Draft Interim Report
[As of December 2, 2008]

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Streamlined Sales Tax Governing Board
Small Seller and Vendor Compensation Task Force

December 5, 2008

Special Note and Disclaimer

This draft report is intended solely for review and comment by the members of the Small Seller Task Force. The report will be reviewed and is subject to revision at a Task Force meeting on December 5, 2008. It is not intended for duplication or distribution and statements herein may not be attributed to the Task Force or any of its members prior to the December 5 meeting. The report is being circulated by the Task Force in this manner in order to facilitate discussion at the December 6 meeting of the Streamlined Sales Tax Governing Board meeting.

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Introduction

Charge to the Task Force

The Task Force was created by the Streamlined Sales Tax Governing Board to assist it with two issues in the federal legislation[1] that has been introduced that would authorize states, under certain conditions, to require remote sellers to collect state and local sales taxes on goods and services sold into the state.

Small Seller Threshold. The federal remote sales legislation provides that a seller would not be required to comply with the terms of the bill (i.e., collect in qualified states even though it does not have nexus as defined under current law) if :

> (1) the seller and its affiliates collectively had gross remote taxable sales nationwide of less than $5,000,000 in the calendar year preceding the date of such sale; or
>
> (2) the seller and its affiliates collectively meet the $5,000,000 threshold of this subsection, but the seller has less than $100,000 in gross remote taxable sales nationwide. [Sec. 4(d)]

The threshold is presumably intended to insure that those sellers required to collect have the capacity to comply with the obligation as well as insuring that inordinate resources are not expended by either the seller or the states to collect a relatively small amount of tax.

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In recent years there has been a substantial difference of opinion about the threshold. Some parties believe the threshold should be substantially less than $5 million while others argue that it should be significantly higher. This disagreement has been an impediment to progress on the legislation. More recently, there has been discussion of

[1] Throughout the report, references to 'federal legislation' should be read to refer to H.R. 3396 and S. 34 as introduced in the 110th Congress. Generally speaking, the legislation would authorize states to require a remote seller to collect state and local sales and use taxes on goods and services sold into a state if the state is a member of the Streamlined Sales and Use Tax Agreement, if the Agreement is operational, if the Agreement complies with the terms of the legislation and if the seller's sales volume exceeds a specified 'small seller threshold' -- $5 million in 'gross remote taxable sales' in the bills introduced in the 110th Congress.

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assigning the task of establishing the small seller threshold to the Streamlined Governing Board. The Board directed the Task Force to undertake a review and analysis of the issue that would aid it in discharging this potential duty as well as to aid all parties in preparing for the 111th Congress.

Vendor Compensation. The federal remote sales legislation also provides:

> 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. [Sec. 7(a)(14)]

The Streamlined Agreement does not currently address the issue of vendor compensation.[2] The manner in which the Board will address the issue is still subject to discussion. It appears from the legislation that the Streamlined Agreement will need to be amended to speak to what constitutes reasonable compensation and that the Board will have to evaluate the compensation systems of each member state to assess its reasonableness on an ongoing basis.

Approach of the Task Force

The Task Force undertook its work in four phases:

- The first effort was to ensure that the Task Force understood the nature of the issues involved, its charge from the Governing Board, and the thoughts of the various Task Force members about the issue;
- Based on this discussion, the Task Force identified a number of areas on which it required education and information in order to be able to discharge its duties, and it developed a series of issues or questions it felt would need to be addressed as it deliberated each issue;
- The Task Force then undertook an education program aimed at filling the information gaps it had identified. Through a series of conference calls and discussions, the Task Force heard from the authors of the most recent study of retailer collection costs as well as others that had participated in that effort, experts on various aspects of the retail industry, and representatives of large online sellers. It also held discussions with several retailers about how they

[2] The Agreement addresses only the issue of the amounts to be paid to 'certified service providers' for their work on behalf of volunteer sellers. The legislative language requires reasonable compensation to all sellers – not just volunteers or those without nexus in a state.

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administered their sales tax responsibilities and those parts of sales tax administration they found most burdensome.[3]

- Finally, the Task Force held a day-long, in-person discussion to address the various issues and questions it had identified and to prepare its report to the Governing Board.

The objective of the Task Force was not to attempt to develop a specific recommendation for each issue, e.g., speaking precisely to what the small seller threshold should be or what constitutes reasonable compensation for any particular state. Instead, the Task Force concentrated on gathering as much evidence as possible on each issue and trying to develop a framework for addressing the issues. The report is intended to provide a starting point from which the Governing Board can identify relevant information and knowledge gaps, devise a plan to fill those gaps within available time and resources and begin to develop a consensus on the specific approach to each issue.

