



COMMONWEALTH of VIRGINIA
Department of Taxation

September 1, 2009

The Honorable Lacey E. Putney
Chairman, House Appropriations Committee
General Assembly Building, Room 947
Capitol Square
Richmond, Virginia 23219

The Honorable Charles J. Colgan
Chairman, Senate Finance Committee
General Assembly Building, Room 626
Capitol Square
Richmond, Virginia 23219

Dear Delegate Putney and Senator Colgan:

Enclosed is the report, entitled "Incentive and Penalty Options to Encourage the Correct Allocation of the Local Retail Sales and Use Tax," prepared by the Virginia Department of Taxation. The report was mandated by Item 270(K) of House Bill 1600, the Appropriations Act for the 2008-10 Biennium (2009 Acts of Assembly, Chapter 781).

This report is being submitted to the Division of Legislative Automated Systems. If you have any questions regarding this report, please contact Mark Haskins, Director of Policy Development at (804) 371-2296 or mark.haskins@tax.virginia.gov.

Sincerely,

A handwritten signature in black ink, appearing to read "Janie E. Bowen".

Janie E. Bowen
Tax Commissioner

JEB/kp
Enclosures



INCENTIVE AND PENALTY OPTIONS TO ENCOURAGE THE CORRECT ALLOCATION OF THE LOCAL RETAIL SALES AND USE TAX



**Submitted Pursuant to Item 270(K) of House Bill
1600, the Appropriations Act
for the 2008-10 Biennium**

Virginia Department of Taxation

Janie E. Bowen
Tax Commissioner

Preface

Authority

Item 270(K) of House Bill 1600, the Appropriations Act for the 2008-10 Biennium (2009 *Acts of Assembly*, Chapter 781) instructs the Virginia Department of Taxation (“TAX”) to provide a report to the Senate Finance and House Appropriations Committees outlining potential incentives for retailers who properly and accurately report the local Retail Sales and Use Tax, as well as penalties for those who err in reporting. The Appropriations Act mandates that the report be completed no later than September 1, 2009.

Staff Assigned to Report

William J. White, Assistant Tax Commissioner, Office of Tax Policy
Mark C. Haskins, Director, Policy Development Division
Lawrence E. Durbin, Assistant Tax Commissioner, Office of Customer Service
Joseph E. Mayer, Lead Tax Policy Analyst, Policy Development Division
Kristen D. Peterson, Tax Policy Analyst, Policy Development Division

Table of Contents

Executive Summary	i
Section I: Overview of the Local Retail Sales and Use Tax	1
Section II: Errors in the Allocation of the Tax	4
Section III: Efforts to Remedy the Problem	6
Section IV: Potential Incentives and Penalties	11
Appendix A: Item 270(K), 2009 Appropriations Act	A-1
Appendix B: Sample Reports and Forms	B-1

INCENTIVE AND PENALTY OPTIONS TO ENCOURAGE THE CORRECT ALLOCATION OF THE LOCAL RETAIL SALES AND USE TAX

EXECUTIVE SUMMARY

Item 270(K) of House Bill 1600, the Appropriations Act for the 2008-10 Biennium (2009 Acts of Assembly, Chapter 781) requires the Virginia Department of Taxation (“TAX”) to provide a report to the Senate Finance and House Appropriations Committees outlining potential incentives for taxpayers who accurately report the local Retail Sales and Use Tax by locality, as well as penalties for those who err in reporting the tax. The Appropriations Act mandates that this report be completed by September 1, 2009.

In addition to requiring this report, Item 270(K) mandates that TAX: 1) secure and utilize software based on Global Positioning System (“GPS”) data in order to properly allocate the local Retail Sales and Use Tax; 2) modify remittance forms to require that each in-state vendor filing a consolidated return report the number of places of business that he maintains in each locality; and 3) provide localities with increased computer systems access to information-only data in order to facilitate local input in error identification. In addition to discussing incentives to encourage accurate reporting of local sales tax, this report provides a status on these mandates.

Inaccurate reporting of the local Retail Sales and Use Tax by businesses has been a longstanding problem for Virginia localities since the inception of the tax in 1966. When a business erroneously assigns the local Retail Sales and Use Tax from a transaction to the wrong locality, the locality entitled to the revenue will experience a loss of revenue. Even if the error is discovered before the statute of limitations to correct the error has expired, allowing TAX to resolve the issue through a transfer, the locality to which the revenue was initially allocated may experience a hardship because it may have already budgeted or spent the funds for local needs.

Although the impact of this problem varies widely across the Commonwealth, it has been a particular source of consternation for only a handful of localities. The problem is more acute in counties adjacent to cities where areas of the counties have a mailing address incorporating the name of the city. One example often cited is Henrico County. In 2009, Henrico County was able to have the United States Postal Service rename sixteen ZIP codes with a “Richmond, Virginia” address which were located entirely in Henrico County to “Henrico, Virginia.” Also, years before the ZIP code change, Henrico County began implementing programs to carefully track Retail Sales and Use Tax revenues to ensure that they were properly attributable to Henrico County.

Over the years, TAX has also worked to minimize the erroneous assignment of the local Retail Sales and Use Tax by improving its procedures for businesses to register for the tax and file returns. TAX recently enhanced the software it uses to allocate local taxes by upgrading to GPS software that is expected to improve the accuracy of locality distributions. TAX also recently updated the schedule used by

consolidated filers, Form ST-9B, Schedule of Local Taxes, to add a column for businesses to provide the number of locations they operate in each locality. These changes are expected to minimize the confusion among consolidated filers regarding the correct locality to which taxable transactions should be assigned.

In 2008, TAX began to review transactions closely that out-of-state merchants are not able to assign to a particular locality to determine the locality to which the allocation should have been assigned. As a result, TAX has seen a decrease in the volume of transactions that out-of-state merchants are unable to assign to a particular locality. TAX has also implemented systems improvements to minimize the potential for human error and further improve processing accuracy.

