Report on

Streamlined Sales Tax Law Changes

January 2007

January 19, 2007

The Honorable Phil Bredesen
Governor of the State of Tennessee
State Capitol
Nashville, TN 37243

The Honorable Ron Ramsey
Lieutenant Governor and Speaker of the Senate
1 Legislative Plaza
Nashville, TN 37243

The Honorable Jimmy Naifeh
Speaker of the House
19 Legislative Plaza
Nashville, TN 37243

Honorable Gentlemen:

We are pleased to present to you the following report and recommendations related to the implementation of Tennessee's legislation conforming to the Streamlined Sales and Use Tax Agreement.

As you are aware, Tennessee passed legislation to conform to the provisions of the Streamlined Sales and Use Tax Agreement which is scheduled to take effect on July 1, 2007. The delegates to the Streamlined Sales Tax Governing Board have evaluated the impact of this legislation on local governments and on small business as directed in Chapter No. 311, Public Acts of 2005.

The attached report lays out a recommended strategy to mitigate local governments that focuses on countering the effects of a change to destination sourcing. The attached report also recommends a method by which to assist small businesses with transitioning to the new sourcing requirement.

The Honorable Phil Bredesen
The Honorable Ron Ramsey
The Honorable Jimmy Naifeh
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We are available to assist you as you consider these matters during the current legislative session.

Respectfully,

John Morgan
Comptroller of the Treasury

Representative Mark Maddox

Connie Hardin by LGC w/ permission

Connie Hardin
Legislative Budget Analyst thru 12/31/06

Loren Chumley
Commissioner of Revenue

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Executive Summary

Under the terms of Chapter No. 311, Public Acts of 2005, the state officials designated as delegates to the multi-state discussions on the Streamlined Sales and Use Tax Agreement (the Agreement) pursuant to §67-6-804 were directed to study the following issues and report their findings and recommendations, if any, to the chairs of the senate and house finance, ways and means committees:

> 1) The revenue distributional effects of changing from situs to destination sourcing of sales and proposals to hold units of local government harmless from such effects;
> 2) The effect on small retailers of the implementation of the streamlined sales tax and options to mitigate against such effects; and
> 3) Such other issues as are deemed appropriate.

Those state officials have met with and received information from 1) representatives of Tennessee city and county governments; 2) representatives of the state of Washington which has put forth a mitigation strategy for its local governments; 3) Dr. Bill Fox who has prepared a study on potential impacts of the Streamlined legislation on local government; and 4) representatives of the Streamlined Sales Tax Governing Board, Inc. and the National Conference of State Legislatures regarding the status of the Streamlined effort nationally.

The Streamlined Sales Tax effort is an effort to modernize, simplify and make more uniform the sales and use tax laws across the country. The states have been working together at this effort for 6 years. At this time, 15 states have changed their laws to fully adopt the simplification provisions of the Streamlined Sales and Use Tax Agreement. Six states, including Tennessee, have either partially changed their laws or have changed their laws with a future effective date so as to conform to the Streamlined Agreement.

Each state that has changed its laws has had to deal with constituencies and interests that have either supported or opposed the law changes. The states that have changed their laws have done so for a variety of reasons, including the motivation to encourage businesses located outside their state to collect their state's sales taxes. States are seeing their sales tax bases erode as a result of the growth in electronic commerce. A barrier to requiring internet sellers to collect tax is the U.S. Supreme Court's recognition that sales tax laws across the country are complex. The Court has held that it would be a burden on interstate commerce to require a business with no physical connection to a state to collect that state and local government's sale taxes.

The states in the Streamlined Sales Tax effort have worked on federal legislation that would, in effect, overturn this Supreme Court case and would require all sellers to collect a state's sales taxes if that state has simplified its laws pursuant to the

Streamlined Sales and Use Tax Agreement. This legislation has been introduced in the past two Congressional sessions. The associations working to represent the states in this effort, including the National Conference of States Legislatures and the National Governors' Association, have expressed support for this legislation through policy statements. There is a widely-held belief among the state associations and the states involved in the Governing Board that federal legislation is more likely to happen as more states change their laws to conform to the Streamlined Sales and Use Tax Agreement.

In Tennessee, the primary concern about conforming to the Streamlined Sales and Use Tax Agreement is the change from origin or "situs" based sourcing of a sale to "destination" based sourcing of a sale. A complete discussion of this sourcing issue is set forth herein. The result of the change in sourcing will result in revenue shifts among local governments and will require a change in the way businesses collect and report sales tax on goods that are delivered into other jurisdictions.

In the event that Tennessee policy makers choose to assist local governments and small businesses as the transition to destination sourcing takes place, it is recommended that policy makers adopt the mitigation and assistance strategies set forth in this agreement.

For local governments, the mitigation strategy may be summarized as follows: A "snapshot" is taken that looks at the local sales tax remitted to local governments in the year prior to the sourcing change by delivery-type businesses located in the local jurisdiction. A second "snapshot" is taken of the same businesses in the year following the change to destination sourcing. The actual sales tax remittances of each of the tracked entities will be compared to the same remittances had they been distributed using percentages calculated for the year prior to the change. The Department of Revenue will aggregate the differences for each taxing jurisdiction and determine a net positive or net negative amount of local tax revenue as compared to the same revenue distributed according to the prior year’s distribution. There will be an offset, prior to mitigation, for any new money that is distributed to the local jurisdiction from new businesses that registered through the Streamlined Sales and Use Tax Central Registration System. To the extent a local jurisdiction resulted in a "net negative," the jurisdiction would be entitled to mitigation. It is estimated that the cost of this mitigation is $30 million during the first year following adoption of the change in sourcing.

For small businesses, the report summarizes technology options that are available to assist in sales tax collection and remittance. These technology options are available for all businesses. As set forth in the report, a business' use of a technology model known as a Certified Service Provider, will assist in better compliance by sellers in the state. This report contains a recommendation that the state consider defraying some of the cost of the service for small sellers under the following critieria:

- Available to an entity that delivers goods to more than one local jurisdiction
- Entity must have gross annual sales of $500,000 or less
- Delivery sales must comprise 5% or more of the entity’s taxable retail sales

- Of the 5% delivered, 20% of the deliveries must be to local jurisdictions other than the home jurisdiction of the entity.