The Task Force arrived at a number of recommendations regarding the general level of a small seller threshold and vendor compensation as well as some specifics regarding the structure of the threshold and compensation systems. One important point that the Task Force wishes to impress upon the Governing Board is that the two issues need to be considered in tandem. Vendor compensation and a small seller threshold can to an extent act as substitutes for one another. That is, to the extent that vendor compensation can cover all the costs of a remote seller, it could be argued that a small seller can be very low because the seller bears no collection burden. In that situation, the primary determinant of the threshold would be the "break-even" point for the state in terms of the vendor compensation being at such a level it would not warrant pursuing the tax. Likewise, a higher threshold could be considered to reduce the level of vendor compensation required for certain classes of sellers.

Further complicating the necessary decisions is the fact that the level of compensation and any small seller threshold is heavily dependent on the degree to which a seller's collection and compliance burden can be reduced by additional simplifications or by making sales tax compliance technology readily available at low or no cost to retailers of all sizes. The Task Force has made specific comments on desirable additional simplifications as well as ways to foster the availability of technology.

Task Force Recommendations

Small Seller Threshold

The Task Force offers the following recommendations to guide the Streamlined Governing Board in considering the issue of a smaller seller threshold.

The Task Force believes the federal remote sales legislation should provide for a threshold below which a seller would not be required to collect tax in states where it does

[3] Copies of presentations and documents prepared for the Task Force are generally available on the Streamlined organization Web site at www.streamlinedsalestax.org.

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not have nexus under current law. A threshold is necessary to rationalize the costs and benefits of collection to both sellers and states and to recognize a reality that the smallest sellers cannot practically collect in all states at a reasonable cost relative to the amount of tax they would collect. At the same time, the Task Force believes that sales tax collection is an obligation of doing business and that fundamental fairness requires that, to the extent practical, all sellers should have a collection obligation.

To this point, the Task Force has not attempted to establish dollar-based parameters or limits for what it believes would be an acceptable threshold.[4] Nonetheless, the Task Force believes that over time the threshold should gravitate in the direction of being a threshold that excludes only occasional sales and sellers from the collection requirement. The Task Force believes that the availability of technology must be improved, the technology must be proven and additional simplifications must be adopted before the threshold can reach such a level. Specific suggestions are made below.

The Task Force believes that any threshold should be plain, simple and straightforward so that a seller can know his/her situation and plan accordingly. As a result, the Task Force recommends that any small seller threshold should be based simply on a seller's gross remote sales[5] for a specified twelve month period, e.g., the twelve months ending Sept. 30 each year. In addition, once it is determined that a seller has exceeded the threshold, the seller must be allowed a period of time (at least one quarter) to prepare before the collection obligation becomes effective. Likewise, if a seller that is collecting currently falls below the threshold, that seller should be required to collect until the end of the following calendar quarter (presuming that is the time allowed for a seller to prepare for the collection requirement.) The Task Force recommendation differs from the current federal legislation which based the threshold on "gross remote taxable sales." The Task Force believes that the "taxable sale" requirement adds complexity and uncertainty to the threshold. Some sellers may not know the volume of taxable sales they shipped without collection of tax (or at least would have to take steps to determine if the item was taxable and the purchaser was not exempt.) In addition, a taxable sales requirement increases the burden of any state audits to determine compliance with the threshold.

In determining whether a seller has exceeded the specified threshold, the sales of the seller should be grouped with affiliates in the same line of business (in the same fashion as required in the current legislation) to avoid an incentive for a seller to split its operations among multiple entities in order to stay below the threshold. The Task Force does not recommend an exclusion for individual sellers below a specified threshold even though the affiliated group of which it is a part exceeds the overall threshold. In a similar vein, the Task Force believes the threshold should be a single national threshold and not

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[4] There has been discussion of other small business exemptions in the Internal Revenue Code such as the $3.5 million estate tax exemption and the ----------. In addition, some members of the Task Force have expressed an interest and willingness to attempt to provide further guidance to the Governing Board on this matter.

[5] "Remote Sales" is used here in the same manner as it is in H.R. 3396 and S. 34 as being a sale into a state in which the seller would not be required to collect tax but for the requirement imposed by the legislation.

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have a state-level component, i.e., not contain a requirement that would say a seller with over X amount of sales in a particular state (where it has no physical presence) would be responsible for collection in that state even though it did not exceed the national threshold.

