



# Streamlined Sales Tax Project

## DRAFT ISSUE PAPERS AND PROPOSALS

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August 2001

The Streamlined Sales Tax Project has prepared Issue Papers to explain in more detail the provisions of the proposals approved by the Project in December, 2000 (amended January, 2001.) In some instances, the draft proposals contain alternative positions. This document will be discussed at the Project meeting in Minneapolis, MN in August 2001.

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## I. Bad Debts

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# STREAMLINED SALES TAX PROJECT

## BAD DEBT ISSUE PAPER

### Background:

Development of a uniform allowance for bad debts was on the original list of uniformity features designated as necessary for the development of a streamlined sales and use tax system. The issue was assigned to the Sourcing and Other Simplifications Work Group. The work group recommended a provision, which was incorporated into the draft of the Streamlined Sales and Use Tax Agreement (the Agreement”), at section 318. The Agreement was adopted by the Streamlined Sales Tax Project (SSTP) on December 22, 2000. A copy of section 318 of the Agreement is Attachment 1 to this report.

Following adoption of the SSTP Agreement, some concerns about the bad debt provision have been raised. The greatest concern centered primarily on whether the language allowed states to offer the bad debt allowance to parties other than vendors, such as purchasers of retail debt. Other issues concerned the definition of a bad debt, the payment of interest on refunds of bad debt allowances, and the treatment of monies recovered on debts that previously had been claimed as bad debts.

On January 27, 2001, the Executive Committee of the National Conference of State Legislatures (NCSL) endorsed the SSTP's Uniform Sales and Use Tax Administration Act and the Agreement with several amendments. One of the amendments was the removal of section 318 from the Agreement for further consideration.

**Proposed Revisions:**

At the SSTP meeting in Milwaukee, WI on May 7, 2001, a meeting was held between the co-chairs of the Sourcing and Other Simplifications workgroup, the co-chairs of the SSTP, and representatives of industry that had expressed concerns about the bad debt language in the SSTP Agreement. As a result of this meeting, revised language for the bad debt provision was drafted. A copy of the revised language is Attachment 2 to this document. The differences between this language and the language of the SSTP Agreement are discussed below.

**Preliminary paragraph.**

Industry was concerned that the preliminary language of the SSTP Agreement, by only mentioning "bad debts incurred by a seller," implied that only sellers would be provided bad debt allowances. It was noted that several states already allow third party purchasers to claim a bad debt allowance. To clarify the point that states can provide allowances to whatever parties they deem appropriate, and to specify that the uniform procedures will apply to all claimants, and not just sellers, two sentences were added to the preliminary language.

**Paragraph a.**

The paragraph was shortened and the reference to refunds was removed. Since refund provisions occur later in the proposed language, it was felt unnecessary to refer to refunds in this paragraph.

**Paragraph b.**

This paragraph would be shortened by defining a bad debt by reference to the federal definition in I.R.C. section 166. Items excluded from the amount of the bad debt remained the same as in the SSTP Agreement with the exception of the exclusion for "debts sold or assigned to third parties for collection." That language was removed. Industry felt that language implied that states could not provide third parties with a bad debt allowance. Removal of the language would cause no harm to states since a seller that sold or assigned a debt could not claim the debt under federal law.

**Paragraph c.**

Unchanged.

**Paragraph d.**

No substantive change.

**Paragraph e.**

The SSTP Agreement allowed a claimant that had bad debts exceeding sales to file for a refund "within a twelve month period defined by that bad debt." The proposed change would allow a claimant to file a refund claim within each state's applicable statute of limitations, except that the statute would be measured "from the reporting period in which the bad debt is charged off."

**Paragraph f.**

No substantive change.

**Paragraph g.**

The proposed change removes language referring to "computing a bad debt deduction." The section will still apply the allocation of payments received on a previously claimed bad debt to tax and purchase price first and to "interest, service charges and any other charges" second. Subsequent to the Milwaukee meeting, one industry representative requested reconsideration of this provision. He advocated a position that any such payments should be applied to purchase price, tax, interest and service charges proportionally, rather than to tax and price first. Since this was not a change that came out of the meeting in Milwaukee, it has not been adopted in the language of Attachment 2.

**Paragraph h.**

This is a new paragraph added at the request of an industry representative. It deals with situations where a claimant has records that support an allocation of its bad debts among the member states. It says in such a case, the allocation will be permitted. The industry representative explained that some multi-jurisdiction sellers can identify and compute their bad debts, but have difficulty determining what debts are charged to which jurisdictions. In such a case, the proposed language would allow an allocation of the debts so long as the claimant can support the allocation in its records.

**ADDITIONAL ISSUES:**

In correspondence, a representative of the Electronic Commerce Association expressed concern with the use of the federal definition of a bad debt in paragraph b. of the proposed language. That paragraph defines a bad debt in terms of the Internal Revenue Code definition of a bad debt. The concern is that this definition would exclude payment processors from claiming a state bad debt allowance, even if a state should wish to provide it to them. In comments submitted on April 26, 2001, the issue was explained as follows:

In cases of worthless credit card payments, there might be a loss absorbed by the payment processor. That loss is a legal deduction for federal income tax purposes, but not as a bad debt. The Electronic Commerce Association maintains that bad debt deductions should be available to whatever entity does not receive payment for purchases on which there is a state sales tax, especially because the Streamlined Sales Tax Project is encouraging vendors to use third parties to handle their transactions.

In an e-mail dated July 2, 2001, the representative of the Electronic Commerce Association suggested an amendment to second sentence the initial paragraph of the proposed language. The suggested amendment to that sentence would read, "To the extent a member state provides a bad debt deduction to any other party, the same procedures will apply (with the exception of the bad debt definition in (b))." This change would make the definition of a bad debt apply only to sellers and allow states to use whatever definition they wished for other parties. One problem with the proposed amendment is that it creates an exception to when the "procedures" of the rule apply. The referenced paragraph (b) does not set out a procedure, it is a definition. If a change of the nature suggested by the ECA is desirable, different language, perhaps in paragraph (b) should be considered. The work group has not addressed this suggested change. This will be an issue for the member states that adopt the Streamlined System.

One industry representative raised a concern at the Raleigh meeting about the language of paragraph c. of the proposed language. That language currently requires a bad debt to be "charged off for federal income tax purposes" before the debt can be claimed for sales tax. The representative stated that many states allow the bad debt deduction to be claimed when the debt is determined to be uncollectible in the taxpayer's books and records. The representative felt the current language made claimants wait until a federal return is filed in order to claim a state bad debt allowance. The possible advantages of the proposed change would include allowing claimants of the bad debt deduction to make claims sooner and not carry them until the federal return is filed. For states, an advantage would be that bad debt claims spread out over the year and situations where taxpayers are in credit situations might be reduced. A disadvantage for states would be that the looser standard for claiming bad debts might be harder to audit and verify. The work group has not addressed this suggested change. This will be an issue for the member states that adopt the Streamlined System.

**Conclusion:**

Attachment 2 exists as an alternative bad debt provision that addresses some of the concerns expressed about the bad debt provision in the SSTP Agreement.

The only version of the bad debt language that has been approved by the Project is the language in the SSTP Agreement adopted in December 2000. As noted above, the version of the Agreement recommended by the NCSL removed the bad debt provision entirely. It will be up to the member states of the Streamlined System to resolve how bad debts will be addressed in the final operating agreement.

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## Attachment 1

### 318 UNIFORM RULES FOR DEDUCTIONS OF BAD DEBTS

In order to reduce the complexity and administrative burden of taking a deduction for bad debts incurred by a seller, the member states must:

- a. In computing the amount of tax due, allow a seller to deduct bad debts from the total amount upon which the tax is calculated for any return. Any deduction taken or refund paid which is attributed to bad debts shall not include interest.
- b. Define for purposes of this section, "bad debt" to mean any portion of the purchase price of a transaction that a seller has reported as taxable and for which the seller legally claims as a bad debt deduction for federal income tax purposes. Bad debts include, but are not limited to, worthless checks, worthless credit card payments, and uncollectible credit accounts. Bad debts do not include financing charges or interest, sales or use taxes charged on the purchase price, uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid, expenses incurred in attempting to collect any debt, debts sold or assigned to third parties for collection, and repossessed property.
- c. Allow bad debts to be deducted within twelve months following the month in which the bad debt has been charged off for federal income tax purposes. For purposes of this paragraph, "charged off for federal income tax purposes" includes the charging off of unpaid balances due on accounts as uncollectible, or declaring as uncollectible such unpaid balance due on accounts in the instance of a seller who is not required to file federal income tax returns.
- d. Require that if a deduction is taken for a bad debt and the seller subsequently collects the debt in whole or in part, the tax on the amount so collected must be paid and reported on the return filed for the period in which the collection is made.
- e. Allow a seller to obtain a refund of tax on any amount of bad debt that exceeds the amount of taxable sales within a twelve month period defined by that bad debt.
- f. Where a seller's filing responsibilities have been assumed by a Certified Service Provider, allow the service provider to claim, on behalf of the seller, any bad debt allowance provided by this section. The CSP must credit or refund the full amount of any bad debt allowance or refund received to the seller.



