
Viewpoint

Will the Failure of Some States To Enact Destination-Based Sourcing Prevent the Streamlined Agreement From Becoming Effective July 1?

by Charles Collins and Carolynn Iafrate

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The Streamlined Sales Tax Project is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The effort has been ongoing since March 2000, when the project was organized. After five years, the project is at a pivotal point. In order for the Streamlined Sales and Use Tax Agreement to become effective, Rule 701 of the agreement provides that at least 10 states with 20 percent of the population of states with sales taxes must be in compliance with the requirements of the agreement under section 805. The target date to reach that threshold is July 1, 2005.

Section 805 of the agreement, "Compliance," provides: "A state is in compliance with the Agreement if the effect of the state's laws, rules, regulations, and policies is substantially compliant with each of the requirements set forth in the Agreement." Substantial compliance was the subject of significant debate between state governments and the business community. The issue is: When is a state in substantial compliance?

The agreement provision that has resulted in the most controversy in several states is the sourcing of intrastate shipments on a destination basis. Section 310 of the agreement provides for destination-based sourcing for both interstate and intrastate sales. Traditionally, states have typically sourced *interstate* sales of products based on the destination to which the property has been shipped. However, many states utilize an origin basis for sourcing *intrastate* sales of taxable products. With many state governments receiving significant political pressure from small businesses and local governments to maintain origin sourcing, several states have delayed the implementation of the agreement's sourcing provisions.

For example, Ohio, which has implemented changes to its sales and use tax laws to conform to the agreement's provisions, has delayed implementation of the destination-sourcing provisions. And, on January 5, Ohio Gov. Bob Taft (R) drafted a letter to the Conforming States and Streamlined Sales Tax Project representatives. In his letter, Taft requested an amendment to the Streamlined Sales Tax Agreement that would modify the agreement's destination-based sourcing requirement. In particular, the governor is requesting relief for small businesses. That relief could take the form of a longer transition period or a permanent *de minimis* exception for small retailers.

Large businesses have expressed significant concerns over such an amendment, particularly from the perspective of the purchaser. In particular, because the exception would exist only for small businesses, purchases from a small business would result in a sales tax calculation based on the rate in the jurisdiction of the origin of the shipment. However, businesses purchasing those items would be responsible for tax at the rate of the jurisdiction to which the property is shipped. As a result, there could be a rate differential that could result in an overpayment or underpayment of sales and use taxes by the purchaser.

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In the situation in which the rate of the jurisdiction to which the property is shipped is greater than that from which the property originated, the purchaser would be responsible for accruing use tax on the rate differential. That is burdensome, because it would require the purchaser to effectively recalculate every invoice received from small businesses. That is not only a time-consuming process, but it also might create enough of a compliance burden for larger businesses to give them an incentive to shift to larger vendors to eliminate the burden.

In the situation in which the rate of the jurisdiction to which the property is shipped is lower than that from which the property originated, the purchaser would likely short-pay the

	State	Population (as determined by 2000 federal census)	Effective Date of Conforming Legislation	Percentage of Population by 7/1/05
1	IN	6,080,485	1/1/2004	2.22
2	IA	2,926,324	7/1/2004	1.07
3	KS	2,688,418	7/1/2003	0.98
4	KY	4,041,769	7/1/2004	1.47
5	MI	9,938,444	9/1/2004	3.62
6	NE	1,711,263	1/1/2004	0.62
7	NC	8,049,313	1/1/2004	2.93
8	OH	11,353,140	1/1/2005	4.14
9	OK	3,450,654	11/1/2003	1.26
10	SD	754,844	1/1/2004	0.28
11	WV	1,808,344	1/1/2004	0.66
12	WY	493,782	1/1/2004	0.18
13	MN	4,919,479	7/1/2005	1.79
14	TN	5,689,283	7/1/2005	2.07
15	UT	2,233,169	7/1/2005	0.81
	Total	66,138,711		24.1

invoice by the rate differential. That would create a compliance nightmare for small businesses, which likely do not have the in-house expertise or resources to handle this, and may in turn remit taxes to the state that were never collected from the purchaser.

Destination sourcing creates increased complexity for businesses that ship products. That increased compliance is felt to a greater extent by small merchants currently located in states that source intrastate sales based on an origin basis. Destination sourcing requires the merchant to collect tax in multiple localities if the merchant ships products and if the state has local taxation. But under origin sourcing, the local retail merchant may have been required to collect sales tax in only one jurisdiction.

States have responded to the concern over a change to destination-based sourcing by agreeing to provide rate and jurisdiction databases that will assist retailers in determining what sales tax rate to charge in various locations and also by providing third parties that will assume the responsibility for sales tax compliance.

