Three Components to an Effective State Sales Tax Structure

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The art of taxation consists of so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing. (J.B. Colbert)

The State of Georgia is currently undergoing a comprehensive review of its tax structure. A special council was established by legislation passed during the 2010 session of the Georgia General Assembly. The council has representatives from the political, academic, business, and professional disciplines. On August 19, 2010 Drs. David Sjoquist and Roger Tutterow , who are members of this council, made a presentation at the Southeast Accounting Show in Atlanta to discuss Georgia's overall tax structure in a way that only an economist can; lots of graphs, charts, and tables. I am not really sure of what conclusion, if any, was actually presented other than that Georgia's overall tax burden is higher than some states and lower than others.

When questioned about the "goal" of the Council, both economists said "everything is on the table…but nothing is on the table"! (Only from an economist). They clarified that by stating that the council has not been given any specific charge other than to evaluate the existing tax code and make changes where needed. Without having a specific charge, however, how will the committee know what changes to make? Although no one was willing to call the question, it seems pretty clear that the likely outcome of any tax code change will be to increase revenue. Georgia, like most every other state, has seen a dramatic decrease in state tax revenue. Sales tax and corporate income tax have been on the slide for years and more reliance is being placed on individual income tax as a source of revenue. Recent changes to the way income from taxpayers over 65 is taxed, however, may soon change the amount of revenue collected from the individual income tax. The corporate income tax only provides 4% of total state revenue compared with sales tax that produces over 33% of total state revenue.

If we assume for a moment that the unspoken goal of this council is to increase state revenue, then there are many options that could be employed. From the discussion, however, it appears that sales tax changes are in the middle of the target when it comes to modernizing the Georgia tax code. With changes to the Georgia sales tax code likely to be implemented during the next 12 months, I wanted to take this opportunity to share my thoughts on the various components that make up an effective state sales and use tax system and outline why changes to one component may not always create the intended benefit without changes in the other components.

For purposes of this article, I believe that there are three separate components working in concert to create a state sales tax structure. The effectiveness of this system depends on how well the components work together; do they complement one another or do they create tension with each other. I am not aware of any "perfect" state sales tax system or even suggesting that a state could have a perfect system. I am, thought, certainly aware of state sales tax systems which are inefficient and somewhat ineffective at maximizing their objectives. This overall sales tax structure must operate in a delicate partnership between the state government who collects the revenue and the business community that has the responsibility for collecting remitting the tax revenue. While much of the sales tax is paid by individual consumers, the cost of compliance and obligation for remitting the tax falls only to businesses.

This is a major difference between sales tax and income tax. For state income tax purposes, both individual and corporate, the party that has the actual economic outlay for the tax payment is the same party that has the obligation to file the return with the state. Sales tax, however, is a "trust fund" tax. That is, the business that actually files the tax return with the state is not the company that has the economic outlay for the tax(assuming it does not make a mistake). If the business does everything correctly, they are merely a conduit or an independent processing center used to remit the tax collected from the customer to the state revenue agency. This distinction, however, seems at times to be lost on legislators and departments of revenue when it comes to designing their particular tax systems.

From my perspective, the three components of an effective state sales tax system are:

1. Clearly written, up-do-date, and comprehensive statutes and regulations setting forth the intentions of the state legislature for revenue generation.

2. A tax calculation and remittance structure that is straight forward and easily automated.

3. A state tax administrative and enforcement function with well trained staff, up-to-date computer systems, readily accessible information, and a taxpayer focused philosophy.

I like to think of theses as the three legs of a stool. If any leg is missing, is weaker than the others, or is any way not sufficient to carry one-third of the load, then the stool will collapse. These three elements made the cut based only on my observations from the past 24 years as both a consultant and as a state tax administrator. This is not a scientific study and I have nothing but personal experience and actual consulting situations to back up my statements. My comments are not directed at any particular department of revenue and should be viewed only as a generic statement. As I will discuss in detail below, the impact to state tax revenue can be significantly influenced (increased or decreased) by changes in any one of these elements. To be truly effective, however, changes must be made in all three of these components to obtain the maximum desired benefit with the least amount hissing (see quote at top of page).

1. Clearly written, up-do-date, and comprehensive statutes and regulations setting forth the intentions of the state legislature.

State sales tax was first introduced in the late 1950s as an experimental tax. I'm not sure how long the experiment lasted, but I think it's safe to say it has been over with for quite some time. Most states which have a sales tax have done a pretty good job at modernizing the language and concepts to make the tax relevant to the economy in their state. Sales tax exemptions can be granted to encourage certain types of industries to expand in their state or to avoid tax collection from certain classes of taxpayers. Over the years, though, the sales tax rules and statutes can become a bit stale or out dated as the economy changes. To remain relevant, sales tax statures must be kept up-to-date; I believe there are still some state sales tax statutes that list telegraph services as a taxable form of communications.