Despite these efforts, the problem of erroneous local sales tax assignment persists, as evidenced by the fact that TAX currently performs approximately fifty locality transfers per month. In response, some localities have suggested that the problem could be reduced if retailers were provided an incentive for properly allocating the tax or were penalized for erroneous allocations. This report sets forth several incentive options that have been proposed to encourage retailers to properly register to collect the Retail Sales and Use Tax, timely inform TAX of changes to business locations, and utilize software certified by TAX to properly allocate the local sales and use tax. All of the incentives presented would provide a local dealer discount similar to the existing state dealer discount used to compensate retailers for accounting for and remitting the state Retail Sales and Use Tax.

Similarly, this report considers penalties that have been proposed for the erroneous assignment of local sales and use taxes. These proposals would penalize retailers who fail to properly register for collection of the local Retail Sales and Use tax, fail to notify TAX of new or changed business locations, or fail to utilize TAX-certified software. While imposing a penalty for these violations would likely decrease the number of erroneous local Retail Sales and Use Tax allocations, penalties could discourage dealers with no nexus with Virginia from voluntarily collecting the Virginia Retail Sales and Use Tax, potentially causing a larger revenue issue.

Retail merchants and businesses appear resistant to the concept of being penalized for incorrectly allocating local revenues. There may be some Virginia localities that are equally resistant to the concept of using local Retail Sales and Use Tax revenues to reward dealers for correctly allocating local revenues. Accordingly, while TAX has considered several options in this report, TAX is not recommending any particular proposal.

SECTION I - OVERVIEW OF THE LOCAL RETAIL SALES AND USE TAX

Components of the State and Local Retail Sales and Use Tax

Virginia's state and local Retail Sales and Use Tax encompasses three separate and mutually exclusive taxes: 1) a sales tax; 2) a use tax; and 3) a consumer use tax.

For the privilege of making retail sales in Virginia, a seller is subject to a sales tax imposed on its gross receipts from retail sales of tangible personal property. The seller collects the tax from the customer by separately stating the amount of the tax and adding it to the sales price or charge. Retail sales are defined as sales to a consumer or to any person for any purpose other than for resale. The tax also applies to the furnishing of transient accommodations and the lease or rental of tangible personal property as part of an established business.

Generally, any person or business engaged in the sale at retail or distribution of tangible personal property in Virginia constitutes a dealer. The definition of "dealer" set forth in *Va. Code* § 58.1-612 also includes those who rent, lease or furnish items that are subject to the tax in Virginia, or who store such items for use or consumption in Virginia. Any individual or organization meeting the definition of "dealer" who has sufficient activity within the Commonwealth to require registration under *Va. Code* § 58.1-613 must register to collect and remit the tax. Dealers collect the tax from their customers by separately stating the amount of the tax, adding it to the sales price or charge, and subsequently remitting it to TAX. A Virginia dealer is required to file Form ST-9, Virginia Retail Sales and Use Tax Return or Form ST-9 CO, Virginia Retail Sales and Use Tax Return – Consolidated. In addition to these forms, consolidated filers must also file Form ST-9B, Schedule of Local Taxes.

Since the 1960s, all states that impose a sales tax have also imposed a complementary use tax.¹ The primary purpose of this tax is to prevent the sales tax from placing in-state merchants at a competitive disadvantage with retailers outside of the state. In Virginia, the use tax is imposed upon the storage, use, or consumption of tangible personal property within Virginia, and applies to items purchased by Virginia individuals and businesses from retailers who are not located in Virginia. As an example, a Virginia-based Information Technology Service Provider may purchase computer equipment from an out-of-state manufacturer for use in a Virginia contract. In this scenario, use tax is owed on the computer equipment.

The legal liability for the use tax rests with the purchaser. Retailers are only required to register and collect Virginia's Retail Sales and Use Tax if they have some type of physical presence within Virginia². Having a physical location or being legally required to collect the tax is generally considered "nexus." Without nexus, federal case law generally prohibits states from mandating that out-of-state dealers collect sales and

¹ Due, John F. & Mikesell, Jon L. *Sales Taxation: State and Local Structure and Administration*, 1983; 245.

² *Quill Corp v. North Dakota*, 504 U.S. 298 (1992)

use tax. Even so, many out-of-state vendors voluntarily collect the tax and forward it to TAX as a courtesy to their customers. Out-of-state dealers who voluntarily collect the tax must register for Out-of-State Dealer's Use Tax and must file Form ST-8, Virginia Out-of-State Dealer's Use Tax Return, along with Form ST-6B Schedule of Local Taxes.

Finally, the Consumer's Use Tax is imposed upon individuals and businesses that make purchases in excess of \$100 during the taxable year from out-of-state mail order, telephone, or television shopping services, provided the seller did not collect the Virginia Retail Sales and Use Tax. Consumers may also be liable for the consumer's use tax if they purchase an item tax-free outside Virginia and bring the item back to be used within the Commonwealth. However, Virginia grants a credit to any person who purchases tangible personal property in another state and who has paid a sales or use tax on the property in the state of purchase. The credit does not apply if the tax is erroneously charged or incorrectly paid in the other state.

Businesses that do not make any retail sales but incur a use tax liability for their taxable use of property in Virginia must register for Business Consumer Use Tax and file Form ST-7, Virginia Business Consumer's Use Tax Return. On this form, the business reports the cost price of tangible personal property arising from all taxable transactions on which the Virginia Retail Sales and Use Tax was not collected by the seller.

Individuals who owe the Consumer's Use Tax because they were not charged the sales tax on a purchase of tangible personal property are liable for Individual Consumer Use Tax. These individuals must file either a Form CU-7, Virginia Consumer's Use Tax Return for Individual, at the end of the taxable year or report the tax on their Virginia income tax return.

