

## WALTER HELLERSTEIN: INNOVATIVE PERSPECTIVES ON THE SALES TAX

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I AM HONORED TO PRESENT THESE FEW WORDS OF tribute to Walter Hellerstein. I have known Wally since we both presented papers at the Paul Hartman Conference at Vanderbilt University, more than 20 years, but knew of and respected him even earlier. I bring a different perspective from the other two contributors in that I have not had the privilege of coauthoring papers with Wally. It is certainly my loss, and hopefully I will have the privilege some time in the future.

Though he looks at issues through the lawyer's keyhole and I through the economist's, there is considerable overlap between our areas of interest so I have followed his work closely for as long as I can remember. Much of his writing has been on the state corporate income tax and the sales tax, topics on which I have much interest. But, I will focus my comments on the sales tax, leaving the corporate income tax for Charles McClure and the legal aspects in the able hands of John Swain.

Wally has been a prolific scholar on sales tax issues, as evidenced by the more than 20 articles and books contained in the reference list. My task would certainly have been easier if he had not been so active in the area. Of course, his work is not only voluminous, but is also of very high quality. Invitations for Wally to participate in the OECD and EU work on consumption taxation and the VAT evidence the high regard that is held for his consumption tax work around the world.

Wally's research topics are obviously very carefully chosen based on the key issues of the day. Following his selection of topics would be a good way to stay abreast of the most important policy issues at a particular time. In the consumption tax area this initially included sales tax on services and more recently sales taxation of electronic commerce and now on to the VAT. His contributions have been substantial and forward looking in each case. His views have not always been the popular ones, even if they are the right conclusions.

Even his choice of the sales tax for research and policy analysis reflects his penchant for selecting important topics. The sales tax was the largest state tax and the second largest state/local (following the property tax) tax when Wally began to write

on the subject. The sales tax has fallen behind the income tax in the state tax dollars generated at least in part because the states (and Congress) have not adequately heeded his counsel.

### HALLMARKS OF HELLERSTEIN RESEARCH

Several features are characteristic of Wally's research and writing. First, his work has considerable *impact*. His work is so well respected that it influences both the setting of policy and the thinking of subsequent authors. For example, he designed much of the broadest experiment with sales taxes on services that we have seen in the tax's history.<sup>1</sup> Elements of his Hellerstein (1997d) on e-commerce can be seen in much subsequent policy thinking, including the current structure of the (Streamlined Sales and Use Tax, SSTP).

Second, he takes a *comprehensive* look at each problem. His analysis consistently examines every dimension of the problem. Obviously he writes on the legal aspects of each issue, but he is not satisfied to leave the problem after only considering the legal dimension. He seeks solutions that account for the full range of effects. One sees economic, administrative, political, technology and the other elements beyond the law that are necessary to fully examine the various problems. While he considers political factors, he never compromises his conclusions.

Third, his research is *thorough*. His writing on how to use billing addresses to situs e-commerce transactions is an excellent example (Hellerstein, 1997a). He analyzes every dimension of the question and does so from the perspective of many different actors. For example, when analyzing where activity should be taxable he examines how to tax an information provider in State A, that employs a server in State B, that sells access to its database in State C to a customer in State D that also uses the data in multiple states, and is billed by a financial intermediary in State E.

Fourth, he looks for *broad* solutions to problems, not for quick fixes or patches. He recognizes that partial fixes often create their own set of difficulties, and the best long-term solution is to bring taxation of services, or taxation of e-commerce

within the broader sales tax and not to try unique solutions. For example, he writes that e-commerce is a chance to fix the sales tax, but the “radical restructuring” should not be carried too far because it must be conducted within the political realities that exist and in ways that do not lead to differential tax treatment that opens opportunities for planning and confusion (Hellerstein and McLure, 2001).

The next two sections review some of Wally’s papers on the sales tax. He has written on these subjects over the course of more than 20 years. His views on many of the issues discussed here may have evolved beyond what he wrote at a particular point in time. So, my discussion should be seen as the contribution that Wally made at each point in time and with recognition that he might reach different conclusions in light of the many things that have changed over the past decade(s).

