



The Impact of the Loss of State Sales and Use Tax Revenue on Businesses and Consumers

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A Sign of the Times

Even a casual observer doesn't have to look too far or listen too hard to realize that most states are feeling enormous pain because of the current economic crisis. State tax revenues from all three major tax revenue buckets (personal income tax, corporate income tax and sales and use tax) are down significantly, and many states are now in panic mode trying to deal with these huge losses. Some states are faced with double-digit revenue shortfalls that will make it extremely difficult to balance their budgets and still fund needed projects and provide essential services.

The goal of this whitepaper is to present credible and timely data that helps to articulate, both in quantitative and practical terms, the depth of the situation that most states find themselves in, both presently, and for the foreseeable future. Additionally, we will examine how states will likely deal with their financial woes, and some of the measures that states have already taken to generate additional revenue. Our analysis is limited to revenue shortfalls related to transactional taxes such as sales and use tax.

Just How Bad Is It?

The Nelson A. Rockefeller Institute of Government, as reported in the October 2009 edition of the State Revenue Report, quantifies the decline of sales tax revenue for the second quarter of 2009 to be 9.5%.

Of the forty-five states that have a broad-based sales tax, forty-two of them had declines during the second quarter of 2009, and fourteen of those states had double digit declines. The state of Wisconsin had the greatest decline of 34.4%, followed by Arizona at 27.3%. This decline represents the greatest decline in the 45 years that quarterly data has been available. Additionally, a Nelson A. Rockefeller Institute of Government State Revenue Flash Report dated November 23, 2009, projected the decline of third quarter sales and use tax revenue to be around 8.2%.

In a recent *Wall Street Journal* article entitled "States' Woes Are Poised to Worsen," dated June 3, 2009, the author Amy Merrick identifies a number of key points that support the depth of the financial woes that states are experiencing due to the current economic crisis. Some of the major points in her article include:

- The drop of tax revenue is set to be deeper and last longer as collection becomes more sensitive to business cycles.
- States are facing growing health-care costs and the need to replenish pension programs funded by decimated investments.
- Quoting from Scott Pattison, executive director of the National Association of State Budget Officers, her article includes the following statement: "This is an awful time for states fiscally, but they're even more worried about 2011, 2012, 2013, 2014."
- Altogether, states face aggregate budget shortfalls of at least \$230 billion from fiscal 2009 through fiscal 2011, according to Mr. Pattison.
- State tax collections could take five years or more from when the recession began in December 2007 to recover to prerecession levels, says Donald J. Boyd, senior fellow at the Nelson A. Rockefeller Institute of Government at the State University of New York.

- In April (2009) Tennessee's sales tax revenue was 9.9% below the previous year, and total tax revenue for the month was nearly \$200 million less than the state's forecast.

(<http://online.wsj.com/article/SB124398568837379031.html>)

There are numerous reports, articles and publications that communicate the exact same story — states are really hurting! In a very consumer sensitive economy, and one that is being threatened by growing unemployment nationwide, the declining tax revenues are forcing states to make difficult decisions that affect us all. Like any other ongoing concern, in order to keep moving forward states will have to increase income, cut costs or both. In today's economic environment, the solution will most assuredly involve both.

What Can States do to Increase Their Sales and Use Tax Revenue?

Obviously a state has a lot of options at its disposal to generate additional sales and use tax revenue and help ease the burden created by the current economic crisis. However, states will have to make sure that they thoroughly weigh all the pros and cons of their decisions to ensure that they will actually be better off as a result of any action taken.

Some options open to states will likely include the following:

- 1) Increase audit activity and enforcement.
 - a. Perform more (or greater revenue-producing) audits either through improving internal processes or increasing audit staff, or both.
 - b. Modify audit policies and procedures to become more efficient.
 - c. Develop more efficient ways of finding and pursuing non-registered sellers that have a legal obligation to collect.
 - d. Be more assertive and objective in conducting audits, and be less sympathetic towards taxpayer, non-compliance stories and excuses.
- 2) Increase tax collection efforts by beefing up collection staff and or becoming more efficient in the collection process.
- 3) Expand existing nexus statutes, following New York's lead relative to the so-called "Amazon" law.
- 4) Increase tax rates.
- 5) Expand the taxable base and eliminate statutory exemptions.
- 6) Reduce or eliminate Vendor Compensation.
- 7) Invest in more advanced tax collection technology.
- 8) Expand mandatory EDI filing, *e-filing* and website filing requirements to reduce publishing and mailing cost, and to shorten time gaps for fund access.
- 9) Become a member of Streamlined Sales Tax (SST).

