Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXECUTIVE SUMMARY

The hearing officers, René Blocker and Harley Duncan, submit this Initial Report without recommending action by the Executive Committee at this time on the proposed Model Direct Payment Permit Regulation. The hearing officers believe that it would be prudent to await issuing a final report with recommendations until after the EDI Task Force has formally and finally approved the Model Regulation. Because the Task Force drafted this proposal and because the Task Force sought to benefit from the MTC's public hearing process before finalizing the proposed regulation, the hearing officers believe that the MTC should hold its consideration until the Task Force has completed its product. In practical terms, since the Model Regulation as revised during this hearing process reflects changes made by members of the EDI Task Force in response to comments submitted during the public hearing, it is anticipated that the Task Force's final version of the Model Regulation will be very much like, if not identical to, the revised proposal set forth in this Initial Report at pages 10 to 13. The hearing officers find these revisions to be reasonable and consistent with the development of a clear guideline for administering direct pay permits and, if required to at this time, would recommend adoption of the Model Regulation as revised.

For the reasons stated above, we present this as an Initial Report with the expectation of submitting an additional report within 60 days after the Task Force has approved its final version of the Model Regulation. The hearing officers' subsequent report would describe the differences, if any, between the Task Force's final approved version and the current revised version and include a recommendation as to whether the MTC should consider the Model Regulation as a uniformity recommendation or whether other action, such as conducting an additional public hearing, should be taken. Of course, the hearing officers understand, as should the public, that the Executive Committee may accept, reject or modify the recommendations set forth in this report and in any subsequent reports.

BACKGROUND AND PROCEDURAL HISTORY

This report reflects the record created during the MTC public hearing regarding a proposed Model Direct Payment Permit Regulation. The Model Regulation was developed by state and business representatives working jointly to comprise the Task Force on EDI Audit and Legal Issues ("Task

jointly to comprise the Task Force on EDI Audit and Legal Issues ("Task Force"). Drafted specifically by the Electronic Business Processes Work Group of this Task Force, the Model Regulation was designed to establish a uniform standard among the states for the administration of taxpayers' direct pay requests.

The Task Force sought to obtain the benefit of the MTC's public hearing process on its work product so that its final "recommended guideline" on direct pay might reflect broad public input. Pursuant to the MTC Executive Committee's authorization of a public hearing on this matter, notice of the hearing was sent to the state tax agencies, business organizations, the state tax press, state tax practitioners and members of the public. The hearing was held on Friday, July 16, 1999, in Washington, D.C., and a number of interested parties participated via telephone. See Notice at Exhibit A. Several members of the Task Force participated in the hearing, as did a number of other state and business representatives. Written comments were submitted on behalf of three states and one company (which also presented its comments orally during the hearing). See Exhibits B through E. In addition, the Task Force submitted suggested revisions to the Model Regulation following consideration of comments made by other hearing participants. See Exhibit F. The public comment period was extended approximately 45 days to accommodate additional submissions like that of the Task Force.

SUMMARY AND DISCUSSION OF PUBLIC HEARING COMMENTS

Overall, the comments received during the hearing process were in general support of the model direct pay permit proposal. None of the comments submitted expressed opposition to the proposal. Several commentators suggested revisions to the language of the proposal. A review and summary of the comments received follows.

The State of Arkansas indicated that the model direct pay proposal, although certainly acceptable, is more restrictive than that State's with respect to the use of direct pay permits. Section F of the Model Regulation lists transactions for which a direct pay permit cannot be used. Arkansas' statute and regulation is written very broadly and would appear to allow direct pay permits to be utilized for many of the transactions excluded under the Model Regulation. See Exhibit B.

The Virginia Tax Commissioner commented that the Model Regulation is clearly and concisely written and is detailed enough to provide guidance on direct pay in Virginia. The Commissioner noted two items, however: 1) Virginia limitations on the type of taxpayers eligible for direct pay status

would have to be incorporated for that state's purposes; and 2) direct pay permit holders in Virginia are not entitled to a dealer's discount on use tax remitted under direct pay. It was suggested that the model direct pay regulation include a similar disallowance of vendor discounts. See Exhibit E.

The Washington Department of Revenue submitted comments expressing its (and the local business community's) continuing interest in a model direct pay permit provision, although a recently introduced bill authorizing direct pay in Washington did not pass. See Exhibit D. The Department also made comments specifically on Sections A, C, G, I and J of the Model Regulation, comments that were the primary subject of discussion during the July 16th hearing. Because of Washington's remarks, the EDI Task Force decided to submit revisions to the Model Regulation in response. These revisions will be discussed in detail below.

Marathon Ashland Petroleum LLC presented its comments applauding the drafting of the model direct pay regulation and illustrating the company's view of the effectiveness of direct payment permits for large companies. The company explained that its experience with the use of direct pay permits helped to reduce its administrative burdens of sales and use tax compliance and facilitated more accurate tax liability determinations. Through the centralization of internal tax decisions, the application of statistically developed net tax rates and the use of direct pay as well as working together with state tax agencies in the implementation and maintenance of its tax compliance program, the company explained that it can more efficiently and accurately handle the tens of thousands of invoices processed on a monthly basis. See Exhibit C.

EDI Task Force Response to State Comments

Comments made by the Washington Department of Revenue prompted the Task Force to review the Model Regulation to try to address the issues raised. As a result, the Task Force has submitted several revisions to the language of the Model Regulation and changes to the Task Force's explanation and commentary to the proposal. See Exhibit F for the Task Force's "redlined" revised version of the full text of the Model Regulation along with the Task Force's revised explanation and commentary. Following is a section-by-section description of each Washington comment and the Task Force response and/or amendment to the specific section of the Model Regulation. The originally drafted language of each section precedes each comment and response.

Section A—{*defines direct pay permit*}
"Direct payment permit" means a permit issued by [taxing authority] that allows a holder of such permit to accrue and pay state and local taxes under [statute] directly to the [taxing authority].

Washington State Comment
We believe a direct pay permit is a privilege a tax authority grants to a specific business. Along this line, we recommend the Model Regulation develop standards related to why a taxing authority may approve or deny an application for a direct pay permit.

Task Force Response – No change:
Section C of the Model Regulation outlines the qualification process and requirements for obtaining a direct payment authorization. If the requirements are not met a taxpayer will be denied a direct payment permit. The Task Force believes the regulation sufficiently provides the basis for approval or denial and further suggests that rather than amending the Model Regulation, a taxing authority may consider development of an administrative ruling/notice to define state-specific requirements.

Section C.(3) [Qualification Process and Requirements.]
The [chief tax administrator] or his/her designee shall review all permit applications. The review of applications shall be conducted in a timely manner so that applicants receive notification of authorization or denial within [30-120] days of the date the [chief tax administrator] or designee receives the application; however if additional documentation or discussion is required, the [chief tax administrator] or designee shall schedule a conference with the applicant prior to the end of the [30-120]-day period.

Washington State Comment
In the event additional information concerning the application for direct pay is necessary, the proposed regulation provides that the chief tax administrator or designee ***shall*** schedule a conference. Such language leaves an administrator little ability to merely request additional explanation or documentation.

Task Force Response – Amend Section C (3) as follows:
The [chief tax administrator] or his/her designee shall review all permit applications. The review of applications shall be conducted in a timely manner so that applicants receive notification of authorization or denial within [30-120] days of the date the [chief tax administrator] or designee receives the application; however if additional documentation or discussion is required, the [chief tax administrator] or designee shall notify the taxpayer

or, at taxpayer's request, schedule a conference with the applicant prior to the end of the [30-120] day period.

Section G-- Permit Holder's Duties.
The holder of a direct payment permit shall furnish a copy of the direct payment permit or other acceptable evidence, if allowed by statute, that the holder has been granted a direct payment permit, including the number of the permit and the date issued, to each vendor from whom the holder purchases tangible personal property or services. Persons who hold a direct payment permit shall not be required to issue a separate exemption certificate and shall not be required to pay the tax as prescribed in [state taxing statutes related to billing of sales or use tax by vendor].

Washington State Comment
Section G, Permit Holder's Duties: There appears to be a drafting error in this section. The second sentence of the second paragraph reads:

> If [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes **paid to vendors** in each reporting period. (Emphasis added.)

The purpose of a direct pay permit is to remit sales or use taxes directly to a taxing authority rather than a vendor. Consequently, it's unclear whether a permit holder, in agreement with the taxing authority, will keep summary records identifying vendor ***purchases*** for which sales or use tax is due ***or*** summary records identifying the amount of sales or use taxes paid to the ***taxing authority***.

Task Force Response – Amend Section G of Model Regulation for clarification. Amend Explanation and Commentary to describe circumstances in which a direct payment permit may not be issued by a taxpayer.
The purpose of a direct payment permit is to allow the taxpayer to remit sales or use taxes directly to a taxing authority. However, certain categories of transactions, such as corporate procurement card transactions, may need to be managed outside the scope of the direct payment authority granted to the taxpayer.

G. Permit Holder's Duties (2nd paragraph)
The holder of a direct payment permit shall have responsibility for accruing and paying tax directly to [taxing authority] on all taxable

transactions not taxed at the time of sale. In certain circumstances, it may be necessary for the permit holder to pay tax directly to the vendor. Where tax is paid directly to the vendor and [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes paid to vendors in each reporting period.

Section I— Local Taxes [if imposed].
A direct pay permit holder that makes taxable purchases of tangible personal property or services shall report and pay applicable local sales or use tax on those purchases. The local sales or use tax shall be calculated at the rate imposed by the jurisdiction in which the first taxable use occurs.

Washington State Comment
Section I, Local Taxes: As written, this section provides that the first place of taxable use will determine the application of local sales and use taxes. We recommend the Model Regulation allow states an option to define the point of sale as the place of first use ***or*** the actual place of sale. Doing so provides a reasonable option for states adopting the Model Regulation. It is also consistent with legislation currently in place in several states.

Task Force Response – No change:
This regulation is a recommended standard only. Certain taxing authorities will be required to amend this section of the regulation to remain consistent with existing state law. In addition, the Explanation and Commentary states "While this is a recommended standard, it is not currently true in all taxing jurisdictions. Each taxing authority will address local tax implications related to tangible personal property and services."