#### SALES TAX AND SERVICES

Wally’s sales tax research addresses the breadth of the base and the role that the transaction mode plays in sales taxation, going to the very essence of the way the tax operates. Sales taxation of services remains a much-discussed topic today as states routinely consider expansion of the base to services as a means of generating additional revenue. But sales taxation of services was the major state tax topic in the 1980s and Wally’s work was an important reason. Rapid growth in services relative to goods’ consumption was and is continuing to cause states to look for ways to enhance the tax’s elasticity. Electronic commerce was the major sales tax topic of the 1990s and on into this decade, and one that continues to be examined by academics and policy makers such as the Streamlined Sales Tax Governing Board. His work in these major policy areas was begun a little over a decade apart, and one can see the influence of the service’s tax experience in his writing on the electronic commerce.

The narrowness of the sales tax base has been written about for many years, and the desirability of expanding the sales tax base to cover a broader set of transactions, and specifically services, has been discussed. Today, even with the pyramiding that is occurring, the sales tax base is only about 40 percent as large as the economy. The desirability of broadening the sales tax to services has been so widely discussed that it has become an accepted part of tax lore. But, this is often a general statement without

consideration of which services should be taxed and what is required to achieve this objective. An analysis of the case for taxing each service needed to be created, and appropriate methodologies needed to be developed. Wally’s papers offer a very careful look at the difficulty of moving from the rhetoric to the reality of what should/would be taxed and how could the system be implemented. Much of his analysis was specific to Florida, but serves as a very useful basis for taxing services today.

#### Florida’s Attempt to Tax Services

Not surprisingly, Florida was an early entrant into discussions of taxing services because the state has no income tax (an income tax is prohibited by the state constitution) and has a challenge financing services in the rapidly growing environment it was experiencing. The Florida Department of Revenue and the Legislature were seeking to move to broad taxation of services (and elimination of many exemptions) and engaged Wally to develop legislation, defend the tax legally, and provide substantial input into design of broader sales taxation. Identification of Wally as the person to develop the comprehensive legislation evidences early recognition of his talents. He subsequently made very strong contributions to the literature on sales taxation of services. Of course, some of what went into the final legislation may not have been of Wally’s design and I apologize if I attribute to him details that he did not support.

In 1986 Florida expressed its intent to broaden the sales tax base to include services but postponed implementation of the tax until 1987. The tax was enacted in April 1987 and became effective July 1, 1987. The tax was repealed less than six months later on December 1, 1987. Many services, such as advertising, legal, accounting, and construction were made taxable but other services, such as medical, health, and education, were left exempt. This surely reflected a balancing of equity, political, and other considerations. The approach had several unique elements in the sales tax context (even when trying to make goods and services taxation comparable). For example, a relatively comprehensive approach to services taxation on a destination basis (exempt if purchased in the state for consumption out of state) was developed, whereas tangible goods are normally taxable if purchased in a state, even if for consumption outside of the state. The tax also included apportionment for some

services consumed both in and out of Florida, which differs from more common treatment of goods taxation.

### Evaluating Service Taxation

Wally evaluated the case for and against sales taxation of service, with the experience of trying to implement the tax. He summarizes the case for taxing services to include greater revenue for a given tax rate, greater revenue elasticity, ease of administration since goods and services need not be separately stated if both are taxable, enhanced neutrality, and less regressive taxation. He lists three concerns about taxing services. He recognizes the tendency to tax business-to-business transactions under the sales tax but observes that the propensity for pyramiding does not differ from imposition of the tax on goods. The incentives to vertically integrate arise for services, as with goods, but he expects that firms are better able to bring services, such as legal and accounting, in-house making vertical integration of services a bigger concern. Similarly, he believes that evasion associated with purchasing out of state is a larger issue for services than for goods. Of course, a use tax is imposed on out-of-state service purchases, but it is difficult to enforce.

A sales tax on services particularly magnifies the issues with state sales taxes – where cross-state transactions should be taxable and how to exempt business-to-business transactions (which is linked to incentives for vertical integration). These two received most of Wally’s attention. He rightly recognized the importance of imposing the tax on a destination basis. Imposing a destination-based sales tax and corresponding use tax on services proves to be quite difficult in practice (for example, see Hellerstein, 1987b, 1988). Careful rules were developed to implement destination-based taxation when transactions crossed state borders, with separate rules for sales to individual consumers and sales to other purchasers. Transactions were generally exempt if the service was produced in Florida and was enjoyed outside Florida. Otherwise, the rules generally depended on whether the service was linked to real or tangible personal property. The service was regarded as being enjoyed in Florida if it was linked to real property that was located in the state or if the beneficiary received tangible personal property in the state that was linked to the service (such as a will). For other services sold to

individuals, the tax was due if the “greater proportion of the service” occurred in the state and for businesses based on where the firms’ markets were located. The latter sometimes entailed apportionment (Hellerstein, 1987a).

