

Summary and Background of Streamlined Compensation Issue (Revised 7/29)

Compensation Requirement in Context of Congressional Action

It has been the position of the Business Advisory Council and many business supporters of the Streamlined effort that federal legislation which grants collection authority over remote sellers include a requirement that states compensate sellers. It has been presented that such a requirement is necessary in order to get business support for federal legislation.

Federal Language

Previous versions of federal legislation granting states collection authority over remote sellers included provisions requiring states to compensate sellers for costs associated with collecting and remitting sales and use taxes. The following is the language from the most recent version of the federal legislation (110th Congress).

(14) As of the day that authority to require collection commences under section 4, each Member State shall provide reasonable compensation for expenses incurred by a seller directly in administering, collecting, and remitting sales and use taxes (other than use taxes on goods and services purchased for the consumption of the seller) to that Member State. Such compensation may vary in each Member State depending on the complexity of the sales and use tax laws in that Member State and may vary by the characteristics of sellers in order to reflect differences in collection costs. Such compensation may be provided to a seller or a third party service provider whom a seller has contracted with to perform all the sales and use tax responsibilities of a seller.

Concerns with this language include:

- 1) Requires all member states to pay compensation before any individual state would be granted remote collection authority
- 2) Uncertainty over what level of compensation would meet the “reasonable” standard.
- 3) State representatives expressed concern over a federal mandate directing states to pay compensation.

As legislation was being prepared for the 111th Congress, business interests proposed language that would place in federal law more definitive language on how compensation

would be paid. Working with state representatives, the following language was developed.

(14)(A) In order for a Member State to require collection under section 4, the Member State shall provide reasonable compensation to all sellers for expenses incurred in administering, collecting, and remitting sales and use taxes (other than use taxes on goods and services purchased for the consumption of the seller) to that Member State. To be deemed reasonable the amount of such compensation shall—

(i) compensate all sellers for the credit card and debit card fees paid to unrelated entities for the sales and use tax portion of a sale; and

(ii) compensate all sellers for other costs, not related to credit card or debit card fees, which may be reasonably related to actual costs incurred in collecting and remitting sales and use taxes.

The compensation described in clause (ii) may vary for each Member State depending on the complexity of the sales and use tax laws in that Member State and may vary by the characteristics of sellers in order to reflect differences in collection costs and may be reasonably capped. Such compensation may be provided to a third party service provider with which a seller has contracted to perform the sales and use tax responsibilities of a seller.

(B) The Governing Board shall establish rules and procedures for compensating credit card and debit card fees in accordance with subparagraph (A)(i) and for determining reasonable compensation in accordance with subparagraph (A)(ii). The Governing Board's determination of reasonable compensation is subject to review under section 6(b)(1).

(C) Notwithstanding the provisions of section 4(c)(3), a Member State's authority to require collection by remote sellers as authorized by section 4 shall automatically terminate 30 days following the date the Member State is finally determined to be out of compliance with the requisite compensation under subparagraph (A). A State shall not be required to comply with the requirements under subparagraph (A) in order to be considered a Member State under the Agreement, but such State shall not have remote seller collection authority authorized under section 4.

After this language was proposed, several states expressed opposition to this approach. Concerns expressed include:

- 1) Requirement to compensate for credit and debit card fees (which could not be capped). The exact cost of paying these fees is not certain and administrative and audit issues were raised.
- 2) This proposal also required compensation in addition to debit and credit card fees which was not defined (leaving concerns over definitively identifying the costs unresolved).
- 3) For states concerned about a federal mandate, this proposal was more troubling as it placed in federal law specific compensation requirements.
- 4) Some states opposed the explicit requirement that compensation be paid to all sellers (not just remote sellers).

With significant state opposition to the above language, a focus group was formed to try and develop a compensation proposal that could garner broad state support and broad business support. This group included Legislators and tax administrators from the Governing Board, a state representative from a non member state, and several business representatives. Over a two month period an alternative compensation proposal was developed. This proposal was presented to the NCSL Task Force and was discussed at the NGA winter meeting. While business representative participated in the development of the proposal and individual businesses indicated that they could possibly support the proposal, the BAC or the business community in general has not taken a position on this proposal.

The following is the proposed federal language (shown as an amendment to the version from the 110th Congress).

(14) A. ~~As of the day that authority~~ In order for a Member State to require collection commences with respect to remote sales under section 4, each the Member State shall provide reasonable compensation for expenses incurred by a seller directly in administering, collecting, and remitting sales and use taxes (other than use taxes on goods and services purchased for the consumption of the seller) to that Member State. Such compensation may vary in each Member State depending on the complexity of the sales and use tax laws in that Member State and may vary by the characteristics of sellers in order to reflect differences in collection costs.

