Report of the Tennessee Advisory Commission on Intergovernmental Relations

Equitable Vendor Compensation Should Consider the Relative Costs of Sales Tax Collection

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Report of the Tennessee Advisory Commission on Intergovernmental Relations

Equitable Vendor Compensation Should Consider the Relative Costs of Sales Tax Collection

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State of Tennessee

Tennessee Advisory Commission on Intergovernmental Relations

226 Anne Dallas Dudley Boulevard, Suite 508
Nashville, Tennessee 37243

January 31, 2025

The Honorable Randy McNally
Lieutenant Governor and Speaker of the Senate

The Honorable Cameron Sexton
Speaker of the House of Representatives

Members of the General Assembly
State Capitol
Nashville, TN 37243

Ladies and Gentlemen:

Transmitted herewith is the commission's report in response to Public Chapter 1013, Acts of 2024, which requested a study of the cost to businesses of collecting and remitting state and local taxes; the cost to the State of Tennessee for reasonable remuneration for sales tax collection, including vendor compensation, to businesses as compared to other states; and the cost to businesses of payment card interchange fees on the tax portion of transactions. The report finds that there are differing views as to whether businesses should be understood as tax collectors or taxpayers of the sales tax, and available evidence and legal precedent do not decisively recommend one view over the other. If, however, the state should wish to reinstate vendor compensation, the commission recommends it use tiered rates and a cap on that compensation to ensure it helps small businesses meet their costs of collection without also creating a windfall for large businesses or a revenue shortfall for the state. On the matter of card payment transaction fees, the commission finds that there is no precedent for any state mandating an exclusion of sales taxes from such fees, and the legality of doing so is in question. The commission therefore recommends the state should refrain from taking any action on card transaction fees until more information is available from the test case in Illinois.

The commission approved the report on January 31, 2025, and it is hereby submitted for your consideration.

Respectfully yours,

Senator Ken Yager
Chairman

Cliff Lippard
Executive Director

The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: Commission Members

FROM: Cliff Lippard
Executive Director

Cliff

DATE: 31 January 2025

SUBJECT: Public Chapter 1013, Acts of 2024 (Vendor Compensation for Sales & Use Tax Collection)—Final Report for Approval

The attached Commission report is submitted for your approval. It was prepared in response to Public Chapter 1013, Acts of 2024. Staff was directed to study the cost to businesses of collecting and remitting state and local taxes; the cost to the State of Tennessee for reasonable remuneration for sales tax collection, including vendor compensation, to businesses as compared to other states; and the cost to businesses of payment card interchange fees on the tax portion of transactions.

After the presentation of the draft report in December, no changes were requested, but staff made some minor edits for the sake of clarity and added appendix B with further details on vendor compensation as offered in other states. The report's two recommendations, however, remain unchanged:

- **If the state were to reinstitute vendor compensation for sales tax collection, the report recommends it continue to use a tiered set of rates and a cap structured to ensure compensation for smaller businesses for whom the relative costs of collection are greatest without creating either a windfall for larger businesses or a revenue shortfall for the state.**
- **Given that the effects of excluding sales tax from card transaction fees are unclear, and that the lawsuit on the legality of such exclusions is currently underway in Illinois, the report recommends that Tennessee refrain from taking any action on card transaction fees until more information is available from the test case in Illinois.**

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When Tennessee's sales tax was first enacted in 1947, it was met with resistance. Using rhetoric indicative of the passions raised, one business owner posted a sign comparing the requirement that he collect sales tax to enslavement and saying he would refuse to "do service against my will." At the time, there was no automation, and collecting sales tax involved manually calculating the tax for each transaction. To compensate businesses for the effort they expended collecting the tax, the state initially allowed them to keep 2% of the amount they collected. Today, Tennessee, with very limited exceptions, no longer offers vendor compensation for sales tax collection. Some businesses say that as a result, they are required to be uncompensated tax collectors, though other stakeholders characterize collecting sales tax simply as a cost of doing business. Moreover, some businesses say it is unfair that credit and debit card transaction fees are charged on the sales tax portion of transactions, given that they see sales tax as the state's money, not theirs.

For the consumer, the cost of the sales tax is clear-cut and printed on their receipt, but for businesses, the costs may be more indirect.

In response to these concerns, Public Chapter 1013, Acts of 2024 (see appendix A), directed the Tennessee Advisory Commission on Intergovernmental Relations to study the cost to businesses of collecting and remitting state and local taxes; the cost to the state for reasonable remuneration for sales tax collection, including vendor compensation, to businesses as compared to other states; and the cost to businesses of payment card interchange fees on the tax portion of transactions. The commission's recommendations encourage the state to consider that the costs of sales tax compliance vary depending on the size of the business and encourage restraint on the issue of card transaction fees.

Businesses are tasked with collecting and remitting sales tax, and that can come with some costs.

Modern sales taxes like those used in Tennessee are collected during a retail transaction: When a consumer buys something from a business, the tax is levied at a certain percentage of the sales price and added to the total bill paid by the consumer. The business then reports and remits the total amount of sales tax it has collected over some period of time—usually a month—to the Tennessee Department of Revenue. For the consumer, the cost of the sales tax is clear-cut and printed on their receipt, but for businesses, the costs may be more indirect. Economists sometimes point out that because sales taxes add to the total costs for consumers, they may lower overall sales or lead businesses to compensate by lowering the base prices of their goods. But more to the point, collecting sales taxes does require a certain amount of effort on the part of businesses: registers must be programmed with the correct sales tax rates for various goods, businesses may need to pay for tax software to help with accounting, and some employees must be trained in the details of sales taxes and be tasked with filing them. For these reasons, some states permit businesses to retain a certain amount of the sales tax they collect to offset these costs, an allowance that may be referred to as vendor compensation.

There are disparate views of vendor compensation and businesses' duties in sales tax collection.

The choice to offer vendor compensation perhaps hinges on how one views the role of businesses in sales tax collection.

Twenty-seven states offer businesses some amount of vendor compensation for sales tax collection, but 16 others do not. Two states (Kansas and Tennessee) only do so under very limited conditions for out-of-state businesses but not in-state (the five remaining states do not have a sales tax). There is a natural question of why states might or might not choose to offer vendor compensation and their rationale for doing so. But arguments for and against vendor compensation don't decisively favor one over the other.

In principle, vendor compensation could incentivize compliance with tax reporting because it is typically only offered when a business files its sales taxes on time. However, there is no evidence that vendor compensation improves compliance rates, and in Tennessee there is already a 5% penalty per month plus interest for late filing.

Instead, the choice to offer vendor compensation perhaps hinges more on how one views the role of businesses in sales tax collection. In one interpretation, it is technically consumers who pay the sales tax, but because it would be impractical to ask individuals to record, report, and remit the tax on everything they bought to the Department of Revenue themselves, businesses act as collecting agents on behalf of the state—and, so the reasoning goes, if businesses are collectors rather than the actual taxpayers, they deserve some compensation for performing that work for the state. Another interpretation, however, is that sales tax collection is simply a cost of doing business and no different from complying with other legal requirements, and as such it should not warrant compensation.

Arguments can be made in favor of both interpretations. There are a select few other taxes for which businesses already receive compensation—for example, beer wholesalers may retain $0.92 of the $35.60 per barrel tax—and some state and local government entities in Tennessee are allowed to retain small portions of taxes that they collect for their own funding. But there are also many other taxes that businesses collect and remit for which they receive no compensation, such as federal payroll taxes or the state's motor fuel tax. Tennessee law has also held from the very beginning of the sales tax that engaging in business and selling tangible goods is a "taxable privilege" and that businesses are ultimately liable for paying sales taxes even if they fail to collect them from consumers. This point has been reinforced in state court cases.

Looking to other states' laws, some construe their sales taxes as being levied on consumers (with businesses then formally standing in the role of collectors who might deserve compensation), while other states explicitly designate businesses as the taxpayers, just as Tennessee does. But some of those states that say businesses are collectors, not taxpayers, still do not offer them vendor compensation, while some of the states that name businesses as the legally liable taxpayers for sales taxes nonetheless are willing to grant them compensation for collecting it—Tennessee was exactly one such state in the past.

Because the arguments for and against vendor compensation don't decisively favor one side over the other, the commission makes no recommendation about whether the state should reintroduce it. But if vendor compensation were to be reintroduced more broadly in Tennessee, there are compelling reasons to use a tiered and capped rate structure.

Sales tax collection costs tend to be a larger percentage of sales tax collections for small businesses than for large ones.

If vendor compensation is to be provided, there are benefits to using a tiered and capped rate structure.

Although vendor compensation was set at a flat rate of 2% when it was first offered in 1947, by the time that it was eliminated for in-state businesses in 2000—and also when it was temporarily restored for fiscal year 2022-23—it was set at 2% on only the first $2,500 of sales tax collected and then at a reduced rate of 1.15% on amounts beyond that. It was also capped so that no business could claim more than $25 in compensation per month. These sorts of constraints—tiered rates and caps—are common today among other states with vendor compensation, and there is evidence to support their use to ensure that, if vendor compensation is to be made available, it is done so equitably.

A handful of studies have tried to estimate the cost of sales tax collection for businesses, and while the resulting estimates have varied, some general findings have been consistent. One such finding is that the cost of collecting sales taxes does not rise in direct proportion with the amount of money collected. This is because the costs to collect sales taxes are largely made up of expenses that do not change much according to how many sales are made or how much money a business earns. And because of that, sales tax collection costs tend to be a larger percentage of sales tax collections for small businesses than for large ones. A large-scale study from 2006, for example, found that while the cost of sales tax collection for small businesses was equal to 13.47% of the tax revenue collected, for large businesses it was only 2.17%. That in turn means that single-rate, uncapped vendor compensation—as opposed to tiered rates and a cap like Tennessee once used—runs the risk of *over*compensating large businesses, allowing them to retain more of the sales tax than it truly costs them to collect it.

Moreover, the costs of collection are not fixed across time and over the long-term may be on a decline. Improvements in technology have automated much of the process, and whereas sales tax reports once had to be made on paper forms and mailed in, they are now done online. As noted in the commission's 2019 report *Leveling the Playing Field: Internet Sales Tax in Tennessee*, because of such changes and streamlining in the reporting process, "the overall cost of complying with sales and use tax collection and remittance is not burdensome and continues to decrease."

Tennessee is one of the most sales tax-reliant states, and stakeholders say that the choice to eliminate vendor compensation in 2000 was largely driven by budgetary concerns.

