

Streamlined Sale Tax: Almost Here! Is it a Curse or a Blessing?

Overview

After more than three years of discussions, nineteen states have joined the SST Governing Board as full and associate members and Streamlined Sales Tax (SST) has evolved from a “project” into an official “agreement”. SST implementation began in July 2005 in all member states.

To date, Georgia has chosen not to join the Streamlined Sales Tax (SST) Agreement, or to modify its own sales tax laws. But for Georgia companies selling into other SST states, the sales tax situation will be impacted sooner or later by this wave of change.

With the increasing popularity of Internet sales, states estimate that their revenue losses from this source alone are in the range of \$15 billion annually, much of which is due to uncollectible inter-state sales. While SST’s ultimate goal is to maximize the collection of sales tax revenues, it also proposes to simplify and standardize the application of sales tax across the country. On a case-by-case basis, it offers companies genuine incentives, and participation in SST is completely voluntary at this time. But it is up to each individual business to evaluate the benefits and costs of voluntary sales tax registration under SST before diving in. The consequences of participation should be evaluated up front.

The following is a summary of a TAG Tax and Finance-hosted discussion held on March 7, 2006 between two sales tax experts, Anson Asbury and Rory Rawlings on the efficacy of the SST agreement, its good and bad points, which states are leading the implementation charge, and what you can and should do to prepare your organization for this new world order - especially if you already sell into SST states. Biographies for Messrs. Asbury and Rawlings appear at the end of this document.

Streamlined Sales Tax

In October 2005, Streamlined Sales Tax, which had been a ‘Project’, officially became an ‘Agreement’ as a critical mass of 19 states signed on as full and associate members. In becoming members, the SST participant states each agreed to work with uniform sales tax definitions, to collect and share information and procedures, and to standardize their sales tax processes - essentially to reduce the complexity of sales tax in order to maximize their ability to collect it. This is a long overdue process, given that there are now over 8,000 taxing jurisdictions in the U.S., each with its own rules and requirements.

All of the SST member states are now underway with their SST implementations, which means they are changing their internal sales tax laws and procedures to comply with the SST Agreement. This is being accomplished at different speeds – Washington and Texas are proceeding very quickly, Colorado is

dragging its feet, and heavyweights including California, New York and Massachusetts are taking a ‘wait and see’ attitude. They are not members of SST at this time, nor is Georgia.

The SST States

The nineteen SST states include these FULL members: Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, West Virginia; and the following ASSOCIATE members: Arkansas, Nebraska, Ohio, Tennessee, Utah, and Wyoming.

Understanding Nexus

‘Nexus’ is key to understanding how sales tax is applied. A company with ‘nexus’ in a jurisdiction is liable for paying sales and use tax to that state’s taxing authorities. Nexus is established when you ***engage in certain activities*** or establish ***a physical presence*** in a jurisdiction. Your nexus or ***physical presence*** in a jurisdiction allows local taxing authorities to reach out and hold you responsible for paying sales tax.

Two Landmark Cases

Sales tax nexus is largely defined by the landmark case, Quill v. North Dakota, 504 U.S. 298 (1992). As Supreme Court authority, the Quill case is the ‘law of the land’ for determining sales tax nexus. In this lawsuit, North Dakota enacted a statute that treated any U.S. company that advertised within its borders at least three times in twelve months as having established nexus. As a result, that company would be liable for sales tax on any items it sold into the state. According to the North Dakota statute, the mere act of advertising created nexus. However, the Supreme Court determined that advertising alone was not sufficient to create nexus. Quill emerged as the standard for determining nexus – i.e., an actual physical presence in a jurisdiction is required to establish nexus for sales tax purposes.

Despite the Quill standard, some states, like California, have put a finer point on Quill. California’s leading case on sales tax nexus is Borders Online, LLC v. State Board of Equalization, 129 Cal. App. 4th 1179 (1st Dist. 2005).

