Whitepaper

The Case for Sales Tax Simplification

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When the United States Supreme Court upended the traditional physical presence limitation in the landmark *South Dakota v. Wayfair* decision, it was sure to rearticulate the foundational principal that the Commerce Clause of the U.S. Constitution prohibits states from enacting tax requirements that discriminate against or unduly burden interstate commerce. As we approach the five-year anniversary of *Wayfair*, this principal has grown in importance. With the expanding significance of sales tax in funding critical government functions, states must take meaningful steps to ensure their tax laws and rules can be readily complied with by local and remote sellers alike.

The new budgetary reality

While nobody knew it at the time, the expanded authority of states to tax remote sellers became a major contributing factor in keeping states afloat during the early months of a global pandemic. The dire predictions of state budget shortfalls have been transformed into significant surpluses, which persist in many states to this day. U.S. states learned what most of the world already knew: consumption taxes are a highly reliable and consistent source of state revenue.

Last year, the Tax Foundation published data showing that for FY 2020, while individual income taxes still represented the largest source of state revenue, sales tax, at 32.2% was growing in importance. Likewise, a recently issued GAO report showed that nationwide sales tax revenue approached $30 billion for CY 2021. This growing confidence in sales tax collections contributed to no fewer than 10 states enacting individual income tax rate reductions and six states reducing their corporate tax rate.

Why simplification is important

In the first few years post *Wayfair*, a handful of states took steps to simplify their sales tax. The Alabama Simplified Sellers Use Tax and the Texas Single Local Use Tax Rate represent notable attempts to make the complexities created by local tax requirements more manageable for remote sellers. In 2021, New Mexico abandoned origin-based local sourcing in favor of simplified destination-based rules and made the rates paid by in-state and remote sellers uniform. Tennessee dropped its complex requirement for drop shippers and Florida finally eliminated its pesky bracket requirements in favor of the basic (5/4) rounding rules we all learned in grade school.

Every state that has home-rule administration of local taxes attempted some form of meaningful simplification. In addition to the Alabama simplification discussed above, many localities in Alaska banded together to form the Remote Seller Sales Tax Commission, creating a uniform local ordinance and remote seller collection requirements. Similarly, many cities in Colorado joined the Sales and Use Tax System (SUTS) program enabling a single portal for local remittance. The Sales and Use Tax Commission for Remote Sellers attempts to provide similar simplification for sellers in Louisiana.

Are these simplifications sufficient? Some taxpayers and politicians are suggesting it is not. Taxpayers have initiated litigation in both Louisiana and Colorado suggesting that despite the simplifications noted above, the tax requirements in both states represent an undue burden on interstate commerce. In recent months, the U.S. Senate Finance Committee held a hearing, "Examining the Impact of South Dakota v. Wayfair on Small Businesses and Remote Sales," and the Government Accountability Office issued a report suggesting that "Congress consider working with states to establish nationwide parameters for state taxation of remote sales."

Given that both the courts and Congress have been actively engaged in evaluating the complexity of existing sales tax requirements, the time seems right for states to consider how they might take matters in their own hands in ensuring their tax requirements are sufficiently simple to pass Constitutional muster.

What should states be thinking about?

State sovereignty is a foundational principal in our governmental system and putting aside a proposal currently before the U.S. Congress to create a national consumption tax, sales tax is likely to remain the sole province of state and local governments. However, sales tax need not be uniform to be simple and states need not wait for federal mandates to provide simplifications. There are numerous ways states could make their sales tax systems meaningfully simpler while maintaining the level of revenue needed to fund important government programs and keeping their sovereignty intact. Below are just a few examples.

A simplified rate structure

The first thing people learn about sales tax is that there are really three different taxes at play. Sales tax, which is charged on intra-state sales, sellers use tax, which is charged on inter-state sales, and consumer's use tax, which is self-assessed on purchases. In many states, the rates are identical but in others, at the local level, sellers and consumer's use tax rates may be lower than sales tax or may not exist at all. This was the case, for example, in New Mexico until it changed the law in July 2021. It remains the case in Alabama but, as noted above, remote sellers have the option of applying the uniform simplified sellers use tax rate.

Arizona, Colorado and Iowa have taken a different approach. Through tax policy they have largely written the concept of sellers use tax out of their systems. Illinois attempted to address this complexity by drafting a series of rules intended to "Level the Playing Field" between in-state companies, remote sellers and marketplace facilitators. Whether they succeeded or not is up for debate.

