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BY ROGER RUSSELL

States get aggressive with sales and use tax to close gaps

States have been hit hard by the economic downturn and will end up facing a cumulative budget gap exceeding $281 billion, according to the National Conference of State Legislatures' report on state budgets.

For the 45 states that reported taxes for April and May, revenues declined close to 20 percent compared with the same period a year ago, according to a report from the Nelson A. Rockefeller Institute of Government at the State University of New York.

Although states with revenue shortfalls are increasingly looking to sales and use taxes to help make up the gap, the Bureau of Economic Analysis said that sales tax revenues fell at the end of 2008 for the first time since it began tracking the data back in 1958.

"Sales and use taxes are the key issue for states and localities," said Dennis Prestia, principal-in-charge of KPMG's Northeast indirect tax practice. "States and localities are getting a lot more aggressive in order to increase their revenue. There's an increase in tax rates, especially on the local side, and a broadening of the taxable base. We're also seeing the application of sales tax to include additional services such as digitized goods and services."

A recent study from corporate tax solutions provider Vertex confirmed the rate increases. In 2008, 554 cities changed their sales tax rates. Of those, 200 were newly imposed city tax rates and 307 were straight increases to existing city tax rates. The average state sales tax rate is currently 5.377 percent, which is the highest average rate recorded since Vertex began tracking that data in 1982.

"The biggest concern is the reactions state and local jurisdictions have shown to the economic downturn and revenue shortfalls," said Faranak Naghavi, partner and national director of sales and use tax at Ernst & Young. "The reactions are all over the place, with no consistent theme. One area is nexus, with states coming up with different ways to assert it."

For purposes of state tax, nexus is the minimum threshold of contact that must exist between a taxpayer and a state that would allow the state to impose tax.

"The [online bookseller] Amazon.com tax is one way to deal with nexus. New York passed its bill last year, and a number of other states have proposed legislation or regulations similar to this," said Naghavi.

A 1992 Supreme Court decision in Quill ruled that out-of-state retailers are not required to collect taxes in jurisdictions in which they do not have a physical presence. The court implied that states must first simplify their laws before they could require retailers to collect and remit such taxes.

The Streamlined Sales Tax Agreement is an outgrowth of the Streamlined Sales Tax Project, or SSTP, which was a reaction by the states to the Quill decision. The agreement creates a simplified sales and use tax collections system with uniform definitions of taxable items, set rules for sourcing transactions, and a centralized registration and administration process for participating retailers. Adherents hope that eventually Congress will require out-of-state merchants to collect sales taxes on all sales to customers in the member states.

There are currently 19 full member states of the SSTP, according to Tom Concitis, tax research manager at Vertex. "It makes our job a little easier because we can look to the agreement for definitions, but we also have to look at the rest to see how those states treat their transactions," he said.

CYBERTAXES

"Amazon laws are viewed as a challenge to the streamline project because they achieve some of the same goals without making the law changes that the SSTP mandates," said Dan Schibley, senior analyst at CCH, a Wolters Kluwer business.

The Amazon legislation is an attempt to collect sales tax from Internet vendors such as Amazon.com and Overstock.com that sell through in-state affiliates' links to their Web site. The Internet vendor pays a commission to the affiliate when the customer they send makes a purchase from the online seller.

"The New York law required sellers with in-state affiliates to collect tax under certain circumstance," said Schibley. "That law was upheld by a New York court several months ago, and Rhode Island has adopted a similar law. Other states have looked at it and passed legislation, but the legislation was either vetoed by governors, or died in legislation."

Both Amazon.com and Overstock.com threatened to end their affiliate programs in any state that passed the legislation.

"There was definitely a level of intimidation," said Diane Yetter, CPA and president of Yetter Consulting Service Inc. "By severing their relationships with the affiliates, it would put them out of business and reduce the income tax they generated. Amazon is taking the position that these affiliates do not have as close a tie as independent sales representatives."

"SSTP has lost some of its momentum," said Schibley. "The goal was to get federal legislation that would promote collection authority, and that bill has not yet been introduced in this session of Congress. Some states allow vendors to keep a reasonable portion of what they collect to compensate them, and the federal legislation is expected to include this. The sticking point is that they haven't been able to agree on what would be reasonable vendor compensation."

With health care and other legislative priorities currently before Congress, Schibley said that he doesn't expect to see legislation in the current session, which runs to the end of 2010.

Naghavi observed that a number of states that proposed Amazon legislation were also members of the Streamlined Sales Tax Agreement. "If they believe that federal legislation will pass, why are they passing the Amazon tax? For New York and other states not active in the agreement, it gives them the revenue source they were looking for and lessens the chance of joining."

STATES GET 'CREATIVE'

Naghavi expects states to continue raising their sales tax rates, and noted that several states have at least temporarily ended their sales tax holidays. "On top of that, we're seeing much more aggressive audit activity from states," she said.

States have become creative in ways to expand their sales tax revenues, said John Genz, partner-in-charge of state and local tax at the firm of Amper, Politziner & Mattia: "The way you expand the sales tax base is to have additional services subject to tax. They'll also expand the definition of tangible personal property. A lot of states don't tax software if it's downloaded electronically, since they consider it to be an intangible, but that's likely to change."

"States are looking at ways to expand their reach," echoed Jeff Cohen, director of tax content and workflow solutions at Thomson Reuters.

"We'll also see taxes and fees that look and smell like sales taxes for specific transactions and purposes that are written in ways that are outside of traditional sales tax statutes," he said. "For example, 911 fees for phone lines to automatically connect are being changed to pay for the actual provisions of emergency services, not just the phone line communication."

"The volume of tax changes is increasing rapidly," said Anton Donde, chief executive of SpeedTax, one of the four certified providers under the SSTP. "The definition of what's taxable is getting tighter. Even nexus is being defined in a far more favorable light so the states can get more revenue."

Many businesses are streamlining and automating their sales tax procedures, noted KPMG's Prestia. "They're looking at third-party engines to handle the procurement side as well as the sales side of transactions," he said. "Clients are focusing on cost optimization, which includes managing sales and use tax costs and making use of all the available exemptions."