The three obvious choices that a state would probably select to increase its revenue would be: 1) raise current tax rates, 2) expand the taxable base to include additional services and digital products, and 3) increase audit and tax collection efforts. Of these three likely candidates, increasing audit and tax collection efforts, or in other words, enforcing existing laws, would be the only one that wouldn't carry any potential negative risk.

Raising tax rates and expanding the taxable base may result in additional reduction of consumer spending and/or an increase in e-commerce purchases from non-tax collecting remote sellers, as well as outcries from the business community. Though increasing the tax burden of existing businesses and consumers would no doubt be positive in favor of the state, it would seem much fairer if the states would just increase the quantity and improve the quality of their sales and use tax audits, thereby better enforcing laws that already exist rather than just taking the easy way out by increasing tax rates. Since an Audit Division and Collections are the primary revenue enforcers (and generators) for the state, it would be advantageous to begin the additional revenue generating process with those that actually enforce the law.

Additionally, in the spirit of enforcing existing laws, there are many businesses out there that have legal obligations to collect sales and use tax in their own state as well as other states, but continue to remain under the radar because states can't seem to catch up with them. Rather than allocating so much time on businesses that are trying to comply with the law, they could allocate additional energy to those folks that are "stinking up the place" by not complying very well or that are hiding from their legal obligations. Also, investing in better tax collection systems would most assuredly make a difference in helping to find those folks that continue to remain one step ahead of the long-arm of the law.

Another item listed above that appears to be drawing a lot of attention right now in the inner-circles of state government is the so-called "Amazon" law that was passed in the state of New York recently. The new law (effective June 1, 2009) essentially creates a "presumption of nexus" for an out-of-state seller when it enters into an agreement

with an affiliate who does have nexus in New York, if the affiliate referrals result in sales of \$10,000 or more in the prior four quarters. Amazon filed a suit challenging the constitutionality of the new law, but was unsuccessful. The New York Supreme Court ruled that the new law did not violate the Clauses of the US Constitution that Amazon claimed — namely the Commerce, Due Process, and the Equal Protection Clauses.

Another possible sales and use tax revenue opportunity for many states would be to introduce Streamlined Sales Tax (SST) conformity legislation that would bring their statutes in conformity with the Streamlined Sales and Use Tax Agreement (SSUTA). As of the end of 2008, it is estimated that the additional sales and use tax revenue generated through voluntary registration in SST was slightly above \$171 million. Although SST appears to be losing some momentum among non-member states because of the current buzz about the so-called "Amazon" law, SST states could benefit greatly from a potential windfall if the Main Street Fairness Act, which will soon be introduced into Congress, becomes law.

The Main Street Fairness Act, similar to prior federal sales tax legislation, is designed to "level the playing field" between e-commerce and traditional "brick and mortar" stores by granting authority for SST states to require tax collection from remote sellers (not otherwise qualifying as exempt under a small business exception) doing business in their state. Currently, remote sellers without "substantial" nexus (associated with the 1992 Quill v. North Dakota Supreme Court decision) are excused from the obligation of collecting transactional taxes. Even though major lobbying efforts have been under way for some time, and states are facing huge revenue shortfalls, the road to passage of Federal sales tax legislation still appears to be an uphill battle.

If and when federal legislation does pass, and/or other states move forward and pass New York type "Amazon" laws, the tax revenue generated from e-commerce will create huge amounts of new revenue for the states. This assumption is well supported by current data. According to a recent study by a team from the University of Tennessee, released in mid-April 2009, the estimated

total annual sales (primarily use) tax revenue lost through e-commerce by 2012 will be between 11.4 billion to 12.65 billion.