Allocating the Local Sales and Use Tax

The state Retail Sales and Use Tax is imposed at a rate of 4%. In addition to the state tax, all Virginia cities and counties impose a 1% local Retail Sales and Use Tax. The law requires that revenue from the local tax be distributed to the locality in which the sale was made, while revenue obtained from out-of-state dealers collecting the local use tax is distributed to the locality to which the tangible personal property is destined. In order to ensure that the proper localities receive the benefit of the tax, in-state retailers must maintain accurate and current records of their retail locations. *Code of Virginia* § 58.1-606(E) also mandates that out-of-state dealers with certificates of registration collecting use tax must, to the extent reasonably practicable, break down their shipments into Virginia by cities and counties so as to show the locality to which the goods are destined. Unassigned use tax revenues are allocated in proportion to the amount of assigned revenues that each locality receives. While TAX administers the distribution of the tax revenue to the various localities, it depends largely upon the accuracy of the retailer's returns to make the proper allocation.

Registration and Return Filing

When a Virginia retailer enters into the business of making retail sales, he is required to submit a registration application, Form R-1, Business Registration Application, to TAX or to complete TAX's online business registration application. Each registration form contains a request for the physical address of each business location at which retail sales will occur. Using this information, TAX is able to identify the locality entitled to receive the 1% local sales tax distribution.

In processing sales tax returns, TAX encounters three types of filers: 1) the single location filer; 2) the combined location filer; and 3) the consolidated filer. As the names suggest, a single location filer has one location in one locality, while a combined location filer has multiple stores in one locality. By contrast, a consolidated filer has multiple locations in multiple localities. The proper form each retailer is required to file depends upon the filing status of the retailer.

Both single and combined location filers are required to file Form ST-9, Virginia Retail Sales and Use Tax Return. Dealers filing Form ST-9 do not need to provide a breakdown of sales by locality because that information was already provided at the time of registration. Consolidated filers are required to file the ST-9 CO, Virginia Retail Sales and Use Tax Return along with Form ST-9B, Virginia Schedule of Local Sales And Use Taxes.

The process for out-of-state retailers registering for and collecting local use tax differs from the process for collecting local sales tax. When an out-of-state retailer who does not have nexus with Virginia voluntarily registers to collect Virginia use tax, he must submit Form ST-8, Virginia Out-of-State Dealer's Use Tax Return, along with Form ST-6B, Schedule Of Local Taxes, in order that he may assign his local use tax by locality. If the out-of-state retailer does not know the proper locality, he may report the local use tax collected as "unassigned." Later, these unassigned funds are placed in the "unassigned 300 account."

Filers are required to remit their returns and payments to TAX by the 20th of every month for sales that occurred in the previous month. Using registration information and information obtained from the returns, TAX makes the local allocations on a monthly basis. Once all of the assigned revenues have been allocated, the unassigned revenues are allocated in proportion to the amount of assigned revenues that each locality receives. An amount is also deducted from the local tax as reimbursement for the work TAX does to administer the local Retail Sales and Use Tax. Given that distributions occur once a month, it is imperative that TAX process incoming returns quickly, as localities are dependent upon their distributions as an important source of revenue. TAX makes distributions to the localities between the 6th and the 10th day of every month following the month in which the return is filed. For example, tax returns for sales occurring in July are due to be filed by August 20 and distributed September 6th through 10th.

SECTION II – ERRORS IN THE ALLOCATION OF THE TAX

Returns filed by businesses may contain errors in the allocation of the tax that result in revenue being distributed to an incorrect locality or improperly distributed to the unassigned 300 account. Misallocations frequently occur for both sales tax accounts and out-of-state dealers' use tax accounts.

For sales tax accounts, misallocations frequently occur as a result of errors made by both consolidated and non-consolidated filers in registering to collect the sales tax.

For example, if a single location dealer registers with TAX using the wrong locality, subsequent payments will automatically be assigned to the wrong locality. Similarly, if a dealer moves to another locality and fails to notify TAX of the change in address, TAX will continue to assign distributions to the original locality.

Consolidated filers face more complex issues that make it much more difficult to properly assign sales to the correct locality. A consolidated filer whose tax functions are located out-of-state may be unfamiliar with Virginia locality boundaries and assign sales to the wrong locality. A consolidated filer may open a new store and neglect to register the new store with TAX, even though they collect and remit the tax. A new shopping center may be constructed on the border between two localities and the retailer may not know the correct locality of his business.

Similarly, incorrect distributions may result from confusion or negligence on the part of non-fixed filers, who, unlike fixed filers, make sales from varied locations. For example, a seller of antiques who makes sales at various flea markets is a non-fixed filer. TAX requires that non-fixed filers provide every location in which they conduct business for each filing period. Fixed filers may fail to properly document each flea market location in which sales are made, and thus, fail to report each location as required by TAX.

While mistakes in local sales tax allocations are generally attributed to human error by taxpayers, misallocations of use tax are largely attributed to retailers' failure to use accurate software programs to identify the jurisdiction where their customer received his purchase. Some taxpayers use software that uses the ZIP Plus Four mailing address. Other retailers use software that uses the five digit ZIP code mailing address. Many of the larger out-of-state companies may use software that is capable of allocating the use tax with greater accuracy. Smaller companies may not have access to these sophisticated software systems. As a result, revenue is incorrectly placed in the unassigned 300 account or assigned to the wrong locality. Smaller retailers may even rely on the purchaser's mailing address to identify the correct locality. Confusion results because of the unique nature of Virginia's local government structure, in which cities and counties are distinct political entities without any overlapping taxing authority. This confusion is compounded by mailing addresses and ZIP codes that cross over multiple jurisdictional boundaries and localities with similar names, e.g., Richmond County and Richmond City.