Nonetheless, this complexity remains in a significant number of states including Idaho, Mississippi, Missouri, North Dakota, Oklahoma and Pennsylvania. Missouri, for example, is rife with local jurisdictions and was the last state in the union to adopt an economic nexus collection requirement. In the year and a half between the passage of the bill and its effective date of January 1, 2023, the legislature or the department of revenue could have worked to minimize this complexity but opted not to.
While some voices will argue that local rates need to be completely uniform to make sales tax manageable, simplifying systems to eliminate the three-rate complexity is a step that would provide local governments flexibility, simplify tax administration and make compliance easier for sellers.

Scheduled rate changes and manageable notice requirements

State level sales tax rates change infrequently and when change does happen, there is generally plenty of advance notice to taxpayers. With respect to local rates, that is not necessarily the case. To their credit, the 24 Member States of the Streamlined Sales Tax Governing Board limit themselves to only making rate changes on the first day of a calendar quarter and only after a minimum of 60 days' notice to sellers. When followed, this is an excellent practice, giving sellers and tax technology providers plenty of time to adapt. However, there are several states where rate changes can happen at the beginning of any given month and there have been no shortage of situations where states have publicly posted a local rate change retroactive to its effective date. That's simply not fair to anybody. There remain a decent number of states where local rate changes can happen during any month including Alabama, Alaska, Arizona, Louisiana, Pennsylvania, Mississippi, Missouri, South Carolina, Tennessee and Virginia.

This is an easy but meaningful step. By following the SST example and limiting local rate changes to specific times of the year and providing 60 days public notice before any change takes effect, states will be giving sellers and their providers more than enough time to understand the new rate and make the necessary system configurations to account for it.

Uniform economic nexus standards

Before the ink was dry on the Wayfair decision, states began adopting laws, regulations and rules imposing a sales tax collection and remittance requirements on remote sellers. In the early days, most states copied what South Dakota had done, creating a 200 separate transaction or $100,000 gross sales registration threshold. Since that time, numerous states have tweaked their standards by adjusting, usually upward, the gross sales threshold and often eliminating the separate transaction threshold. In fact, South Dakota just enacted legislation that eliminated its 200 individual transaction threshold. While no fiscal impact analysis was undertaken, in written testimony in support of the bill, Senator Tim Reed rightly suggested that the 200 transaction threshold is burdensome to small businesses and consumes significant government resources all in exchange for a very small amount of tax paid to the state.

Underlying these basic thresholds are a number of other requirements, which also vary substantially from state to state. They include:

1. In counting sales do you use gross sales, taxable sales, taxable retail sales, taxable sales of tangible property, or something else?
2. Does the threshold include sales where a marketplace facilitator, rather than the seller, collected and remitted tax?
3. When do you need to measure to see if you crossed a threshold? Is it based on the previous calendar year? The previous or current calendar year? A defined 12-month period other than a calendar year?
4. Once a seller crosses a threshold, how long do they have before they need to register? A month? A quarter? The very nexus transaction?
5. Do states allow sellers who have no taxable sales in a given state to forego registration? At a minimum, do they provide consistent zero return filers an option to de-register?

If the U.S. Congress were to step in and act, this is definitely a spot where it could mandate uniform rules. It may be wise for states to jump in and fill the breach. The State and Local Advisory Council to the SST Governing Board is in the very early stages of considering developing disclosed or best practices in this area. It generally takes SST a while to come to consensus and define new requirements, but this initiative is definitely worth the effort.

Give sellers time and information when creating new requirements.

There is no doubt that sales tax needs to evolve as the economy changes and new technologies emerge. For example, as the world begins to embrace electric vehicles, states are unsurprisingly examining how they might replace reduced gas tax revenue. Likewise, as vaping displaces cigarette smoking, a solid handful of states including California, Indiana, Maryland, New York and Colorado (local level) have enacted substantial taxes on vapor products.

Over the last two years, we have experienced economic inflation at levels not seen since the early 80s. According to the Bureau of Labor Statistics, the All Item Consumer Price Index increased 6.5% for the 12-month period ending in January 2023. As a means of mitigating the impact of inflation, states like Illinois, Kansas, and Virginia reduced their tax on groceries. Likewise, Louisiana, Maryland, Indiana, New York, Colorado, Iowa, and Virginia all either exempted or further reduced the tax applicable to diapers.

While most economists would tell you that tax systems work best when applied at a low rate over a wide base, product-based exemptions are well known commodities within our sales tax structure and are long-standing staples of state tax policy. Such exemptions need not be inconsistent with keeping sales tax simple, so long as states follow some basic principles.

First, states should give sellers plenty of advanced notice and the length of notice should be commensurate with the complexity of the change. Adding an exemption for diapers, feminine products or further reducing the rate applied to groceries are not particularly complex and can be addressed by sellers and tax technology providers with a couple months lead time. New and novel taxes and levies, such as the recently enacted Colorado Retail Delivery Fee, that impose both a new tax along with an express customer billing requirement should not be imposed until taxpayers have had at least six months' notice starting from the day substantive regulatory guidance is provided.

