

# DEPARTMENT OF TAXATION

## 2010 Fiscal Impact Statement

1. **Patron** Emmett W. Hanger, Jr.

2. **Bill Number** SB 340

3. **Committee** Senate Finance

**House of Origin:**

  X   **Introduced**

       **Substitute**

       **Engrossed**

4. **Title** Retail Sales and Use Tax; Conformity to Streamlined Sales Tax Agreement

**Second House:**

       **In Committee**

       **Substitute**

       **Enrolled**

### 5. **Summary/Purpose:**

This bill would conform the Virginia Retail Sales and Use Tax Act to the provisions of the national Streamlined Sales and Use Tax Agreement ("the SSUTA"), a multistate compact created to simplify sales and use tax administration for both retailers and state tax agencies in an effort to collect tax from remote business activities.

This bill would become effective on July 1, 2011.

6. **Fiscal Impact Estimates are:** Not available. (See Line 8.)

#### 6a. **Expenditure Impact:**

<i><b>Fiscal Year</b></i>	<i><b>Dollars</b></i>	<i><b>Positions</b></i>	<i><b>Fund</b></i>
2009-10	\$0	0	GF
2010-11	\$320,000	9	GF
2011-12	\$310,000	9	GF
2012-13	\$432,000	9	GF
2013-14	\$523,000	9	GF
2014-15	\$535,000	9	GF
2015-16	\$547,000	9	GF

7. **Budget amendment necessary:** Yes.

ITEM(S): 262 and 264, Department of Taxation

### 8. **Fiscal implications:**

#### Administrative Costs Impact

This bill would require that TAX administer its Retail Sales and Use Tax in conformity with the Streamlined Sales and Use Tax Agreement. In order to do so, TAX would need to add new databases for rates and boundaries, administer an additional dealer discount, create new returns, and revise current forms to reflect the SSUTA provisions. TAX would need to hire two analysts to conduct program software testing for new databases and three additional customer service representatives to respond to additional contacts. In addition, TAX anticipates an increase in consumer use tax audits, as TAX would no longer

be able to hold vendors who accept invalid exemption certificates liable for the tax, which would require three additional desk auditors and one senior auditor.

TAX would incur administrative costs of \$320,000 in Fiscal Year 2011, \$310,000 in Fiscal Year 2012, \$432,000 in Fiscal Year 2013, \$523,000 in Fiscal Year 2014, \$535,000 in Fiscal Year 2015, and \$547,000 in Fiscal Year 2016.

### Revenue Impact

#### **Impact of Conformity with SSUTA**

Until such time as Congress requires out-of-state vendors to register and collect sales and use taxes, the revenue impact of this proposal on Virginia would derive primarily from the tax paid by sellers who register voluntarily under the SSUTA to remit tax to Virginia.

The revenue impact of this proposal does not include any revenue impact from changes to Virginia's Retail Sales and Use Tax resulting from Virginia conforming to the provisions and definitions in the SSUTA. In order to conform to the SSUTA, Virginia would be required to repeal its law authorizing partial exemptions for maintenance contracts that provide for both parts and labor. The current statute, which became effective in 1996, reduces the taxable base by 50% for these maintenance contracts. In repealing this provision, maintenance contracts providing both repair or replacement parts and repair labor would be subject to sales tax on the full price, which would result in a revenue gain to the Commonwealth, the extent of which is unknown. Virginia's current treatment of maintenance contracts that provide solely for the furnishing of labor (nontaxable) or solely for the furnishing of replacement parts (taxable) would not violate any provisions of the Agreement. The revenue estimate of this proposal does not reflect any revenue gain or loss associated with the repeal of Virginia's partial exemption for maintenance contracts that provide both parts and labor.

The SSUTA requires definitional changes, most of which are expected to have no significant impact on revenue. Such terms as "dietary supplement", "direct mail", "over-the-counter drugs", "sales price", and "food" are terms that are currently not defined in the Virginia Sales and Use Tax Act or terms for which the revenue impact of adopting the SSUTA's definition is minimal. Deriving revenue estimates for the other components of the SSUTA, such as the provision granting amnesty for uncollected or unpaid sales taxes to certain dealers or the provision authorizing a refund when the amount of bad debt exceeds the amount of taxable sales, is more problematic, as there is not sufficient data available. The revenue estimate of this proposal does not reflect any revenue impact associated with such changes necessary to conform to the SSUTA.