Finally, there is the question of how much revenue the state may be willing to forgo, as vendor compensation directly reduces sales tax revenue—which is, after all, one of the mainstays of Tennessee's state funding, comprising 64% of all tax collections in fiscal year 2023-24. In fact, Tennessee is one of the most sales tax-reliant states, and stakeholders say that the choice to eliminate vendor compensation in 2000 was largely driven by budgetary concerns. What effects vendor compensation might have on state revenues today depend on how it is structured and especially on whether it is capped.

When vendor compensation was temporarily restored in fiscal year 2022-23, it totaled a little over $14 million in forgone sales tax revenue for the state. That, however, was with the monthly cap of $25 on the total compensation allowed to each business. Without that cap, vendor compensation would have been roughly $145 million according to Department of Revenue data. The few states that do not have either tiered rates or caps on their vendor compensation can also forgo significant revenues: vendor compensation in Texas runs to over $163 million despite a relatively low compensation rate of just 0.5%, for example. An uncapped, flat 2% vendor compensation rate such as Tennessee had from 1947 to 1980 could amount to $200 million or more annually.

Because the costs to collect sales taxes can vary among businesses (and have varied over time), no one rate is appropriate for all cases. Meanwhile, a cap on compensation could help the state control the amount of revenue forgone. **If the state were to reinstitute vendor compensation for sales tax collection, the commission recommends it continue to use a tiered set of rates and a cap structured to ensure compensation for smaller businesses for whom the relative costs of collection are greatest without creating either a windfall for larger businesses or a revenue shortfall for the state.**

Payment card transaction fees are an increasingly prevalent part of sales tax collection costs, but the legality of excluding sales taxes from these fees is uncertain.

When consumers pay for something with a credit or debit card, the retailer must pay a processing fee that is set at a certain percentage of the total card transaction amount, typically somewhere between 1% and 4%. The details of these card transaction fees and how they work are complex, but the fees are often divided among parties such as the card company (for example Visa or Mastercard), the retail business's own bank, and the bank of the cardholding consumer. These fees are meant to cover a variety of costs, including fraud protection, but because they are based on the entire transaction amount, including the sales tax, they feed into a business's sales tax collection costs. And as the use of credit and debit cards has grown over time—with Tennessee retailers now reporting that roughly 80% of transactions are paid with cards—the effect of card transaction fees has become more salient.

Because card transaction fees are based on the entire transaction amount, including the sales tax, they feed into a business's sales tax collection costs. The effects of excluding sales tax from card transaction fees are unclear, and a lawsuit on the legality of such exclusions is currently underway in Illinois.

Businesses say that they should not be responsible for paying card transaction fees on the sales tax portion of transactions, given that the sales tax is money they are only collecting at the state's behest and do not retain for themselves. There have been no fewer than 58 bills introduced in 29 states over the years to that end, seeking to legally exclude sales tax from the calculation of card transaction fees. No such bill had ever passed until recently, though, with new legislation enacted in Illinois. Starting July 1, 2025, businesses in that state must exclude sales taxes (as well as service gratuities) from card transaction fees. Financial industry stakeholders say that this will be difficult to implement, may require significant changes to card processing equipment, will not save businesses as much money as they hope, and could lead banks to raise the costs of other services for their customers. A group of such stakeholders has since sued the state of Illinois over the new legislation, arguing that the state is preempted by the federal National Bank Act, among other federal laws. **Given that the effects of excluding sales tax from card transaction fees are unclear, and that the lawsuit on the legality of such exclusions is currently underway in Illinois, the commission recommends that Tennessee refrain from taking any action on card transaction fees until more information is available from the test case in Illinois.**

Analysis: Most states offer vendor compensation; exempting payment card transaction fees from sales taxes is being litigated.

Whenever someone in Tennessee buys something at a store or online, they will pay a tax on the purchased goods or services equal to some percentage of the sales price. That, of course, is the sales tax, and it is forwarded on to the Tennessee Department of Revenue, from where it then goes on to fund a wide swath of programs and needs across Tennessee and at every level of government, including funding for schools, roads, state parks, and much more. But crucially, consumers do not remit that tax directly to the Department of Revenue themselves. Rather, businesses are tasked with calculating the sales tax, collecting it from the consumer at the moment of sale, and then later reporting the amount of sales tax they have collected and remitting it to the state. Because this does require some amount of time and effort, some states offer businesses a certain amount of compensation to cover their costs for collecting and remitting sales tax.

Most Tennesseans rarely have cause to think about the sales tax, but for businesses it comes with many regulations and procedures that they must actively engage with.

Tennessee used to be such a state but stopped providing this kind of vendor compensation for in-state businesses at the start of the 21st century. In 2022, however, the General Assembly restored vendor compensation for one fiscal year with Public Chapter 1082. The next year, Senate Bill 1140 by Senator Lundberg and House Bill 886 by Representative Hawk sought to make vendor compensation permanent, but it was subsequently amended to request a study from the commission on the subject, which then passed as Public Chapter 1013, Acts of 2024 (see appendix A). Specifically, the public chapter requests an examination of

- the cost to businesses of collecting and remitting state and local taxes;
- the cost to the State of Tennessee for reasonable remuneration for sales tax collection, including vendor compensation, to businesses as compared to other states; and
- the cost to businesses of payment card fees on the tax portion of transactions, including interchange fees and other fees associated with payment processing, as well as the cost to businesses of handling cash.

Sales tax collection is crucial to the state, but it comes with complexities for businesses.

Most Tennesseans rarely have cause to think about the sales tax, even if they might pay it several times a day, but for businesses it comes with many regulations and procedures that they must actively engage with. As one researcher once put it: "The sales tax seems the model of simplicity to the customer making a purchase . . . [but] business compliance with and government administration of the tax is far more complex than its appearance at the cash register."[1]

The state's general sales and use tax is levied at 7%,[2] but that is of course combined with the local option sales tax, which ranges from a low of 2% in a handful of counties to the legal maximum of 2.75% in most other locales.[3] But the state tax rate also varies according to the goods or services that are sold; grocery items are the most well-known exception, being taxed at 4%, but there are others (see table 1). Then, there is also the single article cap, which allows the local sales tax to only be applied to the first $1,600 of a single article of a good sold, meaning that certain items with a large price tag, like cars, receive a partial exemption from the local sales tax, as well as the state single article tax that applies on values between $1,600 and $3,200, neither of which sales tax software can be easily programmed for.[4]

Table 1. Tennessee Special Sales Tax Rates

Special Sales Tax Category	State Tax Rate	Authorizing Statute
Food and food ingredients	4.00%	Tennessee Code Annotated, Section 67-6-228
Aviation fuel	4.25%	Tennessee Code Annotated, Section 67-6-217
Industrial water for manufacturers	1.00%	Tennessee Code Annotated, Section 67-6-206
Industrial energy fuel for manufacturers	1.50%	Tennessee Code Annotated, Section 67-6-206
Electricity for qualified data center	1.50%	Tennessee Code Annotated, Section 67-6-206
Interstate and international telecommunications sold to business	7.50%	Tennessee Code Annotated, Section 67-6-221
Manufactured homes (tax at 1/2 general state tax rate)	3.50%	Tennessee Code Annotated, Section 67-6-216
Video programming services (cable TV monthly charge from $15.01-$27.50)*	8.25%	Tennessee Code Annotated, Section 67-6-226
Direct-to-home satellite television services*	8.25%	Tennessee Code Annotated, Section 67-6-227
Qualified common carriers direct pay use tax on Tennessee purchases of tangible property that is used outside the state	3.75%	Tennessee Code Annotated, Section 67-6-219
Hemp-derived cannabinoids	6.00%	Tennessee Code Annotated, Section 67-6-232

*These taxes are exempt from the local option sales tax.

Source: Tennessee Department of Revenue 2024b.

[1] Mikesell 1997.

[2] The sales and use taxes are technically separate taxes, with the use tax being a sort of specialized variant of the sales tax that applies in the circumstances of goods that are purchased from outside of the state and brought into it without the sales tax being applied. Often, though, the distinction is unimportant, and unless otherwise noted, what is said here regarding the "sales tax" can be assumed to broadly apply to the use tax as well. See Tennessee Code Annotated, Section 67-6-202 et seq.

[3] Tennessee Department of Revenue "Local Sales Tax Rates." However, note that Johnson County opted to raise its rate to 2.0% in August 2024. See Tennessee Department of Revenue 2024a.

[4] Interview with Sherry Hathaway and Michael Ward, tax administration manager, Tennessee Department of Revenue, June 20, 2024. See Tennessee Code Annotated, Section 67-6-202.

In addition, with the enactment of Public Chapter 917, Acts of 2024, local governments can now levy their own separate, reduced grocery sales tax.

Businesses must also often navigate a catalog of sales tax rules to apply the correct tax rate to everything they sell in each location. For instance, a convenience store may have to classify a single product as a grocery item if it is sold chilled or frozen but as a prepared food item (to which the standard 7% state tax rate applies) if it is sold as ready-to-eat.[5] Given that some retail businesses may sell tens of thousands of distinct products, classifying them all correctly for sales tax purposes can demand a not insignificant effort. Moreover, businesses note that whenever there are sales tax holidays, the settings on sales terminals must be changed—sometimes manually—to switch off the sales tax calculation for the duration of the holiday and then reset the terminals when the holiday ends.[6] In fact, one stakeholder reported that it could take up to two weeks of preparatory work to handle all of the needed changes for complying with sales tax holidays.[7]

Businesses must often navigate a catalog of sales tax rules to apply the correct tax rate to everything they sell in each location.

