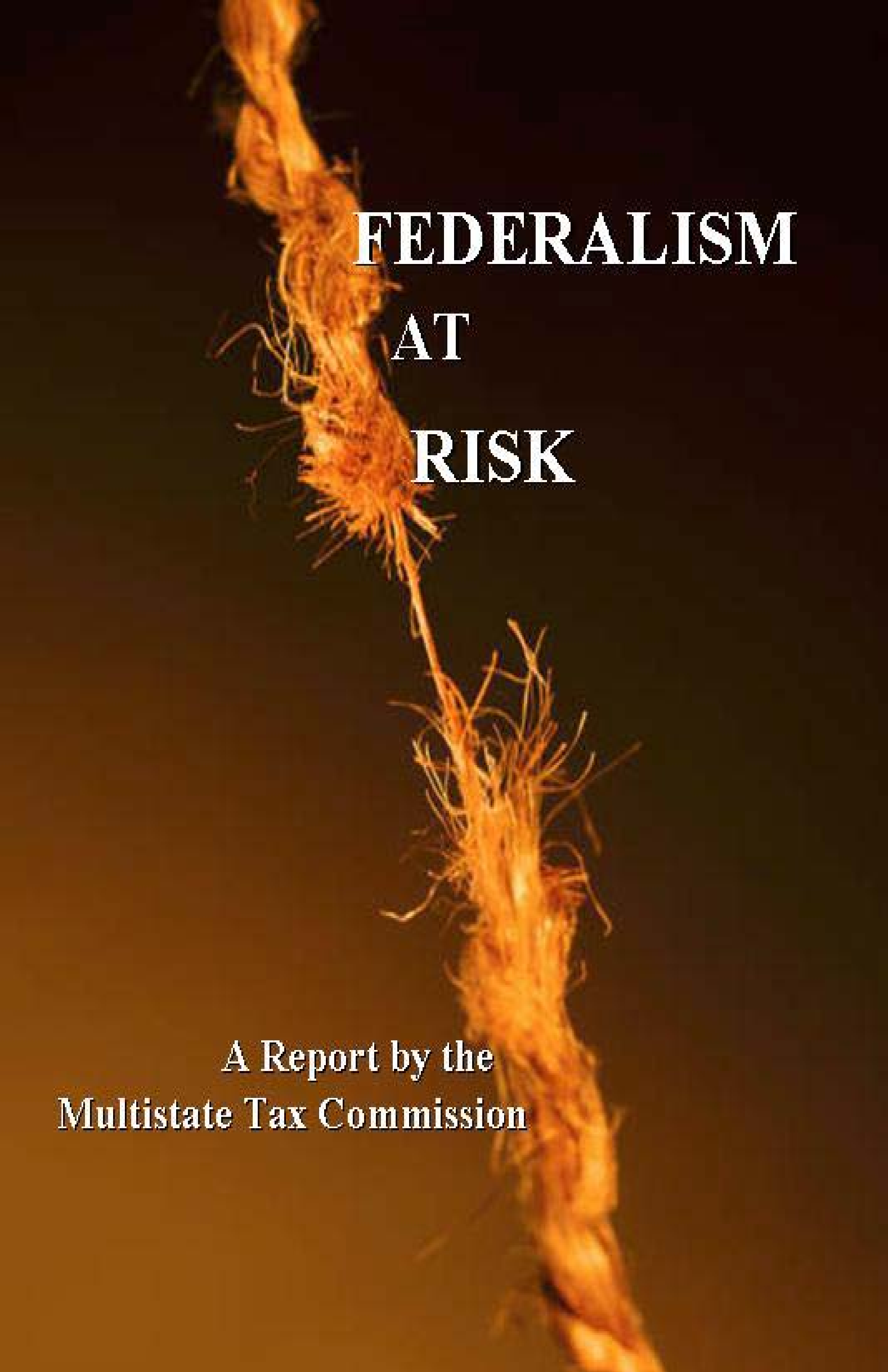

FEDERALISM AT RISK

A Report by the
Multistate Tax Commission

Federalism at Risk

A Report of the Multistate Tax Commission

June 2003

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PREFACE

The states, through the Multistate Tax Compact, formed the Multistate Tax Commission in 1967 to protect and preserve state sovereignty while addressing difficult issues arising from the taxation of multistate businesses. Currently, forty-four states and the District of Columbia participate in the MTC as Compact Members (21), Sovereignty Members (5), Associate Members (16), and Project Members (3). The organizational mission of the MTC is to make state tax systems fair, effective, and efficient as they apply to interstate and international commerce and to protect state fiscal authority.

Beginning in the summer of 2001, the Commission hosted a series of public seminars on the topic of state taxation and federalism. The first seminar covered the broad issues of legitimacy of state and local taxes on interstate commerce, the distribution of costs of state services, and fairness and equity of state and local taxes imposed on interstate commerce. Subsequent sessions focused on specific state taxation topics: sales and use taxes, business activity taxes, and other taxes and administrative issues. The five seminars were held in Bismarck, ND, San Diego, CA, Washington, DC, Denver, CO, and Madison, WI. A list of the presenters, many of whom are national experts on taxation, economics, and the law, is included in the Appendix to this report.

The Commission hosted this inquiry because, as an organization, we believe the states must work together to shape the future of state taxation. As a state compact agency, the Commission has a special responsibility to educate the public policy makers at the state and federal levels about the value of cooperative federalism, and the challenge of reforming state taxation. It is our hope that these public hearings and this report will prompt a constructive dialogue on these important topics and guide policy makers in their efforts to improve state and local tax systems.

Elizabeth Harchenko
Chair, Multistate Tax Commission
Director, Oregon Department of Revenue
June 2003

ABOUT THIS REPORT

It is not the purpose of this report to suggest higher taxes. Nor is it our purpose to recommend a uniform state tax structure. The appropriate level of taxation is a matter for each state and local jurisdiction to decide for itself in consultation with its taxpayers. Similarly, the "mix" of various taxes that may be appropriate for a particular jurisdiction should be decided by the representatives elected by the people to govern that entity. This report does, however, suggest that changes to the structure of state and local taxes are necessary so that policy makers will have the tools necessary to implement their taxes in a fair, equitable, and efficient manner, both for their own residents and for multistate taxpayers doing business in their states.

This publication includes the full report from the *Federalism at Risk* seminar series as well as a re-publication of the previously issued Executive Summary. The full report contains the Commission's recommendations and additional policy questions for the consideration of policy makers. The Executive Summary, which was published initially in February 2003 together with an Overview (not re-printed in this publication), sets forth some, but not all, of the recommendations. See Appendix H for a quick reference to all recommendations and policy questions.

EXECUTIVE SUMMARY

The Multistate Tax Commission is a joint agency of states created by law and dedicated to the achievement of tax fairness, equity, and uniformity. In July 2001, the MTC convened a year-long inquiry to assess the status of state and local tax systems. The study analyzed the existing and future impact of federal action, the changing global economy, and the states' own tax policy choices on those systems. Through a series of *Federalism at Risk* seminars, the Commission examined whether the states' constitutional sovereignty in the U.S. system of federalism can survive in the face of increasing strain on their tax systems. The U.S. Constitution establishes a system of federalism in which sovereign authority is shared by the states and a federal government created by the states. Under the Constitution, states retained their independent authority to establish policy in a number of areas. The authority to tax is a key element of state sovereignty because it provides state governments with the means to implement these policies. Thus, the future vitality of the U.S. system of federalism depends on the viability of state and local tax systems. This executive summary of the Commission's *Federalism at Risk* report briefly describes several of the crucial issues and key recommendations for improving state and local tax systems and strengthening federalism in the 21st century.

The Fiscal Outlook

State and local governments face severe fiscal stress in the foreseeable future, despite any prospective national economic recovery. Recent estimates indicate that state and local budgetary shortfalls will exceed $60 billion this year alone.[1] Expenditure pressures will continue to grow, especially for Medicaid and education. Meanwhile, outdated state and local tax systems will be inadequate to raise the revenue needed to maintain essential services. To establish equitable, efficient, and effective tax systems sufficient to endure the current fiscal distress and beyond, states should consider action in several key areas.

Modernizing the Sales Tax

Aged sales and use tax systems designed in the 1930s are not suited for a service-based, intangibles-oriented global economy. The states have offset the revenue loss caused by shrinking sales tax bases by increasing rates. The lack of uniformity among the states with respect to defining taxable items, determining where a sale takes place and a myriad of administrative and filing requirements places a significant burden on companies doing business in multiple states. The growth of remote sales (via mail, phone, the Internet) and U.S. Supreme Court limitations on the states' power to collect tax on these sales—albeit with an invitation to Congress to legislate to remove these limitations—contributes to the growing inequity and ineffectiveness of state sales and use taxes. To preserve the sales and use tax, the Commission recommends that state policy makers consider the following actions:

- Strengthen nexus standards for companies to collect sales and use taxes to better reflect current business practices.
- Evaluate the scope of sales and use tax bases in relation to the shift of consumption toward services and intangible products.
- Adopt the Streamlined Sales and Use Tax Agreement to make it easier for retailers, including remote sellers, to collect the tax.[2]
- Request that Congress or the Supreme Court approve standards for tax collection that level the playing field for in-state and multistate businesses. Congressional action could be conditioned upon implementation of the streamlined sales tax system by a critical mass of states.

Ensuring Equal and Proper Reporting of Income

State income tax systems are increasingly less equitable and effective because some taxpayers can avoid their fair share of income taxes and others, especially small businesses and wage earners, cannot.

Many multistate companies can avoid fully reporting their income or can limit their tax payments by assigning income to jurisdictions other than the states where the income was earned. Thus, the corporate income tax has declined substantially both as a percent of corporate profits and as a share of state revenues. Further, there is evidence that some affluent individuals able to secure sophisticated tax advice are adopting measures similar to those used by corporations to avoid reporting their income fully or properly to where it was earned. In addition, new inequities are arising because many states do not have adequate, taxpayer-convenient systems to ensure proper reporting of income by non-resident individuals who own portions of "pass-through" businesses operating in those states.[3] States' own legislative choices on tax issues enable a good deal of income shifting by companies and individuals to tax-beneficial jurisdictions, both domestic and international. Additionally, underreporting of income for federal tax purposes undermines state income tax bases as well. To help restore the equity and effectiveness of state income tax systems, the Commission recommends that state policy makers consider the following actions:

- Adopt "combined reporting"[4] for jointly owned and operated companies—including affiliates in international tax havens—to more appropriately report and assign income to where it is earned.
- Ensure proper filing of state income or business tax returns by those earning significant income from within a state by adopting a uniform "factor presence" nexus standard.[5] Concurrently, urge Congress to relieve the restrictions of P.L. 86-272 for those states adopting this "factor presence" nexus standard to support uniform and equitable state taxes to encourage the free flow of interstate commerce.
- Adopt uniform rules for dividing income among the states to ensure multistate income is reported to states where it was earned and to avoid the possibility of over- or under-reporting of income from interstate commerce.

- Develop uniform tax policies and cooperative administrative systems that make it easier for owners, especially non-resident owners, of pass-through entities to file returns and pay the proper amount of tax to states where income was earned.
- Urge Congress to enact legislation to help curb state corporate tax sheltering and to refrain from enacting new restrictions that would harm the ability of states to tax a fair share of the income of interstate enterprises.

Increasing Levels of Interstate and Federal-State Cooperation

The authority to tax is a key element of state sovereignty and is critical to the ability of states to serve the needs of their citizens and interstate commerce effectively. Indeed, the national economy depends on the effective provision of education, infrastructure, public safety, commercial legal systems, and other services at the state and local levels. However, disparate state and local taxes affecting interstate commerce are viewed by critics as creating an unreasonable burden on such commerce or as otherwise interfering with national economic objectives. The tensions surrounding state taxation of interstate commerce can be resolved through greater uniformity and coordination among states in their tax policies and administrative practices affecting interstate commerce. Moreover, Congress could play a supportive role in encouraging equitable, efficient, and effective state and local tax policies. To preserve state sovereign authority and create a productive partnership with Congress on issues of taxation, the Commission recommends that state policy makers consider the following actions:

- Strengthen and expand interstate coalitions and cooperative institutions that harmonize state tax policies, provide simplified and joint tax administrative practices across jurisdictions and improve state and local tax compliance through joint enforcement mechanisms.

- Revive, in cooperation with Congress and the President, a liaison organization established by law between the states and the federal government similar to the former Advisory Commission on Intergovernmental Relations.
- Enhance cooperation between the states and the federal government to simplify administration and improve proper compliance for those taxes shared by the states and the federal government.
- Work cooperatively with Congress to enact legislation that supports equitable state taxation, curbs tax sheltering activities, and rewards state tax uniformity efforts.
- Coordinate federal and state tax bases in a manner that facilitates federal fiscal policy choices while minimizing adverse effects on states and localities.

A Note on Property, Selected Excise and Estate Taxes

The following report also includes a discussion of key issues concerning tobacco taxes, utility taxes, motor fuels excise taxes, and estate or inheritance taxes, including important issues of federal-state relationships concerning these sources of revenue. With respect to property taxes, the Commission intends to issue a supplemental report. For current purposes, the Commission notes that the states and local governments, responding to public demands to limit or reduce property taxes, have increasingly substituted income and sales taxes for property taxes. The public policy trend of limiting property taxes reinforces the need for states to ensure that income and sales taxes function effectively, efficiently, and equitably in the modern economy. [*Ed. Note: The full report does include a section on property taxes, thus, no supplemental report will be issued.*]

SECTION 1
General Economic and Fiscal Conditions

The Commission's inquiry into the condition of state and local taxation commenced in the Summer of 2001 before the U.S. economy was fully entrenched in a recession and before most state and local governments faced extraordinary budget deficits. By the Fall of 2001, economists Mark Zandi and Charles de Seve[1] were in agreement that the economy was performing poorly and that there were few signs at the time of a robust economic recovery. They disagreed, however, on the timing and strength of the recovery. For the near-term, Dr. Zandi saw some signs that economic growth may be vigorous. He estimated that increased cash holdings because of mortgage refinancing and a stimulative federal fiscal policy along with rising consumer confidence should provide an impetus for higher levels of consumer spending. Additionally, in his view, the banking sector had adequate reserves and capital which would reduce the risk of a "credit crunch."

Dr. de Seve's Fall 2001 perspective was more pessimistic. In his view, the weaknesses in the Asian and European economies would act as a drag on economic performance. Dr. de Seve did not foresee a significant upswing in business investment because of excess capacity in the telecommunications and other high-tech sectors. Nor did he foresee either consumer spending or state and local government spending providing enough of an impetus for strong growth. In fact, Dr. de Seve suggested that there was a risk of a "double dip" recession, where the incipient economic recovery may be too weak to be sustained and another recession may occur. The only bright spot, in his view, was the housing sector, which buoys consumer spending.

The downturn in the economy had a profound effect on state and local budgets. Substantial reductions in public revenues from personal and corporate income taxes became more apparent in the second quarter of 2001 as a result of the poorly performing economy. Since then, state expenditures for unemployment compensation and public assistance have risen, while tax revenues have fallen steadily. The events of September 11th deepened and prolonged the recession and generated a new public sector responsibility for homeland security. State and local revenues have declined more severely than the national economy, while costs for existing programs continue to rise. Consequently, recent estimates indicate that state and local budgetary shortfalls will exceed $60 billion in 2003.[2]

The fiscal conditions of most state and local governments, according to the conventional view, would normally be expected to improve following a national economic recovery. However, many analysts believe public finance faces more serious challenges in the decade ahead. The fact that state and local revenues have declined more severely than the national economy in the recent recession suggests that state and local tax systems are increasingly out of date and fail to fit with the nature of the modern economy. Thus, even if the national economy recovers quickly, many state and local tax systems may continue to lag behind the growth in the economy and fail to generate revenues consistent with historic patterns.

The structural inadequacy of state and local tax systems creates inequities among taxpayers, with those who pay existing taxes shouldering a greater burden than those engaged in economic activities that are beyond the scope of existing systems. Further, these inequities reduce economic growth by creating an "uneven playing field" that distorts the allocation of capital away from what the market would determine to be its most efficient uses. Meanwhile, demographic changes in the population will drive increased spending on education and state Medicaid programs, drawing more resources away from other essential public functions. For these reasons, some analysts are cautioning state officials to undertake a more critical review of existing revenue systems with the purposes of modernizing those systems to reflect the modern economy and creating systems that are more effective, efficient, and equitable.

Revenues

Dr. Robert Tannenwald, assistant vice president of the Federal Reserve Bank of Boston, believes that state and local tax systems—specifically general sales taxes, corporate income taxes, and property taxes—are in danger of becoming obsolete. As the mainstays of the state and local tax structure, these taxes are not likely to produce sufficient revenues to fund anticipated expenditure needs without increases in tax bases or tax rates. Dr. Tannenwald enumerated four reasons why these revenue sources are becoming obsolete: 1) the competition among states for economic development; 2) a shift in the macro-economy from production and consumption of goods to production and consumption of services; 3) the rise of electronic commerce; and 4) the failure to include the value of intangibles in the property tax base.

According to Dr. Tannenwald, the major problems confronting state and local governments regarding sales and use taxes are the general exclusion of services from the tax base and the general inability to collect legally owed taxes on remote commerce. Professors William Fox and Donald Bruce of the University of Tennessee at Knoxville agreed with the sober analysis of the structural problems in state sales tax systems. Professor Fox presented evidence on the erosion of sales tax bases resulting from the exclusion of services from taxation. Similarly, Professor Bruce presented data on the deterioration of state sales tax bases due to the growth of electronic commerce. Dr. Bruce estimated that by 2011, the net effect of the growth of electronic commerce would reduce state and local sales tax revenues by approximately $29.2 billion. This figure represents nearly three percent of total state tax revenues in 2011 (ranging from 1.4% in the District of Columbia to 5.3% in Texas).[3]

With respect to business activity taxes, Dr. Tannenwald attributed the crisis to several factors: 1) state tax incentives to attract mobile capital and businesses; 2) changed apportionment formulas to lower tax burdens on in-state businesses and raise the burden on out-of-state businesses, and 3) P.L. 86-272, the federal law that prohibits states from imposing business activity taxes on firms whose only activity in the state is soliciting sales of tangible personal property.

Finally Dr. Tannenwald found that structural problems with the property tax, traditionally imposed on real or personal property but not on intangible property, have led to a reduction in local government revenues which can be expected to continue in the future. Other commentators agreed with the bleak assessment in general of the current and future fiscal condition of the states.[4]

Expenditure Needs Today and Beyond

Donald Boyd, deputy director of the Rockefeller Institute of Government, State University of New York at Albany, Raymond Scheppach, Executive Director of the National Governors Association in Washington, DC, Scott Pattison, Executive Director of the National Association of State Budget Officers (NASBO) in Washington, DC, and Karen Anderson, President of the National League of Cities and Mayor of Minnetonka, MN, identified areas that will require greater state and local expenditures in the coming years: elementary and secondary education, higher education, and health care, particularly Medicaid. Ray Scheppach observed that unfunded federal mandates always command substantial state and local budgetary resources. In addition to those traditional expenditure areas, Dr. Scheppach described how homeland security has become an important new responsibility of state and local governments.

Mr. Pattison reported that Medicaid expenditures constitute nearly 20 percent of state budgets and grew by more than 13 percent in 2002 alone. Table 1 presents the distribution of state spending by function. If expenditures for each function were to continue to grow at the rate of their recent trends, Medicaid alone would consume more than one-third of state budgets in 2011, and easily become the largest item of state spending. Spending on education—elementary and secondary, and higher education— accounted for slightly more than one-third of state spending in 2001. If Medicaid and education continued to dominate state expenditures throughout the decade, the greatest relative decline by 2011 would occur in the category labeled "All Other." This catch-all category includes spending on parks and recreation, care for the mentally ill, state police, contributions to employee pension funds, information technology, housing, the environment, and general aid to local governments.

Table 1

State Spending, by Function, as Percent of Total State Spending

Function	2001	2006	2011
MEDICAID	19.6%	26.2%	33.6%
Elementary and Secondary Education	22.2%	20.6%	18.3%
Higher Education	11.3%	10.5%	9.4%
Public Assistance	2.2%	2.0%	1.8%
Corrections	3.7%	3.4%	3.1%
Transportation	8.9%	8.1%	7.3%
All Other[1]	32.1%	29.2%	26.5%

[1]Includes: Public Health, Parks and Recreation, State Police, Employer Contributions to Pensions and Other Benefits, Information Tehcnology, Care for the Mentally Ill and Disabled, Environment, Housing, and General Aid to Local Governments.
Source: *National Association of State Budget Offices (NASBO).*

These NASBO projections of spending by function portend several critical problems for state and local governments:

- Deferral of maintenance of public infrastructure (roads, bridges, tunnels, schools, and other public buildings).
- New infrastructure investment would cease, leaving traditional public needs unmet.
- Decreased funds available for local governments.
- Further cuts in all but the most politically popular programs.

Although the immediate future of state and local government fiscal conditions is gloomy, Mr. Pattison did note a "silver lining" in the fiscal clouds. The pressures that state and local governments currently face may lead to structural reforms: revitalizing major broad-based taxes and prioritizing expenditure needs.

SECTION 2
The State of Sales and Use Taxes

Forty-five states plus the District of Columbia currently impose a general state sales tax. The general sales tax is the second largest source of state revenues after the personal income tax.[1] In 1999, general sales tax revenues accounted for 17 percent of state and local government revenues and 25 percent of state government revenues. (For local governments nationwide, the sales tax is the largest source of revenue after the property tax, accounting for approximately 7 percent of their revenues.[2]) Despite their importance to states' tax structures and despite the rise in rates, sales taxes as a proportion of state and local revenues, have been flat over the past decade.

Generally, state sales tax systems have not been updated over the years to keep pace with changes in the modern economy. These systems were designed in the 1930s when manufacturing dominated the American economy. As a consequence, current state sales tax bases are largely limited to tangible personal property. Sales tax bases are shrinking in an economy that is increasingly dominated by untaxed services and intangibles. In many states, the burgeoning list of items of tangible personal property being exempted from sales tax compounds the erosion of the base.

The growth of remote commerce (via mail, telephone, the Internet) coupled with the U.S. Supreme Court's use tax nexus jurisprudence limiting the states' ability to require collection of tax on remote sales, has created numerous opportunities to avoid paying or collecting tax on taxable transactions. On the other hand, taxpayers' efforts to comply with sales taxes are complicated by the administrative burdens multistate companies face due to the lack of uniformity among the states with respect to: definitions of taxable items; determining the location of a sale; return filing dates and forms; registration requirements; and other administrative requirements.

Additional compliance complexities arise from the administration of sales and use taxes by numerous local governments. At the end of the 20th century, sales and use taxes were growing more inequitable and less reliable as a source of revenue for state and local governments.

With the purpose of modernizing sales tax systems, states created a coalition committed to simplifying and improving sales tax administration. The Streamlined Sales Tax Project and the Streamlined Sales Tax Implementing States, working closely with the business community, are designing a simplified system for collecting and administering sales and use taxes that will reduce the number of sales tax rates, bring uniformity to definitions of items in the base, reduce paperwork burdens on sellers and incorporate new technology to modernize administrative procedures. If successfully implemented by the states, the streamlined sales tax system will help restore fairness to competition between local retail store purchases and remote sales transactions and provide a means for states to collect taxes that are owed under existing law.[3]

Recommendations

To preserve the sales and use tax, the Commission recommends that state policy makers consider the following actions:

- Strengthen nexus standards for companies to collect sales and use taxes to better reflect current business practices.
- Evaluate the scope of sales and use tax bases in relation to the shift of consumption toward services and intangible products.
- Adopt the Streamlined Sales and Use Tax Agreement to make it easier for retailers, including remote sellers, to collect the tax.
- Request that Congress or the Supreme Court approve standards for tax collection that level the playing field

for in-state and multistate businesses. Congressional action could be conditioned upon implementation of the streamlined sales tax system by a critical mass of states.

Additional Policy Questions

There are additional policy questions that state policy makers might review and evaluate as they seek to improve sales and use taxes:

- Is a European-style value added tax or other comprehensive consumption tax on all or most consumer purchases coupled with no tax on business inputs a viable alternative to the traditional sales and use tax systems in the U. S.?
- What are the issues involved in considering expanding the sales tax base by one or more of the following methods: a) taxing all household purchases; b) taxing all purchases regardless of purchase mode; c) taxing all purchases regardless of a buyer's or seller's identity; d) taxing services?
- Would broadening the scope of the sales tax base to fit modern consumption patterns lead to reduced sales tax rates?

SECTION 3
The State of Business Activity Taxes

Determining when states may impose corporate income taxes (and other business activity taxes such as, franchise taxes, apportionable gross receipts taxes, and value added type taxes) on businesses presents one of the most significant issues currently under debate in Congress and in the state tax community. This debate is particularly important today because of the substantial decline in revenue from corporate income and related business activity taxes. Between fiscal years 1962 and 1980, corporate income taxes, as a percentage of all state tax receipts, rose from 6.4 percent to 9.7 percent. However, since the peak year of 1980, the relative importance of the corporate income tax has declined. In fiscal year 2002, corporate income taxes accounted for 4.9 percent of all state tax revenues.[1]

During the 1960s and 1970s, when the corporate income tax was growing in importance in state budgets, a number of states adopted this tax, and some states that adopted this tax before the 1960's were expanding the base and raising tax rates. Between 1962 and 1980, the effective rate of state corporate income taxes on corporate profits rose from 2.6 percent to 9.6 percent. Between 1980 and 1986, the effective rate declined to a low of 7.8% in 1984, then climbed again to a high of 9.2% in 1986. Since 1986, however, the effective rate has fallen continuously to a low of 5.0 percent in 2002.[2]

There are a number of reasons why the state corporate income tax has declined in terms of both relative share of state tax collections and effective rates. There is general consensus that the current recession is the major cause of the decline in tax receipts now. Other theories abound about the longer-term relative decline in the corporate income tax, including: 1) federal laws that preempt state tax bases; 2) the decline in the federal tax base; 3) aggressive tax planning; and 4) states' own policies that reduce their tax bases.

Federal Laws that Preempt State Taxes

Public Law 86-272[3] prohibits states from imposing their business activity taxes on an out-of-state company whose only activity in the state is the solicitation of sales of tangible personal property. An out-of-state company is exempted from corporate income tax under this federal law regardless of the volume of sales made in a state or the number of sales personnel in the state as long as its in-state activities amount to no more than the solicitation of sales of goods that are approved outside of the state and those goods are delivered from outside the state, either by common carrier or in the company's own trucks. Any income earned from the sale of goods into market states is effectively exempted from state income taxation by those states under the restrictions of this federal provision. P.L. 86-272 is a shield for companies that sell their products primarily through the Internet or through catalogue sales from remote locations. These companies are not subject to market state corporate income taxes because of this federal preemption of state jurisdiction to tax.[4]

More recently, a bill introduced in the 107th Congress (H.R. 2526) proposed greater restrictions on state jurisdiction to impose business activity taxes than current U.S. Constitutional nexus standards and the current restrictions of P.L. 86-272. Under current law, "doing business within the state" creates the necessary connection to justify state taxing authority. The 107th Congress ended its session without taking action on H.R. 2526. Bills like H.R. 2526 are significant because they can, if enacted, diminish the states' authority to impose income taxes to finance schools, transportation, and other essential services for their citizens and they have the potential to cause states to lose billions in revenue per year.[5] Partially in response to H.R. 2526, but more importantly, in an effort to provide a simple, certain and equitable nexus standard for the collection of state business activity taxes, the Multistate Tax Commission developed the "factor presence" nexus standard. This proposed nexus standard provides that a company has substantial nexus with a state for the tax period if it has more than threshold levels of property, payroll or sales in the state.[6] Professor Charles McLure originated the idea of utilizing the same factors that are used in the formula for apportioning the income of multistate businesses to determine nexus for income tax purposes.[7]

Changes in the Federal Tax Base that Affect State Tax Bases

The majority of states that impose corporate income taxes use the federal definition of taxable income, with adjustments, to determine the amount of taxable income. This net income is then apportioned among the states. Consequently, if profits reported to the Internal Revenue Service do not grow apace with the general economy, the profits that states are able to tax will not grow in proportion to the general economy's growth.

One source of shrinkage of the federal and state corporate income tax base is the proliferation of "pass-through" entities. These businesses are not taxed at the entity level. Their income is "passed through" to the constituent shareholders, partners, or members. Any tax liability is borne by the individual or corporate members of the "pass-through" entity.

There are three basic types of "pass-through" entities: "S" corporations, partnerships, and Limited Liability Companies (LLCs). These "pass-through" entities accounted for 67 percent of all corporate businesses in 1999. The income of these entities accounted for 23.5 percent of all corporate gross receipts. Recent federal legislation allowed "S" corporations to have subsidiary "S" corporations. The subsidiary "S" corporations can earn income but are disregarded for federal tax purposes.