Understand new technology before taxing it

At least for a while, Non-Fungible Tokens (NFTs) were all the rage. For those of you not caught up in the mania, an NFT is the representation of a digital asset that is minted and sold over the blockchain. While many people think of NFTs as digital art, they can really represent almost anything, including the future right to possess tangible personal property.

Last year, five states (Minnesota, Pennsylvania, Puerto Rico, Washington and Wisconsin) issued written guidance suggesting that non-fungible tokens are taxable. Some suggested that NFTs were taxed based on existing "digital products" rules while others specified they would be taxed based on the rules applicable to the underlying item they represent.

Of these states, the interim Washington guidance did the best job of understanding and accounting for the tax challenges represented by the underlying technology – which are substantial. They include:

1. Accounting for the fact that NFTs are mostly purchased using cryptocurrency. Knowing the right "tax point" when dealing with a highly volatile medium of exchange is critically important.
2. Acknowledging that both the buyer and seller may be anonymous. How you determine the proper "place of supply" in a transaction that does not necessarily record the location of either party.
3. Recognizing that most NFTs are sold on marketplaces and acknowledging how existing "Marketplace Facilitator" rules may apply to NFT Marketplaces.
4. Understanding that the true value of an NFT may not be known until its exchanged for its tangible equivalent, and
5. Considering that many NFTs represent bundles of varied goods and services, each of which could have disparate tax treatment.

Stated simply, if you don't understand and acknowledge the technology you are trying to tax, the chances of providing incomplete and insufficient guidance to sellers increase exponentially.

The other opportunity that the foray into NFTs revealed was the tendency of states to apply newly articulated rules on a retroactive basis. It's fully understood that there will be times where states specify that the taxation of new technologies falls within the ambit of existing law. Even so, states can recognize and acknowledge that the providers of these new technologies may not fully understand that their new products are taxable until the state provides clear and overt guidance. In those cases, the simple approach is to accept that sellers will need to be compliant going forward. They should not be scared to come into compliance because of the possibly of a retroactive assessment based on rules they had no idea applied to them.

Consider the role of tax technology

Virtually every company employs some form of tax technology in meeting its collection and remittance requirements, whether that be a full-scale tax engine accompanied by filing and certificate management services, or a simple excel spreadsheet. The trick, especially with third-party tax automation, is that it works best with rules that apply to all taxpayers uniformly, without special carveouts or exceptions that are unknowable on a per transaction basis. Take for example the longstanding deduction for grocery food in New Mexico.

For the deduction to apply the seller must:

1. Stock and offer a variety of foods on a continuous basis in each of the four specific stable food categories.
2. For at least two of the staples, the items must be non-perishable.
3. The store must attribute 50% or more of its gross receipts sales to staple foods.

While a traditional "grocery store" clearly qualifies under these requirements, there are likely many convenience stores and other specialty stores that would not. Perhaps more urgently, the application of a rule like this is tough to adapt to the way people may come to buy food in the modern era. Similar challenges exist in states that apply special rental taxes, but only on those companies are "primarily" in the business of renting tangible personal property.

States should also recognize that most sellers will file their taxes electronically and to the extent they can create common upload and electronic data interchange (EDI) standards, it would be extraordinarily helpful. For example, the current EDI format for Illinois is challenging, especially when coupled with its requirement of a unique "taxing district number" for every taxpayer.

Technology can solve a lot of problems but to toggle a tax output, even the best tax system needs to receive transactional inputs that let it know a different result may apply to a particular sale. So long as new rules are written in a way that they can be readily automated, third-party tax providers can take it from there.

Avoid using tax holidays as a means of returning budget surpluses

First introduced in its modern incarnation by New York in 1997, sales tax holidays have been a tax policy staple ever since. At their best, they can offer both meaningful tax relief to consumers while contemporaneously offering a sales boost to retail vendors. State budget surpluses combined with a desire to be seen as easing the inflationary burden on voters combined to make 2022 a banner year for tax holidays. By the numbers, there were 40 sales tax holidays offered in 21 states, with eight brand new holidays occurring at various points throughout this last year.

Sales tax holidays can be fully supported by robust sales tax automation but states should be considerate as to whether they might be abusing the privilege. Florida had so many tax holidays last year that it needed to list them all out on a printable calendar. To some extent, it seems like Florida used sales tax holidays and other temporary exemptions as a means of refunding a substantial budget surplus back to taxpayers and making retail merchants bear the cost through new tax compliance requirements. This year could be equally interesting with respect to tax holidays, as Florida's current budget proposal lists no fewer than 14 proposed holidays and temporary exemptions.

