining
	212221	Gold Mining

<sup>12</sup>One member of the Project has posed the question whether the production/consumption distinction is as important for purposes of classifying services as it is for purposes of classifying goods.

<sup>13</sup> Additional information on the NAICS classifications can be found at: <http://www.census.gov/ftp/pub/epcd/www/naics.html>. An explanation of the NAICS may also be found in the July 1996 edition of *Tax Administrators News*, published by the Federation of Tax Administrators.

<sup>14</sup> To review the BLS Expense Classifications, go to the following Web site: <http://stats.bls.gov/csxgloss.htm#expn>.



physical characteristics of goods or on the nature of the services rendered. CPC provides a framework for international comparison of the various kinds of statistics dealing with goods, services and assets. It covers categories for all products (goods and services) that can be subjects of domestic and international transactions or which can be put into stocks."<sup>15</sup> The CPC system was targeted for a 1998 release, but work continues on that system. Interestingly, the CPC system keys off of the Harmonized Tariff Code System for classification purposes. The U.S. Census Bureau is also working on a product-based classification of goods and services that it hopes will be ready by the year 2002. This system will probably build on the CPC.

Building a tax-specific definition and classification system for goods and services would be extremely labor-intensive because choices cannot be made between the NAICS and Harmonized Systems, including their competing definitions for goods, without detailed review of the two systems. In addition, the process would require that consensus be reached regarding the appropriate level of refinement to be achieved in product or service classifications. On the one hand, the classifications must be detailed enough to provide certainty to taxpayers who are trying to ascertain whether a particular item is included in a state's tax base. On the other hand, too much detail and complexity may stall legislative processes and encumber tax compliance efforts.

The Project generally believes that any further work in this area should focus on the United Nations CPC system and the U.S. Census Bureau's efforts to create integrated classification systems for both goods and services. Additional work must be done with regard to the CPC before it can be utilized at the state and local level for sales and use tax purposes.<sup>16</sup>

### **Other Issues Considered by the Project**

A number of policy issues that arise in the context of an examination of the sales/use tax base were considered by the Project. These issues are summarized below, with alternative

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<sup>15</sup> Cf. URL for United Nations Website <<http://www.un.org/Depts/unsd/class/cpcprof.htm>>.

<sup>16</sup> To begin this effort, one state representative, in conjunction with three states is analyzing the use of the United Nations CPC system as the basis for uniform definitions to be used by states to determine their tax bases. This analysis was ongoing at the time of this Report. Further information is available from the Multistate Tax Commission.

approaches to the issues and the perceived advantages and disadvantages of contrasting approaches.

**Enumeration/Exclusion Approach to Defining Tax Base** — States currently use two methods – enumeration and exclusion -- to specify whether particular goods and services are subject to the sales and use tax. Under the enumeration approach, goods and services are presumed to be exempt unless specifically listed in the statute or administrative rule. Under the exclusion approach, goods and services are deemed taxable unless specifically excluded by statute or administrative rule. As a general rule in current sales tax statutes, states employ the exclusion approach to dealing with the taxation of goods or tangible personal property and the enumeration approach when dealing with the taxation of services. The result of this approach is that most sales of tangible personal property are taxable, but that sales of services are not taxable in the large majority of states.

The enumeration approach puts the burden on the legislature and the tax administration agency to take affirmative action to add new products and services to the tax base, while the exclusion approach assumes that goods and services are taxable unless specifically exempt by statute or rule. Under a uniform national system for classifying goods and services, states could employ either method for delineating taxable goods and services.

**Exemptions** — As with the uniform menu of tax base items, consideration was given to whether the development of a uniform exemption menu may be desirable to promote uniformity, support desirable exemptions (*e.g.*, tax-exempt charitable organization purchasers), and reduce double taxation (*e.g.*, from cascading taxes on business inputs). The Project discussed the issue of purchases of taxable items by exempt organizations and business purchases of taxable items that are incorporated into other products or consumed in the production process. Currently, there is little uniformity among states in their treatment of such purchases, and some Project members suggested that a uniform, simplified sales tax collection system should develop procedures to address these issues while respecting the right of states to set rules for business and exempt organization purchases.

*Business Purchases* — The Project discussed the current practices regarding the taxation of business purchases. The sales tax is intended to be a tax on final consumption. When businesses purchase goods that are resold, including inputs that are incorporated into other products or consumed in the production process -- indeed, any time they make taxable purchases -- the possibility of double taxation, or pyramiding, exists. States have developed rules that provide exemptions for businesses that purchase taxable items that are resold or incorporated into products later sold at retail. In addition, some states exempt from the sales tax goods and services that are used or consumed in the production process—fuels, utilities, or manufacturing machinery, for example.

States vary significantly in the degree to which the taxation of business purchases plays a role in their sales tax structure. Various studies have estimated that from 18 to 65 percent of the initial incidence of the sales tax falls upon businesses, with an overall average of about 40 percent.

This 40 percent figure, however, does not represent the degree of pyramiding in state sales taxes. In some instances, business inputs are taxable, and final sales are not. For example, imposing tax on purchases of paper and computer products by an accounting firm would constitute taxing business inputs. If the accounting services are exempt from the sales tax, however, there is no pyramiding.

It was suggested that a simplified sales tax structure could effectively address this issue by developing uniform definitions for exemptions of business purchases. Under current practice, most states exclude:

- Sales for resale;
- Purchases that become components of another product;
- Items used or consumed in the manufacturing process; and
- Agricultural equipment and supplies.

In the context of communications and electronic commerce, the question may arise whether "sales for resale" should be clarified to include sales of both goods and services. If a state chooses, it could expand the listed exemptions to include categories where there is not an established current practice (*e.g.*, exempt telecommunication services purchased by an Internet service provider).

The Project agreed that states should have the option of deciding whether to grant these exemptions. State policymakers are in the best position to determine which business purchases should be exempt from taxation. Yet, there was also general agreement that simplification could be enhanced if, as in the case of the definitions of potentially taxed (or excluded) products discussed above, there were a uniform "menu" of possibly exempt business purchases from which each state could choose.<sup>17</sup>

An alternative approach that was suggested would be to develop "baseline" business purchase exemptions that all states could agree upon (*e.g.*, two of the four categories listed above). States granting additional tax exemptions could institute a mechanism whereby firms pay the sales tax and then claim a refund for same, with respect to those purchases that are not uniformly granted an exemption.

*Exempt Organizations* — This issue is addressed in the Simplification of State and Local Sales and Use Tax Administration section of this report.

*Additional Comments on Exemptions* — According to some economists, a pure sales tax should apply only to final purchases. The New Mexico gross receipts tax, for example, may closely approximate the economists' ideal sales and use tax by providing an invoice credit system that prevents pyramiding and double taxation. In this respect, the New Mexico gross

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<sup>17</sup> The Project also discussed the use of uniform exemption certificates to simplify administration of exempt purchases. See discussion under Simplification of State and Local Sales and Use Tax Administration elsewhere in this report.

receipts tax (a form of vendor sales tax) comes closest to the transaction-style value added tax (VAT).

Most states, however, have implicitly rejected the VAT in favor of a sales tax that does not exclude all sales to businesses. The imposition of rules to require states to exempt all business purchases from the sales tax would be a dramatic departure from current state tax policy. It would create significant fiscal issues for some states and could undermine support for movement toward uniform definitions of state tax bases. For this reason, the Project acknowledges that states want continued flexibility to determine how business purchases should be treated under the sales tax.

**Uniform Interpretation/Application of the Tax Base Menu** — It was agreed that implementation of a system of uniform definitions of items subject to (and exempt from) the sales tax should, in and of itself, reduce instances of inconsistent treatment of identical tax base items. In addition, the Project discussed establishing “fall-back” measures to ensure that different states interpret and apply identical classifications in a consistent manner. These measures include: (a) utilizing the CPC's rules of interpretation (*i.e.*, four to six rules designed to reduce the options when attempting to classify goods or services as one thing or another under the system); (b) requiring states, as an initial matter, to come to agreement among themselves as to which interpretation is correct; and (c) as a last resort, establishing a "competent authority" to rule on inconsistencies.

**Dynamic Tax Base System** — Changes to the uniform tax base menu will undoubtedly be required (*e.g.*, to address omissions or to introduce new technology-driven goods or services). Most members of the Project agreed that a process must be established to regulate such changes. In cases where the states have compelled such a change, it was considered equitable to require that changes be only periodic (*e.g.*, only every other year) and prospective in effect.

**Bundled Transactions** — The Project also considered the desirability of establishing objective criteria for handling bundled transactions, where one component is deemed taxable and

another component is deemed non-taxable. The objective criteria might depend upon comparison of fair market value or cost of goods sold, for the components. This system may call for all-or-nothing taxability, or it may permit disaggregation of the charge to account for the non-taxable portion (even if the price to the customer is not broken out). The Project did not make a specific recommendation on bundled transactions.

**Classification of Products by Form or Means of Delivery** — Any effort to develop sales and use tax definitions from a standard goods and services classification schedule will need to address the "video example"; *i.e.*, how do we address the fact that there are both technical distinctions and potential tax policy distinctions between various ways to access video material, including: (1) purchase of tangible video cassette; (2) rental of video from retail store; (3) download video material from Internet or online service; and (4) pay to attend screening of video in theatre. The use of a broad tax base classification or definition may result in all forms of access to video material being taxable; however, there may well be sound policy-based reasons for distinguishing the tax treatment by reference to format or means of delivery, just as there may be sound policy-based reasons for distinguishing the tax treatment of products based on their use.

## **Conclusion**

Tax base simplification is a key element of efforts to simplify and reform state and local sales and use taxes. Base simplification must balance the conflicting issues of preserving states' sovereign right to determine whether to tax or exempt goods and services with the need to create a system that is not unduly burdensome. The Project examined several possible product and service classification systems that, if used, could bring substantial uniformity to the current system. Further work needs to be done to determine which systems, if any, can be useful in bringing greater uniformity to the definitions of goods and services for state and local sales tax purposes.

# Sourcing Transactions for Sales and Use Tax Purposes

## Introduction

Currently, the general rule, subject to certain exceptions, is that a transaction is situated or sourced for sales and use tax purposes to the state to which the product is destined for use or consumption. This traditional approach works reasonably well when the buyer and seller are engaged in a face-to-face, over-the-counter transaction or there is other information routinely available to indicate the destination of the item being purchased. Implementation of this traditional construct becomes more complicated in an electronic commerce environment where the actual destination or point of consumption for a digital product or service may not be known to the seller. The task before the Project was to develop recommendations regarding the governmental jurisdiction to which a transaction conducted electronically, or otherwise, should be assigned for tax purposes. Once it reached a conclusion on that general question, the Project also discussed a series of issues regarding potential implementation.

## Project Recommendation

At its January 1999 meeting, the Project Steering Committee approved the following resolution establishing the consensus of the Project regarding the sourcing of transactions:<sup>18</sup>

*For sourcing of transactions for sales and use tax purposes, the following principles should be followed:*

- *Transactions should be sourced only to the state level; sourcing to a sub-state level should not be required.*
- *Transactions should be sourced to the state of use or destination to the extent that adequate information is available in a practical, unobtrusive*

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<sup>18</sup> Readers are reminded of the Prefatory Caveat in connection with all resolutions discussed throughout this report. The agreements reflected in any of the resolutions in this report were tentative only and must be considered in light of the overarching principle that nothing is agreed to unless everything is agreed to.

*and efficient manner. Transactions for which such information is not available should be subject to one or more default rules, to be developed.*

- *Procedures should be developed dealing with audits and recordkeeping.*

While the various parts of the recommendation are discussed separately below, the reader is cautioned not to treat any individual part as a stand-alone conclusion.

