DRAFT

Streamlined Sales Tax Project

A Report to the Legislature on the Streamlined Sales Tax Project

Board of Governance
Honorable John Chiang, Chairman, Board of Equalization
Honorable Steve Westly, State Controller and Chairman, Franchise Tax Board
Honorable Roy Ashburn, California State Senate
Honorable Debra Bowen, California State Senate
Honorable Rudy Bermudez, California State Assembly
Honorable Mark Wyland, California State Assembly
Ms. Anne Sheehan, Department of Finance

January 30, 2006

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Report to the Legislature on the Streamlined Sales Tax Project (SSTP) as of **December 31, 2005.**

BOARD OF EQUALIZATION (BOE) STAFF PARTICIPATION

- BOE staff attended the following meetings:
  - August 29 – 30, 2005, Milwaukee, WI – SSTP Meeting
  - September 30, 2005, Washington D.C. – Implementing States Meeting
  - October 1, 2005, Washington D.C. – Streamlined Sales Tax Governing Board, Inc. (SST Governing Board) Meeting
  - November 8-9, 2005, Tampa, FL – State and Local Advisory Council (SLAC) and SST Governing Board Meetings.

- BOE staff did not attend the following meetings.
  - June 30, 2005, Chicago, IL – SSTP Meeting
  - July 1, 2005, Chicago, IL - Petitioning States Meeting

- BOE staff is meeting with representatives from several states to discuss common concerns and issues regarding the Streamlined Sales and Use Tax Agreement (SSUTA) and the SST Governing Board.

BOARD OF EQUALIZATION – Budget Change Proposal (BCP)

On August 31, 2005, the Board of Equalization, on a 4-1 vote, approved a BCP to request funding to address the increased workload generated by California's participation in the SSTP. The BCP requested funding for 4 limited-term positions for fiscal years 2006-07 and 2007-08.

The Governor's 2006-2007 budget released on January 10, 2006, did not include increased funding relating to California's participation in the SSTP. Accordingly, the BOE will not receive any additional funding for fiscal year 2006-07 relating to California's participation in the SSTP.

IMPLEMENTING STATES

Prior to October 1, 2005, the Implementing States had responsibility for the SSUTA, including the disposition of proposed amendments and the resolution of interpretation requests. As an Implementing State, California had a vote on all matters relating to the SSUTA. When the SSUTA became effective on October 1, 2005, the responsibility for the SSUTA was transferred to the SST Governing Board. The SST Governing Board is comprised of states that have been certified to be in substantial compliance with the SSUTA effective October 1, 2005, or on a subsequent date, but before January 1, 2008. Only states that have been certified to be in substantial compliance with the SSUTA on October 1, 2005, can vote on issues relating to the SSUTA. Accordingly, California no longer has a vote on the final disposition of issues relating to the SSUTA.

Pursuant to SSUTA Section 703(C), for a period of not less than six months nor longer than one year from the effective date of the SSUTA, the Implementing States shall provide advice and shall be consulted by the SST Governing Board before amending the SSUTA. However, as stated, this will only be in an advisory capacity.

Maryland State Delegate Sheila Hixson was appointed Co-chair of the Implementing States in place of Oklahoma State Senator Angela Monson, who will be leaving the Oklahoma Senate. Utah Tax Commissioner Bruce Johnson was re-appointed as the other Co-chair.

SST GOVERNING BOARD

On October 1, 2005, the SST Governing Board was established. The SST Governing Board is comprised of representatives from the following states:

Full Members States (Voting members)

- Indiana
- Iowa
- Kansas
- Kentucky
- Michigan
- Minnesota
- Nebraska
- New Jersey
- North Carolina
- North Dakota
- Oklahoma
- South Dakota
- West Virginia

Associate Member States

- Arkansas
- Ohio
- Tennessee
- Utah
- Wyoming

Nevada will become an associate member state on January 1, 2006.

Executive Committee

The newly elected Executive Committee of the SST Governing Board consists of the following.