Accounting for all these intricacies happens behind the scenes before the moment of a sale so that the sales tax can be automatically calculated at the register and simply factored into the bill paid by the consumer. But there can be more work for the business after that point as well. Virtually all businesses then report their sales tax collections to the Department of Revenue through the department's online portal, dubbed TR3, with each business using a single account to report collections for all of its locations in the state at once.[8] Filing is due on the 20th of the month after a reporting period—for instance, a business would file sales taxes for January by February 20th. While large parts of this process are automated, some businesses say they still must have specially trained staff who work regularly on compiling sales tax reports.[9]

Furthermore, the sales tax may have other indirect effects on business expenses and revenues. Economists sometimes point out, for example, that because sales taxes add to the total costs for consumers, they may lead to lower overall sales or to businesses lowering the base prices of their goods to remain attractive to consumers.[10] But one of the chief

[5] Interview with Tommy Hunt, CEO, Calloway Oil, and president, Tennessee Fuel and Convenience Store Association, July 22, 2024.
[6] Interviews with Rob Ikard, president, Tennessee Grocers and Convenience Store Association, May 20, 2024; and Tommy Hunt, CEO, Calloway Oil, and president, Tennessee Fuel and Convenience Store Association, July 22, 2024.
[7] Interview with Paul Cox, vice president of finance, and Brandy Potts, sales tax specialist, Food City, July 3, 2024.
[8] Interview with Jeff Bjarke, director of research, and Courtney Swim, chief of staff, Tennessee Department of Revenue, May 1, 2024. Note that a small minority of businesses with low sales volumes may report sales tax collections quarterly or annually.
[9] Interview with Sally Edward Darnell, chief marketing officer, Quik Mart, Jun 18, 2024; Paul Cox, vice president of finance, and Brandy Potts, sales tax specialist, Food City, July 3, 2024; and Tommy Hunt, CEO, Calloway Oil, and president, Tennessee Fuel and Convenience Store Association, July 22, 2024.
[10] Due and Mikesell 1994.

complaints of businesses is that credit and debit card transaction fees, which businesses must pay whenever a customer uses a card payment to complete a purchase, also cover the sales tax portion of a transaction. Therefore, the sales tax included on each card payment contributes a small added cost for a business.

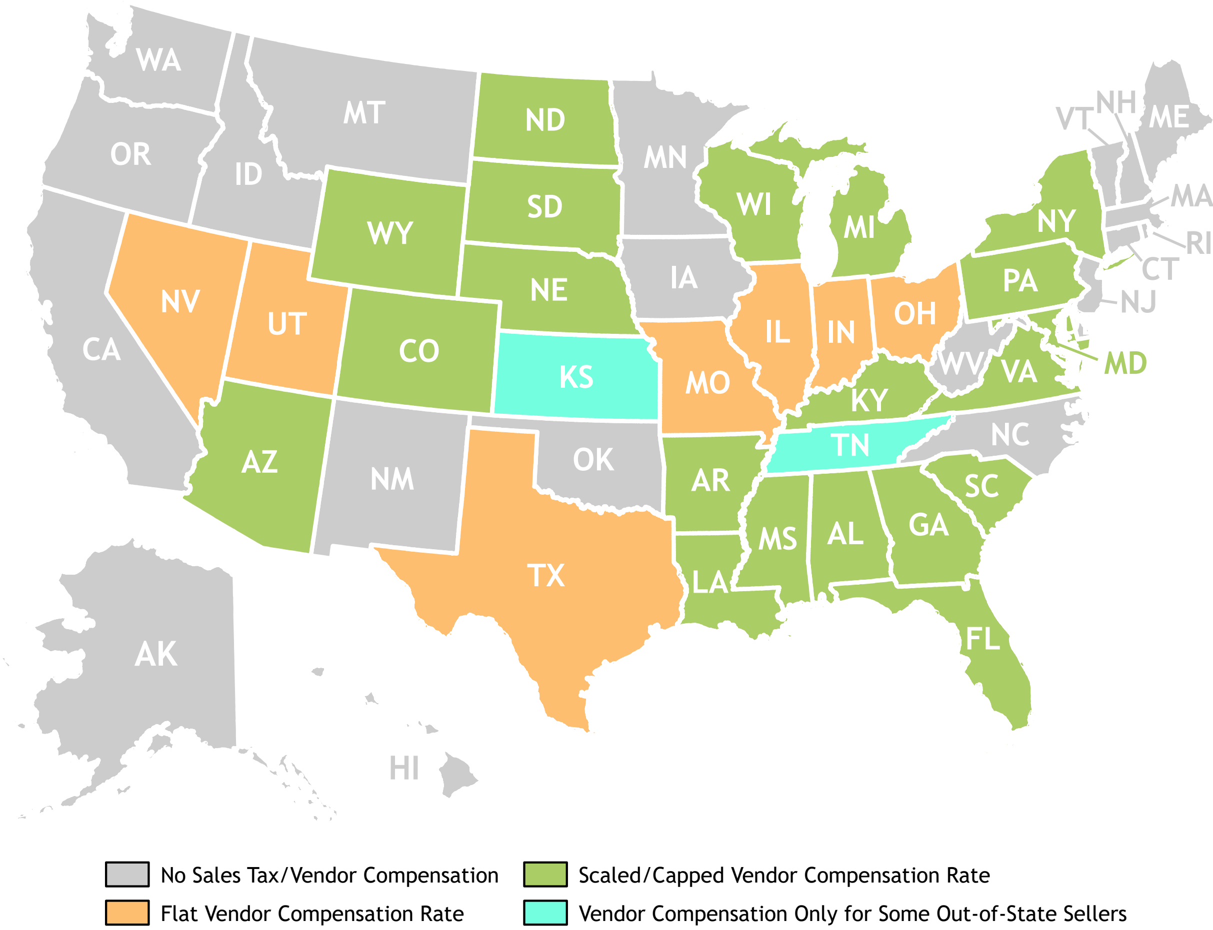
All these sundry factors—time and labor, managing sales tax rule compliance, filing tax reports, training staff, specialized tax software, and all other costs of running a business—become costs for businesses in their collection of sales tax. And because of this, some stakeholders have long championed the idea of granting businesses some kind of compensation to offset those costs, or what may be called vendor compensation. The idea itself is not a new one, and although Tennessee essentially does not have vendor compensation at present, it has offered it in the past. But the idea has currency in other states as well.

In 2024, 27 states offer vendor compensation in some form, while 16 others levy sales taxes without vendor compensation, and two others offer vendor compensation in only narrow circumstances.

In other states, vendor compensation goes by a number of different names (it may sometimes be referred to as an allowance or discount), but it broadly works along the same lines most everywhere, with businesses being permitted to retain some percentage of the sales taxes that they collect. Today, 27 states offer vendor compensation in some form (see map), while 16 others levy sales taxes without vendor compensation.[11] An additional two states offer vendor compensation in only narrow circumstances. Kansas provides it to sellers in a select few neighboring states. Tennessee technically offers vendor compensation to a subset of out-of-state sellers, but according to officials at the Department of Revenue this provision has been rendered essentially obsolete by the multi-state Streamlined Sales and Use Tax Agreement that Tennessee is party to and the 2018 US Supreme Court *Wayfair* decision; it is therefore unclear that any out-of-state sellers actually claim vendor compensation at present. A further five states do not have a state-level sales tax (Alaska, Delaware, Montana, New Hampshire, and Oregon).[12]

[11] Commission staff analysis of states' laws.
[12] Ibid.

Map. States and Vendor Compensation



Source: Commission staff analysis of states' laws. See also appendix B.

There are nuances to how vendor compensation may be structured, though. In just seven states is it provided at a single, flat rate. In most other states, the rate is tiered or stepped down as the amount of tax collected increases beyond some threshold. In Georgia, for example, businesses are allowed to keep 3% of the sales tax they collect, but only on the first $3,000 of sales taxes collected—beyond that point, they are allowed to keep just 0.5% of what they collect.[13] This is done because the cost to collect sales tax does not necessarily scale up with the amount collected, and a flat vendor compensation rate may end up *over*compensating larger businesses to the disadvantage of smaller businesses. Many states also impose a cap on the amount that can be retained, which ranges from $25 per monthly filing in Pennsylvania to $20,000 in Michigan. See appendix B. And in some cases there may be added conditions, such as the compensation being contingent on filing on time.

A flat vendor compensation rate may overcompensate larger businesses to the disadvantage of smaller businesses.

[13] Official Code of Georgia Annotated, Section 48-8-50.

There is a fundamental debate over the role of businesses in sales tax collection.

Although there is a rationale for vendor compensation, not all stakeholders may agree that the costs of collecting a tax entitle a business to compensation. Because sales tax is incurred at a moment when money changes hands—that is, in the sale of some goods or services—it comes with an intrinsic ambiguity over who exactly is the true taxpayer, and that gives rise to two distinct ways of looking at sales tax collection and vendor compensation. One view is that it is consumers who pay the tax, but because it is impractical to ask them to report and remit the taxes on their own purchases, the task is instead entrusted to businesses, who merely act as pass-through agents to collect and remit the tax to the state. Therefore, under that view, businesses are entitled to some form of compensation for their efforts, because they are otherwise uninvolved parties who are performing a service for the state.[14] An alternative view, however, is that sales tax collection is just one of the costs of doing business—that is, it is a routine and expected part of operating any retail business, and just like compliance with other legal and regulatory requirements, it is something that businesses must simply account for. In that view, vendor compensation is unwarranted. Tennessee statute and case law, as well as the examples of other states, give support to both views but do not clearly favor one over the other.

With the sales tax there can be an intrinsic ambiguity over who exactly is the true taxpayer—the customer or the business.

On one hand, there are other taxes for which Tennessee does provide vendor compensation. One is the tire pre-disposal fee (set at $1.35 per tire) collected on new tires sold in the state and for which tire dealers are allowed to deduct and retain 10 cents per tire, provided they timely file and remit the collected fees.[15] The other is the wholesale beer tax (set at $35.60 per barrel), from which beer wholesalers may retain $0.92 per barrel.[16] Somewhat relatedly, certain government entities are allowed to retain commissions on various taxes and fees, for example:

- City court clerks can retain 2% of litigation taxes,[17] and other court clerks can retain 6.75%.[18]
- County registers can retain 2.4% of realty transfer and mortgage taxes collected.[19]
- County clerks can retain 5% of the privilege taxes levied on issuing marriage licenses.[20]

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[14] Interviews with Jim Brown, Tennessee state director, National Federation of Independent Businesses, May 7, 2024; Emily LeRoy, executive director, Tennessee Fuel and Convenience Store Association, June 11, 2024; and Roland Myers, president and CEO, Tennessee Retail Association, June 26, 2024.
[15] Tennessee Code Annotated, Section 67-4-1610(a).
[16] Tennessee Code Annotated, Section 57-6-103(e).
[17] Tennessee Code Annotated, Section 16-18-305(f).
[18] Tennessee Code Annotated, Section 8-21-401(h)(3).
[19] Tennessee Code Annotated, Section 67-4-409(d)(2).
[20] Tennessee Code Annotated, Sections 67-4-411 and 8-21-701(6).

