Sales Tax Reform: Technology And Escrow Accounts to the Rescue

by William Comiskey

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Imagine a sales tax system in which sales taxes paid by consumers to retailers are automatically and instantly remitted to the state as the sale is completed at the cash register. Imagine too a system that is business friendly because it makes compliance easier for retailers and far less costly. Finally, imagine a sales tax system that increases compliance and revenue, provides a more stable revenue stream, and sharply reduces state administrative and processing costs.

> ***Our current sales tax systems are structured and administered in a way that essentially encourages small and midsized retail businesses to become delinquent.***

Sound impossible? It's not. By harnessing the power of modern technology, by fully (and finally) applying long-standing but often ignored legal principles to govern the relationship between the vendor and the state, and by enlisting licensed professionals to serve as true gatekeepers, states can transform broken and inefficient sales tax programs into models of government efficiency. It can be a new and brighter day for sales tax administrators and for the retailers that bear the burden of collecting and remitting the sales tax.

I. Our Current Sales Tax Systems Are Not Working

Make no mistake: Our current sales tax systems are broken. They are antiquated and costly to administer. They impose staggering and unnecessary burdens on businesses and they are structured and administered in a way that essentially encourages small and midsized retail businesses to become delinquent. And worst of all, our systems lead directly to the loss of millions in sales tax revenue that states and local governments desperately need.

It is a safe bet that each year New York loses hundreds of millions and possibly billions in sales and use taxes that are owed but not paid. Although New York has not published a study on the size of its sales tax gap, California has reported that its sales tax gap (not including its use tax gap) exceeds an estimated $1 billion each year,[1] and a witness before a Florida grand jury estimated that Florida's annual sales tax gap of taxes collected from customers but not paid to the state was as much as $2 billion.[2] Even Minnesota, with significantly less sales activity than New York, estimated that its sales tax gap exceeds $100 million.[3] Those numbers are consistent with other tax gap findings. For example, a 2001 IRS tax gap study found that more than half (54 percent) of taxpayers who operate in the segment of the economy where government has little or no information reporting (which describes a significant portion of the retail market) underreport income.[4] Scholars have estimated that in some corners of the retail market only about half of sales are reported.[5] Those losses are occurring in every state. A Florida grand

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[1]Report of the California State Board of Equalization, "Addressing the Tax Gap, Fiscal Years 2011-2012 Through 2013-2014," *available at* http://www.boe.ca.gov/meetings/pdf/P5_3_082311_Tax_Gap_2_Report.pdf.

[2]"Final Report of the Miami-Dade County Grand Jury," Feb. 7, 2011, at page 27, *available at* http://www.miamisao.com/publications/grand_jury/2000s/gj2010s.pdf.

[3]"Minnesota Sales and Use Tax Gap Project: Final Report," Nov. 19, 2002, *available at* http://taxes.state.mn.us/legal_policy/Documents/research_reports_content_taxgap_full_1102.pdf.

[4]*See* http://www.irs.gov/pub/irs-utl/taxgap021406.pdf.

[5]For example, one article reported that "in the aggregate, small business owners report less than half of their income." Susan Morse, Stewart Karlinsky, and Joseph Bankman, "Cash Businesses and Tax Evasion," 20 *Stan. L. & Pol'y Rev.* 37 (2009), *available at* http://digitalcommons.law.scu.edu/facpubs/48.

jury became so frustrated with widespread sales tax cheating that it opened an investigation of Florida's sales tax collection system and found that the system was "not working" and that the cash-strapped state was losing millions in sales taxes that had been paid to merchants but not remitted. The grand jury urged Florida's authorities to "send a message" by increasing audit and criminal enforcement efforts, clamping down on corrupt tax return preparers who facilitate the cheating, and increasing its collection and use of third-party information to verify vendor returns.[6]

New York's strategy to combat its sales tax gap has been strikingly similar to the strategies recommended by the Florida grand jury. New York's approach has been overwhelmingly based on the concept of deterrence.[7] The message to vendors has been constant — follow the law or you will be caught and face severe consequences! And severe they are. In recent years, New York's laws have been amended to create a litany of civil and criminal penalties that are beyond any imposed by any other state[8] and the tax department has pursued those penalties with unprecedented gusto.[9]

