THE STREAMLINED SALES AND USE TAX AGREEMENT AND SOUTH CAROLINA

ADDENDUM TO THE REPORT OF AUGUST 20, 2007

A REVIEW OF THE AMENDMENTS TO THE AGREEMENT AND THE RULES ENACTED BY THE GOVERNING BOARD SINCE THE ORIGINAL REPORT WAS ISSUED IN 2007 AND THEIR POSSIBLE IMPACT ON SOUTH CAROLINA IF THE GENERAL ASSEMBLY AMENDS THE STATE AND LOCAL SALES AND USE TAX LAWS TO CONFORM.
THIS ADDENDUM MUST BE READ IN CONJUNCTION WITH THE ORIGINAL REPORT.

(February 2, 2010)

Prepared by: John P. McCormack
Rick Handel
Office of General Counsel for Policy
SC Department of Revenue

TABLE OF CONTENTS

The Streamlined Sales and Use Tax Agreement and South Carolina
Addendum to the August 20, 2007 Report
(February 2, 2010)

I. Purpose

In 2007, the Director of the SC Department of Revenue requested that a report be prepared that would inform the Department's policy makers of the key elements of the Streamlined Sales and Use Tax Agreement. This report was completed and presented to the Director on August 20, 2007.

The purpose of this addendum is to relate the major changes to the Streamlined Sales and Use Tax Agreement and its governance that have occurred since the original report was issued on August 20, 2007.

This addendum is not meant to replace the original report and should be read in conjunction with the original report issued on August 20, 2007. (See also the Note at the end of the "Conclusion.")

II. Overview[1]

In August 2007, 15 states had been accepted as full members and 7 as associate members. Currently, 20 states are full members and 3 states are associate members.

Between its adoption in November 2002 and our original report, the Streamlined Sales and Use Tax Agreement was amended 9 times (some of these may have included more than one amendment). Since our report approximately two and a half years ago, 23 amendments have been approved out of 101 proposed amendments. It should be noted that often several amendments would be proposed on the same topic, so the process was often choosing the one, if any, that would be approved.

In addition, the Governing Board has approved 16 new "rules"[2] and 8 "interpretation opinions" since our report. Rules and interpretation opinions are as binding on the states that join the Agreement as the Agreement itself.

[1] The numbers in this section were obtained by counting the documents in the Library section of the Streamlined Sales Tax Governing Board Inc.'s website, www.streamlinedsalestax.org.
[2] The Agreement is currently 169 pages long and the rules are 104 pages.

III. Major Amendments to the Agreement (August 2007 - December 2009[3]

As noted in the original report, the Agreement has been amended on numerous occasions. Since the original report was issued on August 20, 2007, the Agreement has been amended 9 times. The following concerns the major amendments to the Agreement since the original report was issued on August 20, 2007:

A. Prohibited Replacement Taxes

Section 334 was added to the Agreement to prohibit replacement taxes. It states:

> No state may have a prohibited replacement tax on any product defined in Part II or Part III(B) of the Library of Definitions which has the effect of avoiding the intent of this Agreement.

A "prohibited replacement tax" is a tax imposed outside a state's general sales and use tax, on or with respect to a product or products that are defined in Part II or Part III(B) of the Library of Definitions that has the effect of avoiding the intent of the Agreement.[4]

The prohibition will, therefore, generally apply to taxes on the following:

> clothing
> computers, software, and software maintenance contracts
> digital products
> food and food products
> health care products
> telecommunications
> sales tax holiday product definitions concerning disaster preparedness and school supplies

However, by rule, the prohibition will not apply to (a) taxes on alcoholic beverages or tobacco; (b) in general, taxes based on measures other than price, such as weight or volume; (c) lodging or hotel occupancy taxes; (d) in general, broad-based business activity or privilege taxes, and; (e) taxes existing prior to the state initiating action to become a member state.

To determine that a replacement tax is a "prohibited replacement tax," the Governing Board must find that the replacement tax has the effect of avoiding the intent of the Agreement, considering (a) whether the tax contains both a sales and a use tax component; and (b) any other factors related to the fundamental purpose of the Agreement (Section 102) that the Board considers relevant.[5]

---

[3] While this report concerns the major amendments to the Agreement, it should be noted that the Governing Board is constantly dealing with a multitude of other issues ranging from minor amendments to the Agreement, new and amended rules, and various interpretative opinions. For example, two issues recently dealt with concern whether certain breakfast cereals and bars constituted candy and whether an employee discount earned through an employee points program qualifies as a discount excluded from the sales price.

[4] See Rule 334 of the Governing Board which was adopted in 2009.

