



1400 K Street, Suite 400 • Sacramento, California 95814
Phone: 916.658.8200 Fax: 916.658.8240
www.cacities.org

January 21, 2009

To: League of California Cities Streamlined Sales and Use Tax Review Sub-Committee
Terry Henderson, Sub-Committee Chair
Mary Bradley, Finance Director, City of Sunnyvale
Fran David, Assistant City Manager, Hayward
Fran Delach, City Manager, City of Azusa
Scott Johnson, Finance Director, City of San Jose
Fred Strong, Council Member, City of Paso Robles

From: Kanat Tibet, Legislative Analyst, League of California Cities
Dan Carrigg, Legislative Director, League of California Cities

Subject: SSUTA Subcommittee Findings and Staff Recommendations

CC: Michael Coleman, Fiscal Policy Advisor, League of California Cities
Fran Mancia, MuniServices, LLC
Doug Kitchen, MuniServices, LLC
Patrick Whitnell, General Counsel, League of California Cities

Executive Summary

The SSUTA subcommittee was formed to provide an in-depth review of the existing Streamlined Sales and Use Tax Agreement¹ (SSUTA), including recent amendments on sourcing, related federal legislation, and to make recommendations to the full Revenue and Taxation Policy Committee.

This memo provides a recap of the SSUTA subcommittee's findings during the 2008 meetings, and League staff recommendations for the future steps to best protect our cities' interests.

The impetus for the subcommittee's formation was the potential momentum for this project with other states and the increasing likelihood of related federal legislation. Thus, the subcommittee was tasked

¹ <http://www.streamlinedsalestax.org/DOCUMENTS/SSTUA/SSUTA%20As%20Amended%209-05-08.pdf>

with analyzing the Agreement for potential impacts to California cities should the state at some point either voluntarily join – or, under the banner of tax simplification-- be forced by federal legislation to adhere to the provisions of the agreement.

The subcommittee met through both telephone conference calls and in-person meetings. The specific details of the agreement were reviewed in detail, including recent amendments. Discussions also involved the history of the SSUTA, its structure, staffing and decision-making process, and potential implications for cities if California joined the Agreement. The subcommittee also received a presentation from Martha Jones, Ph.d., on the report on the SSUTA she prepared for the California Research Bureau in 2005.² Other state municipal Leagues were also surveyed to determine their perspective on the agreement.

For local governments in California the bottom line question is: how would participation in the SSUTA affect their revenue? Regrettably, the subcommittee discovered that –absent a comprehensive analysis by the Board of Equalization -- there are too many unknowns to answer the question in a credible way.

While a fully-enforced, operating SSUTA holds out the lure of capturing additional use taxes from remote sales, losses may also occur due to the adoption of alternative definitions of what can be taxed, potential restrictions imposed on local tax rates, other restrictions potentially applied to local utility user's taxes, and both the state and local government losing authority to both the SSUTA board where it will have only one vote and Congressional intrusion through initial legislation and future amendments.

History and Background of the SSUTA:

The origins of the SSUTA trace back to the 1992 Supreme Court ruling in *Quill Corp. v. North Dakota*, *504 U.S. 298*,³ which focused on whether a state could require Quill, a catalogue sales company, to collect use tax on its sales to residents within North Dakota. The company argued that it should not be required to collect and remit the use tax because it had no physical presence or employees within the state. The Supreme Court agreed with Quill and ruled, consistent with earlier cases, that remote sellers/businesses that sell products to customers within a state or to other states, using the Internet, mail order, or telephone, without having a physical presence in the state where the product is shipped to cannot be required to collect and remit a use tax.

A portion of the Court's reasoning in *Quill* stemmed from the existence of over 6,000 jurisdictions throughout the United States (states, localities, and special tax districts) that levied a sales and use tax. The Court concluded that requiring remote sellers (without a physical presence in the state) to collect and remit use taxes would impose an undue burden on those companies and severely restrict interstate

² The Streamlined Sales and Use Tax Agreement: A California Perspective, Martha Jones, Ph.d., (February, 2005) California Research Bureau, California State Library.