## **Background**

Sales and use taxes have historically been designed to impose an excise on the consumption of goods and services occurring in the jurisdiction in which the consumption occurs. The general rule, subject to certain exceptions, is that a transaction is situated or sourced for tax purposes to the state to which the product is destined for use or consumption.<sup>19</sup> In a face-to-face, over the counter transaction, the tax is applied at the point of sale on the basis that delivery is taken at that point. No further inquiry is made as to the ultimate destination or point of use of the product. The traditional approach works reasonably well when the buyer and seller are engaged in a face-to-face, over-the-counter transaction or other information is routinely available to identify where the purchased item will be used or consumed.

The traditional construct becomes more complicated in an electronic commerce environment because the participants do not engage in face-to-face transactions, and some items being sold may be digital products or services delivered via the Internet or other electronic means. In contrast to the sale of tangible goods, the destination of digital products may be difficult to determine. Products may be accessed from any location where a mobile consumer with a computer chooses to download the product. Moreover, certain buyers, such as companies or charitable organizations, may have multiple users (*e.g.*, employees or members) who access the digital products from locations in various states. In addition, in some electronic commerce

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<sup>19</sup>There are certain categories of exceptions to the general rule. Some sales of services are also sourced to the point of sale or performance and not the point of ultimate use. For example, transportation services may be taxed at the point of sale even if the transportation actually occurs in more than one jurisdiction. Special sourcing rules have been developed for some types of tangible personal property. For example, sales of flowers in which a florist in one jurisdiction makes arrangements for delivery of the flowers in another jurisdiction are commonly sourced to the jurisdiction of the florist with whom the customer placed the order. Finally, some states source sales for local sales tax purposes to the point of sale, rather than point of use, where delivery is not taken at the time of the sale.



transactions, depending upon the form of payment and the nature of the product being sold, the state of consumption or use may not be known to the seller in the normal course of the transaction.

These complications demonstrate that certain traditional principles are likely to require some adaptation if they are to work practically and without creating unnecessary complications and burdens in an electronic environment. They also highlight the importance of developing clear rules regarding the manner in which such transactions should be sourced for tax purposes should a state choose to impose tax on electronic transactions.

During the course of the discussions, the following competing and often conflicting issues emerged:

- Avoiding undue burdens on electronic commerce so that it may continue to thrive. This includes avoiding the imposition of unnecessary and burdensome administrative requirements on interstate sellers that are associated with having to source and report on transactions to the many different state and local jurisdictions that impose a sales and use tax, and minimizing the burden imposed on interstate sellers to obtain and process information.
- Enabling governments to require sellers to collect taxes on consumption that occurs within the governments' borders should they choose to do so, particularly in light of the extensive use of sales and use taxes by local governments in many states;
- Developing sourcing rules that are sufficiently straightforward that they do not confuse consumers and are not likely to cause a potential buyer to forego completion of a purchase;
- Recognizing the unique characteristics of electronic commerce, including the absence of traditional identifying information in some transactions and the inherent limitations that a seller faces in being able to obtain consistently reliable sourcing information in an electronic transaction;

- Avoiding intrusions into the privacy rights of buyers; and
- Pursuing, to the maximum extent possible, neutrality in the treatment of similar goods/services and of similar transactions accomplished through different distribution channels.

### **Sourcing to State Level Only**

As one part of its overall sourcing recommendation, the Project recommends that any requirements for sourcing transactions should be limited to sourcing to the state level only. There should be no requirement that transactions be sourced to a substate (individual city, county or other taxing district) level.

The Project's participants believe that this recommendation appropriately balances many of the issues and interests identified above. Implementation of this recommendation would enable transactions to be sourced (at least to some extent) to the point of destination or use<sup>20</sup> without imposing a set of requirements on sellers that would be as burdensome as those associated with obtaining, processing and reporting detailed information at the sub-state level. It also recognizes that only limited information may be available in certain electronic commerce transactions.

The recommendation provides for tax rules to be applied based on the state (as opposed to locality) in which the consumption will occur. It does so in a manner that requires the seller to be in possession of a minimum amount of information (*i.e.*, identification of the state of the buyer). This should increase the proportion of transactions for which the requisite sourcing information is available in the normal course of business.<sup>21</sup> It should also reduce potential burdens and complications for sellers as well as reduce concerns about intrusions into matters of privacy and personal information, compared to other alternatives. The recommendation helps

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<sup>20</sup> The recommendation was adopted in the context of a recommendation that called for taxing all commerce within a state at a single rate and that contained provisions aimed at ensuring protection and equitable distribution of revenues to local jurisdictions. See Prefatory Caveat section of the Report

<sup>21</sup> See further discussion under section entitled, "Obtaining information in a practical, unobtrusive and efficient manner" below.

avoid drawing distinctions between forms of commerce (*e.g.*, electronic vs. mail order) or types of products (*e.g.*, digital vs. tangible).

**Local Tax Issue** — The administration of local sales taxes was one of the most difficult issues addressed by the Project. Local sales taxes are an important element of local fiscal systems; yet, they also impose substantial burdens on sellers, particularly in an electronic commerce environment. If transactions are sourced only to the state level, sufficient information would not be available to impose local tax rates and to allocate revenues to the substate jurisdiction in which the consumption occurs.<sup>22</sup>

As a consequence, some Project members have expressed concern about sourcing only to the state level, particularly in light of the inability of the Project to agree on an overall package of simplifications and recommendations. These members, in contrast to the Project recommendation, would argue for transactions to be sourced to the individual street address of the buyer so that local option taxes could be imposed. They counter that the information required for sourcing transactions to the substate level is generally available or can be obtained without great difficulty, at least for the large proportion of transactions involving sales of tangible personal property.

Other Project members, including those that support the Project recommendation, express serious reservations over a requirement that would source transactions to a specific substate jurisdiction in an effort to maintain the current system of local option tax rates. Sourcing to this level requires obtaining information at the individual street address level. According to these members, even where such information is normally available (*e.g.*, with the shipment of tangible goods), the assignment of the appropriate tax rate to a transaction is problematic because it requires the development of technology, creates opportunities for errors and consequent audit

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<sup>22</sup>At the present time, 34 states authorize certain local governments to impose a local sales tax of varying rates; a local use tax is likewise imposed in most of these states. As many as 7,600 local jurisdictions impose a sales/use tax currently. In all but four states, these local taxes are generally collected, remitted and administered in conjunction with the state sales tax, but at varying local rates. Tax returns in these states require sellers to report sales by local jurisdiction, and local tax revenues are remitted to individual jurisdictions based at least in part on the jurisdiction in which the tax was collected.

risk and increases the likelihood that a potential buyer will terminate a transaction without consummating the sale. Some Project members also believe it imposes a significant reporting burden on retailers.

Moreover, these members point out, information at the individual street address level is not likely to be routinely available (and is generally not necessary) for transactions involving digital products and services where there is no shipment of tangible property. Obtaining individual street address information for sourcing these electronic commerce transactions requires a buyer to disclose private information, may lead to intentionally misleading information and imposes a compliance burden on sellers. The result may well present such complexity and risk for the seller that a “default rule” could consume the “general rule.”

**Other Options Discussed** — The Project discussed and rejected certain tax rate options that have implications for sourcing to a sub-state level. Those are briefly discussed below.

- One option would be to use the U.S. Postal Service Zip Code of the buyer to determine the tax rate to be applied. Sourcing transactions to the Zip Code would require less information than for sourcing to an individual street address, but give greater precision than the state-level only. Zip codes, however, do not necessarily correspond with the boundaries of local tax jurisdictions. Moreover, from a sourcing standpoint, the question is whether the appropriate Zip Code can reasonably be obtained during the course of all electronic transactions. Such information would normally be available for transactions involving the shipment of tangible personal property, but not necessarily for digital products. For electronic transactions, obtaining the Zip Code of the buyer, if it were not otherwise required for the transaction, imposes a greater burden on the seller than obtaining only state-level information; it also increases the likelihood of error.
- A second option would be to allow local option tax rates (perhaps with some limits) on “over-the-counter” sales, but to have a single rate for each state that

would be applied to interstate<sup>23</sup> or in-state remote sales (*e.g.*, intra-state sales of digital products). From a sourcing standpoint, adoption of this system would be consistent with the approach recommended (*i.e.*, sourcing only to the state level) and not create new sourcing issues. It would, however, treat identical transactions differently, depending on the means by which they are conducted and could be confusing to consumers.

- A third option would be to treat sales of tangible and digital products differently for sourcing purposes. Under such an approach, sales of tangible property could be sourced to the street address level based on available shipping information. Sales of digital products or services transacted electronically could be sourced to the state-level only. From a sourcing standpoint, such a system is likely workable. However, it does create a discrepancy in the treatment of what may be functionally equivalent products (*e.g.*, downloaded music and a compact disc) based solely on the form of the product, thus violating a goal of neutrality. It could also be confusing to consumers.

The level to which transactions should be sourced is a difficult and important one that has a substantial impact on the degree to which local governments will be able to employ local option sales and use taxes as they have in the past. While sourcing considerations should not be the sole determinant of this issue, there are inherent, practical limits regarding the level of information that a seller can reasonably be expected to obtain during a transaction.

### **Sourcing to the State of Destination or Use**

As one part of its overall sourcing recommendation, the Project recommends that all transactions, electronic or otherwise, should be sourced for tax purposes to the state of destination to the extent that adequate information is available in a practical, unobtrusive and efficient manner. In other words, the Project recommends that transactions should be taxable in

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<sup>23</sup> The decision of the U.S. Supreme Court in *Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994), would require that the rate applied to interstate commerce could not exceed the lowest rate applied within the state to an “over-the-counter” sale in order to avoid discrimination against interstate commerce.

the state in which the consumption is presumed to occur based on the destination or use of the product or service being purchased. (Availability of information is discussed below.)

The Project's participants believe this recommendation provides continuity with traditional state tax sourcing practices and represents appropriate modifications of traditional principles to achieve their workability in an electronic commerce environment. It also grants states the greatest degree of control and flexibility in regard to the tax base by focusing taxation on consumption occurring within the borders of the state. It avoids economic distortions that might occur from other sourcing regimes and affords the most appropriate political relationship between the persons and entities being taxed and the use of tax revenues by state and local governments. The principle also supports consistent treatment of electronic commerce and traditional over-the-counter sales.

**Sourcing Alternatives** — Those Project members who did not support the Project sourcing recommendation discussed above suggested certain alternatives.

*Sourcing to the Sub-state Level* — If transactions were to be sourced to a sub-state level, some Project members challenge the continuing vitality and practicality of the Project recommendation for sourcing transactions to the state of use or destination. They believe that the Project recommendations for sourcing to the destination state and sourcing to the state level only were mutually dependent parts of the recommendation. Moreover, they believe that the complexity of sourcing to the sub-state level is such that alternatives to destination state sourcing merit consideration.

*Sourcing to Seller's State* — Another alternative is to source transactions to the seller's state rather than to the buyer's state. Under such an origin state system, there would be a single rate, a single set of exemptions, and a single administrative system (including audits) that would apply to all of a retailer's sales (or at least those sales originating from a single location). Proponents of an origin state system argue that the cost of administering an origin-based system would be substantially less for both merchants and states than is a destination-based system.

Lack of information as to where a digital product is destined would be irrelevant because it would be the location of the merchant, and not the customer, that would determine the state which has the opportunity to tax the transaction. Uniform rules would be needed to identify the state of origin.

Other Project members, including those that support the recommendation of sourcing to the state of destination, are opposed to an origin-based system. They argue that a consumption tax, to achieve its purpose, must flow to the state in which the consumption occurs and not to the state where the seller is located. They also argue that an origin-based tax would amount to a tax on production and on exports, and would lead to economic distortions favoring sellers that located in a jurisdiction without a sales tax or in one exempting all or part of the products/services of the seller.