Officers

President – State Senator Dwight Cook, North Dakota
1st Vice-President – Secretary of Revenue Joan Wagnon, Kansas
2nd Vice-President – State Delegate John Doyle, West Virginia
Secretary/Treasurer - Commissioner Jerry Johnson, Oklahoma

Directors

State Senator Ron Amstutz – Ohio
State Senator Orville Smidt – South Dakota
Commissioner Loren Chumley – Tennessee
Commissioner Bruce Johnson – Utah
Mr. Harold Fox – New Jersey

Through its bylaws adopted on October 1, 2005, the SST Governing Board established the following standing committees. Appointments were also made to these committees on October 1, 2005.

- Nominating
  The Nominating Committee shall actively seek candidates for nomination as officers and directors of the SST Governing Board.

- Finance
  The Finance Committee has the responsibility to prepare an annual budget, monitor finances, review contracts, establish banking procedures and other financial policies, and to recommend cost allocations for States for the SST Governing Board's approval.

- Compliance Review and Interpretations
  The Compliance Review and Interpretations Committee has the dual responsibility for: (1) recommending rules to the SST Governing Board to respond to statements of non-compliance, making recommendations to the SST Governing Board on applications of states for compliance with the SSUTA, maintaining a Compliance Review Guide, reviewing all compliance review reports to determine any needs for reassessment, and recommending findings of compliance or non-compliance to the SST Governing Board; and (2) making recommendations to the SST Governing Board on matters involving interpretations, definitions, revisions or additions to the SSUTA.

- Issue Resolution
  The Issue Resolution Committee has the responsibility to promulgate rules and to implement the issue resolution process in Article X of the SSUTA.

STATE AND LOCAL ADVISORY COUNCIL (SLAC)

Effective October 1, 2005, the SLAC replaced the SSTP as the forum for all state and local government officials to express ideas and concerns relating to the SSUTA and to have a formal process to bring those concerns forward to a body that can effect changes to the SSUTA.

SSUTA Section 810 provides that the SST Governing Board shall create a SLAC to advise the SST Governing Board on matters pertaining to the administration of the SSUTA. The membership shall include at least one representative from each state that was a participating member of the SSTP. Matters pertaining to the administration of the SSUTA shall include, but not be limited to, admission of states into membership, noncompliance, interpretations, and revisions or additions to the SSUTA.

The SLAC will operate under the Rules of Procedure as adopted by the SST Governing Board which may include establishing committees or work groups, decision-making processes and setting the SLAC agenda. The SLAC will consider and respond to those matters referred to it from the SST Governing Board or its committees. In addition, the SLAC may recommend items to the SST Governing Board for consideration.

Diane Hardt, Wisconsin Department of Revenue, and Marshall Stranburg, Florida Department of Revenue, were appointed to Chair and Co-chair the SLAC. The SST Governing Board bylaws allow a SLAC Steering Committee comprised of up to nine members. The SLAC Chair and Co-chair will sit on the Steering Committee. The remaining 7 members of the Steering Committee will be elected by the

SLAC at the January 2006 meeting. At least two and no more than three of the nine Steering Committee members will be local government representatives.

The duties of the Steering Committee include:

1. Planning agendas for meetings,

2. Recommending to the SLAC the organization of work groups or project committees,

3. Recommending to the SLAC such actions and procedures as are necessary for the SLAC to fulfill its mission, and

4. Assisting and advising the Chair and Vice-chair in fulfilling their responsibilities.

Written notice must be given at least 30 days in advance of SLAC meetings and must include the agenda, purpose of the meeting and all pertinent materials for discussion. SLAC members wishing to add action or discussion items to the agenda may do so if submitted 10 days in advance of the meeting to the SLAC Chair and Vice-chair. Those additional action or discussion items shall be considered by the SLAC and with the approval of a majority of those present and voting at the meeting. Emergency meetings may be called by the SLAC Chair and Vice-chair, the Steering Committee, or by petition of forty percent of the SLAC members with no less than 10 days notice being given.

As a member of the SLAC, California has a voting right on all issues brought before the SLAC. This vote, however, is not the final disposition of the issue. It is only a vote to determine what recommendation the SLAC will make to the SST Governing Board relating to specific issues.