#### **Impact of Membership**

The revenue estimate of this proposal is based on revenues received by states that are full members of the Streamlined Sales Tax Project ("SSTP"). Once merchants have volunteered to register with the SSTP, they are required to collect and remit sales and use taxes for all states that are full members of the SSUTA. According to the Governing Board of the SSTP, as of June 30, 2008, the 1100 companies registered under Streamlined had collected \$231 million in sales tax for Streamlined states. Based upon

this information and assuming the proposal set forth in the executive introduced budget to repeal the sales and use tax dealer discount is enacted, the revenue impact from enacting this bill could potentially total \$8.4 million in Fiscal Year 2012, \$9.5 million in Fiscal Year 2013, \$9.9 million in Fiscal Year 2014, \$10.4 million in Fiscal Year 2015 and \$10.9 million in Fiscal Year 2016. As the revenue from voluntary registrants is distributed on a monthly basis, the first distribution would occur one month after Virginia gained membership.

This revenue estimate may not be realized, however, if Virginia does not become a full member state of the SSTP because the requirements set forth under § 310.1(D)(2) of the SSUTA are not satisfied. Section 310.1(D) of the SSUTA authorizes states to use origin-based sourcing as an alternative to the SSUTA's destination-based sourcing mandate if certain requirements are met. States that elect to use origin-based sourcing will be designated as associate member states, provided that they are in substantial compliance with each of the provisions of the SSUTA. Retailers making sales into these states will be permitted, but not required, to collect sales or use tax on sales into these states unless the retailer is otherwise required to collect such taxes under applicable state law. Subsection D(2) provides that a state that becomes an associate member state pursuant to the origin-sourcing election will only gain full membership status if at least five states that are not full member states on December 31, 2007: 1) have been found to be in substantial compliance with each of the provisions of the SSUTA other than the destination sourcing provisions set forth in Section 310 of the SSUTA; 2) have notified the governing board of their election to source sales according to the origin of the sale; and 3) have been found to be in substantial compliance with the provisions of Section 310. Until such time as these requirements are met, Virginia would be classified as an Associate Member State, assuming the Commonwealth was in substantial compliance with all other provisions of the Agreement. As a result, retailers who have registered with SSTP would not be obligated to collect the Retail Sales and Use Tax for sales made into Virginia. Thus, the estimated gain in revenue from voluntary compliance has the potential of decreasing or increasing based on whether or not Virginia becomes a full member state and on the number of registrants who voluntarily collect the tax.

### **Impact of Federal Mandate**

If Virginia conforms and becomes a full member streamlined sales tax state, the enactment of federal legislation would generate significant revenue for Virginia. However, in exchange for the collection authority each member state will be granted once federal legislation is enacted, the federal legislation will likely contain provisions that would mandate that member states compensate both in-state and remote vendors for a portion of the costs incurred in collecting the state's sales and use taxes. The payment of compensation would not be required for Governing Board membership.

Although the specific vendor compensation provisions have not been determined, a special task force of the Streamlined Sales Tax Project, consisting of several states as well as representatives from the business community, was created to draft compensation language to include in the federal legislation, the Agreement, and the rules. Thus far, the task force has determined that: 1) the compensation provisions would apply to all sellers; 2) compensation amounts would be set as minimums and states would be authorized to pay additional compensation; 3) there would be no direct payment to vendors to compensate for credit and debit card fees; 4) the proposal would include caps that would

apply to total compensation; 5) the proposal would include a trigger provision to acknowledge that receipt of new revenue may not be immediate; 6) additional compensation would be required in states with more complex tax structures as a result of local jurisdictions, a second rate for groceries or drugs, and clothing thresholds; 7) additional compensation would be provided to smaller sellers; 8) the proposal would be designed so that the compensation amount owed by a state could be determined from information on a single return; and 9) minimum rates would be set recognizing the overall cost to states relative to new money from remote collection authority, cost compared to total sales and use tax revenue, prospects for achieving broad state support for proposal and ultimate adoption by states.