- g. Provide that for the purposes of computing a bad debt deduction or reporting a payment received on a previously claimed bad debt, any payments made on a debt or account are applied first to the price of the property or service and sales tax thereon, proportionally, and secondly to interest, service charges and any other charges.

This section addresses the priorities for payments on a debt or account. To the extent a payment is made on a debt or account, the payment is applied first to the price of the property or service and sales tax thereon, proportionally, and secondly to interest, service charges and any other charges.

Any deduction for a bad debt is subject to the limitations of Section 166. Any deduction for a bad debt is subject to the limitations of Section 166.

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## Attachment 2

### 318 UNIFORM RULES FOR RECOVERY OF BAD DEBTS

This Section addresses the procedures that member states will use to provide a deduction for bad debts to a seller. To the extent a member state provides a bad debt deduction to any other party, the same procedures will apply. In order to reduce the complexity and administrative burden of taking a deduction for bad debts incurred by a seller, the member states must:

- a. Allow a deduction from taxable sales for bad debts. Any deduction taken which is attributed to bad debts shall not include interest.
- b. The federal definition of "bad debt" in IRC §166 shall be used as the basis for calculating bad debt recovery. However, the amount calculated pursuant to IRC §166 shall be adjusted to exclude: financing charges or interest; sales or use taxes charged on the purchase price; uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid; expenses incurred in attempting to collect any debt, and repossessed property.
- c. Allow bad debts to be deducted within twelve months following the month in which the bad debt has been charged off for federal income tax purposes. For purposes of this paragraph, "charged off for federal income tax purposes" includes the charging off of unpaid balances due on accounts as uncollectible, or declaring as uncollectible such unpaid balance due on accounts in the instance of a seller who is not required to file federal income tax returns.
- d. Require that, if a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount so collected must be paid and reported on the return filed for the period in which the collection is made.
- e. Provide that refund claims for tax, when the amount of bad debt exceeds the amount of taxable sales, may be filed within the Member State's otherwise applicable statute of limitations for refund claims, however, the statute of limitation shall be measured from the reporting period in which the bad debt is charged off.
- f. Where filing responsibilities have been assumed by a Certified Service Provider, allow the service provider to claim, on behalf of the seller, any bad debt allowance provided by this section. The CSP must credit or

refund the full amount of any bad debt allowance or refund received to the seller.

g. Provide that, for the purposes of reporting a payment received on a previously claimed bad debt, any payments made on a debt or account are applied first proportionally to the taxable price of the property or service and the sales tax thereon, and secondly to interest, service charges, and any other charges.

h. In situations where the books and records of the party claiming the bad debt allowance support an allocation of the bad debts among the member states, such allocation shall be permitted.

**NOTE: Bad Debt Questionnaire is located at the end of document beginning on page 78.**

## ROUNDING SURVEY ISSUE PAPER

Page 78

The purpose of this survey is to determine the impact of the rounding issue on the tax liability of taxpayers. The survey is designed to collect information on the following issues:

- 1. The amount of the rounding issue.
- 2. The number of taxpayers affected.
- 3. The impact of the rounding issue on the tax liability of taxpayers.
- 4. The impact of the rounding issue on the tax liability of taxpayers.

Page 79

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## II. Rounding

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# STREAMLINED SALES TAX PROJECT

## ROUNDING SURVEY ISSUE PAPER

### Background

Last year, the Sourcing and Other Simplification Issues Work Group determined a need for uniform application by states for rounding the tax due on a sale. This was supported by comments received from sellers who make sales in multiple states having different rounding statutes or rules. The sellers did not specify which statute or rule they preferred, only that uniform rules be developed. The Work Group recently asked each state to complete a survey regarding the Streamlined Sales Tax Project's rounding recommendation. Twenty-five states responded. Nineteen states responded that there would be little, if any, impact if they adopted the Work Group's recommendation. Four states responded that there would be a major impact, mostly from a revenue standpoint. Two states indicated that they have not yet completed an analysis to determine if they will have a revenue impact.

### Methods of Rounding

The survey showed that states use three different methods for sellers to determine the tax due on a sale when involving a fraction of a cent. Three states use a bracket system to determine the tax owed and 22 states allow rounding when the tax due on a sale or on a return involves a fraction of a cent or dollar. Of those 22 states, four states indicated they round up to the nearest cent, and nine round up for anything .5 and over and round down for anything below .5.

The Work Group recommended that states adopt the latter method because we felt it was the most acceptable method for consumers who might otherwise feel that the state was being enriched at their expense. For those states that have a round up rule or brackets, this change will have some revenue impact.

### **Decimal Points for Tax Due**

The survey also shows that states employ different rules for how far sellers are required to carry out the decimal places in determining the tax due. One state carries out to one decimal place, one state carries out two decimal places, 14 states carry out to three decimal places, one carries out to four decimal places, and one state carries out to six decimal places. Last year, the Work Group recommended that sellers be required to carry out to three decimal places, since this was the method most used by states.

### **Rounding on Tax Returns**

Last year, the Work Group recommended the states which allow taxpayers to round to the nearest dollar on their tax returns when they report the tax owed be allowed to continue this practice. Our survey shows that four states require taxpayers to use this method and one state encourages (but does not require) this method.

### **Taxing Separate Items or Invoice**

The Work Group also considered two alternate approaches to a rounding statute. One approach requires the seller to charge tax on the aggregate taxable amount of the sale if there are multiple taxable items being purchased at one time. The other approach would have sellers charge tax on each individual taxable item being sold where multiple taxable items are being purchased at one time. The Work Group heard from some sellers that they would prefer to charge tax separately on each taxable item included in the sale rather than on the total amount. The Work Group was concerned, however, that some customers may find this confusing and some vendors without computer systems would find it difficult to comply. The survey shows that 16 states either require or allow rounding on the total invoice amount and six states allow the sellers to choose either method, as long as it is consistently used. One state reports requiring rounding on the invoice amount except in cases where a maximum tax is involved. Another state reports that rounding on the total invoice is required for certain taxpayers, while rounding on each item on the invoice is required for others. The Work Group determined it would be best to leave this issue to the sellers. Since this proposal calls for arithmetic rounding, any differences caused by sellers using different approaches should be insignificant.

## Summary

Overall the most significant issue shown by the survey is that four states will experience a major revenue loss if they adopt these recommendations.

Additional comments on the survey

The survey shows that while there is a general consensus that the recommendations are necessary, there is a significant concern about the impact on state revenue. Four states are projected to experience a major revenue loss if they adopt these recommendations. This is a significant issue that needs to be addressed.

Additional comments on the survey

It is important to note that while the recommendations are necessary, the impact on state revenue is a significant concern. Four states are projected to experience a major revenue loss if they adopt these recommendations. This is a significant issue that needs to be addressed.

Additional comments on the survey

The survey results indicate that there is a strong consensus that the recommendations are necessary. However, there is a significant concern about the impact on state revenue. Four states are projected to experience a major revenue loss if they adopt these recommendations. This is a significant issue that needs to be addressed.

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## **STREAMLINED SALES TAX PROJECT**

### **DIRECT PAY PERMIT ISSUE PAPER**

#### **Background**

The Sourcing and Other Simplification Issues Work Group has been asked to review the issue of Direct Pay Permits.

As part of its work on uniform sourcing rules, the Work Group created a "multiple points of use" exemption. (see Section 310 of the Streamlined Sales And Use Tax Agreement ).

This concepts states that "...a business purchaser that is not a holder of a direct pay permit that knows at the time of its purchase of a digital good or a service that the digital good or service will be concurrently available for use in more than one jurisdiction shall deliver to the seller in conjunction with its purchase a form disclosing this fact ("Multiple Points of Use or MPU" Exemption Form)." Upon receipt of this MPU Exemption Form, the seller is relieved of all obligation to collect, pay, or remit the applicable tax and the purchaser shall be obligated to collect, pay, or remit the applicable tax on a direct pay basis.

Coincidentally, but not in conjunction with the SSTP, a Model Direct Payment Permit Regulation was being developed through the FTA-led EDI process. This process involved both the public and private sectors. This document was endorsed by both the FTA and the MTC and was adopted in July 2000. This model regulation has received widespread support from industry and tax agencies.

