

MEMORANDUM

To: House Committee on Ways and Means
Senate Committee on Finance

From: Mary Peterson – Commissioner of Taxes

Date: January 14, 2012

Subject: Feasibility of an Internet based use tax reporting and payment system

Section 36m of Act 45 of 2011 required the Vermont Department of Taxes to evaluate the feasibility of providing a volunteer online use tax reporting system that can be accessed via a link on the notice required by out-of-state sellers to buyers regarding use tax responsibilities. This memorandum is submitted to the Senate Finance Committee and House Committee on Ways and Means in fulfillment of this legislative directive. The memorandum includes pertinent background information, a description of the current state of use tax collection, description of two potential future states to accomplish the goal of link based use tax returns, and the requirements and challenges of implementing electronic use tax returns.

Background and Current State

The Vermont Sales and Use tax is levied on the purchase of tangible personal property and certain other transactions. Vermont-based vendors collect the sales tax on these transactions. An ever increasing amount of sales into Vermont are made by out-of-state vendors, who may not have nexus for the purpose of collecting the sales tax. As a result, the customer may be responsible for paying use tax directly to the State of Vermont.

The Department of Taxes has taken steps to improve the collection of the use tax and to reduce this growing tax gap. These steps include:

- The development of a use tax return
- Including the use tax on the Vermont Income tax return
- Increasing outreach to notify taxpayers of their obligation to pay the use tax

In September of 2011, to satisfy the requirement of Section 36b of Act 45, the Department of Taxes provided information to large e-retailers so that they can link their customers to the Department's website for information on the Vermont use tax. The Department will continue to expand the notification process when notified of other retailers that are not collecting the Vermont sales tax on taxable purchases.

Other States' Use Tax Return Procedures

There are three general approaches for paying use taxes in other states

- Electronic filing
- Paper returns for use tax only
- Including the use tax with income tax returns

Electronic Filing

Florida provides an online use tax reporting system that allows non-business entities to report out-of-state purchases and remit use tax on a quarterly basis using ACH debit transfers from their bank account. The on-line return requires the taxpayer to identify the item purchased, store from which it was purchased and the purchase price. There is no digital link to the transaction data from the out-of-state vendor.

Iowa has electronic filing, but it requires going through the registration process that businesses go through to collect and file sales tax returns. From the Iowa Department of Taxation website:

Persons regularly purchasing taxable goods or services for their own use in Iowa from an out-of-state source not collecting Iowa tax must register with the Department for consumer's use tax. No registration fee is charged and no physical permit certificate is issued to businesses, although a consumer's use tax number is assigned. Complete the [online Iowa Business Tax Registration form](#) to obtain a number. Iowa consumer's use tax is filed online through the Department's Web site at www.state.ia.us/tax/ or by touch-tone telephone at 1-800-514-8296

Iowa does not use a digital link to the transaction data from the out-of-state vendor.

Paper returns for use tax

Several states (including Vermont) have paper returns that can be used to file a use tax payment. In Vermont, this paper return is mainly used to record the use tax paid for vehicles that need to be registered with the Department of Motor Vehicles. The Department of Taxes is working on a use tax return form for other purchases. Other states close in proximity to Vermont that have paper returns include Maine and Connecticut.

Filing the use tax with the personal income tax return

Many states require the payment of the use tax when completing the personal income tax return. In the northeast, these states include New York, Massachusetts and Rhode Island.

Beyond these steps taken to promote use tax collection, the Legislature directed the Department of Taxes to evaluate the feasibility of providing a voluntary internet based use tax reporting and payment system in conjunction with the above mentioned notification effort. The Department's feasibility evaluation commenced after the legislative session, and policy, business, and technology staff has performed a preliminary analysis of a proposed "eUseTax" system.

Improving the Vermont Use Tax return

While Vermont has had a use tax return for several years, the primary mechanism for use tax payment by non-businesses is the income tax return. In order to increase use tax compliance, the Department of Taxes is developing a second use tax return.