These vendor compensation mandates may necessitate an overhaul of Virginia's current dealer compensation scheme, in which registered dealers who timely remit their sales and use taxes are given a percentage of the first three percent of the sales and use tax collected, according to a statutorily fixed schedule. Virginia would be deemed a state with a complex tax structure, and therefore the amount of compensation owed to vendors would increase, thus substantially reducing the amount of additional revenue that is expected to be obtained as a result of passage of the federal legislation.

If Virginia conforms and becomes a full member streamlined sales tax state, the enactment of federal legislation would generate significant revenue for Virginia. Because of the uncertainty of the requirements that may be in the federal legislation, it is impossible to determine the revenue impact associated with the enactment of federal legislation. Potentially, Virginia could see a revenue increase exceeding \$100 million annually. However, this is highly speculative.

## **9. Specific agency or political subdivisions affected:**

TAX

## **10. Technical amendment necessary: Yes.**

To correct a technical drafting error, TAX suggests the following technical amendments:

Page 29, Line 1777, after 604.6

Strike: ,

Insert: and

Page 29, Line 1777, after 609.13

Strike: , and 58.1-610.1,

## **11. Other comments:**

### Streamlined Sales Tax Background

In the United States Supreme Court decision of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court determined that the Commerce Clause barred a state from requiring an out-of-state mail-order company to collect use tax on goods sold to customers located within the state when the company had no outlets, sales representatives, or significant

property in the state. In *Quill*, the court determined that only Congress has the authority to require out-of-state vendors, without a physical presence in a state, to register and collect that state's tax. In reaction to this decision and in an attempt to create a level playing field whereby out-of-state vendors and in-state vendors are both operating under the same tax rules, 40 states and the District of Columbia came together through the SSTP and endorsed the concepts now embodied in the SSUTA.

The SSTP originated as a cooperative effort between the National Conference of State Legislators, the Federation of Tax Administrators, and the National Governor's Association, with significant involvement from the private sector. The objective of the project is to make it easier for multistate retailers to collect state sales tax in both in-state and out-of-state transactions.

The agreement seeks to improve the sales and use tax administration systems used by the states through:

- State level administration of sales and use tax collections.
- Uniformity in the state and local tax bases.
- Uniformity of major tax base definitions.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Simplified administration of exemptions.
- Simplified tax returns.
- Simplification of tax remittances.
- Protection of consumer privacy.

In order for a state to benefit from filers who voluntarily come forward under the terms of the SSUTA or to benefit from any future Congressional action, a state must conform its sales and use tax laws to the terms of the SSUTA.

#### Virginia's Consistency with the Agreement

In many ways, Virginia's sales tax law is more consistent with the SSTP objectives than some states. Virginia's sales tax law already meets three of the important requirements under the SSUTA:

##### State level administration of sales and use tax.

Virginia's sales tax is centrally administered by TAX. All registrations, payments, rules and regulations, and audits are performed by TAX.

##### Uniformity in state and local tax bases.

The base upon which the tax is applied (or not applied) is uniform. In Virginia, unlike some other states, the same items are either taxable or exempt for purposes of both the state and the local sales tax. The only exception under current law is fuel for domestic consumption. Home heating fuels are exempt from the state sales tax; however, the local exemption is permissive.

### Simplification of state and local tax rates.

Unlike most other states, Virginia's 1% local tax rate is applied by all localities statewide.

## Changes Necessary for Virginia to Conform to SSTP Agreement

### Sourcing

A primary hurdle to Virginia's initial involvement in the SSTP was centered on the SSUTA's sourcing rules, which would have required Virginia merchants to source intrastate sales of tangible personal property to the location to which that property was shipped or delivered (destination-based sourcing). Virginia's longstanding policy has been to source intrastate sales to the location in which the tangible personal property was purchased (origin-based sourcing). As local revenue shifts would result from changing this longstanding policy, some local governments expressed stiff opposition to the change.