[5] The fundamental purpose of the Agreement, as set forth in Section 102 of the Agreement, is to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance. This

While the prohibition on certain replacement taxes could apply to many areas depending on how the General Assembly chooses to revise the sales and use tax law, the impact of the prohibition on replacement taxes will have its most significant impact in two areas: (1) the difference in the definitions in the South Carolina law and the definitions in the Agreement with respect to exclusions and exemptions; and (2) certain special impositions in the South Carolina law (*e.g.*, communication services, warranty, maintenance and similar service contracts) that concern terms specifically defined in the Agreement.

Exemption and Exclusion Definitions: With respect to the definition (as stated in the original report of August 20, 2007), the state, in order to comply with the definitions set forth in the Agreement, may need to:

- Eliminate an exemption or exclusion[6] and tax the sale of the item and increase revenue; or

- Comply with the Agreement's definition and either increase revenue or lose revenue; or

- If complying with the Agreement's definition will cause a loss in revenue, the state may be able to create a new "replacement" tax outside of its sales and use tax so that the change is revenue neutral. It should be noted that in some cases it may not be possible to craft a "replacement tax" to ensure it is not a "prohibitive replacement tax" under the Agreement.

Special Impositions: South Carolina imposes the sales and use tax on certain specific services. These are generally referred to as the "special impositions." If a special imposition uses terms defined in the Agreement, then the issue of "prohibited replacement taxes" may impact such tax impositions.

For example, South Carolina imposes the sales and use tax on certain communications services – "charges for the ways or means for the transmission of the voice or messages." Under the special imposition, the sales and use tax is imposed on the following communications services:[7]

(a) Telephone Services, including telephone services provided via the traditional circuit-committed protocols of the public switched telephone network ("PSTN"), a wireless transmission system, a voice over Internet protocol ("VoIP"), or any of other method

---

purpose will be accomplished through all of the following: (1) state level administration of sales and use tax collections; (2) uniformity in state and local tax bases; (3) uniformity of major tax base definitions; (4) a central, electronic registration system for all member states; (5) simplification of state and local tax rates; (6) uniform sourcing rules for all taxable transactions; (7) simplified administration of exemptions; (8) simplified tax returns; (9) simplification of tax remittances; and (10) protection of consumer privacy.

[6] An exemption concerns a sale at retail, and as a retail sale, the transaction would be taxable except for the exemption provided by the General Assembly. An exclusion is typically a transaction that the General Assembly has removed from taxation so as to not include it as a "retail sale" or a part of a "retail sale." Therefore, since it is not a retail sale, or part of one, it is not taxable since the sales and use tax only applies to retail sales.

[7] See SC Regulation 117-329.

(b) Teleconferencing Services

(c) Paging Services

(d) Answering Services

(e) Cable Television Services

(f) Satellite Programming Services and Other Programming Transmission Services, including, but not limited to, emergency communication services and television, radio, music or other programming services

(g) Fax Transmission Services

(h) Voice Mail Messaging Services

(i) E-Mail Services

(j) Electronic Filing of Tax Returns when the return is electronically filed by a person who did not prepare the tax return

(k) Database Access Transmission Services or On-Line Information Services, including, but not limited to, legal research services, credit reporting/research services, and charges to access an individual website (including Application Service Providers)

(l) Prepaid Wireless Calling Arrangements (sale or recharge at retail) as defined in Code Section 12-36-910(B)(5)

(m) 900/976 Telephone Service.

Since the Agreement provides definitions for various "telecommunications" related terms, the taxation of some of the above communications services may be limited or eliminated. Therefore, the state, in order to comply with the definitions set forth in the agreement, may need to:

- Comply with the Agreement's definition and either increase revenue or lose revenue; or

- If complying with the Agreement's definition will cause a loss in revenue, the state may be able to create a new "replacement" tax outside of its sales and use tax so that the change is revenue neutral. It should be noted that in some cases it may not be possible to craft a "replacement tax" to ensure it is not a "prohibitive replacement tax" under the Agreement.

Similar decisions may need to be made with respect to other "special impositions," such as the imposition of the tax on the sale or renewal of warranty, maintenance or similar service contracts for tangible personal property, that use terms defined in the Agreement.

Finally, if a "replacement tax" is the chosen method of complying with the Agreement in certain areas of taxation, then the state will need to draft the replacement tax so it does not constitute a "prohibitive replacement tax." As stated above, to determine that a replacement tax is a "prohibited replacement tax," the Governing Board must find that the replacement tax has the effect of avoiding the intent of the Agreement, considering (a) whether the tax contains both a sales and a use tax component; and (b) any other factors related to the fundamental purpose of the Agreement (Section 102) that the Board considers relevant.