**Unresolved Issue: Gifting Transactions** — Siting a transaction to the state of destination or use is generally not difficult in the sale of tangible personal property. For such goods, there is usually a “ship to” address identifying the state where the customer is located, and this address can be accepted by both sellers and state governments as determinative of the state of use. A problem arises, however, in transactions where a single purchaser directs the delivery of goods to third party donees located in different states. This situation occurs most frequently with gifting transactions, in which the purchaser is not the ultimate recipient and user of the goods. To tax each gift item at a different rate (and possibly subject to differing product exemptions) would result in a transaction that would be confusing to both the buyer and the merchant. One possible way for dealing with this problem is to source all consumer transactions to the state in which the purchaser is located, irrespective of the state where the goods are destined.

### **“Practical, Unobtrusive and Efficient” Information Gathering**

As one part of its overall sourcing recommendation, the Project recommends that information to be used for sourcing to the destination state should be capable of being obtained in a "practical, unobtrusive and efficient manner" (with default rules when that is not possible). In

developing its recommendation, the Project attempted to be sensitive to the burden its proposals would place on sellers and their interaction with customers. The desire was to obtain the information necessary for sourcing, but to do so in a fashion that was “practical, unobtrusive and efficient.”

The Project’s participants felt that it was practical and reasonable to look only to information that would be available to a seller during the normal course of the transaction for sourcing purposes. In other words, a seller should not be expected to undertake steps to examine other information it might have in its files (*i.e.*, that may not be available and used in the course of the transaction). At one point it was thought that current processes for making credit card purchases could be leveraged to obtain and verify sourcing information at the time a transaction was taking place. A more informed understanding of the current credit card approval process caused the Project to conclude that such a verification process is not viable at the present time.

**Possible Sourcing Conventions** — In its work, the Project’s participants discussed a series of approaches that could be used to address practical questions of implementing the general Project recommendation. It does not constitute a Project recommendation, but represents a context for further discussions.

*Tangible Goods* — In the case of tangible goods, the “ship to” address could be used to determine the destination of the product and the state to which it is to be sourced, where the information is available. Such information is expected to be available to the seller in the normal course of the transaction, regardless of whether the transaction is with an individual or a business entity, at least as such transactions are customarily handled today.<sup>24</sup>

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<sup>24</sup>It has been suggested that business practices may be developed that will prevent the seller from knowing the address to which the goods are shipped. If such becomes the case, it would be expected that such sales would be handled in the same manner transactions in digital products for which sourcing information is not available in the normal course of the transaction.



*Digital Products/Services Delivered Online* — For sales of some products/services in electronic commerce, the following hierarchy of sourcing rules and conventions could be applied.<sup>25</sup>

- When the seller, at the time and in the ordinary course of the transaction, has knowledge of the actual state of destination or use, the sale would be sourced to that state. Given current business practices, this situation is most likely to occur in transactions with business customers with whom the seller has an ongoing business relationship.<sup>26</sup>
- In cases where billing and payment for the product/service occur contemporaneously with the delivery of the product, the actual state of use may not be known at the time of the transaction. In such cases, the seller could default to determining the Billing Address of the buyer, defined as the state (not street address) in which the buyer maintains a Billing Address. The Billing Address of the buyer is suggested as a proxy for the actual state of destination or use because the latter may not be known with precision in many electronic commerce transactions. The Billing Address is suggested as a “rough justice” approach to sourcing that reasonably represents the location at which a buyer would make the predominant use of electronic products/services. The most likely sources of this information will be from information requested by the seller for purposes of follow-up marketing and technical support or from information gathered from the

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<sup>25</sup>It should be noted that transactions involving certain digital products, particularly computer software, are not technically “sales” in which title to property is passed, but instead are commonly “licenses to use” the digital product under specified conditions. It is the transfer of this license for consideration that is considered subject to tax here.

<sup>26</sup>The distinction made between “business” and “non-business” purchases is admittedly imperfect. There will be sales to business customers that are “one-time” in nature where the order, payment and delivery take place simultaneously without follow-up requirements. Such sales would most likely be treated in a fashion similar to a sale to an individual, *i.e.*, sourced to the state shown in the billing address. Conversely, there may be cases where an individual maintains an on-going business relationship with an electronic commerce seller and billing and payment are not performed at the time of the transaction. In such cases, a seller may have information on the state of use that can be used for sourcing purposes. The central point of the recommendation is that if information on the state of use is not available to the seller in the normal course of the transaction, the transaction will be sourced to the state of the Billing Address, regardless of the nature of the customer.

customer for purposes of processing payments<sup>27</sup> in today's business environment.<sup>28</sup>

- If the state of Billing Address is not available to the seller in the normal course of the transaction, the transaction will be treated in accord with one of the alternatives discussed in the section on a default rule(s) below. [Note: Project members could not agree on whether a seller should be obligated to request from the buyer the state of the billing address before proceeding to treat the transaction under the default rule. See discussion below.]

In light of the importance of obtaining accurate sourcing information to the proper allocation of tax, the Project discussed (without ultimate resolution) the desirability of encouraging states to provide financial incentives to sellers to obtain the required sourcing information. For example, states could provide a graduated vendor allowance or collection discount to qualified vendors of electronic commerce if the proportion of sales for which sourcing information is obtained exceeds certain levels.

**Unresolved Issue: Inquiries of the Buyer** — The Project's participants do not agree on what requirements should be imposed on a seller if the required sourcing information is not available from normal business records used during the course of the transaction.

Some Project members believe that, in such situations, a seller should be required to request the buyer to identify the jurisdiction to which the transaction should be sourced before proceeding to apply a default rule(s).<sup>29</sup> These members believe that requesting only the state to

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<sup>27</sup>The current practice of some on line vendors is to request the Billing Address of the buyer for purposes of processing the transaction. Such information could be used for sourcing the transaction.

<sup>28</sup>There has been much discussion in technology circles that digital cash and other new electronic payment vehicles that allow for "anonymous" transactions will frustrate any sourcing regime that attempts to tie transactions to a geographic location. The U.S. market, in particular, has been slow to adapt to such technologies.

<sup>29</sup> It is expected that the request would indicate the purpose(s) for which the information is sought and the consequences of not providing it, [*i.e.* that the transaction would therefore be subject to a "default rule" and the

which the transaction should be sourced is not a substantial intrusion into the interaction between the buyer and seller and does not constitute a significant privacy issue. They believe it is an appropriate requirement given the importance they place on sourcing transactions to the point of destination or use. These members are also concerned if there is not a requirement to inquire of the state of destination, the “default rule(s)” (see discussion below) will become the “general rule” and the goal of sourcing to the state of destination will be frustrated.

Other Project members believe such a requirement is inappropriate because it obligates a seller to obtain information not otherwise pertinent to the transaction. They believe such an inquiry might deter a buyer from completing the transaction. They are also concerned that such an inquiry will be seen by consumers as a privacy intrusion and could lead to the gathering of “personal information” that could expose sellers to additional legal obligations.<sup>30</sup> These members believe that if the required sourcing information is not available in the regular course of the transaction, the seller should be excused from collecting a sales tax or the transaction should be subjected to the default rule(s) discussed below.

**Unresolved Issue: Multiple User Products** — Products, data and services that can be accessed or used by multiple individuals in multiple locations present a unique issue for sourcing sales and use taxes. The central question is whether the tax on such transactions should be apportioned among jurisdictions in which the use takes place or whether it should be assigned to a single location, *e.g.*, corporate headquarters or location of Billing Address. If the tax is to be apportioned, the question of obtaining the necessary information must then be addressed. The Project was not able to reach consensus on these issues, and no Project recommendation is presented. The views of some members on this subject are discussed below.

Some Project members believe that the tax on sales of products, data or services that are subject to use or access from multiple locations should be apportioned among the states in which

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nature of the default rule.] [See elsewhere in this section for a discussion of the purpose and nature of a default rule.]

<sup>30</sup>It has been suggested that if the requirement was stated as "an opportunity for the buyer to provide sourcing information" rather than an obligation imposed on the seller, it could be more acceptable to some parties.

the users are present to avoid an over-allocation of tax to some jurisdictions and an under-allocation to others. They believe apportionment will most commonly come into play on sales to customers with whom the seller has an established business relationship and, thus, both an interest and ability to obtain information on where a product is being used and by how many users. These members urge that the obligation to provide the apportionment information should be placed on the purchaser, not the seller, and that the basis for apportionment need only be “reasonable” as opposed to absolutely precise. These members note that some states (*e.g.*, Texas) use this approach currently in taxing information services and that expanded use of direct pay would facilitate compliance with this recommendation by allowing the purchaser to assume full responsibility for apportionment and remittance of the appropriate tax.<sup>31</sup>

Other Project members believe the apportionment approach complicates, rather than simplifies, taxation issues relating to electronic commerce. Moreover, they believe such apportionment would place too great a burden on electronic commerce sellers and potentially expose them to liability for improperly allocated tax. These members contend also that there is no practical way to determine which transactions should be apportioned and which should not since many sales of electronic commerce are capable of being transacted from multiple locations by multiple persons.

### **Default Rule(s)**

As one part of its overall sourcing recommendation, the Project recommends that one or more “default rules” should be developed to govern transactions for which the sourcing information outlined above is not available. The Project members did not reach agreement on the appropriate default rule(s).

If transactions are to be sourced to the destination-state, circumstances will arise where, based upon information available or acquired during the ordinary course of the transaction, the

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<sup>31</sup> See the section on Administrative Simplification for further discussion. “Direct pay” is a procedure entered into with certain types of taxpayers where the taxpayer is relieved of paying tax on its purchases to its vendors and is responsible instead for calculating and remitting tax directly to the tax administration authority.

actual state of destination or use (or the acceptable proxies therefor) will not be known to the seller. This could result from the use of new forms of anonymous payment (so-called “electronic cash”) and other circumstances where the electronic merchant does not obtain location or billing address information, and there are no tangible goods being shipped. Alternatively, sourcing information may not be obtainable because a customer prefers to withhold such information.

The January 1999 resolution of the Project called for “one or more default rules, to be developed” for such transactions. The Project’s participants were not able to agree on any such default rules, although several alternatives were considered.

Proponents of a default rule believe it would serve the interests of both states and sellers. For governmental units, it would mean that all transactions in which destination information could not be obtained would, nonetheless, be subject to some form of sales tax regime. Consequently, no sale would become an exempt sale simply because the requisite information needed to administer the tax could not be obtained from or was withheld by the buyer. For the seller, the default rule would provide certainty and direction on how to deal with situations where the destination of a product being sold could not be determined.

Critics of a default rule are concerned that it could be administratively burdensome. The Project was not able to determine the number of sale transactions currently occurring, or likely to occur in the future, in which the billing address of a buyer (at least to the state level) cannot be identified. These critics believe that unless the problem is one of sufficient magnitude, the establishment of complicated default rules may be a cure that is worse than the illness. They suggest that a decision on the need for a default rule should be deferred until reliable estimates of the volume of transactions potentially subject to a default rule can be made. Absent a default rule, merchants should not be obligated to collect use tax on transactions where no sourcing information can be obtained, in their view.

**Alternatives** — The default rule alternatives considered by the Project included: (1) a “throw-back” approach that would assign the sale to the origin state (*i.e.*, the state of the seller),

and (2) a “throw-around” rule which would subject transactions to a nationwide tax rate with various options for distribution of the proceeds.

*Throw-back Rule* —A “throw-back” rule would provide that transactions where sourcing information is not available would be taxed by the origin state. The determination of the originating state might be based upon commercial domicile, principal facilities, point of product fulfillment, or some other criteria. Supporters of this model consider it to be straightforward and simple, and they believe that it imposes minimal burdens on sellers. Opponents of this approach are concerned that an origin state default system would permit sellers to locate in states with no sales taxes or low sales taxes, thus resulting in economic distortions. They also believe that such a rule would run counter to the intent of taxing consumption in the state in which it occurs.