Enforcement is of course important, especially to address those areas of industry in which noncompliance is entrenched. But after-the-fact enforcement does little to prevent noncompliance and it is often too much and too late. No state has the resources to audit every vendor: Audits and investigations are costly and time-consuming, often covering multiple years of ongoing noncompliance. To maximize both audit revenue and deterrent effect, administrators understandably focus on a relatively small number of high-dollar cases or cases of flagrant abuse, leaving untouched the vast majority of cases that operate below the radar. Moreover, even when noncompliance becomes known to regulators, the department is slow to intervene, in part because department enforcement resources are more focused on exposing past violations than in securing immediate correction. Not infrequently, for example, even if the noncompliance becomes apparent to the department during an audit, the taxpayer is allowed to continue without immediate department intervention as the audit meanders to its conclusion and the

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[6]Grand jury report, *supra* note 2.

[7]Between 2007 and 2010, New York ramped up its enforcement resources and activities and pursued record levels of criminal tax fraud investigations and prosecutions. Also, New York has pursued other strategies, similar to those recommended by the grand jury, to close its sales tax gap. New York was the first in the nation to require annual information returns from franchisers, insurance companies, and some wholesalers regarding their transactions with vendors. *See* New York Tax Law sections 1136(i) and 1145(i). It has tirelessly promoted the message of deterrence (just take a look at the volume of press releases on the Department of Taxation and Finance website since 2007) and it is aggressively investing in data acquisition and analysis to help it intelligently select appropriate candidates from its 600,000 registered vendors for audit and investigation.

[8]The steady rollout of new tax enforcement laws enacted in New York in the past five years has been nothing short of amazing. In 2009 New York revamped its criminal tax code to substantially increase the penalties for criminal tax fraud. *See* William Comiskey, "New Criminal Tax Laws, Taking Aim at Tax Evaders," *New York State Bar Journal*, Vol. 81, No. 9, Nov./Dec. 2009, at 10. That same year the state increased the civil penalty for tax fraud to twice the amount of tax evaded. *See* Tax Law section 1145 (a), (i), and (j). In 2009 it increased the penalty for sales tax vendors that fail to maintain or produce books and records to an astonishing quarterly fine of $1,000 for the first quarter and $5,000 for each succeeding quarter. *See* Tax Law sections 1135(h) and 1145(i), (j), and (k). In 2010 New York became the first state in the nation to affirmatively authorize tax whistleblowers to sue tax cheats for treble damages under its false claims act. *See* New York State Finance Law section 189(4). And in 2011 the sales tax law was amended to authorize the commissioner to require delinquent sales tax vendors to open and use escrow accounts for collected sales taxes and, significantly, to compel the vendor to allow the state to have access to those accounts. *See* Tax Law section 1137(e)(3).

[9]*See, e.g., The Wall Street Journal* report on the 2010 spike in sales tax audits of New York City restaurants. Reddy, S., "Eateries in Tax Crackdown," May 18, 2010, *available at* http://online.wsj.com/article/SB10001424052748704314904575250794154630652.html.

tax liabilities accumulate.[10] When the enforcement goal is to generate high-dollar audit assessments, diverting scarce compliance resources to stop vendor noncompliance at its first sign is simply not a high priority.

But enforcement strategies that focus on past delinquencies are not working. States would be far better served by focusing on strategies to prevent noncompliance in the first instance. That analysis should begin with a hard look at the causes of noncompliance.

Sales tax noncompliance is more complicated than a stark choice between those who cheat and those who follow the law. Instead, noncompliance for many is not so much a deliberate choice to cheat as a choice to survive made by vendors facing intense business pressures who fail to prioritize their sales tax obligations over their business obligations. When we hand vendors our money and turn a blind eye when they use it to solve their immediate problems, should we really be surprised that so many take advantage of our carelessness?

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Consider this. When businesses are confronted with serious cash flow challenges, especially in tough economic times, the temptation to use collected sales tax dollars "temporarily" to cover those costs is, for many, too powerful to resist. Should the vendor use collected sales tax dollars to pay a crucial supplier who is threatening to walk away, pay his employees for their work, or put aside that trust money so that he can pay the tax to the state when the payment becomes due at some distant point down the road? When confronted with such a Hobson's choice it is hardly surprising that many businesses take the path that, at least in the short term, is necessary to keep their business going. They pay their immediate business obligations first and hope that somehow things will improve so that they can meet their obligations to the state when they are required to pay. And thus vendors start down a slippery slope that will ultimately cost the state millions and that will not have a happy ending for many vendors.