Section J— Revocation of Permit.
A direct payment permit is not transferable, and the use of a direct pay permit may not be assigned to a third party. Direct payment permits may be revoked by the [chief tax administrator] at any time whenever the [chief tax administrator] determines that the person holding the permit has not complied with the provisions of this regulation or that the revocation would be in the best interests of the [taxing authority]. The notice of revocation must be in writing and effective as of the end of the direct payment permit holder's normal reporting period. In the case of a business restructuring, where the taxpayer's business remains the same and effective ownership is unchanged, the direct payment permit holder shall be allowed a period of [60-120 days] to apply for direct payment status for the new entity. During such period, the previous permit shall remain in effect.

Any person whose direct payment permit is either voluntarily forfeited or revoked by action of the [taxing authority] shall return the permit to the [taxing authority] and immediately notify all vendors from whom purchases of taxable items are made advising them that the direct payment certificate issued to them pursuant to the direct payment permit is no longer valid. Failure to give notification is a violation of [statute].

Washington State Comment
Section J, Revocation of Permit: We recommend the Model Regulation incorporate language allowing a taxing authority to revoke as provided by the regulation or the normal administrative procedures of the adopting state.

We further note that this section requires the holder of a revoked permit to return the permit to the tax authority and notify vendors that the direct pay permit certificate is no longer valid. In theory, we agree with this provision. In practical terms, we believe it would be difficult to enforce such provisions.

Task Force Response – Amend Section J of Model Regulation as follows (the Task Force determined that certain issues addressed in the Model Regulation would be more appropriate in the Explanation and Commentary):
J. Revocation of Permit.
A direct payment permit is not transferable, and the use of a direct pay permit may not be assigned to a third party. Direct payment permits may be revoked by the [chief tax administrator] at any time whenever the [chief tax administrator] determines that the person holding the permit has not complied with the provisions of this regulation or that the revocation would be in the best interests of the [taxing authority]. Such revocation shall follow the administrative procedures as provided for in [insert appropriate citations to state tax statutes].

DISCUSSION OF PROPOSAL AND RECOMMENDATIONS OF THE HEARING OFFICERS

A direct pay permit authorizes the holder to remit sales or use tax due on the purchase of items directly to the tax authority instead of to the seller. States' adoption of direct pay provisions is one of the items consistently listed by the business community as an important simplification for sales and use tax compliance. (See *e.g.*; MTC Sales Tax Simplification Planning Committee ideas, NTA project report.) A uniform direct pay permit provision would particularly assist multistate taxpayers seeking direct pay authorization in a

number of states. Perhaps language from the EDI Task Force's *Direct Pay Interim Report*, see Exhibit G, best states the business community's concerns:

> Despite the growing interest in direct pay, there has not been a systematic review of the standards and application of the concept in state tax administration. The lack of consistency in eligibility among tax jurisdictions may make it impossible for a taxpayer to obtain direct pay status for some locations in which it does business and cause it to maintain separate recordkeeping for its operations.

The proposed Model Regulation is designed to bring uniformity to the administration of direct pay permits. It represents the thorough research, analysis and deliberation of a group of state and business representatives working jointly to achieve the express goal of producing a simple, concise provision acceptable to the greatest number of states and businesses. The current provisions of the 33 states allowing direct pay vary widely, and this diversity is the source of significant concern for multistate taxpayers seeking to obtain direct pay status in various States. As part of the process of drafting the Model Regulation, the Task Force surveyed the sales and use tax states regarding their then current direct pay requirements and restrictions and conducted independent research of state and local practices and procedures. Out of this research, the Task Force compiled a matrix of each state's direct pay requirements and restrictions. The Task Force utilized the survey responses and its research to fashion a model proposal that incorporates the most effective features of existing state provisions. State and business representatives on the Task Force worked through numerous versions of the proposal in an attempt to draft language acceptable to both tax administrators and taxpayers. As a complement to the Model Regulation, the Task Force also completed an explanation and commentary that describes some of the history and analysis of the each section of the proposal.

As noted in the section above, comments elicited during the public hearing were significant enough to persuade Task Force members to submit revisions to the Model Regulation in response. The hearing officers find these revisions to be reasonable. There are several issues that the hearing officers believe require additional discussion.

One of the comments made by Washington State suggested incorporating a provision for renewing direct pay permits. Although the Task Force's revised proposal does not include a renewability (or expiration) clause, it remains within the discretion of each state to determine whether that state would include such a provision should it adopt the regulation. The hearing officers suggest that those states wishing to address renewable permits, consider an expiration period of no less than three years. A period of three

years or more may strike a balance between the goal minimizing the administrative burdens (on both businesses and states) associated with acquiring and maintaining direct pay permits and addressing states' concerns about regulating open-ended permits.

Handling local taxes (Section I of the Model Regulation) in a direct pay regime was another concern raised by Washington. It bears reiterating the Task Force's response that the Model Regulation sets for a standard for sourcing local sales and use tax that certainly is subject to modification depending on the applicable state and local statutes in each jurisdiction. Although uniformity among all of the states is the goal, it is recognized that states' existing provisions may preclude them from adhering to the standard set forth in the proposal.

Additionally, the comments from Virginia raised an issue (currently in litigation) regarding the availability of vendor discounts to direct payment permit holder. If the purpose of the discount is to try to compensate the vendor for expenses incurred in collecting the sales or use tax from customers on behalf of the state and then remitting the collected tax to the state, it would appear that the reason for providing a vendor discount does not apply to direct pay circumstances, where the holder remits its own use tax to the state. Indeed, since direct pay permits are intended to relieve many of the administrative burdens of both purchasers and vendors, the necessity for a vendor discount becomes more tenuous. Although many states do not provide vendor discounts, the hearing officers alert those states with vendor discounts of the need to address this issue should they adopt the Model Regulation. The vendor discount states should consider including language to clarify that a vendor discount will not be provided for the portion of use tax remitted by a taxpayer under a direct pay permit.

Because the Task Force has not yet formally approved the Model Regulation, the hearing officers will hold in abeyance any recommendations to the Executive Committee until the Task Force has completed its approval process. In this Initial Report, the hearing officers find that the Model Regulation as revised by the Task Force during this hearing process, should be considered for adoption after the Task Force formally approves it. (Additionally, the hearing officers also recommend that the Task Force's explanation and commentary be included in the publication of the Model Regulation, for information purposes only, leaving to the individual states the decision to adopt it or not.) It is the intention of the hearing officers to issue a final report to the Executive Committee within 60 days of the approval of the final proposal by the Task Force. Should the Task Force make additional changes to the proposal, the hearing officers would include in their report a recommendation regarding whether that revised Model Regulation should be

adopted by the Commission. The current revised Model Regulation is set forth below. (The current revised Task Force explanation and commentary is attached as part of Exhibit F.)

MODEL DIRECT PAYMENT PERMIT REGULATION

A. "Direct payment permit" means a permit issued by [taxing authority] that allows a holder of such permit to accrue and pay state and local taxes under [statute] directly to the [taxing authority].

B. Application for Permit. Applicants for a direct payment permit must apply in writing to the [chief tax administrator]. The application shall be on a form required by the [chief tax administrator] or in a letter containing the applicant's name, address, the location of the place or places of business for which the applicant intends to make direct payment of tax, the sales and use tax account number(s) for which direct payment will be made, and any other information that the [taxing authority] may require.

C. Qualification Process and Requirements.

(1) Applicants for a direct payment permit shall demonstrate the applicant's ability to comply with the [taxing authority] sales and use tax laws and reporting and payment requirements. The applicant must provide a description of the accounting system(s) which will be used by the applicant and demonstrate that the accounting system(s) will reflect the proper amount of tax due.

(2) Applicants must establish a business purpose for seeking a direct payment permit and must demonstrate how direct payment will benefit tax compliance. For example, the utilization of direct payment authority should accomplish one or more of the following:

(a) Reduce the administrative work of determining taxability; collecting, verifying, calculating and/or remitting the tax;
(b) Provide for improved compliance with the tax laws of the [taxing jurisdiction];
(c) Provide for accurate compliance in circumstances where determination of taxability of the item is difficult or impractical at the time of purchase;
(d) Provide for more accurate calculation of the tax where new or electronic business processes such as electronic data

interchange, evaluated receipts settlement, or procurement cards are utilized;
(e) Provide for more accurate determination and calculation of tax where significant automation and/or centralization of purchasing and/or accounting processes have occurred and applicant must comply with the laws and regulations of multiple state and local jurisdictions.

(3) The [chief tax administrator] or his/her designee shall review all permit applications. The review of applications shall be conducted in a timely manner so that applicants receive notification of authorization or denial within [30-120] days of the date the [chief tax administrator] or designee receives the application; however if additional documentation or discussion is required, the [chief tax administrator] or designee shall notify the taxpayer or, at taxpayer's request, schedule a conference with the applicant prior to the end of the [30-120]-day period.

D. Recordkeeping Requirements. A direct payment permit holder shall maintain all records that are necessary to a determination of the correct tax liability under [insert appropriate citations to state tax statutes]. All required records must be made available on request by the [taxing authority] or its authorized representatives as provided for in [insert appropriate citations to state tax statutes].

[Insert elements of state law which require certain records to be retained (e.g., books of account, invoices, sales receipts), or specific tax elements or transactions (e.g., credits) for which particular records may be required.]

E. Reporting of Tax. Each holder of a valid direct payment permit shall, on a form approved by the [taxing authority], accrue and pay directly to the [taxing authority] the taxes due under [statute] for all transactions subject to tax for which a direct payment permit applies. Taxes for which the direct payment permit is used shall be considered due and payable on the sales and use tax return next due following the date on which a determination of taxability is, or in the exercise of reasonable care should be, made for a given transaction, unless otherwise provided by written agreement between the taxpayer and the [taxing authority].

F. Certain Transactions Not Permitted. A holder of a direct pay permit shall not use such permit in connection with the following transactions:

(1) purchases of taxable meals or beverages;

(2) purchases of taxable lodging or services related thereto;

(3) purchases of admissions to places of amusement, entertainment or athletic events, or the privilege of use of amusement devices;

(4) purchases of motor vehicles, or other tangible personal property required to be licensed or titled with a taxing authority, taxed under [taxing authority] statutes [list applicable sections];

(5) purchases of any of the following enumerated services listed in [tax authority] statutes. [List applicable sections. May include services such as telecommunications and utilities.]; and

(6) Such other purchases as may be agreed to between the holder of the direct payment permit and the [taxing authority].