If those criteria are present, the estimated cost for this service to small businesses meeting these criteria would be $7.9 million in the first year. This would be in lieu of any vendor's compensation. This amount would be phased in over a period of time as sellers changed over to this service

The delegates to the Streamlined Sales Tax Governing Board, Inc. support the state's continued participation in this important national effort. If all of the provisions of Tennessee's conforming legislation are to take effect on July 1, 2007, the delegates recommend that policy makers implement the mitigation and cost-defrayal strategy set forth herein.

I. Background and History of the Streamlined Sales Tax Effort

For decades, states that levy sales taxes have lost considerable revenue as the result of their inability to efficiently collect use taxes. Use taxes are the companion to sales tax and are levied when a good is imported or consumed in the state where full sales tax has not been collected by the seller on the item. Sales taxes are collected by a seller at the point of sale from the purchaser and are remitted to the taxing jurisdiction. However, under the U.S. Supreme Court decision, *Quill Corp. v. North Dakota*, 504 U.S. 298; 112 S. Ct. 1904; 119 L. Ed. 2d 91 (1992), a seller is not required to collect sales taxes for a taxing jurisdiction unless the seller has "substantial nexus" with the state. The "nexus" that is required in order to impose a sales tax collection obligation on the seller has been an area of evolving case law. However, at a minimum, the seller is required to have some physical presence with that taxing jurisdiction. The Supreme Court determined that it would be a burden on interstate commerce to require a seller who has no physical contacts with a taxing jurisdiction to learn the sales tax laws unique to that state.

The use tax is imposed in order to provide a level playing field to in-state merchants. If a consumer is able to avoid the tax simply by purchasing from a seller that has no physical contacts with the state, the out-of-state seller obtains a competitive advantage over the in-state merchant who is supporting the local community with jobs and investment within the state. However, taxing jurisdictions face considerable difficulty in enforcing the tax. While most states engage in matching programs and information sharing with other states, it is estimated that only a fraction of use tax is successfully collected by the state.[1]

[1] In his July 2004 update to the report "State and Local Sales Tax Revenue Losses from E-Commerce," Dr. Bill Fox at Univ. of Tennessee predicted that state and local governments lost between **$15.5 billion and $16.1 billion** in 2003 as states are unable collect sales taxes from online sales. The trend increases: By 2008 revenue projected loss for state and local governments range between $21.5 billion and $33.7 billion, with the greatest losses occurring in states that rely most heavily on the sales tax as a revenue source.

The states have attempted for decades to require sellers to collect sales taxes on goods to consumers in their state. Those efforts have taken place through audit assessments that are litigated through the courts, through national advisory task forces and through discussions facilitated by Congress. The growth in retail sales through the Internet have made these efforts more urgent.[2]

In October 1998, Congress voted the Internet Tax Freedom Act into law. The law established a three-year moratorium (October 1, 1998 to October 21, 2001) on new Internet access taxes and on multiple or discriminatory taxes on electronic commerce. The legislation did not prevent states and localities from collecting sales tax on sales made over the Internet. The passage of the Internet Tax Freedom Act mandated that an Advisory Commission on Electronic Commerce (ACEC) be formed to explore and recommend solutions to the question of taxing electronic commerce. The ACEC issued a final report that failed to receive the required 2/3 majority vote to recommend any of its proposals.

The Streamlined Sales Tax Project (the "Project") was born out of concern that Congress might take action that limited the ability of states to collect tax on goods sold over the Internet. In 1999, states were invited to a meeting at the request of the National Conference of State Legislatures, the National Governors' Association, the Federation of Tax Administrators and the Multistate Tax Commission. The purpose of the meeting was to see if the states would assume the responsibility of a project to modernize the administration of sales and use tax. By modernizing the administration of sales and use tax, states hoped to eliminate the burden on interstate commerce identified by the Supreme Court in the Quill decision, and thereby have sellers collect sales taxes on all sales into the states regardless of whether the seller has physical presence.

States committed to this effort and became "participating states" in the Project by the passage of legislation or by executive order of the governor. Tennessee Public Chapter 631, Acts 2000, required the commissioner of revenue to enter into discussions with other states to develop a multi-state, voluntary, streamlined system for sales and use tax collection and administration. This effort led to a draft document known as the Streamlined Sales and Use Tax Agreement (the "Agreement"). In 2001, Tennessee adopted the Simplified Sales and Use Tax Administration Act which provided that Tennessee should participate in multi-state discussions regarding the Agreement and for this purpose should be represented by the commissioner of revenue, a member of the House of Representatives, a member of the state senate and the Comptroller of Treasury. The Act also specified certain modernized tax administration provisions that the Agreement must include.

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[2] In a press release issued December 22, 2006, comScore Networks reported that, during the first 50 days of the holiday season, total online retail spending reached $21.68 billion, marking a 26-percent increase versus the corresponding days in 2005. The growth in online retail this holiday season has been primarily driven by significant spending increases in both high-ticket and popular gift categories such as jewelry, consumer electronics and video game consoles.

These representatives participated in the meetings of the Streamlined Sales and Use Tax Implementing States ("SSTIS") which oversaw the work of the Project. The Project and the SSTIS worked in tandem to produce and vote on the provisions that were required to modernize our system of tax administration. On November 12, 2002, the SSTIS voted to approve the SSUTA and since that time numerous refinements and amendments have been added to the Agreement.