- County trustees are allowed to keep 1% of a certain portion of local sales tax collections.[21]
- The Department of Revenue keeps 0.3674% of state sales and use tax collections and 1.125% of local sales tax collections.[22]

However, this could be said to simply be an alternative means of funding such entities in lieu of greater appropriations from legislative bodies. And while businesses may retain vendor compensation on tire disposal fees and wholesale beer taxes, there are many other taxes for which they do not receive compensation, including the withholding and reporting of federal income taxes, as well as state taxes such as the motor fuel tax.[23]

At the very introduction of the sales tax in Tennessee, the express legislative intent was "that every person is exercising a taxable privilege who engages in the business of selling tangible personal property at retail in this State," making the business the official taxpayer,[24] and this remains true under current law.[25] The law further emphasizes that every business making sales of tangible personal property in Tennessee is liable for paying sales taxes,[26] even though the tax "shall be collected by the retailer from the consumer insofar as it can be done."[27] Case law reinforces this, with past cases finding, for example, that if a retailer fails to collect sales tax from a consumer, the consumer can still be required to pay it later,[28] and yet still the "legal incidence of the retail sales tax is upon the vendor of the taxable services or property, and not upon the vendee or consumer."[29]

Some states' laws describe their sales tax as being technically levied on consumers (with businesses then formally standing in the role of collectors), while others explicitly designate businesses as the taxpayers, as Tennessee does.

Looking elsewhere, other states seem to be divided on this question. Some states' laws describe their sales tax as being technically levied on consumers (with businesses then formally standing in the role of collectors), while others explicitly designate businesses as the taxpayers, as Tennessee does, and these states have traditionally viewed sales tax collection as simply a cost of doing business for which there should be no compensation.[30] But then again, some states in the former group—that is, those that treat businesses as collectors and not taxpayers—still do not grant businesses any vendor compensation. The reverse is also true, with some states that position businesses as the legally liable taxpayer for sales tax nonetheless granting them compensation for collecting it—Tennessee again being one such example in the past. As a comprehensive study of sales taxation in

[21] Tennessee Code Annotated, Section 8-11-110(e).
[22] Tennessee Code Annotated, Sections 67-6-103(a)(4) and 67-6-710(b)(2).
[23] Testimony at commission panel on vendor compensation by William Fox, professor emeritus, University of Tennessee, Knoxville, September 11, 2024.
[24] Public Chapter 3, Acts of 1947, Section 3.
[25] Tennessee Code Annotated, Section 67-6-201.
[26] Tennessee Code Annotated, Section 67-6-501.
[27] Tennessee Code Annotated, Section 67-6-502.
[28] Sam Carey Lumber Co. v. Sixty-One Cabinet Shop, Inc., 773 S.W.2d 252 (Tenn. Ct. App. 1989).
[29] South Central Bell Tel. Co. v. Olsen, 669 S.W.2d 649 (Tenn. 1984).
[30] Interview with Scott Peterson, vice president of US tax policy and government relations, Avalara, April 25, 2024.

the US once found, "it would be hazardous to deduce a particular logical relationship between the provision of compensation and the basic nature of the tax."[31]

In short, there is a fundamental and unresolved debate over businesses' role in sales tax collection—it is either a task being imposed upon them for which they deserve compensation, or it is simply a cost of doing business. But state law, historical precedent, and the examples of other states do not decisively favor one view over the other.

Vendor Compensation and Timely Filing

There is an alternative rationale that is sometimes proffered for vendor compensation, and that is that it may help to incentivize timely filing of sales taxes. This is implicitly the view of many states, where compensation is waived if a business files late. However, there is no clear evidence that vendor compensation has much effect on timely filing. Tennessee Department of Revenue officials say compliance is already high even without vendor compensation, and that data from fiscal year 2022-23 when vendor compensation was in effect does not reveal any discernable difference in timely filing rates.[1] And in any event, Tennessee already has a penalty of 5% per month plus interest for late filing.[2]

[1] Interview with Jeff Bjarke, director of research, and Courtney Swim, chief of staff, Tennessee Department of Revenue, May 1, 2024.
[2] Tennessee Department of Revenue 2024c.

Vendor compensation comes at a cost for state revenue—but how much depends on how it is structured.

Tennessee is one of if not the most reliant on sales tax revenue of any state, so vendor compensation naturally has implications for state finances.

In fiscal year 2023-24, Tennessee collected over $14 billion through the state sales and use tax (not including another $4.4 billion in local sales taxes), amounting to 63.6% of the state's revenue from all taxes.[32] In fact, by at least some measures, Tennessee is one of if not the most reliant on sales tax revenue of any state.[33] Because of this, and because it amounts to a deduction of sales tax revenues, vendor compensation naturally has implications for state finances—in fact, stakeholders say the elimination of vendor compensation for most businesses in 2000 was part of an effort to ease fiscal strains on the state at that time.[34] But exactly how much of an effect vendor compensation could have very much depends on how its rates might be structured and whether a cap is applied.

[31] Due and Mikesell 1994.
[32] Tennessee Department of Revenue 2024d.
[33] Staff analysis of Census of Governments data for 2021; and Fox 2016.
[34] Interview with Stan Chervin, former director of research, Tennessee Department of Revenue, July 3, 2024.

During its brief return for all businesses for fiscal year 2022-23, vendor compensation totaled $14,223,926.[35] That, however, was with the monthly cap of $25 on the total compensation allowed to each business. Without that cap, vendor compensation would have been on the order of roughly $145 million.[36] It might also be noted that 2022 saw a month-long sales tax holiday on grocery items,[37] without which the compensation could have been somewhat higher. Reconfiguring either the cap or the rates could similarly lead to higher total compensation. For instance, one important detail of how the $25 cap works is that it applies to businesses as a whole, but there have been suggestions that it should be granted to each business location instead.[38] The effects of such a change would be impossible to calculate based on the limited data available, but with 235,499 business locations identified on reports from the last fiscal year[39]—though not all of them make enough in monthly sales to necessarily qualify for the full $25—the potential vendor compensation would also be larger than in fiscal year 2022-23.[40]

Among the states that do provide vendor compensation in some form, the amount retained by businesses collectively can total as little as the $6.7 million in Wyoming (see table 2), while the few states that do not have either tiered rates or caps can forgo significant revenues—vendor compensation in Texas runs to over $163 million (despite a relatively low compensation rate of just 0.5%)—while in Illinois it is about $313 million. An uncapped 2% vendor compensation such as Tennessee had from 1947 to 1980, and like Missouri still has today, could amount to $200 million or more annually. More importantly, these amounts make up varying proportions of each state's general sales tax revenue, ranging from only about 0.06% in the case of Pennsylvania to as much as 2.7% in Missouri. Were Tennessee to provide vendor compensation at similar percentages of its sales tax revenue as these other states do, the amounts would range from $10.7 million to a little more than $447.5 million.

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[35] Correspondence with Jeff Bjarke, director of research, Tennessee Department of Revenue, August 9, 2024.
[36] Tennessee Department of Revenue 2023.
[37] Public Chapter 1131, Acts of 2022, Section 3.
[38] Interview with Emily LeRoy, executive director, Tennessee Fuel and Convenience Store Association, June 12, 2024.
[39] Staff calculation based on data provided by Jeff Bjarke, director of research, Department of Revenue, September 4, 2024.
[40] An upper-bound estimate, assuming all 235,499 business locations receive $25 per month, would be closer to $70 million per year.

Table 2. Total Amount of Vendor Compensation Provided by State

State	Fiscal Year 23 Vendor Compensation Amount	2022 Sales Tax Revenue	Effective Rate*	Projected Amount if Tennessee Offered Compensation at the Same Rate
Missouri	$174,381,444	$6,462,312,000	2.70%	$447,535,898
Utah	$82,200,000	$5,257,859,000	1.56%	$259,285,607
Georgia	$170,871,627	$11,405,066,000	1.50%	$248,477,850
Illinois	$313,000,000	$25,865,408,000	1.21%	$200,696,839
Colorado	$67,613,454	$7,856,911,000	0.86%	$142,723,937
Nebraska	$25,052,344	$3,285,152,000	0.76%	$126,476,090
South Carolina	$47,237,364	$7,087,474,000	0.67%	$110,537,517
Michigan	$99,000,000	$17,017,985,000	0.58%	$96,481,176
Wyoming	$6,726,450	$1,177,747,000	0.57%	$94,721,686
Arkansas	$29,280,276	$6,216,131,000	0.47%	$78,121,493
Indiana	$63,821,458	$14,914,925,000	0.43%	$70,967,773
North Dakota	$6,657,024	$1,586,316,000	0.42%	$69,599,472
Louisiana	$29,280,276	$7,741,107,000	0.38%	$62,731,782
Ohio	$80,100,000	$24,014,162,000	0.33%	$55,319,801
Alabama	$24,764,000	$7,540,587,000	0.33%	$54,466,713
South Dakota	$6,746,536	$2,067,055,000	0.33%	$54,130,789
Mississippi	$17,381,472	$6,280,106,000	0.28%	$45,902,370
New York	$83,000,000	$30,738,471,000	0.27%	$44,782,812
Arizona	$36,157,792	$13,616,707,000	0.27%	$44,039,800
Wisconsin	$24,923,261	$9,877,449,000	0.25%	$41,848,086
Texas	$163,000,000	$66,917,512,000	0.24%	$40,398,324
Florida	$85,617,401	$47,015,449,000	0.18%	$30,202,089
Kentucky	$13,825,642	$7,718,476,000	0.18%	$29,707,717
Maryland	$20,700,000	$12,139,837,000	0.17%	$28,279,584
Nevada	$16,389,796	$10,504,515,000	0.16%	$25,876,949
Virginia	$16,077,109	$12,931,327,000	0.12%	$20,619,607
Tennessee	$14,223,926	$16,585,002,000	0.09%	$14,223,926
Pennsylvania	$16,600,000	$25,727,120,000	0.06%	$10,701,199

*Effective Rate here refers to the total in vendor compensation as a percentage of the total sales tax revenue. Data for most states is from fiscal year 2022-23 or the closest equivalent; Colorado data is from 2021; Maryland, Michigan, and Nevada data are from 2022; Virginia data is from 2024. New York data is a forecast. Maryland and Mississippi data are both estimates.

Source: Commission staff data collection from states' revenue or comptroller offices.

Recognizing that vendor compensation could be in tension with preserving state revenues, there has been one alternative stakeholder proposal to maintain the current system—sans vendor compensation—but to aid businesses by granting them at least an extra month to remit their sales tax collections. That delay would allow businesses to accrue a small amount of interest on the money while they still hold it, offsetting some of the collection cost.[41] Such an approach, though, would require a temporary interruption in the state's revenue flow while the filing timeline was being adjusted. The value of such a measure to businesses would also be weakened if interest rates were lowered.