It should also be noted that the 30 and 10 day public notice requirements of the SLAC meeting will make it more challenging for BOE staff to ensure that the California Board of Governance is fully informed of issues being discussed at the SLAC for purposes of authorizing its delegate to vote.

ADMINISTRATIVE ISSUES

Following is a summary of issues discussed by the SST Governing Board and the SLAC.

Registration

Sellers wishing to volunteer to collect under the SSUTA and receive amnesty for uncollected or unpaid sales and use tax can register on-line at www.sstregister.org/sellers. They can also update previously submitted registration information at this website. The information provided will be sent to all of the full member states and to associate member states for which the seller chooses to collect tax.

A seller legally required to register in one or more of the member states may still register under the SSUTA at this website. However, the seller will need to contact those states for further licensing requirements.

For each reporting period, only one return for each member state is required under the SSUTA. Sellers may choose to use a state's existing return or a simplified electronic return. A state may require a seller to file a return within one year of registering and annually thereafter, or in the month following the accumulation of $1,000 or more in tax for any state.

Over 300 businesses have registered under the SST Governing Board registration system.

Business representatives expressed concern that information provided by sellers during the registration process will be used by member states in establishing nexus for other taxes. Ms. Diane Hardt, SLAC Chair, explained that registration information should not be used in determining whether a seller has nexus for other taxes. However, representatives from several states agreed that the information could be used as an audit lead for establishing nexus for other taxes, but not the sole determining factor.

Business and SST Governing Board representatives announced that they have been working with the Multistate Tax Commission (MTC) to develop a process under which sellers can resolve other tax liabilities when registering under the SSUTA. Under the proposal, interested sellers would agree to register under the SSUTA and begin collecting sales and use tax in all member states if all the states accepted a single voluntary disclosure contract for the resolution of income, franchise, and other tax liabilities. The contracts would be based on existing voluntary compliance initiatives and disclosure programs in place in member states and would include the standard terms, including the look-back provisions, in current states.

Amnesty Terms

A member state is required to provide amnesty to a seller that registers with it under the SSUTA provided the seller was not registered in that state in the 12 months preceding the state's participation in the SSUTA, as a full or associate member, and the seller has not been contacted for audit. Amnesty precludes assessment for uncollected or unpaid sales or use tax together with penalty or interest for sales made prior to the seller's registration. To qualify for the amnesty, a seller must register with a full member state within 12 months of the state's participation in the SSUTA. An associate member state must provide amnesty from the time it joins as an associate member until 12 months after it becomes a full member. A seller must maintain its registration and continue collecting taxes for at least 36 months in a member state or the amnesty may be voided by the state.

Amnesty is not available to a seller with respect to any matter for which the seller has received notice of the commencement of an audit or for taxes already collected, paid, or remitted. Amnesty does not apply to use taxes due from a seller on its use of products or other types of taxes. The information obtained through registration may not be used by states for determining whether a seller has nexus for any tax.

The fact that the anticipated technology models were not available to sellers on October 1, 2005, as hoped, led to questions about the availability of amnesty during any interim period. Accordingly, a proposal was approved to extend amnesty provisions to include a period commencing from the date of registration to the date a notice is provided that adequate Certified Service Provider (CSP) and Certified Automated System (CAS) services are available as determined by the SST Governing Board.

However, not all member states have the authority to provide amnesty for the interim periods. These states must post their policies on their websites and the SST Governing Board website.

CSP
The SST Governing Board intended to enter into contracts with CSPs on October 1, 2005, so sellers could start collecting taxes the day the SSUTA came into effect. Four CPS candidates are continuing testing in several member states. A completed contract is expected to be presented to the SST Governing Board for approval at the January 2006 meeting.

Role of Issue Papers
During its work over the last five years, the SSTP approved numerous issue papers recording the debate and reasoning behind their actions. The states have discussed having the SST Governing Board ratify these issue papers at some point as a form of legislative history for the SSUTA. However, several states are concerned that there are some things in the issue papers that states should not be expected to follow. Additionally, some things in the issue papers should probably be raised to the level of a "rule," rather than just legislative history.