While the Agreement contained provisions necessary for a simpler and more uniform tax structure, the Agreement did not become effective until a sufficient number of states (10 or more) representing 20 percent of the population of all states that levy sales and use taxes changed their laws to conform to the Agreement. The thresholds that allowed the Agreement to become effective were reached on October 1, 2005, when 13 full member states representing over 20% of the population had effectuated the law changes necessary to modernize their system of sales and use tax administration and conform to the Agreement.[3]

On October 1, 2005, the Streamlined Sales Tax Central Registration System (SSTR) became available that allows a vendor to go to an internet address and register to collect sales taxes in all member states. A seller who registers through this system is required to collect sales tax in all full member states and has the option to collect in associate member states. When an associate member state becomes a full member state, the seller must begin collecting tax for that state within 60 days of the time the state becomes a full member. When a seller registered through the SSTR, the seller became eligible for a sales tax amnesty within the first year of the states becoming Streamlined member states. Sellers can use SSTR for both new voluntary registrations and updates to previously submitted registration information. A taxpayer that registers through the SSTR and is voluntarily collecting sales tax in a state must continue tax collection for the member states for a period of 36 months to receive the sales tax amnesty for periods prior to registration through the SSTR. The amnesty ended in the original 13 full member states on September 30, 2006.

As of January 1, 2007, there are 1069 businesses that are currently registered under the SSTR to collect sales taxes in the full member states. There are now fifteen (15) full member states to the Agreement and six (6) associate member states.[4] The ability to be an associate member state under the Agreement expires on December 31, 2007.

Four Hundred Eight sellers registered under SSTR are collecting sales tax for Tennessee. Tennessee has collected $9,716,880 as of January 1, 2007 from businesses as a result of its participation in the Streamlined effort. If Tennessee

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[3] The full member states as of October 1, 2005 were ND, SD, NE, KS, OK, MN, IA, MI, IN, KY, WV, NC, NJ. The Agreement was amended to provide for an Associate Membership option if a state's law changes had a future effective date or if the state had conformed to the Agreement as a whole but had failed to pass legislation conforming to each provision of the agreement. The Associate Membership option expires on December 31, 2007. Associate Members may not require businesses volunteering to register with the Governing Board to collect sales tax in their state or share Governing State's registration or audit information. Associate Member states at that time were UT, TN, OH, AR, WY NV.

[4] On January 1, 2007, Rhode Island and Vermont joined as new full member states.

becomes a full member state, all sellers registered under the SSTR will have to begin collecting Tennessee's sales tax within 60 days of full membership. If Tennessee loses its membership status under the Streamlined Agreement, the sellers that are currently collecting Tennessee's tax may stop collecting.

II. Principles of the Streamlined Sales and Use Tax Agreement

A. General Discussion

There are 45 states plus the District of Columbia and Puerto Rico, as well as over 7,000 local jurisdictions that levy sales and use tax. Sellers that do business in multiple states face significant hurdles in trying to comply with the myriad of sales tax laws within those jurisdictions. The Streamlined Sales and Use Tax Agreement was drafted with input from sales tax experts across the nation including state tax administrators, state legislators, local government representatives, private sector attorneys and accountants, retailers, lessors, manufacturers, and a wide array of other members of the business community.

The Agreement address nearly every aspect of sales taxation and provides for the following principles: state administration of local sales and use tax; a single state and local tax base; simplified tax rate requirements; uniform definitions; uniform sourcing rules; simplified exemption administration; elimination of "caps" and "thresholds; simplified sales tax holidays; new tax collection technology models; monetary compensation in certain situations; uniform rules for tax rounding; simplified tax returns; uniform direct pay permit requirements; uniform rules for recovery of bad debt; customer refund procedures; and, tax amnesty.

A complete discussion of Tennessee's required law changes is set forth in **Appendix A** to this report.

B. Uniform Rule on Sourcing the Sale of Transactions

"Sourcing” refers to the method by which a seller determines which state and local jurisdictions, if any, can tax the sale. Without uniform rules on sourcing, taxing jurisdictions disagree about who has the first right to tax a transaction, and sellers find themselves uncertain of which rate to collect and to which jurisdiction to remit the collected tax.

The Agreement sets forth rules that requires sellers to source sales of property, services and digital goods on a destination basis. Under a destination-based rule, the seller sources the sale to the seller’s business location for over-the-counter transactions and sources to the customer’s shipping address for transactions where goods are delivered. If the “shipped to” address is not known to the seller, the next level in the sourcing hierarchy is the purchaser’s address as maintained by the seller in the normal course of business. When none of these locations is known, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of the purchaser’s payment instrument, if no other address is available. When the destination rules do not apply, the Agreement contains a default rule whereby the sale is sourced to the origin of the sale.

The destination rule was adopted after much discussion and debate. A majority of the states use destination sourcing for intrastate sales. Significant constitutional issues are raised if a state attempts to source interstate and intrastate sales differently. Adoption of an origin-based rule when dealing with interstate sales would encourage sellers to have sales originate in states which do not levy a sales tax so as to obtain a competitive advantage.

III. Local Government Issues

On February 11, 2005, a report was released entitled *"Revenue Implications of the Streamlined Sales Tax Project in Tennessee"*, by William F. Fox, Ransom Gustafson and Julie L. Marshall.[5] The report analyzes the potential effects on local governments from conforming Tennessee's laws to the provisions of the Streamlined Sales and Use Tax Agreement. The report contains three tables that highlight specific areas: Table 1 highlights the effects of "situsing" or changing to destination sourcing from the current "point-of-sale" sourcing among Tennessee's local jurisdictions; Table 2 summarizes effects of other structural changes to the tax code; and Table 3 provides the total effects of conforming legislation. The following are key summary points from Table 3 as set forth in this report:

- Total local government tax revenues increase by $29.8 million, or just over 2 percent of total local option sales tax revenues.
- The sum of all local governments in 83 counties experience net inflows totaling $44.7 million.
- The aggregate of local governments in 12 counties experience net outflows totaling $14.9 million.
- Grainger County continues to receive the largest percent net inflow, followed by Crockett, Fayette, and Union Counties. These tend to be small counties where many people travel to nearby large urban counties for significant shares of their purchases. The total net outflow for larger urban counties such as Davidson (Nashville), Knox (Knoxville), and Hamilton (Chattanooga) Counties is not as large as the situsing effects because they are significant beneficiaries of destination sourcing of telecommunications. Shelby County (Memphis) has a net revenue inflow because many of the goods shipped to nearby counties would go to other states and no sales tax is currently being collected on these shipments.

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[5] The full report is available at the University of Tennessee's Center for Business and Economic Research's Website at www.cber.bus.utk.edu/pubs/sstp0205.pdf.