In April 2001, a 4-question survey was sent to all SSTP states asking them to provide information on their states' position regarding direct pay in general and this document in particular. The four questions asked were:

1. Does your state currently have a Direct Payment provision for sales and use tax purposes for registered taxpayers?
2. Is Direct Payment offered to all registered taxpayers in your state or are there restrictions as to whom may report through a direct pay provision?
3. Are there certain transactions not permitted to be reported by Direct Payment?
4. Attached is the FTA/MTC Model Direct Payment Permit Regulation (adopted July 28, 2000). Has your state adopted this model regulation? If not, has it been considered in your state? Are there any reasons why it was not adopted? Would your state have any problem if this document were to be used as a draft for the creation of a Direct Pay Provision for the SSTP Project?

### Survey Results

To date, 25 states have responded to this survey request:

(AR CT GA ID IL IA KS KY MD MI MN MO NE NV NJ NC ND OH RI SD TN UT WA WI WY)

Their answers to the inquiries are as follows:

1. Of the 25 states that responded, 22 indicated that they currently have some form of Direct Pay provision in their state and 3 indicated that they did not (NV, RI, UT).
2. All 22 states that offered a Direct Pay provision had some type of restriction as to who was eligible for it. Restrictions included:
  - Only manufacturers and contractors
  - Only to perpetually audited taxpayers
  - Requiring written application
  - Demonstration of accounting and technical capability to comply
  - Sales or use tax liability greater than a certain dollar amount
  - In the best interests of their state
  - Available only to taxpayers who, at the time of purchase, cannot determine tax status
  - Business must agree that its name will be published as a Direct Payment permit holder
  - Remit taxes by electronic funds transfer
  - Taxpayer must be in good standing



3. Most states acknowledge some transactions that were restricted from Direct Payment. The more common transactions not allowed to be reported through direct pay are:

- Food and mixed drinks
- Meals, lodgings, automobiles, new construction, vessels, aircraft, snowmobiles, telecom, utilities, and procurement card purchasers
- Contractors or their suppliers, suppliers of gasoline
- Only for tangible personal property
- Gas, electricity, water, heat, pay television, communication services, motor vehicles
- Energy and energy-producing fuels
- Petty cash purchases made by company employees
- Admissions to places of amusement or athletic events
- Cash purchases

4. As of this date, no state had adopted the FTAMTC proposed Model Regulation although several stated that it was so similar to their current policy that there was no need to adopt it or they based their policy on the model. States that had considered the model regulation and did not pass it mentioned reasons such as:

- it did not include an expiration date
- it might provide an exemption for items purchased for use outside the state
- they did not like the ability of a taxpayer to revoke the procedure "at any time"
- there was no "out" for a state to deny issuance where it feels issuance is not in the state's best interest
- did not allow payment of local taxes

### Summary

Most states felt the FTAMTC Model Regulation was a good document. No state indicated any foreseen problem with the SSTP using the FTAMTC Model Regulation as a starting point for the creation of a Direct Pay Provision.

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## **STREAMLINED SALES TAX PROJECT**

### **CAPS AND THRESHOLDS ISSUE PAPER**

**Caps-** Caps can be classified as either dollar caps or rate caps. Dollar caps are limits to the amount of tax that is charged on a purchase. Rate caps are limits on the rate that can be applied when determining the tax amount.

#### **Existing Caps**

Arkansas- A dollar cap of \$2,500 for local sales and use tax per single item purchased.

Florida- A dollar cap of \$50,000 on the purchase of a single item.

North Carolina- A dollar cap of \$80 in tax for single articles of manufacturing equipment, farm equipment, and a few other items. Legislation passed which removes the cap for manufacturing equipment from the sales and use tax law.

North Dakota- A dollar cap of \$2,500 for local sales and use tax per single item purchased.

South Carolina- A dollar cap of \$300 on the purchase of an automobile.

Tennessee- A dollar cap of \$1,600 for local sales and use tax per single item purchased.

Texas- a rate cap of 8% for the state levy and any local levies. While there are locations for which the combination of the state and local levies exceed 8%, the amount used cannot exceed 8%.

Wisconsin- A dollar cap of \$3,500 on the purchase of a manufactured home.

**Threshold-** an exclusion from taxation or the application of a different tax rate for amounts above or below the set threshold level.

### Existing Thresholds

Connecticut- clothing and footwear priced below \$75 is exempt.

Louisiana- the first \$50,000 on the purchase of farm equipment is exempt.

Maine- 95% of the cost of fuel and electricity used in a manufacturing facility is exempt.

Maryland- all items priced at 20 cents or below are exempt. Equipment used in baking priced below \$2,000 is exempt.

New York- all clothing priced below \$110 is exempt.

Ohio- all items priced at 16 cents and below are exempt.

Tennessee- for cable TV all amounts below \$15 are exempt and amounts between \$15 and \$27.50 and amounts above \$27.50 are charged different rates. Airplanes are taxed at 6% up to \$100,000 and 3% above \$100,000. Purchase and repair of farm machinery costing more than \$250 is exempt. Caskets and burial vaults are exempt on the first \$500. Re-manufacturing machinery costing more than \$1,000 is exempt. Animal grooming is exempt on 85% of the charge. Certain club memberships dues are exempt up to \$150 per year.

Texas- for cable TV all amounts below \$25 are exempt.

### SSTP Agreement Language Concerning Caps and Thresholds

The following is the language regarding caps and thresholds that has been adopted by the project. This language was developed after input from retailers indicating that caps and thresholds are very difficult to administer.

308 a. To reduce the complexity and administrative burden of collecting sales and use taxes, all member states must:

3. Not have caps or thresholds on the application of state sales or use tax rates or exemptions that are based on the value of the transaction or item after December 31, 2005. A State may continue to have caps and thresholds until that date.
6. The provisions of paragraphs (3) and (4) of this subsection do not apply to sales or use taxes levied on the transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes or mobile homes.

308 b. Member states that have local jurisdictions that levy a sales or use tax must:

2. Not place caps or thresholds on the application of local sales or use tax rates or exemptions that are based on the value of the transaction or item.
10. The provisions of paragraphs (1) and (2) of this subsection do not apply to sales or use taxes levied on the transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes or mobile homes.

#### **Issues**

##### **1. Exception for Alternative Administration of Caps**

It is recommended that language be added to the Agreement which allows caps and thresholds in instances where the administrative burden of claiming the exemption is placed on the beneficiary of the exemption and not the retailer.

##### **2. Further Input from Retailers and States**

Retailers are working on additional information related to their position on caps and thresholds.

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## **STREAMLINED SALES TAX PROJECT**

### **SALES TAX HOLIDAYS ISSUE PAPER**

Sales tax holidays are temporary sales tax exemptions on certain items for a specific period of time. The tax holiday typically falls during August, the traditional back-to-school shopping period. The exemption generally only applies to merchandise connected with the new school year, particularly clothing and footwear. Most states have placed a ceiling on the price of eligible merchandise.

#### **Existing Sales Tax Holidays**

**New York** The first state to adopt a sales tax holiday was New York. In January of 1997 a weeklong sales tax exemption was put in place for all articles of clothing and footwear that sold for less than \$500. Local taxing jurisdictions were given the option of exempting these same items from the local sales tax levies. Most counties and cities did suspend their local taxes during the holiday.

For the next three years, New York offered two tax-free shopping weeks per year. Effective March 1, 2000, New York switched to a permanent sales tax exemption for clothing and footwear selling for less than \$110. Participation by local governments is still optional.

**Florida** In 1998, Florida became the second state to approve a sales tax holiday. Their initial holiday exempted clothing with a selling price under \$50 for one week in August. Florida has enacted two additional sales tax holidays since that time and has raised the price limit to \$100.

**Texas** In 1999 Texas enacted an annual back-to-school sales tax holiday on clothing and footwear with a selling price less than \$100. Texas was the first state to place into law that the holiday would reoccur each year.

**Connecticut** Clothing and footwear items that cost less than \$75 are and have been exempt from the sales tax in Connecticut. Under the sales tax holiday that was adopted in 2000, clothing and footwear priced under \$300 is exempt for one week in August. A holiday has also been adopted for 2001.

**Pennsylvania** Two holidays were enacted in 2000 in Pennsylvania. They were for a week in August of 2000 and for a week in February of 2001. Items exempted are computers and computer software and hardware when purchased with a computer. There is no price limit on the application of the exemption. A proposal currently under consideration would expand the holiday to include computer peripherals purchased without a PC and Internet access devices. The proposed periods are a week in August of 2001 and a week in February 2002.