*Throw-around Rule* — A “throw around” rule would provide that sales for which sourcing information is not available would be subjected to a single tax rate that is the same for all sellers in all states. There are three issues that need to be addressed in connection with such a default rule: determination of the tax rate; determination of the distribution of the tax; and determination of which jurisdiction will impose the default tax.

Proponents of a “throw around” default rule have suggested a number of alternative methods of determining the default tax rate. One possibility is to take a simple or weighted average of all state sales tax rates (including zero rates for states without sales taxes). An alternative approach would be to attempt to determine the average rate for all sales to known destinations for the previous year. Yet another approach would be to determine the single rate on a product-by-product or service-by-service basis. The objective would be to avoid the problem of skewing the rates on sales of a particular product or service by reference to the rates on unrelated products or services that might be more heavily or lightly taxed than the service or product in question.

With regard to the distribution of the revenues, at least two approaches have been suggested. The first would be to distribute the revenues among the states in proportion to the

revenues reported for sales with a known destination. A second suggestion is to dedicate the revenues from the default rule to the development or application of electronic commerce, rather than being remitted to the states. For example, the revenues might be dedicated to the development of the next generation Internet, the use of the Internet in education, or the expansion of public access to the Internet.

Third, with regard to the determination of which jurisdiction would impose the default tax and be responsible for its collection and distribution, one possibility would be for the originating state to impose such a tax. A problem with this approach, however, is that it could require states without sales taxes to participate in a system for which they currently have no administrative machinery. Alternatively, it has been suggested that the seller in a default rule transaction would be required to remit the tax to the state to which it remitted the largest portion of its sales tax receipts during the preceding year.

Proponents of the “throw-around” approach contend it provides maximum protection to state and local sales tax bases and avoids situations where sales/use tax revenue cannot be collected due to lack of information. Such a default rule would attempt to treat transactions without sourcing information in a manner that resembles the “average” transaction where sourcing information is known.

Opponents of a “throw-around” rule argue that it is overly complex and confusing and would be burdensome and expensive to administer. Critics also are concerned that certain of the approaches under consideration would result in the distribution of tax revenues to states that have no relationship to the underlying transaction, either in terms of the location of the customer or of the seller. To this extent, the default rule would extend state taxation to transactions over which the state has no jurisdictional authority. In addition, critics of the assumptions underlying the “throw-around” rule are concerned that such a default rule would have the effect of subjecting certain transactions to tax when, if all facts were known, no tax would be imposed. It would also impose a tax when a buyer withholds information, in good faith, on privacy grounds.

*Industry-specific Default Rules* — Several industries have unique circumstances that make either of the alternative default rules difficult to apply. It has been suggested that industry-specific sourcing rules should be considered in some circumstances. Proponents of such an approach have referred to the example of the service industry.

Many types of service transactions are performed in numerous states or performed for multistate customer groups. These transactions have rarely been subject to sales and use taxes, so their sourcing has been a matter of minor consequence. Where they have been taxable, industry-specific rules have been used, such as that approved by the U.S. Supreme Court for interstate bus transportation service in *Oklahoma Tax Commission v. Jefferson Lines*, 514 U.S. 175 (1995). There, Oklahoma, the state where the bus ticket was sold and the transportation began (*i.e.*, the state-of-origin) was permitted to tax the entire cost of an interstate bus ticket, and apportionment among the destination states was not required. The transportation and common carrier industries might generally be dealt with this way, in the event their services are subject to sales and use tax in a jurisdiction.

### **Audit and Recordkeeping Procedures**

As one part of its overall sourcing recommendation, the Project recommends that procedures should be developed to govern the audit and recordkeeping responsibilities of sellers with regard to sourcing. In its deliberations, the Project discussed that if a seller relies on information provided by a purchaser and such information was not "taken in bad faith," the seller should be protected from additional liability if the information on which he/she relied is subsequently found to be erroneous. The Project used the following working definition of "taken in bad faith:"

A seller's reliance on required sourcing information or resolution of conflicting sourcing information is "taken in bad faith" (and the seller is outside the safe harbor) if the seller has assisted in securing, or promoted the receipt of, false sourcing information with the



intent that the information if accepted as true will permit the avoidance of taxes otherwise due.<sup>32</sup>

Frequently, the seller will be required to rely on information provided by the buyer in making certain sales tax determinations; yet, the seller will not have any human or face-to-face interaction with the buyer. The Project considered, therefore, the degree to which sellers should be protected from liability for incorrectly applied or allocated tax if they rely on information provided by a purchaser and that information is subsequently found to be erroneous, provided that the seller has not actively participated in soliciting or inviting the erroneous information.

In its work, the Project discussed a series of safe harbors that would be available to sellers, presuming they were not acting in bad faith in securing the sourcing information from the buyer; however, no Project recommendation was made. Specific safe harbors considered by the Project include:

- If a purchaser provides the seller with address information that is used in conjunction with the order for product/service, the vendor should be able to rely on such information for collecting tax on the transaction.
- If a seller has conflicting information as to the actual state of destination or use, no seller should be held liable when the seller chooses one of the states in question and collects tax based on that state.
- A seller should be able to rely on address information found in established billing arrangements (*i.e.*, invoices, contracts, license agreements, letterhead, etc.) with the customer in determining the applicable address for sourcing.
- If a purchaser makes payment in advance of the transfer of the goods/service, the seller should be able to rely on address information found on checks, billing remittances or other documents (if any) used to effect the transaction.

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<sup>32</sup> In its discussions, the Project noted that accompanying a request for information from the purchaser with a notice of the consequences of providing or not providing the requested information does not constitute acting in bad faith or promoting the receipt of false information.

- If a seller receives information on the state of the buyer's Billing Address during the course a transaction, the seller should be able to rely on that information in determining the appropriate address for sourcing.
- If a seller requests the Billing Address of the customer during the course of the transaction, the seller should be able to rely on information provided by the customer in response to the request for sourcing a transaction. Accompanying such a request with information to the purchaser of the consequences of providing or not providing the requested billing address information should not constitute acting in bad faith, or promoting the receipt of false information.
- If a purchaser refuses to provide information requested by the seller or provides unresponsive information, the sale should be treated in accordance with a default rule.
- If a purchaser provides information that a seller, based on information readily available at the time of the transaction, knows to be false, or cannot reasonably consider as true, the sale should be handled in accordance with a default rule.

### **International Efforts at Coordinating Consumption Tax Sourcing**

As is often recounted, the Internet knows no geographic boundaries and electronic commerce transactions routinely flow across international boundaries as well as state boundaries. Many national governments, particularly in Europe, rely on consumption taxes much to the same degree as state and local governments in the U.S. As a consequence, they are attempting through various multinational organizations to deal with many of the same sourcing issues that are before the Project. The approaches they are discussing can be instructive in this country and should be kept in mind in fashioning a state and local system that will necessarily have international ramifications. The U.S. Treasury Department has made available to the Project a summary of various efforts to coordinate and design sourcing rules on an international basis. Participants in the Project encourage the Treasury Department to make this discussion, and any updates, available to those interested in the subject.

## **Conclusion**

Determining workable, appropriate sourcing rules is critical to the operation of the sales and use tax administration system. If transactions involving digital products are to be made subject to current sales and use taxes, traditional sourcing approaches need to be modified. Developing workable rules for electronic commerce requires the balancing of competing and conflicting interests, commonly requiring a trade-off between sourcing with geographic precision on the one hand and practicality and seller burden on the other.

## **Simplification of State and Local Sales and Use Tax Administration**

### **Introduction**

The Project did not adopt a formal recommendation concerning specific proposals for administrative simplification.<sup>33</sup> As a result, this section focuses on examining the issues most commonly identified by retailers as imposing significant administrative burdens and reviewing the discussions among Project members regarding steps that could be taken to simplify various aspects of sales tax administration and to improve the degree of uniformity exhibited by the states in the administration of the sales tax. The discussions should be considered to represent the "working premise" of the Project, with "working premise" defined as an approach to simplification of sales tax administration that could reasonably be implemented and make a significant reduction in the burden of sales tax administration if implemented. They should not be construed to constitute a specific recommendation by the Project.

### **Background**

State and local sales taxes and their administration are confusing and burdensome. The complexity of today's sales tax arises from the interaction between the sovereignty of states in our federal system and the limitations imposed on that sovereignty by the U.S. Constitution in support of a national market. In current circumstances, the states should reexamine and coordinate their decentralized tax systems to reduce administrative burdens.

In the sales tax arena, the burden of complexity is most keenly felt by those multistate sellers that must comply with the varying laws of the states and localities and must contend with the differing administrative requirements imposed by each jurisdiction. One of the key attributes of electronic commerce is its ability to provide many retailers the opportunity to undertake selling on an interstate and international basis. As a consequence, nearly any examination of the

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<sup>33</sup> Recommendations dealing with Tax Rates and Tax Base obviously promote simplification and uniformity. They are discussed elsewhere.

tax issues associated with electronic commerce should eventually address the sales tax complexity, particularly if consideration is given to potentially extending the duty to collect tax to remote sellers.

### **Approaches to Simplification**

The Project examined and discussed three general or overall approaches to administrative simplification: (1) base state tax administration (hereinafter referred to as the “Base State Approach”); (2) “real time” tax administration (hereinafter referred to as the “Real Time Approach”); and (3) improving the current system.

**Base State Tax Administration** — Under the Base State Approach to sales tax administration, a multistate seller would be responsible for dealing on most matters of tax administration (*e.g.*, registration, return filing, tax remittance and audit) with only one state -- its base state. This would likely be defined as the state in which it had its commercial domicile or its principal operations. It would be responsible for collecting tax on its sales in any state in which it was legally obligated to do so, but would file a tax report (covering all its sales) only with its base state. The tax administration authority in the base state would be responsible for providing information and funds and auditing on behalf of all other jurisdictions in which a particular seller is taxable.

Project members supporting the Base State Approach argue that it represents the quickest, most dramatic reduction in administrative burden for interstate sellers. While they still face the obligation to collect in all states in which they are required to do so, their contact for “paperwork” and administrative issues is limited to a single state, a single return, a single remittance and a single audit. These members note also that the Base State Approach has been effectively implemented in all states for the fuel use tax imposed on interstate motor carriers.<sup>34</sup>

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<sup>34</sup> The International Fuel Tax Agreement (IFTA) started as a voluntary agreement among several states. Federal legislation passed in 1991 made participation in the system mandatory by 1996, after a 5-year phase-in period. The Inter-modal Surface Transportation and Efficiency Act of 1991 provided that after September 30, 1996 no state (other than Alaska and Hawaii) could maintain a fuel use tax unless it participated in a base state agreement which provided for a single filing of return information and apportionment of revenues among the various states. In 1991, about 10 states belonged to IFTA. By 1996, all lower 48 states had joined as had most Canadian provinces.

Supporters believe that any administrative complexity this system would impose on states would be less than the complexity that is imposed on business in the current system. On the other hand, critics of the Base State Approach believe the opposite is true.

Critics of the Base State Approach contend that while it has been implemented in the fuel use tax area, it is not necessarily transferable to the sales tax area. The concerns raised by this group of Project members include:

- The complexity of sales taxes would make it extremely difficult for one state to administer and audit the sales tax on behalf of all others. There are also complex questions of law regarding the manner in which one state would enforce requirements on behalf of another that were unanswered.
- IFTA rests on an “origin-state” legal basis that raises serious questions about the ability to transfer the IFTA administrative system to a “destination-state” sales tax system.
- Adoption of a base state system would negatively affect the considerable investment state tax administration authorities have made in updating computer systems and business processes in recent years.
- Adoption of a base state system could have a potential timing impact on the cash flow of some states.
- The requirement to continue maintaining, collecting and being liable for the accuracy of jurisdiction-specific data causes the proposal not to ameliorate substantially the burden on sellers.