Tennessee counties adjacent to Shelby County are relatively small and do not have a market that is sufficient to allow Shelby County to have as much sales to adjacent Tennessee counties as occurs in places such as in Davidson and Knox Counties. Also, Shelby County will be a significant beneficiary of the telecommunications destination situsing provisions.

Given that this report was drafted in 2005 using data from 2003, policy makers may want to consider updating this report to obtain a more current impact analysis.

A. Principles of Mitigation

While, overall, local governments in the aggregate experience a gain in revenue as a result of streamlined conforming law changes, the change to destination sourcing will result in a loss of revenues in jurisdictions that have a larger percentage of their sales tax base comprised of sales where sellers deliver goods to other jurisdictions. The types of sellers that fall within this category fall predominantly within the area of building materials, furniture and electronic retailers, mining and certain types of manufacturing industries, and providers of certain repair services. The Agreement does not have a uniform sourcing requirement, and therefore there is no change to the sourcing requirements for sales of motor vehicles, boats, and manufactured homes.

Members of the study group and Department of Revenue employees with expertise in local government distribution issues and tax research issues have met with representatives of local governments regarding possible "hold harmless" proposals. In the course of those discussions, the study group representatives were guided by the following principles in their discussions:

1) Negatively-impacted local jurisdictions will receive mitigation.

2) Positively-impacted local jurisdictions will not receive mitigation.

3) Education funding will not be negatively affected.

4) The mitigation plan will have to be accomplished with information and resources available. There will be no supplemental reporting requirements on retailers.

5) The amount of mitigation will be reduced by other monies such as moneys related to Streamlined registrants.

6) Small and large jurisdictions that are negatively impacted will be mitigated using the same mathematical calculations.

7) Mitigation should not be instituted in such a way that it fails to acknowledge that the Streamlined law changes have taken place.

B. Proposal to Hold Local Governments Harmless from Situsing Changes

After significant review of the matters, the technical experts recommend a proposal to the committee that would provide for mitigation to local governments on an "entity" basis. The term "entity," in Revenue parlance, is a taxpayer.

An entity-based mitigation plan is designed to capture the effects of SST structural and sourcing changes on affected taxpaying businesses. Aggregating the impacts of all such firms in each jurisdiction will determine the net impact of SST changes. All jurisdictions will be considered equally—there is no need for a loss of total local sales tax revenue to receive mitigation, nor is a loss of local sales tax revenue a guarantee of mitigation. The goal of the entity-based plan is to discover and mitigate for losses due to SST sourcing changes, regardless of other economic activity within the jurisdiction. The entity-based mitigation plan would have a built-in sunset, due to the nature of its design; however, it is impossible to say with any certainty how many years into the future the sunset will occur. In some isolated instances, it is possible that a jurisdiction may receive mitigation related to an entity for the foreseeable future because there would never be sufficient offsets to make up for the loss of revenue related to that entity.

The funding source for the mitigation plan would be determined by the General Assembly.

C. The "Hold Harmless" Methodology

1. DOR, with the assistance of representatives of each local government, would identify tax-paying entities in the industry sectors most likely to be affected by a change from origin-based to destination-based sourcing, i.e. mining, manufacturing, telecommunications, wholesale trade, building materials, furniture and electronics retailers, certain miscellaneous retailers, and providers of certain repair services. It is estimated that this would affect 15,000 to 20,000 taxpaying entities.[6]

2. For each entity, DOR would calculate a percentage of local sales taxes paid into each local taxing jurisdiction in the year prior to the adoption of destination-based sourcing (base year). Typically, the local taxing

[6] Tennessee has several cities that are located in 2 or more counties. While there are 445 current cities and counties, the cities sitused in more than 1 county have to be tracked separately. Therefore, there are 459 separate jurisdictions that receive sales tax distribution. Under the Entity proposal, there would be a minimum of over 7 million data points that would have to be tracked for mitigation purposes. It must be noted that this is an administrative cost for the Department of Revenue.

jurisdictions involved will be those jurisdictions where the taxpayer has a physical location.

3. In the year following the implementation of destination-based sourcing, the actual sales tax remittances of each of the tracked entities will be compared to the same remittances had they been distributed using percentages calculated for the base year. By aggregating the differences for each taxing jurisdiction, the department can find a net positive or net negative amount of local tax revenue as compared to the same revenue distributed according to the prior year's distribution. The overarching objective is to discover the *net* effects of the changes—most jurisdictions will have some entities that pay more local sales tax under SST and some entities that pay less—the *net* balance is the basis for further calculations to determine the amount of mitigation.

4. Entities that have registered through the Streamlined Central Registration System (typically without nexus in Tennessee) are tracked separately. Local sales taxes from SST registrants paid into a jurisdiction with a net loss of revenue from firms affected by destination-based sourcing will be used to offset the loss before receiving mitigation compensation. In other words, monies that would not have been remitted but for the state's participation in the Streamlined registration system will be first used to offset losses to the local jurisdiction from the sourcing changes.

5. For all those taxing jurisdictions with a net positive impact, no action will be necessary. The positively-impacted jurisdictions will be able to keep the local sales tax gains derived from the change in sourcing rules.

6. For the taxing jurisdictions with a net negative impact, compensation will be available. The amount of compensation paid will depend largely on two factors: first and foremost, the amount needed by the local taxing jurisdiction to fully fund education requirements and, second, the amount of funding appropriated by the General Assembly.

7. Provided that the effective date for Streamlined law changes remains July 1, 2007, payments will be calculated and made on an annual basis beginning with the July 2008 local sales tax distribution. The first payments will be for a 10-month period; subsequent payments will cover a full 12-month period. Payments continue until the tax collections from voluntary SST taxpayers into a particular jurisdiction grow to the point that they exceed the net losses suffered by that jurisdiction due to sourcing and other structural changes from SSTP. The length of mitigation varies from jurisdiction to jurisdiction depending on both factors—the volume of sales by voluntary firms into that jurisdiction and the volume of sales previously sourced to that jurisdiction by firms sourcing sales to other jurisdictions because of SST requirements. In the first year, as many as 125 jurisdictions could be eligible for mitigation,

according to estimates derived from Dr. Fox's 2005 study.[7] For each ensuing year, it is believed that the number of jurisdictions eligible for mitigation would decline considerably.