G. Permit Holder's Duties. The holder of a direct payment permit shall furnish a copy of the direct payment permit or other acceptable evidence, if allowed by statute, that the holder has been granted a direct payment permit, including the number of the permit and the date issued, to each vendor from whom the holder purchases tangible personal property or services. Persons who hold a direct payment permit shall not be required to issue a separate exemption certificate and shall not be required to pay the tax as prescribed in [state taxing statutes related to billing of sales or use tax by vendor].

The holder of a direct payment permit shall have responsibility for accruing and paying tax directly to [taxing authority] on all taxable transactions not taxed at the time of sale. In certain circumstances, it may be necessary for the permit holder to pay tax directly to the vendor. Where tax is paid directly to the vendor and [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes paid to vendors in each reporting period.

H. Vendor's Responsibilities. Receipt of the direct payment permit or other acceptable evidence that the holder has been granted a direct payment permit, shall relieve the vendor of the responsibility of collecting the sales tax on sales made to a direct payment permit holder on qualifying transactions. Vendors and sellers who make sales upon which the tax is not collected by reason of the provisions of this section shall maintain records in such manner that the amount involved and identity of the purchaser may be ascertained. Receipts from such sales shall not be subject to the tax levied in [state taxing statutes related to billing of sales or use tax by vendor].

I. Local Taxes [if imposed]. A direct pay permit holder that makes taxable purchases of tangible personal property or services shall report and pay applicable local sales or use tax on those purchases. The local sales or use tax shall be calculated at the rate imposed by the jurisdiction in which the first taxable use occurs.

J. Revocation of Permit. A direct payment permit is not transferable, and the use of a direct pay permit may not be assigned to a third party. Direct payment permits may be revoked by the [chief tax administrator] at any time whenever the [chief tax administrator] determines that the person holding the permit has not complied with the provisions of this regulation or that the revocation would be in the best interests of the [taxing authority]. Such revocation shall follow the administrative procedures as provided for in [insert appropriate citations to state tax statutes].

Initial Report of the Hearing Officers
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EXHIBIT A

NOTICE OF PUBLIC HEARING

regarding a proposed

MODEL DIRECT PAYMENT PERMIT REGULATION

The MULTISTATE TAX COMMISSION has scheduled a public hearing to obtain comments from interested parties on a proposed model regulation to authorize the use of direct payment permits in the states. The model regulation was developed jointly by state and business representatives participating in the Electronic Business Processes Work Group of the Task Force on EDI Audit and Legal Issues for Tax Administration ("EDI Task Force"). This industry-government cooperative effort has as its purpose to analyze and address the tax administration issues that arise out of electronic data interchange and other emerging business processes.

The hearing on this proposal will be held at the following location on the date and at the time specified below:

FRIDAY, JULY 16, 1999, 2:30 P.M. (EASTERN)
Hall of the States Building
444 North Capitol Street, N.W., Suite 231
Washington, D.C. 20001-1538

Public comment is sought on whether the proposed model regulation as currently drafted should be adopted by the EDI Task Force and by the Multistate Tax Commission. The text of the proposal has been provided with this notice. (The proposed model provision and this notice are available on the MTC's website at www.mtc.gov.) General comments about the proposal as well as comments regarding the specific language of the provisions are encouraged.

All public comments received during this process will be set forth in a hearing officers' report that will be submitted to the MTC Executive Committee and to the EDI Task Force work group. It is anticipated that the MTC Executive Committee will reserve its action on the report until after the EDI Task Force Work Group has reviewed and considered the public comments and hearing officers' recommendations.

The hearing officers for this matter are René Blocker and Harley Duncan. Please submit all questions, comments and correspondence regarding this hearing matter to:, Hearing Officers, Attn.: René Blocker, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (202) 624-8699, Fax: (202) 624-8819, E-mail: rblocker@mtc.gov

All interested parties are invited to participate in this public hearing. Parties wishing to make formal oral presentations are requested to notify the hearing officers in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged and may be provided any time prior to or on the hearing date or by such later date as may be announced for the closing of the public hearing period. Interested parties may participate via telephone by dialing (703) 736-7307 at the time indicated for the hearing. Advise the operator that you wish to participate in the "direct payment hearing" teleconference moderated by René Blocker. The confirmation number for the call is 1610385.

MODEL DIRECT PAYMENT PERMIT REGULATION

A. "Direct payment permit" means a permit issued by [taxing authority] that allows a holder of such permit to accrue and pay state and local taxes under [statute] directly to the [taxing authority].

B. Application for Permit. Applicants for a direct payment permit must apply in writing to the [chief tax administrator]. The application shall be on a form required by the [chief tax administrator] or in a letter containing the applicant's name, address, the location of the place or places of business for which the applicant intends to make direct payment of tax, the sales and use tax account number(s) for which direct payment will be made, and any other information that the [taxing authority] may require.

C. Qualification Process and Requirements.

(1) Applicants for a direct payment permit shall demonstrate the applicant's ability to comply with the [taxing authority] sales and use tax laws and reporting and payment requirements. The applicant must provide a description of the accounting system(s) which will be used by the applicant and demonstrate that the accounting system(s) will reflect the proper amount of tax due.

(2) Applicants must establish a business purpose for seeking a direct payment permit and must demonstrate how direct payment will benefit tax compliance. For example, the utilization of direct payment authority should accomplish one or more of the following:

(a) Reduce the administrative work of determining taxability; collecting, verifying, calculating and/or remitting the tax;
(b) Provide for improved compliance with the tax laws of the [taxing jurisdiction];
(c) Provide for accurate compliance in circumstances where determination of taxability of the item is difficult or impractical at the time of purchase;
(d) Provide for more accurate calculation of the tax where new or electronic business processes such as electronic data interchange, evaluated receipts settlement, or procurement cards are utilized;
(e) Provide for more accurate determination and calculation of tax where significant automation and/or centralization of purchasing and/or accounting processes have occurred and applicant must comply with the laws and regulations of multiple state and local jurisdictions.

(3) The [chief tax administrator] or his/her designee shall review all permit applications. The review of applications shall be conducted in a timely manner so that applicants receive notification of authorization or denial within [30-120] days of the date the [chief tax administrator] or designee receives the application; however if additional documentation or discussion is required, the [chief tax administrator] or designee shall schedule a conference with the applicant prior to the end of the [30-120]-day period.

D. Recordkeeping Requirements. A direct payment permit holder shall maintain all records that are necessary to a determination of the correct tax liability under [insert appropriate citations to state tax statutes]. All required records must be made available on request by the [taxing authority] or its authorized representatives as provided for in [insert appropriate citations to state tax statutes].

[Insert elements of state law which require certain records to be retained (e.g., books of account, invoices, sales receipts), or specific tax elements or transactions (e.g., credits) for which particular records may be required.]

E. Reporting of Tax. Each holder of a valid direct payment permit shall, on a form approved by the [taxing authority], accrue and pay directly to the [taxing authority] the taxes due under [statute] for all transactions subject to tax for which a direct payment permit applies. Taxes for which the direct payment permit is used shall be considered due and payable on the sales and use tax return next due following the date on which a

determination of taxability is, or in the exercise of reasonable care should be, made for a given transaction, unless otherwise provided by written agreement between the taxpayer and the [taxing authority].

F. Certain Transactions Not Permitted. A holder of a direct pay permit shall not use such permit in connection with the following transactions:

(1) purchases of taxable meals or beverages;
(2) purchases of taxable lodging or services related thereto;
(3) purchases of admissions to places of amusement, entertainment or athletic events, or the privilege of use of amusement devices;
(4) purchases of motor vehicles, or other tangible personal property required to be licensed or titled with a taxing authority, taxed under [taxing authority] statutes [list applicable sections];
(5) purchases of any of the following enumerated services listed in [tax authority] statutes. [List applicable sections. May include services such as telecommunications and utilities.]; and
(6) Such other purchases as may be agreed to between the holder of the direct payment permit and the [taxing authority].

G. Permit Holder's Duties. The holder of a direct payment permit shall furnish a copy of the direct payment permit or other acceptable evidence, if allowed by statute, that the holder has been granted a direct payment permit, including the number of the permit and the date issued, to each vendor from whom the holder purchases tangible personal property or services. Persons who hold a direct payment permit shall not be required to issue a separate exemption certificate and shall not be required to pay the tax as prescribed in [state taxing statutes related to billing of sales or use tax by vendor].

The holder of a direct payment permit shall have responsibility for accruing and paying tax directly to [taxing authority] on all taxable transactions not taxed at the time of sale. If [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes paid to vendors in each reporting period.

H. Vendor's Responsibilities. Receipt of the direct payment permit or other acceptable evidence that the holder has been granted a direct payment permit, shall relieve the vendor of the responsibility of collecting the sales tax on sales made to a direct payment permit holder on qualifying transactions. Vendors and sellers who make sales upon which the tax is not collected by reason of the provisions of this section shall maintain records in such manner that the amount involved and identity of the purchaser may be ascertained. Receipts from such sales shall not be subject to the tax levied in [state taxing statutes related to billing of sales or use tax by vendor].

I. Local Taxes [if imposed]. A direct pay permit holder that makes taxable purchases of tangible personal property or services shall report and pay applicable local sales or use tax on those purchases. The local sales or use tax shall be calculated at the rate imposed by the jurisdiction in which the first taxable use occurs.

J. Revocation of Permit. A direct payment permit is not transferable, and the use of a direct pay permit may not be assigned to a third party. Direct payment permits may be revoked by the [chief tax administrator] at any time whenever the [chief tax administrator] determines that the person holding the permit has not complied with the provisions of this regulation or that the revocation would be in the best interests of the [taxing authority]. The notice of revocation must be in writing and effective as of the end of the direct payment permit holder's normal reporting period. In the case of a business restructuring, where the taxpayer's business remains the same and effective ownership is unchanged, the direct payment permit holder shall be allowed a period of [60-120 days] to apply for direct payment status for the new entity. During such period, the previous permit shall remain in effect.