There has to be a better way.

II. To Protect Taxpayer Money, States Must Require Vendors to Safeguard Collected Sales Tax Funds in Separate Trust Fund Accounts

Our quest for a strategy to prevent noncompliance begins in a familiar place — well-established legal principles that govern the conduct of fiduciaries. Why? Because vendors are fiduciaries and any strategy of prevention should be based on their fiduciary status.

In New York the State Legislature has made clear that sales tax vendors are fiduciaries. In plain and unequivocal language, New York's tax law spells it out: Vendors collecting sales tax act as "trustees for and on account of the state."[11] They act "in a fiduciary character . . . and the tax collected shall be deemed to have been entrusted" to the vendor.[12]

What does it mean to be a fiduciary? A fiduciary bears an "unwavering duty of complete loyalty to the beneficiary of the trust." Fiduciaries are bound by a "duty to act for someone else's benefit, while subordinating [their own] personal interests to that of the other person." [13] That duty has been aptly described as the "highest standard of duty implied by law"[14] and our courts have held that to deter the trustee from all temptation and to prevent any possible injury to the beneficiary, the rules prohibiting a trustee from dividing his loyalties must be enforced with "uncompromising rigidity."[15]

Thus, as fiduciaries, sales tax vendors stand in the same legal position as a lawyer holding client funds, a bank holding real estate taxes for a borrower, or a landlord holding a deposit for a tenant. In each situation, the law provides unequivocally that the money held in trust by the fiduciary belongs to the beneficiary of the trust and not to the fiduciary. As New York's tax law plainly provides, the rule is the same for sales tax vendors when they possess

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[10] *See, e.g.*, *Matter of J&L Donut Shop, Inc.*, DTA No. 823143, Apr. 28, 2011. *Matter of 33 Virginia Place, Inc.*, DTA Nos. 821181, 821182, 821183, 821290, 821291, and 821859. Dec. 23, 2009, is another case that illustrates that point well. There, rather than taking immediate action to stop a taxpayer who early on told auditors that he was not going to comply with New York's sales tax record-keeping requirements, the department pursued successive multiyear audits that were ultimately rejected by the Division of Tax Appeals. The audits and litigation spanned more than a half decade without producing any change in taxpayer behavior or any revenue. (For the decision in *J&L Donut Shop*, see *Doc 2011-9683* or *2011 STT 92-32*; for the decision in *33 Virginia Place*, see *Doc 2010-17199* or *2011 STT 151-19*.)

[11] Tax Law section 1132(a).

[12] Tax Law section 1817(h).

[13] *Restatement (Second) of Trust section,* 170(1) (1957); 2 A. Scott, *Law of Trusts,* section 170 (1967).

[14] *See Black's Law Dictionary*, sixth edition, p. 625 (1990), defining fiduciary duty.

[15] *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, C.J.).

collected sales tax trust funds.[16] For that reason, when a vendor uses collected sales tax dollars with the intent to permanently deprive the state of those funds, that vendor can be, and often is, charged with stealing — by embezzling — the state's money.

Everyone understands the rule when it is applied to lawyers who help themselves to their client's money. Even if the lawyer honestly believes that his use of his client's money is only temporary, no one would doubt that a lawyer who even temporarily "borrows" a client's money is breaking the law and violating his fiduciary obligations. That lawyer puts his client's money at risk through this fiduciary violation and he understandably faces a raft of penalties including possible criminal prosecution.

For sales tax vendors, the legal principle is identical. Just like the lawyer who "borrows" from his client's settlement check, a sales tax vendor who "borrows" collected sales tax dollars to run his business or to meet personal obligations violates his duty as a fiduciary. By not safeguarding the trust funds, vendors violate the cardinal rule that governs fiduciary behavior: They put their own interests above the interests of the person they are obligated to protect. They have jeopardized the trust funds, even if they intended only to temporarily use the state's money until they filed their returns.

Wait a minute! That may be the law, but in the sales tax world it is hardly the reality. Everyone, including those who administer the tax law, knows that vendors use the taxes they collect to meet their cash flow obligations during the lengthy periods they hold those funds before they are obligated to pay them over to the state. Those trust funds are not segregated. They are not safeguarded. Instead, they are commingled directly into vendor operating accounts and used as needed.