8. Mitigation payments will be made directly to the jurisdiction suffering a net loss of revenues due to sourcing. The payments will be adjusted to account for the portion of local sales tax revenue dedicated to public education if the jurisdiction receiving the mitigation payments is part of a school district containing other jurisdictions experiencing sufficient SSTP-generated gains in local sales tax revenue to hold school district budgets harmless. Such adjustments will depend on the revenue-sharing agreements between the affected jurisdictions for education funding.

9. The mitigation scenario provides some allowance for growth with the use of the percentage methodology set forth in paragraph 1. By way of example, if a local jurisdiction received 5% of a tracked entity's sales tax revenue in the year prior to sourcing changes, then, with mitigation, the local jurisdiction will continue to receive 5% of that entity's total local sales tax collections. The total mitigation the local jurisdiction is entitled to will be reduced by the additional revenue being collected for that jurisdiction as a result of streamlined registered entities. Furthermore, the mitigation strategy has no effect on natural growth of collections from non-tracked entities or from revenue enhancements received as a result of other conforming streamlined law changes.

Telecommunications service providers will require special handling. Currently, telecommunications providers do not report their sales at the source nor at the destination. The tax receipts are distributed by the Department of Revenue to all taxing jurisdictions in the state based on a formula incorporating population and local sales tax collections from other taxpayers. The base year local tax distributions will then be derived from departmental records rather than sales reported by the taxpaying entity. Tax receipts from out-of-state taxpayers currently reported in situs 9900 will be handled in the same way.[8] It should be noted that the telecommunications sales tax law changes required for SST conformance will result in an overall increase in local collections on the sale of these services.

DOR must be given discretion to make changes to mitigation payments to take into account extraordinary events such as an audit or refund of an entity that reflect a payment or credit that is not in the ordinary course of business.

An example of the mitigation scenario is attached as Appendix B.

[7] See footnote 6, supra.

[8] The 9900 situs group consists of taxpayers that are making sales from a location other than in Tennessee. This group does not include SSTP volunteers.

D. A Procedure for Review and Appeals

A review and appeals committee made up of delegates from the state and local governments would be created to review the list of taxpaying entities selected by the Department of Revenue and the local governments (the "Review and Appeals Committee"). The Review and Appeals Committee would have authority to suggest additions or deletions from the original list before actual tracking of firms' sales tax allocations begins. Additionally, non-standard payments in the initial year can be identified and adjusted in order to create a valid base year for each jurisdiction. Furthermore, jurisdictions gaining or losing taxpaying entities from annexations or economic development may appeal for an adjustment to their mitigation payments after mitigation payments have begun. Such appeals are expected to be rare and would be considered on a case-by-case basis. Confidentiality statutes may have to be amended for this Review and Appeal Committee. Otherwise members of the Committee who are not otherwise authorized to receive confidential taxpayer information will have to sign confidentiality statements before information may be shared.

E. Evaluation and Efficacy—Follow Up Analysis

The state officials designated as delegates to the multi-state discussions on the Streamlined Sales and Use Tax Agreement who prepared this Report will be charged with analyzing the efficacy of the mitigation plan and project its expected useful life span after the first year of its operation. This group will present estimates of funding requirements for the remaining years based on the first year experience. This group will monitor activities at the federal level and include such activities in its analysis. Any recommendations regarding changes to the method of calculation or sources of funding streams will be considered by the full committee.

The Department of Revenue will report to this group concerning the demands placed on the resources of the department in implementing the entity-based mitigation plan.

F.   Proposal for Cash Flow Concerns:

Concerns were raised by local government officials about revenue cash flow problems that may occur as the sales tax law transitions to Streamlined conformity. The mitigation payments proposed above are set to be made on an annual basis. The local government representatives noted that the mitigation plan could potentially leave local governments behind in cash flow since mitigation is based upon a calculation of experience in comparison with pre-Streamlined experience; therefore, state remittance of mitigation payments will occur later than the actual collections would have occurred.

A proposal to address this concern involves local governments Tax Anticipation Notes (“TANs”). Currently, local governments may issue TANs for the purpose of meeting appropriations made for the current fiscal year in anticipation of the collection of taxes and revenues of that fiscal year. The state director of local finance approves the issue of TANs which, by law, must be repaid by the end of the fiscal year. Current law does not provide the ability to waive the repayment deadline, but local governments may apply to the state director of local finance to issue funding bonds if revenues do not meet expectations and, in certain instances, can retire the TANs in the next fiscal year.

Law changes to allow locals an extended period to repay TANs in anticipation of the receipt of state mitigation payments could be beneficial to local governments, if structured correctly. These changes would sunset after one fiscal year due to the nature of the streamlined sales tax mitigation proposal estimating process. In theory, a local government could petition the state director of local finance to allow for a short duration (not to exceed 90 days) extension to the repayment date, provided it shows it has experienced collection lags. The state director could consult with the Department of Revenue to verify, if he felt it necessary.

G. Cost of mitigation:

The Department of Revenue estimates that the total maximum cost of mitigation for the first twelve month period is $30 million. This amount is anticipated to decrease over time as more streamlined registrants collect Tennessee's taxes.

IV. Business Issues

A. Agreement Provisions relating to the Use of Technology

Business community representatives have been involved throughout the process of drafting the Streamlined Sales and Use Agreement. Many provisions of the Agreement are designed to address issues that businesses currently face in trying to collect sales and use taxes across the country. One of the paramount goals of the Streamlined Sales and Use Tax Agreement is to place remote and main street businesses on a level playing field so that remote sellers do not have a competitive edge in pricing over main street businesses that are currently required to collect sales tax on top of their sales price. Another paramount goal is to ease the burden of sales tax collection and remittance through the use of technology.