In addition to these errors, incorrect distributions sometimes occur because of human errors made by TAX staff during processing. When paper tax returns are submitted to TAX, the information on the returns must be captured and keyed into the system that controls the locality distribution process. The data capture process includes both automated and manual processes. TAX staff involved in the manual capture of data and in the back-end reconciliation of “problem” returns can make mistakes that may cause an incorrect distribution. Although TAX’s systems are programmed to minimize the potential for human error via prompts, edits, and systematic processing rules built into TAX’s systems, human error can still occur.

What Happens if an Incorrect Distribution Occurs

Typically, incorrect allocations are discovered by localities and reported to TAX. *Code of Virginia* § 58.1-605(F) sets forth the process for transferring improperly allocated local taxes to the correct locality. Corrections and adjustments in payments must be made within three years of the date of the payment error. Erroneous allocations made more than three years earlier cannot be corrected, even if the error is discovered. *Code of Virginia* § 58.1-605(F) requires that errors be corrected and adjustments be made in the payments for six months following the discovery by allocating one-sixth of the total adjustment to each monthly payment for the next six months.

When a locality discovers that a distribution has been incorrectly assigned to another locality, it must submit a Locality Transfer Request Form to TAX, requesting a correction. The form requires a signature from both the locality requesting the transfer and the locality to which the funds were incorrectly assigned. If the locality in receipt of the incorrectly allocated funds does not respond within sixty days with its signature, the requesting locality may send the unsigned form to TAX, which will typically grant the transfer. Currently, TAX performs approximately fifty transfers per month. Viewed in isolation, this number may seem high; however, TAX processes more than 92,500 local sales and use tax payments monthly.

SECTION III - EFFORTS TO REMEDY THE PROBLEM

The erroneous allocation of local Retail Sales and Use Tax revenues by dealers has a negative impact on TAX and localities. The process of identifying incorrect allocations and having them corrected is time consuming for both TAX and localities. Unless an erroneous allocation is corrected, one or more localities will experience a revenue gain at the expense of the locality entitled to the distribution. If the incorrect allocation is identified and corrected, the correction will deprive one or more localities of revenue that may already have been budgeted and spent. Consequently, TAX and localities have worked independently and collaboratively to reduce this problem.

TAX's Efforts

In recent years, TAX has implemented several measures to identify and correct erroneous assignments.

TAX formed the Accurate Distribution of Sales Tax Revenue Team in 1997 to make recommendations in order to improve the correct distribution of revenues by developing partnerships with localities and other interested parties to ensure accurate distributions. The team reviewed the Locality Pending Transfers in Progress Summary³, which displays information on locality transfers in progress.

On a monthly basis TAX provides each locality with a monthly Locality Distribution Report⁴, which provides details by business of the distribution received by the locality. TAX also distributes a monthly "New Sales Tax Dealers for the Month Report⁵" to each locality. This report lists new business registrations and changes to existing business registrations. TAX encourages each locality to carefully review each report, compare it to the locality's records, and notify TAX of any discrepancies.

In 2008, TAX began to review transactions closely that were allocated to the 300 unassigned account in an effort to determine if some of the transactions could be assigned to a locality. TAX was able to educate numerous taxpayers who were incorrectly assigning transactions to the 300 unassigned account. As a result of these efforts, the volume of transactions assigned to the 300 account has declined significantly.

Allocation errors could be reduced if more taxpayers utilized the electronic filing options currently available to them. If all taxpayers electronically filed their Retail Sales and Use Tax returns, the risks of human error by taxpayers and TAX staff would be reduced. TAX's return and payment processing functions must combine speed and accuracy. Processing paper returns and check payments is labor intensive and time-consuming, but must be rapid to allow TAX to distribute funds to the localities in a timely

³ See Appendix B-1

⁴ See Appendix B-2

⁵ See Appendix B-3

manner. If TAX made electronic filing mandatory, this would reduce errors while capturing more detail from each taxpayer and would have little impact on the speed of the locality distribution. This alternative, however, is likely to be resisted by small merchants. TAX is actively working to identify and implement systems improvements that will ameliorate the allocation problem.

Correctly allocating the local Retail Sales and Use tax requires an understanding by retailers as to the process involved. TAX plans to increase its efforts to educate taxpayers as to the importance of accurate locality allocation. This will be accomplished by updating sales tax forms, instructions, correspondence, and online information resources to include more information to taxpayers that focuses on the mechanics of filing and paying the Retail Sales and Use Tax correctly and the importance of accurate assignment of the local tax. TAX has already begun implementing these education efforts. As discussed previously, Form ST-9 B has been recently revised to include an additional column in which businesses must insert the number of retail locations they operate in each locality. Taxpayers have been sent forms packages with an explanation of this form change. Additional explanations were posted online and emailed to tax practitioners.⁶

With respect to educating TAX staff, TAX created a Learning Support Division several years ago in an effort to provide comprehensive training to TAX staff. Course work is constantly expanding, and TAX has begun developing advanced courses on business taxes.

TAX has recently formed a team responsible for reviewing and analyzing distributions in an effort to locate and correct problems proactively. TAX has intensified its review process by periodically performing quality review checks and actively seeking errors.

Efforts Identified in HB 1600

1. GPS Software

TAX has obtained enhanced software that utilizes GPS technology to more accurately determine the assignment of locality codes to business locations during registration. Effective July 1, 2009, TAX implemented a new version of Trillium, an address perfection and standardization software package. This software provides geo-coded Federal Information Processing Standards ("FIPS") code information that significantly improves upon the ZIP code based software previously used by TAX to validate and assign locality codes to businesses' tax accounts. FIPS codes are numeric codes defined by the United States federal government to uniquely identify states and counties within the United States, certain U.S. possessions, and certain freely associated states. The FIPS code assigned to a business' tax account is for the distribution of local sales revenue to a locality for businesses that operate within a single locality. TAX met with numerous vendors and submitted sample addresses for FIPS

⁶ See Appendix B-5

code assignment and each vendor's test was hand validated by TAX's staff to determine accuracy. This enhancement should significantly improve the assignment of FIPS codes for business tax accounts located in areas whose ZIP codes cross locality boundaries. With the implementation of the Trillium Geo-Code Address software, TAX's FIPS code assignment accuracy is anticipated to increase. Performance testing using the new Trillium software resulted in a statistically significant improvement in accuracy in areas in which assigning FIPS codes has been problematic. This tool is being used by both TAX's web-based registration application and by TAX's internal registration system, thereby ensuring that all registrations are validated.