**South Carolina** The sales tax holiday in South Carolina is an annual event which occurs on the first full weekend in August - beginning on the first Friday at 12:01 am. The list of exempt items is much broader than other states. In addition to exempting school supplies such as paper, pencils, pens, notebooks, and lunchboxes, South Carolina also exempts during the holiday other items such as clothing, footwear, computers, computer software, printers, printer supplies, and clothing accessories (hats, hosiery and handbags). There is no price limit on the application of the exemption; however, the exemption does not apply to items used in a trade or business, jewelry, cosmetics, eyewear, wallets, watches, furniture, layaway items, and the rental of clothing or footwear.

**Iowa** The holiday enacted in Iowa in 2000 exempts clothing and footwear priced under \$100. The holiday is an annual event lasting 2 days each August.

**Maryland** The holiday enacted in Maryland in 2000 exempts sales of clothing and footwear priced under \$100 for the week of August 10-16, 2001. There will not be a holiday in 2002.

Bills authorizing sales tax holidays are currently under consideration in Missouri and Ohio.

CHART 1

## CURRENT SALES TAX HOLIDAYS

STATE	DAYS	ITEMS INCLUDED	MAX. COST	1ST YEAR	2001 DATES	EXEMPT LOCAL
Florida	9	Clothing and Accessories	\$100	1999	N/A*	Yes
Texas	3	Clothing and Footwear	\$100	1999	Aug. 3 - 5	Optional**
Connecticut	7	Clothing and Footwear	\$300	2000	Aug. 18 - 24	N/A***
South Carolina	3	Clothing & Accessories, Footwear, School Supplies, Computers and Software, Printers & Printer Supplies	None	2000	Aug. 3 - 5	Yes
Pennsylvania	14	Computers	None	2000	Feb. 18 - 25	Yes
Iowa	2	Clothing And Footwear	\$100	2000	Aug. 3 - 4	Yes
Maryland	7	Clothing	\$100	2001	Aug. 10 - 16	N/A***

\*The holiday has not yet been enacted for 2001.

\*\*Local jurisdictions have the option of not exempting items during the holiday. In Texas, all cities are now participating.

\*\*\*No local option taxes.

## SSTP Agreement Language Concerning Holidays

The following is the language regarding sales tax holidays that has been adopted by the project.

308 f. If a member state allows for temporary exemption periods, commonly referred to as sales tax holidays, the State must not apply an exemption after December 31, 2003 unless the item exempted has been defined under the provisions of Section 312. Further, if the State provides local jurisdictions with the option of levying a sales or use tax, the State must provide notice of the exemption period at least sixty (60) days prior to the first day of the calendar quarter in which the exemption period will begin and apply the exemptions to both state and local tax bases.

### Issues

**1) Definition Requirement**

The current language would prohibit a state from exempting an item from taxation during a sales tax holiday unless it is specifically defined under the Agreement. Some retailers have expressed a concern that this prohibition is too strict. They agree that if a state is going to exempt items that are defined in the Agreement that the definitions must be followed. They do not, however, want to prohibit a state from exempting items not defined in the agreement if the state chooses to do so.

**2) Separate Definition Section of Agreement for Sales Tax Holidays**

The current language requires that the states must utilize the definitions in Section 312 of the Agreement when enacting a sales tax holiday. It may be more appropriate to create a separate definition section that is specifically for the purpose of sales tax holidays.

**3) Prohibit Use Based Exemptions**

Retailers have expressed a concern that items that are to be defined for the purpose of a sales tax holiday be easily identifiable and that the determination of taxability not be based on the use of the product. This can be addressed through a prohibition on exemptions that are dependent on how the item is used by the customer. It can also be addressed through the language of the definition section. (The outcome of Issue #1 above will also impact how this issue is resolved)



**4) Notification Requirement**

The current language regarding the 60 day notice only applies to states that have local option levies. It has been suggested that this notice requirement should apply to all states.

**5) Administrative Issues**

There are many administrative issues involved with the implementation of a sales tax holiday. These issues include:

- a. Application of caps
- b. Treatment of layaway purchases
- c. Exempt and Nonexempt items that are packaged together
- d. Treatment of coupons or discounts
- e. Splitting of items normally sold together
- f. Treatment of rainchecks
- g. Treatment of items purchased before the holiday being exchanged during the holiday
- h. Treatment of items purchased during the holiday being exchanged after the holiday
- i. Shipping and handling charges

A copy of the Sales Tax Holiday rules used in Texas and information concerning how these issues are handled in Florida are attached. Other states and retailers are asked to review this information and provide comments on the possible adoption of a set of "model rules" that could be used in all states. A concern with adopting rules specifically for sales tax holidays is that they may conflict with rules already in place for other exemptions.

## STATE OF TEXAS

### COMPTROLLER OF PUBLIC ACCOUNTS

#### STATE SALES AND USE TAX

#### Section 3.365. Sales of Clothing and Footwear During a Three-day Period in August. (Tax Code, secs. 151.326 and 151.3111)

- (a) **Definitions.** The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise. Clothing or footwear - An article of apparel that the article manufacturer designs for wear on or about the human body. For the purposes of this section, the term does not include accessories, such as jewelry, handbags, purses, briefcases, luggage, wallets, watches, and similar items that are carried on or about the human body, without regard to whether the item is worn on the body in a manner that is characteristic of clothing.
- (b) **Exempt sales.**
- (1) Sales or use tax is not due on the sale of an article of clothing or footwear if:
    - (A) the sales price of the article is less than \$100; and
    - (B) the sale takes place during the period that begins at 12:01 a.m. on the first Friday in August and ends at 12:00 a.m. (midnight) of the following Sunday.
  - (2) The exemption applies to each article of clothing or footwear that sells for less than \$100, regardless of how many items are sold on the same invoice to a customer. For example, if a customer purchases two shirts for \$80 each, then both items qualify for the exemption, even though the customer's total purchase price (\$160) exceeds \$99.99.
  - (3) The exemption does not apply to the first \$99.99 of an article of clothing or footwear that sells for more than \$99.99. For example, if a customer purchases a pair of pants that costs \$110, then sales tax is due on the entire \$110.
- (c) **Taxable sales.** This exemption does not apply to:
- (1) any special clothing or footwear that the manufacturer primarily designed for athletic activity or protective use and that is not normally

worn except when used for the athletic activity or protective use for which the manufacturer designed the article. For example, golf cleats and football pads are primarily designed for athletic activity or protective use and are not normally worn except when used for those purposes; therefore, they do not qualify for the exemption. However, tennis shoes, jogging suits, and swimsuits are commonly worn for purposes other than athletic activity and thus qualify for the exemption;

(2) accessories, such as jewelry, handbags, purses, briefcases, luggage, umbrellas, wallets, watches, and similar items that are carried on or about the human body, without regard to whether the item is worn on the body in a manner that is characteristic of clothing;

(3) the rental of clothing or footwear. For example, this exemption does not apply to the rental of formal wear, costumes, uniforms, diapers, or bowling shoes;

(4) taxable services that are performed on the clothing or footwear, such as repair, remodeling, or maintenance services, and cleaning or laundry services. For example, sales tax is due on alterations to clothing, even though the alterations may be sold or invoiced, and the customer pays such invoice, at the same time as the clothing is being altered. If a customer purchases a pair of pants for \$90 and pays \$15 to have the pants cuffed, then the \$90 charge for the pants is exempt, but tax is due on the \$15 alterations charge; and

(5) purchases of items that are used to make or repair clothing or footwear, including fabric, thread, yarn, buttons, snaps, hooks, and zippers.

(d) Articles normally sold as a unit. Articles that are normally sold as a unit must continue to be sold in that manner; they cannot be priced separately and sold as individual items in order to obtain the exemption. For example, if a pair of shoes sells for \$150, then the pair cannot be split in order to sell each shoe for \$75 to qualify for the exemption. If a suit is normally priced at \$225 on a single price tag, the suit cannot be split into separate articles so that any of the components may be sold for less than \$100 in order to qualify for the exemption. However, components that are normally priced as separate articles may continue to be sold as separate articles and qualify for the exemption if the price of an article is less than \$100.

(e) Sales of sets containing both exempt and taxable items.

(1) When exempt clothing or footwear is sold together with taxable merchandise as a set or single unit, the full price is subject to sales tax unless the price of the exempt clothing or footwear is separately stated. For example, if a boxed gift set that consists of a French-cuff dress shirt, cufflinks, and a tie tack is sold for a single price of \$95, the full price of the boxed gift set is taxable because the cufflinks and tie tack are taxable and the sales price of the shirt is not separately stated.

(2) When exempt clothing is sold in a set that also contains taxable merchandise as a free gift and no additional charge is made for the gift, the exempt clothing may qualify for this exemption. For example, a boxed set may contain a tie and a free tie tack. If the price of the set is the same as the price of the tie sold separately, the item that is being sold is the tie, which is exempt from tax if the tie is sold for less than \$100 during the exemption period. Note: When a retailer gives an item away free of charge, the retailer owes sales or use tax on the purchase price that the retailer paid for the item.