1. Rates and Jurisdiction Database:

In order to assist businesses in collecting a state's sales taxes under the Agreement, the state is required to create a "Rate and Jurisdiction Database" which maps out the state geographically with all local taxing jurisdictions and indicates what tax rate applies to the jurisdiction. All Streamlined member states have created this database. In Tennessee, the tax rate and jurisdiction tables are available free at http://state.tn.us/revenue/streamlined/sstdatabase.htm. A business may use the table to look up the tax rate using an address, or may download the tables into their computer system. A business that uses the state's "Rate and Jurisdiction Database" when calculating the sales tax on a transaction is *held harmless* if there is an error in collection related to the information on the database.

2. Taxability Matrix:

In order to assist businesses in collecting a state's sales taxes under the Agreement, the state is required to create a "Taxability Matrix" which is a chart that outlines each of the products defined under the Streamlined Agreement. On the chart, the state is required to say whether a product is taxable or exempt under the state's laws. For example, the Agreement has a definition of "food and food ingredients." If a state taxes or exempts "food and food ingredients", the state is required to use the Streamlined definition. The state is also required on the matrix to say affirmatively whether this is taxable or exempt under the state's laws. All Streamlined full member states have created this "Taxability Matrix." Tennessee will create this "Taxability Matrix when its Streamlined conforming legislation becomes effective. This table will be available for free. A business that uses the state's "Taxability Matrix " in determining whether to collect and remit sales tax on a transaction is *held harmless* if there is an error in collection related to the information on the Matrix.

3. Certified Service Providers and Certified Automated Systems

With regard to the use of technology, the Agreement divides sellers into categories: Model 1 Sellers use the services of a Certified Service Provider (CSP); Model 2 use a Certified Automated System (CAS); Model 3 sellers have an in-house (Proprietary) System and all other sellers are referred to as Model 4 or other sellers.

a. Certified Service Provider

A Certified Service Provider or CSP is a third party that provides a full tax service that includes tax liability determination, return filing and tax remittance. A CSP's software applications must meet certification standards and must receive approval by the Governing Board with regard to their calculation accuracy standards and their technology standards. Three CSPs have contract with Governing Board:

- Avalara
- Exactor
- Taxware

Businesses who volunteer to collect tax in state may use CSP's at no cost – the states pay CSP for services to volunteer sellers.[9] The Agreement does NOT require the states to pay for CSP services for businesses that have a legal obligation to collect tax in that state. The Agreement does not prohibit a state from paying for all or part of this service.

In essence, the CSP's service includes a tax calculation engine and an address verification system like the state's Rates and Jurisdiction Database. Depending on the CSPs system, this may be downloadable and may interface with a business' existing accounting program through a secure communication vehicle. For example, when a business sets up a new account, with a customer's name and address, the address verification system will note the tax rate applicable to the jurisdiction within which the address is located. When sales are subsequently made that are shipped to the address of the customer, this system ensures that the correct rate of tax is collected for the jurisdiction. Also, through the use of the Taxability Matrix, the CSP will have a calculation engine that indicates whether products are taxable or exempt for the applicable taxing

[9] The contract between the Governing Board and the CSPs provide that the CSPs are paid compensation per the following schedule:

- For the first $250,000 of Taxes Due from each Volunteer Seller to all Member States and Associate Member States combined, the Contractor shall be allowed compensation in an amount equal to 8% of the Taxes Due.
- For Taxes Due that exceed $250,000 but total no more than $1,000,000, the Contractor shall be allowed compensation in an amount equal 7% of the Taxes Due.
- For Taxes Due that exceed $1,000,000 but total no more than $2,500,000, the Contractor shall be allowed compensation in an amount equal to 6% of the Taxes Due
- For Taxes Due that exceed $2,500,000 but total no more than $5,000,000, the Contractor shall be allowed compensation in an amount equal to five percent 5% of the Taxes Due.
- For Taxes Due that exceed $5,000,000 but total no more than $10,000,000, the Contractor shall be allowed compensation in an amount equal to 4% of the Taxes Due.
- For Taxes Due that exceed $10,000,000 but total no more than $25,000,000, the Contractor shall be allowed compensation in an amount equal to three percent 3% of the Taxes Due.
- For Taxes Due that exceed $25,000,000, the Contractor shall be allowed compensation in an amount equal to 2% of the Taxes Due.

The remainder of tax shall be remitted to the Member States and Associate Member States.

jurisdiction. The CSP also gathers data for the monthly reporting and populates the return for the Seller's review. The Seller reviews and approves the return, sends the money collected to the CSP, and the CSP then files the tax return and remits the money to the state.

A seller that uses a CSP is *held harmless* from liability for any tax calculation errors.

b. Certified Automated Systems

A Certified Automated System is a software system that provides tax liability determination services. A seller licenses the CAS software. The CAS software applications must meet certification standards and must receive approval by the Governing Board that include calculation accuracy standards and technology standards. One company has been certified as a CAS by the Governing Board: Taxware.

While the Seller uses the CAS to determine its tax liability, the Seller has the responsibility for preparing the tax returns and remitting the sales taxes to the states each month. Businesses who license the CAS software must pay the licensor for the software.

A seller that licenses a CAS is *held harmless* from liability for any tax calculation errors.

B. Law Changes for Tennessee Businesses

1. Sourcing: The primary issue for Tennessee businesses that make delivery sales to other taxing jurisdictions is the change in sourcing so that instead of calculating remitting tax for the jurisdiction within which a business is located, the business will have to collect and remit for all jurisdictions within which the business makes deliveries. If a business does not make any delivery sales, it will collect tax only for the state and local jurisdiction within which it is located. If a business makes delivery sales into 5 local jurisdictions, it will have to collect and report the sales made into each jurisdiction every month. If a business makes delivery sales into 50 jurisdictions, it will have to collect and report the sales made into each jurisdiction every month.

It should be noted that the business will be able to use a Simplified Sales and Use Tax Return for this reporting. Under current law, a business is required to fill out a sales tax return for each location that it does business within the state of Tennessee. In some cases, taxpayers are currently required to fill out over 100 returns per month because of their numerous locations. After Streamlined, a business will fill out one return for the entire state of Tennessee. On one separate schedule, the business will report sales for each local jurisdiction within which sales are made.