2. Modify Remittance Forms

TAX has also updated the schedule used by consolidated filers, Form ST-9B, Schedule of Local Taxes, to add a column filers must complete providing the number of locations the filer has in a particular locality⁷. A consolidated sales tax filer is a taxpayer with multiple business locations in multiple localities. Many of the largest retailers in Virginia are consolidated filers. Consolidated filers report taxable sales by locality, aggregating the sales for all business locations within each locality. If a consolidated filer incorrectly reports taxable sales for a business location to the wrong locality, then the local distribution will be incorrect. Effective with their July 2009 return, consolidated filers are required to provide the count of business locations in each locality on the Form ST-9B, Schedule of Local Taxes. The information provided by the consolidated taxpayer on each return filed will be compared to the business location information maintained in TAX's registration database systems. Whenever the count for a locality reported by the business does not match TAX's system, the account will be flagged for review and the discrepancy investigated and resolved.

3. Systems Access by Localities

TAX is actively working with localities on a list of issues and enhancements to include access to additional information. Priority areas for localities will be worked on as TAX technology resources are available.

Local Efforts

Although the impact of this problem varies widely across the Commonwealth, it has been a particular source of consternation for only a handful of localities. The problem is most often reported in counties adjacent to cities such as Richmond, Fredericksburg, Williamsburg and Lynchburg, as well as in Fairfax City and Fairfax County.

Henrico County is one of the localities impacted by this problem. Its border with the City of Richmond is long and runs through heavily developed areas. Until 2009, sixteen ZIP codes located entirely within Henrico County carried a "Richmond, Virginia" address. As a result, Henrico County has dedicated substantial resources to resolving

⁷ See Appendix B-4

the problem. In 2003, Henrico County contacted the United States Postal Service to seek assistance in resolving the postal issue. The Postal Service agreed to conduct a survey of Henrico County citizens to gauge interest in changing the mailing address of these ZIP codes. If a majority of participants responded in favor of replacing the “Richmond, Virginia” mailing address with “Henrico, Virginia” for those ZIP codes, the Postal Service agreed to make the change. Henrico County citizens voted in favor of this change, and on January 1, 2009, the formal transfer of the sixteen ZIP codes was implemented.

Years before the ZIP code change, Henrico County began implementing programs to track retail sales reported by Henrico businesses. In 1998, the County established a program to review the accuracy of the registrations of newly registered sales tax dealers in Henrico County and the City of Richmond. Additional efforts have included verifying that local businesses are using correct locality codes on their sales tax returns, comparing sales tax registrations of Henrico County dealers with Henrico’s business license records, and reviewing exception reports provided by TAX of businesses which appear to be miscoded based upon ZIP code criteria.

Localities have tools at their disposal to curtail the erroneous allocation of local sales and use taxes. Localities maintain lists of taxpayers for purposes of the local business license tax, the personal property and the merchants capital tax that contain information as to businesses within the locality. Also, TAX provides localities with a variety of reports that can be used to monitor local Retail Sales and Use Tax allocations on a monthly basis. For example, each locality receives the Locality Distribution Report, which contains information concerning the local distribution, as well as the amount of funds distributed to the 300 unassigned account. TAX also distributes monthly a New Sales Dealers for the Month Report with information regarding newly registered businesses and changes to previously registered businesses. Localities also have access to sales tax accounts maintained in IRMS for businesses in up to twenty localities. Localities can use these tools to play a larger role in identifying allocation errors. Some localities have been diligently utilizing the reports provided by TAX to identify errors, while others are not able to devote resources to this effort.

Localities can also address the problem of erroneous allocations of local sales and use taxes by identifying and reporting to TAX situations where the locality is receiving local sales and use taxes that should have been reported to another locality. For example, the City of Lynchburg looks for businesses located in surrounding counties that are allocating their local sales and use taxes to the City. This practice limits the impact on the City of Lynchburg of any transfers necessary to correct the erroneous allocations.

Localities can also help dealers to properly register and allocate the tax to the correct jurisdiction. For example, when some localities issue a new business license, they provide the licensee with a Virginia Sales and Use Tax registration packet with the correct locality code preprinted. Local tax officials can verify that each business in the

locality with a Retail Sales and Use Tax liability is using the correct locality code on its tax registration and returns.

Localities can also use their knowledge of activities taking place in their locality that should result in a local Retail Sales and Use Tax liability. For example, if a large construction project is undertaken in a particular locality, there should be significant amounts of use tax being reported by contractors.

Legislation

In the past fifteen years, legislation has been introduced in the General Assembly several times that sought to prevent the erroneous assignment of local Retail Sales and Use Tax revenues. For example, House Bill 2472, introduced in the 1997 legislative session, would have required that use tax revenues assignable to a ZIP code that serves more than one locality be apportioned on the basis of the populations of the portions of the localities within the ZIP code area. A similar bill, Senate Bill 618, was introduced in the 1999 legislative session. Both bills failed to make it out of their respective finance committees. That same year, Senate Bill 1064 (1999 Acts of Assembly, Chapter 0156) was enacted, which required the Tax Commissioner to develop a uniform method to distribute local use tax. Significant changes in the method of distribution had to be phased in over a five year period. TAX worked with local officials and major tax software vendors to enhance the accuracy of the ZIP code based approach that was being utilized prior to enactment of Senate Bill 1064.