The Florida structure sought to provide a sale for resale exemption, but construed it very tightly. Sales for resale were only exempt after all of a very specific set of five rules was met. These rules effectively required that the intermediary service provider act as a broker, not consume the service, and separately state the service on the invoice. Services that were “consumed” by businesses were generally taxable unless otherwise exempt.

He also examined the legal issues that were raised as attacks against the services tax, including:

- First amendment and taxation of advertising
- Right to counsel and equal protection and taxation of legal services
- Due Process and Commerce Clause

Wally provides broad defense against each of these attacks and generally believes that the legal arguments against taxation do not hold up to careful scrutiny. For example, the first amendment issue requires discrimination against the press, and the Florida services tax did not discriminate. Further, a Florida Supreme Court advisory opinion to the governor indicated that the taxpayer’s arguments were not persuasive. However, the legislation was repealed so none of the cases were seen to their natural ending. But, Wally’s analysis generally provides a sound basis for future taxation of services.

Questions about the constitutionality of the structure, such as nexus, arose as well. His nexus conclusions were determined during the time between the *National Bellas Hess* and *Quill* decisions, so physical presence was required but some people, including Wally, believed that cases such as *Burger King v. Rudzewicz* (1985) indicated that the Court would reach a more liberal view of nexus. *Quill* subsequently continued the physical presence standard.

Apportionment of the sales tax base for certain business purchases was a controversial component that provides an excellent example of Hellerstein’s comprehensive analysis. The question was raised whether the approach stood up to the Due Process and Commerce Clauses of the Constitution. Hellerstein (1997b) viewed apportionment as “being on solid constitutional grounds” because the major

related Constitutional issue was whether the structure precluded double taxation. Florida provided a credit against its tax for taxes paid to other states (in the sense that the tax was not due if paid to another state), which eliminated the potential for double taxation. He concluded that the credit was sufficient to meet Constitutional muster, and apportionment was not even required. The need for apportionment was based more on balancing the political considerations that would arise if other states were not taxing a particular activity (and Florida received all of the revenue) and the administrative concerns associated with apportioning the base (Hellerstein and Kaufman, 1982).

### SALES TAX AND ELECTRONIC-COMMERCE

Hellerstein has authored a number of articles addressing the best ways to handle e-commerce within the income and sales tax structures (Doernberg, Hellerstein, and Li, 2001; Hellerstein and Houghton, 2000). In many ways the sales tax analysis was an extension of his work on sales taxation of services. The ideas that he supports reflect the same elements that are seen in his writing on services taxation: pragmatism, administrability, and so forth. He started by identifying a number of problems, though he correctly observes that the challenge is to find solutions, not to identify the problems. His list included:

- Which state should have jurisdiction to impose sales and income taxes on the activity?
- How will states administer the tax?
- How will taxpayers comply with the tax?

He establishes a number of principles for taxing e-commerce including (1) competitive equality should not be violated (Hellerstein and McLure (2001), (2) uniformity and administrability were essential (Hellerstein, 1997d), (3) nexus rules should be rethought (Hellerstein and Hellerstein, 1998), and (4) double taxation should be avoided (Hellerstein and Hellerstein, 1998; Hellerstein, Hellerstein, and Youngman, 2005). He started with the assumption that the mode of ordering or delivery should not directly affect whether transactions are taxable. Further, the solutions should not include design of special rules for e-commerce, because to do so would create significant gaps between traditional and e-commerce transac-

tions. Instead, he emphasized the need to develop rules that would cover traditional commerce and e-commerce in consistent ways. Thus, he examines key issues, such as nexus and pyramiding, to achieve consistent taxation regardless of the mode for accessing and making transactions (Hellerstein, 1992).