(f) Discounts and coupons.

(1) A retailer may offer discounts to reduce the sales price of an item. If the discount reduces the sales price of an item to \$99.99 or less, the item may qualify for the exemption. For example, a customer buys a \$150 dress and a \$100 blouse from a retailer who offers a 10% discount. After application of the 10% discount, the final sales price of the dress is \$135, and the blouse is \$90. The dress is taxable (its price is over \$99.99), and the blouse is exempt (its price is less than \$99.99).

(2) When retailers accept coupons as a part of the sales price of any taxable item, the value of the coupon is excludable from the tax as a cash discount, regardless of whether the retailer is reimbursed for the amount that the coupon represents. Therefore, a coupon can be used to reduce the sales price of an item to \$99.99 or less in order to qualify for the exemption. For example, if a customer purchases a pair of shoes priced at \$110 with a coupon worth \$20, the final sales price of the shoes is \$90, and the shoes qualify for the exemption.

(g) Buy one, get one free or for a reduced price. The total price of items that are advertised as "buy one, get one free," or "buy one, get one for a reduced price," cannot be averaged in order for both items to qualify for the exemption. The following examples illustrate how such sales should be handled.

(1) A retailer advertises pants as "buy one, get one free." The first pair of pants is priced at \$120; the second pair of pants is free. Tax is due on \$120. Having advertised that the second pair is free, the store cannot register the charge for each pair of pants at \$60 in order for the items to qualify for the exemption. However, if the retailer advertises and sells the pants for 50% off, and sells each pair of \$120 pants for \$60, each pair of pants qualifies for the exemption. Note: When a retailer gives an item away free of charge, the retailer owes sales or use tax on the purchase price that the retailer paid for the item.

(2) A retailer advertises shoes as "buy one pair at the regular price, get a second pair for half price." The first pair of shoes is sold for \$100; the second pair is sold for \$50 (half price). Tax is due on the \$100 shoes, but not on the \$50 shoes. Having advertised that the second pair is half price, the store cannot ring up each pair of shoes for \$75 in order for the items to qualify for the exemption. However, if the retailer advertises the shoes for 25% off, and thereby sells each pair of \$100 shoes for \$75, then each pair of shoes qualifies for the exemption.

(h) Rebates. Rebates occur after the sale and do not affect the sales price of an item purchased. For example, a customer purchases a sweater for \$110 and receives a \$12 rebate from the manufacturer. The retailer must collect tax on the \$110 sales price of the sweater.

(i) Layaway sales. A layaway sale is a transaction in which merchandise is set aside for future delivery to a customer who makes a deposit, agrees to pay the balance of the purchase price over a period of time, and, at the end of the payment period, receives the merchandise. An order is accepted for layaway by the retailer when the retailer removes the goods from normal inventory or clearly identifies the items as sold to the customer. A sale of eligible clothing under a layaway sale qualifies for exemption when either:

(1) final payment on a layaway order is made by, and the merchandise is given to, the customer during the exemption period; or

(2) the customer selects the item and the retailer accepts the order for the item during the exemption period, for immediate delivery upon full payment, even if delivery is made after the exemption period.

(j) Rain checks. Eligible items that customers purchase during the exemption period with use of a rain check will qualify for the exemption regardless of when the rain check was issued. However, issuance of a

rain check during the exemption period will not qualify an eligible item for the exemption if the item is actually purchased after the exemption period.

**(k) Exchanges.**

(1) If a customer purchases an item of eligible clothing or footwear during the exemption period, but later exchanges the item for an item of a different size, different color, or other feature, no additional tax is due even if the exchange is made after the exemption period.

(2) If a customer purchases an item of eligible clothing or footwear during the exemption period, but after the exemption period has ended, the customer returns the item and receives credit on the purchase of a different item, the appropriate sales tax is due on the sale of the newly purchased item.

(3) If a customer purchases an item of eligible clothing or footwear before the exemption period, but during the exemption period the customer returns the item and receives credit on the purchase of a different item of eligible clothing or footwear, no sales tax is due on the sale of the new item if the new item is purchased during the exemption period.

**(4) Examples:**

(A) A customer purchases a \$35 shirt during the exemption period. After the exemption period, the customer exchanges the shirt for the same shirt in a different size. Tax is not due on the \$35 price of the shirt.

(B) A customer purchases a \$35 shirt during the exemption period. After the exemption period, the customer exchanges the shirt for a \$35 jacket. Because the jacket was not purchased during the exemption period, tax is due on the \$35 price of the jacket.

(C) During the exemption period, a customer purchases a \$90 dress that qualifies for the exemption. Later, during the exemption period, the customer exchanges the \$90 dress for a \$150 dress. Tax is due on the \$150 dress. The \$90 credit from the returned item cannot be used to reduce the sales price of the \$150 item to \$60 for exemption purposes.

(D) During the exemption period, a customer purchases a \$60 dress that qualifies for the exemption. Later, during the exemption period, the customer exchanges the \$60 dress for a \$95 dress. Tax is not due on the \$95 dress because it was also

purchased during the exemption period and otherwise meets the qualifications for the exemption.

(l) Returned merchandise. For a 30-day period after the temporary exemption period, when a customer returns an item that would qualify for the exemption, no credit for or refund of sales tax shall be given unless the customer provides a receipt or invoice that shows tax was paid, or the retailer has sufficient documentation to show that tax was paid on the specific item. This 30-day period is set solely for the purpose of designating a time period during which the customer must provide documentation that shows that sales tax was paid on returned merchandise. The 30-day period is not intended to change a retailer's policy on the time period during which the retailer will accept returns.

(m) Mail, telephone, e-mail, and Internet orders and custom orders. Under the Texas sales tax law, a sale of tangible personal property occurs when a purchaser receives title to or possession of the property for consideration. Therefore, an item of eligible clothing or footwear may qualify for this exemption if:

(1) the item is both delivered to and paid for by the customer during the exemption period; or

(2) the customer orders and pays for the item and the retailer accepts the order during the exemption period for immediate shipment, even if delivery is made after the exemption period. The retailer accepts an order when the retailer has taken action to fill the order for immediate shipment. Actions to fill an order include placement of an "in date" stamp on a mail order, or assignment of an "order number" to a telephone order. An order is for immediate shipment when the customer does not request delayed shipment. An order is for immediate shipment notwithstanding that the shipment may be delayed because of a backlog of orders or because stock is currently unavailable to, or on back order by, the company.

(n) Shipping and handling charges.

(1) Shipping and handling charges are included as part of the sales price of the clothing or footwear, whether separately stated or not. Except as provided in paragraph (2) of this subsection, if multiple items are shipped on a single invoice, the shipping and handling charge must be proportionately allocated to each item ordered, and separately identified on the invoice, to determine if any items qualify for the exemption. The following examples illustrate the way that these charges should be handled:



- (A) A customer orders a jacket for \$95. The shipping charge to deliver the jacket to the customer is \$5.00. The sales price of the jacket is \$100. Tax is due on the full sales price.
- (B) A customer orders a suit for \$285 and a shirt for \$95. The charge to deliver the items is \$15. The \$15 shipping charge must be proportionately and separately allocated between the items:  $\$285 / \$380 = 75\%$ ; therefore, 75% of the \$15 shipping charge, or \$11.25, must be allocated to the suit, and separately identified on the invoice as such. The remaining 25% of the \$15 shipping charge, or \$3.75, must be allocated to the shirt, and separately identified on the invoice as such. The sales price of the shirt is \$95 plus \$3.75, which totals \$98.75; therefore, the shirt qualifies for the exemption.
- (C) A customer orders a suit for \$285 and a shirt for \$95. The charge to deliver the items is \$20. The \$20 shipping charge must be proportionately and separately allocated between the items:  $\$285 / \$380 = 75\%$ ; therefore, 75% of the \$20 shipping charge, or \$15, must be allocated to the suit, and separately identified on the invoice as such. The remaining 25% of the \$20 shipping charge, or \$5.00, must be allocated to the shirt, and separately identified on the invoice as such. The sales price of the shirt is \$95 plus \$5.00, which totals \$100; because the sales price of the shirt exceeds \$99.99, the purchase of the shirt is taxable.
- (2) If the shipping and handling charge is a flat rate per package and the amount charged is the same regardless of how many items are included in the package, for purposes of this exemption the total charge may be attributed to one of the items in the package rather than proportionately and separately allocated between the items. For example, a customer orders five shirts, with four priced at \$98 and one at \$85. The retailer charges \$10 for shipping and handling the order. The retailer would have charged the same amount for shipping and handling whether the customer ordered one shirt or five shirts. The retailer may chose to attribute the \$10 shipping and handling charge to the shirt that was sold for \$85 rather than allocate the charge proportionately and separately between the shirts. If the charge is attributed to the \$85 shirt, the sales price of that shirt is \$95, and all of the shirts will qualify for the exemption.
- (o) Documenting exempt sales. The retailer is not required to obtain an exemption certificate on sales of eligible items during the exemption period. However, the retailer's records should clearly identify the type of



item sold, the date on which the item was sold, and the sales price of the item.