³ http://en.wikipedia.org/wiki/Case_citation

commerce. Yet the Court did clarify that Congress through its authority to regulate interstate commerce “is free to decide, whether, when and to what extent states may burden interstate mail order concerns with a duty to collect use taxes.”

Additional influence for the SSUTA comes from the efforts of the special National Conference of State Legislatures’ (NCSL) Task Force on State and Local Taxation of Telecommunications and Electronic Commerce,⁴ formed in March, 1999. The NCSL task force aimed to address the consequences for state and local tax systems of the rapid changes in technology and the emerging competitive telecommunications marketplace. This taskforce ultimately adopted the initial version of the Agreement in November, 2002. The Agreement has since been amended several times.

Thus, the SSUTA represents an effort by states to voluntarily streamline and simplify their sales and use tax systems. In the short term, as a *voluntary* arrangement, the member states agree to streamlined statutes, processes and definitions, businesses may seek to take advantage of these streamlined provisions by registering under the Agreement *voluntarily* agreeing to collect and remit use tax to the affected states and jurisdictions. It is further believed by those active within the SSUTA that once simplification of various state’s sales and use tax systems has been demonstrated and achieved – that the state’s are better positioned to lobby Congress to reverse the *Quill* decision and require all remote sellers (that lack physical presence within those member states) to collect and remit use tax to the various states and jurisdictions.

Estimates of Existing Losses From Remote Sales

According to the report “Addressing the Tax Gap”⁵ (2007), the California Governing Board of Equalization (BOE) collected \$5.46 million from 31,000 personal income tax returns in 2006 in use tax, by inserting a new line on the personal income tax form. The report states that the estimated total loss of use tax impacted by electronic commerce and mail orders -- spread among approximately 11.5 million households-- was \$409 million for the same year, \$103 million of which were losses to local agencies. Furthermore, about two million California businesses are not required to register with the BOE because they purchase items for use rather than for sale. The BOE report estimates the unpaid use taxes from these unregistered businesses (averaging \$335 per business) to be \$682 million, \$172 million of which would be local agency loss.

Other estimates of potential lost revenue have been much more aggressive. A 2004 study by the University of Tennessee⁶ suggests that state and local governments lost between \$15.5 and \$16.1 billion in

⁴ <http://www.ncsl.org/programs/fiscal/history.htm>

⁵ Addressing the Tax Gap -- <http://www.boe.ca.gov/news/pdf/gapdoc.pdf>

⁶ "State and Local Sales Tax Revenue Losses from E-Commerce

2003, from being unable to collect sales and use taxes from online sales. The report projects that 2008 revenue loss nationwide for state and local governments would range between \$21.5 billion and \$33.7 billion. The authors estimate that in 2008, California will lose between \$2.3 billion and \$3.6 billion from uncollected sales and use taxes from E-Commerce. This amount translates to a loss between \$637 million and \$996 million for the local governments.

Some Basics on the Agreement, its Governance and Enforcement

The Agreement is a 137-page document with many provisions and lengthy definitions. Its fundamental purpose is “*to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance.*” The Agreement states its goals as:

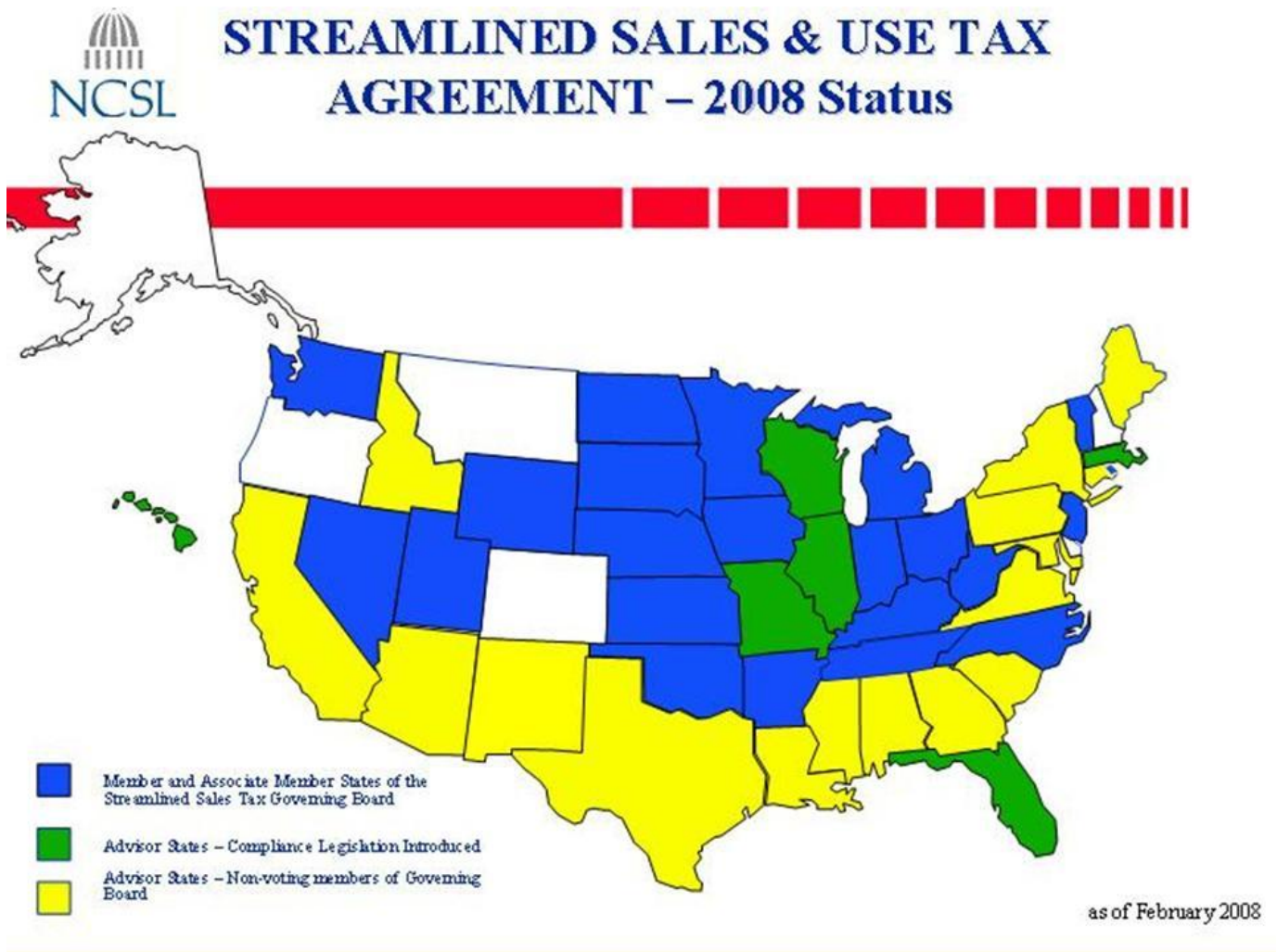
- State level administration of sales and use tax.
- Uniformity in state and local tax bases.
- Uniformity of major tax base definitions.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Simplified administration of exemptions.
- Simplified tax returns.
- Simplification of tax remittances.
- Protection of consumer privacy.

The Agreement is administered by a governing board of member states (with each state getting one vote). The governing board is required to meet at least once per year, including electronically, and is provided broad authority to administer and interpret the agreement. Amendments can only be made with a three-quarters vote of the entire governing board. The Governing Board’s website lists three staff: an executive director, an information technology director, and an executive assistant.

The Governing Board is advised by the State and Local Advisory Council (SLAC), and Business Advisory Council (BAC). The SLAC is a forum for state and local government officials to express ideas and concerns relating to the Agreement. Matters covered include admission of states into membership, noncompliance, interpretations, and revisions or additions to the Agreement. SLAC establishes committees or work groups to study matters before advising the Governing Board. Local government interests are represented at the SLAC by the Government Finance Officers Association (GFOA), National Association of Counties (NACO), and National League of Cities (NLC).