The Task Force expects that any small seller threshold would be implemented on a phased basis, i.e., the threshold would be reduced over time. Phasing is necessary for two reasons: (a) to allow the Streamlined organization to adjust to and work with the influx of registrants; and (b) achieving a threshold at the ultimate level envisioned by the Task Force is contingent on the adoption and implementation of additional simplifications and increases in the availability of proven technological solutions to a broad range of sellers.[6]

The Governing Board should give consideration to whether sellers making remotes sales should be required to certify in some fashion (e.g., via a report filed with the Streamlined Board) that they are below the threshold or whether enforcement of the threshold would be on an "after the fact" audit basis. Requiring some annual certification could be seen as intrusive, but it would allow a seller to think about its position and begin necessary planning as well as putting them in contact with the Streamlined organization so that assistance can be provided.

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The Governing Board should review the small seller threshold regularly (at least annually) to determine its effect and operation as well as other adjustments are necessary or warranted in light of changing technology and simplifications.

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Vendor Compensation

The Task Force offers the following recommendations to guide the Streamlined Governing Board in the discharge of its duties to evaluate whether Member States are providing "reasonable vendor compensation" as required by the federal remote sales legislation.

The Joint Cost of Collection Study completed by PricewaterhouseCoopers under the direction of a joint business government steering committee in 2006 provides a reasonable benchmark of the costs retailers incur in collecting state and local retail sales tax. The results are consistent with similar previous studies and are believed to provide reasonable results as to the general level of costs and the differential costs among retailers of various sizes. It is also helpful in understanding those factors that drive retailer collection costs. While the Task Force believes that the simplifications incorporated in the Streamlined Agreement have reduced the costs of collection from those measured in the JCCS study, it was not able to evaluate the magnitude of that impact.

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[6] Some members of the Task Force have suggested that the threshold should be set at a low level and that a higher level of vendor compensation should be required at the outset in order to create incentives for states to pursue the additional simplifications and technology improvements. Such an approach, it is suggested, would align the interests of the business community in greater simplifications with state interests in reducing vendor compensation payments.

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The JCCS report does not, however, provide all the information one would ideally like to have in establishing and evaluating compensation systems. As a consequence, the Task Force believes the Governing Board should consider sponsoring additional research work along the lines planned for Phase II of the JCCS work. Any new study should emphasize generating sufficient response to the survey to allow detailed evaluation of such issues as the impact of the Streamlined Agreement on collection costs and the impact of differing state sales tax structures on costs of collection. Any new work should also provide for greater segregation of the "large seller" category. In the JCCS study, the large seller category was all sellers with greater than $10 million in sales; The Task Force believes such a categorization can mask significant differences in collection costs among sellers with just over $10 million in sales, those with several hundred million dollars in sales and the very largest sellers with billions of dollars in sales. This is especially important given the economies of scale that are present in the costs of collection.

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The Task Force adopted the following working definition of "reasonable vendor compensation" in its deliberations.

> Reasonable vendor compensation will bear a relationship to the actual costs incurred by retailers in collecting and administering state and local retail sales taxes. Those costs to be evaluated in establishing compensation are those that sellers incur that they would not otherwise incur if they were not required to collect and administer state and local sales taxes.

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The Task Force believes it is useful to recognize that certain costs (e.g., the merchant credit card fee associated with the tax component of any retail transaction or the costs of collecting and managing exemption certificates) are incurred only because of the sales tax responsibility while other costs (e.g., certain system and point of sale costs that serve sales tax and other business needs) are mixed in nature and more akin to a "cost of doing business." There are also certain costs that tend to be fixed and don't vary based on the amount of tax collected (e.g., cash register costs) while others vary directly with the amount of tax collected (e.g., credit card costs.) Both of these observations need to be considered in evaluating compensation systems.

While it is recognized that what constitutes reasonable compensation will be dependent on a number of factors, the Task Force believes that the Governing Board must provide standards to guide the states in establishing their compensation systems, rather than evaluating each state's compensation individually within it's own context, i.e., the "pornography standard" that says reasonableness will be recognized when it is seen. A subsequent study that gathered sufficient data could be used to develop a model that would aid in identifying a range of expected collection costs given certain characteristics of the state and the seller.

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The Governing Board should undertake efforts to identify the drivers of collection costs and undertake steps to reduce those costs. As with the small seller threshold, the Task Force believes that it is important to adopt additional simplifications so as to reduce the costs of collection. Similarly, to the extent that Member States make proven compliance technology available to states and pay the costs of that technology, vendor compensation

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can also be reduced. The Task Force has identified certain simplifications it considers important below.