After a three-year effort by Virginia, Tennessee, Texas, Utah and other state representatives, an alternative sourcing provision, adopted on a temporary basis on December 12, 2007 by the Streamlined Sales Tax Governing Board, eliminated the need for Virginia to completely overhaul its policies concerning sourcing. The provision allows member states to source retail sales, excluding leases or rentals of tangible personal property, to the location in which the order is received, provided that the sale is an intrastate sale, and the recordkeeping system the seller uses to calculate the proper amount of sales or use tax owed captures the location where and when the order is received. Sellers who do not satisfy these requirements must source sales in accordance with the destination-based sourcing provisions set forth in the SSUTA. This exception that would allow Virginia to continue to use origin-based sourcing was permanently adopted by the Streamlined Sales Tax Governing Board on September 30, 2009.

### Revised definitions for certain items

#### Food:

The definition adopted under the agreement for "food and food ingredients" differs from the "food for home consumption" definition under Virginia law. The change in definitions will result in minor changes in the types of food or food products taxed at the lower rate applicable to food for home consumption in Virginia. For example, prepared foods available at the reduced "food for home consumption" rate for meals-on-wheels recipients, women residents of domestic violence shelters, physically or mentally handicapped persons who received prepared meals by nonprofit organizations, etc., would be subject to sales tax at the regular rate, rather than the current reduced rate, absent Virginia specifically exempting these transactions.

## Durable Medical Equipment

Virginia's definition for "durable medical equipment" would have to be revised to explicitly exclude mobility enhancing equipment and equipment worn in or on the body. Virginia could, however, retain the exemption for mobility enhancing equipment by separately identifying these items as exempt under *Va. Code* § 58.1-609.10. Virginia would also have to provide a separately listed exemption for items that are worn in or on the body. As the SSUTA allows states to limit durable medical equipment to items intended for home use, Virginia would not have to change that portion of its definition.

## Repeal of election for gifts transactions

Since 2005, Virginia has authorized retailers carrying out gift transactions to elect to collect either the tax imposed by the state of the recipient or the tax imposed by Virginia, upon approval by the Tax Commissioner. Gift transactions are retail sales resulting from an order for tangible personal property placed by any means by any person that is for delivery to a recipient, other than the purchaser, located in another state. This provision would conflict with the SSUTA's mandate that interstate sales be sourced according to the destination of the tangible personal property, and as such, must be repealed.

## Repeal of partial exemption for maintenance contracts

Since 1996, Virginia has taxed maintenance contracts that provide both services and tangible personal property at 50% of the value of the contract. Similarly, since 2000, Virginia has taxed certain modular buildings at 60% of their value. The partial exemption for modular homes is permissible under Section 323 of the Agreement, which allows caps and thresholds on the retail sale or transfer of modular homes. However, the partial exemption for maintenance contract conflicts with the SSUTA's definition of "sales price," which is:

[T]he total amount of consideration, including cash, credit, property, and services, for which personal property or services are sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for the cost of materials used, labor or service cost, interest, losses, all costs of transportation to the seller, all taxes imposed on the seller, and any other expense of the seller.

As such, the provision authorizing a partial exemption for maintenance contracts must be repealed. However, several proposals have been introduced at SSTP's Governing Board meetings that would require uniform treatment among the states for software maintenance contracts. It is possible that future actions by the Governing Board would allow Virginia and the other member states to reinstate a partial exemption for maintenance contracts.

### Additional registration and administrative requirements

The SSUTA requires that member states participate in an online sales and use tax registration system, maintain several downloadable databases on which retailers can rely to determine rates, boundaries, and other information, utilize exemption certificates created and mandated by the Governing Board, and maintain a taxability matrix, documenting changes in taxability for certain items. These changes would give businesses the tools that would allow them to more accurately source sales to the correct locality.

### Summary

This bill would conform the Virginia Retail Sales and Use Tax to the provisions of the SSUTA. Virginia sales tax law is more consistent with SSTP objectives than many other states. In order to conform to Streamlined, Virginia would be required to make several definitional changes, as well as repeal the election for gift transactions and the partial exemption for maintenance contracts. It is possible that future actions by the Governing Board would allow Virginia and the other member states to reinstate this partial exemption. Thus, the necessary changes to conform to SSUTA are minimal. If federal legislation is enacted that would authorize member states of SSUTA to require remote sellers to collect and remit their sales and use taxes, this would generate significant revenue for Virginia.

This bill would become effective on July 1, 2011.

cc : Secretary of Finance

Date: 1/24/2010 KP  
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