Changes in the federal tax base can effectively preempt state taxing authority. Recently, the federal government passed The Economic Growth and Tax Relief Reconciliation Act (EGTRRA). Two parts of this legislation will lead to the erosion of state tax bases. One part is the gradual elimination of the estate and gift tax. Another part leading to state tax base erosion is the "bonus" depreciation allowed for assets put in service between September 10, 2001 and September 10, 2004. The Center on Budget and Policy Priorities estimates the cost to the states from this item in EGTRRA to be more than $14 billion between 2002 and 2004.[8] States could avoid this revenue loss by "decoupling" their income tax from the federal tax. Decoupling, however, would create more complexity in the tax system and add to the compliance burdens of multistate businesses.

Aggressive Tax Planning that Leads to a Decline in the Federal Tax Base

In its recent publication, "The Cheating of America," the Center for Public Integrity documented numerous examples of how aggressive tax planning is eroding the corporate tax base at the federal level.[9] Businesses shift income out of the U. S. and into countries with low tax rates, or with no tax on profits, by establishing offshore partnerships and subsidiaries. This shifting often occurs by means of questionable transfer pricing arrangements. A simple example is where a corporation may license its foreign affiliates to use patents, trademarks, *etc*., at below market rates. The foreign affiliates then use this ability to produce and sell the company's products or services at market prices. The bulk of the income is thereby shifted away from the U.S. company subject to federal (and state) income tax to the foreign affiliates located in a low-tax or no tax jurisdiction.

If the U.S.-based company were to establish a Bermuda-based partnership to hold its foreign assets, the profits could be assigned to the Bermuda-based company, thereby shielding the foreign source profits of the U.S.-based company until a portion of the profits are repatriated, if ever, to the U.S. Profits subject to both federal and state income taxes could be further reduced if the U.S.-based parent were to borrow funds from the Bermuda-based affiliate at interest rates above market rates in the U.S. This would result in the further shifting of income out of the U.S. into affiliates based in countries that do not tax this source of income.

Modern tax planning techniques can siphon income from areas where real economic activity takes place and send the income to areas that do not tax this type of income. Although the "pass-through" entity form of business organization is not, in and of itself, a tax avoidance scheme, it can be an effective tax planning tool. For example, an LLC can be established to conduct business in a number of taxing jurisdictions, but a holding company in a state that does not tax income from intangible assets can be established that would own 99 percent of this LLC while the parent would own the remaining 1 percent. As a result, 99 percent of the income earned by the "pass-through" entity would be shifted to a jurisdiction that does not impose a tax on the income. In addition, the income earned by "disregarded" entities may never be reported.[10]

State Policies That Reduce Their Tax Bases[11]

States' own tax policy choices also have contributed to the declining effective rates of corporate income taxes. States' failure to adopt combined reporting for multistate businesses is also a significant source of tax base erosion. A business that operates in multiple states can establish an intangibles holding company that owns its intangible assets (trademarks, licenses, patents, copyrights, and logos) in a state that does not tax income from the ownership of these assets, *e.g.*, Delaware. The operating company pays the intangibles holding company a fee for the right to use the company's trademark, for example. In states that do not require combined reporting but instead tax each unit of a multistate business independently (a "separate entity" state), the income accruing to the intangibles holding company may be untaxed while the net income of the operating units is reduced by the royalty payments for the right to use the trademark. The Center on Budget and Policy Priorities has developed a list of 25 states that are vulnerable to this form of tax planning.[12]

To induce firms to expand their facilities and employment within their borders, states offer to change the three-factor income apportionment formula to lower the income tax liability of firms with substantial employment and facilities in the state and to increase the tax on firms with little or no physical presence in the state but with substantial sales. This is accomplished by placing heavier weight on the sales factor and lower weights on the payroll and property factors.

A number of states also have eliminated the "throwback" rule, which also reduces the tax liability of companies located in their state. If sales are made into states where the company is not subject to tax either because of P.L. 86-272 or because the company does not have nexus (*e.g.*, sales of tangible personal property into a state in which the company has no property or payroll), states using a "throwback" rule can attribute those sales back into the sales factor of the state of the company's commercial domicile. This eliminates "nowhere" income and increases the tax liability of the company in the state of commercial domicile. By eliminating "throwback," the company's overall tax liability is diminished.

The growth of "pass-through" entities is creating another source of tax base erosion. As mentioned earlier in this section, the income of these entities accounted for 23.5 percent of all corporate gross receipts in 1999. Unfortunately, the states sometimes lack familiarity with these newer business forms and consequently have not adopted effective provisions to address the taxation of income from pass-through entities. An unknown amount of taxable income may be lost to states, however, as the income flows through to members, partners, shareholders or beneficiaries who are not located or do not reside in the state.

State corporate income tax bases also are affected by the interstate competition for economic development. States offer businesses special tax incentives such as tax holidays, investment credits, research credits, job creation credits, and other inducements that reduce the effective rate of tax on their profits. As more and more states offer these incentives, the overall effective rate of tax on corporate profits declines over time.

Recommendations

To help restore the equity and effectiveness of state income tax systems, the Commission recommends that states consider the following actions:

- Adopt "combined reporting"[13] for jointly owned and operated companies—including affiliates in international tax havens—to more appropriately report and assign income to where it is earned.
- Ensure proper filing of state income or business tax returns by those earning significant income from within a state by adopting a uniform "factor presence" [14] nexus standard. Concurrently, urge Congress to relieve the restrictions of P.L. 86-272 for those states adopting this "factor presence" nexus standard to support uniform and equitable state taxes to encourage the free flow of interstate commerce.
- Adopt uniform rules for dividing income among the states to ensure multistate income is reported to states where it was earned and to avoid the possibility of over- or under-reporting of income from interstate commerce.
- Develop uniform tax policies and cooperative administrative systems that make it easier for owners, especially non-resident owners, of pass-through entities to file returns and pay the proper amount of tax to states where income was earned.
- Develop individual or cooperative administrative systems to verify that owners of pass-through entities are paying taxes to those states from which they earn income.

- Strengthen and expand cooperative administration and enforcement among the states through early review of tax shelters considered questionable by several states, increased joint auditing and other cooperative measures, and through expanded federal-state compliance efforts.
- Urge Congress to enact legislation to help curb federal and state corporate tax sheltering and to refrain from enacting new restrictions that would harm the ability of states to tax a fair share of the income of interstate enterprises.
- Encourage the federal government to improve compliance with the federal income tax through improved tax laws and regulations and adequate budget resources for compliance activities.

Additional Policy Questions

State policy makers might assess additional alternatives to help improve the equity and effectiveness of state income tax systems:

- Should states consider replacing business net income taxes with gross value taxes or using gross value taxes as an alternative minimum tax for businesses?
- Should states consider interstate agreements to standardize or limit special "tax incentives" in bids to attract new businesses?
- Should states more thoroughly explore the pros and cons of varying from the evenly-weighted three factor apportionment formula of UDITPA (Uniform Division of Income for Tax Purposes Act)?
- Should states consider eliminating "nowhere" income through the destination sourcing of sales of services and intangibles or by adopting uniform "throwback" and "throwout" rules?

SECTION 4

The State of Federalism

Federalism generally describes the political relationship between a national government and various sub-national entities. One definition of federalism describes the system as "a mode of governance that establishes unity while preserving diversity."[1] The U.S. Constitution, as adopted by the states, establishes a government structure where the federal government is assigned a specific set of duties and powers,[2] and the states retain a substantial degree of sovereignty. Under the Constitution, states retained their independent authority to establish policy in a number of areas. The authority to tax is a key element of state sovereignty because it provides state governments with the means to implement these policies. The future of American federalism depends critically on the integrity and effectiveness of the tax systems of the states. Unless states and their subdivisions can raise revenues to meet public needs defined by their citizens, the states' role in the federal system will decline and power will inevitably shift to the federal government. While states must conform to legitimate federal constitutional and legislative restrictions on their authority, federal actions over the last 40 years addressing state and local matters have raised significant concerns about whether the U.S. system of federalism is at risk.

Professor John Kincaid's description of the evolution of the American system of federalism suggests that state sovereignty in general, not just state taxing authority, faces unprecedented federal pressure. The relationship between the state and national governments in the last 35 to 40 years has been much less of a partnership than during any other period in U.S. history. The early era of "dual federalism" in which the federal government played a very limited role in most domestic areas spanned over 140 years, dating from 1789 to the 1930s. Federal revenue sources were limited primarily to excise taxes, customs duties, and land sales through 1913, when a federal income tax was adopted. On the political level, the states and the federal government cooperated fairly well.

The 1930s marked the beginning of the period of "cooperative federalism" during which the federal tax system became the dominant revenue system. The devastation of the Great Depression necessitated cooperation between the states and the federal government. Federal grants and aid to states and local governments significantly increased. The federal government created the social security system, developed social welfare programs, and introduced substantial federal economic regulations that expanded the federal role in the daily lives of individuals. Nevertheless, the federal government played a minimal role in state and local policy.

The era of "regulatory federalism" emerged in the late 1960s and continues to the present day.[3] This period of U.S. federalism has been marked by significant increases in federal intervention in the internal affairs of states and localities even as federal financial aid has been on the decline or has become contingent upon meeting federal requirements. Prof. Kincaid sets forth ten characteristics of "regulatory federalism", as follows:

- (i) A decline in federal aid to states and local governments.
- (ii) A change in composition of aid—from capital investment to social welfare.
- (iii) An increase in conditions to receiving federal aid.
- (iv) An unprecedented increase in mandates on states and local governments.
- (v) An unprecedented increase in federal preemption of state and local authority.
- (vi) An increase in federal court intervention in state and local affairs.
- (vii) A decline in intergovernmental institutions.

(viii) A decline in cooperation of programs; more unilateral congressional legislation.

(ix) An increase in federal incursions into state and local tax bases.

(x) Enormous federalization of criminal law—from 4 criminal offenses in the U.S. Constitution to over 3,000 federal offenses.

Early recognition of the shift in the federal-state relationship to one that disadvantages state government is evident in the frustration expressed by Senator Everett Dirksen with the rush to centralize authority on most domestic issues in the federal government during the 1960s, when he wryly predicted that in the future, "The only people interested in state government will be Rand McNally."[4] In the decades since Sen. Dirksen's remark, the federal government has been inconsistently attentive to the needs of state and local governments, frequently imposing federal mandates (and then attempting to restrain them), sometimes devolving social programs to the states, such as Temporary Assistance for Needy Families, and often treating the states and localities as just another special interest group seeking favors from Congress.[5]

Where matters of taxation and revenue are concerned, the states and the federal government (and the states and localities) generally share authority and responsibility.[6] Over time, however, states' ability to raise their own revenue through their tax systems has come under intense pressure from the federal government, especially where state and local taxation affects interstate commerce. As a result, states have struggled in recent years in their efforts to independently exercise their taxing authority to raise revenue for necessary public services. Ironically, the devolution from the national government to the states of responsibility for funding social programs has increased the importance of preserving state taxing authority.

States have responded to federal pressures placed on their tax systems during this era of regulatory federalism by establishing coalitions to resolve state and local tax administration problems among themselves without federal intervention. The Streamlined Sales Tax Project and Streamlined Sales Tax Implementing States groups are current examples of states working in concert to improve the state of state and local taxation without congressional action. The formation of the Multistate Tax Commission in 1967 is an early instance of states joining together to develop solutions to difficult issues of taxation while preserving state tax sovereignty. In the future, the challenge for states will be to reconcile their different tax cultures[7] in their collective effort to improve state tax systems in the face of potentially harmful federal intervention.

As the states struggle with their relationship to the national government and explore ways to solidify a cooperative relationship with each other on tax and fiscal concerns, states also must confront how they deal with their local governments. The same complaints, conflicts and controversies that arise out of federal-state relations also seem to characterize the fiscal relationship between the states and localities. Of course for states, the nature of the local-state relationship differs precisely because the states are sovereign. Local governments generally are not considered sovereign entities, although in a few states, local governments possess "home-rule" authority to raise their own taxes—an authority granted by states under state constitutions or state statutes.

Washington and Colorado represent two different examples of state tax structures and of the local-state fiscal relationship.[8] Washington relies heavily on the sales tax in the absence of an income tax and almost all local taxes in Washington are administered by the state on behalf of the local governments. In Colorado, the state tax structure is split primarily among the traditional three taxes of sales, income, and property, and many municipalities have "home-rule" authority to control their own fiscal fate through administering their own sales tax. Yet, the relationships between the localities and the state governments in both states present similar difficulties: 1) any changes in the state tax base directly affect the local tax bases, although Colorado cities, counties, *etc.*, can independently reverse the effects of state changes; 2) the state governments in both Washington and Colorado tend to hand down mandates obligating locals to provide services without sufficient (or any) funding; 3) seemingly draconian taxpayer initiatives cut revenue streams necessary for adequate provision of local services;[9] and 4) the state legislatures seem inattentive to the needs of localities.

Local governments seem to view the states in many of the same ways states view the national government. Local officials are concerned about state-level insensitivity to local fiscal concerns. Representatives from Washington and Colorado localities expressed a preference for direct control of their fiscal fate through "home rule" authority to administer their own taxes. The interdependence of state and local fiscal conditions is inescapable, however. State-level tax policy decisions undoubtedly affect the availability of revenue needed to cover the costs of local services expected by local citizens, even in instances where localities have "home-rule" authority.

Recommendations

State policy makers should consider the following options to preserve their sovereign authority and create a positive partnership with Congress on issues of taxation:

- Strengthen and expand interstate coalitions and cooperative institutions that harmonize state tax policies, provide simplified and joint tax administrative practices across jurisdictions and improve state and local tax compliance through joint enforcement mechanisms.
- Revive, in cooperation with Congress and the President, a liaison organization established by law between the states and the federal government

similar to the former Advisory Commission on Intergovernmental Relations.

- Enhance cooperation between the states and the federal government to simplify administration and improve proper compliance for those taxes shared by the states and the federal government.
- Work cooperatively with Congress to enact legislation that supports equitable state taxation, curbs tax sheltering activities and rewards state tax uniformity efforts.
- Coordinate federal and state tax bases in a manner that facilitates federal fiscal policy choices while minimizing adverse effects on states and localities.

Additional Policy Questions

State policy makers might also review additional policy questions when evaluating the balance between state and federal authority and state and local government authority in the area of state and local taxation:

- How can states strengthen existing political coalitions in order to present more clearly their collective interests to Congress?
- Should states expand cooperation among themselves to administer state and local taxes on a regional and national basis?
- What role should local governments play in the continuing dialogue on improving revenue systems?
- What are the major concerns of local governments in a particular state that require the immediate attention of state government?

SECTION 5
The State of Excise Taxes and Estate Taxes

Selective sales and gross receipts taxes on utilities, tobacco, and motor fuels accounted for $57.3 billion, or 6.6% of total state tax and local tax revenue for the fiscal year ending in 2000.[1] In addition, estate and gift taxes accounted for approximately $7.4 billion in revenue for the states in the fiscal year ending in 2002.[2] The federal-state relationship has a substantial impact on all of these taxes—through federal efforts to restructure regulated industries, or through a common tax base for motor fuels, tobacco, and estate taxes.

Utility Taxes

The restructuring and deregulation of telecommunications and energy utilities that has occurred over the past 25 years has had a significant impact on state utility taxation. The world of regulated, intrastate monopolies has given way to competition—particularly in telecommunications and the supply of natural gas and electricity. While regulated monopolies could easily pass taxes through to customers as part of their rate structure, high utility taxes now must be borne by the utilities themselves in unregulated competitive markets. In addition, incumbent service providers are often subject to special utility taxes, while their new competitors are sometimes subject to lower taxes that apply to general businesses. Other tax issues in competitive electricity markets include the characterization of electricity (as tangible personal property or as a service), the determination of clear nexus standards and the establishment of uniform sourcing rules.

The potential negative impact of competition and divestiture of local utility networks on local property tax bases is another consequence of deregulation. In many states, utility assets have been assessed at a higher proportion of value than other commercial real property. These high valuations and property taxes were easily passed through to customers as part of the regulated utility rates. In addition, many states have used unitary assessment to value utility property, where the value of an asset is a portion of the value of the entire utility system. Some states have begun to treat utility assets, especially those operating in competitive markets, like other commercial real property, which means that they are now assessed at market value on a non-unitary basis. These valuations are often much lower than those for the traditional, regulated utility system.

Florida and Illinois have made major progress in simplifying their telecommunications taxes. Florida, which previously had 370 jurisdictions with telecommunications taxes, now has a single state-administered communications services tax that replaces many of the previous taxes.[3] Florida has also adopted a broad definition of telecommunications, which includes cable and satellite service. Illinois has adopted a single, state-administered tax that replaced multiple local taxes. In addition, the number of special gross receipts taxes on telecommunications utilities has declined—from 30 states in the late 1980s or early 1990s to 12 today.

Estate Taxes

The estate tax, which was originally a state tax, became a shared federal-state tax in 1924, with the introduction of the state credit against the federal estate tax. The state estate tax credit has essentially provided "free revenue" for the states—it is a credit against the federal tax that would be collected at the federal level in the absence of a state tax. With the phase-out of the estate tax by the federal government, this tax has the potential, once again, to fall within the exclusive domain of the states. Changes in the estate tax introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) include reductions in the marginal estate tax rate, increases in the federal estate tax exclusion, phase-out of the state credit (to be eliminated in 2005), and elimination of the estate tax in 2010. This means that the state credit is eliminated five years prior to the elimination of the federal estate tax. All of the provisions of EGTRRA sunset in 2011, thus, without additional legislation, the federal estate tax returns in 2011.

States have a variety of estate tax provisions. Some tie the state tax to the federal credit allowed as of a certain date. The estate tax in these states is not phased-out by EGTRRA. Other states tie the state tax to the federal credit allowed under current law (a "pickup" tax). Tax in these states is reduced and then eliminated by EGTRRA. For states with a pickup tax only, estate tax revenues were approximately $5 billion in FY 2001, or about 1.3% of general fund revenues.

States will lose substantial revenue with the phase out of the state credit and repeal of the estate tax. Since estate taxes are collected from the wealthiest individuals, the elimination of estate taxes would reduce the overall progressivity[4] of state tax systems.

Upon full repeal of the federal estate tax, states that choose to continue to impose a state-level estate tax will face several administrative issues: they will have to increase their audit activity for estate taxes, since they can no longer depend on the federal audit presence. Some states might also have difficulty with establishing an audit function, since estate tax revenue might not justify substantial audit resources. States also face the potential of creating 50 unique estate tax systems with 50 sets of administrative requirements. The ease with which wealthy individuals can change residence or domicile, creates a potential for tax avoidance. Fixed assets, like real estate, are likely to face a greater tax burden *vis a vis* intangible assets which can be easily moved to take advantage of favorable taxing jurisdictions.

Tobacco Taxes

Cigarettes and other tobacco products are subject to federal, state and local excise taxes. Tobacco excise taxes provided about $9 billion in revenue to the states in the year ending 2001—slightly more revenue than estate taxes. In addition, states are receiving more than $5 billion per year under the provisions of the Master Settlement Agreement (MSA). The MSA was reached in 1998 between the four largest cigarette manufacturers and 46 states, the District of Columbia and six territories.[5]

The federal government, under the Jenkins Act and the Contraband Cigarette Trafficking Act, plays a leading role in control of interstate sales of cigarettes and provides informational and enforcement resources to the states to support tobacco tax enforcement. The Jenkins Act (Title 15, US Code, Section 375) applies to persons who sell or advertise cigarettes in interstate commerce, including mail order sales. The Contraband Cigarette Trafficking Act (Title 18, US Code, Chapter 114) makes it unlawful for any person, other than an exempt person, to ship, transport, receive, posses, sell, distribute, or purchase "contraband cigarettes." "Contraband cigarettes" are defined as a quantity of more than 60,000 cigarettes that bear no evidence of the payment of any state cigarette tax imposed by the state where such cigarettes are found.

Interstate and international smuggling of cigarettes and Internet sales of cigarettes pose significant tax avoidance problems for the states. Additionally, although states cannot tax goods purchased by American Indian tribal members on tribal lands, they can tax sales to non-tribal members. Enforcement of that tax, however, is very difficult.[6]

Motor Fuels Taxes

States generally tax gasoline, diesel fuel, gasohol, and other motor fuels. Tax reporting requirements, in 48 states and 10 Canadian provinces, allow motor carriers to report and pay motor fuel taxes to a single base jurisdiction, typically their home state or province. Under the International Fuel Tax Agreement (IFTA), an interstate motor carrier needs only a single (state-issued) IFTA fuel tax license for each of its qualified motor vehicles. A clearinghouse arrangement is used to forward the portion of motor-fuel taxes owed to other member states and provinces.

The original IFTA was formed by three states—Arizona, Iowa, and Washington, in 1983. By 1990, this had grown to 16 states; however, many states were reluctant to allow other states to collect their fuel tax. The current IFTA was established by the Intermodal Surface Transportation Efficiency Act (ISTEA) in 1991—at the encouragement of the trucking industry. At the time, the industry cited burdensome reporting, audit, and compliance burdens, especially on small trucking companies. Under federal encouragement to participate, 48 states and 10 provinces were participating in IFTA by 1996.

IFTA clearly has been successful in improving tax administration and reducing burdens on interstate truckers, but challenges remain in maintaining an enforcement presence in this area. Some states have had trouble meeting the base state audit requirement of IFTA.

Recommendations

The states' reliance on the federal government with respect to these taxes and the trend toward deregulation of utility industries have placed a strain on state tax structures. The Commission recommends that state policy makers consider the following options:

- Evaluate taxes on formerly regulated industries and decide whether they should be revised or eliminated.
- Update taxes that are retained on formerly regulated industries so that they operate equitably under the new market conditions, adopt uniform provisions on a joint basis for features with a multistate impact and simplify administration, including state-level administration of local taxes, where feasible.
- If choosing to keep a state level estate tax in place, adopt uniform laws and administrative procedures, including provisions for joint administration with other states.
- Strengthen cooperation among states and with the federal government in enforcing excise taxes on tobacco and motor fuels and urge Congress to expand the scope of the Jenkins Act and the Contraband Cigarette Trafficking Act to curb federal and state tobacco tax evasion.

Additional Policy Questions

State policy makers might consider the following additional policy questions in evaluating the effectiveness of various excise taxes and estate taxes:

Utility Taxes

- To level the playing field, should states consider taxing both competitive utility services and incumbent utilities as general businesses rather than under special utility taxes?
- Should states provide guidance on the applicability of P.L. 86-272 to the sale of electricity, where it is characterized as tangible personal property?
- Should states develop uniform rules for sourcing sales of electricity, despite the variance among the states in the treatment of electricity as tangible property or a service?
- What kind of guidance should states provide to remote sellers of electricity on nexus for collection of use taxes?
- Should state government provide hold harmless provisions or transitional aid for local governments whose property tax base is adversely affected by utility deregulation?

Tobacco Taxes

- How beneficial from a tax revenue perspective would it be for state, local, and federal governments to cooperate to license the entire supply chain for the sale of cigarettes?
- Is there room for improved cooperation between federal and state governments and Indian tribes to ensure that all sales of cigarettes are taxed and appropriate rebates are made available to tribal governments?

Motor Fuels Taxes

- Is there room for improved cooperation between the states and the federal government to monitor the achievement of base-state audit requirements under IFTA and motor fuels compliance of multistate motor carriers?

Estate Taxes

- What are the advantages and disadvantages to states of either 1) de-coupling from the federal law and continuing a state level estate tax or 2) opting for no state estate tax?
- Should states evaluate adoption of inheritance taxes?
- Should states commit resources to closely monitor federal activity on the estate tax?

<u>SECTION 6</u>
The State of Property Taxes

The Property Tax as Part of Federalism at Risk

In lieu of holding a separate session on property taxes, the Multistate Tax Commission issued a call for papers on this topic. In response to this request, Bruce Wallin of Northeastern University submitted a paper, *The Tax Revolt in Massachusetts: Lessons from Proposition 2½*. In addition, the MTC received submittals from the following:

> C. Lowell Harriss, Emeritus, of Columbia University, *Improving Property Taxation* (this item was submitted for *Federalism at Risk*) and *Land Taxation as an Evasion-Proof Revenue Source* (this item was prepared for the 49th Congress of the International Institute of Public Finance in 1993).
>
> David Brunori, *To Preserve Local Government, It's Time to Save the Property Tax* (previously published in State Tax Notes, September 5, 2001).

In addition to these submitted materials, this review of the property tax draws on recent published materials from the National Education Association (NEA),[1] the National Conference of State Legislatures (NCSL),[2] the Urban Institute,[3] and by Robert Tannenwald.[4]

What Is the Property Tax and How Is It Administered?

An understanding of some basic elements of the property tax is important to comprehending its role in the state and local fiscal system as well as proposals for reform.

Taxable Property

The range of property subject to property tax has varied considerably over its history in the U.S. Taxable property can include real property, personal property, and intangible property. Real property consists of land and permanent improvements to land. Personal property is any movable or intangible thing that is not classified as real property. A distinguishing feature is that personal property can be severed from real property without injury to the latter. Personal property can be either tangible or intangible. Tangible personal property such as food or computers has a physical or material existence and can be perceived by the senses. Intangible property, such as stock certificates, promissory notes, trademarks, patents or copyrights, lacks a physical existence.

Determining the Tax Base

In addition to the range of property subject to tax, the tax base is usually limited by exemptions and abatements. Exemptions, which vary from state to state, usually include property owned by governments, nonprofit organizations, schools, and religious organizations. Abatements provide for a reduced tax rate for taxable property and are frequently applied to owner-occupied housing, for example, homestead exemptions, or an abatement for a segment of homeowners, such as low-income senior citizens. In addition, abatements are frequently used to encourage commercial or industrial development or encourage investment in areas designated for redevelopment. Assessment of agricultural or open space land on the basis of their current use rather than their unrestricted use has also become a popular form of abatement.

Assessment Practices

The taxable value of property is usually set by the standards of the market—the price that a property sells for in an 'arms-length' transaction. Assessors use three basic approaches to arrive at the value of a property—the market data approach, the cost approach, and the income approach (see Glossary for an explanation of these approaches). With the exception of Maryland and Montana, where all real property is assessed at the state level (referred to as central assessment), most property is valued at the local level. However, many states assess railroad and utility property at the state level and all other property at the local level.

For utilities, it is conceptually difficult to separate the value of the business enterprise from the value of the physical network utilized by the utility. Assessment of such businesses is often done on a unitary basis, where the assessed value is based on the value of the entire business enterprise, including its real property. As discussed in the section on excise taxes, the deregulation of telecommunications and other utilities can lead to substantial decreases in the property tax base—as assessments are changed from a unitary basis for a large monopoly to a non-unitary basis for real property owned by competitive service providers. Deregulation also presents a horizontal equity[5] issue where the assets of incumbent utilities are subject to higher valuation than those of their competitors who are not subject to unitary assessment.

Some observers point out the difficulties of assessing business property at the local level and recommend that all business property be assessed at a higher level of government. In Britain, taxes on business property are collected by the central government and distributed to localities.[6]

Role of Property Tax in State and Local Revenue Systems

The character of the property tax in the U.S. has continued to evolve with changes in the economy and development of alternative revenue sources, particularly at the state level. The early practice of taxing land and enumerated assets gave way to a more comprehensive property tax system in the first half of the 19th century. Later in the 19th century, there was a movement away from a comprehensive tax toward the application of different assessment methods and tax rates to distinct types of property. Many states continue to use the classification systems for property that were established during this period. A large number of states moved away from applying property taxes to intangibles during this period, partly in response to the difficulties in the situsing and valuation of intangible assets.

During the "Great Depression" of the 1930s, many states adopted sales and income taxes to replace declining property and other tax revenues. The availability of revenue from sales and income taxes lessened the need, on the part of the states, for comprehensive property taxation. Today, many states no longer tax non-business personal property, other than automobiles. In addition, only a small number of states tax intangible property. At the beginning of the 21st century, the property tax, which has a history as a comprehensive tax, is now primarily a tax on real property.

The federal role in property taxation has been limited. However, in response to industry claims of over-taxation of railroad property, Congress passed the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act). This legislation prohibits a state or subdivision of a state from assessing rail transportation property at a higher ratio to market value than that applied to other commercial and industrial property.[7] It also granted jurisdiction to the federal district courts. Other utility industries (*e.g.*, natural gas pipelines, electric utilities, and telecommunications) have expressed interest in similar federal protection.