In addition to keeping the statutes relatively current, a state's administrative regulations must also be constantly updated. This may be more critical with respect to services than to sales of tangible personal property. If a state does not keep their statutes up-do-date then the administrative/regulatory function will be limited. States cannot "legislate by regulations". That is, a valid state regulation can only be issued if it is supported by a corresponding statute. It is quite common for taxpayers to challenge the regulatory authority of a state department of

revenue if there is no corresponding statute to back up the regulation. For example, if the state statutes were silent with respect to the taxation of a particular service, a state regulation could not be issued which makes that particular service taxable. The act of establishing what is taxable and what is exempt is left up the legislature.

In addition to being somewhat up-to-date, the state statutes should be relatively easy to understand and should not have significant ambiguity in the language used to either impose a tax or to grant an exemption. The more complex the statute is written, the greater the opportunity for significant unintended consequences to arise. If a statute contains too much ambiguity or has a number of different conditions that must be met in order to for the tax or the exemption to apply, there may be a hesitance on the part of businesses to comply with that provision. If we assume that each of the sales tax provisions and exemptions are intended to tax a particular behavior or transaction, then that goal will not be achieved if the statute is too cumbersome to navigate or is not at all clear. Statutes which include words such as “necessary”, “generally”, or “significant” are difficult for taxpayers to implement.

2. A tax calculation and remittance structure that is straight forward and easily automated

The act of collecting and remitting sales tax by businesses is as much and art as it is a science. When sales tax was first introduced in the 1950s the collection system was based on manual calculations of tax based on specific tax brackets provided to vendors. Where each transaction has the opportunity to be evaluated to determine a number of specific characteristics that are important to its tax treatment, then a manual system may work fine. However, now that almost every sales tax transaction is automated, the ability to make adjustments based on a particular set of facts is lost if the rules are too cumbersome to be automated. From single location restaurants to multistate retailers, the sales tax calculations are done with computer software. Even the least expensive cash register has the capability to automatically calculate sales tax.

In addition to being able to calculate the tax based on the correct set of rules, having simplicity in the application of sales tax rates is also important. In states like Missouri, where there are many different local tax rate combinations that are based on “order taking point”, “ship from point”, and “ship to point”, the act of computing the correct amount of tax and completing the tax returns to remit the tax is quite challenging. States that have complicated tax returns to

prepare or have multiple filings for different taxes may also find compliance to be less than optimal. Alabama, Louisiana, Colorado, and Arizona are some of the states that come to mind as being generally difficult to administer because of the numerous local filings that are required. Fortunately, many of these states are slowly allowing companies to file their local sales tax returns with an independent 3rd party who will process the returns on behalf of the local jurisdictions.

The more challenging it is (whether that challenge is real or perceived) for a company to quickly and accurately collect the sales tax due on taxable transactions and to remit the collected tax to the state there is a chance that companies will either over collect or under collect sales tax on those transactions. This is not to say that companies won't collect sales tax or file at all in a state, but if there are specific types of transactions where the tax calculation cannot be economically automated, then some businesses may elect to run the risk and not charge their customers tax. On the alternative, if it is easier to charge tax on a specific transaction (even though that transaction could be exempt under some circumstances) then the business may charge tax just avoid any possible underpayment risk. Likewise, if the sales tax return preparation process is viewed as too cumbersome or too time consuming by a taxpayer, they may elect not to file in that particular jurisdiction and focus their compliance efforts on other jurisdictions where the liability is larger or the filing is more straightforward.

For many businesses, sales tax compliance is a time consuming and resource intensive endeavor. I believe this detail is lost on most state legislators and tax administrators. All the creative ways to implement sales tax will be lost if the tax can't be collected efficiently and if it can't be put on a form in a timely and automated fashion. For large companies, it is not unusual to file hundreds of state and local sales returns a month. Along with the returns, there are either electronic payments or paper checks to be processed. Electronic filing has helped, but even that is not entirely seamless. When resources are limited and when deadlines are immovable, businesses must make decisions on what level of detail they are able to obtain for use on sales tax returns and what returns will be filed. When the cost of compliance for a particular transaction or in a particular jurisdiction exceeds the perceived risk of non-compliance, some companies will opt to take the risk and not file so that they can devote the limited resources to managing the remaining tax return filings.

3. A state tax administrative and enforcement function with well trained staff, up-to-date computer systems, readily accessible information, and a taxpayer focused philosophy.

