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SST Board Resolves Digital Issues, Sourcing Dispute Remains

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The Streamlined Sales Tax (SST) Governing Board resolved one of its two most enduring controversies, the treatment of digital products, but failed to reach agreement on the other, an alternative to the current sourcing provisions, during its meeting in Kansas City, Kansas, September 19-20, 2007. The meeting also saw the admission of two more states to full membership and leadership changes in the key constituent organizations. Kansas Secretary of Revenue Joan Wagnon is the incoming President of the Governing Board and the Council on State Taxation's Stephen Kranz is the new President of the Business Advisory Council (BAC).

With her term coming to an end, Diane Hardt, Wisconsin Department of Revenue, stepped down as chair of the State and Local Advisory Council (SLAC). Wagnon will appoint her successor. Hardt, who also co-chaired the SLAC's predecessor, the Streamlined Sales Tax Project (SSTP), from its inception over seven years ago, said the group had "set an example" for similar efforts in state government and urged participants to "keep an eye on the big picture" as they continue their work. She will continue

to be involved in the SLAC and the Board as a delegate from Wisconsin.

Action on Membership Petitions

The Board accepted the petitions of Arkansas and Wyoming to become full members on January 1, 2008. Those two states have been associate members since the inception of the Board and recently enacted the remaining conformity provisions required for full membership.

Nevada's petition for full membership was deferred until the Board's December meeting to give the state time to address remaining questions about the extent of its compliance with the SST Agreement.

The Board also approved a petition from Tennessee. Tennessee's current associate membership was scheduled to expire on December 31, 2007, and the state recently delayed previously enacted provisions that will bring it into full compliance. However, at its last meeting, the Board amended the Agreement to allow a state that is in full compliance except that its conformity provisions are not yet in effect to become an associate member up to 18 months before those provisions take effect LK:NON: CYTXDS 20070626-S.1 . The Board found that Tennessee will be in full compliance effective July 1, 2009. Therefore, the Board accepted Tennessee's petition to continue as an associate member until July 1, 2009, at which time it will automatically become a full member barring any further delay or repeal of its conformity legislation.

Compromise Achieved on Digital Products

The Board approved a package of changes that resolved, at least for the present, disputes concerning how digital products are to be defined and treated under the Agreement. This effort has been under way since almost the inception of the SSTP and had proceeded in several different directions, each of which led to significant obstacles. The final result was a compromise between the states and interested members of the business community.

Essentially, a state wishing to tax sales of defined digital products must begin to do so by separate imposition but can continue, in the short term, to tax undefined products as part of its general definition of "tangible personal property." In the longer term, a state may not include any product transferred electronically in its definition of "tangible personal property."

Specifically, the Agreement is amended to add definitions for "specified digital products." The defined products are "digital audio-visual works," "digital audio works," and "digital books." A state cannot include these items in its general definition for "tangible personal property" (or "ancillary services," "computer software," or "telecommunications services"). Therefore, a state wishing to tax one of these defined digital products will have to do so by separate imposition. Unless such an imposition statute states otherwise, it will only impose tax on a sale (1) to an end user, (2) with the right of permanent use granted by the seller, and (3) which is not conditioned on continued payment from the purchaser. A state may treat a subscription differently than a non-subscription purchase. The tax treatment of a digital code must be the same as the tax treatment of the specified digital product to which it relates. A state may provide a product-based exemption for specific items

within the definition of "specified digital products" provided the same exemption is granted to the items' tangible equivalents. These amendments to the Agreement are effective January 1, 2008, and the member states will have two years to come into compliance with them.

There has been general agreement among the states and business representatives on the foregoing provisions for some time. The main disagreement has been whether a state may tax *undefined* digital products under its general definition of tangible personal property. Under the compromise approved by the Board, the Agreement now provides that, effective January 1, 2010, a state cannot include any product transferred electronically in its definition of tangible personal property. States would have two years from the delayed effective date to come into compliance with this mandate (*i.e.,* until January 1, 2012). If a state chooses to adopt a separate tax on products transferred electronically, it is not required to use the "specified digital products" definitions.

