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LEGAL ALERT

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SST Governing Board Considers "Best Practices" Matrix and Marketplace Fairness Implementation; SLAC Contemplates Digital Goods Sourcing

The Streamlined Sales Tax Governing Board (SSTGB), as well as its State and Local Advisory Council (SLAC) and Business Advisory Council (BAC), assembled in Minneapolis this week to discuss a number of policy matters related to Streamlined Sales and Use Tax Agreement (Agreement). The overarching theme, however, was the continued viability of the Agreement in light of the Marketplace Fairness Act as it moves through Congress. This Legal Alert summarizes the more notable issues addressed in Minneapolis, particularly how the SSTGB plans to hit "refresh" on the Agreement if the Marketplace Fairness Act is signed into law.

"Best Practices" Matrix Proposal

The SSTGB on May 15 moved forward with proposed amendments to the Agreement that would implement new "best practices" matrix provisions. The best practice matrix will provide a forum by which member states can agree to address an issue without taking the more formal steps of amending the Agreement or adopting an SSTGB interpretive rule. The SSTGB members who sponsored the best practices matrix amendments stated that the process should provide transparency and certainty for taxpayers and flexibility for member states and potential member states. In general, the business community and state legislators present at the meeting agreed with that sentiment.

Although only subject to a majority vote of full member states present to move forward, the SSTGB by a vote of 18 to 1 approved the revisions to the proposed best practices matrix amendments. The final amendments will be subject to a three-fourths vote of full member states at the SSTGB's annual meeting before becoming part of the Agreement.

The proposed new Section 335 defines "best practice" to mean a practice that the SSTGB identifies and adopts as a best practice in the administration of sales and use taxes in the member states with respect to certain products, procedures, services, or transactions. Under proposed Section 335, the SSTGB would set out the best practice for an issue and that best practice would become an appendix to the Agreement. The SSTGB can approve a best practice by a majority vote, subject to a comment period, rather than the three-fourths vote of the SSTGB required to amend the Agreement or issue an interpretive opinion or interpretive rule. The rationale in making this distinction between voting requirements is that a member state may or may not need to amend its sales tax laws to comply with any given best practice. Moreover, a member state's compliance with any given best practice is voluntary and member states are only "encouraged" to comply with the best practice. However, all member states must complete the best practices matrix and provide liability relief to taxpayers, as described below. In contrast to a section in the Agreement or interpretation of the Agreement, no member state will be found out of compliance with the Agreement so long as it completes the best practices matrix to the best of its ability.

The proposal would also amend Section 328 of the Agreement (which currently deals with the Library of Definitions taxability matrix) to provide operating rules and standards on how member states should complete and apply the best practices matrix. Similar to the Agreement's existing taxability matrix provisions, the best practices matrix would need to be updated annually by each member state. If a member state varies from the best practice then it must explain how it differs from the specific best

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practice standard, must make that explanation available on the state's website, and must provide some relief for the affected taxpayers and Certified Service Providers (CSPs). In general, the relief provided by member states to taxpayers and CSPs is similar to the relief provided under the taxability matrix: (1) member states must give at least 30-days notice for any change in its best practices matrix and (2) member states must relieve taxpayers and CSPs from liability if they relied on erroneous data in the best practices matrix. A member state may have to determine whether it has authority to grant such relief under its existing laws.

The proposed best practices matrix amendments are driven, in large part, by the Marketplace Fairness Act moving out of the Senate and the perceived momentum of this legislation as it moves through the House. Specifically, the best practices matrix concept may mitigate disincentives for new states to join the Agreement or member states to remain compliant with the Agreement. For example, the Marketplace Fairness Act does not require states that adopt the minimum simplification requirements for remote seller collection authority to adopt the Agreement's uniform definitions or some of the Agreement's potentially burdensome administrative simplifications. Thus, the proposed amendments arguably retain the Agreement's relevance and some level of additional uniformity and transparency if the Marketplace Fairness Act becomes law.

On the other hand, the proposed amendments arguably reflect yet another "watering down" of the Agreement's uniformity goals following the invention of "associate members" (and later "contingent members") and the intrastate origin sourcing election. The question remains whether the best practices matrix amendments will encourage more non-uniformity among the member states or allow the Agreement to remain relevant after potential enactment of the Marketplace Fairness Act. The Agreement has always reflected a constant struggle between uniformity and state sovereignty. Indeed, this struggle is reflected in Section 103 of the Agreement, which provides "[t]his 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…" The proposed best practices matrix amendments create a concern that the member states will try to avoid the struggle between uniformity and state sovereignty and use the best practices matrix to avoid addressing tough issues through amending the Agreement, which involves a higher level of approval (and therefore compromise) among the SSTGB, the other member states, and the business community.