The responsibility of any state department of revenue is multifaceted and complicated. I have worked in that environment and understand the pressures to "do more with less" and to not miss a beat when it comes to flawless implementation and enforcement of a state sales tax system. A state department of revenue is the only interface most businesses have with respect to understanding and complying with the state sales tax law. The vast majority of businesses do not hire sales tax consultants for advice and do not have full-time sales tax professionals on staff. They rely on written correspondence from the department of revenue, published guidelines, form instructions, or on phone discussions with DOR staff. Where businesses have been audited, the auditor may be the only personal connection that business will have with the DOR.

Over the years, I have discovered that nearly all businesses want to do the right thing with respect to their sales and use tax obligation. There are a few who want to cut corners or play it fast and loose, but most companies know the risk of not doing things correctly. In most cases, companies have only 2 questions with respect to sales tax: (1) is their product or service taxable and (2) what is the correct tax rate? If department's of revenue could find an effective way to accurately provide these very simple pieces of information to taxpayers, the compliance rate would increase dramatically and the business community would be happy.

I have found that departments of revenue fail on these simple tasks for a variety of reasons. Some of these are:

1. Poorly trained and overworked staff,

2. Uncertain or unpublicized department of revenue policies,

3. Hostile attitude toward business and taxpayers, and

4. Outdated computer systems.

Staff development and retention at departments of revenue is difficult. With little exception, state employees are not paid the same amount as what employees of private businesses are. Employee pay is a huge factor in the overall level of employees who are willing to work at any department of revenue. Most state just cannot compete to hire the best and the brightest students or the experienced CPAs or attorneys they need to provided the level of

service the community expects. Over the years I have been very impressed with the technical ability and professionalism by many department of revenue employees. I have also been horrified by the comments, advice, and lack of professionalism exhibited by other department of revenue personnel. I talk with employees from at least 25 different departments of revenue annually, so I have a pretty good cross section of experiences.

Employees must be trained not only in the "rules" of the sales tax law, but they must also be trained to ask some basic questions to help determine when those rules may apply. Unfortunately, many unsuspecting taxpayers take the information they receive from any DOR as the truth and blindly march forward; sometimes at their own peril. I appreciate the warning the Arizona Department of Revenue provides while you are waiting on hold. They tell you flat out that you cannot rely on any oral information provided to you by the person on the other end of the phone and that you must obtain a response in writing before it is binding.

There is nothing more frustrating than having an auditor reference some "internal" policy as the basis for treating a transaction as taxable. If there is a sales tax policy used to administer taxes, it must be published as a regulation. Tax can only be enforced if the playing field is level; not just perceived as being level, but actually level. No hidden rulings, no un-published policies, and no unpublished court cases. The taxpayers must have access to the same information used by the administrators. The failure of this point, often leads to an adversarial and untrusting relationship between the taxpayer and the revenue agency. I have found that DORs that view taxpayers as the enemy (or worse), will engender no great support from this vital constituency. The more hostility there is between a DOR and the business community, the less effective the overall revenue system will be. For the most part, this is a management issue. The tone set my management will filter down to the staff.

Automation is the life blood of any DOR. Huge amounts of money is spent each year keeping the systems up-to-date with the various rate changes, law changes, and new forms. However, if a DOR cannot process a tax return and generate a delinquency notice is a timely fashion, then revenue is lost and the business community loses faith in the revenue system. Notice generation and management is a vital role played by the automated systems of a department of revenue. When notices are generated months after the tax return is filed, there is a greater opportunity that the business will have repeated the error because they were not alerted to

the issue in a timely fashion. This can lead to under payments of tax, slow collection of revenue, unnecessary payments of interest and penalty, and bad taxpayer relations. Not what you want to have as your agency attempts to collect revenue from the taxpaying (and non-taxpaying) community.

Conclusion

As all of the states wrestle with options to generate additional sales tax revenue, I would encourage them to look at the entire sales tax structure and not focus on only changing the substantive components of the sales tax law. If the tax law, regardless how creative or well intended it may be, is difficult to understand, and the tax intended to be collected under the new law is hard to calculate and collect in an automated process and is difficult to pay over to the state on the forms provided, then the actual revenue collected may be less than the estimate. To compound the situation, if the department of revenue charged with administering and enforcing the law does not understand the law and harbors animosity against the business community charged with collecting and remitting the tax, the system will break down very quickly. I am not suggesting that departments of revenue cozy up to the business community, but there does need to be some sense of a working partnership between the two groups. The failure of either partner to hold up their obligation can breed suspicion and distrust between the partners, this can and will lead to decreased tax compliance and lower revenue collection.