Participation by States

Nineteen states – out of the forty-five states that levy sales and use taxes – are full member states, meaning they are both signatories to the agreement and have also adopted conforming changes to state statutes. The current member states are Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont, West Virginia, Washington, and Wyoming. Three other states -- Ohio, Tennessee, and Utah -- are considered “associate member states,” meaning that they are on track to be in full compliance by July 1, 2009. Another six states -- Hawaii, Illinois, Massachusetts, Michigan and Florida -- have introduced legislation to make conforming changes to their statutes.



California and the Agreement

California passed legislation in 2003, SB 157– (Bowen & Alpert)⁷, which established for California a state Board of Governance consisting of two members of the Senate, two members of the Assembly, one member of the Board of Equalization, one member of the Franchise Tax Board, and a member of the Department of Finance. The Board was tasked with representing California in all meetings related to the SSUTA, and was required to report quarterly to legislative revenue and taxation committees. This legislation made California a non-voting “advisor state” which could serve in an ex officio capacity on the Governing Board. California, however, has not participated in the SSUTA Governing Board meetings since 2005, and its Board of Governance has not met since May 12, 2005. In 2005, the state BOE had commenced a section by section comparative analysis of the SSUTA to determine its impact on California, but that effort is no longer underway.

At a recent meeting in West Virginia, representatives of the SSUTA Governing Board expressed interest in getting together with BOE representatives to bring back momentum to California’s interest and involvement with the Project.

Revenues Collected Under Voluntary SSUTA Agreement

- In October 2006, voluntary vendor participants in the SSUTA have remitted sales/use tax collections of approximately \$66.5 million to the states. (Duncan, Harley, Luna, LeAnn, National Tax Journal⁸, September 1, 2007).
- More recently at the August 08 SSUTA Governing Board meeting in West Virginia, it was reported that 1,100 sellers are currently registered with the SSUTA, and they collected \$135.1 million in use tax during 2007 for remittance to member states.

The Agreement and Federal Legislation

In recent years, several bills have been introduced in Congress to get its consent to the SSUTA, and to give those states that have complied with the Agreement the authority to require remote out-of-state sellers to collect use tax on remote sales. S. 34 (Enzi) and HR 3396 (Delahunt) were similar bills introduced in 2007, but not approved due to a lack of traction and concerns from various interest groups. Congressional legislation, however, can come with its price. Both of these measures, included a “small business exemption” for businesses of under \$5 million in gross remote taxable sales, imposed restrictions and simplification requirements on taxes levied on telecommunications services in participating member states, added a litigation provision authorizing “any person” to bring an action in federal Claims Court seeking judicial review of various actions, and would allow Indian tribes to participate in the agreement and secure voting status.

⁷ http://www.leginfo.ca.gov/pub/03-04//bill/sen/sb_0151-0200/sb_157_bill_20031009_chaptered.pdf

⁸ <http://www.allbusiness.com/legal/tax-law-income-tax/5515408-1.html>

Of note to California, the amendments in the above legislation related to “*taxes on telecommunication services*” (not sales and use tax) required that each taxing jurisdiction levy only one rate for each type of tax levied on telecommunication services, to be accounted for on a single uniform return. It is not clear how this provision would be ultimately be interpreted by the SSUTA Board. At a minimum it would mean a common form. In an expanded interpretation it could mean state centralization for the collection of local utility user tax revenue.

The SSUTA Governing Board plans to sponsor similar federal legislation in 2009 in the 111th Congress, and they are also planning to retain a professional lobbyist to boost their efforts to succeed. League staff, along with local government members of the SSUTA State and Local Advisory Council (SLAC), recently attended a meeting of the SSUTA Governing Board in West Virginia where the benefits of federal legislation were discussed. The Governing Board’s perception is that, with the presence of introduced federal legislation -- and once sales and use tax laws are harmonized by the majority of the states by joining the Agreement, and if ultimately more large states like Texas, Illinois, Massachusetts, and Florida join the Agreement -- either the Supreme Court will alter the *Quill* decision in a future case, or the Congress will pass legislation that will require out-of-state vendors to collect and remit sales and use taxes on interstate transactions.

Sister Leagues and their Perception of the Agreement

League staff surveyed other state municipal Leagues from both member and non-member states found that few were significantly tracking the actual results of participating in the Agreement.