While the property tax has shifted from being the main source of state and local revenue early in the last century to about 29 percent of tax revenue in fiscal year 2000,[8] it remains the dominant source of local revenue—providing 72 percent of all local tax revenue in 2000.[9]

The Role of Tangible and Intangible Assets in the Economy

The transformation of the property tax from a general tax to one that is based on the value of real property has repercussions for state and local government finances. In a recent article in the New England Economic Review, Robert Tannenwald asks if state revenue systems are becoming obsolete; that is, will revenues grow apace with the general economy? Dr. Tannenwald documents the tremendous increase in the role of intangible assets throughout the economy, from 1977 to 1997. For all industries, the ratio of intangible assets to all assets, increased from .01 in 1977 to .15 in 1997. This shift has occurred in all major sectors of the economy, including extractive industries, manufacturing, trade, and services. Tannenwald states, "Consequently, the shift in producers' asset mix toward intangibles has slowed growth in the property tax base [relative to the size of the economy] considerably."[10] He does not advocate an extension of property taxes to intangibles, however, noting the difficulties in valuation and sourcing of intangible assets.

To some extent, the changing structure of the economy has contributed to the stability of the property tax base. In examining the ratio of real property to personal property in goods-producing and service sectors of the economy, Dr. Tannenwald finds that service industries utilize a higher proportion of real property than goods-producing industries. Since service industries have been growing in recent decades, relative to goods-producing industries, he concludes that the role of real estate relative to other tangible personal property "may have risen or at least remained constant during the last two decades."[11]

Property Tax Limitation Measures

California's Proposition 13 (1978) and Massachusetts' Proposition 2½ (1980) marked the end of the post World War II trend toward higher property tax rates.[12] For owner-occupied residential properties, Proposition 13 replaced the assessment principle of current market value with assessments capped at the 1975-1976 value plus an adjustment of no more than 2% annually for inflation. Properties may be reassessed to market value only upon sale. Property tax limitations in a few other states were passed during the same time period. The following description of the Massachusetts experience is summarized from Professor Wallin's submittal for the *Federalism at Risk* series.

Bruce Wallin explains the appeal of Massachusetts Proposition 2½ in the context of that state's recent fiscal history. The Massachusetts initiative set a property tax rate limit of 2½ percent. Local governments were given three years to cut their property taxes to that level, after which, real estate tax revenues could grow no more than 2½ percent each year. The initiative also included a reduction in the automobile excise tax. It also provided tools to local officials to control local school budgets and labor contracts, and outlawed unfunded state mandates on local governments. In addition, the initiative limited revenue increases of counties, special districts, and other authorities to 4 percent per year. Legislative amendments subsequent to Proposition 2½ have removed new construction from the property tax limitations and relaxed the requirements for local overrides of the tax limitations. Subsequent to Proposition 2½, state aid to local government has increased—from 34 percent of local tax levies in 1981 to 55 percent in 1990. In addition, some local services, such as water and sewer service, are now funded with user fees rather than local taxes. Rather than a draconian attack on local government, Professor Wallin sees Proposition 2½ as an understandable public response to a history of high taxation and unresponsiveness of policy makers. Legislative amendments have allowed 203 cities and towns to override some of the tax limitations and a shift to state funding has loosened the funding restrictions on local governments in Massachusetts.

Prospects for the Property Tax as a Revenue Source for Local Government

Many observers of state and local fiscal systems point out the continued importance of the property tax to local government—while local revenue sources have become more diverse since the 1970s, the property tax remains an essential element of the local tax system. The following summarizes the submittals of Mr. Brunori and Professor

Harriss who cite the importance of local government in the American federal system of government and the importance of fiscal autonomy to the viability of local government.

Mr. Brunori reviews current problems with the property tax, alternative local revenue sources, and the prospect of state funding of local services. He concludes that there are severe problems with use of local-option sales and income taxes, and little interest in authorizing other local revenue sources, such as gasoline or cigarette taxes. In addition, reliance on state funding creates more uncertainties about local governments' ability to provide local services, such as police and fire protection and education. He argues that the vitality of local governments depends on strengthening the property tax and identifies several elements of this revitalization effort:

- Challenge the negative public perception of the property tax;
- Counter the property tax limitation movement;
- Tie property tax reform to cuts in other local taxes;
- Increase disclosure and discussion of property tax exemptions;
- Consider stricter qualifications standards for nonprofit property tax exemptions or expand authority for payments in lieu of taxes.

Professor Harriss argues that given the usual criteria for judging potential sources of revenue—who pays the tax, effects on the economy, administrative factors, compliance factors, and the relationship of the tax to benefits from spending—the property tax may be the best source of revenue for local government. He places particular emphasis on compliance factors by identifying the property tax, especially that on land, as evasion proof.

Both Brunori and Harriss cite the economic advantages of land taxation and suggest a split-rate system of taxation on land and improvements.

Under this system, land would be taxed at a higher rate. By reducing the tax burden on improvements, a split rate system could have significant positive effects on economic development.

Conclusions

The property tax, which was a comprehensive tax on all property in its early history, has evolved into a tax on real property, and to some extent, business tangible personal property. The introduction of other sources of revenue, including income, sales, selective excise taxes, and user fees, has accompanied this move to a narrower property tax base. Recent evidence indicates the growing importance of intangible assets in the U.S. economy, which means that the property tax base is significantly smaller relative to the size of the U.S. economy than it was twenty-five years earlier. The case for the unique importance of the property tax to local government and the importance of strengthening the property tax system is clear.

Policy Questions

Policy questions that state policy makers might review and evaluate as they seek to strengthen property taxes include:

- How can property owners who are exempt from property taxes contribute to the cost of supporting local public services?
- What are the advantages of imposing a split rate tax on land and improvements to land?
- What state-level administrative functions, such as central assessment of business property, can strengthen property tax assessments?
- How can states ensure that utility taxpayers are treated equally, for assessment purposes, with other commercial and industrial property owners?

SECTION 7
Tax Administration Issues

The goal of a modern tax compliance system should be to facilitate the remittance of the proper amount of tax in each jurisdiction while minimizing the compliance burden on taxpayers and the administrative burden on state revenue departments. Current tax compliance burdens on multistate businesses and state revenue departments often impose unnecessary costs on business and impede states' ability to timely and efficiently collect tax that is legitimately due. Businesses and state governments often lack sufficient personnel to discharge easily their tax compliance responsibilities. The impact of limited personnel resources is particularly acute during economic downturns as businesses and revenue departments often experience reductions in their tax compliance staff at such times.

Whether a tax system is perceived as fair and equitable could depend significantly on its administrative complexity. In June 2001, the Council on State Taxation (COST) issued an article identifying six important state tax administration issues and ranked the states' performance in those six areas.[1] According to COST, the basic procedural elements of good tax administration are:

- Establishment of an independent tax tribunal;
- Evenhanded statutes of limitations for assessments and refunds;
- Equalized interest rates for assessments and refunds;
- Protest periods of at least 60 days;
- Extended due dates for income and franchise tax returns; and
- Under circumstances where federal audit changes have been made, limits on state adjustments to issues in the federal adjustment.

COST's call for state tax administrative policies and practices that achieve a fair, efficient, and customer-focused environment, is not inconsistent with the goals of the Multistate Tax Commission. One of the Commission's explicit core purposes as set forth in the Multistate Tax Compact, is to "facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration." Towards this end, the Commission has recommended the adoption of uniformity provisions such as, the Uniform Protest Statute, the Model Recordkeeping and Retention Regulation and the Model Direct Payment Permit Regulation. As mentioned earlier in this report, the states are making remarkable progress on establishing a uniform streamlined sales tax system that will substantially reduce the burdens associated with sales tax administration.

Recommendations and Additional Policy Options

The Commission already has recommended a number of tax-specific administrative simplifications in earlier sections of this report. In improving tax administration, there are numerous areas in which the states can act independently or collectively. Because a major focus of this report has been on what the states can do jointly as a group to improve the state of state and local taxation while preserving state tax sovereignty, the Commission lists below potential enhancements of tax administration that states can work on together as they assess the effectiveness of their state tax systems.

Improving Tax Administration

- Uniform limitations period of at least 180 days for filing amended state income tax returns after federal audit.
- Simplified, uniform amended state income tax return after federal audit that requires reporting of only changes to the original return.
- State-provided taxpayer education including guidance on state tax implications of federally tax-exempt

corporate reorganizations and proper state tax treatment of federal short-year returns (returns encompassing a period of less than 12 months).

- Expanded state availability of electronic filing for both sales tax and income tax returns.
- Improved and integrated computer systems among the states to enhance information retrieval and facilitate taxpayer communication.
- Expanded use of alternative dispute resolution processes, like the MTC's Alternative Dispute Resolution (ADR) Program and Nexus Voluntary Disclosure Program.
- Simplified, uniform tax calculation method for taxpayers whose incomes fall below certain thresholds.
- Improved cooperation and communications between audit and legal personnel within revenue departments and among the states' audit and legal personnel.
- Expanded acceptance by states of the MTC multistate resale certificate (Uniform Sales and Use Tax Certificate—Multijurisdiction) for sales of goods and services.
- Increased participation in joint compliance activities, including but not limited to the MTC Joint Audit and National Nexus Programs.

CONCLUSION

Within each state, officials face a huge challenge to reform the state and local tax structure to achieve greater tax equity, minimize economic distortions from preferential tax treatment, and reduce taxpayer compliance burdens. When they work together, the states are in a better position to improve state taxes to achieve these objectives. If states continue to act unilaterally to implement narrow policies that increase burdens or inequities, instead of working towards uniformity that would benefit the states and multistate taxpayers collectively, state tax systems will become more ineffective.

Congressional action based on state cooperation and state input—rather than unilateral decisions that result in federal legislation with potentially damaging consequences—will help forge the kind of partnership envisioned under the Constitution. This kind of federal-state relationship remains a distant ideal. A few exceptions serve as models in federalism that may provide promising new directions for improving state taxation, minimizing business compliance costs, and preserving state sovereignty. For the most part, however, Congress persists in introducing and enacting legislation preempting or limiting state taxing authority and compounding the pressure on state and local tax systems.

Congress' selective limitations of state and local tax authority often harm the equity, efficiency, and effectiveness of state and local tax systems. There is a better way—partnership federalism. Congress should respect and reward interstate cooperation to establish greater uniformity in state and local taxation of interstate commerce. Partnership federalism would entail interstate cooperation supported by Congress. The result would be: a) a stronger system of federalism in which state tax sovereignty is preserved; and b) an improved flow of interstate commerce through the harmonization of state and local tax systems.

ENDNOTES

Executive Summary

[1] Mark Zandi, *Fiscal Drag, State Style*, THE DISMAL SCIENTIST, Nov. 22, 2002, *at* http://www.economy.com; *Governors Cite U.S. in Fiscal Crisis*, THE WASHINGTON POST, Dec. 6, 2002, at A1.

[2] On November 12, 2002, the Streamlined Sales Tax Implementing States approved this multistate agreement to simplify state sales and use tax systems. The Implementing States group, comprised of 33 states and the District of Columbia, worked for nearly a year reviewing and debating provisions in the Agreement proposed by the Streamlined Sales Tax Project. State legislators may begin considering legislation in early 2003 to implement the Agreement.

[3] "Pass-through" entities are business forms through which items of income or loss flow through to the owners instead of accruing at the entity level. Examples of pass-through entities are partnerships, S corporations, trusts, limited liability companies and limited liability partnerships.

[4] Combined reporting is a state tax accounting system approved by the U.S. Supreme Court. It is used by several states to ensure a full and complete division (apportionment) of income of a single (or "unitary") business enterprise operating in multiple states. Under combined reporting, the taxable income of separate legal entities comprising a single business operating in multiple states is added together. In contrast, under "separate entity" reporting, the taxable income for each separate legal entity is reported separately without regard to the combined income of the multistate enterprise. Combined reporting helps curb the ability of multistate enterprises to shift income away from locations where the income was earned to no-tax or low-tax jurisdictions.

[5] Generally, property, payroll and sales are factors used to properly divide (or apportion) business income among the states. The Multistate Tax Commission developed a proposed "factor presence" nexus standard for business activity taxes that provides that a company has substantial nexus with a state for the tax period if it has more than threshold levels of property, payroll or sales in the state. The full text of the "factor presence" proposal is available in the Appendix to the full *Federalism at Risk* report or in MTC Policy Statement 02-02 accessible online at www.mtc.gov.

Section 1 - General Economic and Fiscal Conditions

[1] Dr. Mark Zandi is CEO of Economy.com. Dr. Charles de Seve is president of the American Economics Group.

[2] Mark Zandi, *Fiscal Drag, State Style*, THE DISMAL SCIENTIST, Nov. 22, 2002, *at* http://www.economy.com; *Governors Cite U.S. in Fiscal Crisis*, THE WASHINGTON POST, Dec. 6, 2002, at A1. State and local budgetary shortfalls for fiscal year 2004 are estimated at $78 billion. News Release, National Conference of State Legislatures, Three Years Later, State Budget Gaps Linger (Apr. 24, 2003), *at* http://www.ncsl.org/programs/press/2003/030424.htm.

[3] Donald Bruce and William F. Fox, *State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates*, Center for Business and Economic Research, The University of Tennessee at Knoxville, Sept. 2001, at 1, 12, *at* http://bus.utk.edu/cber/

ecomm/ecom0901.pdf. More recently, Peter A. Johnson of the Direct Marketing Association, estimated, using different assumptions regarding projected growth rates of electronic commerce and compliance rates on business to business commerce, that uncollected sales and use taxes arising from the growth of Internet commerce will grow to $4.5 billion in 2011.
Peter A. Johnson, *A Current Calculation of Uncollected Sales Tax Arising from Internet Growth*, The Direct Marketing Association, New York, NY, Mar. 11, 2003, at 22, 30, *at* http://www.the-dma.org/taxation/CurrentCalculationofUncollectedSalesTax.pdf.
[4] Professor Charles McLure of the Hoover Institution of Stanford University; Dan Bucks, executive director of the MTC; Steve Nechemias of Taft, Stettinius, and Hollister, Cincinnati, OH; Michael Mazerov of the Center for Budget Policy and Priorities; and Scott Pattison, executive director of the National Association of state Budget Officers.

Section 2 - The State of Sales and Use Taxes

[1] The percentage of tax revenue derived from the sales tax for each state varies. At the low end, New York derives about 20% of its tax revenue from the sales tax. At the upper end, Washington, Florida and Tennessee derive about 60% of their tax revenue from the tax.
[2] U.S. Bureau of the Census, *Government Finances: 1998-1999*, Sept. 2001, *available at* http://www.census.gov/govs/estimate/99allpub.pdf. Also, summary *at* http://www.census.gov/govs/estimate/9900us.html.
[3] The Streamlined Sales Tax Implementing States adopted the Streamlined Sales and Use Tax Agreement on November 12, 2002. Since that time, state legislatures across the nation have considered, and some have passed, legislation to implement the Agreement and bring their state into compliance with its provisions. The Agreement becomes binding and effective once it has been adopted by a minimum of 10 states comprising at least 20 percent of the total population of states with a sales tax. Nine states, comprising 7.45% of the population of sales tax states, have adopted the Agreement as of May 2003. The Streamlined Sales Tax Project (SSTP) continues to work on refinements to the streamlined system including, definitions of additional key terms, sourcing of services, returns and remittances, exemption certificates, etc. Detailed information about the SSTP is available at www.streamlinedsalestax.org. The Agreement accompanies this report in Appendix E and also may be accessed on the SSTP web site.

Section 3 - The State of Business Activity Taxes

[1] U.S. Bureau of the Census, *State Government Tax Collections: 2002*, Apr. 2002, *at* http://www.census.gov/govs/statetax/0200usstax.html.
[2] State corporate income tax accruals as percent of profits of Domestic Industries less deposits of Federal Reserve Banks, with inventory valuation and capital consumption allowances adjustments. U.S. Bureau of Economic Analysis, http://www.bea.doc.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N and http://www.bea.doc.gov/bea/dn1.htm.
[3] P.L. 86-272 is codified at 15 U.S.C. §§381-384. The provision was enacted as a temporary measure in 1959, pending the completion a study of state taxes authorized by the public law. The four volumes of a report, including recommendations out of the study, were presented to Congress in 1964 and 1965. *Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, House of*

Representatives, H.R. Rep. No. 1480 (1964). This report is commonly known as the "Willis Committee Report," named for Rep. Edwin E. Willis, Louisiana, who served as chairman of the Special Subcommittee.

[4] Prof. Charles McLure described P.L. 86-272 as "too blunt" and ambiguous because the law can have the effect of both exempting income from taxation where the compliance burden is minimal and imposing tax where the compliance problem would not be minimal. (He similarly described the Court's nexus decision in *Quill* on use tax collection as blunt and ambiguous.) It was during this presentation at the opening seminar of the *Federalism at Risk* series in July 2001 that Prof. McLure presented the idea of "factor presence" nexus for income taxation, which is discussed later in this section. Another commentator has suggested that P.L. 86-272 is unconstitutional based on the U.S. Supreme Court's evolving jurisprudence on federalism over the past decade. *See*, Michael T. Fatale, *Federalism and State Business Activity Taxes: Revisiting Public Law 86-272*, 41 Va. Tax Rev. 435. Mr. Fatale, Tax Attorney with the Massachusetts Department of Revenue, presented his thesis and paper at the MTC's *Federalism at Risk* seminar held in February 2002.

[5] The Commission developed an estimate of $9 billion dollars in potential revenue losses per year. *To Make Permanent the Moratorium Enacted by the Internet Tax Freedom Act; and for Other Purposes: Hearing on H.R. 2526 Before the House Subcomm. on Commercial and Admin. Law, Comm. on the Judiciary*, 107th Cong. (2001) (testimony of June Summers Haas, Commissioner of Revenue, Michigan Department of Treasury).

[6] Generally, property, payroll and sales are the "factors" used to properly divide (or apportion) business income among the states.

[7] Professor Charles McLure, Senior Fellow with the Hoover Institution at Stanford University, originated the idea of factor presence nexus and set forth an explanation of the concept in a recent article. Charles E. McLure, Jr., *Implementing State Corporate Income Taxes in the Digital Age*, Nat'l Tax J. 1287 (2000). Professor McLure reiterated his concept during the Commission's July 2001 *Federalism at Risk* seminar.

[8] Iris J. Lav, Elizabeth McNichol, and Nicholas Johnson, *Preserving State Revenue from the Effects of Recent Federal Legislation*, Center on Budget and Policy Priorities, May 1, 2002, at 3.

[9] Charles Lewis, Bill Allison & The Center for Public Integrity, The Cheating of America: How Tax Avoidance and Evasion by the Super Rich Are Costing the Country Billions - and What You Can Do About It (2001).

[10] For federal tax purposes, a disregarded entity is not required to obtain a taxpayer identification number nor is it required to file federal income returns unless it chooses do so. Typical disregarded entities are qualified Subchapter S corporations (IRC §1361(b)(3) and single-member limited liability companies (see Treas. Reg. §310.7701-2(a) & (b).

[11] Bob Burgner, General Electric, who presented at the February 2002 *Federalism at Risk* seminar, offered a business perspective on policies reducing the state tax bases. He indicated that although the conditions that have eroded the state corporate income tax base present significant compliance burdens for multistate businesses, the tax savings outweigh the additional cost to the companies. Mr. Burgner noted that businesses will lobby state policy makers for these tax "loopholes" because these "loopholes" result in lower effective tax rates on businesses. He also presented evidence that companies with lower effective tax rates had, on the average, higher stock price valuations.

[12] Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, Center on Budget and Policy Priorities, revised May 23, 2002, at 8.

[13] Combined reporting is a state tax accounting system approved by the U.S. Supreme Court. It is used by several states to ensure a full and complete division (apportionment) of income of a single (or "unitary") business enterprise operating in multiple states. Under combined reporting, the taxable income of separate legal entities comprising a single business operating in multiple states is added together. In contrast, under "separate entity" reporting, the taxable income for each separate legal entity is reported separately without regard to the combined income of the multistate enterprise. Combined reporting helps curb the ability of multistate enterprises to shift income away from locations where the income was earned to no-tax or low-tax jurisdictions.

[14] The full text of the "factor presence" proposal is available in the Appendix to the full *Federalism at Risk* report or in MTC Policy Statement 02-02 accessible online at www.mtc.gov.

Section 4 - The State of Federalism

[1] Professor John Kincaid, Director, Meyner Center for the Study of State and Local Government, Lafayette College, Pennsylvania, provided this definition during his review of the history of federalism in the United States, at the MTC *Federalism at Risk* seminar held in January 2002.

[2] According to Prof. Kincaid, originally, the federal government had two primary functions: national defense and foreign affairs. Two additional federal functions evolved over the course of 200-plus years of governance: social welfare and protection of individual rights. These four functions comprise the principal framework functions of the U.S. federal government in the 21st century.

[3] Prof. Kincaid alternatively labeled this era of federalism "coercive federalism." He indicated that changes in the political environment influenced this shift to regulatory federalism. U.S. Supreme Court decisions on voting district reapportionment—emphasizing one person, one vote—undercut the party system which was heavily dependent on sub-national government power for candidates to attain federal office. In addition, the explosion of television media permitted federal political figures to appeal directly to the voters. Consequently, Congress became less attentive to state and local government concerns and started to legislate for persons rather than places.

[4] Quotation from Tom Bonnett, GOVERNANCE IN THE DIGITAL AGE: THE IMPACT OF THE GLOBAL ECONOMY, INFORMATION TECHNOLOGY AND ECONOMIC DEREGULATION ON STATE AND LOCAL GOVERNMENT (National League of Cities, 1999) at 53.

[5] *Id*. at 51-55. *See also* Timothy Conlan, FROM NEW FEDERALISM TO DEVOLUTION: TWENTY-FIVE YEARS OF INTERGOVERNMENTAL REFORM (Brookings, 1998) and Paul L. Posner, THE POLITICS OF UNFUNDED MANDATES: WHITHER FEDERALISM? (Georgetown University Press, 1998).

[6] The state-federal intergovernmental fiscal relationship is generally referred to as "fiscal federalism." A similar relationship exists between the states and their local governments in that they are at least as fiscally interdependent as the state and national governments.

[7] States have varying tolerances for certain taxes (*e.g.*, some abhor the sales tax, others shun the income tax, still others survive without a severance tax despite years of oil

drilling), but each will continue to develop their own economies in order to reduce reliance on federal financing.
[8] Representatives of local governments in Washington and Colorado made presentations during the April 2002 *Federalism at Risk* seminar in Denver, CO.
[9] Both local and state governments must contend with taxpayers' frustrations with taxes, in general—frustrations that sometimes are manifested in the passage of taxpayer initiatives that significantly limit taxing authority and as a result, restrict government's ability to respond appropriately to fiscal demands.

Section 5 - The State of Excise Taxes and Estate Taxes
[1] See endnote 2, Section 2.
[2] See endnote 1, Section 3.
[3] While the top combined state and local tax rate dropped from 20.5% to 16.3%, the main intent of Florida's legislation was administrative simplification and revenue neutrality.
[4] A tax, or group of taxes, is considered "progressive" if the proportion of income paid as taxes rises as incomes rise. A tax, or group of taxes, is considered "regressive" if the proportion of income paid as taxes falls as incomes rise.
[5] The four states not participating in the MSA—Minnesota, Florida, Texas, and Mississippi—had previously settled out of court with the original participating manufacturers. A total of $39.8 billion was paid to these states. In addition to the monetary settlement, the MSA includes substantial restriction of cigarette marketing and advertising.
[6] Many states have tax compacts with tribes that prescribe tribal taxes on sales on tribal lands, and in some cases, revenue sharing arrangements between tribes and the state.

Section 6 - The State of Property Taxes
[1] National Education Association, UNDERSTANDING THE PROPERTY TAX (1998).
[2] Mandy Rafool, A GUIDE TO PROPERTY TAXES: AN OVERVIEW (Nat'l Conference of State Legislatures, May 2002).
[3] THE FUTURE OF STATE TAXATION (Urban Institute Press, David Brunori ed., 1998).
[4] Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*, NEW ENG. ECO. REV. 25 (Issue 4, 2001).
[5] Horizontal equity is a standard of equal treatment that calls for the equal taxation of similar individuals, business enterprises, or business assets.
[6] Joan M.Youngman, *Property, Taxes, and the Future of Property Taxes, in* THE FUTURE OF STATE TAXATION, 117 (David Brunori ed. 1998).
[7] In addition, Congress enacted similar legislation for air carrier transportation property (49 U.S.C. §40116(d)(2)) and motor carrier transportation property (49 U.S.C. §14502(b)).
[8] This ranges from a high of 61.9 percent in New Hampshire to less than 15% in Alabama and New Mexico. See U.S. Department of Commerce, Bureau of the Census, www.census.gov/govs/www/estimate.html.
[9] This ranges from over 98 percent in Connecticut, New Hampshire and New Jersey to a low of 39% in Alabama. See U.S. Department of Commerce, Bureau of the Census, www.census.gov/govs/www/estimate.html.

[10] Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*, New Eng. Econ. Rev. 25 (Issue 4, 2001) at 36.
[11] *Id*. at 35.
[12] Nat'l Educ. Ass'n, Understanding the Property Tax (1998) at 15.

Section 7 - Tax Administration Issues
[1] Douglas L. Lindholm and Stephen P.B. Kranz, *Best and Worst of State Tax Administration: COST's Scorecard*, State Tax Notes, June 18, 2001, at 2139. Steve Kranz, Tax Counsel with COST, made a presentation on this article at the first *Federalism at Risk* seminar held in July 2001.

GLOSSARY

In order to make the Federalism at Risk report more understandable to general readers, we are providing a glossary of key terms and concepts. These are arranged alphabetically.

Advisory Commission on Intergovernmental Relations (ACIR): The federal agency that was established under Public Law 86-380 in 1959 to consider the federal government's intergovernmental relationships and the nation's intergovernmental relationships. The activities of the ACIR were terminated in 1996.

Apportionment: The division of the income of a business engaged in interstate commerce among the states in which the business operates. (See formula apportionment.)

Business Income: That income of a business subject to apportionment among the states in which the business operates, as distinguished from nonbusiness income, which is allocated to a specific state, usually the business' headquarters state. Under the Uniform Division of Income for Tax Purposes Act (UDITPA), business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Central Assessment: Determination of the value of a property or properties within a state by a state agency. The purpose for which the value is set by the state agency may be either for taxation by the local jurisdiction or by the state. Most often, this term applies to public utility property or property with special characteristics where the state preempts local authority in order to achieve uniformity in determination of value. (See unitary assessment).

Combined Reporting: Combined reporting is a state tax accounting system approved by the U.S. Supreme Court. It is used by several states to ensure a full and complete division (apportionment) of income of a single (or "unitary") business enterprise operating in multiple states through multiple entities. Under combined reporting, the taxable income of separate legal entities comprising a single business operating in multiple states is added together. In contrast, under "separate entity" reporting, the taxable income for each separate legal entity is reported separately without regard to the combined income of the multistate enterprise. Combined reporting helps curb the ability of multistate enterprises to shift income away from locations where the income was earned to no-tax or low-tax jurisdictions.

Commerce Clause*:* Article 1, Section 8 of the U.S. Constitution grants Congress the sole power to regulate commerce among the states. The U.S. Supreme Court has interpreted the Commerce Clause to include an implied power granted to Congress to regulate state taxes that, in the judgment of Congress, interfere with its power to regulate interstate commerce. The Commerce Clause also grants Congress the power to regulate commerce with foreign nations and with the Indian Tribes.

Cost Approach: An appraisal method where value is determined by analyzing the costs to construct or replace the subject property.

Due Process Clause: The Fourteenth Amendment of the U.S. Constitution prohibits a State from depriving any person of their property without due process of law and from denying any person within its jurisdiction the equal protection of the laws.

Estate Tax: Commonly referred to as a death tax, an estate tax is imposed on the net value of property owned by a decedent. Since 1977, the federal gift tax has been linked to the estate tax, with the same credits and rates applicable to the estate tax.

Formula Apportionment: The process of assigning a multijurisdictional business' income to an individual tax jurisdiction by use of a mathematical formula. The formula used by most states is a combination of the firm's sales in the state, its property owned or leased in the state, and its payroll in the state. Thus, a multistate company's profits that would be assigned to a state is determined by the ratio of the firm's sales in that state to the firm's total sales multiplied by a weighting factor, plus the ratio of the firm's property in that state to its total property multiplied by a weighting factor, plus the ratio of the firm's payroll in that state to its total payroll multiplied by a weighting factor. The sum of the products is then multiplied by the firm's total net income to obtain this state's share of the firm's total net income. The sum of the sales weighting factor, the property weighting factor, and the payroll weighting factor must equal one.

Horizontal Equity: A standard of equal treatment that calls for the equal taxation of similar individuals, business enterprises, or business assets.

Income Approach: An appraisal method where value is determined by capitalizing the anticipated annual income for the useful life of the subject property.

Market Data Approach: An appraisal method, also referred to as the comparable sales method, under which the value of real estate is determined by analyzing recent sales of similar properties.

Medicaid: The federal program, operated by the States, that provides health services for low-income adults and children.

Nexus: The connection between the business and the state that allows the state to impose a tax or tax collection duty on that business.