These concerns caused the Project to focus on other approaches to administrative simplification.

**Real Time Approach** — The central concept underlying a Real Time Approach to tax administration is to use the electronic technology through which the purchase and payment is

being made to also administer the sales and use tax. Under a Real Time Approach, as discussed in the Project, states and local governments would enter into arrangements with private sector interests, to develop and operate the technology for sales tax administration. To be viable, this technology would need to accommodate a full range of tax administration functions, including rules governing taxability determinations, selecting the appropriate tax rates, collection of the tax, remittance to the appropriate jurisdiction(s), and appropriate reporting. As a purchase is made, the information on what is being purchased, the purchase price and the jurisdiction to which the transaction is to be sourced would be brought together so the tax could be collected at the time of the transaction. Retailers would be relieved of tax collection duties and liability, and such responsibilities would be borne by the private sector interests operating the system. It should be noted that this system is not a system that would mandate a financial intermediary to collect and remit taxes.

The concept of the Real Time Approach was of great interest to some Project members. They feel it represents an appropriate approach to tax administration in that it places tax administration authorities in control of the technology responsible for tax administration and relieves the vendor of this obligation. It also makes appropriate use of technology in tax administration.

Given its far-reaching nature, there were naturally a number of issues and concerns raised regarding the Real Time Approach. As with Base State Approach, the complexity of the sales tax system was seen as a potential obstacle to the technical feasibility of the approach. Other issues raised included the potential for residual liability of vendors, financial feasibility, the institutional framework necessary to support the system, appropriate audit trails and procedures, exempt transactions, and the applicability to non-electronic means of commerce.

The Project determined that the concept of using electronic technology on a real-time basis for tax collection warranted further consideration. The Project, however, found it necessary to focus on other approaches to simplification, given the current state of knowledge concerning

the technological and cost feasibility of a real-time system as well as other issues that would need to be resolved.<sup>35</sup>

**Improving the Current System** — The third approach to simplification considered by the Project was to make substantive and procedural improvements to the current basic structure in which a seller interacts with each state in which it collects tax and each state is responsible for administration of its own tax. Some Project members felt that there were significant opportunities to simplify the current system and to reduce the burden it imposes, particularly by bringing greater uniformity to state administrative procedures and requirements. They felt that by concentrating efforts on simplifying filing and reporting procedures, bringing greater consistency to audit approaches, and addressing certain other administrative issues, the burden of the current system could be significantly reduced.

The Project focused most of its efforts on this third approach of developing improvements to the current sales and use tax administration system as representing the most realistic approach to achieving significant simplification in the near term. The results of that work are presented below.

### ***Scope of Recommendations***

**Issue:** As it performed its analysis, the Project addressed the question of whether its administrative simplification recommendations should apply to only electronic commerce, to all remote commerce, or to all commerce regardless of the marketing channel through which it occurs.

**Working Premise:** The Project worked from the premise that its sales and use tax simplification measures should be designed for all forms of commerce and not be limited to electronic commerce. However, different implementations of a simplification objective may be necessary depending on the type of taxpayer, the scale of the business or the type of transaction.

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<sup>35</sup> The real time concept is discussed further below.



**Discussion:** The benefits derived by both business and government from a new and improved sales and use tax system will clearly benefit all participants in commerce. The Project's work is therefore directed to “over-the-counter” transactions and to all forms of remote commerce, including direct mail, telephone and electronic commerce. The proposals are designed to give priority to the Project’s goal of neutrality among different channels of commerce, and within that goal, to advocate as much simplification as possible. To the extent practical, the work is directed at all forms of commerce.

### ***Uniform Registration Forms and Requirements***

**Issue:** Each state requires a vendor to register for the collection of sales/use tax. Registration forms differ from state to state. They very often request information that is not applicable to a remote seller without substantial facilities and employees in the state.

**Working Premise:** A uniform national form for vendor registration that would be accepted by each state in lieu of its own form would contribute to simplification.

**Discussion:** In its work, the Project discovered that registration forms in many states have been designed to serve a number of different purposes that may be conveniently aggregated, *e.g.*, registration for multiple taxes or multiple state permits and licenses. The Project sees no reason to interfere with these mutually beneficial arrangements.

However, such an approach is not necessarily well-suited to the environment in which some vendors operate. One approach that could simplify matters, particularly for multistate vendors, would be to develop a uniform national registration form that would be fully acceptable to the states in lieu of their own forms. It is expected that multistate vendors would normally prefer to use the uniform national form to register in most or all jurisdictions. To the extent that making the registration process electronic can reduce the burden for business and government, such efforts could be pursued.

## **Returns and Filing**

**Issue:** In today's environment, a multistate vendor must file returns and make remittances to each state in which the vendor is registered. State and local sales and use tax returns differ substantially among the states as do remittance frequencies, filing dates and the like. To the extent that returns are required in a simplified sales tax system, steps should be taken to reduce the burden currently associated with returns and remittances.

**Working Premise:** For the foreseeable future, the sales tax administration system will require the filing of tax returns and remittances. Maximizing the use of electronic filing for sales tax returns and remittances, reducing the frequency of returns, and making the returns as uniform as possible could produce substantial simplification for multistate sellers. Developing a system where vendors can file and pay all taxes through a single point (i.e., a "virtual national clearinghouse") could also be helpful.

**Discussion:** As with taxpayer registration forms, the Project examined the benefits that could be achieved by development and use of a standard or uniform sales and use tax return in lieu of any individual state form, should a seller prefer to use such a return. Presumably, multistate sellers would find it easier to file and remit if the return is uniform and elicits uniform data for all states. The burden associated with filing returns could be further reduced if there were widespread use of electronic filing, accompanied by adherence to uniform standards for the development of the electronic return.<sup>36</sup>

A substantial part of the filing burden in the current system is associated with the need to report data on the collection of local tax at the individual local government level. Thus, to a considerable degree, the complexity of return filing will be determined by decisions made regarding local sales and use tax rates. Likewise, the complexity of the sales tax base adds to the

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<sup>36</sup> Currently about 10-15 states have begun or have plans to develop an electronic filing program for sales and use tax returns. These programs use a variety of approaches including electronic data interchange, telefile, and Internet-based technologies. For a survey of state electronic filing programs, see the Federation of Tax Administrators Home Page at <<http://www.taxadmin.org>>. Click on the "Electronic Commerce" icon.

complexity of sales tax returns. Greater uniformity in the tax base could aid uniformity in the tax return.<sup>37</sup>

In the area of remittance, states could consider treating remote vendors more favorably than over-the-counter vendors. Some states now require sales taxes to be remitted more frequently than monthly, depending on the volume of tax collected. The Project does not recommend changes to this arrangement. However, if the duty to collect tax is extended to remote vendors, states could promote simplification by requiring remittances from remote vendors not more frequently than monthly.<sup>38</sup>

With respect to the frequency of tax returns, states could simplify matters for all vendors by requiring less frequent returns. Instead of requiring monthly returns as is generally the case now, states could provide that all vendors would be required to file reconciliation returns only quarterly or perhaps less frequently.<sup>39</sup> Such a system would be similar to the Federal payroll tax system where periodic deposits are made, but only a quarterly reconciliation return is required.<sup>40</sup>

### ***Bad Debt and Similar Deductions***

**Issue:** State laws vary in whether a vendor is allowed a deduction for tax paid on sales where the vendor ultimately is not fully compensated for the purchase because of insufficient funds checks, terminated installments sales and other bad debts. Some states do not allow a deduction in all such circumstances, and in others the procedures and standards for taking the deduction vary.<sup>41</sup>

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<sup>37</sup> See discussion elsewhere in the Report.

<sup>38</sup> Some Project members also believe that remote vendors should not be required to make estimated payments for sales and use tax collections as is currently required by some jurisdictions.

<sup>39</sup> California and Iowa, for example, require monthly tax remittances, but require complete reconciliation returns only on a quarterly basis.

<sup>40</sup> Nothing in this recommendation is intended to imply that financial institutions that play a role in the Federal payroll tax system should play a role in the return and remittance process for sales/use tax collection of others.

<sup>41</sup> Data on current state practices are somewhat incomplete. One source indicates that only four states – Nevada, Pennsylvania, South Carolina and West Virginia – do not allow a bad debt deduction, but that there are structural and procedural variations among the states. Complete data are not available on the treatment of installment sales.

**Working Premise:** A uniform provision permitting vendors to avoid liability for the sales/use tax attributable to bad debts and bad checks where the tax on the sale has previously been remitted to the state and to remit tax on installment sales as the purchase price is collected could simplify and improve the sales and use tax administration system.

**Discussion:** No attempt was made to define the details of such a law or procedures. The issue was seen primarily as one of fairness and consistency with accounting practices. If a vendor operates on an accrual basis of accounting, recognizes the entire sale at the time it is made, and remits tax on the sale, he/she should be able to recover tax if the proceeds of the sale are not realized because the debt becomes uncollectible.

### ***Direct Pay Permits***

**Issue:** Many businesses believe that increased use of “direct pay permits”<sup>42</sup> would be helpful in their tax compliance efforts and in accommodating emerging business practices, including some involving electronic commerce. While thirty-three states authorize direct pay, its use is generally quite limited, and procedures for obtaining the authority are cumbersome and difficult in some instances.

**Working Premise:** A uniform provision for direct payment of use tax by purchasers and more aggressive use of direct pay could be beneficial to both taxpayers and states.

**Discussion:** Direct pay was originally designed for situations in which the taxability of a transaction could not be easily determined at the time of purchase, *e.g.*, items that might be exempt if

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See John F. Due and John L. Mikesell, Sales Taxation: State and Local Structure and Administration, Urban Institute Press, Washington, D.C., 1994, pp. 38-40.

<sup>42</sup> Direct pay is an authority granted by a tax jurisdiction that generally allows the holder of a direct payment permit to purchase otherwise taxable goods and services without payment of tax to the supplier at the time of purchase. (Also in the case of exempt transactions, it allows a holder to purchase without issuing exemption certificates). Suppliers are to be furnished a written notification of the purchaser’s direct pay authority (often a numeric designation). The holder of the direct payment permit is to timely review its purchases and make a determination of taxability and then report and pay the applicable tax due directly to the tax jurisdiction. The permit holder’s tax determinations and adequacy of payment are subject to audit by the tax jurisdiction.

used in the manufacturing process or as an "ingredient and component part." With direct pay, such items could be purchased without tax, and the appropriate tax remitted once the actual use had been determined. In recent years, businesses have become interested in expanding the use of direct pay as a means of dealing with the increased volume of activities in interstate commerce and better controlling their tax compliance. In addition, direct pay can be helpful in insuring appropriate tax compliance when new electronic business processes such as evaluated receipts settlement (ERS)<sup>43</sup> and procurement cards<sup>44</sup> are used.

Direct pay authority could also be helpful in dealing with certain transactions in a destination-based sales tax regime as recommended elsewhere in this Report. Vendors might consider it an unrealistic burden if they were required to apportion the tax on purchases of products, data or information services that are capable of being used or accessed by multiple parties in multiple states among the states in which actual use occurs. Direct pay authority would allow a buyer to assume responsibility for apportionment and payment of the tax and remove the burden from the seller.<sup>45</sup>

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<sup>43</sup> Evaluated Receipts Settlement is a business process between trading partners that conduct commerce without invoices. In an ERS transaction, the supplier ships goods based upon an Advance Shipping Notice, and the purchaser, upon receipt, confirms the existence of a corresponding purchase order or contract, verifies the identity and quantity of the goods, and then pays the supplier. See also Evaluated Receipts Settlement and Tax Compliance, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published September 1998.

