

**Testimony before the Senate Finance Committee**  
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**Department of Revenue**  
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Chairman Brubaker, Chairman Wozniak and members of the committee, my name is Dan Hassell, and I'm the Department of Revenue's Deputy Secretary for Tax Policy. Thank you for giving me the opportunity to give a general overview of our current sales and use tax and how it relates to commerce. I would like to begin by discussing use tax generally, reviewing steps the Department has already taken to educate the public about use tax liabilities they may have. I would like to then move on to discuss what other states have done recently to address the issue of Internet sales in an attempt to collect additional revenues.

Use tax is the counterpart of sales tax and applies to taxable purchases made over the Internet, through toll-free numbers, from mail order catalogs and from out-of-state locations, or any other occasion where sales tax was not charged and collected by the seller. The use tax rate is the same as the sales tax rate: 6 percent state tax, plus an additional 1 percent local tax for items purchased or used in Allegheny County and 2 percent local tax for Philadelphia.

Use tax is charged on the use, within Pennsylvania, of taxable goods and services purchased at retail when the sales tax was not paid to the vendor. Taxable items are the same for both sales tax and use tax purposes. In general, a person who purchases items or services subject to sales tax for which the seller didn't collect sales tax becomes personally responsible for remitting the use tax directly to the Department of Revenue.

For example, let's say a resident of Pennsylvania purchases jewelry from an Ohio seller for direct shipment to Pennsylvania. If the Ohio vendor has nexus, or physical presence, in Pennsylvania, it is required to collect Pennsylvania sales tax on the sale. However, if the Ohio vendor does not have nexus in Pennsylvania, it is not required to collect the tax.

Assuming the Ohio seller has no Pennsylvania nexus, it collects no sales tax on the jewelry, under Ohio law, because the destination of the sale is not in Ohio. Here is where use tax becomes due by the person who bought the jewelry.

Businesses that file sales tax returns are required to report use tax on regularly filed sales tax returns. Businesses and individuals that don't regularly incur use tax liabilities may file PA-1 use tax returns to report and remit the tax due.

The Department currently concentrates its use tax outreach and education efforts on business use tax, because we've seen a proven return on investment from mailers informing businesses about use tax and encouraging them to review purchases and voluntarily pay past-due use tax without penalty. Since this program began in 2007, it has generated \$137.3 million in use tax payments from more than 53,000 self-identified use tax payers. This fiscal year alone the program has generated \$36.54 million in use tax payments. Additionally, every sales tax audit includes a review of use tax potentially due.

The Department of Revenue collected \$372.7 million in use tax in fiscal year 2009-10, of which \$337 million was remitted by 41,000 businesses registered with sales tax licenses in PA. Another 17,000 use tax payments came in on PA-1 use tax returns. Given the educational outreach to businesses regarding use tax, we know the vast majority of those payments came from businesses as well.

Encouraging individuals to address and pay use tax responsibilities is more difficult, from the educational and voluntary compliance perspectives. While we can't offer exact numbers on how many individual taxpayers self-reported use tax last year, it's safe to say it was a very small number.

While the Pennsylvania personal income tax booklet offers information about use tax and how to pay it, it currently does not provide a reporting line. We know that the existing reporting mechanism – a PA-1 use tax return that is to be submitted along with full payment by the 20<sup>th</sup> of the month following the month in which the taxable purchase was made – is unfamiliar to and cumbersome for individual taxpayers. For that reason, the Department of Revenue is in the process of placing a use tax line on the 2011 personal income tax return so that taxpayers can easily and voluntarily report and remit use tax once a year. Based on similar initiatives in other states, we estimate this new use tax line on the PA-40 could generate \$5 to \$6 million in additional use tax payments annually.

All states that impose a sales tax encounter these same issues. Because of the 1992 decision of the US Supreme Court in *Quill v. North Dakota* and similar cases, states are prohibited from forcing businesses without nexus to collect the state sales tax. In the *Quill* decision, the US Supreme Court found that the diversity and complexity of state sales taxes imposed an unreasonable burden on interstate commerce, unless the seller has a substantial connection to the taxing state. That substantial connection is what we call nexus, and is usually understood to mean some kind of physical presence, either directly or through an agent or representative.

So how are other states addressing e-commerce with regard to use tax? We've been closely monitoring legal and legislative actions in other states, so I would like to provide a short synopsis of a few key scenarios.

The largest effort to date to address this issue is the Streamlined Sales Tax Agreement. The purpose of the Streamlined project is to simplify and modernize the administration of sales taxes in order to substantially reduce the burden of tax compliance. In this way, the project attempts to change the premise of the *Quill* decision. The project sets out uniform definitions of taxable items, uniform sourcing rules, and a simplified state-funded system for calculating the tax due for online transactions, among other things. Currently, 24 states have joined the agreement.

However, currently the Streamlined system is entirely voluntary for participation by online retailers. Unless Congress acts to make the Streamlined system mandatory, or the Supreme Court hears another case and overturns *Quill*, it will not substantially change the landscape or produce substantial new revenues. If Pennsylvania were to join the agreement, there would be some new revenue from retailers who voluntarily agree to collect sales tax, but there would also be revenue lost due to adopting the agreement's uniform definitions of taxable items. As a

result, the Streamlined effort should be viewed as more of a long-term investment that could pay dividends at some point in the future, if there is a significant change in federal law.

Meanwhile, several states have taken another approach by enacting expanded nexus laws. In New York, a legal challenge is being pursued against a law passed in 2008 that requires Internet retailers to collect taxes based on in-state affiliates. The case is currently in the state appeals court. New York collected \$70 million in sales tax from online retailers in fiscal year 2009-2010. New York's standard as it applies to affiliates presumes that an out-of-state seller establishes nexus if "the seller enters into an agreement with a resident of New York under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller." That standard applies if the seller's aggregate gross receipts from these referrals surpass a threshold of \$10,000 for the prior four quarters.

Earlier this year, Illinois enacted a law that forces online retailers with affiliates in the state to collect sales tax on purchases made by Illinois residents. Beginning in July, any business with an "affiliated presence" in Illinois will be required to collect a 6.25 percent sales tax. Illinois officials have estimated that the state loses between \$153 million and \$170 million in sales tax revenue annually due to retailers not collecting the tax. In response, a prominent online retailer cut ties with its Illinois affiliates, and is challenging the law in court.

Colorado enacted a law in 2010 that requires online retailers to either collect sales tax or send customers an annual notice informing them of how much they owe in state use tax. Retailers also have to file an annual report with Colorado officials listing all sales to Colorado purchasers. Again, a prominent online retailer announced it would drop its Colorado affiliates in response to the law's passage, and the law is being challenged in court.

Moving forward, the Department of Revenue will continue to educate the public on the use tax and will continue to enforce the laws as they exist.

Thank you for the opportunity to testify on this important topic.