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The collected trust money is treated, in essence, as a free loan to the vendor, which is a great deal for the vendor and an unacceptable risk for the state. But that is the practice and, because of the department's acquiescence, that has become the expectation in New York. Vendors have told me, repeatedly and sometimes with what sounds like righteous indignation, that the sales taxes they collect are theirs to use until they are required to remit and that the state has no right to limit what they do with those funds. Given the department's historical acceptance of vendor misuse of trust funds, it is easy to see how those vendors have come to this wrong conclusion.

And as every practitioner and tax auditor also knows, the commingling that the department tolerates creates a dangerous and slippery slope. Every month and every quarter, tens of thousands of New York vendors file a sales tax return without paying over the taxes they admittedly collected. Many of those vendors are repeat customers who have learned that they can extend the float indefinitely by repeatedly filing but not remitting. Collectively, the amounts reported but not paid in every filing period are in the many millions of dollars.

Of course, the department chases those admitted delinquents, but the more pressing question is how did it let these vendors get to this point in the first place? For many of them, their delinquent obligations escalate as penalties and interest grow and new delinquencies arise. Finally, often years later, when the state finally catches up, the business is crushed by the magnitude of its accumulated sales tax debt, interest, and penalties. To reach that point, the state will expend considerable resources chasing the vendor often only to find that the obligations are beyond collection. Not infrequently, the vendor just "disappears," only to reemerge hidden under another corporate or business identity. Enforcement efforts against those "shirt-changers" are rarely successful.

But the problem is far more significant than dealing with vendors who file but do not pay. They are only the most obvious problem caused by a system that allows vendors to "temporarily" use trust funds for their own purposes. The bigger problem is that caused by vendors who spend the trust funds and then handle the problem by either not filing or by underreporting their sales and thus paying the state less than they collected.[17] Some are deliberate cheats and some are desperate and caught in a cycle they cannot escape, but they all opt to play audit roulette, hoping that they will never be audited or investigated. The sad truth is that most get away with it year after year and become emboldened by their success.

The state unquestionably bears responsibility for this mess. This is not an apology for individual misconduct by vendors, but by knowingly allowing businesses to use the state's money to pay their bills, the state has created an intolerable temptation that

[16] *See also People v. Lyon*, 82 A.D.2d 516, 442 N.Y.S, 2d 532 (2d Dept. 1981); *Canale v. New York State Dept. of Taxation & Fin.*, 378 N.Y.S. 2d 566 (N.Y.Ct.Cl. 1975).

[17] IRS findings on the federal income tax gap are illuminating. The IRS estimates that more than 80 percent of that tax gap is attributable to underreporting by taxpayers. *See* http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf.

has produced an entirely predictable and unacceptable level of delinquency. And by creating a system in which vendors are allowed to retain and use the state's money for months at a clip, and in which serious enforcement efforts do not begin until long after the vendor has shown its first sign of noncompliance, the state has only exacerbated that temptation.

> ***The solution is obvious: To prevent delinquency, states must remove the temptation.***

The solution is obvious: To prevent delinquency, states must remove the temptation. They must make it unmistakably clear to vendors that the state expects them to behave like fiduciaries and to segregate, protect, and not use trust funds. No more free loans!

But more is needed than mere talk.

To build a legal foundation based on well-established principles governing fiduciary behavior, states need to enact laws that require vendors to open and use separate trust fund escrow accounts to safeguard the public money they hold in trust. Requiring all vendors to deposit collected sales taxes immediately into those accounts is the most critical step that a state can take to protect the tax revenue that its citizens paid and entrusted to their vendor. Only a rule that requires all vendors to segregate and safeguard the taxes on receipt can remove the temptation that leads to delinquency.

To be sure, mandatory escrow accounts won't stop all cheating or end noncompliance. But requiring those accounts would make clear the state's expectations and make noncompliance more difficult without costing taxpayers anything and, given modern banking practices and technology, without imposing unacceptable burdens on vendor/trustees.

