POLICY brief
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Sourcing Complicates Tax Simplification

BRIEFLY

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The Streamlined Sales Tax Project is a multi-state organization working to implement a common, simplified sales and use tax framework across all the states. The immediate objective is to reduce the administrative burden placed on businesses by the current hodgepodge of state tax laws. Ultimately the member states hope that, if compliance with state sales and use tax laws is simplified, Congress will enact legislation requiring out-of-state retailers to collect sales and use taxes on interstate sales.

Washington has been a member of the Project since 2002.

The sales and use tax framework developed by the Project is embodied in a document called the Streamlined Sales and Use Tax Agreement. The 2003 Legislature enacted changes to conform Washington's sales and use tax laws with significant aspects of the agreement. The 2004 Legislature considered legislation that would have brought the state further into conformity. This legislation failed to pass, largely due to the opposition of certain cities who would have lost a portion of the local sales tax revenue to other jurisdictions as a result of the changes.

The Legislature will consider the issue again in the upcoming session.

Retail sales and use taxes

Like 46 other states, Washington State imposes *sales tax* on final sales within its borders of most tangible personal property and some services. The state first imposed a sales tax in 1935, at a rate of 2 percent. The current state rate is 6.5 percent. The tax is formally levied on buyers, although sellers are responsible for collecting the funds from buyers and remitting them to the state.

In addition to the state, a number of Washington's local governments (counties, cities, transit districts, public facilities districts, public stadium authorities) also levy sales taxes. The aggregate local tax rate varies from place to place within the state, from a low of 0.5 percent to a high of 2.4 percent.

State residents avoid paying Washington sales tax on purchases made from out-of-state sellers. To compensate, the state and local jurisdictions impose *use taxes* at rates equal to their sales tax rates on goods and services for which sales tax has not been collected. The user is expected to report to the Department of Revenue the value of the good or service on which use tax is due and to pay the tax. As a practical matter, enforcement of the use tax is difficult and non-compliance is high.

In some cases Washingtonians travel to other states in order to purchase goods and services without paying Washington sales tax. John Beck, a professor at Gonzaga University and member of the Washington State Tax Structure Committee, estimates that taxable sales in the counties that border Oregon and Idaho would be 22 percent higher if those two states were to impose sales taxes at the Washington level.

In other cases Washingtonians use mail- or phone-order catalogues or the Internet to buy from out-of-state sellers without paying sales tax. (Collectively, catalogue and Internet sales are called remote sales.) While sales tax loss due to mail-order catalogues has been a minor problem for years, the growth of the Internet and e-commerce has greatly increased concerns about remote sales.

Washington's sales and use taxes are among the highest in the nation. The state received $5.8 billion in sales taxes and $386 million in use taxes in fiscal year 2004. This was 54 percent of general fund revenue. Retail sales and use distributions to local governments totaled $1.9 billion in calendar year 2003.

Two key Supreme Court cases

A pair of United States Supreme Court decisions, have limited states' powers to compel out-of-state sellers to collect taxes on remote sales.

The first of these decisions was issued in 1967 in the case *National Bellas Hess, Incorporated v. the Department of Revenue of the State of Illinois* (386 U.S. 753). Bellas Hess was a mail order retailer specializing in clothing, based in North Kansas City, Missouri. The company had neither stores nor sales representatives in Illinois but did advertise to Illinois customers through the mail, using twice-yearly catalogues and occasional advertising flyers. Purchases were delivered to customers via the mail or other common carriers. The state of Illinois sued the company in state court to force it to collect use taxes on goods sold to state residents. The state prevailed in state court and eventually the issue was appealed to the U.S. Supreme Court.

Citing both the Due Process and the Commerce clauses of the U.S. Constitution, the Supreme Court held that Bellas Hess had no obligation to collect taxes for the state. The Court explicitly noted the complex variation of sales and use tax bases and rates from location to location and held that Bellas Hess lacked sufficient connection to the state ("nexus") for Illinois to be able to impose on the company the considerable administrative burden of collecting the tax.

> And if the power of Illinois to impose use tax burdens upon [Bellas Hess] were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements

> could entangle [Bellas Hess's] interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government'.

The second important Supreme Court decision on the obligation of out-of-state sellers to collect use tax was issued in 1992 in the case of *Quill Corporation v. North Dakota* (504 U.S. 298). Quill is a retailer of office equipment and supplies that at the time had offices and warehouses in Illinois, California and Georgia. Although it was the sixth largest seller of office supplies in North Dakota, it had no physical presence in the state; these sales were all solicited from outside the state by mail, telephone or ads in national publications, and were all delivered by mail or common carrier.

In this case, North Dakota argued that rulings subsequent to *Bellas Hess* had refined the Supreme Court's interpretation of the Due Process and Commerce clauses and that by these newer precedents states could require sellers without a physical presence to collect use tax.

The Court agreed with North Dakota that the due process standard for nexus had changed since *Bellas Hess*, but distinguished between the "minimal contacts" required by the due process clause and the "substantial nexus" required by the Commerce Clause. The Court stated that its interpretation of the Commerce Clause had not changed and held Quill was not obligated to collect use tax for North Dakota.