B. Definitions

While it is not necessary to discuss each new definition or each amendment of a definition in the Agreement, it is important to note that such changes in the Agreement are occurring with regularity and most likely will continue to occur on a regular basis.

The Agreement presently contains 105 definitions, with 16 of these definitions having been added since the original report was issued on August 20, 2007. In addition, 4 definitions have been amended since August 20, 2007.

New Definitions: The definitions for the following words or terms have been added to the Agreement since the original report on August 20, 2007:

digital books
digital audio-visual works
digital audio works
disaster preparedness supply
disaster preparedness general supply
disaster preparedness safety supply
disaster preparedness food related supply
disaster preparedness fastening supply
energy star qualified product
essential clothing school art supply
school computer supply
school instruction material
school supply
software maintenance contracts
specified digital products

Amended Definitions: The definitions for the following words or terms found in the Agreement have been amended since the original report was issued on August 20, 2007. In some cases, these amendments are "technical" in nature, and in other cases the change may be more substantial:

delivery charges
model 1 seller
model 2 seller
model 3 seller

Finally, the rules adopted by the Governing Board may contain various definitions. For example, a rule recently approved essentially defines what a "prohibitive replacement tax" is for purposes of the Agreement.

If South Carolina joins the Agreement, the General Assembly may need to amend the South Carolina sales and use tax law each year to maintain compliance with the Agreement.

In order to comply with the definitions added to or amended in the Agreement each year, the General Assembly may need to:

- Eliminate an exemption or exclusion[8] and tax the sale of the item and increase revenue; or

- Comply with the Agreement's definition and either increase revenue or lose revenue; or

- If complying with the Agreement's definition will cause a loss in revenue, the state may be able to create a new "replacement" tax outside of its sales and use tax so that the change is revenue neutral. It should be noted that in some cases it may not be possible to craft a "replacement tax" to ensure it is not a "prohibitive replacement tax" under the Agreement.

If the General Assembly fails to amend the law, the Governing Board could rule South Carolina out of compliance with the Agreement, thus jeopardizing South Carolina's participation in the Agreement.

In addition, South Carolina will need to follow any definition found in the rules and interpretative opinions approved by the Governing Board.[9]

Finally, there is a specific rule concerning definitions and any sales tax holiday a state may have or enact in the future. Under the Agreement, the sale of a particular item can only be exempt as part of a sales tax holiday if the definition of that item is in the Agreement. For example, as part of a temporary proviso in 2009, South Carolina held a sales tax holiday for handguns, shotguns and rifles. This type of sales tax holiday is not permitted under the Agreement at this time since the Agreement does not define the terms "handguns," "shotguns," or "rifles."[10]

[8] An exemption concerns a sale at retail, and as a retail sale, the transaction would be taxable except for the exemption provided by the General Assembly. An exclusion is typically a transaction that the General Assembly has removed from taxation so as to not include it as a "retail sale" or a part of a "retail sale." Therefore, since it is not a retail sale, or part of one, it is not taxable since the sales and use tax only applies to retail sales.

[9] As noted in the original report, the rules and interpretative opinions by the Governing Board would, as a practical matter, serve as regulations and that would not comply with the regulation approval process presently established by the General Assembly.

[10] If South Carolina joined the Governing Board, it would need to suggest, and have the Governing Board approve, an amendment to the Agreement that would define the terms "handguns," "shotguns" and "rifles" for purposes of a sales tax holiday in order to exempt these items during a sales tax holiday.

C. Sourcing

Sourcing is the determination as to where a transaction is taxed. The Agreement contains a general sourcing rule, and several industry specific sourcing rules. Sourcing is another area that has seen much discussion as various industries seek rules specific to their industry. This is another area that will affect revenue in either a positive or negative way, depending on how the sourcing rules for that industry are written.

Since the original report was issued on August 20, 2007, sourcing rules have been added or amended with respect to:

direct mail
florists
software maintenance contracts

In addition, with respect to local sales and use taxes collected by a state tax agency on behalf of the state's local jurisdictions, the Agreement was amended to allow an election by a state to use "origin based sourcing" as opposed to "destination based sourcing."[11]

As with definitions (or any other provision of the Agreement), if the General Assembly fails to amend the law to comply with the various sourcing rules as they are adopted or amended, the Governing Board could rule South Carolina out of compliance with the Agreement and thus jeopardizing South Carolina's participation in the Agreement.