A motion was passed asking the Compliance Review and Interpretation Committee to review the issue papers to identify information that should be incorporated into rules.

Audit Standards
Audit Standards and Overview of the Re-Certification and Audit Process issue papers were presented for review and comment. Comments from the business community included the following.

1. Business representatives from Costco and other retail stores expressed concern over the requirement that if credits (for returned merchandise) cannot be tracked to the original transaction to document that tax was originally charged, then no credit may be taken on the tax return and a refund claim with supporting documentation must be filed by the appropriate party to pursue that tax amount. In Costco's case, the original receipt is not required when a refund is made. This would require Costco to file a claim for refund for most returned merchandise as compared to taking a credit on the next tax return, as is the current practice.
2. The process for retailers and CSPs to ask questions about how to interpret uniform definitions and seek clarification or help to correctly identify the nature of a product or service must provide timely responses and be easy to navigate.
3. The requirement for each retailer to maintain a database encompassing all product codes and be accessible by member states to verify proper mapping through random on-line tests of the system will create security concerns for businesses.
4. The requirement that the customer name appear on each sales transaction whenever an exemption is claimed creates a confidentially issue for health-care patients. Retailers can substitute a customer number in place of the customer name. As long as the customer number can be traced to a patient's name during the audit.
5. Sellers should be allowed to make prepayments on completed audits to reduce interest amounts.
6. The SST Governing Board should adopt a uniform waiver of limitations for use by all member states.
7. The SST Governing Board should limit follow-up reviews or reaudits by member states of completed multi-jurisdictional Streamlined Sales and Use Tax audits.

The Audit and Standards Workgroup will review business comments and revise the issue papers as deemed appropriate.

STATUS OF THE SSUTA

The SST Governing Board voted to amend several areas of the SSUTA effective October 1, 2005. The following is a summary of the approved amendments.

Exemption Issues

The SST Governing Board approved an amendment that attempts to eliminate ambiguities concerning entity- and use-based exemptions. Essentially, the amendment precludes states from using these types of exemptions to circumvent the existing limitations on product-based exemptions. An entity-based exemption may not be "for all human beings." A state may enact a use-based exemption for an item included in a term defined in the SSUTA, so long as it is "consistent" with the definition and it does not "effectively constitute" a product-based exemption. States will be given until January 1, 2008, to bring their laws into conformity with these changes.

Exemption Certificate Instructions

It was clarified that sellers do not necessarily have to accept the SSUTA approved exemption certificate in order to qualify for the relaxed good faith standard as long as sellers capture all the data required for the form. All sellers satisfying the requirements qualify for the relaxed good faith, not just the sellers registering under the SST system.

Business representatives distributed a revised version of the approved exemption certificate with an additional check-box to allow purchasers to indicate they are submitting a multi-state supplement similar to the MTC Uniform Sales and Use Tax Certificate – Multijurisdiction. California currently limits the use of the MTC certificate to use as a resale certificate. Similar limitations would likely be placed on a multi-state supplement version of the SSUTA exemption certificate.

Multiple Remittances

Business representatives expressed concern that several states require different forms of accelerated return payments. Often this results in sellers having to make multiple remittances for each reporting period. States expressed concern that eliminating the advance payments would result in a revenue loss they could not accept. Business representatives responded that their main interest was in reducing the number of remittances and different remittance dates. Business representatives agreed not to press for any amendment to the SSUTA at this time. The SLAC agreed to support efforts to simplify these requirements, so long as they do not have a negative effect on revenue.

Purchaser Use Tax Issues

Business representatives presented an issue paper relating to a purchaser's responsibility for use tax. The paper notes that, in certain situations, the SSUTA either shifts the burden for tax onto the purchaser or is silent with regard to the effect on the purchaser. As a result, the purchaser's compliance burden and audit exposure could be increased under the SSUTA. The business paper states that this is a result not contemplated by the SSTP or by businesses during development of the project.