Again, sales tax holidays are not the problem but if states want to ensure they retain their ability to tax remote sellers, a little restraint may be in order.

What's next?

Forecasting what the United States Congress might do is a risky proposition. From the very beginning, the Commerce Clause has granted them affirmative authority to step into the fray and regulate how state and local governments apply their sales tax. Apart from a handful of minor restrictions, they have never done so. Whether they could do so now is up for debate. Nonetheless, given how states have grown to rely on their post-*Wayfair* expanded tax collection authority, the risk of not taking matters into their own hands is substantial. Regardless, making tax compliance as manageable as possible for all your taxpayers, wherever they may be located, should be considered a solemn obligation.

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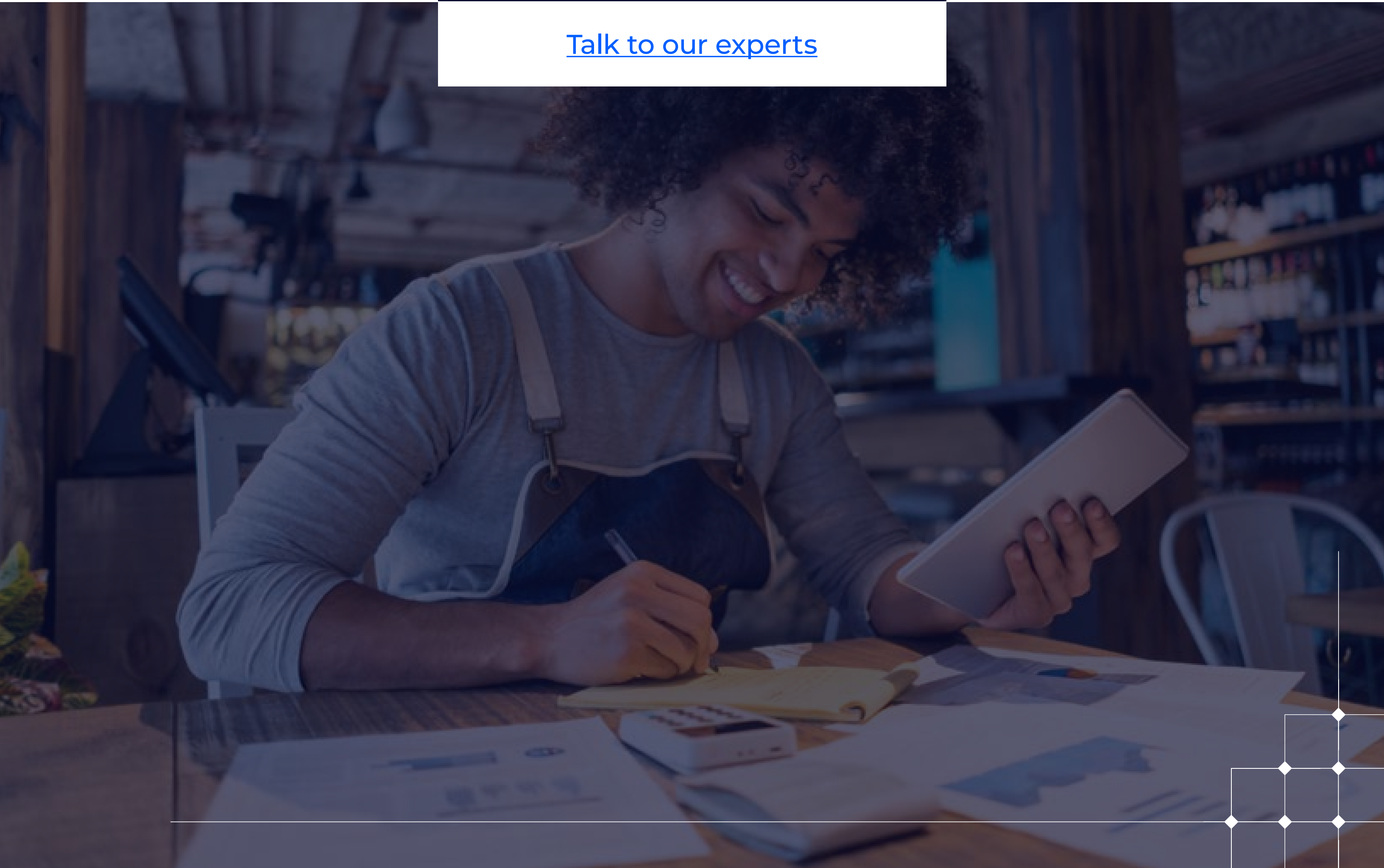

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