Any person whose direct payment permit is either voluntarily forfeited or revoked by action of the [taxing authority] shall return the permit to the [taxing authority] and immediately notify all vendors from whom purchases of taxable items are made advising them that the direct payment certificate issued to them pursuant to the direct payment permit is no longer valid. Failure to give notification is a violation of [statute].

Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXHIBIT B

Blocker, René

From: Ed Hicks [ed.hicks@rev.state.ar.us]
Sent: Thursday, July 08, 1999 11:15 AM
To: 'rblocker@mtc.gov'
Cc: John Theis
Subject: Model Direct Payment Permit Regulation

René:

Arkansas has reviewed the proposed regulation and found the regulation acceptable but somewhat more restrictive (Section F. (1)(2) of proposed regulation) than our statute and regulation on direct pay permits. Arkansas would allow our direct pay permit holders to accrue the purchase of items 1&2 of Section F. Please see the following Arkansas code and regulation treatment of direct pay permits:

§ 26-52-509. Direct payment of tax by consumer or user generally.
Statutes
(a) In the exercise of his discretion, the Director of the Department of Finance and Administration may, by agreement with any consumer or user, permit a consumer or user under such agreement to accrue and remit gross receipts taxes directly to the Department of Finance and Administration, instead of such taxes being collected and paid by the seller as provided in § 26-52-508.
(b) The agreements may be revoked at any time by the Director of the Revenue Division whenever the director determines that the revocation thereof should be in the best interests of collection of gross receipts taxes.
(c) A consumer or user being permitted to report gross receipts taxes directly to the department shall not be entitled to any discount for any collection and shall be subject to all provisions of the Arkansas Gross Receipts Act, § 26-52-101 et seq., in the same manner as the taxpayer liable to remit taxes under the Arkansas Gross Receipts Act.
(d) This section is supplemental to the Arkansas Gross Receipts Act.

GR-87. DIRECT PAYMENT TO THE STATE:
A. In his discretion, the Commissioner may permit a consumer to accrue and remit the tax directly to the Commissioner instead of having such tax collected and paid by the seller. In order for a consumer to obtain a direct payment number he must show and certify the following:
1. that he will comply with the provisions of Ark. Code Ann. §26-52-101 et seq., 26-53-101 et seq. and 26-18-101 et seq., and these regulations;
2. that he will faithfully report and remit the tax on or before the twentieth day of the month for the previous month's taxable purchases.
B. Direct payment permits may be canceled by the Commissioner at any time whenever the Commissioner determines that the person holding the permit has not complied with the provisions of this regulation or that the cancellation would be in the best interests of the collection of the tax. A direct pay permittee is not entitled to any discount for prompt payment of the tax.
C. The tax will be remitted directly by a direct pay permit holder to the Commissioner of Revenues. A use vendor or sales tax retailer selling to the holder of a valid direct pay permit is not responsible for the collection of the tax.

D. Direct pay permit holders shall accrue and remit the local tax of the city or county where the property purchased is first used, stored, consumed or distributed. When direct pay permit holders purchase taxable services, they must accrue and remit the local tax of the city or county where the services are performed.

Ed Hicks

Excise Tax Administrator
501-682-7200

Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXHIBIT C

Comments to Multi-State Committee on Direct Pay

Personal Introduction - Good Afternoon, my name is Brad Allsop. I am the Sales, Use, and Tax Systems Manager for Marathon Ashland Petroleum LLC (MAP).

MAP is an entity with $20 billion in annual sales and over 30,000 employees. It operates 7 refineries and distributes refined products in 25 states under the brand names of Marathon, Speedway, and SuperAmerica. I appreciate the opportunity today to make comments.

The purpose of my comments are to applaud the drafting of this model regulation and to provide insight on how MAP, in partnership with state taxing authorities, has used Direct Pay Permits to streamline compliance. The adoption of this model regulation would permit the expansion of this partnership.

Several years ago one of our Tax Department employees, who works with State Tax Auditors, came to Management with an idea to simplify the use tax compliance procedures. As the idea developed it became apparent that not only would the Tax Department benefit, but so would our operating and accounting personnel as well as the state taxing authorities.

As we began to refine the concept inside the Company and with various state tax authorities, everyone who was involved in the old process could see the benefits. It used the science of statistics and technology to relieve hundreds of non-tax professionals from making use tax decisions. Decisions which only a few people are competent to make. I'll explain the program in more detail later.

The one critical element necessary to allow this innovative program to proceed is a **Direct Pay Permit**. Today, in some states MAP and some of it's subsidiaries do not qualify to obtain Direct Pay Permits because of obscure and out-dated rules or regulations.

Your model regulation, when enacted, will remove such impediments and allow MAP and other large, sophisticated taxpayers to work with State Tax Administrators to comply efficiently with the state sales & use tax rules. This will permit State Tax Administrators to focus their limited resources toward areas that currently lack attention.

To appreciate the new use tax program, which we have called STATS which stands for Sales Tax Administration Through Statistics, let me first describe the old process. (Please refer to the picture labeled "Old Process").

All Sales & Use Tax returns are filed by the Tax Department out of one central office. Data for these returns would come from many different field locations. Invoices were being reviewed, in those field locations, by non-tax professionals and Tax was receiving the results of their analysis. There were records processors, accounts payable personnel, purchasing personnel, drilling superintendants, production managers, and numerous others reviewing the invoices for tax consequences. This invoice review process must be completed quickly to pay our vendors and receive any discount for timely payments. The small window for payment eliminated the idea of sending the information to Tax for review and then sending the information back to the field locations for processing. Even as technology has evolved to allow us to communicate with electronic Imaging and e-mail systems, the shear volume of invoices processed made a manual review in Tax impractical. MAP in any given month processes over 65,000 invoices. These invoices are received in paper, via EDI and using ERS systems.

Tax made every effort to train these non-tax professionals. Annual Sales & Use Tax sessions were put on for the field location personnel. A Sales & Use Tax manual was developed and sent out to all tax reviewers with updates sent out periodically. Significant time was being spent to assist these people in making tax decisions. And for the first two weeks or so after a training session, they did an adequate job. This usually lasted until their responsibilities were reassigned or a new project came up and tax was put on the back burner.

The results of this process were that Tax made every effort to re-review the work completed by the field location personnel. This was time consuming, inefficient and always after the fact. In some cases, tax was accrued, but in the wrong state or the Michigan manufacturing exemption laws were being applied to a Louisiana invoice. Come audit time, our audits were becoming longer in duration and the undesirable audit exposure was increasing. Our exposure was going up because so many non-tax professionals were involved in the decision making process. Because so many people were involved, reverse audits became necessary to look for overpayments. Again, a time consuming process. Reverse audits are nothing more than trying to fix a symptom instead of addressing the root cause of the problem. In addition to these existing problems, new ones were popping up with the evolution of electronic data interchange and evaluated receipts settlement systems. As you can tell the old process was very administratively heavy.

The new process is based on the science of statistics and technology to streamline the compliance effort. A review of those 65,000 monthly invoices showed that for any state up to one half of the transactions generated from those invoices are less than $100. To further elaborate, 97% of the accounting entries make up approximately 45% of the expenditures. Leaving 55% of the expenditures comprised of about 3% of the accounting entries. STATS uses statistical analysis to develop a net tax rate for those 97% of the accounting entries. Those

invoices that make up 3% of the accounting entries or 55% of the expenditures are reviewed in detail within the Tax Department and the statutory tax rates are applied.

The STATS program uses statistical analysis, random sampling and stratafications to determine a net tax rate. This net tax rate is simply the taxable percentage of purchases times the statutory tax rate for those purchases.

Here is how we work with the States to implement STATS. First, our companies chart of accounts will be reviewed with the State Auditor to determine which accounts could have some type of taxable transactions run through them. Those accounts that hold Payroll, Cost of Goods Sold, and Accruals are excluded from STATS because they would never hold a transactions that could be subject to Sales or Use Tax. Other accounts that hold Business Meals & Lodging, Telecommunication or Utility expense are also excluded from STATS because we will not issue a direct pay permit to the utility companies or hotels and restaurants used while on business trips. After the review, we are left with the accounts that are considered taxable because they could have some taxable activity run through them.

We then will randomly sample one years transactions for entries in those taxable accounts. Stratifications are used to reduced the required sample size and improve the accuracy of the sample. We may sample 100 transactions that are between 1 cent and $100. The invoices that made up those transactions will be reviewed in detail by our Tax Auditor and the State Auditor. After reviewing all invoices, a taxable percentage will be derived. This is the dollars subject to tax divided by the total dollars in the sample. If there were $750 that were taxable and the total of all sampled transactions was $1000, the taxable percentage would be 75%. This is saying that 75% of the transactions between 1 cent and $100 are taxable based on the random sample. The tax rate, both state and local, for these taxable items is also accumulated. After reviewing the

invoices, the average tax rate of those invoices may be 6%. This yields a net tax rate of 4.5% for transactions between 1 cent and $100 (75% times 6%). This same process is completed for all stratums. Each strata will then have a different net net tax rate.

During the initial statistical analysis, a threshold is set. This threshold is a ceiling for when the net tax rate will be applied to a transaction. Any invoices that generates an accounting entry over the threshold, it will be reviewed by the Tax Department and the statutory tax rates will be applied. This ensures that over 55% of the dollar are being reviewed in the Tax Department and the statutory tax rates are applied to them. This review is typically less than 3% of the overall invoices.

Any transactions in a taxable account that is below the threshold, will have the appropriate net tax rate applied to it based on the strata it falls in.

This process of developing the net tax rates by strata is completed for every business component. Each business component has different business purposes. To improve the accuracy of the statistics, Refinery operations are a separate business component from Marketing operations which are separate from the Corporate office. Each of these business components have different purchasing patterns and enjoy different exemptions from sales and use taxes. Procedures are also in place that require the Tax Department to validate all new accounts set up by Accounting as either Taxable or Exempt from the STATS process. Accounting can not close out until Tax validates their new accounts.