Nonbusiness Income: Income other than business income.

Nowhere Income: A term used to describe income (usually starting with a base of federal taxable income) that is not sourced to a state. This can occur when a seller of tangible personal property has no nexus in a destination state, or a state is limited, by the U.S. Constitution or statute, from imposing a tax. It can also occur where states have inconsistent sourcing rules, e.g., where the origin state uses a destination-based sourcing rule and the destination state uses an origin (or cost of performance)-based sourcing rule for a transaction for income tax purposes. Some states use throwback or throwout rules to address this situation. (See throwback and throwout rules.)

Separate Entity Reporting: The practice of determining corporate net income tax and the assignment of income to a state for each legal entity, regardless of common ownership or unitary business operation.

Streamlined Sales Tax: This multistate project (Streamlined Sales Tax Project (SSTP)), created by state governments, with input from local governments and the private sector, has the goal of providing the states with a streamlined sales tax system. Features of this system will include: uniform definitions among the states, rate simplification, state level tax administration, uniform sourcing rules, simplified exemption administration, uniform audit procedures, and state funding support for use of technology. The Streamlined Sales Tax Implementing States (SSTIS), an outgrowth of the SSTP, approved an interstate Streamlined Sales and Use Tax Agreement in November 2002 that is being enacted by the states. (See www.streamlinedsalestax.org.).

Three-factor Apportionment Formula: See formula apportionment.

Throwback Rule: A rule affecting the numerator of the sales factor of the income apportionment formula, where sales made by a seller into a state which has no jurisdiction to impose income tax on the seller are assigned back to the state from which the goods sold have been shipped. (If a seller makes sales into a state in which it is taxable, the sales are assigned to the sales factor of that state.) The throwback rule has been adopted by several states to minimize nowhere income.

Throwout Rule: The throwout rule, an alternative to throwback, is a rule under which sales are eliminated from both the numerator and the denominator of the sales factor of the income apportionment formula where those sales are made into a state which has no jurisdiction to impose income tax on the seller.

Uniform Division of Income for Tax Purposes Act (UDITPA): This model law, promulgated by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1957, prescribes methods for assignment of income among the states for businesses that maintain operations in more than one state. Most income tax states have modeled their income apportionment laws on UDITPA's three-factor formula apportionment approach. A slightly amended version of UDITPA is a key component of the Multistate Tax Compact, the interstate agreement that created the Multistate Tax Commission.

Unitary Assessment: Determination of the value of property based upon an estimate of what the entire system is worth on a given date. Usually applies to public utility property.

Unitary Business: The branches of a corporation or members of a controlled corporate group that are treated as a single entity for calculation and assignment of income subject to tax. The unitary business principle can be applied to just a single entity or to a commonly controlled group of entities. The U.S. Supreme Court has declared that the "linchpin of apportionability in the field of state income taxation is the unitary-business principle." Allied Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).

Value Added Tax (VAT): A general tax where the base is the value added by a business, which is the sum of its compensation of employees and profits. Another measure of value added is the business' sales less the cost of its purchases from other firms.

Appendix A

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS SIXTY-SIXTH YEAR
AT NEW YORK, NEW YORK
JULY 8 – 13, 1957

WITH PREFATORY NOTE AND COMMENTS

Approved by the American Bar Association at its Meeting at
New York, New York, July 16, 1957

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

The Committee which acted for the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Division of Income for Tax Purposes Act was as follows:

GEORGE V. POWELL, 1111 Dexter Horton Bldg., Seattle 4, Wash., *Chairman*.
GUY W. BOTTS, Barnett National Bank Bldg., Jacksonville, Fla.
RUPERT R. BULLIVANT, Pacific Bldg., Portland, Ore.
BARTON H. KUHNS, First National Bank Bldg., Omaha 2, Nebr.
JO. V. MORGAN, District of Columbia Tax Court, 4th & E Sts., N.W., Washington 1, D.C.
O. H. THORMODGSGARD, University of North Dakota Law School, University, N.D., *Chairman, Section C*.

Copies of all Uniform Acts and other printed matter issued by the Conference may be obtained from

NATIONAL CONFERENCE OF COMMISSIONERS ON
UNIFORM STATE LAWS
1155 East Sixtieth Street
Chicago, Illinois 60637

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

PREFATORY NOTE

The Uniform Division of Income for Tax Purposes Act is designed for enactment in those states which levy taxes on or measured by net income.

The need for a uniform method of division of income for tax purposes among the several taxing jurisdictions has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed on more than its net income. At present there are various formulae for determining the amount of income to be taxed in use by the states, and the differences in the formulae produce inequitable results. Many states now use the three factor formulae of this Act. The problem has been well analyzed and its historical background outlined in an article appearing in 18 Ohio State Law Journal, page 84.

The Uniform Division of Income for Tax Purposes Act is the result of conferences with the representatives of the Controller's Institute of America, the Council of State Governments and various interested individuals. It was promulgated in 1957. The comments in the present reprinting of the Act were revised and extended in February 1966 in order to clarify the solutions to some of the problems which have been experienced in securing enactment of the Act in the several states.

March 1, 1966

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

[Be It Enacted . . .]

SECTION 1. As used in this Act, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Comment

This definition refers to "the" taxpayer's trade or business as if he had one business. It is not intended by this language to require a taxpayer having several "businesses" to use the same allocation and apportionment methods for the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment.

Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

Comment

The phrase "directed or managed" is not intended to permit both the state where the board of directors meets and the state where the company is managed to claim the commercial domicile. The phrase "directed or managed" is intended as two words serving the same end; not as two separate concepts.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

Comment

This definition is derived from the Model Unemployment Compensation Act which has been adopted in all states.

Compensation paid to "employees" becomes important in the payroll fraction in section 13. If a corporation is employed to provide personal services, section 18 may be used to include compensation paid to corporations in the fraction if exclusion of compensation paid to corporate agents fails to reflect adequately the business activity in the state.

(d) "Financial organization" means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.

Comment

This definition and the definition of "public utility" in subsection (f) is necessary because section 2 excludes from allocation and apportionment under this Act, income from these two types of business activity. The exclusion is proposed because some states have separate legislation for apportionment and allocation of income of such taxpayers. If not, and the state proposes to change subsection (2) so as to apply the Act to such taxpayers, this would not necessarily detract from the uniformity objective of this Act.

(e) "Non-business income" means all income other than business income.

(f) "Public utility" means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas].

Comment

It is expected that "public utility" will be defined to include all taxpayers subject to the control of the state's regulatory bodies on the theory that separate legislation will provide for the apportionment and allocation of the income of such taxpayers.

See Comment to the definition of "financial organization" for purpose of this definition. "Oil, oil products or gas" is not intended to be so restrictive as to treat differently a public utility, if any, which transmits or produces "gas products." The essential point of the definition is the requirement that the business excluded by this definition and subsection 2 be a "public utility." Private transmission lines and private production or storage companies are thus not excluded.

(g) "Sales" means all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act.

Comment

This all inclusive definition of sales is intended to make apportionable all income not allocated under sections 4 through 8. As indicated in the Comment to subsection 1(a) income from sales or property used in trade or business is included in apportionable income.

(h) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

SECTION 2. Any Taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act.

SECTION 3. For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Comment

This section defines, for purposes of section 2, where a taxpayer is "taxable both within and without this state." To bring this Act into operation a taxpayer must have income from business activity, and he must be taxable in this state, and also in some other state.

Two tests are used by this section to determine when a taxpayer is “taxable in another state.” The first test is a fairly obvious one, the taxpayer is taxable in another state if he is actually subjected to the type of taxes listed in subparagraph (1).

The second test, in subparagraph (2) uses a “notional” or “hypothetical” standard rather than an actual one. Thus, if a corporation has its commercial domicile in state X, which has only a sales tax and no tax measured by net income, but that corporation has business activity in state A, which has this apportionment Act, state A must apportion the business income as provided in this Act so that some of it is allocated to state X, even though as a result of the tax system of state X a portion of the business income escapes income taxation. This is desirable in order to treat the business of all states equally, and in order to avoid having this Act as a factor in inducing a state to have an income tax. If it does not wish to tax income, that is no reason for a state which does wish to tax income to attempt to obtain more than its share of taxable income.

It should be noted that in subsection 1(h) the word “state” is defined broadly enough to include a foreign country. This means that “taxable in another state” within section 3 may mean a foreign country. The apportioning state, however, need consider only whether the foreign country “could have” taxed the income under the constitution of the United States if it had been a state.

While subparagraph (1) lists several types of taxes which might be actually in effect in another state, the reference in subparagraph (2) only to a “net income” tax is not intended to be more restricted in the hypothetical tax than the section is with respect to an actual tax.

SECTION 4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute non-business income, shall be allocated as provided in sections 5 through 8 of this Act.

Comment

This section is the general section on “allocating” non-business income to a state just as section 9 is the general section on apportionment of business income. Section 2 refers to an allocation and an apportionment of “net income.” In “allocating” nonbusiness income to a state, the states concerned with this allocation may desire to allocate the expenses properly attributable to nonbusiness but allocable income in the same way that income is allocated so that these expenses will not be involved in determining net income from business activity where apportionment is used. Section 18 of this Code empowers the state to make this adjustment if it wishes.

SECTION 5.

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

Comment

Rents from mobile tangible property are to be allocated in accordance with section 5(c). This subsection apportions the rents by a fraction based on the number of days in the state on the assumption that the rents are generally based on time of use. If the rent itself is calculated on the basis of some factor other than time, section 18 would permit a state to substitute a fraction based on this substitute factor. Thus, if the rent for a drilling rig is calculated on the basis of number of feet drilled, the "extent of utilization" in the state might also be determined on the basis of a fraction which uses "feet drilled" rather than days in the state.

SECTION 6.

(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

SECTION 7. Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

SECTION 8.

(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state, or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

SECTION 9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

SECTION 10. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

Comment

The property to be included in the numerator and denominator is property producing the net income to be apportioned. If net income from property is allocated property under sections 5 through 8 such property should be excluded in constructing the fraction.

SECTION 11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

Comment

This section is admittedly arbitrary in using original cost rather than depreciated cost, and in valuing rented property as eight times the annual rental. This approach is justified because the act does not impose a tax, nor prescribe the depreciation allowable in computing the tax, but merely provides a basis for division of the taxable income among the several states. The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing the property would probably be universally acceptable.

In any situation where it is impossible to ascertain original cost, section 18 may be used to determine a fair value for such property. Section 18 may also be necessary to aid in determining "net annual rental value" of tangible personal property where the actual rent is so related to services that the part attributable to the object is difficult to determine.

Section 18 may also be used to determine a reasonable rental rate for this fraction where the actual rent is zero or nominal such as may be the case where a local government in attempting to induce an industry to come to a community supplies the property at a nominal rental.

SECTION 12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period of reasonably required to reflect properly the average value of the taxpayer's property.

SECTION 13. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

Comment

Payroll attributable to management or maintenance or otherwise allocable to nonbusiness property should be excluded from the fraction.

Payroll "paid" should be determined by the normal accounting methods of the business so that if the taxpayer "accrues" such matters the payroll should be treated as "paid" for purpose of this section.

SECTION 14. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state; or

(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Comment

This section is derived from the Model Unemployment Compensation Act. This is the same figure which will be used by taxpayers for unemployment compensation purposes.

SECTION 15. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

Comment

The sales to be included in the fraction are only the sales which produce business income. Sales which produce "capital gains" are under section 6 and are to be allocated rather than apportioned.

"Total sales" means "total net sales" after discounts and returns.

SECTION 16. Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Comment

The phrase "delivered or shipped to a purchaser" in this state includes shipments, at the designation of the purchaser, to a person in this state such as designating, while a shipment is enroute, the ultimate recipient.

Sales to the United States are treated separately. It is thought that this is justified because sales to the United States are not necessarily attributable to a market existing in the state to which the goods are originally shipped. This different treatment may also be justified because, if the goods are defense or war materials, it may be impossible to determine whether the goods ever come to rest in the state due to use of coded delivery instructions.

The section does not specify how sales from a subsidiary in the state to an out-of-state parent, such as a marketing corporation who thereupon redirects the goods back into the state, should be treated. If returns are not consolidated under existing state tax law, it may be necessary to use section 18 to make a fair representation of the business income in this situation.

SECTION 17. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or

(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

SECTION 18. If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Comment

It is anticipated that this Act will be made a part of the income tax acts of the several states. For that reason, this section does not spell out the procedure to be followed in the event of a disagreement between the taxpayer and the tax administrator. The income tax acts of each state presumably outline the procedure to be followed.

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

SECTION 19. This Act shall be so construed so as to effectuate its general purpose to make uniform the law of those states which enact it.

SECTION 20. This Act may be cited as the Uniform Division of Income for Tax Purposes Act.

SECTION 21. [The following acts and parts of acts are hereby repealed:

(a)

(b)

(c) .]

SECTION 22. This Act shall take effect . . . .

Appendix B

THE MULTISTATE TAX COMPACT

Entered into force August 4, 1967

Article I. Purposes.

The purposes of this compact are to:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicative taxation.

Article II. Definitions.

As used in this compact:

1. "State" means a State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any Territory or Possession of the United States.

2. "Subdivision" means any governmental unit or special district of a State.

3. "Taxpayer" means any corporation, partnership, firm, association, governmental unit or agency or person acting as a business entity in more than one State.

4. "Income tax" means a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions.

5. "Capital stock tax" means a tax measured in any way by the capital of a corporation considered in its entirety.

6. "Gross receipts tax" means a tax, other than a sales tax, which is imposed on or measured by the gross volume of business, in terms of gross receipts or in other terms, and in the determination of which no deduction is allowed which would constitute the tax an income tax.

7. "Sales tax" means a tax imposed with respect to the transfer for a consideration of ownership, possession or custody of tangible personal property or the rendering of services measured by the price of the tangible personal property transferred or services rendered and which is required by State or local law to be separately stated from the sales price by the seller, or which is customarily separately stated from the sales price, but does not include a tax imposed exclusively on the sale of a specifically identified commodity or article or class of commodities or articles.

8. "Use tax" means a nonrecurring tax, other than a sales tax, which (a) is imposed on or with respect to the exercise or enjoyment of any right or power over tangible personal property incident to the ownership, possession or custody of that property or the leasing of that property from another including any consumption, keeping, retention, or other use of tangible personal property and (b) is complementary to a sales tax.

9. "Tax" means an income tax, capital stock tax, gross receipts tax, sales tax, use tax, and any other tax which has a multistate impact, except that the provisions of Articles III, IV and V of this compact shall apply only to the taxes specifically designated therein and the provisions of Article IX of this compact shall apply only in respect to determinations pursuant to Article IV.

Article III. Elements of Income Tax Laws.

Taxpayer Option, State and Local Taxes.

1. Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party State or pursuant to the laws of subdivisions in two or more party States may elect to apportion and allocate his income in the manner provided by the laws of such States or by the laws of such States and subdivisions without reference to this compact, or may elect to apportion and allocate in accordance with Article IV. This election for any tax year may be made in all party States or subdivisions thereof or in any one or more of the party States or subdivisions thereof without reference to the election made in the others. For the purposes of this paragraph, taxes imposed by subdivisions shall be considered separately from State taxes, and the apportionment and allocation also may be applied to the entire tax base. In no instance wherein Article IV is employed for all subdivisions of a State may the sum of all apportionments and allocations to subdivisions within a State be greater than the apportionment and allocation that would be assignable to that State if the apportionment or allocation were being made with respect to a State income tax.

Taxpayer Option, Short Form.

2. Each party State or any subdivision thereof which imposes an income tax shall provide by law that any taxpayer required to file a return whose only activities within the taxing jurisdiction consist of sales and do not include owning or renting real estate or tangible personal property and whose dollar volume of gross sales made during the tax year within the State or subdivision, as the case may be, is not in excess of $100,000 may elect to report and pay any tax due on the basis of a percentage of such volume and shall adopt rates which shall produce a tax which reasonably approximates the tax otherwise

due. The Multistate Tax Commission, not more than once in five years, may adjust the $100,000 figure in order to reflect such changes as may occur in the real value of the dollar, and such adjusted figure, upon adoption by the Commission, shall replace the $100,000 figure specifically provided herein. Each party State and subdivision thereof may make the same election available to taxpayers additional to those specified in this paragraph.

Coverage.

3. Nothing in this Article relates to the reporting or payment of any tax other than an income tax.

Article IV. Division of Income.

1. As used in this Article, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, small loan company, sales finance company, investment company, or any type of insurance company.

(e) "Nonbusiness income" means all income other than business income.

(f) "Public utility" means any business entity (1) which owns or operates any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, except by pipeline, or the production, transmission, sale, delivery, or furnishing of electricity, water or steam; and (2) whose rates of charges for goods or services have been established or approved by a Federal, State or local government or governmental agency.

(g) "Sales" means all gross receipts of the taxpayer not allocated under paragraphs of this Article.

(h) "State" means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any Territory or Possession of the United States, and any foreign country or political subdivision thereof.

(i) "This State" means the State in which the relevant tax return is filed or, in the case of application of this Article to the apportionment and allocation of income for local tax purposes, the subdivision or local taxing district in which the relevant tax return is filed.

2. Any taxpayer having income from business activity which is taxable both within and without this State, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Article. If a taxpayer has income from business activity as a public utility but derives the greater percentage of his income from activities subject to this Article, the taxpayer may elect to allocate and apportion his entire net income as provided in this Article.

3. For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another State if (1) in that State he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that State has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.

4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in paragraphs 5 through 8 of this Article.

5. (a) Net rents and royalties from real property located in this State are allocable to this State.

(b) Net rents and royalties from tangible personal property are allocable to this State: (1) if and to the extent that the property is utilized in this State, or (2) in their entirety if the taxpayers's commercial domicile is in this State and the taxpayer is not organized under the laws of or taxable in the State in which the property is utilized.

(c) The extent of utilization of tangible personal property in a State is determined by multiplying the rents and royalties by a fraction the numerator of which is the number of days of physical location of the property in the State during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the State in which the property was located at the time the rental or royalty payer obtained possession.

6. (a) Capital gains and losses from sales of real property located in this State are allocable to this State.

(b) Capital gains and losses from sales of tangible personal property are allocable to this State if (1) the property had a situs in this State at the time of the sale, or (2) the taxpayer's commercial domicile is in this State and the taxpayer is not taxable in the State in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this State if the taxpayer's commercial domicile is in this State.

7. Interest and dividends are allocable to this State if the taxpayer's commercial domicile is in this State.

8. (a) Patent and copyright royalties are allocable to this State: (1) if and to the extent that the patent or copyright is utilized by the payer in this State, or (2) if and to the extent that the patent or copyright is utilized by the payer in a State in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this State.

(b) A patent is utilized in a State to the extent that it is employed in production, fabrication, manufacturing, or other processing in the State or to the extent that a patented product is produced in the State. If the basis of receipts from patent royalties does not permit allocation to States or if the accounting procedures do not reflect States of utilization, the patent is utilized in the State in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a State to the extent that printing or other publication originates in the State. If the basis of receipts from copyright royalties does not permit allocation to States or if the accounting procedures do not reflect States of utilization, the copyright is utilized in the State in which the taxpayer's commercial domicile is located.

9. All business income shall be apportioned to this State by multiplying the income by a fraction the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

10. The property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this State during the tax period and the denominator of which is the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the tax period.

11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period; but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

13. The payroll factor is a fraction the numerator of which is the total amount paid in this State during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period.

14. Compensation is paid in this State if:

(a) the individual's service is performed entirely within the State;

(b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or

(c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State.

15. The sales factor is a fraction the numerator of which is the total sales of the taxpayer in this State during the tax period and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

16. Sales of tangible personal property are in this State if:

(a) the property is delivered or shipped to a purchaser, other than the United States Government, within this State regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the State of the purchaser.

17. Sales, other than sales of tangible personal property, are in this State if:

(a) the income-producing activity is performed in this State; or

(b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.

18. If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Article V. Elements of Sales and Use Tax Laws.

Tax Credit.

1. Each purchaser liable for a use tax on tangible personal property shall be entitled to full credit for the combined amount or amounts of legally imposed sales or use taxes paid by him with respect to the same property to another State and any subdivision thereof. The credit shall be applied first against the amount of any use tax due the State, and any unused portion of the credit shall then be applied against the amount of any use tax due a subdivision.

Exemption Certificates. Vendors May Rely.

2. Whenever a vendor receives and accepts in good faith from a purchaser a resale or other exemption certificate or other written evidence of exemption authorized by the appropriate State or subdivision taxing authority, the vendor shall be relieved of liability for a sales or use tax with respect to the transaction.

Article VI. The Commission.

Organization and Management.

1. (a) The Multistate Tax Commission is hereby established. It shall be composed of one "member" from each party State who shall be the head of the State agency charged with the administration of the types of taxes to which this compact applies. If there is more than one such agency, the State shall provide by law for the selection of the Commission member from the heads of the relevant agencies. State law may provide that a member of the Commission be represented by an alternate, but only if there is on file with the Commission written notification of the designation and identity of the alternate. The Attorney General of each party State or his designee, or other counsel if the laws of the party State specifically provide, shall be entitled to attend the meetings of the Commission, but shall not vote. Such Attorneys General, designees, or other counsel shall receive all notices of meetings required under paragraph 1(e) of this Article.

(b) Each party State shall provide by law for the selection of representatives from its subdivisions affected by this compact to consult with the Commission member from that State.

(c) Each member shall be entitled to one vote. The Commission shall not act unless a majority of the members are present, and no action shall be binding unless approved by a majority of the total number of members.

(d) The Commission shall adopt an official seal to be used as it may provide.

(e) The Commission shall hold an annual meeting and such other regular meetings as its bylaws may provide and such special meetings as its Executive Committee may determine. The Commission bylaws shall specify the dates of the annual and any other regular meetings and shall provide for the giving of notice of annual, regular and special meetings. Notices of special meetings shall include the reasons therefor and an agenda of the items to be considered.

(f) The Commission shall elect annually, from among its members, a Chairman, a Vice Chairman and a Treasurer. The Commission shall appoint an Executive Director who shall serve at its pleasure, and it shall fix his duties and compensation. The Executive Director shall be Secretary of the Commission. The Commission shall make provision for the bonding of such of its officers and employees as it may deem appropriate.

(g) Irrespective of the civil service, personnel or other merit system laws of any party State, the Executive Director shall appoint or discharge such personnel as may be necessary for the performance of the functions of the Commission and shall fix their duties and compensation. The Commission bylaws shall provide for personnel policies and programs.

(h) The Commission may borrow, accept or contract for the services of personnel from any State, the United States, or any other governmental entity.

(i) The Commission may accept for any of its purposes and functions any and all donations and grants of money, equipment, supplies, materials and services, conditional or otherwise, from any governmental entity, and may utilize and dispose of the same.

(j) The Commission may establish one or more offices for the transacting of its business.

(k) The Commission shall adopt bylaws for the conduct of its business. The Commission shall publish its bylaws in convenient form and shall file a copy of the bylaws and any amendments thereto with the appropriate agency or officer in each of the party States.

(l) The Commission annually shall make to the Governor and legislature of each party State a report covering its activities for the preceding year. Any donation or grant accepted by the Commission or services borrowed shall be reported in the annual report of the Commission and shall include the nature, amount and conditions, if any, of the donation, gift, grant or services borrowed and the identity of the donor or lender. The Commission may make additional reports as it may deem desirable.

Committees.

2. (a) To assist in the conduct of its business when the full Commission is not meeting, the Commission shall have an Executive Committee of seven members, including the Chairman, Vice Chairman, Treasurer and four other members elected annually by the Commission. The Executive Committee, subject to the provisions of this compact and consistent with the policies of the Commission, shall function as provided in the bylaws of the Commission.

(b) The Commission may establish advisory and technical committees, membership on which may include private persons and public officials, in furthering any of its activities. Such committees may consider any matter of concern to the Commission, including problems of special interest to any party State and problems dealing with particular types of taxes.

(c) The Commission may establish such additional committees as its bylaws may provide.

Powers.

3. In addition to powers conferred elsewhere in this compact, the Commission shall have power to:

(a) Study State and local tax systems and particular types of State and local taxes.

(b) Develop and recommend proposals for an increase in uniformity or compatibility of State and local tax laws with a view toward encouraging the simplification and improvement of State and local tax law and administration.

(c) Compile and publish such information as would, in its judgment, assist the party States in implementation of the compact and taxpayers in complying with State and local tax laws.

(d) Do all things necessary and incidental to the administration of its functions pursuant to this compact.

Finance.

4. (a) The Commission shall submit to the Governor or designated officer or officers of each party State a budget of its estimated expenditures for such period as may be required by the laws of that State for presentation to the legislature thereof.

(b) Each of the Commission's budgets of estimated expenditures shall contain specific recommendations of the amounts to be appropriated by each of the party States. The total amount of appropriations required under any such budget shall be apportioned among the party States as follows: one-tenth in equal shares; and the remainder in proportion to the amount of revenue collected by each party State and its subdivisions from income taxes, capital stock taxes, gross receipts taxes, sales and use taxes. In determining such amounts, the Commission shall employ such available public sources of information as, in its judgment, present the most equitable and accurate comparisons among the party States. Each of the Commission's budgets of estimated expenditures and requests for appropriations shall indicate the sources used in obtaining information employed in applying the formula contained in this paragraph.

(c) The Commission shall not pledge the credit of any party State. The Commission may meet any of its obligations in whole or in part with funds available to it under paragraph 1(i) of this Article; provided that the Commission takes specific action setting aside such funds prior to incurring any obligation to be met in whole or in part in such manner. Except where the Commission makes use of funds available to it under paragraph 1(i), the Commission shall not incur any obligation prior to the allotment of funds by the party States adequate to meet the same.

(d) The Commission shall keep accurate accounts of all receipts and disbursements. The receipts and disbursements of the Commission shall be subject to the audit and accounting procedures established under its bylaws. All receipts and disbursements of funds handled by the Commission shall be audited yearly by a certified or licensed public accountant and the report of the audit shall be included in and become part of the annual report of the Commission.

(e) The accounts of the Commission shall be open at any reasonable time for inspection by duly constituted officers of the party States and by any persons authorized by the Commission.

(f) Nothing contained in this Article shall be construed to prevent Commission compliance with laws relating to audit or inspection of accounts by or on behalf of any government contributing to the support of the Commission.

Article VII. Uniform Regulations and Forms.

1. Whenever any two or more party States or subdivisions of party States have uniform or similar provisions of law relating to an income tax, capital stock tax, gross receipts tax, or sales or use tax, the Commission may adopt uniform regulations for any phase of the administration of such law, including assertion of jurisdiction to tax or prescribing uniform tax forms. The Commission may also act with respect to the provisions of Article IV of this compact.

2. Prior to the adoption of any regulation, the Commission shall:

(a) As provided in its bylaws, hold at least one public hearing on due notice to all affected party States and subdivisions thereof and to all taxpayers and other persons who have made timely request of the Commission for advance notice of its regulation-making proceedings.

(b) Afford all affected party States and subdivisions and interested persons an opportunity to submit relevant written data and views, which shall be considered fully by the Commission.

3. The Commission shall submit any regulations adopted by it to the appropriate officials of all party States and subdivisions to which they might apply. Each such State and subdivision shall consider any such regulation for adoption in accordance with its own laws and procedures.

Article VIII. Interstate Audits.

1. Any party State or subdivision thereof desiring to make or participate in an audit of any accounts, books, papers, records or other documents may request the Commission to perform the audit on its behalf. In responding to the request, the Commission shall have access to and may examine, at any reasonable time, such accounts, books, papers, records, and other documents and any relevant property or stock of merchandise. The Commission may enter into agreements with party States or their subdivisions for assistance in performance of the audit. The Commission shall make charges, to be paid by the State or local government or governments for which it performs the service, for any audits performed by it in order to reimburse itself for the actual costs incurred in making the audit.

2. The Commission may require the attendance of any person within the State where it is conducting an audit or part thereof at a time and place fixed by it within such State for the purpose of giving testimony with respect to any account, book, paper, document, other record, property or stock of merchandise being examined in connection with the audit. If the person is not within the jurisdiction, he may be required to attend for such purpose at any time and place fixed by the Commission within the State of which he is a resident.

3. The Commission may apply to any court having power to issue compulsory process for orders in aid of its powers and responsibilities pursuant to this Article, and any and all such courts shall have jurisdiction to issue such orders. Failure of any person to obey any such order shall be punishable as contempt of the issuing court. If the party or subject matter on account of which the Commission seeks an order is within the jurisdiction of the court to which application is made, such application may be to a court in the State or subdivision on behalf of which the audit is being made or a court in the State in which the object of the order being sought is situated.

4. The Commission may decline to perform any audit required if it finds that its available personnel or other resources are insufficient for the purpose or that, in the terms requested, the audit is impracticable of satisfactory performance. If the Commission, on the basis of its experience, has reason to believe that an audit of a particular taxpayer, either at a particular time or on a particular schedule, would be of interest to a number of party States or their subdivisions, it may offer to make the audit or audits, the offer to be contingent upon sufficient participation therein as determined by the Commission.