Several states disagree with the business paper. Throughout the development process, business representatives continually argued that they should not have to police purchasers that claim an exemption from tax. Accordingly, relaxed good faith standards were incorporated into the SSUTA to reduce the verification process for claimed exempt sales. Sellers are required to make identifying information available to member states for purchasers claiming an exemption. This allows states to verify the claimed exemption with the purchaser. Any effort to limit the ability to pursue use tax from a purchaser will not be easily accepted by member states.

Database Issues
The SSUTA provides that states must provide and maintain a database that assigns ZIP codes to the proper tax rate and jurisdictions for use by sellers and CSPs. The SSUTA was amended, effective immediately, to give states the option of also providing address-based boundary database records for assigning taxing jurisdictions. The SST Governing Board may allow a state to require sellers to use an address-based database provided by the state. A state that provides such a database may also cease providing liability relief for sellers that rely on the ZIP code-based database, although relief may be extended for a seller that can demonstrate undue hardship from the change. A database provided directly by a state or by a vendor designated by a state must be provided at no cost to the users. Vendors providing address-based databases may request certification of their databases from the SST Governing Board, although they must also be certified by the individual states.

Floral Sales
The SSUTA was amended, effective immediately, to allow floral sales to continue to be sourced on an origin basis for another two years. After January 1, 2008, these sales will have to be sourced using a destination basis.

Multiple Remittances
The SSUTA allows a state to require more than one remittance per return from sellers that collect more than $30,000 in taxes in the state during the preceding year. The SSUTA was amended, effective immediately, to clarify that the seller can remit either actual collections or an amount determined through a calculation method.

Technical Issues
The SST Governing Board approved several motions on technical matters, including the approval of the format for a multistate exemption certificate previously adopted by the SSTP.

INTERPRETATION REQUESTS
The SST Governing Board also considered the following interpretation requests submitted by business representatives.

Floral Sales
The SST Governing Board approved a requested interpretation of the SSUTA clarifying that the florist taking and transmitting an order is the "seller" for purposes of sales and use tax liability, regardless of whether it is registered to collect tax in the state to which the sale is sourced. This is consistent with the SSUTA's treatment of drop shippers.

Prepared Food
Food industry representatives requested an interpretation of the "utensils provided by the seller" element of the "prepared food" definition. The SSTP previously approved an interpretation supported by business that attempted to set standards for restaurants different from those for convenience stores, distinguished from one another by the use of a quantitative test. However, five states currently on the SST Governing Board opposed that interpretation at the time. Accordingly, the SST Governing Board voted to refer the matter to the SST Governing Board, Compliance Review and Interpretations Committee for further work.

COMPARATIVE ANALYSIS OF SSUTA

The comparative analysis currently underway by BOE staff involves a detailed review of each section and definition of the SSUTA and a comparison to California's Constitution, statutes, regulations, Policy and Procedure Manuals, and other information relating to the administration of sales and use tax. The SSUTA is comprised of 82 sections and 39 definitions. The analysis will strive to identify the impact of conforming to the SSUTA in the following areas:

- Changes necessary to California's Constitution, statutes, regulations, Policy and Procedure Manuals;
- Tax revenues, including revenue shifts for local jurisdictions;
- Administrative and operational costs for the state and local governments;
- Compliance and cost issues for businesses; and
- The responsibility of the Governor, California Legislature, BOE, and courts.

The analyses for the following sections of the SSUTA are complete.

- 302 – State and Local Tax Bases
- 309 - Application of General Sourcing Rules and Exclusions from the Rules
- 310 - General Sourcing Rules
- 311 - General Sourcing Definitions
- 313 – Direct Mail Sourcing
- 326 – Direct Pay Permit
- Definition – Direct Mail

Sections 309 and 310 require further study to determine the impact conforming to these sections would have on the state, local governments and businesses. A study plan is being evaluated to determine the most effective method to ascertain the impact of conforming to the destination-based sourcing rules.

FEDERAL LEGISLATION

S 2152 – Enzi (R-Wyo.)
S 2153 – Dorgan (D-N.D.)