(http://www.streamlinedsalestax.org/Executive%20Committee/Previous_meetings/4_13_09/SSTP%20e-commerce%202009%20REV041309.pdf)

What Are States Doing, to Combat Their Revenue Shortfalls?

There are plenty of examples out there of actions that states have taken or are in the process of implementing that will generate additional needed revenue. I won't attempt to list all of the things that have been done or that will be done, but I will attempt to present a representative sample of them.

- 1) A handful of states have or will be increasing their tax rates this year or early next year including the following: **California, Maine, Massachusetts, Minnesota, Nevada, North Carolina, and Utah.** **Arizona** also appears to be working on an increase.
- 2) A number of localities have or will be increasing their tax rates this year including localities in the following states: **Alabama, Arizona, California, Illinois, Oklahoma, Louisiana, Missouri, New York, North Dakota, Ohio, South Carolina, Tennessee, Texas, Utah and Washington.**
- 3) A number of states are expanding their taxable bases this year or early next year to include current non-taxable services or digit products. These states include: **Maine, Mississippi, New York, Washington and Wisconsin.**
- 4) A number of states have also introduced or are seriously considering introducing expanded nexus legislation. These states include: **California, Connecticut, Florida, Illinois, Michigan, North Carolina, Rhode Island, Tennessee and Texas.**

Note: The state of Hawaii actually passed a similar law recently, which was vetoed by the Governor.

- 5) Last year, the state of **Maryland** implemented a new \$90 million tax collection system to make it easier to find businesses and individuals not paying taxes.

- 6) Audit activity is up pretty much across the board according to numerous published articles as well as independent audit defense consulting firms. Another example of the plans to increase audit activity is the state of **Maryland**, which hired 22 additional auditors last year to target a small number of tax "scofflaws" as reported in an article printed in the *Baltimore Business Journal* (March 20, 2009). Also, at the Georgetown University Law Center's 32nd Annual Advance State and Local Tax Institute held on May 14th and 15th 2009, state employees from the various Department of Revenues were part of a discussion panel that indicated that their states intended to step up audit efforts in various ways to help deal with the bad economy.
- 7) The state of Connecticut has implemented a sophisticated systemic audit selection scoring process that makes audit selection more efficient and is increasing the amount of tax revenue assessed per audit hour conducted. Since its implementation, tax revenue through audits has increased while the number of audits performed has decreased slightly.
- 8) The state of **Colorado** reduced its Service Fee (also identified as Vendor Compensation in other states) from 3.33% to 1.35%.
- 9) Effective January 1, 2010, the state of **Washington** will replace existing self issued resale certificates with sellers' permits that must be pre-approved by the state. This law is expected to generate \$130 million in state and local revenue annually that has been lost as a result of taxpayers abusing resale certificate privileges.
- 10) A number of states have recently or are seriously considering introducing Streamlined Sales Tax (SST) conformity legislation including: **Florida, Hawaii, Illinois, Massachusetts and Texas.**

About the Author

Phil Schlesinger has been in the sales/use tax field for 22 years and has been involved in all areas of sales/use tax including compliance, audit, tax research, and automation, both in a corporate environment and in a consulting role. While in consulting, he prepared taxability matrixes for dozens of companies representing numerous types of industries such as software, manufacturing, services, food, medical, advertising and construction. Over his career, Phil has also been heavily involved in the design, testing and operation of several sales/use tax software tax calculation engines and tax return processing systems including CCH, Vertex, Taxware and AvaTax.

Conclusion:

The goal of this whitepaper was to create for the reader a fairly realistic view of the landscape as seen from the eyes of the struggling states. For many states, the picture is very grim and could take years to rebound from the current economic downturn. Whether popular or not, states will have cut costs and generate additional revenue. The hope is that states would first become more efficient and enforce the existing laws that they have (as demonstrated by the state of Washington relative to resale certificate administration), but the preferred and easiest approach to adjusting to revenue shortfalls may be to have the businesses and consumers shoulder the burden by having them endure tax rate increases. Whatever approach the states decide to take to generate the additional needed revenue, you can bet that sales and use tax will be at the forefront of the discussions and resolutions.



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