Marketplace Fairness Act Implementation

The SSTGB has begun the arduous task of developing implementation resources for states in the event they obtain remote seller collection authority through the enactment of the Marketplace Fairness Act. A working group has started to identify key implementation issues for states (both member and non-member states), consumers, remote sellers, and non-remote sellers. The SSTGB reviewed a draft chart and FAQs that highlighted numerous issues, many of which do not have clear answers. For example, if a state chooses to give notice under the Marketplace Fairness Act that it will require collection by remote sellers, what should that notice look like? Does the notice need to be the same for member states and non-member states? The implementation working group also questioned the ramifications of a member state being out of compliance with the Agreement. Does an out of compliance member state immediately lose the authority to require collection by remote sellers? If so, can it qualify for remote collection authority by meeting the minimum simplification requirements under the federal law? Does the state need to issue a new notice?

A number of the implementation issues considered apply only to non-member states attempting to meet the federal minimum simplification requirements. For example, a state can carve out specific products and services from the federal simplification standard. The working group questioned how that might apply in

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the absence of any uniform definitions. The group also questioned definitional differences between the Agreement and the federal minimum simplification requirements. Tribes and certain U.S. possessions cannot become members to the Agreement, but they may qualify for remote collection under the Marketplace Fairness Act. The SSTGB also considered whether there can be a unified registration process to allow sellers to register with member states and non-member states. These examples are but a few of numerous issues states—whether or not they are Agreement members—must address if the Marketplace Fairness Act is enacted, thereby creating parallel methods for states to gain remote seller collection authority.

Digital Products Sourcing

Early in the week, the SLAC continued its discussions on sourcing sales of digital goods. The bulk of the discussion involved the application of Section 310(A)(5) of the Agreement, which is the origin-based default rule in the Agreement's general "waterfall" sourcing regime. The SLAC reviewed a Draft Issue Paper and a Draft Rule addressing the application of Section 310(A)(5) to digital goods.

For background, the Agreement generally adopts destination-based sourcing for interstate transactions. The Agreement provides a series of five general sourcing rules for the sale of all products except those specifically sourced under other provisions of the Agreement. *See* SSUTA §§ 310, 311. The Agreement's general sourcing rules adhere to destination-based principles unless the seller does not know the purchaser's delivery address because the seller has inadequate books and records or otherwise does not know where the purchaser "receives" the product. In the context of digital goods, "receive" means "taking possession or making first use of digital goods."

When none of the above destination-based rules apply, Section 310(A)(5) of the Agreement sources the sale on an origin basis. More specifically, Section 310(A)(5) provides:

> 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).

While that rule may appear simple to apply on its face, questions continue to arise under Section 310(A)(5) on a scenario where the seller does not necessarily know where the digital good is "first available for transmission by the seller" to the purchaser. Such a scenario may result from the location of a seller's server(s) and/or the method of transmission of a digital product. In certain cases, the seller may know the location of the server from which first transmission of the digital product occurs. For instance, Example 5 in Draft Rule describes that fact pattern:

> The seller has sold a digital song that qualifies as a specified digital product. The sourcing provisions in Sections 310.A.1 – 4 of the SSUTA do not apply. The seller has a server located at its research and development facility in State A from which it transmits digital songs to purchasers. Upon the purchase of a digital song, the product is transmitted from the R&D facility server and then routed through several other servers in States B and C before final delivery to the purchaser. The sale is not sourced under SSUTA section 310.A.1 through 4. Therefore, the seller will source the sale to the location from which the digital song was first available for transmission by the seller

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(disregarding for these purposes any location that merely provided the digital transfer of the product sold). In this case, the sale may be sourced to the State A R&D facility where the digital song was first made available for transmission. The server locations in states B and C merely represent locations provided for the transfer of the digital songs and should not be used for sourcing purposes.

However, in other cases, the seller may not know where that server is located with any accuracy. For example, neither the location at which the digital good was received by the purchaser *nor* "first available for transmission by the seller" may be known when: the seller has multiple datacenters throughout the country and may alternately route a transaction through any one or more of those servers; the seller uses so-called ghost servers; the seller engages a third party to deliver the digital product on behalf of the seller to the purchaser; or the seller receives payment from a third-party electronic payment processor such as PayPal.

The SLAC working group formed to address digital goods sourcing will continue its review of the above issues and then recommend to the full SLAC whether or not to amend the Agreement (e.g., add a new subsection -(A)(6) to Section 310), or adopt a rule interpreting Section 310(A)(5) to reach an adequate and workable result. As part of this review and the working group's presentation of a revised Draft Issue Paper and revised Draft Rule to the full SLAC, the SLAC requested that the business community provide fact patterns involving the application of Section 310(A)(5) to the sale of digital goods and, particularly, when the seller may or may not know the location where a digital good was "first available for transmission by the seller."

The digital goods sourcing working group will also study the interplay among the sourcing rules in the Agreement, the Mobile Telecommunications Sourcing Act, and the current iteration of the proposed Digital Goods and Services Tax Fairness Act.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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