- The general reaction from the municipalities in states participating in the Agreement was mainly positive. They were unable to track the financial gains for municipalities; however, they were hopeful that they would reap the benefits in time. Only a handful of them had staff assigned to monitoring the benefits of the Agreement for municipalities.
- The Leagues from Florida, Texas, Georgia, Illinois, and Massachusetts who are not in the agreement informed us that their states have been looking at joining, yet the sourcing-related issues and tax definitions were holding them back. Only the Texas league has a staffer analyzing the Agreement and following developments.

Some Issues Identified by Subcommittee with the Agreement

- 1. Purpose of the Agreement Is Tax Simplification:** The SSUTA is often referred to as a tool to tax interstate internet purchases that would otherwise not be taxed, yet it is imperative to note that nowhere in the Agreement is such an intention stated. The stated fundamental purpose of the Agreement is to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance. Sec. 102. Before joining, states and local agencies would be wise to carefully weigh the “gives” as they consider the potential “gets.”
- 2. Seller Participation Is Uncertain:** A seller may cancel its registration under the system at any time under uniform procedures adopted by the governing board. Section 303. Cancellation does not relieve the seller of its liability for remitting to the proper states any taxes collected, but with seller participation key to receipt of revenue this creates uncertainty. Consequently, there are possible unknown risks to state and local revenues over time, unless future federal legislation mandates all sellers -- whether they were registered with the agreement or not-- to collect and remit use tax.
- 3. Categories of Products, Exemptions and California Politics:** Joining the Agreement and implementing its definitions and rules would require extensive changes to California’s Revenue and Taxation Code. The Agreement divides taxable products into different categories at a very detailed level. For instance, under “Clothing” steel-toed boots are taxable, while belt buckles sold separately are not. Initially, this will require a state to estimate item by item what joining the Agreement will mean to revenues. The Agreement requires member states to adopt the definitions and listed exemptions in their *entirety*, or opt to exempt all items within a category from sales and use tax. A state may not pick and choose within a category, or add other items not listed within a category. Evaluating how the California Legislature may choose to respond to these choices is another matter. Currently, a two-thirds vote is required to enact a new tax, but only a majority vote to repeal a tax or grant an exemption. Thus, the politics may be that the adoption of any category of definition that expands a tax will be opposed, with similar dynamics as currently being experienced in the state’s budget process. Sec 327.
- 4. Requirement for State and Local Common Tax Base:** The Agreement requires state and local agencies to have identical tax bases. Sec 302. This provision will impact California local governments. Under California law sales and use tax can only be applied to items that the state identifies as taxable. Similarly, if the state does not tax the item then local taxes cannot be imposed. There are a number of instances, however, where the state has chosen to provide an *exemption* from state sales and use taxes for an item, but the local tax continues to apply. The recent state budget proposal to eliminate the sales tax on gas included an *exemption* for local sales and use tax levied on gas. The ability for the state to grant such exemptions would need to be removed for the state to join the agreement.
- 5. Telecommunication Taxes and UUT’s:** It is unclear how the Agreement will ultimately affect telecommunication taxes and local utility user’s taxes should the state ever join the agreement.

The telecommunications industry has been quite active both at the SSUTA level as well as seeking amendments to federal legislation. California cities would be concerned about any proposals which would seek to centralize collection and distribution of UUT revenues as well as attempt to establish a standardized rate.