Recent bills have unsuccessfully sought to improve the software that businesses use to assign local Retail Sales and Use Tax revenues to a given locality. House Bill 2874, introduced in the 2007 legislative session, would have authorized TAX and representatives from local governments to develop a list of certified software products, the use of which would entitle dealers to a discount based on a percentage of the local tax and limited to the purchase price of the certified software. Two years later, Senate Bill 1474 was introduced, which would have provided an additional dealer discount to retailers using certified software products and would have eliminated the existing dealer's discount for those retailers who do not use a certified software product to account for and remit the local tax. Small dealers would have been exempt from this requirement.

SECTION IV – POTENTIAL INCENTIVES AND PENALTIES

In the 2007 General Assembly Session, House Bill 2874 was proposed to encourage retailers to properly allocate the tax, by providing a local dealer discount, in addition to the existing state dealer discount, for utilizing software certified by the Department of Taxation to allocate the tax. Similar legislation was introduced in 2009, Senate Bill 1474, again proposing a local dealer discount as an incentive for utilizing the certified software, but removing the existing dealer discount for those retailers who elected not to use TAX's certified software.

Incentives

Under *Code of Virginia* § 58.1-622, a discount is available to certain dealers to relieve them of a portion of their state Retail Sales and Use Tax liability in order to compensate them for accounting for and remitting the state tax. As set forth below, dealers are given a percentage amount of the first three percent of the state sales and use tax levied, provided they timely submit their returns and timely pay the amount due. Currently, there is no discount offered on a retailer's local Retail Sales and Use Tax liability.

Monthly Taxable Sales	Percentage
\$0 to \$62,500	4%
\$62,501 to \$208,000	3%
\$208,001 and above	2%

There are a variety of additional incentives Virginia could offer retailers that may encourage the proper allocation of the local sales and use tax.

OPTION 1 – Local Sales Tax Discount, Sliding Scale

Option 1 would provide a discount to retailers on their local tax liability. The discount could be made available for all retailers who elected to use software certified by TAX to allocate the local tax. Like the current dealer discount available on certain dealers' state Retail Sales and Use Tax liability, the discount could be offered on a sliding scale. Retailers could receive a 4% discount of the 1% local sales tax if their monthly taxable sales fall between \$0 and \$62,500. Retailers with monthly taxable sales between \$62,501 and \$208,000 could receive a 3% discount of the local sales tax. Retailers with monthly taxable sales of \$208,001 or more would receive a 2% discount of the local sales tax.

OPTION 2 – Local Sales Tax Discount, Fixed Amount

Option 2 would offer a similar discount from the local sales and use tax for the use of software certified by TAX. Rather than imposing the discount according to a schedule, Option 2 could grant a discount at a flat rate of 2% of the 1% local sales tax.

As with the 2007 legislation, both Option 1 and Option 2 could require that every retailer annually certify to TAX the use of the certified software product in order to be eligible for the discount.

OPTION 3 – Discount for Proper Registration

Option 3 would provide a local Retail Sales and Use Tax discount to all retailers who remain properly registered with TAX. Using the monthly reports distributed to localities, the local sales tax schedules that accompany sales tax returns, and any information submitted by local officials, TAX could track sales tax locations for given retailers and determine whether their registration information is current, and offer a one-time, 1% discount for every five-year period in which a retailer remains properly registered and makes no allocation mistakes.

Pros of Proposed Incentives

Each of the proposed options set forth above would likely motivate retailers to change their behavior. Retailers who currently use less sophisticated software may be motivated to purchase more developed software if they were offered a discount in exchange. Retailers who are careless in documenting and reporting changes in their business locations may work harder to ensure that TAX is notified of any registration changes if a discount is offered as an incentive.

Options 1 and 2 are also consistent with the Streamlined Sales Tax Agreement's ("SSUTA")'s provisions concerning Certified Automated Systems ("CAS's"), which are software programs certified under the SSUTA to calculate the tax imposed by each jurisdiction on a transaction, determine the amount of tax to remit to the appropriate state, and maintain a record of the transaction. Given the Streamlined Sales Tax Project's current process of certifying software, it would not be difficult for TAX to implement a similar software certification process, modeled after the SSUTA's.

Cons of the Proposed Incentives

Each of the proposals above would provide a discount from the Local Retail Sales and Use Tax. Because some localities are not impacted or only minimally impacted by local sales and use tax misallocations, these localities may resist the use of local revenue for this purpose.

Option 3 raises a number of additional concerns. It may be difficult for TAX to track the number of businesses that are not properly updating their registration status. Further, this option could potentially reward retailers who continue to misallocate use tax because they are not using suitable software.

Any option that would require TAX to certify software and to maintain an incentive system, available only to a limited number of dealers, would create substantial

costs for TAX. In 2007 when TAX prepared a Fiscal Impact Statement for HB 2874, TAX estimated that it would cost approximately \$500,000 to redesign and reprint forms, inform dealers of the requirement to register with TAX in order to receive the dealer discount, and hire additional staff for software evaluation and error resolution.

Penalties

Another possible option would be to impose a penalty upon retailers for their role in misallocating the local sales tax by disallowing the current dealer's discount for those retailers.

Option 4 – Limit Dealer Discount

Option 4 would limit the dealer discount for retailers that fail to utilize TAX-certified software. Retailers that fail to utilize TAX-certified software to allocate local Retail Sales and Use Taxes would only be entitled to 50% of the state dealer discount.

Option 5 – Eliminate Dealer Discount

Option 5 would totally eliminate the state dealer discount for any retailer who elected not to utilize the Tax-certified software.

Pros of the Proposed Penalties

Like the incentives set forth above, these penalties would likely motivate some retailers who currently use less sophisticated software to purchase and utilize the TAX-certified software.

Cons of the Proposed Penalties

Each of these penalties may require a complete overhaul of some retailers' tax system operations, which may be expensive and unreasonably burdensome. The possibility of a complete or partial loss of their dealer discount may be insufficient to motivate them to purchase the TAX-certified software.