IV. Other Issues of Note

A. Current Proposals

As noted in the "Overview" section of this addendum, proposals to amend the Agreement are constantly being submitted. The following are examples of important recent proposals that have been or will be considered by the Governing Board:

One Tax Rate: This proposal would forbid states from having more than one tax rate, thereby, preventing political subdivisions of a state from having their own tax rates. A state would be required to develop a method of distributing sales tax revenue to local jurisdictions. It could not require the seller to submit a report with this local jurisdiction information. The Governing Board's Executive Committee recently rejected this proposed amendment; however, this proposal could still be presented to the full Governing Board with the Executive Committee's negative recommendation.

[11] South Carolina is a "destination" state with respect to sourcing. See SC Revenue Ruling #09-9 for information on the sourcing of local sales and use taxes administered and collected by the Department of Revenue on behalf of local jurisdictions.

Vendor Compensation: Vendor compensation is the amount allowed a vendor for collecting and remitting the sales tax. This proposal would require compensation rules to apply to all sellers. The compensation authorized in a particular state would depend on the average state and local rate in the state.

The proposal would also allow additional compensation if the state requires the reporting for local jurisdictions or if the state has a separate rate for drugs or groceries. Since South Carolina presently requires the reporting of the tax due local jurisdictions and allows the imposition of most local sales taxes on unprepared foods, the additional compensation will apply in South Carolina (if this proposal is adopted).

Other Taxes on Communications Services: This proposal may extend the application of the Agreement to "other taxes on communications services." With certain exceptions, the same provisions of the Agreement that apply to a state's sales and use tax would apply to certain communications taxes (including, perhaps, local business license taxes on communications services). This proposal is being proposed in consideration of legislation that may be introduced in Congress.[12] As discussed earlier in this addendum, one option South Carolina has in complying with the Agreement with respect to communications services it presently taxes under its sales and use tax law, would be to create a "replacement tax" on communications services. That option, however, may not be available for all communications services if South Carolina joins the Agreement and this legislation is enacted by Congress. However, if Congress does not enact the legislation, but the Governing Board adopts this proposal, then a state has the option to adopt the Agreement's restrictions on "other taxes on communications services" but it is not required to do so.

B. Compliance Problems in Bad Economic Times and Outside Challenges to a State's Compliance Recertification

The original report discussed the fact that each year the state has to demonstrate that it continues to comply with the Agreement, and any amendments, rules or interpretations that have been added. What follows is a cautionary tale published on December 15, 2009, in *State Tax Notes.*

"Governing Board Panel Hears Arguments on Challenge to Nevada's Compliance"

by John Buhl

A Streamlined Sales Tax Governing Board committee on December 14 heard arguments on a petition challenging the governing board's May 12 decision finding Nevada in substantial compliance with the Streamlined Sales and Use Tax Agreement.

The Issue Resolution Committee during a conference call discussed a petition from the Business Advisory Council (BAC) appealing the governing board's ruling on Nevada's compliance. (For coverage of the governing board's May 12 ruling, see *State Tax Notes*, May 18, 2009, p. 512, *Doc 2009-10984* , or *2009 STT 91-1* .)

[12] The legislation has not been introduced in Congress as of the date of this addendum. Also, it should be noted that similar legislation has been introduced in Congress in previous years, but has not been enacted.

> Fred Nicely, tax counsel for the Council On State Taxation, argued that Nevada was out of compliance because although the state could accept automated clearinghouse (ACH) debit payments, it could not accept ACH credit payments, as required by the agreement.
>
> Section 319 (C) of the agreement says that states shall "allow for electronic payments by all remitters by both ACH credit and ACH debit."
>
> Dino DiCianno, executive director of the Nevada Department of Taxation, said that because of a lack of funding, the state had been unable to make the necessary system upgrades to accept ACH credit payments.
>
> "I'm in a predicament," DiCianno said.
>
> DiCianno also said that although he would seek the additional funds necessary during the state's interim session, he had serious doubts whether he could secure them. DiCianno added that he had just been asked to propose additional spending cuts for the department. …."

As of the date of this addendum, it appears that this matter has not been resolved.

C. Associate Membership - Rule Adopted by the Governing Board

As noted in the "Overview" section of this addendum, there are currently 3 associate members of the Governing Board. Associate membership is authorized in Section 801 of the Agreement, which states in part:

> A state that petitions for membership after January 1, 2007, that is found to be in compliance pursuant to Sections 804 and 805 of the Agreement except that the changes to their statutes, rules, regulations or other authorities necessary to bring them into compliance are not yet in effect, shall be designated an associate member effective on the first day of the calendar quarter that is not more than twelve months before its proposed date of entry as a member state. Such twelve month period may be extended to eighteen months if the governing board, by unanimous vote approves such extension. …

If a state is not in compliance at the end of this twelve or eighteen month period, it forfeits its status as an associate member. In addition, the state may not file another petition for membership for a period of twelve months after it forfeits its status as an associate member.