III. Trust Fund Escrow Accounts Are a Good Start, but States Have to Embrace Available Technologies to Achieve True Reform

Making escrow accounts mandatory is only the first step. Real reform will not be accomplished until states embrace technology to establish those accounts, and even more fundamentally, to gain immediate access to the funds placed in those accounts by vendors. This is not science fiction. It can be done. And if states fully capitalize on available technologies and adopt the right regulatory framework, use of escrow accounts and sales tax compliance in general should become simple, seamless, and painless for vendors and a boon for states.

For most retail vendors — those that accept credit and debit cards to pay for goods and services — the escrow solution can be achieved easily through the credit card processing company (CCPC) the retailer uses to process its credit card transactions. As set forth below, those companies can automatically set aside a portion of each day's credit card transactions[18] into a separate account for payment to the state. By incorporating that technology into the sales tax process, states and vendors will be able to safeguard trust fund dollars from the moment retail transactions take place. Given the beauty of the system for both vendors and the state, states should require, or at the least strongly encourage, every vendor that accepts credit cards to set up a CCPC trust fund escrow account to safeguard collected sales taxes. Vendors that do not accept credit cards should be required to open a traditional escrow account and to manually separate collected sales taxes and deposit those taxes into their escrow account daily. The sooner collected trust funds are in a trust account, the sooner the temptation to use those funds will be removed.

A. CCPC Trust Fund Escrow Accounts

CCPC escrow accounts provide vendors with an automated system to withhold and escrow a portion of each day's credit card transactions. The amount placed in escrow will represent the vendor's total daily estimated sales tax obligation for both cash and credit transactions. Unlike traditional escrow accounts, which are funded through daily calculations and deposits, once a vendor sets up the CCPC account and sets its parameters, the account will be funded automatically, without additional vendor effort.

To automate the funding of the CCPC escrow account, the vendor and the CCPC will have to establish an algorithm that represents an estimated calculation of the amount of sales taxes owed each day for both the vendor's credit card and cash transactions. Once this ratio is established, the CCPC will automatically use that ratio to set aside funds from each day's credit card transactions and deposit those funds into the merchant's designated CCPC escrow account. The funds will never reach the vendor and will be instead automatically preserved for payment to the state — all without additional cost to the vendor or to the state. The vendor or the CCPC should be required to inform the state of the ratios at the time the escrow account is established. Similarly, if the ratios change during the year as a result of changes in sales activities, the vendor should be allowed to notify the state of the changes and adjust the algorithm to reflect those business changes.

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[18]When used in this article, the term "credit card transactions" is intended to include both credit card and debit card transactions.

Here is how a CCPC account will work. The vendor first determines, based on historical and current sales data, his ratio of credit to cash transactions. For some businesses, the vendor will also need to determine his ratio of taxable to nontaxable transactions. As discussed below, given the importance of those calculations, states should require an independent licensed tax professional to certify the accuracy of the ratios. Once these two ratios are established, the CCPC will set up an algorithm to determine how much to withhold each day from the vendor's credit transactions to meet the vendor's total daily sales tax obligation and the vendor or the CCPC will notify the state that it has set up a CCPC account and the ratios the vendors intends to use. Assume, for example, that the vendor's cash-to-credit-card ratio is 50/50 and that all items sold by the vendor are subject to tax. Assume further that the sales tax rate is 8 percent. If the vendor has $1,000 in daily credit card sales, the estimated total sales (cash and credit) for the day would be $2,000. At an 8 percent sales tax rate, the CCPC would deposit $160 into the vendor's CCPC escrow account, which represents 8 percent of the day's estimated total cash and credit sales of $2,000 or 16 percent of the daily credit card sales.

CCPC escrow accounts offer states the best solution to their vexing sales tax compliance issues while providing vendors with a simple and automatic system to budget and pay their sales tax obligations.

The process is as simple as that. Voluntary CCPC escrow accounts already exist and are already being used by some businesses without additional cost to the vendor. In fact, Alabama is urging vendors to safeguard and budget their sales tax obligations by opening and using a CCPC escrow account arrangement offered by one of my firm's clients, Pay My Taxes LLC (PMT).[19] PMT, in collaboration with First Data, a *Fortune* 500 company and industry leader in payment processing, is the first company to offer vendors this automated escrowing mechanism. Other processing banks are reportedly developing similar programs.