Example: Acme Lumber currently has 10 locations in the state of Tennessee and fills out 10 sales and use tax returns. Acme makes sales over the counter and makes delivery sales from each of the 10 stores. For every return filed, Acme reports the sales for that store, whether over the counter or delivery. After the Streamlined law changes, Acme Lumber will file one return. On the return, it will combine all the sales tax collected on behalf of the state on one line of the return labeled: "state sales tax". For each local jurisdiction within which it made sales, whether over-the-counter or delivery, it will report the sales tax collected for that local jurisdiction.

State sales tax collected at 7%:	$10,000
Kingsport (Sullivan)	1,000
Kingsport (Hawkins)	403
Bristol	394
Blountville	297
Sullivan County	394
Johnson City (Washington)	27
Johnson City (Carter)	490
Johnson City (Sullivan)	169
Erwin	20
Jonesboro	27
Washington County	63
Church Hill	49
Rogersville	49
Hawkins County	49

Businesses may use the Rate and Jurisdiction Database and the Taxability Matrix to assist in this process. Businesses may contract with a CSP or license a CAS for assistance with tax collection as well.

The use of a CSP in performing sales tax collection will assist in better compliance by sellers in the state. To this end, the state may wish to consider defraying some of the cost of the service for smaller sellers in this state. Given cost considerations, the Committee recommends that the cost defrayal should operate as follows:

- Available to an entity that delivers goods to more than one local jurisdiction
- Entity must have gross annual sales of $500,000 or less
- Delivery sales must comprise 5% or more of the entity's taxable retail sales

- Of the 5% delivered, 20% of the deliveries must be to local jurisdictions other than the home jurisdiction of the entity.

If those critieria are present, the state may want to consider paying for CSP services for sellers. Using a graduated scale that the State of Washington has tentatively negotiated with a CSP that focuses primarily on small sellers, the estimated cost for this service in Tennessee would be $7.9 million in the first year. [10] This would be in lieu of any vendor's compensation. This amount would be phased in over a period of time as sellers changed over to this service.

2. Exemption Certificates: Tennessee currently issues many different types of exemption certificates such as non-profit, manufacturing, resale, etc. With regard to resale certificates for drop shipments, Tennessee requires that businesses register to obtain a Tennessee resale certificate even if the business does not have a location in Tennessee. A business that accepts a resale certificate other than one issued by the Tennessee Department of Revenue may be held liable on audit for the sales tax that should have been collected. Under Streamlined, businesses may use and sellers may accept a multi-use tax exemption form that is acceptable in all Streamlined states. As long as the exemption certificate is properly completed, the seller is *held harmless* from liability if there is a misuse of the certificate. The state looks to the purchaser who misused the certificate for any tax liability.

3. Notification of tax rate and boundary changes:

A current issue that sellers face in collecting taxes is the possibility of a tax rate or a jurisdictional boundary change taking place without sufficient time to change computer software systems. The Agreement and Tennessee's conforming legislation require a minimum of 60 days notice prior to the effective date of either a local tax rate change or a local boundary change.

4. Single Article Cap:

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[10] The State of Washington is introducing Streamlined conforming legislation this session and is proposing to defray costs of a CSP for sellers meeting the criteria set forth above. As of the date of this report, the State of Washington intends to propose payments as follows and has obtained the tentative agreement of the CSP focusing on small sellers to provide the service at these costs. Tennessee would have to negotiate and obtain an agreement from the CSP to provide the service to sellers at this cost.

Gross sales	% to CSP of tax collected
$200,000 - $500,000	2.3%
$100,000 - $200,000	2.7%
$50,000 - $100,000	3.0%
$20,000 - $50,000	3.3%
$5,000 - $20,000	3.7%
< $5,000	4.0%

Tennessee currently has a cap on the amount of local tax that may be charged on the sale of single articles of tangible personal property. The Agreement requires that these caps be eliminated. The prohibition does not apply to the sale of motor vehicles, boats or planes and therefore the single article cap will continue to apply to these sales after the Streamlined conforming legislation takes effect.

As a result of these requirements, a business or citizen that makes a purchase of an item costing over $1,600 will be required to pay full state and local tax on that purchase.

There is a mechanism in the Streamlined conforming legislation that allows a business to seek a refund for the additional local tax paid as a result of this law change. While this allows the change to be revenue neutral to the business, there will be a requirement for businesses that wish to seek a refund to maintain the administrative paperwork to seek the refund claim. At the same time, this eliminates the current burden placed on sellers that attempt to collect proper tax on these sales.

5. Rate Simplification:

Tennessee law contains many special rates for certain industries such as a reduced rate for electricity and energy fuels used in manufacturing. In order to conform to the requirements of the Agreement and, at the same time, preserve the tax benefits granted to these industries, the conforming legislation provides generally that these industries are granted an exemption from sales tax law for these purchases. At the same time, a special privilege tax is levied at the same rate as the sales tax on these same purchases. This will require the purchasers of these goods to self-report these taxes on a separate tax form.

As set forth above, other specific law changes are set forth on Appendix A.