Senators Enzi and Dorgan introduced separate bills that would authorize states to require out-of-state (remote) sellers to collect tax on goods and services sold into a state under certain conditions. The bills would authorize states that are members of the SSUTA to require remote sellers to collect sales and use tax. The bills are identical except for the "small business exception," defining sellers who will not be required to collect tax under the SSUTA. Sponsors could not agree on how small a seller should be to qualify for the exception. The Enzi bill was introduced with a $5 million per year threshold. The Dorgan bill establishes a procedure where the Small Business Administration would undertake a rulemaking process to recommend a small business exception. The number would have to be approved by Congress before becoming effective. Though, both senators indicated that they would work with all parties to arrive at an acceptable level.

In addition to the small business exceptions, the bills specify a variety of simplification requirements that go beyond what is required in the SSUTA. The bills also include definitions for terms that are inconsistent with the SSUTA or are not included in the SSUTA.

Areas beyond the SSUTA
The bills:

1. Extend from sixty days to six months the minimum timeframe a registered seller will have to begin collecting and remitting sales and use tax in member states.

2. Provide a requirement that the multistate registration system not be used in any way to determine if a seller is responsible for any taxes other than sales and use tax.

3. Provide monetary allowances to all sellers for expenses in administering, collecting, and remitting sales and use tax and appears to provide guidelines on how the monetary allowances will be calculated. These requirements are more expansive than those found in the SSUTA.

4. Include taxes on telecommunication services other than sales and use tax. This could include local utility taxes that are not included in the SSUTA.

5. Provide for tax credits on purchases of digital goods and services purchased from a foreign country. The SSUTA does not provide a tax credit for taxes paid to foreign countries.

6. Provide that the United States Court of Federal Claims has exclusive jurisdiction over the SST Governing Board and the SSUTA. The SSUTA does not provide for such oversight.

BOE REVENUE ESTIMATE – ELECTRONIC COMMERCE AND MAIL ORDER SALES
Based on new information from the U.S. Census Bureau and additional research, the BOE recently updated its estimate of remote sales (electronic and traditional mail order sales) revenue losses from out-of-state vendors. The estimated annual revenue loss is $1,010 million. Of the total, $409 million is owed by consumers and $601 million is unpaid by businesses. The previous estimated annual revenue loss from out-of-state vendors was $1,345 million, based on a report completed by the BOE in May 2004.

WASHINGTON STATE CITIES REACH A COMPROMISE ON SOURCING MITIGATION
In September 2005, the Association of Washington Cities reconvened it Streamlined Sales Tax Committee, which was comprised of 12 representatives from an equal number of negatively impacted cities and positively impacted cities. The committee reached agreement on principles to guide advocacy efforts in the 2006 Legislature. The cities' mitigation principles call for full mitigation of sourcing losses and ask the Legislature to appropriate general-fund monies to create a dedicated fund for mitigation. Mitigation would not be permanent; it would remain in place for a given jurisdiction until its revenue gains from voluntary compliance meet or exceed its revenue losses due to sourcing. For most jurisdictions, this transition should only be a few years. For the other jurisdictions, the mitigation transition will be longer.

A 2004 Department of Revenue study estimated that 117 cities, as well as some counties, transit agencies, and Public Facility Districts would lose a total of $32 million in sales tax revenue in the first year due to sourcing changes. Gains will occur in 164 cities, the majority of the counties, and other local taxing districts.

Several proposals to enact the destination-based sourcing rules and provide mitigation were introduced in the 2004 and 2005 sessions. But an agreement was not reached, and the Legislature did not act on the proposals.

FUTURE MEETING SCHEDULE
January 11 – 13, 2006 – SLAC and SST Governing Board Meetings, Phoenix, Arizona

SUMMARY
BOE staff will continue to attend and monitor the SLAC and the SST Governing Board meetings and observe the activities of other participating states. Work on the comparative analysis of the SSUTA will continue to move forward.

BOE staff will continue to work with local government and business representatives regarding the analysis of the SSUTA and any new emerging issues.