CCPC accounts are currently offered to merchants only on a voluntary basis. But the concept and the technology are too powerful and offer such promise that it is unsurprising that legislators in several states are already working on legislation to mandate escrow accounts and to make CCPC accounts an acceptable form of escrowing. Simply stated, CCPC escrow accounts offer states the best solution to their vexing sales tax compliance issues while providing vendors with a simple and automatic system to budget and pay their sales tax obligations.

B. Traditional Escrow Accounts

Vendors that do not accept credit cards should be required to open and use a traditional escrow account to safeguard the trust funds they collect. New York already has a law that permits the tax department to require escrow accounts in some circumstances. Tax Law section 1137(e)(3) authorizes the department to require delinquent vendors to deposit collected sales taxes "at least one time per week in a separate account in any banking institution approved by the commissioner and located in this state the deposits in which are insured by any agency of the federal government." The New York statute further gives the commissioner two options: He can require that the accounts be "held in trust for and payable to the commissioner, and that the amount of such tax shall be kept in such account until payment over to the commissioner" or he can require that the vendor "authorize the commissioner to debit such account," presumably whenever the commissioner wants.[20]

New York's statute is a start, but a better statute would embrace both the options set out in the New York statute and require both that the accounts be held in trust and, equally important, grant the state the right to access the trust funds by directly debiting the accounts. Also, the law should require daily, not weekly, deposits and it should further make clear that the funds collected are trust funds and that vendors are prohibited from making withdrawals.[21]

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[19]The Alabama Department of Revenue's website contains a page urging vendors to establish escrow accounts and referencing the PMT CCPC escrow system, *available at* http://www.revenue.alabama.gov/salestax/escrow.htm.

[20]The commissioner in New York has long had the power under this statute to impose escrow account requirements on delinquent vendors, but historically the department has not used that power. That appears to be changing. In 2010 the law was amended to broaden the commissioner's authority to require weekly deposits into the escrow account and to require the vendor to permit the state to debit the account as the taxes are deposited. In comments to the Albany-Colonie Chamber of Commerce on October 12, 2011, New York Commissioner Thomas Mattox reported that following these amendments, the department initiated several pilot programs and that dozens of vendors have been directed to open and use escrow accounts under the new statute.

[21]Because mistakes happen, however, states will have to provide vendors with a mechanism to promptly seek a refund of any amounts paid into the escrow account that exceed their sales tax liability.

More fundamentally, New York's law is flawed because it is limited to situations in which the vendor is demonstrably noncompliant. Only a general mandate applicable to all vendors will reach the tens of thousands of vendors who have managed to hide their delinquencies successfully. The goal, remember, is to prevent delinquency by removing the temptation.

IV. Once Trust Funds Are in a Vendor Escrow Account, the State Should Have the Right to Immediately Collect Those Funds

Since the trust funds belong to the state, each state should draft laws to enable the state to access those funds as they are deposited into every vendor's escrow account. To achieve maximum compliance and the greatest level of revenue, every state should adopt laws granting its revenue department the right to sweep both traditional and CCPC trust fund escrow accounts, and revenue departments should exercise that right every day for every vendor. Modern banking technology can automate those sweeps, thereby creating a steady pipeline of tax revenue that will reach the state in close proximity to the moment the consumer paid the tax to the vendor.

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By requiring trust fund escrow accounts and getting real-time access to the trust funds in those accounts, states will see huge increases in sales tax collections and will be better able to forecast tax revenue and get a clearer picture of economic trends while controlling delinquencies and spending less on administration, collection, and enforcement.

Vendors will benefit as well. Today, state sales tax laws put businesses through a wringer, all in an effort to accelerate the collection of sales tax revenue and to ensure the accuracy of the numerous returns that vendors are required to file. Once escrow accounts are mandatory and states have immediate access to the accounts, states won't need as many returns and vendors should accordingly be relieved of the obligation to file so many returns, make so many manual payments, incur such high costs for accounting services, and be subjected to so many audits and other compliance requirements.

Instead, sales tax collection will become more like the system for collecting income tax on employee wages, in which the states receive the bulk of the taxes owed through estimated payments withheld and paid throughout the year followed by an annual tax return reconciling the year's payments and activities. A single sales tax return, including a full report on all the year's sales activity and reconciling the amounts paid through the escrow sweeps with a final calculation of the amounts collected and owed, would be all that is necessary. Goodbye quarterly and monthly returns. Hello to an annual reporting system that is tied to the same period covered by the business's annual income tax return. We will have a sales tax system with easier accounting, less administrative burdens, easier compliance, less temptation, and increased revenue. What could be better than that?