B. Congress hereby finds that the compensation required of member states under the terms of the Agreement as it exists on the effective date of this act is reasonable compensation when considered in connection with the simplification requirements contained in the Agreement on the effective date of this Act. Congress further finds that variation in compensation in Member States depending on the complexity of the sales and use tax laws in that Member State as provided in the Agreement is reasonable and the caps on total compensation provided in the Agreement are reasonable. Congress further finds that variation in compensation in Member States depending on the complexity of the sales and use tax laws in that Member State as provided in the Agreement is reasonable. Congress further finds that the process set out in the Agreement for modifying the

compensation required for a Member State to comply with the requirements of subsection A of this section is reasonable and in accordance with the requirements of subsection C of this Section.

C. When amendments are made to the Agreement after the effective date of this Act which affect the expenses incurred by sellers in administering, collecting and remitting sales and use taxes, the Governing Board may amend the Agreement to modify the compensation required for a Member State to comply with the requirement of subsection A of this section to provide reasonable compensation for all sellers for expenses incurred by a seller in administering, collecting, and remitting sales and use taxes (other than use taxes on goods and services purchased for the consumption of the seller) to that Member State. Any such changes in the required compensation must be based on an independent review of the expenses incurred by sellers in administering, collecting and remitting sales and use taxes

D. The compensation required by this section shall be provided pursuant to the implementation schedule set out in the Agreement on the effective date of this Act. Nothing in this Act shall prohibit a Member State from providing compensation greater than the amount required by this Act or the Agreement or on a date earlier than required by this Act or the Agreement.

E. ~~Such compensation~~ Compensation necessary to meet the requirement of this section may be provided to a seller or a third party service provider whom a seller has contracted with to perform all the sales and use tax responsibilities of a seller.

Based on discussions at the NGA winter meeting a letter from NGA was sent to the Governing Board outlining concerns with the proposal. Modifications were made to the proposal to address the concerns that were raised. A letter encouraging support of the modified proposal was sent to all Governors by Governor Rounds.

Current Proposal

The following is a summary of the major components of the compensation proposal.

- Compensation will be applied to state and local sales and use taxes and must be paid to all sellers.
- The requirement to pay credit and debit card fees is removed.
- No specific compensation requirements will be included in federal law. The details of how compensation will be paid will be placed in the Streamlined Agreement. The federal Main Street Fairness Act would include a requirement that states pay “reasonable” compensation in order to get remote collection authority and would specifically find that the Agreement provisions on compensation meet this standard.

- The federal language and Agreement Amendment would allow compensation to be adjusted for the following reasons.
 - In relationship to changes in the small seller exception
 - Decreased if additional simplifications are adopted which reduce collection costs
 - Decreased if improvements in technology reduce collection costs
 - Increased if the Agreement is changed to increase collection costs
 - ~~Decreased as more states come into compliance and begin paying compensation~~
- States will be required to pay new remote sellers when collection authority is granted. Remaining sellers must receive compensation within 15 months or when sufficient new revenue is accumulated to cover the cost of compensating existing sellers (whichever is later). States will be allowed to “opt out” of the requirement to pay existing sellers if new revenues do not meet the expectations of the state.
- Compensation will be paid through percentage rates applied to the tax remitted by a seller. The Agreement will establish a methodology to determine the minimum rates that each state must pay. A higher rate will be paid to smaller sellers since these sellers have higher costs relative to the amount of tax they collect. For medium size sellers, the minimum rate a state will be required to pay will be 50% of the rate for small sellers. The minimum rate for large sellers will be 25% of the rate required for small sellers.
- The compensation rates for an individual state will be set by that state but must meet the minimum compensation level required by the Agreement. The proposed minimum compensation level for a state that requires a seller to report tax for local jurisdictions will be .75% ~~1%~~ of sales and use tax revenue. For a state without reporting to local jurisdictions, the proposed minimum compensation level will be .5% ~~.9%~~.
- States will be required to pay a higher rate of compensation to new remote sellers for a period of 6 months after the seller has started to collect use tax. The rates will be 3% for Tier 1, 1.5% for Tier 2, and .75% for Tier 3.
- A state may cap the total amount of compensation an individual seller may receive. The proposed caps are set to impact only the largest sellers in each state (caps are maximum amounts and are applied as limits on the amount of tax remitted each month on which compensation will be paid).

<u>Total Sales and Use Tax</u>	<u>Cap</u>
○ Less than \$1 Billion	\$750,000
○ Between \$1 and \$2.5 Billion	\$1 Million
○ Between \$2.5 and \$5 Billion	\$3 Million
○ Between \$5 and \$7.5 Billion	\$5 Million
○ Between \$7.5 and \$10 Billion	\$10 Million

- The minimum rates will vary by state since the characteristics of sellers vary significantly between large and small states.
- States that have a different sales tax rate on groceries or drugs will be required to pay additional compensation to impacted sellers. An additional rate of .2% will

be added to the Tier 1 rate, an additional rate of .1% will be added to the Tier 2 rate, and an additional .05% will be added to the Tier 3 rate.

- States that have a clothing threshold will be required to pay additional compensation to impacted sellers. An additional rate of .2% will be added to the Tier 1 rate, an additional rate of .1% will be added to the Tier 2 rate, and an additional .05% will be added to the Tier 3 rate. (NCSL motion specifically noted that this issue needs additional work. Primary concerns expressed include the amount of the additional compensation and the application to all sellers that sell any clothing).
- Compensation will not be required for transactions such as a seller's purchases for their own use or on late filed returns.