With respect to technology, the Task Force recognizes that the costs of software licenses and processing transactions reflect only a portion of the overall costs of using compliance technology. As the Task Force learned in its discussions with retailers, integrating tax software into a business's operations can be costly. The Task Force would encourage states and the Governing Board to consider providing a credit to businesses adopting compliance software to offset some portion of the costs of integration.

Consistent with the JCCS study and other similar efforts, the Task Force believes that state compensation systems should reflect differences in the size of retailers, i.e., provide proportionately greater compensation to retailers with a smaller sales volume. The Task Force believes this differentiation is best achieved by varying the percentage of compensation based on the amount of tax collected. At the same time, the Task Force believes there needs to be further discussion and work on the relationship of various types of collection costs to the amount of tax collected. That is, certain costs (e.g., credit card fees) tend to increase in direct relation to tax collected (at least for credit card sales) while other costs (e.g., cash register programming) serve both sales tax and other business purposes and tend to be fixed costs or at least are not directly proportional to the amount collected. Other costs (e.g., certificate management, audit burden) increase with the size of the retailer, but do not necessarily increase in direct relation to the amount of tax collected. Accounting for these differences in costs, especially as they vary across individual sellers, is not an easy or a precise task within a single compensation system applied to all sellers.

There is a difference of opinion within the Task Force on compensation systems that include a limit on the maximum amount of compensation that a seller may claim in any reporting period as a way to differentiate the amount of compensation paid to retailers of different sizes.[7] The retail community believes a system that uses such a limit deviates from the reasonable compensation requirement because it does not account for those costs of collection, such as credit card fees, that are not capped and increase as the amount of tax collected increase. States, on the other hand, believe that a system that uses a compensation limit should not be considered *per se* unreasonable. Because of differences in the types of costs involved in administering sales taxes and the variability of those costs across individual retailers, any compensation will likely over-compensate some sellers and under-compensate others. An overall limit could be appropriate in certain circumstances.

In evaluating compensation systems, the Board needs to be cognizant of differences in tax rates and their impact on the actual amount of compensation. For example, if collection costs are 2 percent of the tax collected on average and the average rate is 6 percent, a compensation rate of 1.5 percent of the tax collected would yield the same

[7] Of the 27 jurisdictions that currently provide vendor compensation, 11 of them cap the compensation in some manner. The caps range from as low as $500 per month to as high as $5,000 per month. Some states limit the compensation to a maximum amount per location in the state.

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nominal amount of compensation with a 9 percent tax rate. To the extent that certain parts of the costs of collection vary in direct proportion to the amount of tax collected (e.g., credit card fees), the cost is going to be 50 percent higher under the 9 percent rate than the 6 percent rate.

The Task Force believes that state compensation systems must reflect the relative complexity of the state's tax structure. To the extent that a state's structure contains elements that inherently add complexity to the collection process, such complexity should be reflected in the level of vendor compensation. In preparing for the JCCS study, the factors with relevance to collection under the Streamlined Agreement[8] that were identified as adding the greatest complexity were: (a) the existence of numerous local option sales taxes; (b) the degree to which the local option tax rates can vary across local governments; and (c) whether the state's tax system retained origin sourcing for certain sales and destination sourcing for others. The Board should evaluate whether these are still major sources of complexity in light of the simplifications contained in the Agreement.

The Task Force did not consider it important to reflect differences between nexus and non-nexus sellers in the compensation system. Likewise, the Task Force does not recommend that the compensation system reflect differences in the proportion of remote sales among sellers.

[Note: The Task Force is still deliberating whether and in what manner it might want to address a differential compensation rate as between local tax collected and state tax collected.]

The Task Force believes that the issue of reasonable vendor compensation should be reviewed regularly to ensure that determinations reflect the latest data available and all relevant simplifications. It is likely that the Board will need to periodically undertake efforts similar to the Joint Cost of Collection Study.

[Note: The Task Force has not yet addressed the question of whether the allowance of vendor compensation may be conditioned on certain factors. For example, a number of states currently require that vendor compensation if allowed only on timely filed and paid returns. In another case, the amount of compensation is graduated based on when the payment is made (i.e., the earlier in the month, the higher the compensation allowance.) Finally, some states provide higher compensation for electronically filed returns.]

Additional Simplifications and Technology

As noted, the Task Force believes that the level of a small seller threshold and determinations on what constitutes reasonable compensation are heavily dependent on the level of simplification achieved through the Agreement. The Task Force believes that the

[8] The JCCS study also identified states in which the local base differs from the state base and states in which local governments administer their sales tax directly as being more complex than others. The Streamlined Agreement, however requires a uniform state and local tax base and state-level administration of all local taxes, so those attributes are not relevant to vendor compensation under the federal remote sales legislation.