*Nexus* was the first issue that he addressed, and an area where he has made significant contributions to our understanding. He begins where many others have, by talking about nexus based on physical presence and nexus based on economic presence. But, he observes that this does not take us very far because both are nexus based on contacts, whether tangible or intangible and linking taxable presence to contacts is not the best means to achieve a solution.

Instead, he concludes that nexus should be seen as containing two aspects: substantive nexus and enforcement nexus. Substantive nexus refers to whether sufficient linkage exists between the state and the activity, usually arising from residence or source basis. Enforcement nexus refers to the ability to compel payment, which arises from an agency basis or a direct basis. He ultimately concludes that nexus should be “reverse-engineered” meaning we should determine taxable presence so that tax liabilities can be reasonably enforced on all taxable commerce (Hellerstein and Hellerstein, 1998).

Here he takes a very practical bent on the solution by arguing that the nexus regime needs to include certainty for vendors and reasonable administrative costs. This leads to a number of conclusions on the appropriate statutory regime. He makes a case for siting transactions based on the billing address of the recipient. Even here, he does so only after a very careful evaluation of the issue by raising and answering many related questions. A billing address rule is simple and could allow those vendors who follow the system to be relieved from further obligations. He observes the difficulty of identifying the billable address in some cases, and the potential for manipulating the address to reduce or eliminate tax liability. But, he argues that financial institutions can be major players in lessening the burden though the costs imposed on these firms should be taken into consideration as the system is designed (with the possibility for compensation). He also notes that third-party intermediaries, such as telephone companies, are used to collect other taxes so a requirement imposed on

financial firms would not be unique (Hellerstein and Hellerstein, 1998).

Following his intent for e-commerce to be consistent with other aspects of sales tax practice and administration, he sees collection of the tax by e-commerce vendors (and even remote vendors) as an imperative aspect of the tax structure. And, he observes that remittance by registered businesses is appropriate in certain cases (Hellerstein, 1988).

*Pyramiding* is a second issue addressed by Hellerstein. He notes that pyramiding may be more important for e-commerce, which might be relatively more oriented to the sale of services, because fewer exemptions are allowed for resale of services than for goods. But, as with nexus, he argues that pyramiding is a concern that transcends e-commerce. The result is solutions should extend throughout the sales tax, and not be developed only for e-commerce (Hellerstein and Hellerstein, 1998, Hellerstein, 1997a, 1997b, 1997c, 1998a, 1998b, 1999).

*Uniformity, simplicity and administrability* is a third issue that he emphasizes. Here he evidences his broad concern for designing a tax system that works and not just a legal construct. He observes that uniformity, simplicity, and administrability are overlapping and reinforcing. Again, he gets into the details of what this means, raising issues such as uniform definitions, uniform administrative procedures (and all that entails), de minimis rules, and a mechanism for handling local taxes. Each of these issues has become important components of the SSUTA (Hellerstein and Hellerstein, 1998; Hellerstein and Swain, 2005a, 2005b; Hellerstein, 2005).

He observes that treatment of e-commerce must be consistent with federal constitutional concerns arising from the Commerce and Due Process clauses. He points out that certain elements of his proposed solutions, such as a collection responsibility for out-of-state vendors, may not fit with existing constitutional rulings. His main prescription is to seek congressional approval wherever significant concerns exist about the constitutionality of a tax plan to ensure certainty for all players.

Here he asks whether congressional approval can overcome both Commerce Clause and Due Process clause impediments. He quickly answers that Congress can override Commerce Clause concerns. He believes Due Process is the bigger issue because Congress does not have the “power

to authorize violation of the Due Process Clause” in areas where Congress itself is bound – due process violations of individual rights. He notes that the Due Process Clause requires a “definite link” or “minimum connection,” and comments that to achieve this the out-of state taxpayer must purposely direct its activities at the taxing state’s residents (Hellerstein and Hellerstein, 1998).

## CONCLUSION

The few comments provided here just provide the tip of the iceberg of Wally’s many contributions in sales taxation, let alone his impact on tax analysis in other areas. His work has impact, is comprehensive, thorough and broad, and is voluminous. Wally is without a doubt the leading state/local tax lawyer of his generation and his broad writing and keen insights clearly evidence that he exceptionally deserves to be a recipient of the Daniel Holland Award.

## Note

- <sup>1</sup> Of course, a few states, such as Hawaii and New Mexico, already had broad taxation of services.

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