In addition, Virginia must consider the possible impact of the measure on voluntary compliance by out-of-state retailers who do not have nexus with Virginia. In *Quill Corp v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court opined that, due to the complicated nature of state and local sales tax systems, and their tendency to burden interstate commerce, sellers are not required to collect sales or use tax unless the seller has nexus with the state of the purchaser. Nexus is established based on the amount and form of business activity that a business has in a given state. Nexus must be present before a state can require that an entity collect sales tax. *Code of Virginia* § 58.1-612 sets forth the activities that give rise to nexus in Virginia. A retailer who maintains a place of business of any nature in Virginia will be

deemed to have sufficient nexus in accordance with *Code of Virginia* § 58.1-612. Retailers who solicit business in the Commonwealth through employees, independent contractors, agents or other representatives are also deemed to have nexus in the state of Virginia.

Some retailers without Virginia nexus choose to voluntarily register to collect and remit the Virginia Retail Sales and Use Tax, though they are under no legal obligation to do so. Once a retailer registers with TAX, whether voluntarily or by mandate of statute, TAX has ruled that the retailer is obligated to satisfy the requirements for assigning the local use tax. The voluntary registrant is under the same obligations with respect to properly reporting the Retail Sales and Use Tax as a mandatory registrant. *Code of Virginia* § 58.1-606(E) provides:

Out-of state dealers who hold certificates of registration to collect the use tax from their customers for remittance to this Commonwealth shall, to the extent reasonably practicable, in filing their monthly use tax returns with the Tax Commissioner, break down their shipments into this Commonwealth by cities and counties so as to show the city or county of destination. If, however, the out-of-state dealer is unable accurately to assign any shipment to a particular city or county, the local use tax on the tangible personal property involved shall be remitted to the Commonwealth by such dealer without attempting to assign the shipment to any city or county.

Public Document (“PD”) 89-328 (November 20, 1989) illustrates the principle that there is no distinction between voluntary and mandatory registrants for purposes of satisfying this requirement. An out-of-state direct mail merchandiser wished to voluntarily apply for a certificate of registration to collect and remit the Virginia Retail Sales and Use Tax, but did not want the burden of allocating the local tax among the localities. The Tax Commissioner determined that Virginia law does not authorize the registration of a dealer to collect only the state tax or only the local tax. An out-of-state dealer is required to collect both the state and local tax, and break down shipments into Virginia according to the city or county of destination, to the extent reasonably practicable. Further, the imposition of a penalty in the form of a decrease or removal of the dealer’s discount does not offend interstate commerce, as the dealer discount is an additional benefit extended to retailers for properly and timely collecting the state sales tax. Suspending the benefit of the dealer discount does not amount to an additional tax. As such, TAX may impose a penalty in the form of eliminating or decreasing the dealer discount for voluntary registrants who improperly assign the local Retail Sales and Use Tax.

Though PD 89-328 speaks to the legality of imposing a penalty upon an out-of-state retailer who voluntarily collects use tax for its customers when he or she improperly allocates the tax, it does not address the practicality of imposing such a penalty. If too much pressure is placed upon the out-of-state company to collect the tax properly, that company may elect to stop collecting the tax altogether. Thus, the need for the proper allocation of local sales and use tax must be balanced against the need

for localities to receive local sales and use taxes from out-of-state retailers with no nexus in the state of Virginia. Any penalties associated with the proper allocation of the local sales and use tax, whether in response to the locality's election not to use certified software, or their negligence in properly completing their registration, sales, or use tax forms, provide a disincentive for those dealers to continue to voluntarily collect Virginia's taxes.

Other States

TAX recently surveyed the other forty-five states that currently impose a state sales and use tax regarding the incentives or penalties these states make available to registered dealers.

While none of the twelve responding states provides an incentive for properly assigning the local sales and use tax, several states impose various penalties upon retailers who improperly allocate the tax. Minnesota imposes a penalty in the amount of \$500 for each return on those retailers who file consolidated tax returns, but fail to report location information. Minnesota also authorizes the Tax Commissioner to revoke the privilege for a taxpayer to file consolidated returns and may require the taxpayer to separately register for and file a tax return for each location.

While Virginia's local sales tax rate is uniform across localities, most states have local sales and use tax rates that vary from one locality to the next. This produces a greater need for penalties for businesses who improperly allocate the tax. In these instances, the penalties are generally related to the amount of tax that should have been collected. For example, New York imposes a penalty upon both in-state and out-of-state merchants for any additional tax (including penalty and interest as applicable) if the correct locality has a higher tax rate than the locality that improperly received the tax. Similarly, in Oklahoma, if an incorrect rate is charged for a city or county and the tax is underreported as a result of the retailer's misallocation, the retailer is responsible for any additional tax due. The retailer may also be required to pay a late filing penalty as well as interest.

Based on survey responses, if Virginia rewarded retailers who properly allocate the tax through an additional dealer discount, or imposed a penalty so as to discourage erroneous allocation of the tax, it would be one of only few states to do so. While this may encourage proper allocation of the local tax by in-state retailers, it may result in an adverse impact on local revenues to the extent that it discourages out-of-state retailers with no Virginia nexus from collecting Virginia's use tax.

Conclusion/Recommendation

Retail merchants and businesses appear resistant to the concept of being penalized for incorrectly allocating local revenues. There may be some Virginia localities that are equally resistant to the concept of using local Retail Sales and Use Tax revenues to reward dealers for correctly allocating local revenues. Accordingly, TAX cannot recommend any proposal to provide incentives for retailers who properly and accurately report the local Retail Sales and Use Tax or to provide penalties for those who err in reporting the tax.

Appendix A
2009 Appropriation Act, Item 270(K)

The Department of Taxation shall (1) secure and utilize software based on Global Positioning System data in the allocation to localities of the one percent local option sales and use tax, (2) modify remittance forms as appropriate to require each in-state vendor filing a consolidated return to report how many places of business that the vendor has in each locality, (3) provide localities with increased computer systems access to information-only data in order to facilitate local input in error identification, and (4) report to the Chairmen of the Senate Finance and House Appropriations Committees by September 1, 2009, on options for providing incentives and/or penalties for erroneous reporting of sales and use tax data by merchants.