The Court concluded regarding the physical presence nexus test: "The continuing value of a bright-line rule in this area and the principle of *stare decisis* [to stand by that which is decided] indicate that the rule remains good law. . . . The underlying issue here is not only one that Congress may be better qualified to resolve, but also one that it has the ultimate power to resolve."

The Streamlined Sales Tax Project

In the latter half of the 1990s analysts began to recognize that emerging modes of electronic commerce practices would create problems for state and local tax systems.

The National Tax Association held a conference on the taxation of electronic commerce and telecommunications in November 1996. Out of this conference grew the Association's Communications and Electronic Commerce Tax Project, which brought together representatives from business and government. The Project issued an inconclusive final report in 1999. The Internet Tax Freedom Act, enacted by Congress in 1998, imposed a moratorium on new taxes on Internet access and multiple and discriminatory taxes on electronic commerce. (The Act does not prohibit the application of general sales and use taxes to electronic commerce transactions.) The Act also created the Advisory Commission on Electronic Commerce (Gov. Gary Locke was one of the Commission's 19 members), which submitted a report to Congress in 2000. Commission members were unable to reach agreement on a number of key issues, so this report also was inconclusive.

The Streamlined Sales Tax Project (SSTP) was convened in March 2000—just as the Advisory Commission on Electronic Commerce was winding down—by the Federation of Tax Administrators, the National Conference of State Legislatures, the Multistate Tax Commission, and the National Governors Association. SSTP is a cooperative effort, involving a number of states and the District of Columbia, to design and implement a common, simplified sales and use tax system. The states hope that they will be able to convince Congress to impose the obligation to collect sales and use taxes on remote sales if such a common system is widely adopted.

A state may become a participating (full voting) member of the project either if the state legislature enacts a bill authorizing participation in the project or the governor issues an executive order to that effect. The 2002 Washington Legislature enacted SSB 6342 so that this state could be a participating member.

Forty-two states and the District of Columbia are participating members in the project. (The eight non-participating states are: Delaware, Montana, New Hampshire, Oregon, which do not levy sales taxes; and Alaska, Colorado, Idaho, and New Mexico.)

The Streamlined Sales and Use Tax Agreement

The participating states adopted the Streamlined Sales and Use Tax Agreement (SSUTA) in November 2002. SSUTA is 55 pages long. Key provisions include:

- Uniform definitions for key items in the tax base
- Within these definitions, freedom for states to specify which goods and services are exempt from taxation
- A single state tax rate for each state, except a second state rate is allowed for food and/or drugs, and a single local tax rate
- State and local sales and use taxes must be administered at the state level
- Uniform sourcing rules specifying which state and local governments will receive the taxes due on various transactions
- Simplified administration for tax exemptions, making purchasers responsible for paying taxes, interest, and penalties on improperly claimed exemptions
- Amnesty for past uncollected or unpaid tax, interest and penalties in a state for sellers who register to collect and pay sales or use taxes under the agreement, as long as registration occurs within 12 months of the effective date of a state's participation in the agreement
- Uniform audit procedures
- Compensation to sellers for collecting sales and use tax
- Authorization for certified third-party service providers to collect and remit sales and use taxes to states for participating sellers

SSUTA takes effect when tax systems of ten or more states with a combined population exceeding 20 percent of the total population of all sales-tax states are found to substantially conform to the requirements of the agreement. At present there are 18 states deemed to be in substantial conformance, and it is believed that the 20 percent population threshold will soon be passed. Washington does not yet substantially conform to SSUTA. Once SSUTA is effective, formal control of the agreement passes from the group of participating states to the smaller group of conforming states. If Washington is not a conforming state, it will lose its vote in the process. DOR staff believes that continued participation as a voting member is in the interest of the state and its businesses as the member states continue to meet to adopt additional uniform definitions and standards to simplify tax administration.

In 2003, through SB 5783, the legislature did enact a substantial number of provisions of SSUTA. The bill changed a number of definitions in the tax code. As a result: Delivery charges are now included in the purchase price of “repair services” and are subject to tax. Bottled water is considered to be a “food” and exempt from tax. Fruit beverages containing less than 50 percent fruit juice are “soft drinks” and taxed. Eyeglass frames sold with prescription lenses are exempt. Most of the definitional changes, however, have no impact on tax revenues. The bill also included a number of minor administrative changes.

Remaining Work

A few SSUTA provisions, however, remain to be enacted in Washington. The state must

- Allow remote sellers to register with the state over the Internet
- Give monetary allowance to sellers using certified service providers or tax compliance software
- Provide conditional amnesty for remote sellers who register to collect and pay tax under SSUTA
- Adopt rules specifying to which location tax is attributed for a transaction (“sourcing” rules)
- Adopt confidentiality and privacy protections for sellers
- Develop a taxability matrix showing which goods and services are subject to tax in Washington
- Adopt a provision concerning how tax is applied to delivery charges when the delivery includes both taxable and nontaxable items

Bills incorporating these provisions (HB 2500, SB 6544) failed to pass during the 2004 session of the Legislature. The sticking point was the sourcing rule that determines which jurisdictions get the local sales tax revenues from various transactions.