In November 2009, the Governing Board adopted Rule 801 to set forth minimum criteria for becoming an associate member. Rule 801 states:

> The Governing Board may not approve a state as an associate member pursuant to Section 801.3 of the Agreement unless such state has at a minimum the following in effect on the day the become an associate state:
>
> 1. Provide amnesty pursuant to Section 402 of the Agreement;

2. Pay certified service providers pursuant to the Governing Board's contract;

3. Have certified the service providers and automated systems;

4. Have adopted a majority of the definitions in the Agreement to the extent such definitions are relevant for such state's sales and use tax administration;

5. Have provided liability relief to sellers and purchasers as required in the Agreement;

6. Be able to accept registration from the central registration system;

7. Have completed the Governing Board's taxability matrix;

8. Have completed the Governing Board's certificate of compliance;

9. Be able to accept the simplified electronic return as required in the Agreement;

10. Have complied with the exemption administration provisions as required by the Agreement; and

11. Have adopted a majority of the sourcing requirements as required by the Agreement.

D. Department of Revenue Computer Systems

Implementation of the Streamlined Sales and Use Tax Agreement will have a significant impact on the Department's processing systems. First, the Information Resource Management Division ("IRM") of the Department will need to develop a parallel process for Sales Tax Registration, which differs in many respects from the established Department's Business Taxpayer Registration. The parallel system will have the following requirements:

- It will have to interface to the central Streamlined Registration System and download registrations from the central vendor

- It will have to register Streamlined sellers without data required for normal business registration, including ownership type (Corporation, Partnership, etc.), principals/owners, business locations, etc.

- It will have to implement a Sales-only registration, independent of any other tax types normally linked to Sales accounts.

Secondly, IRM will need to develop a parallel Sales filing process for the Simplified Electronic Return ("SER"), which differs in many respect from established Sales tax filing. The parallel system will have the following requirements:

- It will have to implement electronic filing protocols and technology required for SER filing and communications with Certified Service Providers

- It will have to support SER, without data required for established Sales returns, such as breakout by physical location/retail license.

Finally, IRM will need to develop software for electronic certification and audit of Certified Service Providers, as specified by the Governing Board.

The implementation of these requirements will include detailed analysis, design, development, internal testing, and testing with the central Registration vendor and the Certified Service Providers. Due to the complexity of the requirements, this effort would take a minimum of two years, provided that IRM resources are available. Because of the Department's commitment to the SCITS project,[13] as well as normal legislative changes[14] and system maintenance, additional resources would be needed to accomplish the implementation within the near timeframe.

V. Conclusion

The changes made to the Agreement in the past two and a half years do not change the original report's general conclusions or concerns. They do re-emphasize the smaller policy role the General Assembly and the South Carolina Supreme Court will have over sales and use taxes. In addition, they make it clear for the first time, the possibility of losing autonomy over other taxes through the "replacement tax" rules. These rules have the practical effect for the first time of restricting the General Assembly from enacting legislation that will only affect taxpayers that have a physical presence in South Carolina.

Note: As stated above, this addendum is not meant to replace the original report and should be read in conjunction with the original report issued on August 20, 2007. In addition, it should be noted that some of the exhibits included with the original report of August 20, 2007 have been updated or revised. These updates and revisions also do not change the original report's general conclusions or concerns. For information concerning relevant updated or revised versions of these exhibits, see Exhibit B of this addendum.

[13] "SCITS" means South Carolina Integrated Tax Systems. It is a project to replace the Department's tax computer system. It is a massive project that began several years ago and is on-going. Its purpose is to create an encompassing tax system that will improve Department processes and improve voluntary compliance by taxpayers. It is a tax system that concerns all taxes administered by the Department. However, it should be noted that the sales and use tax module of the new system has already been designed and is nearing completion of development and testing. As such, it is too late to merely build streamlined sales tax into the system. Adoption of the Streamlined Sales and Use Tax Agreement would require re-design and re-testing of the sales and use tax module.

[14] Each change in tax legislation requires the Department to determine if its computer system must be modified in some manner to conform to the change in the law.

VI. Exhibits

A. Streamlined Sales and Use Tax Agreement

B. Updated Information Concerning Exhibits of the Original Report

Exhibit A

Streamlined Sales and Use Tax Agreement
(As Amended through September 30, 2009)

Exhibit B

Updated Information Concerning Exhibits of the Original Report