At the end of the month, all of the use tax accruals, whether automated or hand generated get reported. This information is then used to allocate the use tax between the state portion and the local jurisdictions portion, if applicable. The percentages between the state and local allocation is

derived during the initial review of the sampled invoices. This allocated use tax is then used to file the tax return.

The concept of STATS is simple. Many thousands of invoices are being handled on a monthly basis. Many of which are reoccurring types of purchases. Without STATS the process has many people involved from many different locations trying to make tax decisions. Few who are capable of making accurate tax decisions. The administrative effort is extremely high, and improved accuracy can be achieved by using technology. STATS allows for statistical analysis to be used to accrue tax on the 97% of the transactions. Big ticket items, those over the threshold, are being reviewed by Tax professionals and the statutory tax rates applied. STATS simplifies the process by using technology and statistical analysis. Administrative time is reduced, reverse audits are a thing of the past, the monthly filings will be more accurate and the audit time for the tax payer and State will be reduced. As the second picture shows, the computer has replaced all the people involved in the administrative process except for the State and Company Tax Professionals.

In Conclusion – This model Direct Payment Permit Regulation is right on target. Being able to obtain a direct pay permit allows for effectively reducing administrative work in determining taxability, embraces the use of technology and automation, and will allow tax payers to provide more accurate information without being buried in administrative efforts. This allows for fixing the core problem and not simply addressing a symptom to the problem. This will also foster the partnership between the State Administration and Industry who are both looking for new and innovative ways to correctly pay and collect Sales & Use taxes in the most efficient manor. With this model regulation it will make it possible for use tax compliance to move into the new millennium.

Thank you for allowing me to make comments and I will be happy to answer whatever questions you may have.

Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXHIBIT D

STATE OF WASHINGTON
DEPARTMENT OF REVENUE
P.O. Box 47450 • Olympia, Washington 98504-7450 • (360) 786-6100 • FAX (360) 586-5543

RECEIVED
JUL 22 1999
MTC/DC

July 16, 1999

VIA FAX
(202) 624-8819

Hearing Officers
Attention: René Blocker
Multistate Tax Commission
444 North Capital Street N.W., Suite 425
Washington, D.C. 20001-1538

Dear Ms. Blocker:

As a representative of the Washington State Department of Revenue, I thank the Multistate Tax Commission for its invitation to comment on the proposed Model Direct Payment Permit Regulation.

We are very interested in a model regulation promoting consistency among those states issuing direct pay permits. Although the Department currently lacks authority to institute such a program, a direct pay bill was introduced during our 1999 legislative session. While the bill did not pass, both the Department and the business community are interested in exploring the idea further.

With respect to the proposed model regulation, our comments are noted below, section by section:

> **Section A, "Direct pay permit":** We believe a direct pay permit is a privilege a tax authority grants to a specific business. Along this line, we recommend the Model Regulation develop standards related to why a taxing authority may approve or deny an application for a direct pay permit.
>
> **Section C (3), Qualification Process and Requirements:** In the event additional information concerning the application for direct pay is necessary, the proposed regulation provides that the chief tax administrator or designee ***shall*** schedule a conference. Such language leaves an administrator little ability to merely request additional explanation or documentation.

Section G, Permit Holder's Duties: There appears to be a drafting error in this section. The second sentence of the second paragraph reads:

> If [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes **paid to vendors** in each reporting period. (Emphasis added.)

The purpose of a direct pay permit is to remit sales or use taxes directly to a taxing authority rather than a vendor. Consequently, it's unclear whether a permit holder, in agreement with the taxing authority, will keep summary records identifying vendor ***purchases*** for which sales or use tax is due ***or*** summary records identifying the amount of sales or use taxes paid to the ***taxing authority***.

Further, we recommend the Model Regulation incorporate the idea of a renewable direct pay permit. Consistent with the premise that a direct pay permit is a privilege and not a right, a renewable permit serves to:

- Remind permit-holding businesses of the obligations and responsibilities inherent in continued use of the permit;
- Aid a tax authority with scheduling audits to verify compliance with direct payment of sales and use taxes; and
- Act as an enforcement tool in those situations where a permit has been revoked.

Another advantage of a renewable direct pay permit is linked to the comfort and confidence level of vendors. Vendors may not be comfortable accepting copies of an open-ended direct pay permit. Small vendors especially may question the integrity of a program allowing the open-ended use of a direct pay permit.

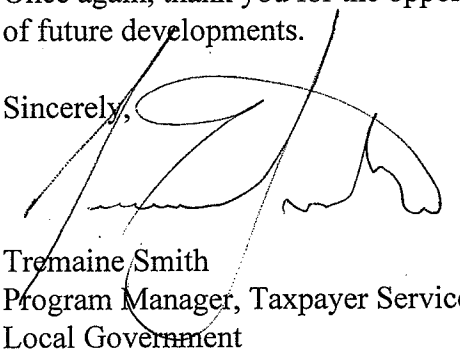
Section I, Local Taxes: As written, this section provides that the first place of taxable use will determine the application of local sales and use taxes. We recommend the Model Regulation allow states an option to define the point of sale as the place of first use ***or*** the actual place of sale. Doing so provides a reasonable option for states adopting the Model Regulation. It is also consistent with legislation currently in place in several states.

Section J, Revocation of Permit: We recommend the Model Regulation incorporate language allowing a taxing authority to revoke as provided by the regulation or the normal administrative procedures of the adopting state.

We further note that this section requires the holder of a revoked permit to return the permit to the tax authority and notify vendors that the direct pay permit certificate is no longer valid. In theory, we agree with this provision. In practical terms, we believe it would be difficult to enforce such provisions.

Once again, thank you for the opportunity to contribute to the proposal. Please keep us apprised of future developments.

Sincerely,



Tremaine Smith
Program Manager, Taxpayer Services Division
Local Government

cc: Frederick C. Kiga, Director
William N. Rice, Deputy Director
Sharon Brown, Assistant Director, Taxpayer Account Administration
Ken Capek, Assistant Director, Audit
Mike Grundhoffer, Assistant Director, Compliance
Vikki Riffe, Assistant Director, Taxpayer Services
Russ Brubaker, Assistant Director, Legislation an Policy
Claire Hesselholt, Policy Counsel, Legislation and Policy
Jim Thomas, Legislation Manager, Legislation and Policy

Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXHIBIT E

RECEIVED
JUL 2 7 1999
MTC/DC

COMMONWEALTH of VIRGINIA

Department of Taxation

July 21, 1999

Ms. Rene Blocker
Hearing Officer
444 N. Capitol Street, N.W.,Suite 425
Washington, D.C. 20001-1538

Re: Comments: Model Direct Payment Permit Regulation

Dear Ms. Blocker:

This is in reply to your Notice of Public Hearing regarding the proposed Model Direct Payment Permit Regulation. The Virginia Department of Taxation has reviewed the proposed regulation and offers the following comments:

The proposed regulation is written in a clear and concise manner with sufficient detail to provide the necessary guidance for direct payment permit holders in Virginia. However, there are two issues related specifically to Virginia law which are in need of clarification and may be of interest to you.

- Code of Virginia § 58.1-624, entitled Direct Payment Permits, provides that only a manufacturer, mine operator, or public service corporation may be authorized to use a direct payment permit in Virginia. This limitation would need to be footnoted or incorporated in the regulation for Virginia purposes.

- Under current Virginia tax policy, direct payment permit holders are not entitled to a dealer's discount on the state portion of use tax remitted under a direct payment permit return, Form ST-6. We believe this policy should be included in the regulation for clarification, as the department is currently in litigation with respect to this issue.

I hope these comments will be helpful to the EDI Task Force and the Multistate Tax Commission in your endeavor to develop a uniform Direct Payment Permit Regulation. If you should have any questions, please feel free to contact me at (804) 367-8005.

Sincerely,

Danny M. Payne
Tax Commissioner

OTP/23387K

Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXHIBIT F

FEDERATION OF TAX ADMINISTRATORS
444 NORTH CAPITOL STREET, NW
WASHINGTON, DC 20001
(202) 624-5890

Task Force on EDI Audit and Legal Issues for Tax Administration

MEMORANDUM

To: Rene Blocker
Deputy Executive Director, Multistate Tax Commission

From: Stephanie Rosenbusch
Federation of Tax Administrators

Re: Direct Payment Report and Regulation

Date: August 13, 1999

This memorandum is intended to respond to the written comments offered by the Washington State Department of Revenue regarding the proposed Model Direct Payment Permit Regulation.

Background

The Task Force on EDI Audit and Legal Issues for Tax Administration (Task Force) was formed to coordinate efforts between the business community and tax administrators in analyzing and addressing issues that electronic data interchange and related new business practices pose for proper tax administration. Under the direction of the Task Force, the Electronic Business Processes Work Group has examined the tax management and compliance issues associated with direct payment authority and expanding its use to assist taxpayers with their sales and use tax compliance responsibility.

Despite the growing interest in direct pay, there has not been a systematic review of the standards and application of the concept in state tax administration. The lack of consistency in eligibility among tax jurisdictions may make it impossible for a taxpayer to obtain direct pay status for some locations in which it does business and cause it to maintain separate recordkeeping for its operations.

To address the concerns of the taxpayer community, the Task Force developed a Model Direct Payment Permit Regulation which provides simplified, consistent rules for tax authorities to follow when considering whether to grant direct pay authority. This regulation is intended as a *recommended guideline* only. The Task Force also completed and introductory report on direct pay authority and practices as well as an explanation/commentary intended to accompany the model regulation. The report, regulation and commentary when read as a whole provides a complete understanding of how direct pay authority may benefit the tax compliance process.

Task Force Response
Comments from the Washington State Department of Revenue are listed section by section. Task Force comments follow.

Washington State Comment
Section A, "Direct pay permit": We believe a direct pay permit is a privilege a tax authority grants to a specific business. Along this line, we recommend the Model Regulation develop standards related to why a taxing authority may approve or deny an application for a direct pay permit.

Task Force Response - No change:
Section C of the Model Regulation outlines the qualification process and requirements for obtaining a direct payment authorization. If the requirements are not met a taxpayer will be denied a direct payment permit. The Task Force believes the regulation sufficiently provides the basis for approval or denial and further suggests that rather than amending the Model Regulation, a taxing authority may consider development of an administrative ruling/notice to define state-specific requirements.