Existing Vendor Compensation

Appendix 1 outlines the compensation that is currently paid by the states.

- 26 states currently pay some level of vendor compensation.
- As expressed as a percent of total collections, the average cost of vendor compensation for these 26 states is .69%. The average cost for all states is .43%. For states that are currently members of the Streamlined Governing Board, the average is .32% while the average for non member states is .49%.
- Under the compensation proposal, the average cost will be .71% ~~.98%~~.
- 9 states currently pay compensation in excess of .98%.
 - Colorado- 2.47%
 - Nevada- 2.18%
 - Missouri- 2.03%
 - Illinois- 1.56%
 - Virginia- 1.45%
 - Utah- 1.40%
 - Louisiana- 1.18%
 - Arkansas- 1.13%
 - Oklahoma- 1.06%
- In addition to the amount of compensation to be paid, the proposal will likely impact the distribution of compensation among retailers within a state. This will be more likely in states that currently apply relatively low caps.

Revenue from Remote Collection Authority

Estimates for additional revenue from remote collection authority are based on the Fox, Bruce, Luna study which was released in April of 2009. This study estimated additional revenue from collection authority over electronic commerce. Federal authorization for collection authority would also include remote sales that are not transacted through electronic commerce. Estimates for revenue gains from these transactions were prepared by state representatives in consultation with the authors of the 2009 study. Anticipated revenue projections for FY'12 are included in column D of the Summary worksheet of

Appendix 2. The total projected additional revenue is \$18.2 Billion (assuming a small seller exception of \$100,000).

It is important to note that this proposal is not conditioned on these revenue estimates. Each state is allowed to determine its revenue expectations and take action accordingly.

Projected Cost of Compensation Compared to New Revenue

Appendix 2 includes an analysis of the FY' 12 projected cost of the compensation proposal for each state. The projected total cost of the minimum compensation requirement for all states is ~~\$2.04~~ ~~\$2.8~~ Billion (Summary, column C). The projected FY' 12 cost of total compensation payments under existing law is \$1.23 Billion (Summary, column F). This proposal would require an increase in overall compensation of ~~\$800 Million~~ ~~\$1.6 Billion~~ or ~~61%~~ ~~130%~~.

The cost of compensation is then compared to the projected new revenue that each state may receive with remote collection authority. The total cost (assuming that each state pays the minimum) is ~~11.2%~~ ~~15.5%~~ of the projected new revenue. For ~~three~~ ~~four~~ states (~~Connecticut~~, Iowa, North Dakota and Washington), the projected cost is ~~18%~~ ~~25%~~ or more of projected new revenue.

The FY' 12 projected cost of compensation under existing law is provided (Summary, column F) to show the extent to which states could utilize existing compensation funding to meet the proposed minimum cost.

Projected Rates

The projected rates for each Tier are also included in Appendix 2. The rates are listed in columns G, H and I of the Summary sheet. The data used to calculate the rates is included on the Rate Calculation sheet. For states that did not provide data, the rates are estimated based on the calculated rates of those states that did submit data. For states with total sales and use tax collections below \$2 Billion, the estimated rate is ~~1.1%~~ ~~1.8%~~ for Tier 1. For states with total sales and use tax collections between \$2 Billion and \$5 Billion, the estimated rate for Tier 1 is ~~1.5%~~ ~~2%~~. For states with collections above \$5 Billion, the estimated rate for Tier 1 is ~~1.6%~~ ~~2.2%~~. Note, these figures are for states with local jurisdictions (a .75% compensation requirement).

Compensation Examples by Size of Seller/Application of Caps

Appendix 3 illustrates the minimum amount of compensation retailers of different sizes would receive in compensation under this proposal. Examples are provided at Tier 1 rates of ~~1.6%~~, ~~1.4%~~ and ~~1.2%~~ ~~2.2%~~, ~~2%~~ and ~~1.8%~~. An additional chart is included that illustrates the allowance the new remote sellers will receive (a 3% Tier 1 rate).

Under the proposal states would be allowed to cap compensation based on the amount of tax remitted each month. The outlined figures on the spreadsheets are the proposed cap amounts.

It should be noted that the application of a cap results in a redistribution of the compensation to smaller sellers. It does not result in a reduction in the overall cost to the state.

Small Seller Exception

These spreadsheets assume that the Governing Board will set the small seller exception at \$100,000 (consistent with the Amendment adopted by the Governing Board). At this level, revenue estimates are reduced by 17%. If the small seller exception is set at \$500,000, it is estimated that revenues would be reduced by 33%.

Governing Board Motion and Vote

The Governing Board voted to adopt this proposal (as an Amendment to the Agreement and Rule for the Agreement) for referral to NGA, NCSL and the Business Advisory Council and for input from other organizations and interested parties. The vote was 14 yes, 4 no and 2 abstain. States voting no were Indiana, North Carolina, North Dakota and Wyoming. States abstaining were Iowa and New Jersey.