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Effective Third Parties for E-Commerce Taxation

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Objectives of this Proposal

- Minimize audit burden on merchants.

- Create records that are hard to falsify without detection.

- Make effective audits consistent with nexus standards.

- Meet unique requirements of information products (software, digitized music, text, ...)

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Difficulties with Information Products

- Deterring tax evasion is especially difficult.
  - Since a product can be sold many times, inventory records cannot corroborate sales records.
  - Since products are transferred over the Internet, which leaves no trace, shipping records and phone records cannot corroborate sales records.
- Determining the appropriate tax authority and tax rate is difficult.
  - With no shipping address, it is often impossible to determine the location of the buyer.

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According to the
Streamlined Sales Tax System Business and Technology Models

"the CSP can

- calculate the tax due,

- remit the tax to the appropriate state,

- file a return with the appropriate state, and

- maintain a record of the transaction."

These functions are separable.

It should be possible for a third party to provide any of these functions, all of these functions, or any subset of these functions.

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Basic Proposal

- Third parties should perform tax calculation.
  - Use of this function should be voluntary.
  - Merchants will do so to avoid liability for incorrect calculation.
- Third parties should transfer funds to correct state.
  - Use of this function should be voluntary.
  - Merchants will do so to reduce costs.
- Third parties (called *notaries)* should create trustworthy records.
  - Use of this function should be *mandatory.*

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Notaries Create Trustworthy Records

- Merchant submits records for *all* transactions to notary, regardless of location of buyer.
  - To insure compliance, merchant is subject to possible audit by its state, and only its state.
- Third-party "notary" stores transaction record, and merchant identifier.
  - in a form such that subsequently altering or deleting a record would be detectable to an auditor.
  - Notaries are subject to audit from all states.

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Using Encryption as a Tool

It is technically feasible to

- prove whether records have not been altered.
- conduct basic audit of notaries over the Internet
  - Instead of using computer hardware and software that you hope is tamper-proof, store information in view of auditors.
- do this without compromising privacy of consumers or merchants.

These valuable technologies will not be used unless it is a requirement for certification.

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Benefits of Notaries

- Useful for taxation.
  - Trustworthy records for interstate purchases.
  - Merchants not subject to audit from remote states.
  - Simpler audits.
- Trustworthy "proof of purchase" records could also serve other purposes.
  - Protect consumers from fraud (false claims, ...)
  - Protect merchants from fraud (lack of payment ...)
  - Show whether all consumer warnings, warranties, etc. were delivered to consumer.

Determining Buyer's Address with Information Products

- Another third party, a *verifier*, can authenticate the identity of a buyer, and then provide the location of that buyer's home.
  - Note: this may not be the same as the location of the buyer at the instant of the purchase.
- Verifiers can check other credentials too, e.g.
  - whether buyer is officially tax exempt.
  - whether buyer is old enough to purchase liquor.
- These functions need not undermine privacy
  - e.g. a verifier can reveal buyer's home state and not reveal buyer's name.

Summary of This Proposal

- Merchants should be required to use third-party notaries to keep trustworthy records.
  - All states can audit the notary.
  - A state cannot audit a merchant without nexus.
- Merchants should be allowed to use one or more third parties for tax calculations, funds transfers, or both.
  - A third party can decide which services to offer.
- Verifiers can provide buyer location information when there is no other source.

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Some Criteria to Evaluate Proposals

- If a merchant or third party alters or "loses" transaction records, could an auditor tell?

- Can merchants avoid onerous audits, or audits by remote states?

- Can most audits of third parties be conducted over the Internet? (Important because third parties are subject to audit by many states.)

- Would tax law allow the possibility of anonymous purchases?

- Will the system function as well with information-based products? (e.g. software or digitized music)

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No Technology Risks

- **We have designed a system that can achieve all of these goals.**

- Despite claims from some stake-holders, if the policy is carefully crafted, there are no insurmountable technical barriers.

- When the policy is in place, the systems will follow.