Washington State Comment
Section C (3), Qualification Process and Requirements: In the event additional information concerning the application for direct pay is necessary, the proposed regulation provides that the chief tax administrator or designee ***shall*** schedule a conference. Such language leaves an administrator little ability to merely request additional explanation or documentation.

Task Force Response - Amend Section C (3) as follows:
The [chief tax administrator] or his/her designee shall review all permit applications. The review of applications shall be conducted in a timely manner so that applicants receive notification of authorization or denial within [30-120] days of the date the [chief tax administrator] or designee receives the application; however if additional documentation or discussion is required, the [chief tax administrator] or designee shall notify the taxpayer or, at taxpayer's request, schedule a conference with the applicant prior to the end of the [30-120] day period.

Washington State Comment
Section G, Permit Holder's Duties: There appears to be a drafting error in this section. The second sentence of the second paragraph reads:

> If [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in

summary, and in respect to each transaction, the amount of sales or use taxes **paid to vendors** in each reporting period. (Emphasis added.)

The purpose of a direct pay permit is to remit sales or use taxes directly to a taxing authority rather than a vendor. Consequently, it's unclear whether a permit holder, in agreement with the taxing authority, will keep summary records identifying vendor ***purchases*** for which sales or use tax is due ***or*** summary records identifying the amount of sales or use taxes paid to the ***taxing authority***.

Task Force Response - Amend Section G of Model Regulation for clarification. Amend Explanation and Commentary to describe circumstances in which a direct payment permit may not be issued by a taxpayer.
The purpose of a direct payment permit is to allow the taxpayer to remit sales or use taxes directly to a taxing authority. However, certain categories of transactions, such as corporate procurement card transactions, may need to be managed outside the scope of the direct payment authority granted to the taxpayer.

Model Regulation
G. Permit Holder's Duties (2nd paragraph)
The holder of a direct payment permit shall have responsibility for accruing and paying tax directly to [taxing authority] on all taxable transactions not taxed at the time of sale. In certain circumstances, it may be necessary for the permit holder to pay tax directly to the vendor. Where tax is paid directly to the vendor and [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes paid to vendors in each reporting period.

Explanation and Commentary
Section G. Permit Holder's Duties (2nd paragraph)
This section further states that the permit holder has final responsibility for accruing and paying tax directly to the taxing authority on all taxable transactions not taxed at the time of sale. The permit holder is generally required to issue the direct payment permit to all vendors required to collect tax (except as noted in section F). However, certain categories of transactions, such as corporate procurement card transactions, raise tax compliance issues that may be best managed outside the scope of the direct payment authority granted to the taxpayer.[1]

---

[1] See Corporate Procurement Cards and Tax Compliance: Bridging the Gap, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published June 1997.

Washington State Comment, cont'd.
Further, we recommend the Model Regulation incorporate the idea of a renewable direct pay permit. Consistent with the premise that a direct pay permit is a privilege and not a right, a renewable permit serves to:

- Remind permit-holding businesses of the obligations and responsibilities inherent in continued use of the permit;
- Aid a tax authority with scheduling audits to verify compliance with direct payment of sales and use taxes; and
- Act as an enforcement tool in those situations where a permit has been revoked.

Another advantage of a renewable direct pay permit is linked to the comfort and confidence level of vendors. Vendors may not be comfortable accepting copies of an open-ended direct pay permit. Small vendors especially may question the integrity of a program allowing the open-ended use of a direct pay permit.

Task Force Response - No change:
Task Force participants discussed the issue of renewable direct payment permits at length. Both taxpayer and tax authority representatives believe this recommendation would impose an undue burden on both the taxpayer and revenue agencies. In addition, taxpayers are required to comply with all provisions of the Model Regulation or risk having their direct payment permit revoked.

Washington State Comment
Section I, Local Taxes: As written, this section provides that the first place of taxable use will determine the application of local sales and use taxes. We recommend the Model Regulation allow states an option to define the point of sale as the place of first use *or* the actual place of sale. Doing so provides a reasonable option for states adopting the Model Regulation. It is also consistent with legislation currently in place in several states.

Task Force Response - No change:
This regulation is a recommended standard only. Certain taxing authorities will be required to amend this section of the regulation to remain consistent with existing state law. In addition, the Explanation and Commentary states "While this is a recommended standard, it is not currently true in all taxing jurisdictions. Each taxing authority will address local tax implications related to tangible personal property and services."

Washington State Comment
Section J, Revocation of Permit: We recommend the Model Regulation incorporate language allowing a taxing authority to revoke as provided by the regulation or the normal administrative procedures of the adopting state.

We further note that this section requires the holder of a revoked permit to return the permit to the tax authority and notify vendors that the direct pay permit certificate is no longer valid. In theory, we agree with this provision. In practical terms, we believe it would be difficult to enforce such provisions.

Task Force Response - Amend Section J of Model Regulation as follows (the Task Force determined that certain issues addressed in the Model Regulation would be more appropriate in the Explanation and Commentary):
J. Revocation of Permit.
A direct payment permit is not transferable, and the use of a direct pay permit may not be assigned to a third party. Direct payment permits may be revoked by the [chief tax administrator] at any time whenever the [chief tax administrator] determines that the person holding the permit has not complied with the provisions of this regulation or that the revocation would be in the best interests of the [taxing authority]. Such revocation shall follow the administrative procedures as provided for in [insert appropriate citations to state tax statutes].

Amend Explanation and Commentary as follows:
Section J. Revocation of Permit.
This section provides that direct payment permits are not transferable or assignable, and identifies circumstances for which the taxing authority may revoke direct payment authority. Generally, the notice of revocation must be in writing and effective as of the end of the direct payment permit holder's normal reporting period.

Taxing authorities will also need to determine how direct payment authority will be handled in cases of business restructuring, where the taxpayer's business remains the same and effective ownership is unchanged. Taxing authorities may consider establishing a specific time period (e.g. 60-120 days) to allow the permit holder to apply for direct payment status for the new entity. During this period, the previous permit would remain in effect.

MODEL DIRECT PAYMENT PERMIT REGULATION

A. "Direct payment permit" means a permit issued by [taxing authority] that allows a holder of such permit to accrue and pay state and local taxes under [statute] directly to the [taxing authority].

B. Application for Permit. Applicants for a direct payment permit must apply in writing to the [chief tax administrator]. The application shall be on a form required by the [chief tax administrator] or in a letter containing the applicant's name, address, the location of the place or places of business for which the applicant intends to make direct payment of tax, the sales and use tax account number(s) for which direct payment will be made, and any other information that the [taxing authority] may require.

C. Qualification Process and Requirements.

(1) Applicants for a direct payment permit shall demonstrate the applicant's ability to comply with the [taxing authority] sales and use tax laws and reporting and payment requirements. The applicant must provide a description of the accounting system(s) which will be used by the applicant and demonstrate that the accounting system(s) will reflect the proper amount of tax due.

(2) Applicants must establish a business purpose for seeking a direct payment permit and must demonstrate how direct payment will benefit tax compliance. For example, the utilization of direct payment authority should accomplish one or more of the following:

(a) Reduce the administrative work of determining taxability; collecting, verifying, calculating and/or remitting the tax;
(b) Provide for improved compliance with the tax laws of the [taxing jurisdiction];
(c) Provide for accurate compliance in circumstances where determination of taxability of the item is difficult or impractical at the time of purchase;
(d) Provide for more accurate calculation of the tax where new or electronic business processes such as electronic data interchange, evaluated receipts settlement, or procurement cards are utilized;
(e) Provide for more accurate determination and calculation of tax where significant automation and/or centralization of purchasing and/or accounting processes have occurred and applicant must comply with the laws and regulations of multiple state and local jurisdictions.

(3) The [chief tax administrator] or his/her designee shall review all permit applications. The review of applications shall be conducted in a timely manner so that applicants receive notification of authorization or denial within [30-120] days of the date the [chief tax administrator] or designee receives the application; however if additional documentation or discussion is required, the [chief tax administrator] or designee shall notify the taxpayer or, at taxpayer's request, schedule a conference with the applicant prior to the end of the [30-120]-day period.

D. Recordkeeping Requirements. A direct payment permit holder shall maintain all records that are necessary to a determination of the correct tax liability under [insert appropriate citations to state tax statutes]. All required records must be made available on request by the [taxing authority] or its authorized representatives as provided for in [insert appropriate citations to state tax statutes].

[Insert elements of state law which require certain records to be retained (e.g., books of account, invoices, sales receipts), or specific tax elements or transactions (e.g., credits) for which particular records may be required.]

E. Reporting of Tax. Each holder of a valid direct payment permit shall, on a form approved by the [taxing authority], accrue and pay directly to the [taxing authority] the taxes due under [statute] for all transactions subject to tax for which a direct payment permit applies. Taxes for which the direct payment permit is used shall be considered due and payable on the sales and use tax return next due following the date on which a determination of taxability is, or in the exercise of reasonable care should be, made for a given transaction, unless otherwise provided by written agreement between the taxpayer and the [taxing authority].

F. Certain Transactions Not Permitted. A holder of a direct pay permit shall not use such permit in connection with the following transactions:

(1) purchases of taxable meals or beverages;
(2) purchases of taxable lodging or services related thereto;
(3) purchases of admissions to places of amusement, entertainment or athletic events, or the privilege of use of amusement devices;
(4) purchases of motor vehicles, or other tangible personal property required to be licensed or titled with a taxing authority, taxed under [taxing authority] statutes [list applicable sections];
(5) purchases of any of the following enumerated services listed in [tax authority] statutes. [List applicable sections. May include services such as telecommunications and utilities.]; and
(6) Such other purchases as may be agreed to between the holder of the direct payment permit and the [taxing authority].

G. Permit Holder's Duties. The holder of a direct payment permit shall furnish a copy of the direct payment permit or other acceptable evidence, if allowed by statute, that the holder has been granted a direct payment permit, including the number of the permit and the date issued, to each vendor from whom the holder purchases tangible personal property or services. Persons who hold a direct payment permit shall not be required to issue a separate exemption certificate and shall not be required to pay the tax as prescribed in [state taxing statutes related to billing of sales or use tax by vendor].