- (p) Reporting exempt sales. No special reporting procedures are necessary to report exempt sales made during the exemption period. Sales should be reported as currently required by law.
- (q) Local taxes. The three-day exemption also applies to local taxes, unless the local taxing authority adopts an appropriate order such as an ordinance to repeal the application of the exemption in the manner provided by Tax Code, sec. 326.003. A taxing authority that has repealed the application of the exemption under this section may reinstate the exemption in the same manner. The repeal of the application of the exemption or a reinstated exemption takes effect on the first day of the first calendar quarter that occurs after the expiration of the first complete calendar quarter that occurs after the date on which the comptroller receives a copy of the order adopted. State taxes on qualifying purchases are still not due.

## Florida Information on Administrative Issues

### Refunds/Exchanges

**If a customer purchases an eligible item before the exemption period then exchanges the items during the exemption period for an eligible item which costs less than \$100.00, how would the exemption of sales tax apply?**

The customer should get a full refund/credit, including tax, for the returned item (assuming proof tax was paid). No tax will be due on the new item.

**If a customer has a refund/exchange between July 31 and September 30 without a sales receipt, how do I explain that I can't refund the tax? What if the customer says the item was purchased after August 8 and tax was paid?**

The Emergency Rule 12AER99-1, F.A.C., which is in effect for the tax relief days requires the customer must provide a receipt or invoice as proof the tax was paid to get a refund/credit of the tax.

Alternatively, if the store has documentation that tax was paid, a refund/credit of tax is appropriate. For example, the store can verify that the merchandise was received and placed in inventory for sale after August 8, 1999.

**If a customer returns an exempt item and is given a different item of equal price after the exemption period, do I have to charge sales tax on the new item?**

If a customer purchases an item during the exemption period and later exchanges the item for the same item (different size, different color, etc.), no tax will be due, even if the exchange is made after the exemption period.

If a customer purchases an item during the exemption period and later returns the item and gets a different item, even if the same price, the sales tax will apply to the new item. For example, if a shirt is returned and the customer purchases a pair of pants, or a dress is returned and the customer purchases a different style dress, tax is due on the price of the new pants/dress.

#### Coupons, Rebates, and Discounts

**Why will a store coupon make an item eligible for the exemption but a manufacturer's coupon or rebate will not?**

Tax is due on the total consideration received by the store for the sale of merchandise. "Consideration" is not limited to money given by the customer, but also includes other valuable items. A manufacturer's coupon is a valuable item, and part of the consideration received by the store, because the store will be reimbursed by the manufacturer, and, therefore, does not reduce the selling price of the item. However, a store coupon or discount actually reduces the sales price of the item, because the store does not receive any additional compensation for the store coupon.

For example: A customer buys a purse for \$115.00 and the store is offering a discount of 20%, the selling price of the purse would be \$92.00 and the purse would be exempt.

However, if a customer purchases a purse for \$115.00 with a manufacturer's coupon of \$25.00, the selling price of the purse would be \$115.00 and it would be taxable. The \$25.00 coupon is part of the valuable consideration paid for the purse, which consideration is received by the retailer as payment for the purse, and therefore does not reduce the selling price of the purse.

#### Gift Certificates

**If a gift certificate for clothing only is purchased during the exemption period and the customer doesn't use the certificate until the following period, can the customer make purchases tax exempt?**

No. To be exempt from tax, the purchase of clothing must be made during the exemption period.

#### Rain Checks

**Why won't rain checks issued during the exemption period hold the exemption from tax?**

To be exempt from tax, the clothing or other eligible item must be purchased during the exemption period. When a rain check is issued, a sale has not occurred. The sale occurs when the rain check is redeemed and an item is purchased. If an item is purchased using a rain check after the exemption period, the item is taxable.

Layaway Sales

**Are clothing items that are put on layaway from July 31, 1999 through August 8, 1999 eligible for the tax exemption?**

Yes. Items placed on layaway (set aside for future delivery to a customer who makes a deposit, agrees to pay the balance of the purchase price over a period of time, and, at the end of the payment period, receive the merchandise) during the tax relief days are exempt from tax. Also, if final payment on a layaway order of clothing items is made and the merchandise is given to the customer during this time the items are exempt from tax, regardless of when placed on layaway.

Mail Order or Internet Sales

**If I purchase tax free items by mail order (normally I would have to pay use tax on form DR-15MO), do I get the exemption?**

Yes. All purchases of qualifying items during the tax relief days are exempt from tax, including purchases made by mail order.

**How does the exemption apply to sales over the Internet?**

Sales over the Internet are treated the same as mail order sales.

**How do I proportionately allocate the shipping charges between the items ordered on a mail order sale?**

The Emergency Rule 12AER99-X, F.A.C., provides that to proportionately allocate the shipping charge, the amount of each item should be divided by the total amount of the items ordered to obtain the percentage that each item bears to the total order. Then the total shipping charge should be multiplied by the percentage for each item to determine the amount of the shipping charge applicable to that item. The shipping charge for each item must be separately stated on the invoice to the customer. The shipping charge is part of the selling price when determining if an item meets the \$100.00 threshold.

**For example**, a customer orders a \$100.00 dress and a \$50.00 shirt, for a total of \$150.00. The shipping charge is \$10.00.  $\$50.00 / \$150.00 = 33\%$  (50 divided by 150 equals 33 percent). Therefore 33%, or \$3.33 of the shipping charge is allocated to the shirt, and included as part of the selling price of the shirt.

**Draft Document Not For Publication But For Discussion Purposes Only –**  
Nothing contained herein represents a final position or opinion of the Streamlined Sales Tax Project, any of the participating or observing states, or any member of their staff. Readers should neither rely on any information herein nor make any inferences about final project positions or positions of participating or observing states or their members from the statements contained herein as this is a draft only and may change in response to comments and input from the public or private sector.

## STREAMLINED SALES TAX PROJECT

### FOOD ISSUE PAPER

**Issue:**

Should the definition of food be referenced to the federal food stamp definition used in determining food eligible for purchase with federal food stamps?

**Background:**

Federal law requires that a state that wishes to participate in the program may not impose its sales and use taxes upon sales of food purchased with the use of federal food stamps. In addition, seven states exempt food eligible for purchase with food stamps (even though not purchased with food stamps) with certain exceptions for food for immediate consumption, etc. (see page 6 for a summary of those states).

The Food Stamp Act of 1977, as amended (7 U.S.C. §§ 2011 to 2036), governs the Food Stamp Program. It is amended regularly. The Act provides that eligible households within the State shall be provided an opportunity to obtain a more nutritious diet through the issuance to them of an allotment. The coupons so received by such households shall be used only to purchase food from retail food stores that have been approved for participation in the food stamp program.

The Act (7 U.S.C. § 2013) defines food as follows:

“Food” means

- (1) any food or food product for home consumption except alcoholic beverages, tobacco, and hot foods or hot food products ready for immediate consumption other than those authorized pursuant to clauses (3), (4), (5), (7), (8), and (9) of this subsection.
- (2) seeds and plants for use in gardens to produce food for the personal consumption of the eligible household,
- (3) in the case of those persons who are sixty years of age or over or who receive supplemental security income benefits or disability or blindness payments under title I, II, X, XIV, or XVI of the Social Security Act [(42 U.S.C. 1381 et seq.)], and their spouses, meals prepared by and served in senior citizens' centers, apartment buildings occupied primarily by such persons, public or private nonprofit establishments (eating or otherwise) that feed such persons, private establishments that contract with the appropriate agency of the State to offer meals for such persons at concessional prices, and meals prepared for and served to residents of federally subsidized housing for the elderly,
- (4) in the case of persons sixty years of age or over and persons who are physically or mentally handicapped or otherwise so disabled that they are unable adequately to prepare all of their meals, meals prepared for and delivered to them (and their spouses) at their home by a public or private nonprofit organization or by a private establishment that contracts with the appropriate State agency to perform such services at concessional prices,
- (5) in the case of narcotics addicts or alcoholics, and their children, served by drug addiction or alcoholic treatment and rehabilitation programs, meals prepared and served under such programs,
- (6) in the case of certain eligible households living in Alaska, equipment for procuring food by hunting and fishing, such as nets, hooks, rods, harpoons, and knives (but not equipment for purposes of transportation, clothing, or shelter, and not firearms, ammunition, and explosives) if the Secretary determines that such households are located in an area of the State where it is extremely difficult to reach stores selling food and that such households depend to a substantial extent upon hunting and fishing for subsistence,
- (7) in the case of disabled or blind recipients of benefits under title I, II, X, XIV, or XVI of the Social Security Act, or are 3-1 individuals described in paragraphs (2) through (7) of subsection (r), who are residents in a public or private nonprofit group living arrangement that serves no more than sixteen residents and is certified by the appropriate State agency or agencies under regulations issued under section 1616(e) of

the Social Security Act or under standards determined by the Secretary to be comparable to standards implemented by appropriate State agencies under such section [(42 U.S.C. 1382e(e))], meals prepared and served under such arrangement

- (8) in the case of women and children temporarily residing in public or private nonprofit shelters for battered women and children, meals prepared and served, by such shelters, and
- (9) in the case of households that do not reside in permanent dwellings and households that have no fixed mailing addresses, meals prepared for and served by a public or private nonprofit establishment (approved by an appropriate State or local agency) that feeds such individuals and by private establishments that contract with the appropriate agency of the State to offer meals for such individuals at concessional prices.