Appendix B Locality Pending Transfers In Progress Summary

IRMS - External - Microsoft Internet Explorer

File Help

Locality Pending Transfers In Progress Summary

Search Information

FIPS:

Transaction Date	From FIPS	Tax Account Number	To FIPS	Customer Name	Period	Total Amount of Transfer	Amount Transferred	Balance to be Transferred
08/06/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200607-200612	\$34870.40	\$0.00	\$5811.73
09/06/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200607-200612	\$34870.40	\$0.00	\$5811.73
10/06/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200607-200612	\$34870.40	\$0.00	\$5811.73
11/06/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200607-200612	\$34870.40	\$0.00	\$5811.73
12/06/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200607-200612	\$34870.40	\$0.00	\$5811.73
01/06/2010								
	FIPS Unassigned-00300		Fairfax County - 51059		200607-200612	\$34870.40	\$0.00	\$5811.75
08/11/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200901-	\$4286.08	\$0.00	\$714.33
08/12/2009								
	Fairfax City - 51600		Fairfax County - 51059		200601-200901	\$6438.70	\$0.00	\$1073.10
08/16/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200512-200612	\$2817.08	\$0.00	\$469.53
08/17/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200608-200703	\$1742.24	\$0.00	\$290.37
09/17/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200608-200703	\$1742.24	\$0.00	\$290.39
08/26/2009								
	Fairfax City - 51600		Fairfax County - 51059		200603-200810	\$17373.57	\$0.00	\$2895.57
08/26/2009								
	FIPS Unassigned-00300		Fairfax County - 51059		200601-200612	\$2026.32	\$0.00	\$337.72
09/26/2009								

Mock-up example: (Shows only partial for one Locality)

Detailed Information of Distribution Entries for Each Locality

FIPS Code 51001 Accomack

FIPS Code 51001 Accomack

Tax Account Number	FEIN/SSN	Display Name	Tax Period	Amount
10-V00000003F-01	V0-0000003	[REDACTED]	8909	2.68
			8909	2.68
10-V00000004F-01	V0-0000004	[REDACTED]	8907	18.23
			8907	18.23
12-000000002F-00	00-0000002	[REDACTED]	0812	-2.20
			0812	-2.20
10-000000005F-01	00-0000005	[REDACTED]	0803	6.04
			0803	6.04
10-000000006F-01	00-0000006	[REDACTED]	0802	261.41
10-000000007F-01	00-0000007	[REDACTED]	0802	112.50
12-000000008F-01	00-0000008	[REDACTED]	0802	10.57
10-000000009F-01	00-0000009	[REDACTED]	0802	9.19
10-000000010F-01	00-0000010	[REDACTED]	0802	8.59
10-000000011F-00	00-0000011	[REDACTED]	0802	3.46
10-000000012F-00	00-0000012	[REDACTED]	0802	0.37
10-000000013F-00	00-0000013	[REDACTED]	0802	0.32
12-000000014F-00	00-0000014	[REDACTED]	0802	0.01
			0802	406.42

Appendix B
New Sales Tax Dealers for the Month Report

Mock-up

Section I: This section is by each locality

Report ID: 243.0
Run Date:
mm/dd/yyyy

Virginia Department of Taxation
New Sales Tax Dealers Monthly
Report

Page 1

Month: July
2005

Locality: 120 -
Chesterfield

External ID	SSN	Tax Account Number	Business Name and Address	Mailing Address	Transaction Type	BLDELD	Transaction Date
12-3456789	123-12-1234	00-987654321F-001	John Doe Leather Inc. Cloverleaf Mall Richmond, Virginia 23235	John Doe Leather Inc. xxxx West Marshall Street Richmond, Virginia 23230-4717	Closed	04/01/2005	05/31/2005
00-9999999	999-99-9999	11-123456789F-001	Doe Scaffolding Co. Inc. xxxxx Jefferson Highway Richmond, Virginia 23234-2258	Wilbur Doe Scaffolding Co. Inc P.O. Box xxxxxx Durham, NC 27702	Added	06/01/2005	06/24/2005
99-1234567	888-88-8888	99-999999999F-001	ZZZ LLC xxxxxx Midlothian Turnpike Midlothian, VA 23113-4211	ZZZ LLC P.O. Box xxxxxxxx Midlothian, VA 23113-0125	New	06/01/2005	06/16/2005

Appendix B
Sample Email and Form

Dear Tax Professional:

Please find attached a copy of the newly revised Form ST-9B, Virginia Schedule of Local Taxes, that will be implemented with the July 2009 monthly sales and use tax returns for dealers who file consolidated returns on Form ST-9CO. Two major changes have been made to the ST-9B, one to provide new data and one to streamline the existing reporting requirements.

New Data: Column B1, Number of Locations in Locality, will provide critical data to facilitate the proper allocation of local sales and use tax revenues. TAX will compare this column entry with the dealer's account records each month to ensure that we make any necessary changes to business location information in a timely manner.

Streamlined Reporting: Column E/F, Exempt Sales & Other Deductions, combines exempt sales and other deductions from gross sales as a single entry. These items are currently reported in separate categories.

Please share this information with your clients who file the Form ST-9CO, so they can prepare for the new reporting format. TAX will be mailing a letter to all affected dealer's within the next week announcing this change and providing the dealers with a copy of the new Form ST9B. We will also be notifying commercial software companies of this change. If you have any questions, please contact the Tax Professionals Hotline at (804) 367-9286. If your clients prefer to contact us directly, they can reach a representative at (804) 367-8037.

Thank you,

Lee Mikelson
Director, Quality Management Services
VA Department of Taxation