5. Information obtained by any audit pursuant to this Article shall be confidential and available only for tax purposes to party States, their subdivisions or the United States. Availability of information shall be in accordance with the laws of the States or subdivisions on whose account the Commission performs the audit and only through the appropriate agencies or officers of such States or subdivisions. Nothing in this Article shall be construed to require any taxpayer to keep records for any period not otherwise required by law.

6. Other arrangements made or authorized pursuant to law for cooperative audit by or on behalf of the party States or any of their subdivisions are not superseded or invalidated by this Article.

7. In no event shall the Commission make any charge against a taxpayer for an audit.

8. As used in this Article, "tax," in addition to the meaning ascribed to it in Article II, means any tax or license fee imposed in whole or in part for revenue purposes.

Article IX. Arbitration.

1. Whenever the Commission finds a need for settling disputes concerning apportionments and allocations by arbitration, it may adopt a regulation placing this Article in effect, notwithstanding the provisions of Article VII.

2. The Commission shall select and maintain an Arbitration Panel composed of officers and employees of State and local governments and private persons who shall be knowledgeable and experienced in matters of tax law and administration.

3. Whenever a taxpayer who has elected to employ Article IV, or whenever the laws of the party State or subdivision thereof are substantially identical with the relevant provisions of Article IV, the taxpayer, by written notice to the Commission and to each party State or subdivision thereof that would be affected, may secure arbitration of an apportionment or allocation if he is dissatisfied with the final administrative determination of the tax agency of the State or subdivision with respect thereto on the ground that it would subject him to double or multiple taxation by two or more party States or subdivisions thereof. Each party State and subdivision thereof hereby consents to the arbitration as provided herein, and agrees to be bound thereby.

4. The Arbitration Board shall be composed of one person selected by the taxpayer, one by the agency or agencies involved, and one member of the Commission's Arbitration Panel. If the agencies involved are unable to agree on the person to be selected by them, such person shall be selected by lot from the total membership of the Arbitration Panel. The two persons selected for the Board in the manner provided by the foregoing provisions of this paragraph shall jointly select the third member of the Board. If they are unable to agree on the selection, the third member shall be selected by lot from among the total membership of the Arbitration Panel. No member of a Board selected by lot shall be qualified to serve if he is an officer or employee of or is otherwise affiliated with any party to the arbitration proceeding. Residence within the jurisdiction of a party to the arbitration proceeding shall not constitute affiliation within the meaning of this paragraph.

5. The Board may sit in any State or subdivision party to the proceeding, in the State of the taxpayer's incorporation, residence or domicile, in any State in which the taxpayer does business, or in any place that it finds most appropriate for gaining access to evidence relevant to the matter before it.

6. The Board shall give due notice of the times and places of its hearings. The parties shall be entitled to be heard, to present evidence, and to examine and cross-examine witnesses. The Board shall act by majority vote.

7. The Board shall have power to administer oaths, take testimony, subpoena and require the attendance of witnesses and the production of accounts, books, papers, records, and other documents, and issue commissions to take testimony. Subpoenas may be signed by any member of the Board. In case of failure to obey a subpoena, and upon application by the Board, any judge of a court of competent jurisdiction of the State in which the Board is sitting or in which the person to whom the subpoena is directed may be found may make an order requiring compliance with the subpoena, and the court may punish failure to obey the order as a contempt.

8. Unless the parties otherwise agree, the expenses and other costs of the arbitration shall be assessed and allocated among the parties by the Board in such manner as it may determine. The Commission shall fix a schedule of compensation for Arbitration Board members and of other allowable expenses and costs. No officer or employee of a State or local government who serves as a member of a Board shall be entitled to compensation therefor unless he is required on account of his service to forego the regular compensation attaching to his public employment, but any such Board member shall be entitled to expenses.

9. The Board shall determine the disputed apportionment or allocation and any matters necessary thereto. The determinations of the Board shall be final for purposes of making the apportionment or allocation, but for no other purpose.

10. The Board shall file with the Commission and with each tax agency represented in the proceeding: the determination of the Board; the Board's written statement of its reasons therefor; the record of the Board's proceedings; and any other documents required by the arbitration rules of the Commission to be filed.

11. The Commission shall publish the determinations of Boards together with the statements of the reasons therefor.

12. The Commission shall adopt and publish rules of procedure and practice and shall file a copy of such rules and of any amendment thereto with the appropriate agency or officer in each of the party States.

13. Nothing contained herein shall prevent at any time a written compromise of any matter or matters in dispute, if otherwise lawful, by the parties to the arbitration proceedings.

Article X. Entry Into Force and Withdrawal.

1. This compact shall enter into force when enacted into law by any seven States. Thereafter, this compact shall become effective as to any other State upon its enactment thereof. The Commission shall arrange for notification of all party States whenever there is a new enactment of the compact.

2. Any party State may withdraw from this compact by enacting a statute repealing the same. No withdrawal shall affect any liability already incurred by or chargeable to a party State prior to the time of such withdrawal.

3. No proceeding commenced before an Arbitration Board prior to the withdrawal of a State and to which the withdrawing State or any subdivision thereof is a party shall be discontinued or terminated by the withdrawal, nor shall the Board thereby lose jurisdiction over any of the parties to the proceeding necessary to make a binding determination therein.

Article XI. Effect on Other Laws and Jurisdiction.

Nothing in this compact shall be construed to:

(a) Affect the power of any State or subdivision thereof to fix rates of taxation, except that a party State shall be obligated to implement Article III 2 of this compact.

(b) Apply to any tax or fixed fee imposed for the registration of a motor vehicle or any tax on motor fuel, other than sales tax; provided that the definition of “tax” in Article VIII 9 may apply for the purposes of that Article and that the Commission’s powers of study and recommendation pursuant to Article VI 3 may apply.

(c) Withdraw or limit the jurisdiction of any State or local court or administrative officer or body with respect to any person, corporation or other entity or subject matter, except to the extent that such jurisdiction is expressly conferred by or pursuant to this compact upon another agency or body.

(d) Supersede or limit the jurisdiction of any court of the United States.

Article XII. Construction and Severability.

This compact shall be liberally construed so as to effectuate the purposes thereof. The provisions of this compact shall be severable and if any phrase, clause, sentence, or provision of this compact is declared to be contrary to the constitution of any State or of the United States or the applicability thereof to any government, agency, person or circumstance is held invalid, the validity of the remainder of this compact and the applicability thereof to any government, agency, person or circumstance shall not be affected thereby. If this compact shall be held contrary to the constitution of any State participating therein, the compact shall remain in full force and effect as to the remaining party States and in full force and effect as to the State affected as to all severable matters.

Appendix C
Federal Statutes that Preempt or Limit State Taxation

(*This list is not exhaustive. There may be other federal statutes not listed here, including statutes pertaining to specific federal instrumentalities and Indian tribes.)*

Statute	Topic
Pub. L. 89-554, 80 Stat 608, 4 USCA § 111	States cannot tax federal employees differently from state employees. See *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989).
Pub. L. 104-95, 109 Stat 979, 4 USCA § 114	Preempts state taxation of pension and other types of deferred compensation when paid out to nonresidents.
Soldiers and Sailors Civil Relief Act of 1940, 566 Stat. 777, 50 USC 574	Members of the armed forces are subject to tax only in their respective states of residence, and not necessarily in the state in which they are stationed or assigned.
"4-R Act" (Railroad Regulatory Reform and Revitalization Act of 1976). Pub.L. 94-210, 90 Stat 31, 45 U.S.C. § 801	A state may not treat railroads differently from other commercial and industrial property for property tax purposes.
49 U.S.C. §1513(d)(1)(A)	A state is prohibited from assessing air carrier transportation property at a value that has a higher ratio to its true market value than the ratio that the assessed value of other property has to its true market value.

Federal Statutes that Preempt or Limit State Taxation *continued*

Statute	Topic
Pub.L. 104-88, 109 Stat 803, 49 U.S.C. §101	Preempts state taxation of interstate motor carrier passenger transportation. This includes the sale of transportation or the gross receipts derived from such transportation. Enacted as a result of the U.S. Supreme Court decision in *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175 (1995).
Federal Aviation Act 49 U.S.C. §40116(b), Pub. L. 103-272. Amended Pub. L. 103-105	Prohibition of head tax on passengers in air transportation.
49 U.S.C. §40116(c)	State may tax a flight only if the aircraft takes off or lands in the state or political subdivision as part of the flight.
Pub.L. 101-322, 104 Stat 295, 45 U.S.C. §501	Compensation paid to an employee of an interstate railroad or an interstate motor carrier may be subject only to income tax laws of the state of the employee's residence. In 1994 Pub.L. 103-440, 108 Stat 4615, 49 U.S.C. §20101, extended to include years prior to 1990.
Pub.L. 96-113, 94 Stat 50, 49 USCA 2101, and Pub.L. 103-305, 108 Stat 1569, 49 U.S.C. §40101	Airline employees are subject to tax in the state of residence and the state in which they perform 50 percent or more of their duties.

Federal Statutes that Preempt or Limit State Taxation *continued*

Statute	Topic
Pub.L. 101-322, 104 Stat 295, 49 U.S.C. §14503(b)(2)	Water carriers are subject to tax withholding only in the state of residence and the state in which the employee earned more than 50 percent of the pay.
Pub.L. 106-489, 114 Stat 2207, 46 U.S.C. §11108(b)	Limits state income taxation of workers on vessels operating in the waters of more than one state to the state in which the individual resides.
Pub.L. 101-322,104 Stat 295, 45 USCA §501	Prevents state taxation of Amtrak transportation for the sale of the transportation or gross receipts derived from the transportation.
Pub. L. 95-67, 91 Stat 271 4 USC §113	Members are not to be considered residents of any state other than the state from which they are elected for purposes of individual income taxation.
Pub.L. 86-272, 73 Stat. 555-56, 15 U.S.C. 381-384	Prevents state from imposing income tax on a business whose only contact with a state is to solicit sales through employees or contractors.
12 USC 1723a (c)(2) and 40 USC 24301(1)	Government sponsored enterprises receive complete exemption from state and local tax.

Federal Statutes that Preempt or Limit State Taxation *continued*

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Pub.L. 86-272, 73 Stat. 555-56, 15 U.S.C. 381-384	Prevents state from imposing income tax on a business whose only contact with a state is to solicit sales of tangible personal property through employees or contractors.
12 USC 1723a (c)(2) and 40 USC 24301(1)	Government sponsored enterprises receive complete exemption from state and local tax.

Federal Statutes that Preempt or Limit State Taxation *continued*

Statute	Topic
Intermodal Surface Transportation Efficiency Act (ISTEA) of 1992, Pub.L. 102-240, 105 Stat 1914, 49 USCA § 101	Requires states to collect motor fuel use taxes through a base-state mechanism. [49 USCA §§31701-31707.]
Airport Development Acceleration Act of 1973, Pub. L. 93-44, 87 Stat. 88, 49 U.S.C. 1513	Preempts state and local gross receipts taxes on the sale of commercial air transportation.
Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 15 U.S.C. 391	Prevents state from imposing taxes on or with respect to the generation or transmission of electricity when such a tax would discriminate against out-of-state manufactures, producers, wholesalers, retailers, and consumers of that electricity.
11 USC § 505	Allows a bankruptcy court to make decision regarding state tax matters. Other bankruptcy provisions affect the ability of states to assess taxes after a bankruptcy has been filed; also, case law indicates that, in some cases, the filing of a claim by a state can be viewed as a waiver of the state's sovereign immunity.
Defense Authorization Act of 1998 (P.L.105-261)	Prevents states from imposing individual income tax on nonresidents employed on certain federal installations.

Federal Statutes that Preempt or Limit State Taxation *continued*

Statute	Topic
ERISA, Employee Retirement Income Security Act, 29 USCA § 1144(a)	Provides that ERISA supercedes any and all state laws insofar as they may now of hereafter relate to any employee benefit plan.
19 USCA 1309	Exemption from Custom Duties and Internal Revenue Tax based on bonded aviation fuel.
7 USC § 2013	States may only participate in the food stamp program if state and local sales taxes are not collected on food purchases with coupons issued under this act. Similar exemption presumed for women's, infants and children program payments, under Child Nutrition Act of 1966, 42 USC §§ 1771-1789.
31 USCA § 3124	Prohibition on state and local taxation of federal obligations or the interest thereon other than under a nondiscriminatory franchise tax.
12 USCA § 531	Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom shall be exempt from federal, state and local taxation, except taxes upon real estate.
43 USCA §1333(2)(A)	State taxation laws shall not apply to the outer Continental Shelf.
47 USCA §152, nt.	Direct-to-home satellite services exempt from local, but not state, taxation.

Federal Statutes that Preempt or Limit State Taxation *continued*

Statute	Topic
49 USCA §40116(c)	State may tax a flight "only if the aircraft takes off or lands in the State or political subdivision as part of the flight."
Mobile Telecommunications Sourcing Act, P.L. 106-252, 4. U.S.C. §116-126	Establishes the "customer's place of primary use" as the situs for taxation of all mobile telecommunication services used by the customer.
Internet Tax Freedom Act, Pub. L. 105-277, 112 Stat 2681-719, 47 U.S.C. §151, nt.	Except for grandfathered states, the states are prohibited from taxing Internet access, as defined in the statute, and from imposing multiple or discriminatory taxes on Internet activity, for the duration of the moratorium.
Intermodal Surface Transportation Efficiency Act (ISTEA) of 1992, Pub.L. 102-240, 105 Stat 1914, 49 USCA § 101	Requires states to collect motor fuel use taxes through a base-state mechanism. [49 USCA §§31701-31707.]
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Federal Statutes that Preempt or Limit State Taxation *continued*

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Appendix D
Factor Presence Nexus Standard for Business Activity Taxes

Approved by the Multistate Tax Commission
October 17, 2002

A. (1) Individuals who are residents or domiciliaries of this State and business entities that are organized or commercially domiciled in this State have substantial nexus with this State.

(2) Nonresident individuals and business entities organized outside the State that are doing business in this State have substantial nexus and are subject to [list appropriate business activity taxes for the state, with statutory citations] when in any tax period the property, payroll or sales of the individual or business in the State, as they are defined below in Subsection C, exceeds the thresholds set forth in Subsection B.

B. (1) Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of $50,000 of property; or
(b) a dollar amount of $50,000 of payroll; or
(c) a dollar amount of $500,000 of sales; or
(d) twenty-five percent of total property, total payroll or total sales.

(2) At the end of each year, the [tax administrator] shall review the cumulative percentage change in the consumer price index. The [tax administrator] shall adjust the thresholds set forth in paragraph (1) if the consumer price index has changed by 5% or more since January 1, 2003, or since the date that the thresholds were last adjusted under this subsection. The thresholds shall be adjusted to reflect that cumulative percentage change in the consumer price index. The adjusted thresholds shall be rounded to the nearest $1,000. As used in this subsection, "consumer price index" means the Consumer Price Index for All Urban Consumers (CPI-U) available from the Bureau of Labor Statistics of the United States Department of Labor. Any adjustment shall apply to tax periods that begin after the adjustment is made.

C. Property, payroll and sales are defined as follows:

(1) Property counting toward the threshold is the average value of the taxpayer's real property and tangible personal property owned or rented and used in this State during the tax period. Property owned by the taxpayer is valued at its original cost basis. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals. The average value of property shall be determined by averaging the values at the beginning and ending

of the tax period; but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

(2) Payroll counting toward the threshold is the total amount paid by the taxpayer for compensation in this State during the tax period. Compensation means wages, salaries, commissions and any other form of remuneration paid to employees and defined as gross income under Internal Revenue Code § 61. Compensation is paid in this State if (a) the individual's service is performed entirely within the State; (b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or (c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State.

(3) Sales counting toward the threshold include the total dollar value of the taxpayer's gross receipts, including receipts from entities that are part of a commonly owned enterprise as defined in D(2) of which the taxpayer is a member, from

(a) the sale, lease or license of real property located in this State;
(b) the lease or license of tangible personal property located in this State;
(c) the sale of tangible personal property received in this State as indicated by receipt at a business location of the seller in this State or by instructions, known to the seller, for delivery or shipment to a purchaser (or to another at the direction of the purchaser) in this State; and
(d) The sale, lease or license of services, intangibles, and digital products for primary use by a purchaser known to the seller to be in this State. If the seller knows that a service, intangible, or digital product will be used in multiple States because of separate charges levied for, or measured by, the use at different locations, because of other contractual provisions measuring use, or because of other information provided to the seller, the seller shall apportion the receipts according to usage in each State.
(e) If the seller does not know where a service, intangible, or digital product will be used or where a tangible will be received, the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is available from the business records of the seller maintained in the ordinary course of business when such use does not constitute bad faith. If that is not known, then the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is obtained during the consummation of the sale, including the address of the purchaser's payment instrument, if no other address is available, when the use of this address does not constitute bad faith.

(4) Notwithstanding the other provisions of this Subsection C, for a taxpayer subject to the special apportionment methods under [Multistate Tax Commission Regulations IV.18.(d) through (j)], the property, payroll and sales for measuring against the

nexus thresholds shall be defined as they are for apportionment purposes under those regulations. Financial institutions subject to an apportioned income or franchise tax shall determine property, payroll and sales for nexus threshold purposes the same as for apportionment purposes under the [MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions]. Pass-through entities, including, but not limited to, partnerships, limited liability companies, S corporations, and trusts, shall determine threshold amounts at the entity level. If property, payroll or sales of an entity in this State exceeds the nexus threshold, members, partners, owners, shareholders or beneficiaries of that pass-through entity are subject to tax on the portion of income earned in this State and passed through to them.

D. (1) Entities that are part of a commonly owned enterprise shall determine whether they meet the threshold for nexus as follows:

(a) Commonly owned enterprises shall first aggregate the property, payroll and sales of their entities that have a minimum presence in this State of $5000 of combined property, payroll and sales, including those entities that independently exceed a threshold and separately have nexus. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. If that aggregation of property, payroll and sales meets any threshold in Subsection B, the enterprise shall file a joint information return as specified by the [tax agency] separately listing the property, payroll and sales in this State of each entity.

(b) Those entities of the commonly owned enterprise that are listed in the joint information return and that are also part of a unitary business grouping conducting business in this State shall then aggregate the property, payroll and sales of each such unitary business grouping on the joint information return. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. The entities shall base the unitary business groupings on the unitary combined report filed in this State. If no unitary combined report is required in this State, then the taxpayer shall use the unitary business groupings the taxpayer most commonly reports in States that require combined returns.

(c) If the aggregate property, payroll or sales in this State of the entities of any unitary business of the enterprise meets a threshold in Subsection B, then each entity that is part of that unitary business is deemed to have nexus and shall file and pay income or franchise tax as required by law.

(2) "Commonly owned enterprise" means a group of entities under common control either through a common parent that owns, or constructively owns, more than 50 percent of the voting power of the outstanding stock or ownership interests or through five or fewer individuals (individuals, estates or trusts) that own, or constructively own, more than 50 percent of the voting power of the outstanding stock or ownership

interests taking into account the ownership interest of each such person only to the extent such ownership is identical with respect to each such entity.

E. A State without jurisdiction to impose tax on or measured by net income on a particular taxpayer because that taxpayer comes within the protection of Public Law 86-272 (15 U.S.C. § 381) does not gain jurisdiction to impose such a tax even if the taxpayer's property, payroll or sales in the State exceeds a threshold in Subsection B. Public Law 86-272 preempts the state's authority to tax and will therefore cause sales of each protected taxpayer to customers in the State to be thrown back to those sending States that require throwback. If Congress repeals the application of Public Law 86-272 to this State, an out-of-state business shall not have substantial nexus in this State unless its property, payroll or sales exceeds a threshold in this provision.

Appendix E

STREAMLINED SALES AND USE TAX AGREEMENT
Adopted November 12, 2002

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ARTICLE I
PURPOSE AND PRINCIPLE

Section 101: TITLE
This multistate Agreement shall be referred to, cited, and known as the Streamlined Sales and Use Tax Agreement.

Section 102: FUNDAMENTAL PURPOSE
It is the purpose of this Agreement to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance. The Agreement focuses on improving sales and use tax administration systems for all sellers and for all types of commerce through all of the following:

A. State level administration of sales and use tax collections.
B. Uniformity in the state and local tax bases.
C. Uniformity of major tax base definitions.
D. Central, electronic registration system for all member states.
E. Simplification of state and local tax rates.
F. Uniform sourcing rules for all taxable transactions.
G. Simplified administration of exemptions.
H. Simplified tax returns.
I. Simplification of tax remittances.
J. Protection of consumer privacy.

Section 103: TAXING AUTHORITY PRESERVED
This Agreement shall not be construed as intending to influence a member state to impose a tax on or provide an exemption from tax for any item or service. However, if a member state chooses to tax an item or exempt an item from tax, that state shall adhere to the provisions concerning definitions as set out in Article III of this Agreement.

Section 104: DEFINED TERMS
This Agreement defines terms for use within the Agreement and for application in the sales and use tax laws of the member states. The definition of a term is not intended to influence the interpretation or application of that term with respect to other tax types.

An alphabetical list of all the terms defined in the Agreement and their location in the Agreement is found in Appendix B of this Agreement, the Index of Definitions. Terms defined for use within this Agreement are set out in Article II of the Agreement. Many of the uniform definitions for application in the sales and use tax laws of the member states are set out in Appendix C of this Agreement, the Library of Definitions. Definitions that are not set out in Appendix C are defined when applied in a particular section of the Agreement and are set out in that section of the Agreement. The appendices have the same effect as the Articles in the Agreement.

Section 105: TREATMENT OF VENDING MACHINES

The provisions of the Agreement do not apply to vending machines sales. The Agreement does not restrict how a member state taxes vending machine sales.

ARTICLE II
DEFINITIONS

The following definitions apply in this Agreement:

Section 201: AGENT

A person appointed by a seller to represent the seller before the member states.

Section 202: CERTIFIED AUTOMATED SYSTEM (CAS)

Software certified under the Agreement to calculate the tax imposed by each jurisdiction on a transaction, determine the amount of tax to remit to the appropriate state, and maintain a record of the transaction.

Section 203: CERTIFIED SERVICE PROVIDER (CSP)

An agent certified under the Agreement to perform all the seller's sales and use tax functions, other than the seller's obligation to remit tax on its own purchases.

Section 204: ENTITY-BASED EXEMPTION

An exemption based on who purchases the product or who sells the product.

Section 205: MODEL 1 SELLER

A seller that has selected a CSP as its agent to perform all the seller's sales and use tax functions, other than the seller's obligation to remit tax on its own purchases.

Section 206: MODEL 2 SELLER

A seller that has selected a CAS to perform part of its sales and use tax functions, but retains responsibility for remitting the tax.

Section 207: MODEL 3 SELLER

A seller that has sales in at least five member states, has total annual sales revenue of at least five hundred million dollars, has a proprietary system that calculates the amount of tax due each jurisdiction, and has entered into a performance agreement with the member states that establishes a tax performance standard for the seller. As used in this definition, a seller includes an affiliated group of sellers using the same proprietary system.

Section 208: PERSON

An individual, trust, estate, fiduciary, partnership, limited liability company, limited liability partnership, corporation, or any other legal entity.

Section 209: PRODUCT-BASED EXEMPTION

An exemption based on the description of the product and not based on who purchases the product or how the purchaser intends to use the product.

Section 210: PURCHASER
A person to whom a sale of personal property is made or to whom a service is furnished.

Section 211: REGISTERED UNDER THIS AGREEMENT
Registration by a seller with the member states under the central registration system provided in Article IV of this Agreement.

Section 212: SELLER
A person making sales, leases, or rentals of personal property or services.

Section 213: STATE
Any state of the United States and the District of Columbia.

Section 214: USE-BASED EXEMPTION
An exemption based on the purchaser's use of the product.

ARTICLE III
REQUIREMENTS EACH STATE MUST ACCEPT TO PARTICIPATE

Section 301: STATE LEVEL ADMINISTRATION
Each member state shall provide state level administration of sales and use taxes. The state level administration may be performed by a member state's Tax Commission, Department of Revenue, or any other single entity designated by state law. Sellers are only required to register with, file returns with, and remit funds to the state level authority. Each member state shall provide for collection of any local taxes and distribution of them to the appropriate taxing jurisdictions. Each member state shall conduct, or authorize others to conduct on its behalf, all audits of the sellers registered under the Agreement for that state's tax and the tax of its local jurisdictions, and local jurisdictions shall not conduct independent sales or use tax audits of sellers registered under the Agreement.

Section 302: STATE AND LOCAL TAX BASES
Through December 31, 2005, if a member state has local jurisdictions that levy a sales or use tax, all local jurisdictions in the state shall have a common tax base. After December 31, 2005, the tax base for local jurisdictions shall be identical to the state tax base unless otherwise prohibited by federal law. This section does not apply to sales or use taxes levied on the retail sale or transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, or mobile homes.

Section 303: SELLER REGISTRATION
Each member state shall participate in an online sales and use tax registration system in cooperation with the other member states. Under this system:

A. A seller registering under the Agreement is registered in each of the member states.
B. The member states agree not to require the payment of any registration fees or other charges for a seller to register in a state in which the seller has no legal requirement to register.
C. A written signature from the seller is not required.
D. An agent may register a seller under uniform procedures adopted by the member states.
E. A seller may cancel its registration under the system at any time under uniform procedures adopted by the governing board. Cancellation does not relieve the seller of its liability for remitting to the proper states any taxes collected.

Section 304: NOTICE FOR STATE TAX CHANGES

A. Each member state shall lessen the difficulties faced by sellers when there is a change in a state sales or use tax rate or base by making a reasonable effort to do all of the following:

1. Provide sellers with as much advance notice as practicable of a rate change.
2. Limit the effective date of a rate change to the first day of a calendar quarter.
3. Notify sellers of legislative changes in the tax base and amendments to sales and use tax rules and regulations.

B. Failure of a seller to receive notice or failure of a member state to provide notice or limit the effective date of a rate change shall not relieve the seller of its obligation to collect sales or use taxes for that member state.

Section 305: LOCAL RATE AND BOUNDARY CHANGES

Each member state that has local jurisdictions that levy a sales or use tax shall:

A. Provide that local rate changes will be effective only on the first day of a calendar quarter after a minimum of sixty days' notice to sellers.

B. Apply local sales tax rate changes to purchases from printed catalogs wherein the purchaser computed the tax based upon local tax rates published in the catalog only on the first day of a calendar quarter after a minimum of one hundred twenty days' notice to sellers.

C. For sales and use tax purposes only, apply local jurisdiction boundary changes only on the first day of a calendar quarter after a minimum of sixty days' notice to sellers.

D. Provide and maintain a database that describes boundary changes for all taxing jurisdictions. This database shall include a description of the change and the effective date of the change for sales and use tax purposes.

E. Provide and maintain a database of all sales and use tax rates for all of the jurisdictions levying taxes within the state. For the identification of states, counties, cities, and parishes, codes corresponding to the rates must be provided according to Federal Information Processing Standards (FIPS) as developed by the National Institute of Standards and Technology. For the identification of all other jurisdictions, codes corresponding to the rates must be in the format determined by the governing board.

F. Provide and maintain a database that assigns each five digit and nine digit zip code within a member state to the proper tax rates and jurisdictions. The state must apply the lowest combined tax rate imposed in the zip code area if the area includes more than one tax rate in any level of taxing jurisdictions. If a nine digit zip code designation is not available for a street address or if a seller is unable to determine the nine digit zip code designation of a purchaser after exercising due diligence to determine the designation, the seller may apply the rate for the five digit zip code area. For the purposes of this section, there is a rebuttable presumption that a seller has exercised due diligence if the seller has attempted to determine the nine digit zip code designation by utilizing software approved by the governing board that makes this designation from the street address and the five digit zip code of the purchaser.

G. Participate with other member states in the development of an address-based system for assigning taxing jurisdictions. The system must meet the requirements developed pursuant to the federal Mobile Telecommunications Sourcing Act (4 U.S.C. Sec. 119). The governing board may allow a member state to require sellers that register under this Agreement to use an address-based system provided by that member state. If any member state develops an address-based assignment system pursuant to the Mobile Telecommunications Sourcing Act, a seller may use that system in place of the system provided for in subsection (F) of this section.

Section 306: RELIEF FROM CERTAIN LIABILITY

Each member state shall relieve sellers and CSPs from liability to the member state and local jurisdictions for having charged and collected the incorrect amount of sales or use tax resulting from the seller or CSP relying on erroneous data provided by a member state on tax rates, boundaries, or taxing jurisdiction assignments. A member state that provides an address-based system for assigning taxing jurisdictions pursuant to Section 305, subsection (G) or pursuant to the federal Mobile Telecommunications Sourcing Act will not be required to provide liability relief for errors resulting from the reliance on the information provided by the member state under the provisions of Section 305, subsection (F).