Vendor compensation must be calibrated to collection costs, which have varied over time and with business size.

Vendor compensation originated alongside the sales tax in Tennessee in 1947, but much has changed in the 70-plus years since then. In the intervening decades, Tennessee's state sales tax rate has risen incrementally from 2% to 7% (and the maximum local option sales tax, after being introduced in 1963, has also been stepped up several times). The ways that businesses report sales taxes and the costs entailed in collections have evolved with changing technology; and before its final elimination (with a narrow exception for out-of-state sellers), vendor compensation was adjusted multiple times to become increasingly constrained. If vendor compensation were to be made available, this history illustrates the means to structure it so that it may be more equitable.

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The first modern sales taxes began to take off during the Great Depression in the 1930s as states sought a means of shoring up revenues in the face of fiscal shortfalls.[42] By the end of that decade, more than 20 states had implemented sales taxes.[43] A nearly 10-year lull followed before a new wave of states began adopting sales taxes, this time in part because of increased state expenditures in the postwar period. Tennessee's own state sales tax was a part of this second wave, being introduced in 1947 at 2%, primarily with the intent that it would be used to bolster funding for public schools.[44] Other states were to follow; today, 45 states in total have a general sales tax at the state level.[45]

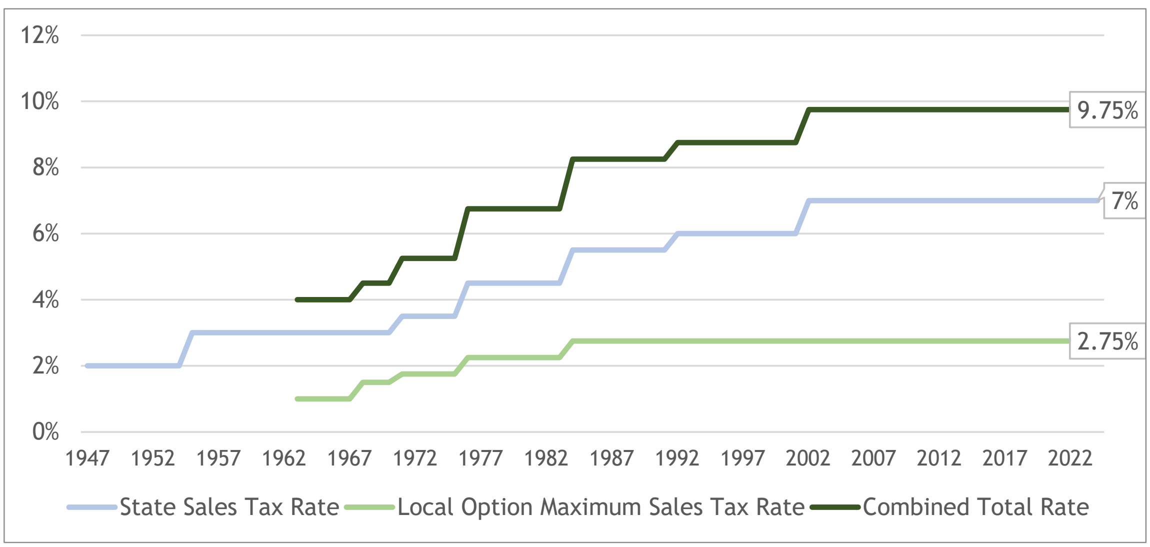
However, in those early years, the businesses who were now being asked to do the job of collecting these new taxes initially did so with "strong

[41] Interview with Rob Ikard, president, Tennessee Grocers and Convenience Store Association, May 20, 2024.
[42] Due and Mikesell 1994.
[43] Emanuel 2014; and Mikesell and Kioko 2018.
[44] Public Chapter 3, Acts of 1947, Preamble.
[45] Commission staff analysis of states' laws.

protests."[46] Understanding that the "cooperation of retailers was critical for operation of the tax and retailers wanted to avoid being seen as responsible for the increase in price necessary to cover the tax,"[47] it became routine for states to offer vendor compensation to assuage the opposition. When Tennessee introduced its own sales tax, it was no exception to this pattern—one business owner, for instance, protested that being asked to collect sales tax on the part of the state was akin to enslavement and that he would not "do service against my will."[48] And so, in the very same legislation that created the state sales tax, Tennessee also provided for vendor compensation, which was set at a single rate of 2% and without any cap.[49]

In the decades after, the sales tax in Tennessee would see recurring increases, rising from 2% to 7% today—while also then being compounded with the local option sales tax that was introduced in 1963 (see figure 1). Yet as the sales tax rose, vendor compensation would be repeatedly curtailed (see figure 2).

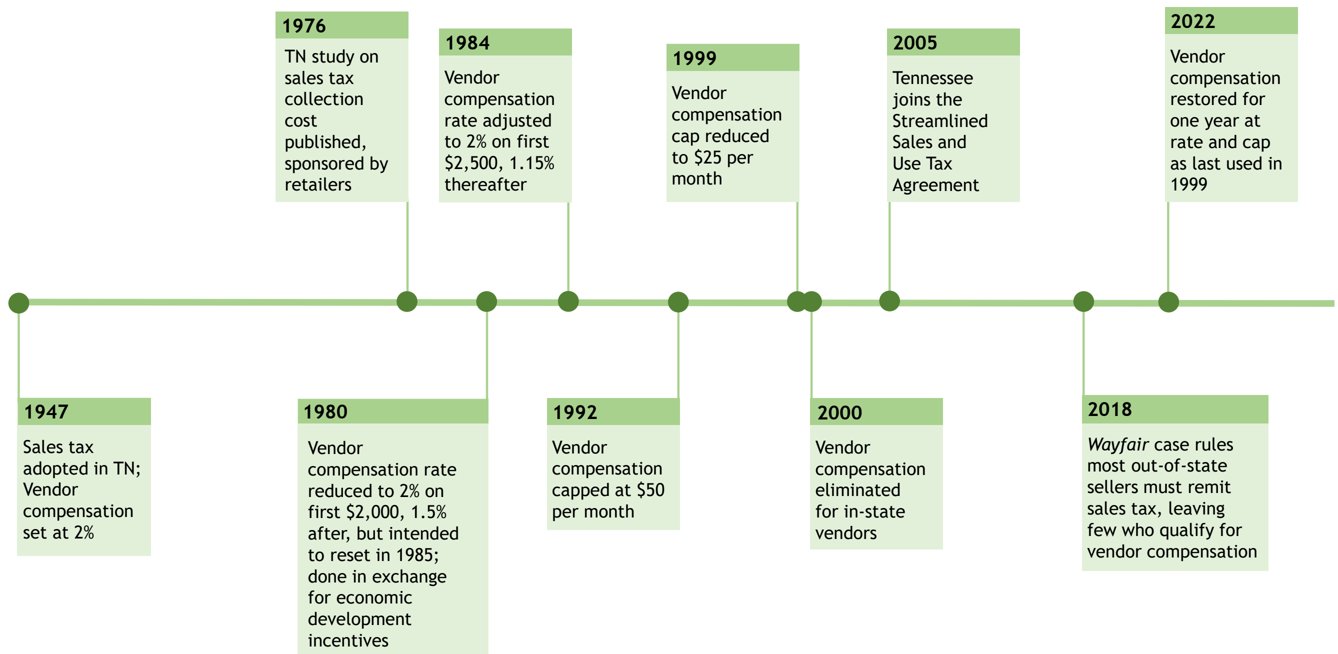
Figure 1. Tennessee State and Local Option Sales Tax Rates, 1947 to 2024



Source: Tennessee Advisory Commission on Intergovernmental Relations 2002; Tennessee State Library and Archives Education Outreach Program "Modern Tennessee"; and commission staff analysis of Public Chapter 3, Acts of 1947.

[46] Due and Mikesell 1994.
[47] Mikesell and Kioko 2018.
[48] Nashville Banner 1947.
[49] Public Chapter 3, Acts of 1947.

Figure 2. Timeline of Vendor Compensation in Tennessee



Source: Public Chapter 3, Acts of 1947; Hendershot et al. 1976; Public Chapter 871, Acts of 1980, Section 3; Public Chapter 3, Acts of 1984 (Extraordinary Session); Public Chapter 529, Acts of 1992, Section 13; Public Chapter 412, Acts of 1999, Public Chapter 983, Acts of 2000, Section 7; Tennessee Department of Revenue "Streamlined Sales Tax."; South Dakota v. Wayfair, Inc., 138 S. Ct. 2080 (2018); and Public Chapter 1082, Acts of 2022.

Beginning in 1980, Tennessee introduced a tiered rate structure for the first time, and in 1984, the vendor compensation formula was adjusted to 2% on the first $2,500 of sales tax collected, but then stepping down to 1.15% on all collections beyond that point. The total amount of compensation that could be claimed each month was capped at $50 in 1992 and later reduced still further to $25 in 1999. And then the very next year vendor compensation was virtually eliminated altogether.

A trend can be seen in other states towards vendor compensation that is more targeted to small businesses and often capped.

In fiscal year 2022-23, however, vendor compensation was restored for all businesses for a single year;[50] the legislation that would have renewed it for fiscal year 2023-24 did not pass but was instead amended to request the current study.[51] During that one year when it was restored, vendor compensation operated by the same formula and cap as had been in place from 1999 to 2000, and it was stipulated to only apply to the state portion of the sales tax, not the local.[52]

This trend towards more restrained vendor compensation can be seen in other states as well. A review of vendor compensation across all states in the early 1990s found that, over time, "states have become more likely

[50] Public Chapter 1082, Acts of 2022.
[51] Public Chapter 1013, Acts of 2024 (see appendix A).
[52] Public Chapter 1082, Acts of 2022.