The holder of a direct payment permit shall have responsibility for accruing and paying tax directly to [taxing authority] on all taxable transactions not taxed at the time of sale. In certain circumstances, it may be necessary for the permit holder to pay tax directly to the vendor. Where tax is paid directly to the vendor and ~~If~~ [taxing authority] and permit holder agree, the holder may maintain accounting records in sufficient detail to show in summary, and in respect to each transaction, the amount of sales or use taxes paid to vendors in each reporting period.

H. Vendor's Responsibilities. Receipt of the direct payment permit or other acceptable evidence that the holder has been granted a direct payment permit, shall relieve the vendor of the responsibility of collecting the sales tax on sales made to a direct payment permit holder on qualifying transactions. Vendors and sellers who make sales upon which the tax is not collected by reason of the provisions of this section shall maintain records in such manner that the amount involved and identity of the purchaser may be ascertained. Receipts from such sales shall not be subject to the tax levied in [state taxing statutes related to billing of sales or use tax by vendor].

I. Local Taxes [if imposed]. A direct pay permit holder that makes taxable purchases of tangible personal property or services shall report and pay applicable local sales or use tax on those purchases. The local sales or use tax shall be calculated at the rate imposed by the jurisdiction in which the first taxable use occurs.

J. Revocation of Permit. A direct payment permit is not transferable, and the use of a direct pay permit may not be assigned to a third party. Direct payment permits may be revoked by the [chief tax administrator] at any time whenever the [chief tax administrator] determines that the person holding the permit has not complied with the provisions of this regulation or that the revocation would be in the best interests of the [taxing authority]. Such revocation shall follow the administrative procedures as provided for in [insert appropriate citations to state tax statutes]. ~~The notice of revocation must be in writing and effective as of the end of the direct payment permit holder's normal reporting period. In the case of a business restructuring, where the taxpayer's business remains the same and effective ownership is unchanged, the direct payment permit holder shall be~~

~~allowed a period of [60-120 days] to apply for direct payment status for the new entity. During such period, the previous permit shall remain in effect.~~

~~Any person whose direct payment permit is either voluntarily forfeited or revoked by action of the [taxing authority] shall return the permit to the [taxing authority] and immediately notify all vendors from whom purchases of taxable items are made advising them that the direct payment certificate issued to them pursuant to the direct payment permit is no longer valid. Failure to give notification is a violation of [statute].~~

MODEL DIRECT PAYMENT PERMIT REGULATION
Explanation and Commentary

Purpose. The purpose of this regulation is to define the requirements imposed on taxpayers seeking direct payment status. It is also the purpose of this regulation to focus on the business needs of the taxpayer in determining whether direct pay authority should be granted rather than relying on traditional qualification requirements currently in place in many states.

Section A defines "direct payment permit" for purposes of this regulation. The holder of a direct payment permit may make purchases of taxable items for use in its business and defer the taxes imposed until such time as taxability is determined. The permit holder is responsible for accruing and paying state and local taxes directly to the taxing authority based on the requirements of this regulation.

Section B. Application for Permit.
This section establishes the process the taxpayer must follow when applying for a direct payment permit and identifies the basic information that must be submitted to the taxing authority. It further provides the taxing authority discretion to require additional information that may be necessary to initiate the application process.

Section C. Qualification Process and Requirements.
This section defines the general requirements a taxpayer must meet to qualify for a direct payment permit.

Subsection C (1) requires that a taxpayer demonstrate its ability to comply with the applicable sales and use tax laws and generally be in good standing with the taxing authority. The taxpayer must provide an explanation of the accounting procedures that will be used to determine the taxability of purchases and to ensure that any tax due is correctly accrued and remitted. The taxpayer must maintain records that clearly distinguish between taxable and nontaxable purchases and must demonstrate that the internal controls used will ensure accurate and reliable processing and reporting of the tax liability.[1]

Subsection C (2) focuses on the business needs of the taxpayer in determining whether direct pay authority should be granted. Advanced business processes, such as evaluated receipts settlement (ERS), have allowed businesses to streamline their purchasing and payment processes, but have increased the administrative

[1] When entering into sales and use tax compliance agreements, taxpayers and taxing authorities would agree upon a single factor tax rate for the reporting of state and local taxes due for a specified period rather than making a determination of tax due on a per transaction basis.

work of complying with state and local tax laws. This section requires the taxpayer to demonstrate how direct payment authority will benefit tax compliance.

Subsection C (3) provides that the review of all applications for direct payment status be conducted in a timely manner, normally within 30-120 days of receipt of the application. It further states that the taxing authority notify the applicant during the review period if additional information is required to ensure final notification of authorization or denial is provided to the taxpayer on or before the end of the review period.

Section D. Recordkeeping Requirements.
This section outlines the recordkeeping requirements of the taxpayer and is consistent with the Model Recordkeeping and Retention Regulation developed by the Task Force.[2] The taxpayer has an obligation to retain all records necessary to the correct determination of the tax liability and to make such records available to the taxing authority upon request. Each taxing authority may list specific types of records or specific tax elements or transactions for which particular records may be required.

Section E. Reporting of Tax.
This section addresses the sales and use tax reporting and payment requirements placed on each holder of a direct payment permit and states that the permit holder is responsible for accruing and reporting tax on all taxable transactions for which a direct payment permit applies. It further states that a taxpayer must exercise reasonable care when determining the point at which tax is due for a given transaction. The term "reasonable" should be defined by each state implementing a direct payment program.

Section F. Certain Transactions Not Permitted.
This section identifies transactions for which the direct payment permit may not be issued and for which the permit holder must pay tax directly to the vendor at the time of purchase. Types of transactions not permitted typically include travel and entertainment, motor vehicles, and taxable services, but may include other categories of transactions as designated by the taxing authority. Nothing in this section should be interpreted to override existing tax law or statutes.

Section G. Permit Holder's Duties.
This section defines the duties of the taxpayer who has been granted direct payment status by the taxing authority. It states that the permit holder will not be required to pay tax to the vendor on qualifying transactions as long as evidence is provided to the vendor of the permit holder's direct payment status. This may be

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[2] See Model Recordkeeping and Retention Regulation, A Report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published March 1996.

a copy of the direct payment certificate or other evidence as prescribed by the taxing authority.

This section further states that the permit holder has final responsibility for accruing and paying tax directly to the taxing authority on all taxable transactions not taxed at the time of sale. The permit holder is generally required to issue the direct payment permit to all vendors required to collect tax (except as noted in section F). However, certain categories of transactions, such as corporate procurement card transactions, raise tax compliance issues that may be best managed outside the scope of the direct payment authority granted to the taxpayer.[3] ~~In some instances, the taxing authority may agree to allow the permit holder to maintain sufficient documentation to show in summary and detail the amount of sales or use taxes paid to vendors in each reporting period.~~

Section H. Vendor's Responsibilities.
This section defines the responsibility of the vendor when making sales to a direct payment permit holder and states that the vendor is relieved of the responsibility of collecting tax on qualifying transactions as long as sufficient detail level information is maintained which supports the tax free sale.

Section I. Local Taxes [if imposed].
This section addresses the responsibility of the direct payment permit holder to accrue and pay applicable local sales or use taxes on purchases of tangible personal property made pursuant to this regulation. It further states that local tax is imposed by the jurisdiction in which the first taxable use occurs. While this is a recommended standard, it is not currently true in all taxing jurisdictions. Each taxing authority will address local tax implications related to tangible personal property and services.

Section J. Revocation of Permit.
This section provides that direct payment permits are not transferable or assignable, and identifies circumstances for which the taxing authority may revoke direct payment authority. Generally, the notice of revocation must be in writing and effective as of the end of the direct payment permit holder's normal reporting period. ~~It further defines the responsibility of the permit holder to its vendors upon cancellation or forfeiture of direct payment authority.~~

Taxing authorities will also need to determine how direct payment authority will be handled ~~In~~ in cases of business restructuring, where the taxpayer's business remains the same and effective ownership ~~and business activities remain~~ is unchanged. Taxing authorities may consider establishing a specific time period (e.g., 60-120 days) to allow the permit holder to apply for direct payment status for

[3] See Corporate Procurement Cards and Tax Compliance: Bridging the Gap, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published June 1997.

the new entity. During this period, the previous permit would remain in effect. ~~, a direct payment permit will remain in effect for a period of time as determined by the taxing authority to allow the new entity to apply for direct payment status.~~

Initial Report of the Hearing Officers
regarding the
Proposed Model Direct Payment Permit Regulation

EXHIBIT G

Model Direct Payment Permit Regulation

Interim Report

Task Force on EDI Audit and Legal Issues for Tax Administration

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FOREWORD

The Task Force on EDI Audit and Legal Issues for Tax Administration (Task Force) was formed to coordinate efforts between the business community and tax administrators in analyzing and addressing the issues posed for tax administration by electronic data interchange and related business processes. The Task Force is comprised of representatives of the Committee on State Taxation (COST), Institute for Professionals in Taxation (IPT), Tax Executives Institute (TEI), Multistate Tax Commission (MTC), and Federation of Tax Administrators (FTA). This report is the *fifth* in a series of Task Force reports on issues relating to electronic commerce, emerging business processes and tax administration.

As part of the Task Force, the Electronic Business Processes work group is exploring alternative processes that can reduce the burden associated with sales and use tax compliance and administration for taxpayers and taxing authorities alike. It is for this reason that the Task Force has developed a *Model Direct Pay Regulation* that states could follow when implementing or expanding a direct pay program. The purpose of this regulation is to focus on the business process of a taxpayer when a tax jurisdiction considers whether to grant direct pay authority; to stress how applicable tax laws and business processes relate from a compliance perspective; and to demonstrate how direct pay authority will benefit tax compliance. The model regulation, as presented in this report, is not binding on any one state or taxpayer organization.

The Steering Committee wishes to acknowledge the contributions of all individuals who devoted their time and effort in developing and refining this report. A complete list of participants will be included with the final report.