In addition to the software solutions provided by states, legislation introduced in Congress regarding the Streamlined Sales Tax Project has specifically addressed concerns for small businesses, including an exception for them. That exception would address the complications of complying with state sales and use tax laws for small business and would reduce the burden of mandatory collection for small businesses.

For example, H.B. 3184, introduced in the 108th Congress, contained the following small-business exception. Specifically, section 4(b) provided:

No seller shall be subject to a requirement of any State to collect and remit sales and use taxes with respect to a remote sale where the seller and its affiliates collectively had gross remote taxable sales nationwide of less than \$5,000,000 in the calendar year preceding the date of

such sale. No seller shall be subject to a requirement of any State to collect and remit sales and use taxes with respect to a remote sale where the seller and its affiliates collectively meet the \$5,000,000 threshold of this subsection but the seller has less than \$100,000 in gross remote taxable sales nationwide.

The federal legislation, in effect, would provide relief to those small businesses that have limited nexus. Those businesses would not be mandated to collect tax on remote sales in states in which nexus has not been established. However, small businesses would still have to conform to the destination-based sourcing rules in the states in which they have nexus, including their home state.

The streamlined initiative has a July 1, 2005, target date to review states' conforming legislation to determine if the compliance requirements are met to make the agreement effective. Although the states have met the challenge of implementing many of the agreement's provisions, the destination-sourcing provisions have proved to be the most difficult because of opposition by in-state merchants and many local governments. In addition to the problem in Ohio, Kansas, Texas, Tennessee, Utah, and Washington have also experienced opposition in this area. California, Illinois, and many other states have yet to face this issue, as they have not yet enacted conforming legislation. The above chart, as presented at the August 2004 Conforming States Committee Meeting, shows the states that have enacted conforming legislation and, if in substantial compliance, will be included for the calculation required under section 701 of the agreement.

If destination sourcing is not enacted by a particular state, it is likely that the state would not be deemed in compliance with the provisions of the agreement. With the July 1 deadline fast approaching, many involved in the effort believe that alternatives need to be evaluated to ensure that the effort maintains its momentum. These alternatives include the following:

No Amendments — If no amendments are made to the agreement, states will be required to be in compliance under section 805 of the agreement by the target date of July 1, 2005. Thus, the states that are not in substantial compliance with the agreement would not be included in the calculation for the purpose of determining the 10 state/20 percent threshold.

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It is too early to determine if the threshold can be met by July 1, but it seems the sourcing issues in several states put meeting the threshold in jeopardy. Members of government and business that have been involved in the initiative for a significant period want the effort to succeed but recognize that there is a need to accommodate small businesses make the transition to destination-based sourcing (that is, providing time to ensure that software solutions are in place and so forth).

Delay of Effective Date for a Provision(s) — An amendment to the agreement could be proposed that would provide states with an extended time frame to implement specific provisions, such as the sourcing provision. There is precedent for such an extended time because the agreement currently allows time for states to move to one local rate, eliminate caps and thresholds on products, move to a standard rounding rule, and harmonize their state and local tax bases.

Contingent Membership — Another alternative is to provide a second level of membership to the Governing Board for

a state as long as the state is in substantial compliance in all areas with the exception of sourcing. In that scenario a state could become a member and could be counted for the 10 state/20 percent threshold but would have limited membership rights (that is, limited voting rights, not be permitted to require collection, and so forth).

Similar to the delay, the concern over this alternative is that sourcing, while likely the most significant issue that states are facing to be in substantial compliance, is not the only issue that some states are facing to obtain substantial compliance. Thus, even with an amendment that would provide a state with additional time to implement the destination-based sourcing provisions, the July 1, 2005, target date might not be met. Therefore, states could consider contingent membership if most of the provisions are met. This amendment would provide the states with additional time to implement conforming provisions, including sourcing, and would guarantee that the July 1 deadline is met.

In summary, the states and the business community have been working together on this effort for five years. Many involved in this effort believe that the July 1 target date must be met to maintain its momentum. Further, many believe that the July 1, 2005, target date is paramount to the enactment of federal legislation supporting the streamlined sales tax effort. Two of the alternatives noted above would provide a mechanism for the agreement to become effective and allow the states an opportunity to perfect the technology solutions that are a part of streamlining and also would provide time to deploy software solutions to address some of the issues of small merchants. The outcome of the April 16 meeting of the Streamlined Sales Tax Implementing States, where these alternatives will likely be discussed, should have a significant bearing on whether the July 1, 2005, target date will be met and on the future of the Streamlined Sales Tax Project. ☆