Appendix A

Tennessee's Required Changes under the Streamlined Sales and Use Tax Agreement

Current Law	Streamlined law change
Intrastate telecommunications: Subject to 7% state plus 2.5% local	Subject to 7% state and applicable local rate. Fiscal effect: $2.9M decrease in local sales tax
Interstate residential telecommunications: Subject to 7% state plus 1.5% local	Subject to 7% state and applicable local rate. Fiscal effect: $6.6M increase in local sales tax
Interstate business telecommunications: subject to 7.5% state and no local	Subject to 7% state and applicable local rate. Fiscal effect: $7.95M increase in local sales tax
Direct to home satellite tv - Current 8.25% state tax - no local per federal law.	Exempt from sales tax and impose privilege tax at same rate. Fiscal Effect: $0; but $850K decrease in state shared sales taxes
Cable TV: Current tax: first $15 exempt; $15.01 to $27.50 subject to state tax rate of 8.25%; charges above $27.50 taxed at 7% state plus applicable local.	Exempt from sales tax, and impose privilege tax which exempts first $15 and taxes at 9 percent all charges above $15. Fiscal Effect: $0; but $1.35M decrease in state shared sales taxes
Energy fuels sold to businesses(other than manufacturers and farmers): Subject to 7% state and no local	Subject to 7% state and 1/2% local: Fiscal effect: $7.3M increase in local sales tax
Energy fuels and water sold to manufacturers: Taxed at 1.5% state and no local.	Exempt from sales tax, subject to privilege tax at same rate. Fiscal effect: $0; but $1.48M decrease in state shared sales taxes
Goods sold to common carriers for export outside Tennessee: State tax at 3.75% and local tax at 1.5%.	Exempt from sales tax and subject to 5.25% privilege tax. Fiscal effect: $0; but $320K decrease in state shared sales taxes
Dyed Diesel Fuel: Current: tax at 7% rate and no local.	Exempted from sales tax and applied privilege tax at same rate. Fiscal effect: $0
Diesel Fuel sold to Railcar common carriers: Current: tax at 7% rate and no local.	Exempted from sales tax and applied privilege tax at 6% rate. Fiscal effect: $0
Aviation fuel: Current: tax at 4.5% state rate and no local tax	Exempted from sales tax and applied privilege tax at same rate. Fiscal effect: $0
Dealers with no location in the state: Collect flat 2.25% local tax which is formula distributed by the Department.	Require collection at applicable local jurisdiction rate for delivery. Fiscal effect: 1.7M increase in local sales tax
Electricity and liquefied gas sold to farmers and nurserymen: taxed at 1.5% state rate and no local rate.	Exempt from sales tax. Fiscal effect: 1.2M state loss; $400K local loss but we estimate greater compliance with farm exemption due to new farmer registration
Farm Machinery: fully taxable if cost less than $250	Full exemption of farm machinery when purchased by qualified farmers and nurserymen. Fiscal effect: some loss of state and local revenue. However, we estimate greater compliance with farm exemption due to new farmer registration
Single article cap on tangible personal property: State sales tax applies to entire	Single article cap eliminated after 1/1/06 except on cars, planes, boats and mobile homes. Fiscal

purchase price of single article. Local tax applies to first $1,600 of purchase price. State sales tax of 2.75% applies to second $1,600 of purchase price.	effect: Increase local revenue: $8.54M; decrease state revenue.
Caskets and Burial Vaults: Currently first $500 purchase price of casket or burial vault is exempt.	Change: Full price of casket or burial vault is subject to tax.
Annual club membership dues: Currently first $150 annual club membership of certain clubs is exempt.	After, the total price for annual club membership dues are subject to tax.
Remanufacturing Industrial Machinery: Currently machinery costing less than $1,000 which is used for purpose of remanufacturing industrial machinery is subject to tax.	Full exemption of any remanufacturing equipment. Added a definition of "remanufacturing" which helps with administration of exemption. Fiscal impact negligible.
Sourcing: Currently all sales are sourced to location of store. Out of state sellers with no location collect flat 2.25% local rate which is divided among locals based on formula.	Change from origin or "over the counter" sourcing to destination or "delivery address" on sales that involve delivery of goods or taxable services. State provides rate and jurisdiction database to assist with determining correct local tax. Seller held harmless if collects based on database. Local government impact discussed in report.
Definition: **Sales price:** Previously taxed separately stated delivery charge based on whether title transferred prior to or after delivery.	Primary change is on sales price which **now includes all delivery charges** even if separately itemized. Fiscal impact is unknown.
Amnesty: Currently have no amnesty in our law	Streamlined agreement requires a one year amnesty period after becoming full member state.

Appendix B

Entity-Based Mitigation Plan, Simplified Scenario

BASE YEAR

	Total Local	Rutherford County	Murfreesboro	Smyrna	La Vergne	Williamson County	Franklin	Brentwood
Super Home - Murfreesboro	5,000	0	5,000	0	0	0	0	0
Super Home - Smyrna	1,000	0	0	1,000	0	0	0	0
Super Home - Brentwood	2,000	0	0	0	0	0	0	2,000
Super Home - Franklin	4,000	0	0	0	0	0	4,000	0
Bob's Hardware	300	0	0	0	300	0	0	0
Joe's Furniture	200	0	200	0	0	0	0	0
Total / Situs	12,500	0	5,200	1,000	300	0	4,000	2,000

BASE YEAR PERCENTAGES

	Total Local	Rutherford County	Murfreesboro	Smyrna	La Vergne	Williamson County	Franklin	Brentwood
Super Home - Murfreesboro	42%	0%	42%	0%	0%	0%	0%	0%
Super Home - Smyrna	8%	0%	0%	8%	0%	0%	0%	0%
Super Home - Brentwood	17%	0%	0%	0%	0%	0%	0%	17%
Super Home - Franklin	33%	0%	0%	0%	0%	0%	33%	0%
Bob's Hardware	100%	0%	0%	0%	100%	0%	0%	0%
Joe's Furniture	100%	0%	100%	0%	0%	0%	0%	0%

COLLECTIONS IN FIRST YEAR OF STREAMLINED

	Total Local	Rutherford County	Murfreesboro	Smyrna	La Vergne	Williamson County	Franklin	Brentwood
Super Home - All 4 locations	12,900	1,000	4,000	1,300	200	800	3,800	1,800
Bob's Hardware	325	50	0	25	250	0	0	0
Joe's Furniture	250	0	175	0	0	75	0	0
Total / Situs	13,475	1,050	4,175	1,325	450	875	3,800	1,800

FIRST YEAR COLLECTIONS--Using base year percentages

	Total Local	Rutherford County	Murfreesboro	Smyrna	La Vergne	Williamson County	Franklin	Brentwood
Super Home - All 4 locations	12,900	0	5,375	1,075	0	0	4,300	2,150
Bob's Hardware	325	0	0	0	325	0	0	0
Joe's Furniture	250	0	250	0	0	0	0	0
Total / Situs	13,475	0	5,625	1,075	325	0	4,300	2,150

MITIGATION

Total Local	Rutherford County	Murfreesboro	Smyrna	La Vergne	Williamson County	Franklin	Brentwood
2,300	0	1,450	0	0	0	500	350