Various Sourcing Proposals Debated

Currently, the Agreement requires states to adopt destination sourcing of sales. The switch to destination sourcing has been politically difficult for many states that formerly used origin sourcing, particularly Kansas and Washington. Other origin sourcing states have said that they cannot (or *probably* cannot) make the switch, including current associate members Ohio, Tennessee, and Utah, and non-member advisor states New Mexico, Texas, and Virginia. Those states that say they are unable to make the switch have sought to amend the Agreement to allow them to continue to use origin sourcing in at least some circumstances. They also argue that origin sourcing must be allowed if bigger

states, including California, Illinois, and New York, are ever to join as members.

At its last meeting, the Board appointed a task force to evaluate proposals to amend the sourcing provisions in the Agreement and to make recommendations. The task force recommendations and other proposals were considered during a series of intermittent and occasionally tense debates in Kansas City, but no final action was taken.

The three main proposals that were considered were the following.

Task force proposal: The task force proposal would permit a state to elect to source all “intrastate” sales of tangible personal property on an origin basis. An intrastate sale is a sale made from a seller's place of business within a state and delivered to a purchaser at a location within that state. The state would have to permit a seller making an interstate sale into the state to collect tax at either the destination rate or an optional rate. The optional rate would be set by law and could not be greater than the sum of the state rate and the highest local rate in the state. If the seller collected the optional rate and that rate was higher than the rate imposed at the location where the purchaser took receipt of the product, the state would have to grant the purchaser a refund or credit for the difference. If the optional rate was lower than the rate at the location of receipt, the state could not seek additional use tax from the purchaser.

Business representatives raised several objections to this proposal. They argued that it would shift burdens from sellers to purchasers and make it difficult for the latter to verify that the correct rate was being collected. It could lead to purchasing decisions based on

whether a particular seller charged the optional rate or the destination rate. It would not help small businesses making interstate sales. It was unclear how it would apply to bundled transactions that include services. Some state representatives also questioned whether the optional rate provision would be constitutional.

Business proposal: Some representatives of the business community offered an alternative proposal that the states saw for the first time during the meeting. Under this proposal, a state could adopt a "delivery rate" that would apply to all taxable sales of tangible personal property sourced to that state (whether intrastate or interstate) other than over-the-counter sales. The delivery rate could not exceed the highest combined rate levied in the state. A purchaser that had paid the delivery rate could not be held liable for additional use tax in that state, even if the item was moved to a jurisdiction with a higher rate. There would be no need for a refund or credit mechanism like that in the task force proposal.

The business proposal met with a wary, but largely positive, response from most of the states present. However, the main objections came from the states the proposal was ostensibly designed to help: Ohio, Tennessee, Texas, and Virginia, as well as representatives of local governments. They objected that, assuming the delivery rate was higher than the state rate alone, residents in locations without a local sales tax would consider this a tax increase. Also, the rate could vary even within a local jurisdiction depending on whether the item was delivered or receipt was taken over the counter. The skeptics also worried about the ability to avoid significant revenue shifts by identifying the local jurisdictions where the sales originated and allocating the revenues back to those jurisdictions.

Tennessee/Texas proposal: Sherry Harrell, Tennessee Department of Revenue, and Robin Corrigan, Texas Comptroller of Public Accounts, presented a modified version of the task force proposal that eliminated the optional rate for interstate sales (and the related refund/credit mechanism) and added that a purchaser that had paid tax on a sale would not be liable to that state for additional tax, even if the item was moved. Harrell said that the proposal differed from the current situation by offering uniform destination sourcing to the state level and requiring all member states that choose to use origin sourcing to apply it in a uniform manner as set forth in the proposal.

Business representatives objected that this proposal would essentially enshrine the current situation in the states and that the elimination of the optional rate would open it to constitutional challenges. Several state representatives also expressed misgivings. Corrigan warned: "If you slam the door on this proposal, you are slamming the door on Texas." Ohio State Rep. Bob Gibbs echoed Corrigan, saying a rejection "would also slam the door on Ohio."