The U.S. Department of Agriculture administers the Food Stamp Program at the federal level through its Food and Nutrition Service (FNS). State agencies administer the program at State and local levels, including determination of eligibility and allotments and distribution of benefits.

The FNS provides the following information for purposes of determining what qualifies for purchase with food stamps:

"Households can use food stamps to buy any food or food product for human consumption, and seeds and plants for use in home gardens to produce food.

Households CANNOT use food stamps to buy:

- Alcoholic beverages and tobacco
- Lunch counter items or foods to be eaten in the store
- Vitamins or medicines
- Pet foods
- Any non-food items (except seeds and plants)

Restaurants can be authorized to accept food stamps from qualified homeless, elderly, or disabled people in exchange for low-cost meals. Food stamps cannot be exchanged for cash."

A contact made with the Midwest Regional Office of Food and Consumer Services of the U.S. Department of Agriculture (Chicago) indicates there are no rules or regulations that define food products, alcoholic beverages, tobacco, hot foods, or hot food products ready for immediate consumption.

The FNS receives numerous requests for ruling each year as to whether products qualify for purchase with food stamps. While they keep a record of determinations they have made at a regional level, there is no overall guidance provided to qualifying retailers as to what products do and do not qualify. Determinations previously made by FNS change periodically with no specific notification system in place. Several state agencies that administer food stamp programs have provided lists to retailers. Determinations of qualifying food and food products may differ among states due to differing interpretations.

**Discussion:**

The Tax Base Work Group discussed whether the starting point for defining food should be the definition of food under the federal Food Stamp Act. The Group dismissed that approach for the following reasons:

- States that exempt food based on food stamp eligibility are still required to make determinations of whether food qualified for food stamps and were, therefore, exempt from sales or use tax.
- Federal law and any changes to it would be determinative of tax treatment. The states were not sure they wanted to be bound by federal determinations. Changes in federal eligibility could have fiscal impacts upon states.
- There are no clear definitions for terms used in the federal code. States were concerned as to whether they would be able to obtain timely federal determinations for products not enumerated by the federal agency as qualifying for food stamp purchase.
- The federal food stamp program may not give states the option of maintaining exemption for certain products that are currently not eligible for purchase with food stamps.

**Effect on States:**

The following states generally tax all food items so are not affected by the use of food stamp eligibility in defining food.

Alabama  
Arkansas  
Hawaii  
Idaho  
Kansas  
Louisiana

Mississippi  
New Mexico  
Oklahoma  
South Carolina  
South Dakota  
Tennessee

Utah  
Virginia  
West Virginia  
Wyoming

Of the 30 states that exempt food with certain exceptions, 23 do not use federal food stamp eligibility to define what is and is not "food" for purposes of exemption from sales and use taxes (23 of 30).

**Alternatives:**

- Use the definition of "food" in the Food Stamp Act, as amended, for purposes of determining federal food stamp eligibility.
- Develop our own definition of "food."

**Recommendation:**

Define "food" independent of the Food Stamp Act as follows:

"Food and food ingredients" means substances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. "Food and food ingredients" does not include:

- (1) "Alcoholic Beverages" which means beverages that are suitable for human consumption and contain one-half of one per cent or more of alcohol by volume, and
- (2) "Tobacco" which means cigarettes, cigars, chewing or pipe tobacco, or any other item that contains tobacco.



## Summary of States That Exempt Food Eligible for Purchase with Food Stamps

State	General Tax Treatment	Exception Related To Prepared Food
Colorado	Exempt food that are eligible for purchase with food stamps except:	<ul style="list-style-type: none"> <li>• Prepared salads and salad bars.</li> <li>• Packaged and unpackaged cold sandwiches.</li> <li>• Deli trays.</li> </ul>
Georgia	Exempt food that are eligible for purchasing with food stamps	Nothing further.
Iowa	Exempt food that are eligible for purchasing with food stamps except:	<ul style="list-style-type: none"> <li>• Food prepared for immediate consumption, including food prepared on or off the premises of the retailer, which is consumed on the premises of the retailer.</li> <li>• Foods sold by caterers.</li> <li>• Hot or cold foods prepared for immediate consumption off the premises of the retailer, except bakery.</li> </ul>
Maryland	Exempt food stamp eligible food except	<ul style="list-style-type: none"> <li>• Food that the vendor serves for consumption on the premises of the buyer or of a third party.</li> <li>• Food for immediate consumption.</li> </ul>
Missouri	Food eligible for food stamp purchase taxed at a reduced rate 1.225 except:	<ul style="list-style-type: none"> <li>• Meals and drinks furnished at any hotel, motel, tavern, inn, restaurant, eating house, drugstore, dining car, tourist cabin, tourist camp or other place in which rooms, meals or drinks are regularly served to the public taxed at 4%.</li> <li>• The term "food" shall not include food or drink sold for consumption on or off the premises by a restaurant, delicatessen, cafe, or other eating establishment that derives more than 80% of its total gross receipts from food sales.</li> </ul>
Nebraska	Exempt food that are eligible for purchasing with food stamps except:	<ul style="list-style-type: none"> <li>• Meals other food prepared for immediate consumption on or off the premises of the retailer.</li> <li>• Other food prepared for immediate consumption on or off the premises of the retailer.</li> </ul>
North Carolina	Exempt food that are eligible for purchasing with food stamps	Nothing further.

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## **STREAMLINED SALES TAX PROJECT**

### **PREPARED FOOD ISSUE PAPER**

#### **Background:**

The Streamlined Sales and Use Tax Agreement (Agreement) as approved on December 22, 2000 (and amended on January 24, 2001) provides for a definition of prepared food that may be used as an exception to an exemption for “food and food ingredients” at the option of a state. Therefore, a state that chooses to exempt “food and food ingredients” may choose to tax “prepared food.”

The Agreement provides the following definition of “prepared food”:

1. Food sold in a heated state or heated by the seller;
2. Two or more food ingredients mixed or combined by the seller for sale as a single item; or
3. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws.

The Agreement also provides that “prepared food” does not include food that is only sliced, repackaged, or pasteurized by the seller.

#### **Issue:**

Should the definition of the prepared food be modified for three independent suggestions:

1. Remove "or heated" from the phrase "Food sold in a heated state or heated by the seller."

**Concerns:**

- a. Many types of food are heated by the seller in preparation of food, but are not sold heated. A state that chooses to exempt food but tax prepared food may be required to impose tax on a number of items on which it currently does not impose tax. For example:
    - A grocer's deli prepares a casserole that involves boiling pasta, mixing in vegetables, meat, and other ingredients, and baking it in an oven for 30 minutes. After cooling, it is placed in a display case for sale to customers at room temperature. With the current definition in the agreement, the sale of servings of the casserole that the customer will take home and reheat is prepared food.
    - A bakery makes cakes, rolls, doughnuts, and other baked goods. The ingredients are mixed, placed in pans, and baked. They are sold at room temperature by the bakery to customers. Under the current definition in the agreement, the baked goods are prepared food.
    - A food processing company manufactures and sells canned vegetables. The vegetables come in from the fields and are cleaned, sorted, and boiled in water prior to canning. The canned vegetables are sold at the company's retail outlet to consumers for home consumption. Under the current definition in the agreement, the canned vegetables are prepared food because the seller heated the vegetables during its manufacturing process.
    - A convenience store receives frozen baked goods, such as donuts and cookies, from its suppliers. The convenience store thaws the donuts and cookies by applying heat and places them in display cases for sale at room temperature. Under the current definition in the agreement, the cookies and donuts are prepared food.
  - b. States have already taken steps to statutorily adopt the definition to put forward by the project as amended by January 24, 2001. If a revised definition is adopted by the project, the states that have enacted what they thought were conforming amendments will be out of compliance.
2. Add "that does not require further preparation by the consumer" to the phrase "Two or more food ingredients mixed or combined by the by the seller for sale as a single item"