Out-of-State Businesses, Vendor Compensation, and the Streamlined Sales and Use Tax Agreement

Technically, since 2000, Tennessee has continued to allow for vendor compensation but only as an option for out-of-state businesses that are "volunteer sellers."[1] At that time, out-of-state sellers could not be legally required to remit sales tax to Tennessee. Under the Streamlined Sales and Use Tax Agreement (SSUTA) that Tennessee joined several years later, the state gives out-of-state businesses who sell goods to customers in Tennessee the option of the use of a Certified Service Provider (CSP), which is a third-party business that provides software for tax reporting as well as other services such as assistance with audits. Then, in 2018, the US Supreme Court in *South Dakota v. Wayfair, Inc.* ruled that businesses are required to remit sales taxes to a state if they make sufficient sales there—that is, if they have "substantial nexus," which may be met when an out-of-state business has at least $100,000 in annual sales in Tennessee.[2] As a result, few if any out-of-state businesses may qualify as volunteer sellers and therefore able to claim vendor compensation.[3]

[1] Tennessee Code Annotated, Section 67-6-509.
[2] Tennessee Department of Revenue 2024c.
[3] Correspondence with Jeff Bjarke, director of research, Tennessee Department of Revenue, November 26, 2024.

to constrain the compensation to large vendors, either by graduating the rate according to the amount due or by establishing a maximum payment amount."[53] Now, 30 years later, the total number of states offering vendor compensation has hardly changed,[54] but the general trend towards tamping down compensation rates and reining in maximum allowed amounts with caps has continued, with 20 states applying such constraints to compensation.[55]

The general trend towards tamping down compensation rates and reining in maximum allowed amounts with caps has continued, with 20 states applying such constraints to compensation.

Exactly how much vendor compensation should be—what rate or rates it should be set at—has been a question since the beginning: if it is meant to offset businesses' costs of collecting sales tax, then, in an ideal scenario, it should meet those costs precisely, no more and no less. In the middle of the 20th century, when sales taxes were still relatively new, there was a bevy of studies put forward by various groups in different states aiming to answer that very question of what it cost businesses to collect sales taxes, assessing such direct and indirect costs as the time to complete a sales transaction (and how much of that could be attributed to calculating the sales tax, if it was done manually), employee pay, time for employee training on sales tax issues, overhead costs such as for registers or other equipment that could be traced in some part to sales tax collection, and even the postage entailed in mailing in sales tax reports. The final answers were standardly

[53] Due and Mikesell 1994.
[54] Based on a comparison of current laws and those recorded in Due and Mikesell 1994, Arizona, New York, and Wyoming have introduced vendor compensation since the 1990s, while Oklahoma and Tennessee have eliminated it.
[55] Staff analysis of changes between the rates from 1994 to 2024, as based on data provided in Due and Mikesell 1994.

reported as a percentage of the tax that businesses collected (see table 3 for example results from studies in other states).

Table 3. Overall Costs of Sales Tax Collection as a Percentage of Sales Tax Collections for Businesses in Various States

State	Cost of Collection Found	Year of Study
Florida	9.82%	1971
Georgia	4.48%	1972
Illinois	4.20%	1963
Ohio	7.64%	1959
Virginia	6.81%	1971

Source: As summarized in Hendershot et al. 1976.

There is an economy of scale to sales tax collection that makes the costs typically lower for larger businesses.

One such study was conducted in Tennessee in 1976 under the sponsorship of the Tennessee Retail Merchants Association. Based on businesses' own reports, that study conducted two separate samples of businesses, the smaller of which, based on referrals to respondents, found the cost of collection to be 12.52%. The other study, based on a randomized sample of businesses, found the cost to be only 4.7%, with wide variations between and within businesses of different industries, leaving some uncertainty over the results.[56]

Studies of the cost of sales tax collection have seemingly become less common since the 20th century, but a PricewaterhouseCoopers study in 2006 found that the cost of sales tax collection ranged from 13.47% for small businesses to 2.17% for large businesses (or about 0.19% of all taxable sales).[57] In other words, there is an economy of scale to sales tax collection that makes the costs typically lower for larger businesses. And because of the wide differentials in what businesses collect, a simple form of vendor compensation that is built on a single flat rate or does not include a cap can leave large businesses taking sizable amounts in compensation, likely in excess of their actual costs. This is important because the distribution of sales tax collections is heavily skewed: half of businesses remit $2,591 or less per year in sales taxes each, while the top 1% of businesses each remit over $1.2 million (see table 4).[58]

[56] Hendershot et al. 1976.
[57] PricewaterhouseCoopers 2006.
[58] Correspondence with Jeff Bjarke, director of research, Tennessee Department of Revenue, September 6, 2024.

Because it is expressed as a percentage, the cost to collect will also appear lower if the sales tax rate—and thus the revenue collected—increases.

Table 4. Sales Tax Remitted by Tennessee Businesses by Decile

Percentile	Sales Tax Paid for Fiscal Year 2023-24
10th	$21.52
20th	$92.00
30th	$362.67
40th	$987.77
50th	$2,591.47
60th	$6,205.00
70th	$14,140.00
80th	$33,043.49
90th	$86,786.00
99th	$1,200,420.00

Source: Correspondence with Jeff Bjarke, director of research, Tennessee Department of Revenue, September 6, 2024.

Take Colorado as one example. Until 2020, that state allowed vendor compensation at a rate of 3.33% of sales tax collected, without any tiered rates or caps. Since 2020, the rate has been set at 4% but with a $1,000 cap that applies business-wide (as opposed to each store location of a business being able to individually claim $1,000 in compensation). An analysis by the Colorado state auditor found that a moderately-sized business with $1 million in monthly taxable sales and a large retailer with $100 million in monthly sales both would receive $1,000 in vendor compensation *after* that rate change and cap. Under the old scheme, however, the moderately-sized business would have received $966 in vendor compensation while the large retailer would have gotten $96,570.[59]

It's also important to note that because it is expressed as a percentage—that is, as a relative rather than an absolute value—the cost to collect will also appear to vary if the sales tax rate changes. For instance, suppose in a given state that the combined state and local sales tax rate was 5%. On a $100 purchase, the sales tax would be $5. Then suppose that the cost to a particular business to process that $5—purely as a hypothetical—was $0.25. This would mean that the cost to collect was 5% of the sales tax. However, if the sales tax rate were 9.75%—the actual combined state and local rate in most of Tennessee today—then the sales tax on the $100 purchase would of course be $9.75. But because past studies have suggested that the cost to collect does not scale directly with the amount of sales tax collected, the cost of collection on that transaction might still be $0.25, which is only about 2.6% of the sales tax collected instead of 5%, simply because the sales

[59] Colorado Office of the State Auditor 2019.

tax rate itself is higher. In short, as the sales tax rate goes up, the cost of collection as a percentage of the tax may go down and vice versa.

The cost factors for collection themselves have perhaps also changed over time. In the period before widespread automation, collecting sales tax did require a measurable amount of time on the part of cashiers, who either had to do a manual calculation or consult a chart of tax amounts for corresponding sales totals during each transaction to determine how much sales tax was owed. Today, of course, that is no longer the case. While there is still some amount of work involved in, for example, documenting tax-exempt sales or having employees check and compile tax report data, much of the process is now aided by software at one point or another, and reports can be made online. Some stakeholders do question whether other costs, like those for software, may not have offset any gains from automation.[60] But as the Department of Revenue has noted previously, "The overall cost of complying with sales and use tax collection and remittance is not burdensome and continues to decrease because of technological advances, software availability, and sales tax simplification."[61]

Card transaction fees have become a key concern for collection costs.

There is one cost factor that may have gained more prominence in recent decades, and that is credit and debit card transaction fees. Whenever a consumer makes a purchase with a credit or debit card, the retailer must pay a processing fee to have the payment moved from the consumer's bank to theirs, and that fee is based partly or entirely on a percentage of the transaction amount—for instance, if the card transaction fee were 2%, then on a $100 sale paid with a card, the business would naturally have to pay a fee of $2 for the processing of that $100. However, because the fee is based on the total transaction amount—including any taxes—any sales tax levied on a purchase contributes to the card transaction fees that businesses must pay. And as businesses say that the sales tax is not their money but the state's, many also argue that it is unfair that they should have to pay card transaction fees on the sales tax. For this reason, businesses have proposed having the state legally exclude sales taxes from being counted towards card transaction fees.

Whenever a consumer makes a purchase with a credit or debit card, the retailer must pay a processing fee to have the payment moved from the consumer's bank to theirs, and that fee is based partly or entirely on a percentage of the transaction amount.

There is no one model for how card transaction fees work—in fact, there is not even exact agreement over what to call them. Whereas some stakeholders refer to them as interchange fees, others insist that that term should only apply to a specific portion of the transaction fees. In any case, the fees are paid by the business that receives a customer's payment; what varies is who the fees are paid to, and that depends on the card used.

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[60] Interview with Rob Ikard, president, Tennessee Grocers and Convenience Store Association, May 20, 2024.
[61] Tennessee Advisory Commission on Intergovernmental Relations 2019.

Transaction fees may be split among the customer's bank, the business's bank, and the card network company, and not with an even distribution.

Some credit card companies like American Express and Discover establish direct relationships with merchants and then issue their own cards to consumers, making for what is sometimes referred to as a three-party model—that is, the merchant, cardholder, and the card company. In the case of those credit cards, the retailer receiving a customer's payment then pays the card transaction fee directly to the card company. Others like Visa and Mastercard, however, operate differently, in what is (somewhat confusingly) called a four-party model, consisting of the cardholder, the cardholder's bank that issues the credit or debit card (often referred to as the "issuer" in finance parlance), the merchant, and then the merchant's own bank with whom they do business (referred to as the "acquirer"); Visa, Mastercard, or some other card company then sits in the middle as a fifth party, serving as the network to link together both the merchant's bank and the cardholder's. For these cards, the transaction fees are split among several parties, and not with an even distribution. One example referenced by several stakeholders suggests that about 80% of the fee will go to the customer's bank that issued the card; about 12.5% to the business's bank that receives the payment; and then 7.5% to the card network company, such as Visa or Mastercard.[62] These percentages are not fixed, though, and again could vary depending on the exact kind of card used.[63] The fees for each bank and the card network company are all set separately, and only the largest portion exchanged between the merchant's and customer's banks is what most financial industry stakeholders consider to be the "interchange fee."[64]

Card transaction fees are typically set as a percentage of the total transaction, though the exact rate depends on the specific card and even how it is used—for instance, whether the card is used in person or online or whether a PIN is entered or not, as these choices are associated with different levels of fraud risk.[65] Rates are typically in the range of about 1% to 4%,[66] with one payments industry source reporting that the weighted average fee for all credit cards in 2022 was 2.19%.[67] For a sample breakdown of card transaction fees, see figure 3. Debit cards can be similar, but many are subject to Regulation II (pronounced "eye eye") under the Durbin Amendment, a federal regulation that was set in 2011. This requires that debit cards issued by banks with assets of $10 billion or more be limited to

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[62] America's Credit Unions 2024.
[63] Interview with Michael Mettee, chief financial officer, FirstBank, July 8, 2024.
[64] Interview with Paul Russinoff, head of state government engagement, and William Sheedy, senior advisor to chair and CEO, Visa, and Mandy Young, attorney, Butler Snow, June 5, 2024.
[65] Interviews with Andy Treharne, senior manager, state and local government affairs, Ralph Haro, managing vice-president, and Kayla Marshall, in-house legal counsel, Capital One, August 23, 2024.
[66] Interviews with Hugh Morrow, president and CEO, Ruby Falls, May 15, 2024; Rob Ikard, president, Tennessee Grocers and Convenience Store Association, May 20, 2024; and Emily LeRoy, executive director, Tennessee Fuel and Convenience Store Association, June 11, 2204.
[67] Electronic Payments Coalition 2023.

a base fee of $0.21 per transaction, plus 0.05% of the transaction amount, making for a much lower rate than most credit cards.