<sup>44</sup> Procurement cards are corporate charge cards issued to specific employees to purchase designated goods and services on behalf of the company. Procurement card programs can effectively simplify and streamline the procurement process by replacing the various steps in the traditional purchasing process with an authorization to an employee to use a charge card to procure the necessary goods and services. See also Procurement Cards And Tax Compliance: Bridging The Gap, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published June 1997.

<sup>45</sup> A task force of state tax administrators and business representatives coordinated by the Federation of Tax Administrators has developed a model regulation to recommend to states that would establish uniform procedures and standards for the issuance, administration and governance of direct pay permits. The model regulation represents a logical starting point in developing the uniform provisions called for in its recommendation. The model regulation prepared by the Task Force is currently the subject of the uniformity process of the Multistate Tax Commission with a goal of making a uniformity recommendation to the states. Further information is available from the FTA Website at <[www.taxadmin.org](http://www.taxadmin.org)>.

### ***Uniform Refund Claim Forms and Procedures***

**Issue:** Refund procedures and claims forms vary greatly from state to state. For instance, states require taxpayers seeking refunds to file amended sales tax returns, or claim credits for the overpayments on the taxpayers' next return, or file special refund claim forms, or some combination of these procedures. Further, statutes of limitations for filing refund claims (and for assessing tax) vary among the states. Additionally, interest availability and rates on refunds vary from state to state and are not always consistent with interest rates on assessments. Greater uniformity would simplify matters for multistate sellers and their customers.

**Unresolved Issue:** The Project did not have time to explore this area and therefore did not address the issue and possible solutions.

### ***Uniform Resale Certificates and Exemption Administration***

**Issue:** The current system for administering exempt transactions is paper-intensive, cumbersome, complex and exposes sellers to risk that some consider unacceptable. If a buyer makes an exempt purchase, he/she must generally provide some documentation to the seller (in the form of an exemption certificate or exemption number) that the transaction or the purchaser is exempt from tax. Exemption forms and identification systems differ widely among the states, and there is no uniformity on the standards of documentation for exempt transactions that must be produced on audit.

**Working Premise:** More widespread acceptance of a uniform, multi-jurisdictional certificate of exemption for "sales for resale" as well as consideration of other means of simplifying exemption administration could help reduce the burden of sales tax administration.

**Discussion:** With regard to sales for resale, the Project discussed the desirability of a uniform "resale exemption certificate", the benefits of a certificate that could be adapted to all channels of commerce, including electronic commerce, and uniform standards for documenting electronic sales. Certain existing efforts could provide a basis for promoting uniformity among all states. Currently, 36 states accept the uniform multi-jurisdictional resale certificate developed by

the Multistate Tax Commission (which may be viewed at <[www.mtc.gov](http://www.mtc.gov)>) as a “blanket” certificate evidencing that purchases of goods and services are intended for resale and not consumption.<sup>46</sup>

Vendors also face complexity in dealing with purchases by exempt entities (*e.g.*, charitable and educational organizations) because there is no uniform or universally available means of identifying such organizations and the standards for documenting such transactions vary among the states. To address these issues, the Project discussed whether states could consider developing a refund system for purchases below a certain uniform dollar amount. Utah and North Carolina, for example, use a system of refunds as opposed to exemptions for certain types of transactions. For purchases above that amount or if the refund approach is not used, states could assist sellers in dealing with exempt organization purchases by providing a consistent registration process and a universal means of verifying the exempt status of a potential purchaser through the Internet and other avenues. Some states have begun to use the Internet to make such information available. In Maryland, a seller can inquire via the Internet to validate a direct pay authorization number. In California, a seller’s permit number (required for resale transactions) may be validated through the Internet.

**Unresolved Issue:** The Project discussed<sup>47</sup>, but did not reach agreement, on the degree to which a vendor may rely on a resale exemption certificate offered by a potential purchaser. Most state laws provide that if a vendor is shown not to have acted in “good faith” in accepting an exemption certificate, the vendor may be held liable if it is ultimately determined that the certificate was inappropriately accepted. The imposition of a duty on vendors to “police” the

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<sup>46</sup> As an example, the Model Recordkeeping and Retention Regulation developed by the Task Force on EDI Audit and Legal Issues for Tax Administration addresses this issue in part of transactions conducted using electronic data interchange and for certificates that are retained using imaging technology. See Model Recordkeeping and Retention Regulation, A Report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published March 1996.

<sup>47</sup> The Project did not deal with complex issues regarding placement of the burden of proof in these situations, and no inference should be drawn with respect thereto.

use of exemption certificates was presumed by all to potentially shift the tax liability to the vendors when they fail to fulfill that duty.<sup>48</sup>

*Absolute Reliance Proposal* — Some Project members believe that the “good faith” requirement should be eliminated in the interests of simplification and in adapting current processes to an electronic environment. They argue that a vendor should be able to place “absolute reliance” on a proffered exemption certificate and to be held harmless if it is ultimately found to be erroneous. The current system makes it necessary for a vendor to receive and evaluate information on the nature of a purchaser’s retail business at the point of purchase. This is considered by some to be incompatible with the needs of electronic commerce. These members believe it is inappropriate to require vendors to “police” the use of a resale certificate. They also note that at least one previous Congressional Commission has recommended against using a “good faith” standard.<sup>49</sup>

*Modified Good Faith Standard* — Other members of the Project contend that the “good faith” standard is one that has been used nearly universally (although meanings vary by state) for a considerable period of time. It has been used as a means of deterring fraud and abuse. Some members believe that sacrificing the standard invites undermining the integrity of the tax system.

These members note that any of several measures could ameliorate some of the issues associated with the “good faith” standard. These might include clarifying definitions of what constitutes “good faith” or defining more clearly what falls outside the boundaries of “good faith,” and allowing a uniform period of time for a vendor to obtain additional documentation if requested on audit. In addition, the “good faith” standard could be modified to obligate states to pursue any additional tax from the purchaser and to impose substantial penalties on purchasers for inappropriate use of the certificate. These standards and practices should be based on the best

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<sup>48</sup> Several states involved in the Project indicated that while this statement is true, their recourse in such a situation would be against the purchaser that inappropriately offered the certificate rather than the seller.

<sup>49</sup> Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the



practices that states have adopted in balancing ease of administration and maintaining the integrity of the tax system.

*“Not in Bad Faith” Standard* — As an alternative to the “absolute reliance” or the “good faith” standard, some Project members suggest that consideration be given to a standard being suggested elsewhere in this Report for sourcing information provided by a buyer. There, the Project has examined a system in which a seller could rely on information provided by a buyer if the seller had not “acted in bad faith” in obtaining the information, with “bad faith” being defined generally as actively participating in the solicitation of false information for purposes of defeating the tax.<sup>50</sup>

### ***Vendor Safe Harbor for Uncollected Tax in Certain Situations***

**Issue:** In some sectors of remote sales and mail order businesses, a high proportion of customers complete a written order for merchandise, compute the total owed (including any applicable tax) and remit the computed amount by check. In these situations, it is not infrequent that the tax is not remitted or computed incorrectly because of confusion, math errors, incorrect tax rates, and the like. If such sellers were to be required to collect tax on all sales, they believe they should have some safe harbor for non-payment or under-payment of tax by purchasers who pay by check. Absent such protection, they would be in a position of pursuing uncollected tax when it is not cost-effective (or paying the same from net revenues) and of potentially alienating customers over relatively small amounts.

**Working Premise:** The Project work in this area was limited to describing a safe harbor for remote vendors that must deal with non-payment or underpayment of sales taxes by

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Judiciary (H.R. Report Number 565 and 952).

<sup>50</sup> For its purposes, the Project has discussed the following definition of “taken in bad faith:”

A seller's reliance on required sourcing information or resolution of conflicting sourcing information is “taken in bad faith” (and the seller is outside the safe harbor) if the seller has assisted in securing, or promoted the receipt of, false sourcing information with the intent that the information if accepted as true will permit the avoidance of taxes otherwise due. (Indicating the purpose for which the information is used and the consequences of not providing would not be considered “acting in bad faith.”)

purchasers who pay by check. The Project also notes that expansion of a “tax included” pricing option could help to mitigate the issues caused by check-payers if utilized by vendors.<sup>51</sup>

**Discussion:** The safe harbor examined is as follows:

States would not hold a vendor liable or otherwise responsible for remittance of sales and use taxes, beyond taxes actually collected, in connection with sales transactions where:

1. The obligation to pay the applicable tax was clearly indicated on the order form and the customer was responsible for computing the amount of tax due;
2. The vendor remits to the state all taxes collected from customers located within the state, and the vendor certifies to the state that the outstanding uncollected tax is less than eight percent of the total tax due to the state for sales during the quarter; and
3. The vendor makes a good-faith effort to correct any errors in tax rates and exemptions that are brought to its attention through audit documentation or other writing by a state.

Nothing in this provision would relieve a purchaser’s direct liability to the state for use taxes due on purchases from a vendor.

Some Project members note that the permissible limit on uncollected tax (*e.g.*, eight percent of taxes due) should, in part, be contingent on other features of the final administrative system. Features that might affect this figure include the frequency of remittance, vendor allowance, complexity of the rate structure and the availability of a “tax included” pricing alternative.

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<sup>51</sup> The “tax included” pricing option may not be attractive to all marketers because of the need to deal with transactions involving customers in states with no sales tax.

### ***Uniform Exemption for Shipping and Handling Charges***

**Issue:** The taxability of charges for shipping and handling vary widely among the states. The result is confusion for both buyers and sellers that leads to poor tax compliance.

**Recommendation:** The Project considers it inappropriate to include a recommendation on this subject because it is incompatible with the Project resolution:

*Nothing in this project shall be viewed as determining or recommending what products or services should or should not be taxed.*

**Discussion:** Some Project members believed it would add substantially to a simplified sales tax administration system if all charges for shipping and handling were exempt. After consideration, however, it was deemed to be inappropriate to adopt a recommendation that would restrict the ability of state and local governments to determine their tax base in this manner.

### ***Audits, Assessments and Appeals***

**Issue:** The current approach to auditing the records of taxpayers for compliance with sales and use tax laws is cumbersome and burdensome for multistate sellers. Dealing with state tax audits consumes time and resources of sellers, and the varying procedures used by states exposes them to potential liability despite good faith efforts to comply with state law. Attempting to resolve audit issues also requires the seller to pursue redress in each state individually, a process that is also considered burdensome and expensive.

**Working Premise:** Significant streamlining of the process of auditing multistate businesses for sales and use taxes is both possible and desirable. Further, states could provide mechanisms for the voluntary resolution of differences in cases where two or more states do not interpret uniform law provisions in the same manner.

**Discussion:** The examination of ways to simplify and achieve more uniform audit, assessment and appeals procedures centered around two approaches: (1) the Base State Approach; and (2) the “customer tailored” system. The Project did not reach a conclusion as to a preferred approach.

### *Audits*

*Base State Approach* — Some Project members supported adopting a Base State Approach for sales and use tax audits wherein a multistate seller would be subject to audit only by its “base” or home state. The base state would be responsible for auditing on behalf of all other states in which the seller had a legal obligation to collect tax.<sup>52</sup> Such a system is considered by some to reduce the burden of the audit process for multistate sellers. However, concerns that base state auditing was not practical outside the context of a base state filing system, foreclosed opportunities for change over time, could undermine the integrity of the audit process in some cases, and posed certain state constitutional problems lead some members to suggest the “customer tailored” approach discussed below.