Sourcing

SSUTA generally sources a sale at the point where a customer takes delivery of a good or service (“destination-based” sourcing). The alternative is to source a sale at the seller's place of business (“origin-based” sourcing). Washington is one of a minority of states that use origin-based sourcing for intrastate sales of goods. (The state’s rule for services is destination-based.) Washington's origin-based rule is unique in one key way: it sources sales of delivered goods to the warehouse from which delivery is made rather than the store at which the sale was made.

For most transactions the sourcing rule does not matter. If a resident of Tacoma drives to a store in Auburn, buys a shirt, and takes the shirt home from the store, the sale will be sourced to Auburn under either a destination-based or an origin-based rule. But for about 15 percent of transactions (measured by value) the sourcing rule does matter. When the Tacoma resident drives to an Auburn store and there purchases a mattress that is then delivered directly to her home from a warehouse in Kent, destination-based sourcing would give Tacoma the tax. Origin-based sourcing, as applied everywhere but Washington, would give Auburn the sales tax. Washington's current origin-based rule gives Kent the sales tax.

Shifting to the new sourcing rule would have little impact on state tax revenue but would redistribute the local sales and use tax base among local jurisdictions in the state. Cities in which warehouse/distribution centers are concentrated, Kent and Tukwila for example, lose, while cities with relatively little retail activity, Des Moines and University Place, gain.

The Department of Revenue (DOR) has prepared estimates of the extent to which specific local jurisdictions would gain or lose from the change to destination-based sourcing, based on 2002 sales. By these estimates the total gains to gainers is $28.5 million, while the total losses to losers is $32.1 million. One hundred sixty-four cities gain, while 117 cities lose. Overall, cities lose $16.4 million. Thirty-seven counties win, while two counties lose. Overall, counties gain $16.5 million. Thirteen transit districts gain, while 10 transit districts and Sound Transit loose. Overall, transit looses $3.6 million.

Des Moines is the city with the biggest estimated gain, $734,300. Kent is the city with the largest loss, $3.3 million. King County is the county with the largest gain, $5.1 million. Lewis County is the county with the largest loss, $283,500.

(A note of caution concerning these estimates: While the technical advisory committee for the DOR study believes that the aggregate estimates of the shift in local tax revenues with the change in sourcing rules are reasonably accurate, the committee "has little confidence in the specific tax dollar loss estimates for individual taxing jurisdictions.")

Opposition from the losing cities stalled legislation during the 2004 session. Various mitigation plans were proposed to use either state funds or gains of the winners to offset the losses of the losing jurisdictions. There was no consensus among the cities on a mitigation plan.

Discussions among the cities continued over the summer of 2004 under the auspices of the Association of Washington Cities. Again, these discussions failed to reach consensus. Legislation will be introduced again in the 2005 session to implement the SSUTA sourcing rules.

Once SSUTA takes effect, some retailers voluntarily will begin paying sales and use taxes on remote sales to all states that are certified to conform to SSUTA in order to benefit from the agreement's amnesty provision. DOR estimate such voluntary compliance could increase state tax revenues by $33.8 million for the 2005-07 biennium and $63.6 million for the 2007-09 biennium, assuming that the agreement becomes effective in April 2006. Receipts from local sales and use taxes would increase by $10.0 million for 2005-07 and $19.0 million for 2007-09.

Discussion

Independent of an effect on the collection of taxes on remote sales, simplification and harmonization of state sales and use tax systems is good policy as it reduces compliance costs for businesses, particularly for multi-state businesses.

The SSUTA-required sales and use tax sourcing rule is consistent with the sourcing rule that the Legislature recently specified for municipal B&O taxes, beginning in 2008, which is an advantage. Having different sourcing rules for local sales and B&O taxes would complicate the tax accounting problem for businesses.

The $33.8 million in additional state revenue projected if Washington is in compliance when SSUTA takes effect will certainly be tempting to legislators facing a $1.6 billion budget gap for the 2005-07 biennium. Legislation introduced in the last session would have passed this additional revenue (and then some) on to local jurisdictions to mitigate the impact of the new sourcing rule. The jurisdictions that would lose revenue by the SSUTA sourcing rule are on average richer in sales taxes than the gaining jurisdictions (although there are certainly some gainers that are rich and some losers that are poor). Thus, some will argue that the redistribution of local sales tax revenue under the SSUTA sourcing is, on balance, fair, particularly if limited mitigation is provided to the most adversely impacted sales tax poor jurisdictions.

Some will see the extension of sales and use taxes to currently untaxed remote sales as a tax hike. Others view the extension as simply better enforcement of existing taxes, which would make the system more fair and would level the playing field for in-state retailers facing tax-advantaged out-of-state competitors.

The gold standard for simplification would be a sales and use tax system under which each state's base was identical and where there was a single combined state and local rate which applied statewide for each state. However, that kind of simplification conflicts directly with the principles of self-governance that allow citizens of various state and local governments to determine how they want to be taxed and what burdens they are willing to bear.