Figure 3. Breakdown of Card Transaction Fees on an Example Purchase

Base Cost of Goods Purchased	$ 100.00
Sales Tax (State and Local)	9.75
Total	$ 109.75
Card Transaction Fee Based on Total (Assuming a 2.2% Fee)	$ 2.41
Fee Portion Going to Cardholder's Bank (Assuming 80%)	$ 1.93
Fee Portion Going to Merchant's Bank (Assuming 12.5%)	0.30
Fee Portion Going to Card Network (Assuming 7.5%)	0.18
Out of Which, Portion of Card Transaction Fee Attributable to Sales Tax ($9.75 x 2.2%)	$ 0.21

Source: Commission staff analysis based on America's Credit Unions 2024.

Business stakeholders cite the costs related to card payments as a central concern.

Over the years, credit and debit card payments have outstripped cash and checks as the preferred means for retail purchases, elevating card transaction fees as an issue for retailers. Whereas ATM cash withdrawals amounted to $730 billion in 2021, credit and debit card payments combined amounted to $9.43 trillion, more than an order of magnitude greater.[68] Nationally, Federal Reserve data chart a decline from 31% of transactions being made in cash in 2016 to just 18% six years later—while for credit card usage those numbers were exactly reversed.[69] When combined with debit card usage, card payments accounted for 60% of all transactions as of 2022.[70] Furthermore, in that same year, 41% of Americans reported that they never used cash for any of their everyday purchases—although it is crucial to note that that number varied according to income, with lower-

Over the years, credit and debit card payments have outstripped cash and checks as the preferred means for retail purchases, elevating card transaction fees as an issue for retailers—card payments accounted for 60% of all transactions as of 2022.

[68] Federal Reserve Payments Study 2022. However, for context, automated clearinghouse (ACH) payments dwarfed all other payments, coming to $91.85 trillion—but these types of transactions are not necessarily for ordinary consumer purchases and are commonly used for larger payments, such as direct deposit of employee wages, mortgage or rent payments, and so on.
[69] Cubides and O'Brien 2023.
[70] Cubides and O'Brien 2023.

income individuals more likely to use cash.[71] All of this is perhaps reflected in anecdotal reports from Tennessee businesses that card payments now make up 80% or more of purchases at their businesses.[72] Because of this growth in card usage, even though card transaction fee rates have held relatively steady in recent years, the absolute fee amounts that retailers must pay have increased because of the sheer volume.[73]

Even small businesses attribute thousands of dollars in card transaction fees to the sales tax.[74] Some larger businesses might see more than a million dollars in transaction fees deriving from sales tax amounts.[75] And in a small sample of Tennessee businesses reporting their collection costs, an average of 85% came from card transaction fees on sales taxes.[76] As an upper bound estimate, and assuming an average transaction fee rate of 2.2% across all cards and that 80% of the dollar amount of sales tax was made with card payments, Tennessee businesses could have paid up to $200 million in card transaction fees based on sales tax amounts in 2022 (see table 5).[77]

Even small businesses attribute thousands of dollars in card transaction fees to the sales tax.

Table 5. Estimate of Card Transaction Fees Based on Sales Taxes in Tennessee, 2022

	Estimated Sales Tax through Credit Cards	Estimated Card Transaction Fees on Sales Tax
State Portion	$ 7,208,600,000	$ 158,589,200
Local Portion	1,766,763,037	38,868,787
Total	$ 8,975,363,037	$ 197,457,987

Note: This assumes 100% of card payments are subject to state and local sales taxes and that the average fee rate for such transactions is 2.2%. In practice these numbers will vary.

Source: Commission staff analysis based on Federal Reserve credit card payment data and Tennessee Department of Revenue sales tax data.

[71] Faverio 2022.
[72] Interview with Hugh Morrow, president and CEO, Ruby Falls, May 15, 2024; and correspondence with Sally Edwards Darnell, chief marketing officer, Quik Mart, June 24, 2024.
[73] Interview with Sarah Waters, chief advocacy officer, Tennessee Credit Union League, and Glenn Grossman, independent consultant, June 25, 2024.
[74] Correspondence with Stefan Wilson, CEO, Allevia Technology, July 8, 2024; and with Todd Murphy, owner, Murphy Group, July 17, 2024.
[75] Interview with Paul Cox, vice president of finance, and Brandy Potts, sales tax specialist, Food City, July 3, 2024.
[76] Commission staff survey of businesses.
[77] In reality, a rate of 2.2% is representative of credit cards (see Caporal 2024); many debit cards actually have much lower transaction fee rates, averaging at around 0.47% across all debit card networks (see Federal Reserve 2024). In the absence of precise data about the mix of debit versus credit card payments in Tennessee, however, the estimate here errs on the side of caution and assumes the rate of 2.2% is generally applicable so as to yield an upper bound estimate.

Financial industry stakeholders say that excluding sales taxes from card transaction fees would present a variety of issues.

Card transaction fees, financial industry stakeholders say, cover multiple costs, including the cost of issuing the cards themselves—reportedly anywhere from $2 to $11 each[78]—customer service for cardholders, rewards programs, and, perhaps most importantly, fraud protection. Financial industry stakeholders say that when, for example, there is a data breach or cyberattack at a retailer that leaks cardholders' information, it is the banks and credit unions that are responsible for making cardholders whole and restoring their security, and cards may have to be reissued en masse.[79] Even small credit unions may routinely see thousands of dollars in fraud losses a month that they must cover for their customers.[80] And from the point of view of financial institutions, the fact that some part of a transaction is made up of sales tax or some other fee is irrelevant—it is still money that has to be moved and accounted for.[81]

From the point of view of financial institutions, the fact that some part of a transaction is made up of sales tax or some other fee is irrelevant—it is still money that has to be moved and accounted for.

Banks and credit unions alike say that their card programs are not necessarily moneymakers,[82] and some may lose money if card transaction fees were curtailed. According to one financial industry source, credit card programs cost 1.6 times what interchange fees bring in; whatever profits can be obtained come from the interest on credit balances.[83] Some have found that in the wake of the Durbin Amendment and its effect of reducing revenue from debit card programs, banks responded by increasing fees or rates for various customer services to offset the lost revenue.[84] On that basis, some have suggested that any other regulation to limit card transaction fees would only lead to displacing costs onto banking customers.[85]

Financial industry stakeholders also say that businesses benefit from card payments, in part because some research has found that consumers buy more when paying with a card than with cash—a phenomenon sometimes referred to as "ticket lift."[86] But they also point out that, while

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[78] Interview with Sarah Waters, chief advocacy officer, Tennessee Credit Union League, and Glenn Grossman, independent consultant, June 25, 2024; and interview with Amy Heaslet, executive vice president and general counsel, Stacey Langford, executive vice president and chief operating officer, Tennessee Bankers Association, June 20, 2024.
[79] Interview with Sarah Waters, chief advocacy officer, Tennessee Credit Union League, and Glenn Grossman, independent consultant, June 25, 2024.
[80] Interview with Laura Parham, CEO, Heritage South Community Credit Union, July 25, 2024.
[81] Interview with Amy Heaslet, executive vice president and general counsel, Stacey Langford, executive vice president and chief operating officer, Tennessee Bankers Association, June 20, 2024.
[82] Interviews with Michael Mettee, chief financial officer, FirstBank, July 8, 2024; and Laura Parham, CEO, Heritage South Community Credit Union, July 25, 2024.
[83] America's Credit Unions 2024.
[84] Evans, Chang, and Joyce 2013; Haltom and Wang 2015; and Mukharlyamov and Sarin 2019.
[85] Zywicki, Manne, and Morris 2014.
[86] Interviews with Andy Treharne, senior manager, state and local government affairs, Ralph Haro, managing vice-president, and Kayla Marshall, in-house legal counsel, Capital One, August 23, 2024; and Julian Morris, senior scholar, International Center for Law and Economics, and Mandy Young, attorney, Butler Snow, August 6, 2024.

card transactions may come with an explicit cost for businesses, other forms of payment also come with costs. One study by IHL Group, a retail industry research group based in Tennessee, found that the average cost of handling cash across all industries amounted to 9.1% of payments, though it can vary from 4.7% for grocery businesses to as much as 15.5% for bars and restaurants (see table 6).[87] Those costs come from various factors that consume employee time and labor, like opening and closing out registers, reconciling amounts, handling audits, replenishing change and sometimes having to move money from registers to safes throughout the day, and so on—a separate study suggested that the staff in a typical convenience store spend "an average of 15-20 hours a week just counting cash."[88] Then there are also the costs of armored truck transport to banks, bank fees, and the loss of a certain amount of cash through theft or fraud, commonly called "shrinkage." Although these costs may be less visible and more indirect, financial industry stakeholders say that they can exceed those associated with card payments.

Financial industry stakeholders say there have been at least 58 bills introduced in 29 states over the years to exclude sales taxes from the calculation of card transaction fees, but none had ever passed until 2024.

Table 6. Cost of Handling Cash as a Percentage of Sales by Industry, 2017

Industry	Average Cost of Handling Cash
Bars/Restaurants	15.5%
Specialty Soft	12.9%
Fast Food	11.4%
Specialty Hard	11.3%
Department Stores	10.5%
Drug Stores	8.5%
Convenience Stores/Gas Stations	8.3%
Mass Merchants	7.0%
Warehouse Club/Hypermarket	5.5%
Food/Grocery	4.7%

Source: Buzek 2018.

Excluding sales taxes from card transaction fees is untested.