*Customer Tailored Approach* — The “Customer Tailored Approach” to auditing is designed to achieve efficiency for taxpayers and states alike, maintain the integrity of the audit process, and encourage consistent interpretations of uniform law provisions. This approach also avoids state constitutional problems and seeks to allow a variety of methods of audit coordination without mandating a “one size fits all approach” for all taxpayers and states.

The Customer Tailored Approach is based on the premise that the degree to which coordinated auditing is appropriate varies among taxpayers according to their particular circumstances. For example, some taxpayers are subject to audit primarily for the collection of their customers’ sales and use taxes in several states, but are subject to audit for use taxes on their own consumption in only one or a few states. Other taxpayers are subject to a broader audit scope that includes both the collection of their customers’ sales and use taxes and their payment of use taxes due on the company’s own consumption in most or all states. A coordinated audit

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<sup>52</sup> The Base State Approach is discussed more fully earlier in this section.

for a larger number of states is more feasible and appropriate for the first type of taxpayer than the latter. Other factors that determine a taxpayers' suitability for a joint audit include the type of business operations (remote or local stores), complexity and diversity of product and service lines, industry sector, size and geographic scope of operations.

Under the Customer Tailored Approach, states would classify taxpayers into categories for which joint audits of varying scale and number would be conducted. Thus, states could provide for a classification of national, remote sellers (*i.e.*, companies collecting customer use taxes nationally, but that are responsible for use taxes on their own consumption in only one or a few states) that would be subject to a single audit for all states. With regard to other taxpayer categories, states should, at a minimum, seek to group themselves into no more than three groups for conducting joint audits, with each group including a minimum of ten states. This level of grouping is based on current experience with coordinated auditing by states. States might well group themselves by type of sales tax (vendor/vendee), scope of tax (goods vs. goods and services) or geography.

All states would work together to develop common or coordinated audit procedures to apply in coordinated audits, whether national or smaller in scale. Further, these states could develop common standards for interpreting uniform provisions of sales and use tax laws. Those common standards could guide auditors conducting coordinated audits and could advise state tax officials as they make decisions on audit assessments.

### ***Assessments***

With regard to the assessment process, the goals of the Customer Tailored Approach would be to encourage the consistent interpretation of uniform law provisions by states and to ensure adequate notice to taxpayers of the basis for assessments. Joint audits would generate a proposed audit assessment for each state. In the tax agency review of the proposed assessment, individual state tax agencies could raise different views on items in the proposed assessment concerning uniform provisions of laws or multistate issues. The potential for differing views

could be minimized, however, by the states having developed common standards for interpreting uniform law provisions. However, if there are such differing views, participating states, through procedures provided for in the interstate agreement, could convene a review panel of state tax officials to recommend to the states the appropriate treatment of such items. For constitutional reasons, the recommendations of the review panel would be advisory to the participating states. Thereafter, states would make decisions on the recommendations in the audit and issue their individual assessments. In the notice and explanation of the assessments, states should notify taxpayers of any instances where their respective interpretations of uniform law provisions are inconsistent with those of other states in the same audit.

Those who prefer the Base State Approach note that one of its principal advantages would be to eliminate any opportunity for states to take inconsistent positions on multistate issues or on items governed by uniform laws. Even under the base state system for fuel taxes (IFTA), however, states retain the authority to conduct separate audits in some circumstances. Some believe it is unlikely in the context of the sales/use tax – that is more complex than fuel taxes – that states would consider it appropriate and constitutional to delegate to other states their authority to issue assessments that interpret their own laws.

### *Appeals*

With regard to appeals, the goal of the Customer Tailored Approach would be to encourage the voluntary and consistent resolution of disputes involving the interpretation of uniform law provisions. If the taxpayer wishes to appeal any state-specific issues of no multistate impact, those issues could be handled through the normal individual state appeal process. With regard to interpretations of uniform provisions of the law or multistate issues, states could agree to offer a taxpayer a multistate alternative dispute resolution procedure as the first means of resolving the dispute.

Proponents of the Base State Approach advocate its simplicity in this arena. As currently in effect for the interstate fuel tax, the base state provides a single forum in which all appeals are heard.

Others note that because of the simple nature of the fuel tax, the base state appeals process usually does not involve one state interpreting the laws of another state. They believe in the more complex context of sales/use taxes that such a process is not acceptable from a policy perspective, and would likely be the subject of constitutional challenge.

### ***Requirements For A “Real-Time” System***

**Issue:** As discussed above, the Project’s participants discussed the prospects and feasibility of developing a “real-time” system for the administration of sales and use taxes. The central concept underlying the real-time system is to create technology that would enable a third party (*i.e.*, neither the vendor nor the customer) to collect and remit sales and use tax.

**Working Premise:** The Project believes that the concept of using electronic technology on a real-time basis for tax collection remains an interesting one. However, a recommendation in this area is premature given the current state of knowledge concerning the technological and cost feasibility of a real-time system as well as other issues that would need to be resolved. Any recommendation should be deferred until the characteristics of a practical real-time system are better understood.

Many Project members were of the opinion that no industry should be required to build or maintain a real time system. A real time system that requires changes to existing business practices and information flows should be instituted through voluntary compliance by the affected industries along with appropriate compensation covering reasonable costs from the tax collecting governments to the affected industries.

One proposal for creating a real time tax system was for a state or group of states to issue a request for proposals to industry to see if technology existed or could be developed for such a system. Another proposal called for the enactment of laws that provided appropriate profit-making incentives for industry to develop competing systems.

### ***Vendor Compensation***

**Issue:** Currently, twenty-seven states provide an allowance to vendors for collection and administration of sales tax.<sup>53</sup> In some states, current allowances are considered insufficient to offset costs incurred in sales tax administration.

**Working Premise:** The Project did not adequately explore the subject of vendor compensation and thus developed no proposals.

**Discussion:** Some Project members believe that all states should provide "meaningful" compensation to vendors for their cost of collecting sales/use taxes. Other members of the Project agree that the subject should be discussed and "be part of the mix" in developing a revamped system of sales and use tax administration. However, how and to what degree government might assume a share of these costs has not been sufficiently studied.

If vendor compensation is to be provided by all states, the obvious issue is the amount of such compensation. A recent study of traditional retailers by the State of Washington<sup>54</sup> indicates that gross costs of collection, before accounting for the offsetting impact of the "float" on the tax collected, average approximately 1.42 percent of the amount of the tax. Further, the largest portion of these costs does not arise from particular governmental requirements, but rather from the cost of credit and debit card fees charged to vendors by payment processing companies on the amount of taxes for charged transactions. Credit and debit card fees on the taxes were 0.76 percent of the tax collected, or over one-half the total costs, and they represent an out-of-pocket cost to the seller. When the float on the collected tax dollars was taken into account, costs of collection fell to 1.02 percent on average. The Washington study also indicated that there are substantial economies of scale in tax collection, with the costs of tax collection comprising a greater burden for small companies as compared to large ones.

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<sup>53</sup> Not all of these states provide an allowance for collection of use tax. See Due and Mikesell, op.cit., , pp. 194-195.

<sup>54</sup> Washington State Department of Revenue, Retailer's Cost of Collecting and Remitting Sales Tax, December 1998. See < <http://dor.wa.gov/reports/retail/retailsum.htm>> for the Executive Summary of the report and to download a copy.



The degree to which the Washington costs are representative of collection costs across the country and across different types of vendors is not known. In fact, another study performed by Price Waterhouse estimated collection costs nationally to average 3 percent of sales.<sup>55</sup> The degree to which tax collection costs may be different for remote sellers as opposed to traditional retailers, for example, is also not known. In general, credit card costs, the largest cost component in the Washington State study, are higher for remote sales (*i.e.*, sales at which there is “no card present”) than for traditional sales (*i.e.*, sales at which a card is present).<sup>56</sup> These issues are among those that deserve further study if vendor compensation is to be considered on a nationwide basis. Most importantly, a total simplification package should be developed before efforts are made to determine an exact level of compensation since the degree to which the system is made simpler will affect collection costs.

The process of discovering the appropriate level for vendor compensation may be difficult and prone to some controversy. One suggested alternative to vendor compensation that deserves further study is a system under which governments could provide software that calculates and enables electronic filing of tax returns and payments to vendors at no cost. Under this alternative, governments would view calculation and filing software as a new form of instruction booklet and forms. The object under this alternative would be to make compliance much easier and more convenient for the vendor and to drive the vendor's collection costs as close to zero as possible.

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<sup>55</sup> Cited in the Washington State study in the above reference.

<sup>56</sup> Information from some credit card companies indicates that, because of the greater potential for fraud in remote sales, the discount fee will be 40-60 basis points higher for a transaction in which the card is not present. Credit card costs will also be higher for a remote seller because the proportion of credit card sales will be higher for a remote seller than for a fixed-base retailer. In the case of a pure Internet seller, virtually all sales will be credit card, charge card, debit card and other non-cash transactions.

## **Conclusion**

The current system for the administration of state and local sales and use taxes is complex and burdensome, in large part due to local option taxes, differing substantive law requirements among states, and varying, duplicative administrative requirements. The Project did not arrive at a formal recommendation regarding specific measures for simplifying the system. It did, however, examine a number of areas and identified a number of options that, if implemented, could have a substantial impact on the administrative burden associated with today's system. In particular, there appear to be opportunities for reducing certain paperwork requirements by greater uniformity and electronic filing of returns. In addition, attention to streamlining exemption administration, adopting direct pay, and coordinating the audit and appeal process could pay substantial simplification dividends. Successful implementation of these simplifications will require cooperation among all affected parties.

## Telecommunications Tax Issues

### Introduction

The Steering Committee approved the inclusion of telecommunication taxes in the Project's scope for two principal reasons: First, the Project's Organizing Document states that "[t]he first focus of the project will be issues concerning state and local sales and use taxation of *communications* and electronic commerce, including gross receipts taxes that are functionally equivalent to sales and use taxes." Second, since telecommunications constitutes much of the "backbone" of the Internet and electronic commerce, a tax structure which impedes the growth of a competitive telecommunications industry may impede the development of an efficient and competitive Internet and electronic commerce marketplace.

The Project addressed two primary issues. First, how can "telecommunications" be defined to ensure competitive neutrality among competing firms and services without regard to historical industry classifications that may be no longer relevant for tax purposes. Second, how can state and local jurisdictions reform existing taxes to reduce the tax and compliance costs faced by some firms.

### Scope

The Project agreed to examine state and local transaction taxes on telecommunications providers and their customers. The Steering Committee agreed to exclude franchise fees from the discussions. While no single justification was provided for excluding consideration of franchise fees, the rationale for franchise fees (*i.e.*, charges by local governments for the use of public "rights-of-way") versus the rationale underlying most forms of taxation (*i.e.*, revenue generation) was a frequently-cited justification for excluding them. Also, the effect of franchise fees on various segments of the telecommunications industry varies greatly, and therefore some felt that there would be little agreement on how to bring about reform in that area.

The Project specifically agreed to defer discussions of property taxes, 911 fees, TDD fees, and Universal Service Fees. Deferring discussions of these taxes and fees was not meant to imply that reform in this area is not considered important. Some representatives believe that, in many ways, these fees and taxes raise the most significant issues. Nevertheless, most felt that narrowing the scope of the discussions would improve the pace and the likelihood of resolving other telecommunications tax issues.

## Issues Addressed

**Competitive Neutrality** — Most members agreed that current state and local tax systems do not treat providers on a competitively neutral basis, and there was general agreement with the following statement:

The premise of telecommunications tax simplification is that telecommunications providers and services should be taxed similarly to other businesses and services. In light of the changing environment, the existing tax structure originally designed for rate-regulated telecommunications companies needs to be reassessed as it applies to an increasingly competitive industry.

Two forms of competitive neutrality were discussed within the context of this principle: (1) Competitive neutrality in the taxation of telecommunications services within the industry; and (2) Tax neutrality between the telecommunications industry and "all other commercial businesses."