V. Monitoring Vendor Compliance Will Improve as States Operate With Real-Time Data

Not only will vendors and the state have far fewer returns to deal with, but also the state's ability to monitor and correct vendor noncompliance will improve significantly.

Income tax withholding works well because a third party, the employer, does the reporting and the withholding. In contrast, the amounts paid into sales tax the trust fund escrow accounts will be determined by the vendor and not a third party. States will accordingly have to find alternative mechanisms to ensure that the amounts deposited reasonably reflect the amounts actually collected. Although gaining immediate access to the escrow accounts will provide states with faster access to their money, which by itself is a benefit worth pursuing, states will be slow to reduce vendor reporting requirements if they believe that those reductions will somehow limit their ability to monitor compliance and enforce the sales tax law.[22]

Fortunately, movement to a system in which trust funds are deposited into trust fund escrow accounts that are swept daily will only increase compliance and assist states in their efforts to monitor vendor behavior. In tax administration, data is power and the information that the state will gather through those daily sweeps will tremendously improve its ability to monitor vendor compliance and to immediately detect and correct noncompliance.

Moreover, once freed of the need to process tens of thousands of unnecessary sales tax returns, states will have the resources to increase and leverage their investments in data acquisition and data analysis to establish computer-driven assessments of the accuracy of any CCPC ratio set up by a vendor

[22]Of course, requiring vendors to file the monthly or quarterly returns has had no effect on the level of noncompliance. Vendors can and do easily game the honor system of sales tax administration regardless of the number of returns they are required to file. The only benefit of the multiple returns now required is that those returns provide a mechanism for states to gain quicker access to collected sales tax revenue and sales data.

or the amounts being deposited into traditional escrow accounts. Smart technology coupled with the immediacy of the information provided by daily collection of sales tax escrow funds will fundamentally change sales tax enforcement. Vendors won't be given the chance to run up huge sales tax obligations. Instead, noncompliance will be immediately identified and corrected through adjustments to the amounts escrowed.

This too is not science fiction. New York's hugely successful case identification selection system (CISS) program, used to identify audit candidates for income tax cases, provides a model for emulation.[23] The system transformed New York's "pay and chase" approach to handling cases of income tax refund fraud to one in which fraud is detected through a real-time, computer-driven analysis of returns as they are received. The moment the department receives an income tax return seeking a refund, CISS matches the data in the return with the department's enormous databases and uses powerful data analytics built by IBM to score the return. Each day those returns with the highest score reach the top of the list, and the department's automated systems and audit personnel hold off sending refunds until the accuracy of the returns can be verified. The program has saved New York taxpayers a whopping $1.6 billion since 2004.

The CISS model will work for sales tax compliance as well, especially as a tool to analyze the increased volume of information that will result from daily sweeps of escrow account deposits. States already have volumes of data available about their vendors. They have the vendor's prior sales and income tax returns. They have the income tax returns of the individuals who own the businesses. They have the returns of similar businesses operating within the same geographic areas. They have profiles of the return preparers and they have rapidly increasing volumes of data (at least in New York) from third-party vendors, credit card companies, franchisers, and insurance companies about their transactions with the vendor.

Equipped with all that information, smart computer analytical programs like CISS will be able to assess immediately whether a CCPC ratio looks right and whether the amounts being escrowed appear to be accurate. Because the accuracy of these ratios and amounts will become the most critical part of sales tax compliance, when discrepancies are identified by technology-aided analysis, states should immediately deploy audit and compliance resources to intervene with the vendor to review the issue and correct the accuracy of the amounts being withheld or the CCPC ratios being used. By intervening before the state incurs significant losses and preventing continuing noncompliance, the state will reduce its need to conduct costly and time-consuming audits and will save the resources it now devotes to pursuing uncollectible obligations from businesses that are beyond redemption.

Technology holds the promise of revolutionary change. Technology can provide the mechanism for states to gather the sales tax revenue as it is deposited into the vendor escrow accounts, and technology can identify whether vendors are accurately funding those accounts.