Section 307: DATABASE REQUIREMENTS AND EXCEPTIONS

A. The electronic databases provided for in Section 305, subsections (D), (E), (F), and (G) shall be in a downloadable format approved by the governing board.

B. The provisions of Section 305, subsections (F) and (G) do not apply when the purchased product is received by the purchaser at the business location of the seller.

C. The databases provided by Section 305, subsections (D), (E), and (F) are not a requirement of a state prior to entering into the

Agreement. The governing board shall establish the effective dates for availability and use of the databases.

Section 308: STATE AND LOCAL TAX RATES

A. No member state shall have multiple state sales and use tax rates on items of personal property or services after December 31, 2005, except that a member state may impose a single additional rate, which may be zero, on food and food ingredients and drugs as defined by state law pursuant to the Agreement.

B. A member state that has local jurisdictions that levy a sales or use tax shall not have more than one local sales tax rate or more than one local use tax rate per local jurisdiction. If the local jurisdiction levies both a sales tax and use tax, the local rates must be identical.

C. The provisions of this section do not apply to sales or use taxes levied on electricity, piped natural or artificial gas, or other heating fuels delivered by the seller, or the retail sale or transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, or mobile homes.

Section 309: APPLICATION OF GENERAL SOURCING RULES AND EXCLUSIONS FROM THE RULES

A. Each member state shall agree to require sellers to source the retail sale of a product in accordance with Section 310. The provisions of Section 310 apply regardless of the characterization of a product as tangible personal property, a digital good, or a service. The provisions of Section 310 only apply to determine a seller's obligation to pay or collect and remit a sales or use tax with respect to the seller's retail sale of a product. These provisions do not affect the obligation of a purchaser or lessee to remit tax on the use of the product to the taxing jurisdictions of that use.

B. Section 310 does not apply to sales or use taxes levied on the following:

1. The retail sale or transfer of watercraft, modular homes, manufactured homes, or mobile homes. These items must be sourced according to the requirements of each member state.
2. The retail sale, excluding lease or rental, of motor vehicles, trailers, semi-trailers, or aircraft that do not qualify as transportation equipment, as defined in Section 310, subsection (D). The retail sale of these items shall be sourced according to the requirements of each member state, and the lease or rental of these items must be sourced according to Section 310, subsection (C).

3. Telecommunications services, as set out in Section 315, shall be sourced in accordance with Section 314.

Section 310: GENERAL SOURCING RULES

A. The retail sale, excluding lease or rental, of a product shall be sourced as follows:
   1. When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location.
   2. When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery to the purchaser (or donee), known to the seller.
   3. When subsections (A)(1) and (A)(2) do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller that are maintained in the ordinary course of the seller's business when use of this address does not constitute bad faith.
   4. When subsections (A)(1), (A)(2), and (A)(3) do not apply, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of a purchaser's payment instrument, if no other address is available, when use of this address does not constitute bad faith.
   5. When none of the previous rules of subsections (A)(1), (A)(2), (A)(3), or (A)(4) apply, including the circumstance in which the seller is without sufficient information to apply the previous rules, then the location will be determined by the address from which tangible personal property was shipped, from which the digital good or the computer software delivered electronically was first available for transmission by the seller, or from which the service was provided (disregarding for these purposes any location that merely provided the digital transfer of the product sold).

B. The lease or rental of tangible personal property, other than property identified in subsection (C) or subsection (D), shall be sourced as follows:
   1. For a lease or rental that requires recurring periodic payments, the first periodic payment is sourced the same as a retail sale in accordance with the provisions of subsection (A). Periodic payments made subsequent to the first payment are sourced to the primary property location for each period covered by the payment. The primary property location shall be as indicated by an address for the property provided by the lessee that is available to the lessor from its records maintained in the ordinary course of business, when use of this address does not

constitute bad faith. The property location shall not be altered by intermittent use at different locations, such as use of business property that accompanies employees on business trips and service calls.

2. For a lease or rental that does not require recurring periodic payments, the payment is sourced the same as a retail sale in accordance with the provisions of subsection (A).
3. This subsection does not affect the imposition or computation of sales or use tax on leases or rentals based on a lump sum or accelerated basis, or on the acquisition of property for lease.

C. The lease or rental of motor vehicles, trailers, semi-trailers, or aircraft that do not qualify as transportation equipment, as defined in subsection (D), shall be sourced as follows:

1. For a lease or rental that requires recurring periodic payments, each periodic payment is sourced to the primary property location. The primary property location shall be as indicated by an address for the property provided by the lessee that is available to the lessor from its records maintained in the ordinary course of business, when use of this address does not constitute bad faith. This location shall not be altered by intermittent use at different locations.
2. For a lease or rental that does not require recurring periodic payments, the payment is sourced the same as a retail sale in accordance with the provisions of subsection (A).
3. This subsection does not affect the imposition or computation of sales or use tax on leases or rentals based on a lump sum or accelerated basis, or on the acquisition of property for lease.

D. The retail sale, including lease or rental, of transportation equipment shall be sourced the same as a retail sale in accordance with the provisions of subsection (A), notwithstanding the exclusion of lease or rental in subsection (A). "Transportation equipment" means any of the following:

1. Locomotives and railcars that are utilized for the carriage of persons or property in interstate commerce.
2. Trucks and truck-tractors with a Gross Vehicle Weight Rating (GVWR) of 10,001 pounds or greater, trailers, semi-trailers, or passenger buses that are:
   a. Registered through the International Registration Plan; and
   b. Operated under authority of a carrier authorized and certificated by the U.S. Department of Transportation or another federal authority to engage in the carriage of persons or property in interstate commerce.

3. Aircraft that are operated by air carriers authorized and certificated by the U.S. Department of Transportation or another federal or a foreign authority to engage in the carriage of persons or property in interstate or foreign commerce.
4. Containers designed for use on and component parts attached or secured on the items set forth in subsections (D)(1) through (D)(3).

Section 311: GENERAL SOURCING DEFINITIONS

For the purposes of Section 310, subsection (A), the terms "receive" and "receipt" mean:

A. Taking possession of tangible personal property,

B. Making first use of services, or

C. Taking possession or making first use of digital goods, whichever comes first.

The terms "receive" and "receipt" do not include possession by a shipping company on behalf of the purchaser.

Section 312: MULTIPLE POINTS OF USE

Notwithstanding the provisions of Section 310, a business purchaser that is not a holder of a direct pay permit that knows at the time of its purchase of a digital good, computer software delivered electronically, or a service that the digital good, computer software delivered electronically, or service will be concurrently available for use in more than one jurisdiction shall deliver to the seller in conjunction with its purchase a form disclosing this fact ("Multiple Points of Use or MPU" Exemption Form).

A. Upon receipt of the MPU Exemption Form, the seller is relieved of all obligation to collect, pay, or remit the applicable tax and the purchaser shall be obligated to collect, pay, or remit the applicable tax on a direct pay basis.

B. A purchaser delivering the MPU Exemption Form may use any reasonable, but consistent and uniform, method of apportionment that is supported by the purchaser's business records as they exist at the time of the consummation of the sale.

C. The MPU Exemption Form will remain in effect for all future sales by the seller to the purchaser (except as to the subsequent sale's specific apportionment that is governed by the principle of subsection (B) and the facts existing at the time of the sale) until it is revoked in writing.

D. A holder of a direct pay permit shall not be required to deliver a MPU Exemption Form to the seller. A direct pay permit holder shall follow the provisions of subsection (B) in apportioning the tax due on a digital good or a service that will be concurrently available for use in more than one jurisdiction.

Section 313: DIRECT MAIL SOURCING

A. Notwithstanding Section 310, a purchaser of direct mail that is not a holder of a direct pay permit shall provide to the seller in conjunction with the purchase either a Direct Mail Form or information to show the jurisdictions to which the direct mail is delivered to recipients.

1. Upon receipt of the Direct Mail Form, the seller is relieved of all obligations to collect, pay, or remit the applicable tax and the purchaser is obligated to pay or remit the applicable tax on a direct pay basis. A Direct Mail Form shall remain in effect for all future sales of direct mail by the seller to the purchaser until it is revoked in writing.
2. Upon receipt of information from the purchaser showing the jurisdictions to which the direct mail is delivered to recipients, the seller shall collect the tax according to the delivery information provided by the purchaser. In the absence of bad faith, the seller is relieved of any further obligation to collect tax on any transaction where the seller has collected tax pursuant to the delivery information provided by the purchaser.

B. If the purchaser of direct mail does not have a direct pay permit and does not provide the seller with either a Direct Mail Form or delivery information, as required by subsection (A) of this section, the seller shall collect the tax according to Section 310, subsection (A)(5). Nothing in this paragraph shall limit a purchaser's obligation for sales or use tax to any state to which the direct mail is delivered.

C. If a purchaser of direct mail provides the seller with documentation of direct pay authority, the purchaser shall not be required to provide a Direct Mail Form or delivery information to the seller.

Section 314: TELECOMMUNICATION SOURCING RULE

A. Except for the defined telecommunication services in subsection (C), the sale of telecommunication service sold on a call-by-call basis shall be sourced to (i) each level of taxing jurisdiction where the call originates and terminates in that jurisdiction or (ii) each level of taxing jurisdiction where the call either originates or terminates and in which the service address is also located.

B. Except for the defined telecommunication services in subsection (C), a sale of telecommunications services sold on a basis other than a call-by-call basis, is sourced to the customer's place of primary use.

C. The sale of the following telecommunication services shall be sourced to each level of taxing jurisdiction as follows:

1. A sale of mobile telecommunications services other than air-to-ground radiotelephone service and prepaid calling service, is sourced to the customer's place of primary use as required by the Mobile Telecommunications Sourcing Act.
2. A sale of post-paid calling service is sourced to the origination point of the telecommunications signal as first identified by either (i) the seller's telecommunications system, or (ii) information received by the seller from its service provider, where the system used to transport such signals is not that of the seller.
3. A sale of prepaid calling service is sourced in accordance with Section 310. Provided however, in the case of a sale of mobile telecommunications service that is a prepaid telecommunications service, the rule provided in Section 310, subsection (A)(5) shall include as an option the location associated with the mobile telephone number.
4. A sale of a private communication service is sourced as follows:
    a. Service for a separate charge related to a customer channel termination point is sourced to each level of jurisdiction in which such customer channel termination point is located.
    b. Service where all customer termination points are located entirely within one jurisdiction or levels of jurisdiction is sourced in such jurisdiction in which the customer channel termination points are located.
    c. Service for segments of a channel between two customer channel termination points located in different jurisdictions and which segment of channel are separately charged is sourced fifty percent in each level of jurisdiction in which the customer channel termination points are located.
    d. Service for segments of a channel located in more than one jurisdiction or levels of jurisdiction and which segments are not separately billed is sourced in each jurisdiction based on the percentage determined by dividing the number of customer channel termination points in such jurisdiction by the total number of customer channel termination points.

Section 315: TELECOMMUNICATION SOURCING DEFINITIONS

For the purpose of Section 314, the following definitions apply:

A. "Air-to-Ground Radiotelephone service" means a radio service, as that term is defined in 47 CFR 22.99, in which common carriers are authorized to offer and provide radio telecommunications service for hire to subscribers in aircraft.

B. "Call-by-call Basis" means any method of charging for telecommunications services where the price is measured by individual calls.

C. "Communications Channel" means a physical or virtual path of communications over which signals are transmitted between or among customer channel termination points.

D. "Customer" means the person or entity that contracts with the seller of telecommunications services. If the end user of telecommunications services is not the contracting party, the end user of the telecommunications service is the customer of the telecommunication service, but this sentence only applies for the purpose of sourcing sales of telecommunications services under Section 314. "Customer" does not include a reseller of telecommunications service or for mobile telecommunications service of a serving carrier under an agreement to serve the customer outside the home service provider's licensed service area.

E. "Customer Channel Termination Point" means the location where the customer either inputs or receives the communications.

F. "End user" means the person who utilizes the telecommunication service. In the case of an entity, "end user" means the individual who utilizes the service on behalf of the entity.

G. "Home service provider" means the same as that term is defined in Section 124(5) of Public Law 106-252 (Mobile Telecommunications Sourcing Act).

H. "Mobile telecommunications service" means the same as that term is defined in Section 124(5) of Public Law 106-252 (Mobile Telecommunications Sourcing Act).

I. "Place of primary use" means the street address representative of where the customer's use of the telecommunications service primarily occurs, which must be the residential street address or the primary business street address of the customer. In the case of mobile telecommunications services, "place of primary use" must be within the licensed service area of the home service provider.

J. "Post-paid calling service" means the telecommunications service obtained by making a payment on a call-by-call basis either through the use of a credit card or payment mechanism such as a bank card, travel card, credit card, or debit card, or by charge made to a telephone number which is not associated with the origination or termination of the telecommunications service. A post-paid calling service includes a telecommunications service that would be a prepaid calling service except it is not exclusively a telecommunication service.

K. "Prepaid calling service" means the right to access exclusively telecommunications services, which must be paid for in advance and which enables the origination of calls using an access number or authorization code, whether manually or electronically dialed, and that is sold in predetermined units or dollars of which the number declines with use in a known amount.

L. "Private communication service" means a telecommunication service that entitles the customer to exclusive or priority use of a communications channel or group of channels between or among termination points, regardless of the manner in which such channel or channels are connected, and includes switching capacity, extension lines, stations, and any other associated services that are provided in connection with the use of such channel or channels.

M. "Service address" means:

1. The location of the telecommunications equipment to which a customer's call is charged and from which the call originates or terminates, regardless of where the call is billed or paid.
2. If the location in subsection (M)(1) is not known, service address means the origination point of the signal of the telecommunications services first identified by either the seller's telecommunications system or in information received by the seller from its service provider, where the system used to transport such signals is not that of the seller.
3. If the location in subsection (M)(1) and subsection (M)(2) are not known, the service address means the location of the customer's place of primary use.

Section 316: ENACTMENT OF EXEMPTIONS

A. A member state may enact a product-based exemption without restriction if the Agreement does not have a definition for the product or for a term that includes the product. If the Agreement has a definition for the product or for a term that includes the product, a member state may exempt all items included within the definition but shall not exempt only part of the items included within the definition unless the Agreement sets out the exemption for part of the items as an acceptable variation.

B. A member state may enact an entity-based or a use-based exemption without restriction if the Agreement does not have a definition for the product whose use or purchase by a specific entity is exempt or for a term that includes the product. If the Agreement has a definition for the product whose use or specific purchase is exempt, a member state may enact an entity-based or a use-based exemption that applies to that product as long as the exemption utilizes the Agreement definition of the product. If the Agreement does not have a definition for the product whose use or specific purchase is exempt but has a definition for a term that includes the product, a member state may enact an entity-based or a use-based exemption for the product without restriction.

C. For purposes of complying with the requirements in this section, the inclusion of a product within the definition of tangible personal property is disregarded.

Section 317: ADMINISTRATION OF EXEMPTIONS

A. Each member state shall observe the following provisions when a purchaser claims an exemption:
   1. The seller shall obtain identifying information of the purchaser and the reason for claiming a tax exemption at the time of the purchase as determined by the governing board.
   2. A purchaser is not required to provide a signature to claim an exemption from tax unless a paper exemption certificate is used.
   3. The seller shall use the standard form for claiming an exemption electronically as adopted by the governing board.
   4. The seller shall obtain the same information for proof of a claimed exemption regardless of the medium in which the transaction occurred.
   5. A member state may utilize a system wherein the purchaser exempt from the payment of the tax is issued an identification number that shall be presented to the seller at the time of the sale.
   6. The seller shall maintain proper records of exempt transactions and provide them to a member state when requested.
   7. A member state shall administer use-based and entity-based exemptions when practicable through a direct pay permit, an exemption certificate, or another means that does not burden sellers.

B. Each member state shall relieve sellers that follow the requirements of this section from any tax otherwise applicable if it is determined that the purchaser improperly claimed an exemption and to hold the purchaser liable for the nonpayment of tax. This relief from liability does not apply to a seller who fraudulently fails to collect the tax or solicits purchasers to participate in the unlawful claim of an exemption.

Section 318: UNIFORM TAX RETURNS

Each member state shall:

A. Require that only one tax return for each taxing period for each seller be filed for the member state and all the taxing jurisdictions within the member state.

B. Require that returns be due no sooner than the twentieth day of the month following the month in which the transaction occurred.

C. Allow any Model 1, Model 2, or Model 3 seller to submit its sales and use tax returns in a simplified format that does not include more data fields than permitted by the governing board. A member state may require additional informational returns to be submitted not more frequently than every six months under a staggered system developed by the governing board.

D. Allow any seller that is registered under the Agreement, which does not have a legal requirement to register in the member state, and is not a Model 1, 2, or 3 seller, to submit its sales and use tax returns as follows:

1. Upon registration, a member state shall provide to the seller the returns required by that state.
2. A member state may require a seller to file a return anytime within one year of the month of initial registration, and future returns may be required on an annual basis in succeeding years.
3. In addition to the returns required in subsection (D)(2), a member state may require sellers to submit returns in the month following any month in which they have accumulated state and local tax funds for the state in the amount of one thousand dollars or more.

E. Participate with other member states in developing a more uniform sales and use tax return that, when completed, would be available to all sellers.

F. Require, at each member state’s discretion, all Model 1, 2, and 3 sellers to file returns electronically. It is the intent of the member states that all member states have the capability of receiving electronically filed returns by January 1, 2004.

Section 319: UNIFORM RULES FOR REMITTANCES OF FUNDS

Each member state shall:

A. Require only one remittance for each return except as provided in this subsection. If any additional remittance is required, it may only be required from sellers that collect more than thirty thousand dollars in sales and use taxes in the member state during the preceding calendar year as provided herein. The amount of the additional remittance shall be determined through a calculation method rather than actual collections and shall not require the filing of an additional return.

B. Require, at each member state's discretion, all remittances from sellers under Models 1, 2, and 3 to be remitted electronically.
C. Allow for electronic payments by both ACH Credit and ACH Debit.
D. Provide an alternative method for making "same day" payments if an electronic funds transfer fails.
E. Provide that if a due date falls on a legal banking holiday in a member state, the taxes are due to that state on the next succeeding business day.
F. Require that any data that accompanies a remittance be formatted using uniform tax type and payment type codes approved by the governing board.

Section 320: UNIFORM RULES FOR RECOVERY OF BAD DEBTS

Each member state shall use the following to provide a deduction for bad debts to a seller. To the extent a member state provides a bad debt deduction to any other party, the same procedures will apply. Each member state shall:

A. Allow a deduction from taxable sales for bad debts. Any deduction taken that is attributed to bad debts shall not include interest.
B. Utilize the federal definition of "bad debt" in 26 U.S.C. Sec. 166 as the basis for calculating bad debt recovery. However, the amount calculated pursuant to 26 U.S.C. Sec. 166 shall be adjusted to exclude: financing charges or interest; sales or use taxes charged on the purchase price; uncollectable amounts on property that remain in the possession of the seller until the full purchase price is paid; expenses incurred in attempting to collect any debt, and repossessed property.
C. Allow bad debts to be deducted on the return for the period during which the bad debt is written off as uncollectable in the claimant's books and records and is eligible to be deducted for federal income tax purposes. For purposes of this subsection, a claimant who is not required to file federal income tax returns may deduct a bad debt on a return filed for the period in which the bad debt is written off as uncollectable in the claimant's books and records and would be eligible for a bad debt deduction for federal income tax purposes if the claimant was required to file a federal income tax return.
D. Require that, if a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount so

collected must be paid and reported on the return filed for the period in which the collection is made.

E. Provide that, when the amount of bad debt exceeds the amount of taxable sales for the period during which the bad debt is written off, a refund claim may be filed within the member state's otherwise applicable statute of limitations for refund claims; however, the statute of limitations shall be measured from the due date of the return on which the bad debt could first be claimed.

F. Where filing responsibilities have been assumed by a CSP, allow the service provider to claim, on behalf of the seller, any bad debt allowance provided by this section. The CSP must credit or refund the full amount of any bad debt allowance or refund received to the seller.

G. Provide that, for the purposes of reporting a payment received on a previously claimed bad debt, any payments made on a debt or account are applied first proportionally to the taxable price of the property or service and the sales tax thereon, and secondly to interest, service charges, and any other charges.

H. In situations where the books and records of the party claiming the bad debt allowance support an allocation of the bad debts among the member states, permit the allocation.

Section 321: CONFIDENTIALITY AND PRIVACY PROTECTIONS UNDER MODEL 1

A. The purpose of this section is to set forth the member states' policy for the protection of the confidentiality rights of all participants in the system and of the privacy interests of consumers who deal with Model 1 sellers.

B. As used in this section, the term "confidential taxpayer information" means all information that is protected under a member state's laws, regulations, and privileges; the term "personally identifiable information" means information that identifies a person; and the term "anonymous data" means information that does not identify a person.

C. The member states agree that a fundamental precept in Model 1 is to preserve the privacy of consumers by protecting their anonymity. With very limited exceptions, a CSP shall perform its tax calculation, remittance, and reporting functions without retaining the personally identifiable information of consumers.

D. The governing board may certify a CSP only if that CSP certifies that:

1. Its system has been designed and tested to ensure that the fundamental precept of anonymity is respected;

2. That personally identifiable information is only used and retained to the extent necessary for the administration of Model 1 with respect to exempt purchasers;
3. It provides consumers clear and conspicuous notice of its information practices, including what information it collects, how it collects the information, how it uses the information, how long, if at all, it retains the information and whether it discloses the information to member states. Such notice shall be satisfied by a written privacy policy statement accessible by the public on the official web site of the CSP;
4. Its collection, use and retention of personally identifiable information will be limited to that required by the member states to ensure the validity of exemptions from taxation that are claimed by reason of a consumer's status or the intended use of the goods or services purchased; and
5. It provides adequate technical, physical, and administrative safeguards so as to protect personally identifiable information from unauthorized access and disclosure.

E. Each member state shall provide public notification to consumers, including their exempt purchasers, of the state's practices relating to the collection, use and retention of personally identifiable information.

F. When any personally identifiable information that has been collected and retained is no longer required for the purposes set forth in subsection (D)(4), such information shall no longer be retained by the member states.

G. When personally identifiable information regarding an individual is retained by or on behalf of a member state, such state shall provide reasonable access by such individual to his or her own information in the state's possession and a right to correct any inaccurately recorded information.

H. If anyone other than a member state, or a person authorized by that state's law or the Agreement, seeks to discover personally identifiable information, the state from whom the information is sought should make a reasonable and timely effort to notify the individual of such request.

I. This privacy policy is subject to enforcement by member states' attorneys general or other appropriate state government authority.

J. Each member states' laws and regulations regarding the collection, use, and maintenance of confidential taxpayer information remain fully applicable and binding. Without limitation, the Agreement does not enlarge or limit the member states' authority to:

1. Conduct audits or other review as provided under the Agreement and state law.
2. Provide records pursuant to a member state's Freedom of Information Act, disclosure laws with governmental agencies, or other regulations.
3. Prevent, consistent with state law, disclosures of confidential taxpayer information.
4. Prevent, consistent with federal law, disclosures or misuse of federal return information obtained under a disclosure agreement with the Internal Revenue Service.
5. Collect, disclose, disseminate, or otherwise use anonymous data for governmental purposes.

K. This privacy policy does not preclude the governing board from certifying a CSP whose privacy policy is more protective of confidential taxpayer information or personally identifiable information than is required by the Agreement.

Section 322: SALES TAX HOLIDAYS

A. If a member state allows for temporary exemption periods, commonly referred to as sales tax holidays, the member state shall:
1. Not apply an exemption after December 31, 2003, unless the items to be exempted are specifically defined in the Agreement and the exemptions are uniformly applied to state and local sales and use taxes.
2. Provide notice of the exemption period at least sixty days' prior to the first day of the calendar quarter in which the exemption period will begin.

B. A member state may establish a sales tax holiday that utilizes price thresholds set by such state and the provisions of the Agreement on the use of thresholds shall not apply to exemptions provided by a state during a sales tax holiday. In order to provide uniformity, a price threshold established by a member state for exempt items shall include only items priced below the threshold. A member state shall not exempt only a portion of the price of an individual item during a sales tax holiday.

C. The governing board shall establish procedures to provide uniformity for the administrative issues involved with the implementation of a sales tax holiday. These issues include, but are not limited to:
1. Treatment of layaway purchases;
2. Exempt and nonexempt items that are packaged together;
3. Treatment of coupons or discounts;
4. Splitting of items normally sold together;

5. Treatment of rainchecks;
6. Exchanges;
7. Shipping and handling charges;
8. Service charges;
9. Restocking fees; and
10. Order date/Back orders.

Section 323: CAPS AND THRESHOLDS

A. Each member state shall:
   1. Not have caps or thresholds on the application of state sales or use tax rates or exemptions that are based on the value of the transaction or item after December 31, 2005. A member state may continue to have caps and thresholds until that date.
   2. Not have caps that are based on the application of the rates unless the member state assumes the administrative responsibility in a manner that places no additional burden on the retailer.

B. Each member state that has local jurisdictions that levy a sales or use tax shall not place caps or thresholds on the application of local rates or use tax rates or exemptions that are based on the value of the transaction or item after December 31, 2005. A member state may continue to have caps and thresholds until that date.

C. The provisions of this section do not apply to sales or use taxes levied on the retail sale or transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, or mobile homes or to instances where the burden of administration has been shifted from the retailer.

Section 324: ROUNDING RULE

A. After December 31, 2005, each member state shall adopt a rounding algorithm that meets the following criteria:
   1. Tax computation must be carried to the third decimal place, and
   2. The tax must be rounded to a whole cent using a method that rounds up to the next cent whenever the third decimal place is greater than four.

B. Each state shall allow sellers to elect to compute the tax due on a transaction on an item or an invoice basis, and shall allow the rounding rule to be applied to the aggregated state and local taxes. No member state shall require a seller to collect tax based on a bracket system.

Section 325: CUSTOMER REFUND PROCEDURES

A. These customer refund procedures are provided to apply when a state allows a purchaser to seek a return of over-collected sales or use taxes from the seller.

B. Nothing in this section shall either require a state to provide, or prevent a state from providing, a procedure by which a purchaser may seek a refund directly from the state arising out of sales or use taxes collected in error by a seller from the purchaser. Nothing in this section shall operate to extend any person's time to seek a refund of sales or use taxes collected or remitted in error.

C. These customer refund procedures provide the first course of remedy available to purchasers seeking a return of over-collected sales or use taxes from the seller. A cause of action against the seller for the over-collected sales or use taxes does not accrue until a purchaser has provided written notice to a seller and the seller has had sixty days to respond. Such notice to the seller must contain the information necessary to determine the validity of the request.

D. In connection with a purchaser's request from a seller of over-collected sales or use taxes, a seller shall be presumed to have a reasonable business practice, if in the collection of such sales or use taxes, the seller: i) uses either a provider or a system, including a proprietary system, that is certified by the state; and ii) has remitted to the state all taxes collected less any deductions, credits, or collection allowances.

Section 326: DIRECT PAY PERMITS

Each member state shall provide for a direct pay authority that allows the holder of a direct pay permit to purchase otherwise taxable goods and services without payment of tax to the supplier at the time of purchase. The holder of the direct pay permit will make a determination of the taxability and then report and pay the applicable tax due directly to the tax jurisdiction. Each state can set its own limits and requirements for the direct pay permit. The governing board shall advise member states when setting state direct pay limits and requirements, and shall consider use of the Model Direct Payment Permit Regulation as developed by the Task Force on EDI Audit and Legal Issues for Tax Administration.

Section 327: LIBRARY OF DEFINITIONS

Each member state shall utilize common definitions as provided in this section. The terms defined are set out in the Library of Definitions, in Appendix C of this Agreement. A member state shall adhere to the following principles:

A. If a term defined in the Library of Definitions appears in a member state's sales and use tax statutes or administrative rules or regulations, the member state shall enact or adopt the Library definition of the term in its statutes or administrative rules or regulations in substantially the same language as the Library definition.

B. A member state shall not use a Library definition in its sales or use tax statutes or administrative rules or regulations that is contrary to the meaning of the Library definition.

C. Except as specifically provided in Section 316 and the Library of Definitions, a member state shall impose a sales or use tax on all products or services included within each definition or exempt from sales or use tax all products or services within each definition.

Section 328: TAXABILITY MATRIX

A. To ensure uniform application of terms defined in the Library of Definitions each member state shall complete a taxability matrix adopted by the governing board. The member state's entries in the matrix shall be provided and maintained in a database that is in a downloadable format approved by the governing board. A member state shall provide notice of changes in the taxability of the products or services listed in the taxability matrix as required by the governing board.