## Concerns

- a. A state that chooses to exempt food but tax prepared food may be required to impose tax on a number of items on which it currently does not impose tax. For example:
    - A grocery store meat department mixes raw meat with a marinade of herbs and liquid which is available for purchase by customers. The customer will take the meat home, cook it, and eat it. Under the current definition in the agreement, the marinated meat is prepared food because the seller mixed or combined several food ingredients for sale as a single item.
    - A grocery store inserts bread stuffing into a raw turkey and offers it for sale. The customer will take the meat home, cook it, and eat it. Under the current definition in the agreement, the turkey is prepared food because the seller mixed or combined several food ingredients for sale as a single item.
  - b. Use of the phrase "require further preparation by the consumer" is too broad. It requires a subjective determination by the seller of intent as to whether the item must be further prepared by the customer. Further preparation could mean removing a lid, brushing with butter, stirring before serving, sprinkling with a topping such as sugar, and other trivial acts.
  - c. States have already taken steps to statutorily adopt the definition to put forward by the project as amended by January 24, 2001. If a revised definition is adopted by the project, the states that have enacted what they thought were conforming amendments will be out of compliance.
3. Allow states the option of removing from "Two or more food ingredients mixed or combined by the seller for sale as a single item" and/or "food sold in a heated state or heated by the seller" one or more of the following:
- Items manufactured and sold at retail by the manufacturer
  - Deli items (room temperature or cold), such as potato salad, fruit salad, etc.
  - Bakery products

## Concerns

- a. The current definition may result in taxation of items not currently taxed including: bakery items made and sold by a seller, deli items made and sold by a seller, items that are made and sold by a manufacturer at retail (these items are usually exempt when sold to a grocer for resale by the grocer).

States that currently exempt food, but tax sub-categories of food, need more options in the definition of "prepared food."

- b. There should be no concern from states that have already taken steps to statutorily adopt the prepared food definition of the project as amended January 24, 2001. This provision is optional to states. Those states that do not adopt these options will still be in compliance.

### **Proposed Solution:**

The following modified definition is proposed (changes appear in italics):

"Prepared food" means:

1. Food sold in a heated state or heated by the seller;
2. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws.
3. Two or more food ingredients mixed or combined by the seller for sale as a single item *not requiring cooking by the consumer as recommended by the Food and Drug Administration in its Food Code so as to prevent food born illnesses.*

*States may exclude any of the following from items 1 and 3 above:*

- a. *Food sold by a seller whose proper primary NAICS classification is manufacturing in sector 31, except subsector 3118.*
- b. *Food sold in an unheated state by weight or volume as a single item.*
- c. *Bakery items, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, tortillas.*

"Prepared food" does not include food that is only sliced, repackaged, or pasteurized by the seller.

**Alternatives:**

1. Adopt the modified definition of prepared food described above.

- The modified definition maintains uniformity in food definitions while providing states flexibility to avoid significant revenue gains or losses.
- The modified definition allows those states that exempt deli foods and bakery to maintain that tax treatment.
- The modified definition adds complexity. The definition of prepared food will not be identical among states with the assumption that states will use the options a. through c. above differently.

**Example 1:** Wisconsin could define prepared food as follows, using all three additional options and thereby exempt factory store sales, cold deli food sold by the pound, and bakery:

“Prepared food” means:

1. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws.
2. Two or more food ingredients mixed or combined by the seller for sale as a single item and food sold in a heated state or heated by the seller, except:
  - a. Food sold by a seller whose proper primary NAICS classification is manufacturing in sector 31, except subsector 3118.
  - b. Food sold in an unheated state by weight or volume as a single item.
  - c. Bakery items, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, tortillas.

**Example 2:** Iowa could define prepared food as follows, using only two additional options, and thereby exempt factory store sales and bakery, but not cold deli food sold by the pound:

“Prepared food” means:

1. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws.

2. Two or more food ingredients mixed or combined by the seller for sale as a single item and food sold in a heated state or heated by the seller, except
    - a. Food sold by a seller whose proper primary NAICS classification is manufacturing in sector 31, except subsector 3118.
    - b. Bakery items, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, tortillas.
2. Retain the "Agreement" definition previously adopted by the project.
- The "Agreement" definition will likely result in revenue gains (additional tax) for states that exempt food but tax prepared food. However, this may be offset by other changes proposed in the food definitions.
  - States may risk their participation in the simplification efforts if they must tax food products that have traditionally been exempt from tax.
  - The "Agreement" definition provides an identical definition of prepared food among all states that choose to use it.

**Effects on States:**

Attachment A summarizes the sales and use tax treatment of "prepared food" for states that have a sales tax.

The following states generally tax all food items so are not affected by the modified "prepared food" definition.

Alabama	Mississippi	Tennessee
Arkansas	New Mexico	Utah
Hawaii	Oklahoma	Virginia
Idaho	South Carolina	West Virginia
Kansas	South Dakota	Wyoming
Louisiana		

The following states exempt food and tax prepared food in some manner. These states will benefit from flexibility in the modified prepared food definition.

Arizona	Maryland	Ohio
California	Massachusetts	Pennsylvania
Colorado	Minnesota	Rhode Island
Connecticut	Nebraska	Texas
Florida	Nevada	Vermont
Indiana	New Jersey	Washington
Iowa	New York	West Virginia
Kentucky	North Dakota	Wisconsin
Maine		



## Prepared Food — State-by-State Summary

State	General Tax Treatment	Exception Related To Prepared Food
Alabama	Tax food	
Arizona	Exempts food except:	<p>"Food for consumption on the premises" which includes:</p> <ul style="list-style-type: none"> <li>a) Hot prepared food.</li> <li>b) Hot or cold sandwiches.</li> <li>c) Food served by an attendant to be eaten at tables, chairs, benches, booths, stools, counters and similar conveniences and within parking areas for the convenience of in-car consumption of food.</li> <li>d) Food served with trays, glasses, dishes or other tableware.</li> <li>e) Beverages sold in cups, glasses, or open containers.</li> <li>f) Food sold by caterers.</li> <li>g) Food sold within the premises of theaters, movies, operas, shows of any type or nature, exhibitions, concerts, carnivals, circuses, amusement parks, fairs, races, contests, games, athletic events, rodeos, billiard and pool parlors, bowling alleys, public dances, dance halls, boxing, wrestling and other matches and any business which charges admission, entrance or cover fees for exhibition, amusement, or entertainment.</li> <li>h) Any items contained in subdivisions (a) through (g) of this paragraph even though they are sold on a "take-out" or "to go" basis, and whether or not the item is packaged, is wrapped or is actually taken from the premises.</li> </ul>
Arkansas	Tax food	

State	General Tax Treatment	Exception Related To Prepared Food
California	Exempt food except:	<ul style="list-style-type: none"> <li>• Food products served as meals on or off the premises of the retailer.</li> <li>• Food products furnished, prepared, or served for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware whether provided by the retailer or by a person with whom the retailer contracts to furnish, prepare, or serve food products to others.</li> <li>• Food products ordinarily sold for immediate consumption on or near a location at which parking facilities are provided primarily for the use of patrons in consuming the products purchased at the location, even though those products are sold on a "take out" or "to go" order and are actually packaged or wrapped and taken from the premises of the retailer.</li> <li>• Food products sold for consumption within a place, the entrance to which is subject to an admission charge, except for national and state parks and monuments, marinas, campgrounds, and recreational vehicle parks.</li> <li>• Food products sold are furnished in a form suitable for consumption on the seller's premises, and both of the following apply:               <ol style="list-style-type: none"> <li>1. Over 80 percent of the seller's gross receipts are from the sale of food products.</li> <li>2. Over 80 percent of the seller's retail sales of food products are sales subject to tax pursuant to paragraphs (1), (2), (3), or (7).</li> </ol> </li> <li>• Hot prepared food products.</li> </ul>
Colorado	Exempt food that are eligible for purchase with food stamps except:	<ul style="list-style-type: none"> <li>• Prepared salads and salad bars.</li> <li>• Packaged and unpackaged cold sandwiches.</li> <li>• Deli trays.</li> </ul>
Connecticut	Exempt food except:	<ul style="list-style-type: none"> <li>• Meals sold by an eating establishment or caterer.</li> </ul>