The reason for the alternative use tax return is as a first step towards more automated use tax payments. While an automated system will take more time in order to establish our information technology capability, the manual return will establish a processing routine for the Department. Greater outreach on use tax payment is taking place through the notification legislation aimed at internet retailers and in our regular communications with taxpayers. To match the outreach, the new form will make filing use tax payments easier.

The next sections of this document describe the proposed eUseTax system and the requirements and challenges of implementation.

eUseTax Models

Any eUseTax model would be integrated into existing electronic tax reporting and payment services offered by the Department through the State's relationship with the *Vermont Information Consortium (VIC)*. In this case, the VTPay system is the logical system to use to facilitate reporting and payments of use tax. The internet address for VTPay is: <https://secure.vermont.gov/vtpay>

Currently VTPay allows for the payment of:

- Bills or notices of payment due received from the Department
- Personal Income Tax Return payments
- Estimated Personal Income Tax payments

Currently, VTPay only accepts credit card payments and the taxpayer incurs a convenience fee charged by the credit card processor. A pre-requisite for the eUseTax application is the ability for VTPay to accept Direct Debit payments. VIC is scheduled to implement Direct Debit payment functionality during 2012 at which time VTPay will be better positioned to support online payment of use tax.

eUseTax-Future State 1

The additional functionality of filing and paying a Vermont Use Tax return would be added to the list of options available on VTPay, and a new electronic Use Tax return/payment form would be created and implemented in VTPay.

At the completion of a sale with an out of state vendor over the internet, the vendor is currently required to provide a link to the Vermont Department of Taxes website describing the use tax. In the future state, the purchaser will also be provided a link to the Use Tax section of the VTPay application. The online form will capture details such as:

- Name/Address of purchaser
- SSN
- Vendor Name
- Dollar value of the purchase
- Description of the purchase

The system will calculate the 6% tax due on the sale, and the purchaser will have the option of paying online via direct debit or credit card. The option for the purchaser to pay by paper check with an accompanying payment voucher could be provided as well.

Data from the online form will be captured for each filing and securely stored in the Department's database. This information can then be viewed by the Department for taxpayer inquiry or compliance auditing purposes.

eUseTax- Future State 2

Beyond Future State 1, there is a possibility of further automating this process whereby the vendor could automatically pass all the required information to VTPay thereby eliminating the need for the purchaser to enter it themselves. This would require significant additional work by VIC to allow for the data to be passed automatically into the system. Also, each vendor would need to implement the passing of data from their site to VTPay. Because the business that is directing customers to the use tax filing has no nexus with Vermont, the Department of Taxes has no basis to require such cooperative data sharing. In addition, the platforms for each business are different and the logistics to establish the computer interface with all possible internet vendors is extraordinarily complex. Inability to surmount these technical challenges may mean the possibility that Vermont may not be able to identify all possible vendors for establishing the linked system, and this may lead to unequal treatment of businesses and taxpayers. Ultimately, this leads to concerns about fairness and potential litigation. Given these challenges, the Department's analysis of the requirements to implement a link based use tax return will focus on implementation of Future State 1.

Requirements and Challenges to Implementing eUseTax

There are several requirements to implementing eUseTax:

- *Allowing for direct debit payments on VTPay*
 - Though the eUseTax site could be implemented without the ability to pay by direct debit (payment would be made by check with an accompanying paper payment coupon) it makes little sense to implement the ability to file electronically without the ability to pay electronically with other than a credit card. Thus we consider this a pre-requisite to implementing eUseTax. This challenge is not considered insurmountable as this enhancement to VTPay is on VIC's project calendar to be completed during 2012.
- *Provide a link to eUseTax from our website*
 - In 2011, the Department of Taxes sent notices to the top 500 e-retailers regarding their requirement to notify customers of the Vermont use tax. Included in this communication was the link to the web site that describes the Vermont use tax. If the eUseTax system is implemented, we will modify the Vermont use tax page on our website to include a link to the eUseTax service. Retailers would not need to change their link to our site.
 - To provide a level playing field and expand the opportunities for paying the use tax, we will need to identify additional remote sellers and provide them the information necessary to connect with our use tax site on the internet.
- *Creating an electronic use tax return/payment form with all required validations and edits*
 - The Department of Taxes works with VIC to produce and manage the electronic filing services already in place and used by our taxpayers. These include VTPay and VT Biz File. The use tax filing and payment process is no more complicated than other electronic filing and payment processes currently in place today.
- *Creating a printable use tax return/payment form for check payments that can be read by our scanners.*
 - The Department has already worked internally and with VIC on a printable payment form as part of the Electronic Property Transfer Tax Return (ePTTR) service. A similar return/payment form could be created for eUseTax that would not only contain payment information but also information pertaining to the purchase.

- *Integrating transactions with existing back end tax processing systems*
 - There are two separate tax processing systems on two different technology platforms hosting business and individual taxpayer accounts at this time. Direct integration of eUseTax filing information into these systems requires significant programming and testing resources from the Department. In the short term, filing information would be captured and stored in our production databases but outside of the individual tax processing systems. This information would still be able to be queried for compliance or taxpayer inquiry purposes.
 - Actual payment information would be directly integrated into the payment processing portions of our systems.

The implementation of the eUseTax system and related technical requirements pose several challenges to the Department. These are listed below:

- *Staff support*
 - As with any tax return, errors require the intervention of Department staff. Customers providing taxpayer identification information or submitting a tax different than the tax due will eventually lead to staff intervention. We cannot predict the level of staff involvement in this new program, but assuming 100,000 transactions per year, a 1% error rate requires 1000 staff interventions.
 - As with any new technology based system, IT staff time will need to be dedicated to the initial development of the system and ongoing support and maintenance of the system.
 - Given the current assumed high level requirements for this electronic filing capability, it is estimated that the level of effort by Tax Department resources would equate to 2.5 people for two months. If this project is launched, then the detailed analysis phase would spawn more granular requirements possibly changing the level of effort required.
- *Lack of Funding through VIC's Traditional Model*
 - VIC has a funding model based on fees associated with electronic payment transactions. An example of this is the \$5 fee charged for using the ePTTR service. It seems unlikely that a fee could be charged to a taxpayer for paying use tax online, making it unclear how VIC's work on this project would be funded.
- *VTPay Upgrade*
 - VIC has indicated plans to re-architect the VTPay system. Since VTPay is the logical system to house the functionality for electronic payment of use tax, the timeline for

implementing this capability may be dependent on the re-architecture work being completed.

- *Unknown if this will Close Tax Gap Beyond Project Costs*
 - We do not have an estimate for the number of returns or amount of revenue that would be expected post implementation. Accordingly, the return on investment is unknown.

Conclusion

The implementation of an electronic use tax filing and payment systems is feasible and not overly complex from a technical or operational perspective. Also, it would support the shared goals of the Legislature and Department of educating taxpayers on the use tax and attempting to collect the proper amount of tax revenue in a timely and efficient manner. Furthermore, it would support the Department's strategic goals of closing the tax gap and providing electronic filing whenever possible.

The Department would recommend that the eUse Tax be designed within the functional capabilities of VTPay, the existing electronic tax reporting and payment services offered by the Department through VIC. The system could avoid serious technical issues, and potential fairness and legal issues, by designing a system that would place the burden of compliance on taxpayer's that owe the tax at the point of sale, rather than businesses that lack nexus with the State.

- While feasible, the project would face several challenges. The project would require staff resources beyond the status quo. VIC would be the Department's primary partner in this project; however, the project does not lend itself easily to VIC's funding model. Also, VIC's planned upgrade of VTPay presents a variable regarding the speed of implementation. Lastly, the return on investment for devoting resources to eUseTax is unknown, as the Department does not know how many taxpayers would use this method to remit the tax, nor how many customer service interventions would arise due to the tax.