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ultimate practical and desirable small seller threshold requires the adoption of additional simplifications beyond those incorporated in the Agreement to this point. Likewise, additional simplifications can allow the level of vendor compensation to be reduced beyond what might be required at this point.

Specifically, the Task Force believes the Governing Board should consider simplifications along the following lines in order to achieve a goal of reducing vendor compensation and the small seller threshold.

- Development of a centralized location where state rate and boundary data bases can be accessed online by sellers and the general public and can be downloaded electronically by service providers and others requiring this data.
- Development of an enhanced taxability matrix that provides more information than currently required on items that exempt and taxable in a particular state and making the same available in a useable electronic form.[9] ***[Note: This recommendation is being further refined.]***
- Development of a 'clearinghouse' or other central utility that would allow a seller or its service providers (CSPs or shopping carts) to file returns and payments for all states with a single entity. This would be the equivalent for returns and payments of the central registration system developed by the Streamlined organization.

In a similar vein, the Task Force believes the levels of vendor compensation and a small seller threshold are significantly dependent on increasing the use of tax compliance software by sellers of all types (particularly smaller sellers) by making the technology readily available at little or no cost to a wide range of sellers. The Governing Board should devote attention to steps it can take ot achieve these ends. The Task Force has identified two steps that can assist.

- The Board should establish procedures that would allow private entities to qualify to certify various types of certified service providers. The Task Force believes this could increase the availability of technology providers and that it will be necessary to accommodate the influx of sellers once the federal legislation is passed.
- The Board should consider promoting a tax credit to cover costs associated with implementing compliance software and integrating it with a seller's current systems. [Discussed further above.]

Additional Information Needs

In its deliberations, the Task Force identified several areas in which further information would benefit the Board's decision making process. They include:

[9] Currently, the taxability matrix required by the Agreement is limited to items that are product exemptions for which a definition is developed and included in the "Library of Definitions."

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- While the JCCS Cost of Collection Study provides a meaningful and sound benchmark for evaluating retailer costs, further work in this area will be helpful to the Board and to the states in designing compensation systems. At least five issues should be examined in any work done in this area: (a) the impact of the simplifications currently in the Agreement on the costs as estimated in the JCCS work; (b) the impact of additional simplifications including, but not limited to, those outlined by the Task Force on costs of collection; (c) the impact of varying tax structures on costs of collection (e.g., local taxes, origin sourcing, etc.); (d) the relationship of various types of collection costs to the amount of tax collected (i.e., are they directly proportional, partially proportional or fixed); and (e) greater segregation of sellers in the over $10 million category so that the trend in relative collection costs between those just over the threshold and the very largest sellers can be better identified. The Task Force recognizes that such a study will take time and considerable resources. Further, it will require the active support of all groups to encourage sufficient survey response to make valid judgments about the collection costs. If it is determined that another statistical analysis cannot be performed, the Board will still need to attempt to assess the manner in which Streamlined may have reduced collection costs and to better specify the drivers of collection costs so that additional simplifications can be addressed to those areas.

- One of the issues for the Board must face in evaluating small seller thresholds is the impact a threshold will have on potential revenue collections. The Task Force heard from researchers at the University of Maryland suggesting that as much as 40-50 percent of all e-commerce sales are made by as many as 5 million small firms with less than $1 million in sales annually. While the statistical approach of the study has been determined be sound, a side-product of the study is to suggest that other measurements (e.g., Census Bureau) of the e-commerce market have underestimated the total by as much as 15 percent. In addition, if the e-retailer universe is that fragmented, it stands in stark contrast to fixed-base retailers which exhibit substantial concentration of all sales in the largest firms. Also, the Internet Retailer magazine estimates that the Top 500 Internet sellers accounted for about 60 percent of all Internet sales in 2007. Further clarification of this important issue would be helpful. The issue of the credit card merchant fees imposed on the amount of tax collected on credit card sales is an important one.[10] It is a cost that is solely attributable to the seller's role as a tax collector, it is not in the control of the seller, it will become more important as electronic payments become more prevalent, it increases as the amount of tax collected increases, and it can be a substantial amount for large sellers. There are also some costs associated with other electronic payments such as debit card payments. The Task Force believes further work is necessary to gain an understanding of the

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[10] The issue is this: On a $100 credit card sale in a state with a 6 percent tax rate, the seller would be responsible for paying to the credit card processor a fee of about 2 percent (or $.12) on the $6 in tax collected on the sale.

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relative role of electronic payments among various types and sizes of retailers as well as the distribution of electronic payments across debit cards, credit cards and private or store label cards and the relative costs associated with such payments.

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