Financial industry stakeholders say there have been at least 58 bills introduced in 29 states over the years to exclude sales taxes from the calculation of card transaction fees,[89] but none had ever passed until 2024, when Illinois passed a measure to do just that.[90] The provision to exclude sales tax—and also gratuities—from card transaction fees does not take effect until July 1, 2025, and while businesses say it should be easy for the payment system to adapt to the sales tax exclusion, financial institutions

[87] Buzek 2018.
[88] National Association of Convenience Stores 2024.
[89] Grossman 2023.
[90] Illinois Public Act 103-0592, 2024.

and card companies say it would be technically challenging and require carving out local exceptions to what is a global system. They outline a few possible approaches, each of which they say presents its own difficulties. One possibility is that financial institutions and card processors might simply refuse to process the sales tax portion of a transaction, meaning a customer who tried to purchase something by card would then have to pay the sales tax separately by cash or check.[91] Alternatively, to continue handling sales taxes as part of a single transaction, financial institutions and card processors would have to revamp current systems, including both physical equipment and what data is reported to them.

When most credit and debit cards transmit data for transaction authorizations, they include only a minimal amount of information about the transaction.[92] This is what is sometimes referred to as level one processing. But there are also level two and level three cards that may include progressively more detailed information in the authorization, including the sales tax amount. Level two and three cards, however, are generally not available for use by individual consumers but only as commercial cards—that is, cards that businesses issue to employees for business-related expenses.[93] Businesses accepting these cards must also have compatible card reader equipment, which not all retail businesses do, and one representative for the card payment industry cautioned that the sales tax data transmitted with level two and three cards is only appended for reference and is not actually auditable on its own.[94] Financial industry stakeholders further note that, if this level of data is to be made available with every consumer transaction made for personal use, it may raise privacy concerns, as in some cases the specific taxes on a transaction (like those listed in table 1) might inadvertently reveal information about the contents of a purchase.[95]

Financial institutions and card companies say excluding sales taxes from card transaction fees would be technically challenging and require carving out local exceptions to what is a global system.

In any case, they warn that based on the experience of introducing chip-enabled cards and the several years it took to achieve widespread acceptance of them among retailers, any similar overhaul to the system would likely take considerable time.[96] It has also been suggested that efforts to exclude sales taxes from card transaction fees may not save businesses as much

[91] Interviews with Sarah Waters, chief advocacy officer, Tennessee Credit Union League, and Glenn Grossman, independent consultant, June 25, 2024; and Steven Rauschenberger, lobbyist for the Electronic Payments Coalition, July 8, 2024.
[92] Grossman 2023; and interview with Steven Rauschenberger, lobbyist for the Electronic Payments Coalition, July 8, 2024.
[93] Interview with Sarah Waters, chief advocacy officer, Tennessee Credit Union League, and Glenn Grossman, independent consultant, June 25, 2024.
[94] Interview with Steve Rauschenberger, lobbyist for the Electronic Payments Coalition, July 8, 2024.
[95] Interview with Paul Russinoff, head of state government engagement, William Sheedy, senior advisor to chair and CEO, Visa, and Mandy Young, attorney, Butler Snow, June 5, 2024.
[96] Interviews with Steven Rauschenberger, lobbyist for the Electronic Payments Coalition, July 8, 2024; and Laura Parham, CEO, Heritage South Community Credit Union, July 25, 2024.

as believed.[97] Card reader equipment—which businesses say can cost well in excess of $1,000 for a single terminal[98]—might have to be entirely replaced.[99] Financial institutions could also comply with an exclusion but then demand higher card transaction fee rates in new contracts with businesses to offset their losses.[100]

Ultimately, it is unclear how different stakeholders might respond if an exclusion of sales taxes from card transaction fees goes forward. In Illinois, a coalition of bankers and credit unions sued the attorney general of the state, arguing that the new law is preempted by federal laws such as the National Bank Act, the Home Owners' Loan Act, and the Federal Credit Union Act.[101] A Tennessee attorney general opinion from 2006 is of a similar view that there is a substantial likelihood that a court would find the National Bank Act preempts a state from regulating bank charges and fees on merchants.[102]

It is unclear how different stakeholders might respond if an exclusion of sales taxes from card transaction fees goes forward.

[97] Testimony at commission panel on vendor compensation by William Fox, special advisor to the chancellor, University of Tennessee, Knoxville, September 11, 2024.
[98] Correspondence with Tommy Hunt, CEO, Calloway Oil, and president, Tennessee Fuel and Convenience Store Association, July 19, 2024.
[99] Interviews with Sarah Waters, chief advocacy officer, Tennessee Credit Union League, and Glenn Grossman, independent consultant, June 25, 2024; and Steven Rauschenberger, lobbyist for the Electronic Payments Coalition, July 8, 2024.
[100] Interview with Steven Rauschenberger, lobbyist for the Electronic Payments Coalition, July 8, 2024; and testimony at commission panel on vendor compensation by William Fox, special advisor to the chancellor, University of Tennessee, Knoxville, September 11, 2024.
[101] Illinois Bankers Association, American Bankers Association, America's Credit Unions, and Illinois Credit Union League v. Kwame Raoul (1:24-cv-07307).
[102] Opinion No. 06-072.

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Appendix A: Public Chapter 1013, Acts of 2024

State of Tennessee

PUBLIC CHAPTER NO. 1013

SENATE BILL NO. 1140

By Lundberg, Walley

Substituted for: House Bill No. 886

By Hawk, Doggett

AN ACT to amend Tennessee Code Annotated, Title 67, Chapter 6, Part 5, relative to compensation for certain costs incurred by dealers in accounting for and remitting sales and use taxes to the state.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE:

SECTION 1.

(a) The Tennessee Advisory Commission on Intergovernmental Relations (TACIR) is directed to perform a study of the collection and remittance of state and local taxes, including sales and use taxes, collected at the point of sale by businesses in this state. The study must include, but not be limited to, examinations of:

(1) The cost to businesses of collecting and remitting state and local taxes;

(2) The cost to the State of Tennessee for reasonable remuneration for sales tax collection, including vendor compensation, to businesses as compared to other states; and

(3) The cost to businesses of payment card fees on the tax portion of transactions, including interchange fees and other fees associated with payment processing, as well as the cost to businesses of handling cash.

(b) All appropriate state departments and agencies shall aid TACIR in connection with the study required by subsection (a). It is the legislative intent that this study be conducted within existing resources.

(c) On or before January 31, 2025, TACIR shall report its findings and recommendations, including any proposed legislation, to the chairs of the Finance, Ways and Means committees of the House of Representatives and the Senate and to the General Assembly's legislative librarian.

SECTION 2. This act takes effect upon becoming a law, the public welfare requiring it.

SENATE BILL NO. 1140

PASSED: April 23, 2024

Randy McNally

RANDY McNALLY
SPEAKER OF THE SENATE

CAMERON SEXTON, *SPEAKER*
HOUSE OF REPRESENTATIVES

APPROVED this 28th **day of** May **2024**

Bill Lee

BILL LEE, *GOVERNOR*

Appendix B: Vendor Compensation Rates by State

State	State Sales Tax	Vendor Compensation	Tiered Rates	Rate(s)	Cap
Alabama	Yes	Yes	Yes	5% up to $100; 2% above	$400
Alaska	No	--	--	--	--
Arizona	Yes	Yes	Yes	1%, but 1.2% if filing electronically	$10,000 (annual); $12,000 (annual, filing electronically)
Arkansas	Yes	Yes	Yes	2%	$1,000 (for state and local each)
California	Yes	No	--	--	--
Colorado	Yes	Yes	Yes	4%	$1,000
Connecticut	Yes	No	--	--	--
Delaware	No	--	--	--	--
Florida	Yes	Yes	Yes	2.5% on first $1,200	$30
Georgia	Yes	Yes	Yes	3% up to $3,000; 0.5% above	--
Hawaii	Yes	No	--	--	--
Idaho	Yes	No	--	--	--
Illinois	Yes	Yes	No	Greater of $5 or 1.75% tax collected	--
Indiana	Yes	Yes	No	1%	
Iowa	Yes	No	--	--	--
Kansas	Yes	Out-of-state only	Variable	Variable	Variable
Kentucky	Yes	Yes	Yes	1.75% up to $1,000; 1.5% above	$50
Louisiana	Yes	Yes	Yes	1.05%	$1,500
Maine	Yes	No	--	--	--
Maryland	Yes	Yes	Yes	1.2% up to $6,000; 0.9% above	$500
Massachusetts	Yes	No	--	--	--
Michigan	Yes	Yes	Yes	0.75% on 2/3 of tax if remit before 12th of month; otherwise 0.5%	$20,000 before 20th; $15,000 thereafter
Minnesota	Yes	No	--	--	--
Mississippi	Yes	Yes	Yes	2%	$50
Missouri	Yes	Yes	No	2%	
Montana	No	--	--	--	--
Nebraska	Yes	Yes	Yes	3% up to $5,000	--
Nevada	Yes	Yes	No	0.25%	--

State	State Sales Tax	Vendor Compensation	Tiered Rates	Rate(s)	Cap
New Hampshire	No	--	--	--	--
New Jersey	Yes	No	--	--	--
New Mexico	Yes	No	--	--	--
New York	Yes	Yes	Yes	5%	$200
North Carolina	Yes	No	--	--	--
North Dakota	Yes	Yes	Yes	1.50%	$110
Ohio	Yes	Yes	No	0.75%	
Oklahoma	Yes	No	--	--	--
Oregon	No	--	--	--	--
Pennslyvania	Yes	Yes	Yes	1%	$25 monthly filing; $75 quarterly filing; $150 semiannual filing
Rhode Island	Yes	No	--	--	--
South Carolina	Yes	Yes	Yes	3% up to $100; 2% above	$3,000 annually for paper returns; $3,100 annually for electronic returns; $10,000 for out-of-state filers not required to file
South Dakota	Yes	Yes	Yes	1.50%	$70
Tennessee	Yes	Out-of-state only	--	2% up to $2,500; 1.15% above	$25
Texas	Yes	Yes	No	0.50%	--
Utah	Yes	Yes	No	1.31%	--
Vermont	Yes	No	--	--	--
Virginia	Yes	Yes	Yes	1.116% up to $62,500; 0.837% from $62,501 to $208,000; 0.558% above	Only for those with tax liability of less than $20,000
Washington	Yes	No	--	--	--
West Virginia	Yes	No	--	--	--
Wisconsin	Yes	Yes	Yes	0.75% or $10, whichever is greater	$8,000
Wyoming	Yes	Yes	Yes	1.95% up to $6,250; 1% above	$500

Source: Commission staff analysis of states' laws.