B. A member state shall relieve sellers and CSPs from liability to the member state and its local jurisdictions for having charged and collected the incorrect amount of sales or use tax resulting from the seller or CSP relying on erroneous data provided by the member state in the taxability matrix.

Section 329: EFFECTIVE DATE FOR RATE CHANGES

Each member state shall provide that the effective date of rate changes for services covering a period starting before and ending after the statutory effective date shall be as follows:

A. For a rate increase, the new rate shall apply to the first billing period starting on or after the effective date.

B. For a rate decrease, the new rate shall apply to bills rendered on or after the effective date.

ARTICLE IV
SELLER REGISTRATION

Section 401: SELLER PARTICIPATION

A. The member states shall provide an online registration system that will allow sellers to register in all the member states.

B. By registering, the seller agrees to collect and remit sales and use taxes for all taxable sales into the member states, including member states joining after the seller's registration. Withdrawal or revocation of a member state shall not relieve a seller of its responsibility to remit taxes previously or subsequently collected on behalf of the state.

C. In member states where the seller has a requirement to register prior to registering under the Agreement, the seller may be required to provide additional information to complete the registration process or the seller may choose to register directly with those states.

D. A member state or a state that has withdrawn or been expelled shall not use registration with the central registration system and the collection of sales and use taxes in the member states as a factor in determining whether the seller has nexus with that state for any tax at any time.

Section 402: AMNESTY FOR REGISTRATION

A. Subject to the limitations in this section:

1. A member state shall provide amnesty for uncollected or unpaid sales or use tax to a seller who registers to pay or to collect and remit applicable sales or use tax on sales made to purchasers in the state in accordance with the terms of the Agreement, provided that the seller was not so registered in that state in the twelve-month period preceding the effective date of the state's participation in the Agreement.
2. The amnesty will preclude assessment for uncollected or unpaid sales or use tax together with penalty or interest for sales made during the period the seller was not registered in the state, provided registration occurs within twelve months of the effective date of the state's participation in the Agreement.
3. Amnesty similarly shall be provided by any additional state that joins the Agreement after the seller has registered.

B. The amnesty is not available to a seller with respect to any matter or matters for which the seller received notice of the commencement of an audit and which audit is not yet finally resolved including any related administrative and judicial processes.

C. The amnesty is not available for sales or use taxes already paid or remitted to the state or to taxes collected by the seller.

D. The amnesty is fully effective, absent the seller's fraud or intentional misrepresentation of a material fact, as long as the seller continues registration and continues payment or collection and remittance of applicable sales or use taxes for a period of at least thirty-six months. Each member state shall toll its statute of limitations applicable to asserting a tax liability during this thirty-six month period.

E. The amnesty is applicable only to sales or use taxes due from a seller in its capacity as a seller and not to sales or use taxes due from a seller in its capacity as a buyer.

F. A member state may allow amnesty on terms and conditions more favorable to a seller than the terms required by this section.

Section 403: METHOD OF REMITTANCE

When registering, the seller may select one of the following methods of remittances or other method allowed by state law to remit the taxes collected:

A. MODEL 1, wherein a seller selects a CSP as an agent to perform all the seller's sales or use tax functions, other than the seller's obligation to remit tax on its own purchases.

B. MODEL 2, wherein a seller selects a CAS to use which calculates the amount of tax due on a transaction.

C. MODEL 3, wherein a seller utilizes its own proprietary automated sales tax system that has been certified as a CAS.

Section 404: REGISTRATION BY AN AGENT

A seller may be registered by an agent. Such appointment shall be in writing and submitted to a member state if requested by the member state.

ARTICLE V
PROVIDER AND SYSTEM CERTIFICATION

Section 501: CERTIFICATION OF SERVICE PROVIDERS AND AUTOMATED SYSTEMS

A. The governing board shall certify automated systems and service providers to aid in the administration of sale and use tax collections.

B. The governing board may certify a person as a CSP if the person meets all of the following requirements:
   1. The person uses a CAS;
   2. The person integrates its CAS with the system of a seller for whom the person collects tax so that the tax due on a sale is determined at the time of the sale;
   3. The person agrees to remit the taxes it collects at the time and in the manner specified by the member states;
   4. The person agrees to file returns on behalf of the sellers for whom it collects tax;
   5. The person agrees to protect the privacy of tax information it obtains in accordance with Section 321 of the Agreement; and
   6. The person enters into a contract with the member states and agrees to comply with the terms of the contract.

C. The governing board may certify a software program as a CAS if the governing board determines that the program meets all of the following requirements:
   1. It determines the applicable state and local sales and use tax rate for a transaction, in accordance with Sections 309 to 315, inclusive;
   2. It determines whether or not an item is exempt from tax;
   3. It determines the amount of tax to be remitted for each taxpayer for a reporting period;
   4. It can generate reports and returns as required by the governing board; and
   5. It can meet any other requirement set by the governing board.

D. The governing board may establish one or more sales tax performance standards for Model 3 sellers that meet the eligibility criteria set by the governing board and that developed a proprietary system to determine the amount of sales and use tax due on transactions.

ARTICLE VI
MONETARY ALLOWANCES FOR NEW TECHNOLOGICAL MODELS FOR SALES TAX COLLECTION

Section 601: MONETARY ALLOWANCE UNDER MODEL 1

A. Each member state shall provide a monetary allowance to a CSP in Model 1 in accordance with the terms of the contract between the governing board and the CSP. The details of the monetary allowance will be provided through the contract process. The governing board shall require that such allowance be funded entirely from money collected in Model 1.

B. The contract between the governing board and a CSP may base the monetary allowance to a CSP on one or more of the following:
   1. A base rate that applies to taxable transactions processed by the CSP.
   2. For a period not to exceed twenty-four months following a voluntary seller's registration through the Agreement's central registration process, a percentage of tax revenue generated for a member state by the voluntary seller for each member state for which the seller does not have a requirement to register to collect the tax.

Section 602: MONETARY ALLOWANCE FOR MODEL 2 SELLERS

The member states initially anticipate that they will provide a monetary allowance to sellers under Model 2 based on the following:

A. All sellers shall receive a base rate for a period not to exceed twenty-four months following the commencement of participation by a seller. The base rate will be set after the base rate has been established for Model 1. This allowance will be in addition to any discount afforded by each member state at the time.

B. The member states anticipate a monetary allowance to a Model 2 Seller based on the following:
   1. For a period not to exceed twenty-four months following a voluntary seller's registration through the Agreement's central registration process, a percentage of tax revenue generated for a member state by the voluntary seller for each member state for which the seller does not have a requirement to register to collect the tax.
   2. Following the conclusion of the twenty-four month period, a seller will only be entitled to a vendor discount afforded under each member state's law at the time the base rate expires.

Section 603: MONETARY ALLOWANCE FOR MODEL 3 SELLERS AND ALL OTHER SELLERS THAT ARE NOT UNDER MODELS 1 OR 2

The member states anticipate that they will provide a monetary allowance to sellers under Model 3 and to all other sellers that are not under Models 1 or 2 based on the following:

A. For a period not to exceed twenty-four months following a voluntary seller's registration through the Agreement's central registration process, a percentage of tax revenue generated for a member state by the voluntary seller for each member state for which the seller does not have a requirement to register to collect the tax.

B. Vendor discounts afforded under each member state's law.

ARTICLE VII
AGREEMENT ORGANIZATION

Section 701: EFFECTIVE DATE

The Agreement shall become binding and take effect when at least ten states comprising at least twenty percent of the total population, as determined by the 2000 Federal census, of all states imposing a state sales tax have petitioned for membership and have been found to be in compliance with the requirements of the Agreement pursuant to Section 805. The Agreement shall take effect on the first day of a calendar quarter at least sixty days after the tenth state is found in compliance, but cannot take effect prior to July 1, 2003.

Section 702: APPROVAL OF INITIAL STATES

Prior to the effective date of the Agreement, a state may seek membership by forwarding a petition for membership and certificate of compliance to the Co-Chairs of the Streamlined Sales Tax Implementing States. A petitioning state shall also provide a copy of its petition for membership and certificate of compliance to each of the Streamlined Sales Tax Implementing States. A petitioning state shall also post a copy of its petition for membership and certificate of compliance on that state's web site.

Upon receipt of the requisite number of petitions as provided in Section 701, the Co-Chairs shall convene and preside over a meeting of the petitioning states for the purpose of determining if the petitioning states are in compliance with the Agreement. An affirmative vote of three-fourths of the other petitioning states is necessary for a petitioning state to be found in compliance with the Agreement. A petitioning state shall not vote on its own petition for membership.

The Co-Chairs shall provide the public with an opportunity to comment prior to any vote on a state's petition for membership.

ARTICLE VIII
STATE ENTRY AND WITHDRAWAL

Section 801: ENTRY INTO AGREEMENT

After the effective date of the Agreement, a state may apply to become a party to the Agreement by submitting a petition for membership and certificate of compliance to the governing board. The petition for membership shall include such state's proposed date of entry. The petitioning state's proposed date of entry shall be on the first day of a calendar quarter. The proposed date of entry shall be a date on which all provisions necessary for the state to be in compliance with the Agreement are in place and effective.

The petitioning state shall provide a copy of its petition for membership and the certificate of compliance to each member state when the petitioning state submits its petition for membership to the governing board. A petitioning state shall also post a copy of its petition for membership and certificate of compliance on that state's web site.

Section 802: CERTIFICATE OF COMPLIANCE

The certificate of compliance shall be signed by the chief executive of the state's tax agency. The certificate of compliance shall document compliance with the provisions of the Agreement and cite applicable statutes, rules, regulations, or other authorities evidencing such compliance.

Section 803: ANNUAL RE-CERTIFICATION OF MEMBER STATES

Each member state shall annually re-certify that such state is in compliance with the Agreement. Each member state shall make a re-certification to the governing board on or before August 1 of each year after the year of the state's entry. In its annual re-certification, the state shall include any changes in its statutes, rules, regulations, or other authorities that could affect its compliance with the terms of the Agreement. The re-certification shall be signed by the chief executive of the state's tax agency.

A member state that cannot re-certify its compliance with the Agreement shall submit a statement of non-compliance to the governing board. The statement of non-compliance shall include any action or decision that takes such state out of compliance with the Agreement and the steps it will take to return to compliance. The governing board shall promulgate rules and procedures to respond to statements of noncompliance in accordance with Section 809.

Each member state shall post its annual re-certification or statement of non-compliance on that state's web site.

Section 804: REQUIREMENTS FOR MEMBERSHIP APPROVAL
The governing board shall determine if a petitioning state is in compliance with the Agreement. A three-fourths vote of the entire governing board is required to approve a state's petition for membership. The governing board shall provide public notice and opportunity for comment prior to voting on a state's petition for membership. A state's membership is effective on the proposed date of entry in its petition for membership or the first day of the calendar quarter after its petition is approved by the governing board, whichever is later, and is at least sixty days after its petition is approved.

Section 805: COMPLIANCE
A state is in compliance with the Agreement if the effect of the state's laws, rules, regulations, and policies is substantially compliant with each of the requirements set forth in the Agreement.

Section 806: AGREEMENT ADMINISTRATION
Authority to administer the Agreement shall rest with the governing board comprised of representatives of each member state. Each member state may appoint up to four representatives to the governing board. The representatives shall be members of the executive or legislative branches of the state. Each member state shall be entitled to one vote on the governing board. Except as otherwise provided in the Agreement, all actions taken by the governing board shall require an affirmative vote of a majority of the governing board present and voting. The governing board shall determine its meeting schedule, but shall meet at least once annually. The governing board shall provide a public comment period at each meeting to provide members of the public an opportunity to address the board on matters relevant to the administration or operation of the Agreement. The governing board shall provide public notice of its meetings at least thirty days in advance of such meetings. The governing board shall promulgate rules establishing the public notice requirements for holding emergency meetings on less than thirty day's notice. The governing board may meet electronically.

The governing board is responsible for the administration and operation of the Agreement, including the appointment of all manner of committees. The governing board may employ staff, advisors, consultants or agents. The governing board may promulgate rules and procedures it deems necessary to carry out its responsibilities. The governing board may take any action that is necessary and proper to fulfill the purposes of the Agreement. The governing board may allocate the cost of administration of the Agreement among the member states.

The governing board may assign committees certain duties, including, but not limited to:

A. Responding to questions regarding the administration of the Agreement;

B. Preparing certification requirements and coordinating the certification process for CSPs;
C. Coordinating joint audits;
D. Issuing requests for proposals;
E. Coordinating contracts with member states and providers; and
F. Maintaining records for the governing board.

Section 807: OPEN MEETINGS

Each meeting of the governing board and the minutes thereof shall be open to the public except as provided herein. Meetings of the governing board may be closed only for one or more of the following:

A. Personnel issues.
B. Information required by the laws of any member state to be protected from public disclosure. In the meeting, the governing board shall excuse any attendee to whom confidential taxpayer information cannot be disclosed under the law of any member state.
C. Proprietary information requested by any business to be protected from disclosure.
D. The consideration of issues incident to competitive bidding, requests for information, or certification, the disclosure of which would defeat the public interest in a fair and competitive process.
E. The consideration of pending litigation in a member state the discussion of which in a public session would, in the judgment of the member state engaged in the litigation, adversely affect its interests. In the meeting, the governing board shall excuse any attendee to whom confidential taxpayer information cannot be disclosed under the law of any member state.

A closed session of the governing board may be convened by the chair or by a majority vote of the governing board. When a closed session is convened, the reason for the closed session shall be noted in a public session. Any actions taken in the closed session shall be reported immediately upon the reconvening of a public session.

Section 808: WITHDRAWAL OF MEMBERSHIP OR EXPULSION OF A MEMBER

With respect to each member state, the Agreement shall continue in full force and effect until a member state withdraws its membership or is expelled. A member state's withdrawal or expulsion cannot be effective until the first day of a calendar quarter after a minimum of sixty days' notice. A member state shall submit notice of its intent to withdraw from the Agreement to the governing board and the chief executive of each member state's tax agency. The member state shall provide public notice of its intent to withdraw and post its notice of intent to withdraw on its web site. The withdrawal by or expulsion of a state does not affect the validity of the Agreement among other member states. A state that withdraws or is expelled from the Agreement remains liable for its share of any financial or contractual obligations that were incurred by the governing board prior to the effective date of that state's withdrawal or expulsion. The appropriate share of any financial or contractual obligation shall be determined by the state and the governing board in good faith based on the relative benefits received and burdens incurred by the parties.

Section 809: SANCTION OF MEMBER STATES

If a member state is found to be out of compliance with the Agreement, the governing board may consider sanctions against the state. The sanctions that the governing board may impose include expulsion from the Agreement, or other penalties as determined by the governing board. The adoption of a resolution to sanction a member state for noncompliance with the Agreement shall require the affirmative vote of three-fourths of the entire governing board, excluding the state that is the subject of the resolution. The member state that is the subject of the resolution shall not vote on such resolution. Resolutions seeking sanctions shall be acted upon by the governing board within a reasonable period of time as set forth in the governing board's rules. The governing board shall provide an opportunity for public comment prior to action on a proposed sanction.

Section 810: STATE AND LOCAL ADVISORY COUNCIL

The governing board shall create a State and Local Government Advisory Council to advise the governing board on matters pertaining to the administration of the Agreement. The membership shall include at least one representative from each state that is a participating member of the Streamlined Sales Tax Project pursuant to the Operating Rules of the Project as designated by that state. In addition, the governing board shall appoint local government officials to the State and Local Government Advisory Council. The governing board may appoint other state officials as it deems appropriate. Matters pertaining to the administration of the Agreement shall include, but not be limited to, admission of states into membership, noncompliance, and interpretations, revisions or additions to the Agreement. The State and Local Government Advisory Council shall advise and assist the Business and Taxpayer Advisory Council in the functions noted in Section 811.

Section 811: BUSINESS AND TAXPAYER ADVISORY COUNCIL

The governing board shall create a Business and Taxpayer Advisory Council from the private sector to advise the governing board on matters pertaining to the administration of the Agreement. These matters shall include, but not be limited to, admission of states into membership, noncompliance, and interpretations, revisions or additions to the Agreement. The Business and Taxpayer Advisory Council shall advise and assist the State and Local Government Advisory Council in the functions noted in Section 810.

ARTICLE IX
AMENDMENTS AND INTERPRETATIONS

Section 901: AMENDMENTS TO AGREEMENT
Amendments to the Agreement may be brought before the governing board by any member state. The Agreement may be amended by a three-fourths vote of the entire governing board. The governing board shall give the Governor and presiding officer of each house of each member state notice of proposed amendments to the Agreement at least sixty days prior to consideration. The governing board shall give public notice of proposed amendments to the Agreement at least sixty days prior to consideration. The governing board shall provide an opportunity for public comment prior to action on an amendment to the Agreement.

Section 902: INTERPRETATIONS OF AGREEMENT
Matters involving interpretation of the Agreement may be brought before the governing board by any member state or by any other person. All interpretations shall require a three-fourths vote of the entire governing board. The governing board shall publish all interpretations issued under this section. Interpretations shall be considered part of the Agreement and shall have the same effect as the Agreement. The governing board shall act on requests for interpretation of the Agreement within a reasonable period of time and under guidelines and procedures as set forth in the governing board's rules. The governing board may determine that it will not issue an interpretation. The governing board shall provide an opportunity for public comment prior to issuing an interpretation of the Agreement.

Section 903: DEFINITION REQUESTS
Any member state or any other person may make requests for additional definitions or for interpretations on how an individual product or service fits within a definition. Requests shall be submitted in writing as determined by the governing board. Such requests shall be referred to the Advisory Council created in Section 810 or other group under guidelines and procedures as set forth in the governing board's rules. The entity to which the request was referred shall post notice of the request and provide for input from the public and the member states as directed by the governing board. Within one hundred eighty days after receiving the request, they shall report to the governing board one of the following recommendations:

A. That no action be taken on the request;
B. That a proposed amendment to the Library be submitted;
C. That an interpretation request be submitted; or
D. That additional time is needed to review the request.

If either an amendment or an interpretation is recommended, the entity to which the request was referred shall provide the appropriate language as required by the governing board. The governing board shall take action on the recommendation of the entity to which the request was referred at the next meeting of the governing board pursuant to the notice requirements of Section 806. Action by the governing board to approve a recommendation for no action shall be considered the final disposition of the request. Nothing in this paragraph shall prohibit a state from directly submitting a proposed amendment or an interpretation request to the governing board pursuant to Section 901 or Section 902.

ARTICLE X
ISSUE RESOLUTION PROCESS

Section 1001: RULES AND PROCEDURES FOR ISSUE RESOLUTION
The governing board shall promulgate rules creating an issue resolution process. The rules shall govern the conduct of the process, including the participation by any petitioner, affected state, and other interested party, the disposition of a petition to invoke the process, the allocation of costs for participating in the process, the possible involvement of a neutral third party or non-binding arbitration, and such further details as the governing board determines necessary and appropriate.

Section 1002: PETITION FOR RESOLUTION
Any member state or person may petition the governing board to invoke the issue resolution process to resolve matters of:

A. Membership of a state under Article VIII;
B. Matters of compliance under Section 805;
C. Possibilities of sanctions of a member state under Section 809;
D. Amendments to the Agreement under Section 901;
E. Interpretation issues, including differing interpretations among the member states, under Section 902; or
F. Other matters at the discretion of the governing board.

Section 1003: FINAL DECISION OF GOVERNING BOARD
The governing board shall consider any recommendations resulting from the issue resolution process before making its decision, which decision shall, as with all other matters under the Agreement, be final and not subject to further review.

Section 1004: LIMITED SCOPE OF THIS ARTICLE
Nothing in this Article shall be construed to substitute for, stay or extend, limit, expand, or otherwise affect, in any manner, any right or duty that any person or governmental body has under the laws of any member state or local government body. This Article is specifically subject to the terms of Article XI and shall not be construed as taking precedence over Article XI.

ARTICLE XI
RELATIONSHIP OF AGREEMENT TO MEMBER STATES AND PERSONS

Section 1101: COOPERATING SOVEREIGNS

This Agreement is among individual cooperating sovereigns in furtherance of their governmental functions. The Agreement provides a mechanism among the member states to establish and maintain a cooperative, simplified system for the application and administration of sales and use taxes under the duly adopted law of each member state.

Section 1102: RELATIONSHIP TO STATE LAW

No provision of the Agreement in whole or part invalidates or amends any provision of the law of a member state. Adoption of the Agreement by a member state does not amend or modify any law of the state. Implementation of any condition of the Agreement in a member state, whether adopted before, at, or after membership of a state, must be by the action of the member state. All member states remain subject to Article VIII.

Section 1103: LIMITED BINDING AND BENEFICIAL EFFECT

A. This Agreement binds and inures only to the benefit of the member states. No person, other than a member state, is an intended beneficiary of this Agreement. Any benefit to a person other than a state is established by the laws of the member states and not by the terms of this Agreement.

B. Consistent with subsection (A), no person shall have any cause of action or defense under the Agreement or by virtue of a member state's approval of the Agreement. No person may challenge, in any action brought under any provision of law, any action or inaction by any department, agency, or other instrumentality of any member state, or any political subdivision of a member state on the ground that the action or inaction is inconsistent with the Agreement.

C. No law of a member state, or the application thereof, may be declared invalid as to any person or circumstance on the ground that the provision or application is inconsistent with the Agreement.

Section 1104: FINAL DETERMINATIONS

The determinations pertaining to the Agreement that are made by the member states are final when rendered and are not subject to any protest, appeal, or review.

ARTICLE XII

REVIEW OF COSTS AND BENEFITS ASSOCIATED WITH THE AGREEMENT

Section 1201: REVIEW OF COSTS AND BENEFITS

The governing board will review costs and benefits of administration and collection of sales and use taxes incurred by states and sellers under the existing sales and use tax laws at the time of adoption of the Agreement and the proposed Streamlined Sales Tax Agreement.

APPENDIX A
STREAMLINED SALES AND USE TAX AGREEMENT
PETITION FOR MEMBERSHIP

WHEREAS, it is in the interest of the private sector and of state and local governments to simplify and modernize sales and use tax administration;
WHEREAS, such simplification and modernization will result in a substantial reduction in the costs and complexity for sellers of personal property and services in conducting their commercial enterprises;
WHEREAS, such simplification and modernization will also result in additional voluntary compliance with the sales and use tax laws;
WHEREAS, such simplification and modernization of sales and use tax administration is best conducted in cooperation and coordination with other states; and
WHEREAS, the State of ___________________ levies a sales tax and levies a use tax. "Sales tax" means the tax levied under (CITE SPECIFIC STATUTE) and "use tax" means the tax levied under (CITE SPECIFIC STATUTE).
NOW, the undersigned representative hereby petitions the governing board of the Streamlined Sales and Use Tax Agreement (or Co-Chairs of the Streamlined Sales Tax Implementing States) for membership into the Agreement.

____
NAME

____
TITLE
STATE OF ______________________

Appendix B
INDEX OF DEFINITIONS

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Appendix C
LIBRARY OF DEFINITIONS

Part I Administrative definitions including tangible personal property. Terms included in this Part are core terms that apply in imposing and administering sales and use taxes.

Part II Product definitions. Terms included in this Part are used to exempt items from sales and use taxes or to impose tax on items by narrowing an exemption that otherwise includes these items.

Part III Reserved for sales tax holiday definitions.

PART I

Administrative Definitions

1. **"Delivery charges"** means charges by the seller of personal property or services for preparation and delivery to a location designated by the purchaser of personal property or services including, but not limited to, transportation, shipping, postage, handling, crating, and packing.
   A member state may exclude from "delivery charges" the charges for delivery of "direct mail" if the charges are separately stated on an invoice or similar billing document given to the purchaser.

2. "**Direct mail**" means printed material delivered or distributed by United States mail or other delivery service to a mass audience or to addressees on a mailing list provided by the purchaser or at the direction of the purchaser when the cost of the items are not billed directly to the recipients. "Direct mail" includes tangible personal property supplied directly or indirectly by the purchaser to the direct mail seller for inclusion in the package containing the printed material. "Direct mail" does not include multiple items of printed material delivered to a single address.

3. **"Lease or rental"** means any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration. A lease or rental may include future options to purchase or extend.
   A. Lease or rental does not include:
      1. A transfer of possession or control of property under a security agreement or deferred payment plan that requires the transfer of title upon completion of the required payments;
      2. A transfer or possession or control of property under an agreement that requires the transfer of title upon completion of

required payments and payment of an option price does not exceed the greater of one hundred dollars or one percent of the total required payments; or

3. Providing tangible personal property along with an operator for a fixed or indeterminate period of time. A condition of this exclusion is that the operator is necessary for the equipment to perform as designed. For the purpose of this subsection, an operator must do more than maintain, inspect, or set-up the tangible personal property.

B. Lease or rental does include agreements covering motor vehicles and trailers where the amount of consideration may be increased or decreased by reference to the amount realized upon sale or disposition of the property as defined in 26 USC 7701(h)(1).

C. This definition shall be used for sales and use tax purposes regardless if a transaction is characterized as a lease or rental under generally accepted accounting principles, the Internal Revenue Code, the [state commercial code], or other provisions of federal, state or local law.

D. This definition will be applied only prospectively from the date of adoption and will have no retroactive impact on existing leases or rentals. This definition shall neither impact any existing sale-leaseback exemption or exclusions that a state may have, nor preclude a state from adopting a sale-leaseback exemption or exclusion after the effective date of the Agreement.

4. "Purchase price" applies to the measure subject to use tax and has the same meaning as sales price.

5. "**Retail sale or Sale at retail**" means any sale, lease, or rental for any purpose other than for resale, sublease, or subrent.

6. "**Sales price**" applies to the measure subject to sales tax and means the total amount of consideration, including cash, credit, property, and services, for which personal property or services are sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for the following:

A. The seller's cost of the property sold;

B. The cost of materials used, labor or service cost, interest, losses, all costs of transportation to the seller, all taxes imposed on the seller, and any other expense of the seller;

C. Charges by the seller for any services necessary to complete the sale, other than delivery and installation charges;

D. Delivery charges;

E. Installation charges;

F. The value of exempt personal property given to the purchaser where taxable and exempt personal property have been bundled together and sold by the seller as a single product or piece of merchandise; and

G. Credit for any trade-in, as determined by state law.

States may exclude from "sales price" the amounts received for charges included in paragraphs (C) through (G) above, if they are separately stated on the invoice, billing, or similar document given to the purchaser.

"Sales price" shall not include:

A. Discounts, including cash, term, or coupons that are not reimbursed by a third party that are allowed by a seller and taken by a purchaser on a sale;

B. Interest, financing, and carrying charges from credit extended on the sale of personal property or services, if the amount is separately stated on the invoice, bill of sale or similar document given to the purchaser; and

C. Any taxes legally imposed directly on the consumer that are separately stated on the invoice, bill of sale or similar document given to the purchaser.

7. **"Tangible personal property"** means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. "Tangible personal property" includes electricity, water, gas, steam, and prewritten computer software.

PART II

Product Definitions

CLOTHING

"Clothing" means all human wearing apparel suitable for general use. The following list contains examples and is not intended to be an all-inclusive list.

A. "Clothing" shall include:
   1. Aprons, household and shop;
   2. Athletic supporters;
   3. Baby receiving blankets;
   4. Bathing suits and caps;
   5. Beach capes and coats;
   6. Belts and suspenders;
   7. Boots;
   8. Coats and jackets;
   9. Costumes;
   10. Diapers, children and adult, including disposable diapers;
   11. Ear muffs;
   12. Footlets;
   13. Formal wear;
   14. Garters and garter belts;
   15. Girdles;
   16. Gloves and mittens for general use;
   17. Hats and caps;
   18. Hosiery;
   19. Insoles for shoes;
   20. Lab coats;
   21. Neckties;
   22. Overshoes;
   23. Pantyhose;
   24. Rainwear;
   25. Rubber pants;
   26. Sandals;
   27. Scarves;
   28. Shoes and shoe laces;
   29. Slippers;
   30. Sneakers;
   31. Socks and stockings;
   32. Steel toed shoes;
   33. Underwear;
   34. Uniforms, athletic and non-athletic; and
   35. Wedding apparel.

B. "Clothing" shall not include:

1. Belt buckles sold separately;
2. Costume masks sold separately;
3. Patches and emblems sold separately;
4. Sewing equipment and supplies including, but not limited to, knitting needles, patterns, pins, scissors, sewing machines, sewing needles, tape measures, and thimbles; and
5. Sewing materials that become part of "clothing" including, but not limited to, buttons, fabric, lace, thread, yarn, and zippers.

"Clothing accessories or equipment" means incidental items worn on the person or in conjunction with "clothing." "Clothing accessories or equipment" are mutually exclusive of and may be taxed differently than apparel within the definition of "clothing," "sport or recreational equipment," and "protective equipment." The following list contains examples and is not intended to be an all-inclusive list. "Clothing accessories or equipment" shall include:

A. Briefcases;
B. Cosmetics;
C. Hair notions, including, but not limited to, barrettes, hair bows, and hair nets;
D. Handbags;
E. Handkerchiefs;
F. Jewelry;
G. Sun glasses, non-prescription;
H. Umbrellas;
I. Wallets;
J. Watches; and
K. Wigs and hair pieces.