6. **Tax Sourcing:** Other state's joining the Agreement originally had to agree to destination-based sourcing (meaning the tax was delivered to the location where the good was received). This is opposite of California's origin-based assignment of taxes based upon the location where the goods are sold. Shifting to a destination-based sales and use tax system would mean major shifts in where the local government revenues are allocated within the state. A recent amendment to the Agreement gives states the option of joining the Agreement while retaining origin-based sourcing for intrastate sales⁹. However, the amendment provides that the "origin" has to be where the order for the good is received by the seller. In California, retail sales tax is sourced to the warehouse from which taxable goods are shipped not the storefront where the order is received. This change would have significant impacts on California communities that are major hubs of warehouse activity. Furthermore, the term "first receipt of the order" has not been functionally defined by the SSTUA Governing Board and creates ambiguity that could change the location where the tax is allocated when the order is received at a call center or a server located in a different state. In addition to the changes to origin based sourcing, a significant number of transactions which are now intrastate transactions will be changed to interstate based and therefore will be sourced by destination rather than by origin sourcing. The volume of transactions which would be impacted by this change is expected to be large but as of yet it is unquantifiable. The most heavily impacted sector will most likely be the business-to-business sector and could change the allocation location for as high as 20-30% of the total business to business transactions. In addition gaming of the allocation system to gain the lowest tax rate is also a possibility that could impact local tax revenues.
7. **Additional Costs For Sales And Use tax Collection:** One condition imposed on origin-based states joining the Agreement is a requirement the taxing entities reimburse sellers for their expenses incurred in collecting and remitting sales and use taxes. This condition appears to not be limited to costs of remote sellers, but also for in state transactions. Section 604 is specific to states that choose origin-based sourcing. It requires substantial state costs to generate and maintain a combined destination and origin sourcing system which would then be reflect administration fees

⁹ Section 310.1 ELECTION FOR ORIGIN-BASED SOURCING – <http://www.streamlinedsalestax.org/DOCUMENTS/SSTUA/SSUTA%20As%20Amended%209-05-08.pdf>

paid by local jurisdictions. On top of this fee, there would also be a vendor compensation of amount equal to the “reasonable vendor expense.” Those closely tracking the SSUTA estimate that the vendor compensation will range between 1% and 15% depending on the size of the business and should average between 2-2.5%. These direct and indirect costs are in addition to the BOE’s current administration fees. With technological advances in future years, it is anticipated that the vendor compensation fee as a percentage of sales tax would decrease over a period of time.

- 8. Reduced Role of State in Future Tax Policy:** California’s participation in the SSUTA could reduce the role of the BOE and the State Legislature in tax policy. The SSUTA Governing Board is responsible for the implementation of the Agreement, including any amendments, interpretations and resolution of disputes. Each member of the Governing Board is entitled to one vote. Votes are not weighted according to state population. California could lose some sovereignty over tax policy, and any future expansion of state taxes would need to match the terms of the Agreement. This could significantly limit state flexibility to respond to its budget challenges.
- 9. Periodic Changes to State Statutes Required:** Since inception, the Agreement has been evolving with new amendments impacting the member states. These changes, in turn, require member states to modify their laws to comply with the Agreement. Also, if the Congress passes legislation that adds additional conditions then member states would have to adjust their statutes accordingly.
- 10. Lack of Adequate Staffing and Independent Professional Expertise:** Considering the pivotal role the Agreement would play in national tax policy, it is logical to anticipate a major staffing load associated with developing, maintaining and interpreting the agreement, and responding to legal and other disputes. Yet, the current staffing for this effort relies largely on a staff of three and the participants active in various subcommittees. The majority of the BAC representatives appear to be lawyers, business consultants, and lobbyists, while the SLAC representatives are state representatives with backgrounds in finance and tax law. The Governing Board members rely heavily on the feedback they get from the SLAC and BAC representatives before they make organization-wide matters pertaining to administration of the SSUTA, rather than having the advice of independent analysts, attorneys, and other professional staff responsible to the Board. This structure raises many questions about the reliability, transparency, accountability and longevity of such an effort.

Conclusion and Recommendations

As documented above there are more questions than answers for California cities about the potential participation in the SSUTA. While the lure of capturing lost use tax in an evolving economy that relies increasingly on remote sales remains tempting, the SSUTA appears to offer -- at this point—many more risks for California cities than benefits. Thus, we recommend the California League:

- 1) Continue to monitor developments of the SSUTA and related federal legislation, but not support any additional efforts that would lead to California joining the agreement. This position can always be revisited at a future point if events change.
- 2) Strongly oppose any federal effort that attempts to force California to conform to the Agreement, or amendments to federal legislation that would directly undermine California's utility user tax structure.
- 3) Focus on working with the State Board of Equalization and other parties on alternative efforts to increase the collection of use taxes within California. Share our analysis of the SSUTA with interested parties, exchange information on use tax collection issues with municipal Leagues in other states, including those states with tax structures similar to California.