Stanley R. Arnold, Steering Committee Chair
Commissioner, New Hampshire Department of Revenue Administration

November 1999

INTRODUCTION

The Task Force on EDI Audit and Legal Issues for Tax Administration (Task Force) was formed to coordinate efforts between the business community and tax administrators in analyzing and addressing issues that electronic data interchange and related new business practices pose for proper tax administration. Under the direction of the Task Force, the Electronic Business Processes Work Group has examined the tax management and compliance issues associated with direct payment authority (direct pay) and expanding its use to assist taxpayers with their sales and use tax compliance responsibility.

Direct pay is an authority granted by a tax jurisdiction that generally allows the holder of a direct payment permit to purchase otherwise taxable goods and services without payment of tax to the supplier at the time of purchase. (Also in the case of exempt transactions, it allows a holder to purchase without issuing exemption certificates.) Suppliers are to be furnished a written notification of the purchaser's direct pay authority (often a numeric designation). The holder of the direct payment permit is to timely review its purchases and make a determination of taxability and then reports and pays the applicable tax due directly to the tax jurisdiction. The permit holder's tax determinations and adequacy of payment are subject to audit by the tax jurisdiction.

Direct pay was originally designed to overcome the tax complexities in situations where the taxability of a transaction could not be easily determined at the time of purchase. For example, a number of states exempt transactions if the item purchased is used in a particular manner, e.g., for manufacturers, if the item is used in the manufacturing process or as an "ingredient and component part" of their sale products. In such instances, direct pay authority would allow an entity to purchase certain products for all types of uses and to report the appropriate tax after the actual use had been determined.

In today's environment, however, with the increased volume of activities in interstate commerce and the application of new technologies to purchasing practices, some members of the business community have expressed an interest in expanding the use of direct pay authority. This expanded use of direct pay is seen as a way of allowing more taxpayers to better administer their tax compliance activities and accommodate new electronic business processes such as evaluated receipts settlement (ERS)[1] and procurement cards[2].

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[1] ERS is a business process between trading partners that conduct commerce without invoices. In an ERS transaction, the supplier ships goods based upon an Advance Shipping Notice, and the purchaser, upon receipt, confirms the existence of a corresponding purchase order or contract, verifies the identity and quantity of the goods, an then pays the supplier. See also Evaluated Receipts Settlement and Tax Compliance, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published September 1998.

[2] Procurement cards are corporate charge cards issued to specific employees to purchase designated goods and services on behalf of the company. Procurement card programs can

Another example of the interest in expanding direct pay authority the increasing reliance on a mutually agreed upon percentage to maintain tax compliance. In an effort to place tax decisions in the hands of tax professionals, businesses are increasingly approaching states to enter into sales and use tax compliance agreements that allow a taxpayer to report and pay tax on purchases using a predetermined effective taxable rate.[3] Using direct pay authority facilitates implementation of such agreements. Tax jurisdictions are hesitant to enter into these agreements unless the business is a direct pay permit holder.

Despite the growing interest in direct pay, there has not been a systematic review of the standards and application of the concept in state tax administration. The lack of consistency in eligibility among tax jurisdictions may make it impossible for a taxpayer to obtain direct pay status for some locations in which it does business and cause it to maintain separate recordkeeping for its operations.

Current Practices

Thirty-three of the forty-five states with sales and use taxes provide for the direct payment of tax. Two states—Maryland and Massachusetts—repealed their direct pay provisions; however, Maryland has allowed permits issued prior to July 1, 1993 to remain in effect. Research of the direct pay states indicates that application procedures, requirements and restrictions for direct pay status vary widely. A comprehensive chart outlining state requirements and procedures for obtaining direct pay authority is included as Appendix A.

Several states impose the obligation to collect taxes strictly on the vendor. These states would not be able to implement a direct pay program under their current taxing structures and principles. For these states it may be difficult, but not impossible, to implement a direct payment program.

Other states must also consider the impact of new or expanded direct pay programs on local tax revenues. Local option and home rule tax structures have caused problems for some tax jurisdictions as they try to implement direct pay programs or expand existing ones. Local tax structures may differ from state laws making direct pay programs difficult to administer. These differences also add to the expense and confusion for multi-state businesses that are trying to comply with the law.

Local Tax Issues

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effectively simplify and streamline the procurement process by replacing the various steps in the traditional purchasing process with an authorization to an employee to use a charge card to procure the necessary goods and services. See also Procurement Cards And Tax Compliance: Bridging The Gap, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published June 1997.

[3] See Sales and Use Tax Compliance Agreements, a report of the Steering Committee, Task Force on EDI Audit and Legal Issues for Tax Administration, published [date]. This report examines alternative reporting methodologies and provides recommendations for taxpayers and tax authorities to follow when entering into these agreements.

Local sales and use taxes can present complex issues for direct pay programs, and in some cases, can seriously restrict the attractiveness and effectiveness of the program. There are at least two issues that present themselves.

First, when a taxpayer remits tax under direct pay authority, it is technically remitting a use tax as opposed to a sales tax. In states which allow local sales taxes, but not local use taxes, there may be a reduction in the total tax paid to local governments. In some cases, a tax jurisdiction may enter into an informal arrangement with a taxpayer to allow for the direct payment of local sales taxes provided the taxes are allocated as if they had been paid to the retailer.

Second, an issue can arise depending on the "sourcing" or "situsing" rules employed for applicable local taxes. If the local tax is "sitused" or applied based on the jurisdiction in which the taxpayer is using the item purchased, no issue arises, i.e., the taxpayer simply remits based on the jurisdiction in which the good or service is used. The information necessary to make these determinations should be known to the taxpayer. If, on the other hand, local taxes are "sitused" to or applied based on the point of sale instead of point of use, serious complexity can arise for the taxpayer. In such instances, the taxpayer would need to know more specific transaction details in order to track, report and remit tax for all jurisdictions in which it made purchases. This can seriously detract from the attractiveness of direct pay to a taxpayer and reduce the benefits it provides.

A November 1997 report by the National Conference of State Legislatures provides the following statistics with regard to local option taxes.[4]

Thirty-three of the forty-five states with sales and use taxes allow one or more local governments to levy sales taxes;

Alaska, which lacks a state sales and use tax, allows cities and boroughs to levy a sales tax;

Twenty-three of the thirty-three states that allow local sales taxes provide authority to both cities and counties;

Nine states allow counties but not cities to levy sales taxes, while one state allows cities but not counties to impose a sales tax; and

Nine states allow "other" authorities (e.g., transit and/or school districts) to levy sales taxes.

Taxpayer Perspective

Advanced technology has allowed businesses to streamline their purchasing and payment processes, but has increased the administrative work of complying with state and local tax laws. Large multi-state businesses view direct pay

[4] Critical Issues in State-Local Fiscal Policy, A Guide to Local Option Taxes, Foundation for State Legislatures and National Conference of State Legislatures, November 1997.

authority as a valuable tool in automating their accounts payable function and managing their tax compliance responsibility. Automation of these functions is becoming increasingly important in today's leaner business climate. For example, many hours are spent verifying rates and amounts charged by vendors. Direct pay authority would eliminate this expense by allowing the purchaser to determine the correct rate and taxable amount. Under direct pay, EDI transactions can be handled more efficiently, and ERS transactions are much more straightforward and auditable. Direct pay authority also facilitates prospective accrual agreements for remittance of use tax.

Businesses have expressed concern over the diverse and complex rules that must be met to qualify for direct pay status. In many cases, the criteria currently employed restrict direct pay authority to a very few taxpayers. The application process can also be difficult and time-consuming. Consistent and logical direct payment provisions among all states would enhance the industry's ability to comply with state and local tax requirements. At a minimum, tax jurisdictions should consider requests on a case by case basis rather than imposing arbitrary restrictions that disqualify many businesses up front. Businesses also agree that to be considered for direct pay status, they must be in good standing with the taxing authority and demonstrate that their accounting system(s) will reflect the proper amount of tax due.

Tax Jurisdiction Perspective

Tax jurisdictions are interested in administering programs that ease tax compliance and administration. When evaluating whether to expand an existing direct pay program or implement a new program, taxing authorities must consider the overall effect on the tax administration process.

Direct pay authority is typically granted to very large and/or multi-state businesses with large volumes of potentially taxable transactions that must be reviewed during regular audit cycles. An increase in the number of direct pay taxpayers may impact the number of audit personnel required to adequately monitor taxpayer compliance. Tax jurisdictions are also under increasingly tighter budget and resource constraints and are losing staff. Local tax allocations have also been identified as a major disincentive to implementing or expanding direct pay programs. Tax jurisdictions may be more willing to expand direct pay authority to taxpayers that mitigate the audit resource problem by providing access to electronic records for conducting the tax compliance audits.

Tax jurisdictions also are concerned that expanded direct pay authority would have a negative impact on the their cash flows and revenues. It is for this reason that some states have accelerated the payment due date for direct pay returns and have stipulated that direct pay permit holders must agree to submit all tax payments via EFT and file electronically if so required.

Some tax jurisdictions also are searching for prospective tax compliance solutions and have entertained the possibility of using sales and use tax compliance agreements. Under these agreements a predetermined taxable percentage is approved by the tax jurisdiction and used by the taxpayer for reporting tax and

making tax allocations on expense purchases.[5] There are tax jurisdictions that are reluctant to adopt this procedure unless the taxpayer has been granted direct pay authority.

Conclusion

Tax jurisdictions and taxpayers should work together to establish tax compliance procedures that ease the tax administration process. State legislatures play an important role as their laws directly affect local option and home rule tax structures. As stated previously, it is these local tax structures that impose the biggest burden on taxpayers working to comply and tax administrators carrying out the tax laws. Taxpayers should make use of available opportunities to work with the appropriate legislative bodies to ensure that lawmakers understand business concerns and to minimize the number or reduce the complexity and issues associated with local sales and use taxes and the burden such taxes cause on businesses.

Taxpayers believe that simplified, consistent rules for direct pay authorization should be considered by all taxing jurisdictions. It is for this reason that the Task Force has developed a *Model Direct Pay Regulation* that states could follow when implementing or expanding a direct pay program. The purpose of this regulation is to focus on the business process of a taxpayer when a tax jurisdiction considers whether to grant direct pay authority; to stress how applicable tax laws and business processes relate from a compliance perspective; and to demonstrate how direct pay authority will benefit tax compliance.

[5] Each tax authority must consider whether it has, or requires, statutory authority to enter into sales and use tax compliance agreements.