"Protective equipment" means items for human wear and designed as protection of the wearer against injury or disease or as protections against damage or injury of other persons or property but not suitable for general use. "Protective equipment" are mutually exclusive of and may be taxed differently than apparel within the definition of "clothing," "clothing accessories or equipment," and "sport or recreational equipment." The following list contains examples and is not intended to be an all-inclusive list. "Protective equipment" shall include:

A. Breathing masks;
B. Clean room apparel and equipment;
C. Ear and hearing protectors;
D. Face shields;
E. Hard hats;
F. Helmets;
G. Paint or dust respirators;
H. Protective gloves;
I. Safety glasses and goggles;
J. Safety belts;

K. Tool belts; and
L. Welders gloves and masks.

"Sport or recreational equipment" means items designed for human use and worn in conjunction with an athletic or recreational activity that are not suitable for general use. "Sport or recreational equipment" are mutually exclusive of and may be taxed differently than apparel within the definition of "clothing," "clothing accessories or equipment," and "protective equipment." The following list contains examples and is not intended to be an all-inclusive list. "Sport or recreational equipment" shall include:

A. Ballet and tap shoes;
B. Cleated or spiked athletic shoes;
C. Gloves, including, but not limited to, baseball, bowling, boxing, hockey, and golf;
D. Goggles;
E. Hand and elbow guards;
F. Life preservers and vests;
G. Mouth guards;
H. Roller and ice skates;
I. Shin guards;
J. Shoulder pads;
K. Ski boots;
L. Waders; and
M. Wetsuits and fins.

COMPUTER RELATED

"**Computer**" means an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions.

"Computer software" means a set of coded instructions designed to cause a "computer" or automatic data processing equipment to perform a task.

"Delivered electronically" means delivered to the purchaser by means other than tangible storage media.

"**Electronic**" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

"Load and leave" means delivery to the purchaser by use of a tangible storage media where the tangible storage media is not physically transferred to the purchaser.

"Prewritten computer software" means "computer software," including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more "prewritten computer software" programs or prewritten portions thereof does not cause the combination to be other than "prewritten computer software." "Prewritten computer software" includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the specific purchaser. Where a person modifies or enhances "computer software" of which the person is not the author or creator, the person shall be deemed to be the author or creator only of such person's modifications or enhancements. "Prewritten computer software" or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains "prewritten computer software;" provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute "prewritten computer software."

A member state may exempt "prewritten computer software" "delivered electronically" or by "load and leave."

FOOD AND FOOD PRODUCTS

"**Alcoholic Beverages**" means beverages that are suitable for human consumption and contain one-half of one percent or more of alcohol by volume.

"Candy" means a preparation of sugar, honey, or other natural or artificial sweeteners in combination with chocolate, fruits, nuts or other ingredients or flavorings in the form of bars, drops, or pieces. "Candy" shall not include any preparation containing flour and shall require no refrigeration.

"Dietary supplement" means any product, other than "tobacco," intended to supplement the diet that:

A. Contains one or more of the following dietary ingredients:
   1. A vitamin;
   2. A mineral;
   3. An herb or other botanical;
   4. An amino acid;
   5. A dietary substance for use by humans to supplement the diet by increasing the total dietary intake; or
   6. A concentrate, metabolite, constituent, extract, or combination of any ingredient described in above; and

B. Is intended for ingestion in tablet, capsule, powder, softgel, gelcap, or liquid form, or if not intended for ingestion in such a form, is not represented as conventional food and is not represented for use as a sole item of a meal or of the diet; and

C. Is required to be labeled as a dietary supplement, identifiable by the "Supplemental Facts" box found on the label and as required pursuant to 21 C.F.R § 101.36.

"**Food and food ingredients**" means substances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. "Food and food ingredients" does not include "alcoholic beverages" or "tobacco." A member state may exclude "candy," "dietary supplements" and "soft drinks" from this definition, which items are mutually exclusive of each other.

Notwithstanding the foregoing requirements of this definition or any other provision of the Agreement, a member state may maintain its tax treatment of food in a manner that differs from the definitions provided herein, provided its taxation or exemption of food is based on a prohibition or requirement of that state's Constitution that exists on the effective date of the Agreement.

"**Food sold through vending machines**" means food dispensed from a machine or other mechanical device that accepts payment.

"Prepared food" means:

A. Food sold in a heated state or heated by the seller;
B. Two or more food ingredients mixed or combined by the seller for sale as a single item; or
C. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws. A plate does not include a container or packaging used to transport the food.

"Prepared food" in B does not include food that is only cut, repackaged, or pasteurized by the seller, and eggs, fish, meat, poultry, and foods containing these raw animal foods requiring cooking by the consumer as recommended by the Food and Drug Administration in chapter 3, part 401.11 of its Food Code so as to prevent food borne illnesses.

The following items may be taxed differently than "prepared food" and each other, if sold without eating utensils provided by the seller, but may not be taxed differently than the same item when classified under "food and food ingredients."

1. Food sold by a seller whose proper primary NAICS classification is manufacturing in sector 311, except subsector 3118 (bakeries).
2. Food sold in an unheated state by weight or volume as a single item.
3. Bakery items, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, tortillas.

Substances within "food and food ingredients" may be taxed differently if sold as "prepared food." A state shall tax or exempt from taxation "candy," dietary supplements," and "soft drinks" that are sold as "prepared food" in the same manner as it treats other substances that are sold as "prepared food."

"Soft drinks" means non-alcoholic beverages that contain natural or artificial sweeteners. "Soft drinks" do not include beverages that contain milk or milk products, soy, rice or similar milk substitutes, or greater than fifty percent of vegetable or fruit juice by volume.

"Tobacco" means cigarettes, cigars, chewing or pipe tobacco, or any other item that contains tobacco.

HEALTH-CARE

“Drug” means a compound, substance or preparation, and any component of a compound, substance or preparation, other than “food and food ingredients,” “dietary supplements” or “alcoholic beverages:”

A. Recognized in the official United State Pharmacopoeia, official Homeopathic Pharmacopoeia of the United States, or official National Formulary, and supplement to any of them; or
B. Intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease; or
C. Intended to affect the structure or any function of the body.

A member state may independently:

A. Limit the definition of “drug” to human use (as opposed to both human and animal use) in the administration of its exemption;
B. Draft its exemption for “drug” to specifically add insulin and/or medical oxygen so that no prescription is required, even if a state requires a prescription under its exemption for drugs;
C. Determine the taxability of the sales of drugs and prescription drugs to hospitals and other medical facilities;
D. Determine the taxability of free samples of drugs; and
E. Determine the taxability of bundling taxable and nontaxable drug, if uniform treatment of bundled transactions is not otherwise defined in the Agreement.

“Durable medical equipment” means equipment including repair and replacement parts for same, but does not include “mobility enhancing equipment,” which:

A. Can withstand repeated use; and
B. Is primarily and customarily used to serve a medical purpose; and
C. Generally is not useful to a person in the absence of illness or injury; and
D. Is not worn in or on the body.

A member state may limit its exemption to “durable medical equipment” used for home use only. A member state may limit the application of this definition by requiring a “prescription,” or limit an exemption based on Medicare or Medicaid payments or reimbursements.

“Grooming and hygiene products” are soaps and cleaning solutions, shampoo, toothpaste, mouthwash, antiperspirants, and sun tan lotions and screens, regardless of whether the items meet the definition of “over-the-counter-drugs.”

“Mobility enhancing equipment” means equipment including repair and replacement parts to same, but does not include “durable medical equipment,” which:

A. Is primarily and customarily used to provide or increase the ability to move from one place to another and which is appropriate for use either in a home or a motor vehicle; and
B. Is not generally used by persons with normal mobility; and

C. Does not include any motor vehicle or equipment on a motor vehicle normally provided by a motor vehicle manufacturer.

A member state may limit the application of this definition by requiring a "prescription," or limit an exemption based on Medicare or Medicaid payments or reimbursements.

"Over-the-counter-drug" means a drug that contains a label that identifies the product as a drug as required by 21 C.F.R. § 201.66. A member state may exclude "grooming and hygiene products" from this definition. The "over-the-counter-drug" label includes:

A. A "Drug Facts" panel; or

B. A statement of the "active ingredient(s)" with a list of those ingredients contained in the compound, substance or preparation.

"Prescription" means an order, formula or recipe issued in any form of oral, written, electronic, or other means of transmission by a duly licensed practitioner authorized by the laws of the member state.

"Prosthetic device" means a replacement, corrective, or supportive device including repair and replacement parts for same worn on or in the body to:

A. Artificially replace a missing portion of the body;

B. Prevent or correct physical deformity or malfunction; or

C. Support a weak or deformed portion of the body.

A member state may exclude any or all of the following from the definition of "prosthetic device:"

A. Corrective eyeglasses;

B. Contact lenses;

C. Hearing aids; and

D. Dental prosthesis.

A member state may limit the application of this definition by requiring a "prescription," or limit an exemption based on Medicare or Medicaid payments or reimbursements.

PART III

Reserved for Sales Tax Holiday Definitions

Appendix F

Schedule and Topics of *Federalism at Risk* seminars

July 26, 2001	Bismarck, ND	Overview: Critical Issues in State and Local Taxation of Interstate Commerce
January 18, 2002	San Diego, CA	Critical Issues in State and Local Taxation: The State of Sales and Use Taxation
February 22, 2002	Washington, DC	The State of Business Activity Taxation
April 26, 2002	Denver, CO	Federal, State and Local Shared Responsibilities and Shared Taxes
August 1, 2002	Madison, WI	State and Local Tax Policy for the Future

Appendix G
Federalism at Risk Presenters

July 26, 2001—Bismarck, North Dakota—Overview: Critical Issues in State and Local Taxation of Interstate Commerce

Name	Session	Title of Presentation (if different from session)
Rick Clayburgh, State Tax Commissioner, North Dakota Office of State Tax Commissioner	Opening Remarks	
Thomas W. Bonnett, Public Policy Consulting, Brooklyn New York	Legitimacy of State and Local Taxes on Interstate Commerce	The New Economy
Dan Bucks, Executive Director, Multistate Tax Commission	Legitimacy of State and Local Taxes on Interstate Commerce	
Professor Charles McLure, Senior Fellow, Hoover Institution at Stanford University	Legitimacy of State and Local Taxes on Interstate Commerce and Fairness and Equity of State and Local Taxes Imposed on Interstate Commerce	Legitimacy, Fairness and Equity of State and Local Taxes on Interstate Commerce
Donald J. Boyd, Director, Fiscal Studies Program, Nelson A. Rockefeller Institute of Government	Distribution of Costs of State Services	State Fiscal Issues and Trends

July 26, 2001—Bismarck, North Dakota—Overview: Critical Issues in State and Local Taxation of Interstate Commerce *continued*

Name	Session	Title of Presentation (if different from session)
Michael Mazerov, Senior Policy Analyst, Center on Budget and Policy Priorities	Distribution of Costs of State Services	
Matthew G. Smith, Commissioner, Minnesota Department of Revenue	Distribution of Costs of State Services	Refinancing State Government: A View from Ground Zero
Governor John Hoeven	Keynote Address	
Stephen P.B. Kranz, Tax Counsel, Committee on State Taxation	Fairness and Equity of State and Local Taxes Imposed on Interstate Commerce	
Val Oveson, Managing Director, PriceWaterhouseCoopers	Fairness and Equity of State and Local Taxes Imposed on Interstate Commerce	Fairness and Equity of State and Local Taxation

January 18, 2002—Critical Issues in State and Local Taxation: The State of Sales and Use Taxation

Name	Session	Title of Presentation (if different from session)
John Kincaid, Director, Meyner Center for the Study of State and Local Government, Lafayette College	The State-Federal Relationship in a New Century	
Lenny Goldberg, Director, California Tax Reform Association	The State-Federal Relationship in a New Century	
Charles de Seve, President, American Economics Group	The National Crisis: An Assessment of the Fiscal Impact on the States	
Mark Zandi, Chief Economist, Economy.com	The National Crisis: An Assessment of the Fiscal Impact on the States	The Economic Outlook
William F. Fox, Director, Center for Business and Economic Research, The University of Tennessee	Sales and Use Taxes: The Heart of State Taxation	Sales Taxes and the State/Local Revenue Structure

January 18, 2002—Critical Issues in State and Local Taxation: The State of Sales and Use Taxation *continued*

Name	Session	Title of Presentation (if different from session)
Ray Scheppach, Executive Director, National Governors Association	Luncheon Speech	
Donald J. Bruce, Research Assistant Professor, Center for Business and Economic Research, The University of Tennessee	Jurisdiction to Tax: How the Internet has Brought this Issue to a Head	State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates
Richard Pomp, Professor Law, University of Connecticut	Jurisdiction to Tax: How the Internet has Brought this Issue to a Head?	
Senator Matthew Kisber, Co-Chair of the Streamlined Sales Tax Implementing States	Will Streamlining the Sales Tax Save State Tax Sovereignty?	
Diane Hardt, Administrator, Wisconsin Department of Revenue and Co-Chair of the Streamlined Sales Tax Project	Will Streamlining the Sales Tax Save State Tax Sovereignty?	Streamlined Sales Tax Project, Executive Summary, January 2002
Commissioner Bruce Johnson, Co-Chair of the Streamlined Sales Tax Implementing States	Will Streamlining the Sales Tax Save State Tax Sovereignty?	

February 22, 2002—The State of Business Activity Taxation

Name	Session	Title of Presentation (if different from session)
Herbert Huff, Deputy Chief Financial Officer, District of Columbia Office of Tax and Revenue	Opening Remarks	
Professor Walter Hellerstein, University of Georgia Law School	Surveying the Landscape: How do and Should States Tax Business Activity?	
Bill Allison, Managing Editor, The Center for Public Integrity	Federal and State Tax Planning Perspectives—Race to the Bottom?	
Dan Bucks, Executive Director, Multistate Tax Commission	Federal and State Tax Planning Perspectives--Race to the Bottom?	Corporate Tax Planning: A Race to the Bottom?
Bobby L. Burgner, Senior Tax Counsel and Director-State and Local Taxes, General Electric Company	Federal and State Tax Planning Perspectives--Race to the Bottom?	See Things the Way They Are . . . What Drives Tax Professionals
Michael T. Fatale, Tax Attorney, Massachusetts Department of Revenue	Taxing the Internet and Other Fallacies of the Federal Debate on the Future of Taxation	Federalism and State Business Activity Tax Nexus; Revisiting Public Law 86-272

February 22, 2002—The State of Business Activity Taxation *continued*

Name	Session	Title of Presentation (if different from session)
John S. Warren, Esq., Loeb & Loeb, Los Angeles, CA	The Successes and Failures of UDITPA	
Robert Tannenwald	Are State/Local Revenue Systems Becoming Obsolete?	Are State/Local Revenue Systems Becoming Obsolete? (handout)
Stephen M. Nechemias, Esq., Taft, Stettinius & Hollister, Cincinnati, Ohio	Pass-Throughs: The Unknown Entities	
Susan Nelson, Financial Economist, U.S. Department of the Treasury	Pass-Throughs: The Unknown Entities	Changing Landscape of Business Organizations, 1985-1999
Michael Mazerov, Senior Policy Analyst, Center on Budget and Policy Priorities	Business Activity Taxes--A Holistic Approach	Revitalizing the State Corporation Income Tax
Fred O. Marcus, Esq., Horwood, Marcus & Berk, Chicago, IL	Business Activity Taxes--A Holistic Approach	
David Brunori	Summary	

April 26, 2002—Federal, State and Local Shared Responsibilities and Shared Taxes

Name	Session	Title of Presentation (if different from session)
Steve Tool, Legislative Liaison, Colorado Department of Revenue	Opening Remarks and Understanding the Local Government-State Fiscal Relationship	
Stan Finkelstein, Executive Director, Association of Washington Cities	Understanding the Local Government-State Fiscal Relationship	Federal, State and Local Shared Responsibilities and Shared Taxes
Geoff Wilson, General Counsel, Colorado Municipal League	Understanding the Local Government-State Fiscal Relationship	
Geoff Withers, Colorado Department of Local Affairs	Understanding the Local Government-State Fiscal Relationship	
Marilyn Wethekam, Esq., Horwood, Marcus & Berk, Chicago, IL	Utility Taxes	
James Kratochvill, Esq., AT&T Corp.	Utility Taxes	
Bill Speckman, Tax Policy Manager, Colorado Department of Revenue	Utility Taxes	

April 26, 2002—Federal, State and Local Shared Responsibilities and Shared Taxes *continued*

Name	Session	Title of Presentation (if different from session)
William T. Pound, Executive Director, National Conference of State Legislatures	Keynote Speaker	
Karen J. Boucher, CPA, Andersen, Milwaukee	Issues in Tax Administration	
Harley Duncan, Executive Director, Federation of Tax Administrators	Issues in Tax Administration	
Joe Thomas, Tax Division Chief, Connecticut Department of Revenue Services	Issues in Tax Administration	

April 26, 2002—Federal, State and Local Shared Responsibilities and Shared Taxes *continued*

Name	Session	Title of Presentation (if different from session)
Wayne Zakrzewski, Esq., JC Penny Company, Inc.	Issues in Tax Administration	
Valerie Barbin, Esq., Pennsylvania Department of Revenue, Office of Chief Counsel	Federal/State Taxes: Estate Taxes, Motor Fuels Taxes and Special Excise ("SIN") Taxes	
Rich Hall, Colorado Department of Revenue, Motor Carrier Services	Federal/State Taxes: Estate Taxes, Motor Fuels Taxes and Special Excise ("SIN") Taxes	
Beth Kaufman, Esq., Caplin & Drysdale, Washington, DC	Federal/State Taxes: Estate Taxes, Motor Fuels Taxes and Special Excise ("SIN") Taxes	Estate and Gift Taxes under EGTTRA: The Impact on the States
Janet McCubbin, Financial Economist, U.S. Department of the Treasury	Federal/State Taxes: Estate Taxes, Motor Fuels Taxes and Special Excise ("SIN") Taxes	See Above

August 1, 2002--Madison, Wisconsin--State and Local Tax Policy for the Future

Name	Session	Title of Presentation (if different from session)
Karen Anderson, President, National League of Cities and Mayor of Minnetonka, MN	Keynote Speaker	
Scott Pattison, Executive Director, National Association of State Budget Officers	The Future of State Fiscal Policy: Where are the States Headed?	Fiscal State of the States: Implications for the Future
Robert Milbourne, President, Greater Milwaukee Committee	The Future of State Fiscal Policy: Where are the States Headed?	
Tom Bonnett, Public Policy Consulting, Brooklyn, New York	State Tax Policy in Our Federal System: To Form a More Perfect Union	The New Economy and State-Local Tax Policy
Andrew Reschovsky, University of Wisconsin, Madison, WI	State Tax Policy in Our Federal System: To Form a More Perfect Union	The Future of State-Local Fiscal Relations

August 1, 2002--Madison, Wisconsin--State and Local Tax Policy for the Future *continued*
Property Tax--Papers Submitted

Name	Session	Title of Presentation (if different from session)
C. Lowell Harriss, Emeritus, Columbia University	Property Tax	Improving Property Taxation
Bruce Wallin, Northeastern University	Property Tax	The Tax Revolt in Massachusetts: Lessons from Proposition 2 1/2
David Brunori	Property Tax	To Preserve Local Government, It's Time to Save the Property Tax
J. Fred Giertz, University of Illinois and Executive Director, National Tax Association	Property Tax	The Impact of the Property Tax on State-Local Revenue Changes

Appendix H
Recommendations and Policy Questions

The following recommendations, policy questions, and policy options are those presented in the individual sections of the Federalism at Risk Report.

IMPROVING SALES AND USE TAXES

Recommendations

To preserve the sales and use tax, the Commission recommends that state policy makers consider the following actions:

- Strengthen nexus standards for companies to collect sales and use taxes to better reflect current business practices.
- Evaluate the scope of sales and use tax bases in relation to the shift of consumption toward services and intangible products.
- Adopt the Streamlined Sales and Use Tax Agreement to make it easier for retailers, including remote sellers, to collect the tax.
- Request that Congress or the Supreme Court approve standards for tax collection that level the playing field for in-state and multistate businesses. Congressional action could be conditioned upon implementation of the streamlined sales tax system by a critical mass of states.

Additional Policy Questions

There are additional policy questions that state policy makers might review and evaluate as they seek to improve sales and use taxes:

- Is a European-style value added tax or other comprehensive consumption tax on all or most consumer purchases coupled with no tax on business inputs a viable alternative to the traditional sales and use tax systems in the United States?
- What are the issues involved in considering expanding the sales tax base by one or more of the following methods: a) taxing all household purchases; b) taxing all purchases regardless of purchase mode; c) taxing all purchases regardless of a buyer's or seller's identity; d) taxing services?
- Would broadening the scope of the sales tax base to fit modern consumption patterns lead to reduced sales tax rates?

IMPROVING BUSINESS ACTIVITY TAXES

Recommendations

To help restore the equity and effectiveness of state income tax systems, the Commission recommends that states consider the following actions:

- Adopt "combined reporting" for jointly owned and operated companies—including affiliates in international tax havens—to more appropriately report and assign income to where it is earned.
- Ensure proper filing of state income or business tax returns by those earning significant income from within a state by adopting a uniform "factor presence" nexus standard. Concurrently, urge Congress to relieve the restrictions of P.L. 86-272 for those states adopting this "factor presence" nexus standard to support uniform and equitable state taxes to encourage the free flow of interstate commerce.
- Adopt uniform rules for dividing income among the states to ensure multistate income is reported to states where it was earned and to avoid the possibility of over- or under-reporting of income from interstate commerce.
- Develop uniform tax policies and cooperative administrative systems that make it easier for owners, especially non-resident owners, of pass-through entities to file returns and pay the proper amount of tax to states where income was earned.
- Develop individual or cooperative administrative systems to verify that owners of pass-through entities are paying taxes to those states from which they earn income.
- Strengthen and expand cooperative administration and enforcement among the states through early review of tax shelters considered questionable by several states, increased joint auditing and other cooperative measures and through expanded federal-state compliance efforts.
- Urge Congress to enact legislation to help curb federal and state corporate tax sheltering and to refrain from enacting new restrictions that would harm the ability of states to tax a fair share of the income of interstate enterprises.
- Encourage the federal government to improve compliance with the federal income tax through improved tax laws and regulations and adequate budget resources for compliance activities.

Additional Policy Questions

State policy makers might assess additional alternatives to help improve the equity and effectiveness of state income tax systems:

- Should states consider replacing business net income taxes with gross value taxes or using gross value taxes as an alternative minimum tax for businesses?
- Should states consider interstate agreements to standardize or limit special "tax incentives" in bids to attract new businesses?
- Should states more thoroughly explore the pros and cons of varying from the evenly-weighted three factor apportionment formula of UDITPA?

- Should states consider eliminating "nowhere" income through the destination sourcing of sales of services and intangibles or by adopting uniform "throwback" and "throwout" rules?

IMPROVING FEDERALISM

Recommendations

State policy makers should consider the following options to preserve their sovereign authority and create a positive partnership with Congress on issues of taxation:

- Strengthen and expand interstate coalitions and cooperative institutions that harmonize state tax policies, provide simplified and joint tax administrative practices across jurisdictions and improve state and local tax compliance through joint enforcement mechanisms.
- Revive, in cooperation with Congress and the President, a liaison organization established by law between the states and the federal government similar to the former Advisory Commission on Intergovernmental Relations.
- Enhance cooperation between the states and the federal government to simplify administration and improve proper compliance for those taxes shared by the states and the federal government.
- Work cooperatively with Congress to enact legislation that supports equitable state taxation, curbs tax sheltering activities and rewards state tax uniformity efforts.
- Coordinate federal and state tax bases in a manner that facilitates federal fiscal policy choices while minimizing adverse effects on states and localities.

Additional Policy Questions

State policy makers might also review additional policy questions when evaluating the balance between state and federal authority and state and local government authority in the area of state and local taxation:

- How can states strengthen existing political coalitions in order to present more clearly their collective interests to Congress?
- Should states expand cooperation among themselves to administer state and local taxes on a regional and national basis?
- What role should local governments play in the continuing dialogue on improving revenue systems?
- What are the major concerns of local governments in a particular state that require the immediate attention of state government?

IMPROVING EXCISE TAXES AND ESTATE TAXES

Recommendations

The states' reliance on the federal government with respect to these taxes and the trend toward deregulation of utility industries have placed a strain on state tax structures. The Commission recommends that states:

- Evaluate taxes on formerly regulated industries and decide whether they should be revised or eliminated.
- Update taxes that are retained on formerly regulated industries so that they operate equitably under the new market conditions, adopt uniform provisions on a joint basis for features with a multistate impact and simplify administration, including state-level administration of local taxes, where feasible.
- If choosing to keep a state level estate tax in place, adopt uniform laws and administrative procedures, including provisions for joint administration with other states
- Strengthen cooperation among states and with the federal government in enforcing excise taxes on tobacco and motor fuels and urge Congress to expand the scope of the Jenkins Act and the Contraband Cigarette Trafficking Act to curb federal and state tobacco tax evasion.

Additional Policy Questions

State policy makers might consider the following additional policy questions in evaluating the effectiveness of various excise taxes and estate taxes:

Utility Taxes

- To level the playing field, should states consider taxing both competitive utility services and incumbent utilities as general businesses rather than under special utility taxes?
- Should states provide guidance on the applicability of P.L. 86-272 to the sale of electricity, where it is characterized as tangible personal property?
- Should states develop uniform rules for sourcing sales of electricity, despite the variance among the states in the treatment of electricity as tangible property or a service?
- What kind of guidance should states provide to remote sellers of electricity on nexus for collection of use taxes?
- Should state government provide hold harmless provisions or transitional aid for local governments whose property tax base is adversely affected by utility deregulation?

Tobacco Taxes

- How beneficial from a tax revenue perspective would it be for state, local and federal governments to cooperate to license the entire supply chain for sale of cigarettes?

- Is there room for improved cooperation between federal and state governments and Indian tribes to ensure that all sales of cigarettes are taxed and appropriate rebates are made available to tribal governments?

Motor Fuels Taxes

- Is there room for improved cooperation between the states and the federal government to monitor the achievement of base-state audit requirements under IFTA and motor fuels compliance of multistate motor carriers?

Estate Taxes

- What are the advantages and disadvantages to states of either 1) de-coupling from the federal law and continuing a state level estate tax or 2) opting for no state estate tax?
- Should states evaluate adoption of inheritance taxes?
- Should states commit resources to closely monitor federal activity on the estate tax?

IMPROVING PROPERTY TAXES

Policy Questions

Policy questions that state policy makers might review and evaluate as they seek to strengthen property taxes:

- How can property owners who are exempt from property taxes contribute to the cost of supporting local public services?
- What are the advantages of imposing a split rate tax on land and improvements to land?
- What state-level administrative functions, such as central assessment of business property, can strengthen property tax assessments?
- How can states ensure that utility taxpayers are treated equally, for assessment purposes, with other commercial and industrial property owners?

IMPROVING TAX ADMINISTRATION

Recommendations and Additional Policy Options

The Commission already has recommended a number of tax-specific administrative simplifications in earlier sections of this report. In improving tax administration, there are numerous areas in which the states can act independently or collectively. Because a major focus of this report has been on what the states can do jointly as a group to improve the state of state and local taxation while preserving state tax sovereignty, the Commission lists below potential enhancements of tax administration that states can work on together as they assess the effectiveness of their state tax systems.

- Uniform limitations period of at least 180 days for filing amended state income tax returns after federal audit.

- Simplified, uniform amended state income tax return after federal audit that requires reporting of only changes to the original return.
- State-provided taxpayer education including guidance on state tax implications of federally tax-exempt corporate reorganizations and proper state tax treatment of federal short-year returns (returns encompassing a period of less than 12 months).
- Expanded state availability of electronic filing for both sales tax and income tax returns.
- Improved and integrated, computer systems among the states to enhance information retrieval and facilitate taxpayer communication.
- Expanded use of alternative dispute resolution processes, like the MTC's Alternative Dispute Resolution (ADR) Program and Nexus Voluntary Disclosure Program.
- Simplified, uniform tax calculation method for taxpayers whose incomes fall below certain thresholds.
- Improved cooperation and communications between audit and legal personnel within revenue departments and among the states' audit and legal personnel.
- Expanded acceptance by states of the MTC multistate resale certificate (Uniform Sales and Use Tax Certificate—Multijurisdiction) for sales of goods and services.
- Increased participation in joint compliance activities, including but not limited to the MTC Joint Audit and National Nexus Programs.