Debate: The prolonged debate that ensued ultimately turned on disagreement over whether the Board needed to accept compromises that would bring more states on board, or it should strive to maintain as much uniformity as possible even at the risk of alienating large states, and which of these approaches was more likely to convince Congress to pass federal authorizing legislation. Ohio's Gibbs said the project would "unravel" without more states. Kansas State Senator Janis Lee responded that the choice was between adding more states by "lowering the bar" and "sticking to the group's original principle and reducing complexity." Ohio State Senator Ron Amstutz added: "This group is divided down the middle and cannot continue divided."

In a series of procedural votes taken to test the support for the various proposals, it became apparent that a majority of states preferred the business proposal. Opponents could not garner more than five votes for their position, with Michigan consistently joining Ohio and Tennessee in the minority. Three times as many states indicated a preference for the business substitute. However, it was unclear if any of the origin sourcing states other than Utah would be able or willing to take advantage of the alternative sourcing provisions offered by the business proposal, undercutting the rationale for adopting it. Ultimately, the Board approved by voice vote a motion by Oklahoma to refer the sourcing issue back to the task force. Another attempt to resolve the issue will be made during the Board meeting in December.

Delivery Charges and Direct Mail

The Board amended the definition of “delivery charges” at the request of Michigan to create separate toggles for its components. Michigan wishes to exempt separately stated charges for transportation, shipping, and postage, but not for handling and similar charges. The Board rejected a request from the direct mail industry to withhold action pending a comprehensive solution to all delivery charge issues.

In a separate action, the SLAC approved a recommendation to the Board to amend the Agreement and related rules to (1) source business correspondence to a single location (rather than to multiple mailboxes as other “direct mail” is sourced), and (2) to expand the existing optional exclusion from “delivery charges” for charges for delivery of direct mail to include charges by data

processing and mailing service providers that deliver materials to a mass audience but do not print those materials. The states, however, were unsympathetic to a business proposal to reverse the existing toggle and create a presumption that delivery charges for direct mail are excluded from the tax base. The SLAC proposal will be submitted to the Board at its next meeting.

Other Actions Taken

The Board approved two interpretation recommendations submitted by the Compliance Review and Interpretations Committee (CRIC). One holds that flour substitutes are not flour for purposes of the "candy" definition. The other provides that a sale is not received by a purchaser, and consequently sourced to the seller's location, when a third-party shipping company picks up the product on behalf of the purchaser.

The Board referred to the CRIC proposals approved by the SLAC to (1) require states to relieve sellers from tax liability for failing to collect tax at a new effective tax rate for which the state provided less than 30 days' notice, and (2) adopt a new sales tax holiday definition for an "ENERGY STAR qualified product."

The SLAC called for final comments on (1) a proposed sourcing rule for software term licenses and subscriptions, and (2) a proposal to deny a purchaser relief from liability for erroneous data when the purchaser has actual knowledge of the correct data. After a 30-day comment period, these proposals will be forwarded to the CRIC for its consideration.

A SLAC committee was appointed to evaluate proposals for how to source floral wire order sales. It will prepare a recommendation for the next meeting.

The SLAC was told that little tangible progress has been made in the attempt to define prohibited "replacement taxes" (*i.e.,* taxes created by states outside the sales tax code to avoid the intent of the Agreement). As a result, the BAC may ask the Board to adopt a general standard governing replacement taxes and then ask the Board to enforce that standard.

Jerry Johnson, Oklahoma Tax Commission, said that he would like to extend the existing simplified electronic return to more sellers. He suggested that the Board establish criteria for sellers that states would have to allow to use the return. Johnson also said that he wants to enhance the existing SST registration system to assist taxpayers in updating corporate officer lists and filings by related entities.

The next meeting of the SLAC and the Board will occur December 10-12, 2007, in Dallas.

Streamlined Sales Tax Governing Board and State and Local Advisory Council, Kansas City, Kansas, September 18-20, 2007