VI. Additional Safeguards

There are other steps that states can also take to increase the likelihood that vendors accurately deposit all of their collected sales tax revenue into manual escrow accounts and accurately report their ratios of cash to credit transactions and taxable to nontaxable sales for CCPC accounts.

For example, states should require vendors to employ independent licensed professionals to verify and certify the accuracy of the vendor's escrow account payments.[24] Because states will experience a major increase in sales tax revenue once they mandate escrow accounts and access those accounts through automated programs, states should consider reimbursing vendors for their reasonable costs incurred in hiring those professionals to perform what is essentially an integrity assessment for the state's benefit. Those reimbursed costs would be a small investment that would add to the integrity of the program and pay significant dividends. Alternatively, because vendors will have reduced accounting and compliance costs as a consequence of their reduced filing obligations, states may find that vendors will have the resources to employ licensed professionals to perform this important integrity function.

For manual escrow accounts, the certifications, which should be signed by the vendor and the licensed professional when accounts are established and once a year thereafter when the sales tax returns are filed, can state that the professional has examined the vendor's books and records for a

[23]More about the CISS program and its results can be found at William Jackson, "Tax Evaders Beware: NY State Has an APP for That," *Government Computer News*, May 11, 2010, *available at* http://gcn.com/articles/2010/05/17/ny-tax-analytics.aspx. In a press release issued May 23, 2011, the department reported that in 2010, the CISS program saved New York taxpayers $400 million. The release can be found at http://www.tax.ny.gov/press/rel/2011/ibmevent052311.htm.

[24]The professional certifying the vendor's trust fund accounts should be independent and not otherwise affiliated with the vendor. Given the importance of this gatekeeping function, the professional examining the trust fund escrow fund accounts on behalf of the state should have a primary allegiance to the state and not to the vendor.

specific period of time and that the amounts deposited into the vendor's escrow accounts for those periods represent the amount of collected sales taxes. For CCPC escrow accounts, the licensed professionals can certify the accuracy of the ratios when the escrow accounts are set up, at any point when they are adjusted, and when the vendor's annual sales tax return is filed.

States should require vendors to employ independent licensed professionals to verify and certify the accuracy of the vendor's escrow account payments.

States can set guidelines for the certification process, train the professionals allowed to make the certifications, and draft strong certification language to ensure that the certifying professionals exercise due diligence before executing the certification.

In addition to requiring professionals to certify the accuracy of the trust fund escrow accounts, states should also consider authorizing their revenue departments to require delinquent vendors to hire and use licensed professionals to serve as independent monitors to review, audit, and certify the vendor's business activities and to report their findings to the state. State audit resources are already stretched thin and the use of monitors would be one mechanism to supplement those resources. Independent monitors are routinely used by government in financial, healthcare, and other regulatory investigations; there is no reason why they would not work here. Monitors could be deployed to ensure that sales taxes are being properly collected and paid into the vendor escrow accounts, that the vendor is maintaining adequate records, and that the vendor's annual returns are accurate. Depending on the circumstances, the monitors could be deployed to conduct repeated but limited audits of troubled vendors, examining only recent transactions within a relatively brief period of time. The monitors would report their findings to the state and the audits would be designed to find and correct current noncompliant behavior, not to expose all past delinquencies. Of course, if serious and continuing deficiencies are found, the state can pursue a broader audit if appropriate, but the focus of the limited audits conducted by independent professionals on the state's behalf should be corrective and vendors should be required to enter into a compliance agreement to correct any deficiencies as a condition of continuing as a sales tax vendor.

Finally, states should adopt laws imposing penalties, similar to those imposed under the income tax law for inadequate payments of estimated liabilities, when the vendor's annual sales tax return reveals that the escrow account deposits were insufficient to meet the vendor's sales tax obligations. In addition to imposing those penalties, the state should demand that the vendor agree to fully fund the escrow in future years and should require implementation of those adjustments as a condition of permitting the vendor to continue to operate in the state.

Conclusion

There you go. A new and better day for sales tax administration is within reach. It will begin as soon as vendors are required to have escrow accounts and states begin sweeping those accounts. In short order, states will transform their sales tax systems into modern automated systems that are fairer, less demanding on business, and more efficient to administer. Better yet, those systems will reduce delinquencies, increase revenue, level the playing field for businesses, and provide the state with a vastly better and more predictable revenue stream.

What are we waiting for? ✩

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