Concerning the first form of competitive neutrality (*i.e.*, taxation of telecommunication services within the industry), there was general agreement that, to the extent possible, telecommunications taxation should be competitively neutral between the services received, regardless of the method of delivery or the historical or regulatory classification of the provider. It was recognized that some telecommunication providers that might fit within a traditional definition of a "telephone company" are today providing services that do not fit within some traditional definitions of "telephone service," (*e.g.*, voice mail, television programming and

Internet access.) Conversely, other companies that may not fit within a traditional definition of a “telephone company” provide telephone service. The premise stated above incorporates the belief of a number of Project members that similar services should be taxed similarly, regardless of the business organization utilized by the provider or the historical classification of the company.

Some representatives, however, expressed concern about promoting tax policy that would result in causing services that are currently subject to the general sales and use tax to be taxed as telecommunications services, which is, for the large part, a more onerous and burdensome structure of state and local taxes. These members believed the better alternative was to eliminate any special telecommunications tax structure and treat all telecommunications services under the general sales and use tax system. This premise also ties in with the second form of competitive neutrality discussed below.

Concerning the second form of competitive neutrality (*i.e.*, taxation of telecommunication providers *vis-à-vis* other commercial businesses), the Project could not agree. Some representatives argued that industry-specific telecommunication taxes are inherently inequitable, and that any justification for imposing industry-specific taxes has been eliminated by the advent of competition. Providers can no longer pass these taxes through to their customers as part of the public utility commission rate-setting process.

Others expressed serious reservations about abolishing industry-specific taxes. They argued that state and local tax systems do not treat “all other commercial businesses” in a similar manner. Providers in different industries employ different capital structures and different mixes of labor, tangible assets, and intangible assets in creating value in the economy. These differences produce different effective tax rates, whether measured as a share of net income, capital-employed, or gross receipts. These representatives felt it was not feasible to meet the goal of developing a tax system that “treats telecommunications providers like all other commercial businesses” because there is no single way that all other businesses are taxed.

Furthermore, these representatives noted that differential taxation of various industries reflects a variety of social, economic, and political considerations by the governments in our federal system. “Sin taxes” on cigarettes and alcohol are just two of many examples. These representatives, while noting that telecommunications providers pay and collect more taxes than many other industries, felt that state and local policymakers must be free to make tax policy decisions within the political and legal frameworks of their respective jurisdictions.

**Defining “Telecommunications”** — While the Project members agreed to try to develop definitions of “telecommunications provider” and “telecommunications service,” this goal was not achieved. Attempts to develop agreed-upon definitions (including the definitions used by the Federal Communications Commission) for universal use among the states failed for a variety of reasons.

Some members were concerned that a broad definition of “telecommunications” would incorporate non-traditional forms of electronic communications — not currently defined as telecommunications — because such a classification could impose substantial regulatory and other (including tax) consequences on the providers of such services. However, other representatives expressed frustration regarding the fact that similar services are currently taxed differently as a result of historical distinctions. The failure to define “telecommunications” was a substantial impediment to progress since some Project participants were unwilling to deal with other issues of reform without agreement as to these fundamental terms.

**Consolidation of State-Local Taxes** — Some representatives proposed that local transaction taxes<sup>57</sup> should be consolidated into a single statewide tax. This tax would be imposed

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<sup>57</sup> In response to comments made by some government representatives, the industry representatives offered the following definition of the taxes to be considered under this topic. Local transaction taxes were defined as any tax, charge or other imposition levied as a fixed charge or measured by gross amounts charged to customers for telecommunications services, regardless of whether such tax or charge is legally imposed on the vendor or consumers of the service and regardless of the terminology used to describe the tax or charge. The term does *not* include special purpose funding fees, any tax, charge or fee levied upon or measured by the net income, capital stock, net worth, or property value of the telecommunications service provider. Special purpose funding fees include, without limitation, Universal Service Fees (USF), Hearing Impaired fees (TDD), Emergency Service fees (911) and any fees charged solely for the use of public rights-of-way. To be administered centrally means there is a single

at a single rate and replace the numerous gross receipts and excise taxes that localities currently impose. Collection of this tax would not necessarily need to be performed by the state, only centrally to one location.

Not all members of the Project agreed with this recommendation. Some members believed that localities should be able to set their own rates, if only to compensate for all the services that can be required by business conducted in highly-concentrated urban areas. Others, however, felt that the burden of reporting to hundreds of taxing jurisdictions in one state was so onerous that a single rate and a single point of collection should be considered to address that burden.

. **“Bundling” of Charges** — The Project recognized the need to address the issue of “bundled” services, especially in light of the changes taking place in the market. Discussions focused on whether a uniform method could be developed for “breaking out” bundled charges for the purpose of determining the taxable and exempt elements of the bundled charge. Little progress was made in identifying a workable method of disaggregating a bundled charge into taxable and non-taxable portions because the Project stalled on other issues.

**Other Issues** — A number of other issues were identified as important elements of telecommunications tax reform, but discussion was deferred because they were being addressed elsewhere in this Project or in other venues. These issues included:

- whether the situs of sales and customers should be made uniform to ensure that telecommunications companies avoid collecting tax for the wrong jurisdiction;
- whether the Project should endorse the uniform sourcing methodology proposed for wireless telecommunications that is under cooperative development by the Wireless Tax Group and various government organizations;

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source for information about the tax, a single schedule for remittance of the tax, a single point to which remittances are made and with sufficient lead-time for changes to be implemented by compliant taxpayers.

- whether the taxation of prepaid calling cards and other similar prepaid arrangements should be uniform to avoid multiple taxation (*i.e.*, tax collected at the time of the sale of the card or on the subsequent usage of the service); and
- whether a uniform “telecommunications resale” exemption form should be accepted by all states.

## **Conclusion**

The Project failed to reach agreement on the foregoing issues of telecommunications tax reform and simplification. The inability to agree on an acceptable definition of the term “telecommunications” (and thus define what services would be included or excluded in any discussions) was the primary impediment to such agreement.



## Implementation Issues

### Introduction

During its discussion of various proposals for modifying existing state and local tax regimes to accommodate an electronic commerce environment, the Project considered two basic approaches to implementing any potential recommendations: federal legislation and cooperative state action. Because the Project never agreed on any specific substantive proposal, it was never compelled to specify a preferred means of implementation for any particular proposal. Summarized below are the principal points that emerged from the Project's consideration of implementation issues along with the major areas of agreement and disagreement.

### Federal Legislation

Federal legislation offers one means of implementing proposals to modify existing state and local sales tax systems. Pursuant to its power to regulate interstate commerce,<sup>58</sup> Congress could require states to adhere to federally-determined substantive criteria when taxing specified activity that affects interstate commerce. Congress might achieve the same goal indirectly by forbidding the states from taxing specified activity that affects interstate commerce unless the states enacted recommended legislation incorporating federally-determined criteria. As another variation, Congress could subject states to additional limitations on their taxing authority beyond those present now as an incentive to adopt the federally-determined criteria (*e.g.*, a state that failed to enact the federally-specified system could be prevented from taxing any remote sales). On the other hand, Congress could simply remove the restraints that the so-called "dormant" Commerce Clause imposes on state action in the absence of implementing congressional legislation<sup>59</sup> without requiring state adherence to, or adoption of, federally-determined criteria.

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<sup>58</sup>U.S. Constitution, article I, section 8, clause 3.

<sup>59</sup>As the U.S. Supreme Court declared in Quill Corp. v. North Dakota, 504 U.S. 298, 318 (1992), which held that the dormant Commerce Clause precludes the states from requiring mail-order sellers without physical presence in a state to collect use taxes on sales to local consumers, "Congress is . . . free to decide whether, when, and to what extent States may burden interstate mail-order concerns with a duty to collect use taxes."

Those supporting federal legislation incorporating federally-determined criteria as a preferred means of implementing proposals for modifying existing sales and use tax laws believe it is the only effective way to ensure uniformity in the adoption of such proposals. Proponents of this view contend that the history of voluntary state action in the area of state tax uniformity (*e.g.*, the Uniform Division of Income for Tax Purposes Act (UDITPA)) provides little basis for confidence that such voluntary measures will achieve uniformity. They note that state tax-related compacts and uniformity efforts have often resulted in the adoption of only similar (rather than uniform) provisions. Even where uniform provisions are enacted or recommended, there is not uniform adoption (*e.g.*, the evenly-weighted three-factor corporation income tax apportionment formula in UDITPA.) Those favoring federal legislation incorporating federally-determined criteria also note that such federal legislation would be necessary as a political matter if Congress were to relax existing Commerce Clause restraints limiting state tax power (*e.g.*, those governing the duty of remote sellers to collect use tax).

### **Cooperative State Action**

Cooperative state action offers an alternative to federal legislation as a means of implementing proposals to modify existing state and local tax systems. Voluntary state adoption of uniform legislation could follow the pattern of the states' enactment of other uniform state legislation (*e.g.*, the Uniform Commercial Code), or it could be effectuated through the states' adoption of a multistate compact embodying the proposal.

Proponents of a state-based implementation of proposals to modify existing sales and use tax laws believe that federal intervention is inappropriate if the desired results can be achieved by voluntary state action. They believe that certain of the proposals under consideration (*e.g.*, uniformity) do not require federal action, and they maintain that a voluntary state solution to the problems under consideration is likely to be more sensitive to the actual experience of the states and taxpayers than a federally-imposed solution.

These proponents of state action, however, recognize that federal action, either legislative or judicial, would likely be necessary to expand the duty of remote sellers to collect use taxes

beyond that permitted by current Commerce Clause jurisprudence. Some of those favoring state action as a matter of general principle nevertheless appear to believe that it would be appropriate for Congress to require states to adopt certain federally-determined simplifications in their existing state and local sales tax regimes in return for the right to avail themselves of the expanded duty to collect. Others, however, seem to be of the view that the states should act to modify their state and local tax systems and rely either upon voluntary collection by remote sellers of use taxes or upon re-litigation of the issue of whether, under the modified system, the burden imposed on interstate commerce by requiring remote sellers to collect use tax violates the Commerce Clause.

### **Joint State and Federal Action**

A third or hybrid approach would blend both state and federal action. Interested states could develop a multistate tax compact creating a harmonized tax system, and Congress could remove potential constitutional objections to such a compact by approving it. States not enacting the harmonized system through the compact would continue to be subject to current constitutional limitations on their taxing authority. This approach would allow states to retain their historic authority over the details of their tax system while permitting Congress to act to encourage consistency and uniformity in state and local taxation.

Proponents of this approach believe it incorporates the best features of the other options and few of their disadvantages. Details of state and local taxation would be left primarily in the hands of those who are most familiar with them: the states. At the same time, Congress would exercise appropriate control over the jurisdictional reach of state tax systems and protect interstate commerce from undue burdens due to inconsistent state tax practices.

The Project identified, but did not explore, two other concerns that would need to be considered in designing any legislative modification to existing state and local sales and use tax

regimes. First, any legislative proposal (whether based on federal or state legislation) would have to satisfy federal due process restraints on state taxation.<sup>60</sup> Second, any legislative proposal (whether based on federal or state legislation) would need to take account of internal state constitutional restraints on state action.<sup>61</sup>

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<sup>60</sup>“[W]hile Congress has plenary power to regulate commerce among the States and thus may authorize state actions that burden interstate commerce, it does not similarly have the power to authorize violations of the Due Process Clause.” *Quill*, 504 U.S. at 305.

<sup>61</sup>For example, if the federal government prohibited the states from taxing electronic commerce unless they imposed their sales and use tax at a single state rate, but if state constitutional requirements limited the ability of a state to impose a single state-wide rate, a state might be unable to tax electronic commerce without modifying its constitution.