Borders segregated its bookstore business, which included multistate locations and therefore nexus in several states, from Borders.com, its online book-selling business, by creating a separate legal entity. The company continued to collect and remit sales tax where its bookstores were located, but limited its sales tax liability for its online entity to the physical location of that entity. Borders.com had no physical presence in any jurisdiction other than Michigan. Therefore, Borders.com was not required to collect sales tax for books it shipped to customers in California or any other state.

However, the California State Board of Equalization maintained that Borders (the bookstore business) was an agent of Borders.com because customers were allowed to return books that they had purchased online to Borders stores. The California Court of Appeals agreed with the Board of Equalization and held that Borders.com was liable for collecting and remitting sales tax on all of its online book sales into California.

The Bottom Line: In some states, like California, allowing an entity to service your clients (like Borders bookstores did by accepting book returns for Borders.com), even if that entity has no other activity in

that state, can establish nexus for sales tax purposes. The definition of nexus thus may vary from state to state. And even though the legal battles over what constitutes nexus are often determined by the activities of large multi-national companies, the outcomes affect all businesses.

Cash-strapped states have a strong incentive to go after every revenue opportunity that presents itself and they sometimes do this by working to expand the legal definitions of tax-related terms.

Sales Tax versus State Income Tax

State income tax represents a slightly different standard of nexus. For income tax purposes, nexus might be best described as ‘physically availing oneself of a market’. State income tax nexus doesn’t necessarily require the same physical presence in a state that sales tax nexus does.

In 1959 Congress enacted Public Law 86-272, which maintains that a state cannot impose income tax on a company whose only activity in a state is the solicitation of orders for sales of tangible personal property when those orders are processed and filled by shipment from a point outside of the state.

However, some of the more aggressive tax states have expanded the definition of this law also so as to enhance their revenue opportunities. Two landmark cases demonstrate how this has been done.

Two State Income Tax Cases To Consider

The U.S. Supreme Court in Wisconsin v. William Wrigley Jr., Co., 505 U.S. 214 (1992), determined that although selling and shipping chewing gum into retail outlets in Wisconsin didn’t constitute nexus for state income tax purposes according to PL 86-272, the fact that Wrigley’s sales representatives physically took gum out of boxes and stacked it onto store shelves exceeded the PL 86-272 standard and established nexus. Company representatives were considered to be facilitating the selling process by their presence in the state, making Wrigley liable for state income tax.

In another leading case, Toys R Us transferred the intangible property rights in its mascot ‘Geoffrey’ the giraffe, to a separate legal entity and licensed the property to its corporate parent company. In so doing, licensing revenue generated from the use of Geoffrey would all be sourced to the Delaware entity. Toys R Us was essentially paying itself a royalty on the use of its mascot to minimize its state income taxes.

However, this structure was challenged in the case of Geoffrey v. South Carolina, 437 S.E.2d 13 (S.C. 1993). South Carolina argued that the local use of Geoffrey allowed Toys R Us to avail itself of the South Carolina market and that that was sufficient to establish state income tax nexus. Similar cases have been decided against corporate taxpayers in Massachusetts and New York where intangibles were also licensed between related parties.

States Expand Laws for Revenue Purposes

So why are these definitions and laws relevant to SST?

Because despite the existence of standards for nexus that should, in theory, be applied uniformly across the country, states have historically taken the opportunity to expand the definition of nexus where ever possible in order to maximize their revenues - a goal that has trumped other considerations.

Although the Streamlined Sales Tax Agreement and its consistent definitions and standards are now in implementation, SST currently includes only a limited number of participant states. This leaves considerable leeway for potential future changes and modifications to its objectives, as other states join the agreement, as demonstrated by state challenges to the definition of nexus under existing sales tax and state income laws.

To date, California, Massachusetts, and New York, the three states that lead the way on state income tax issues, are not participants in the Streamlined Sales Tax Agreement. This is a concern in terms of how they may eventually choose to implement or modify SST, and how this will affect the overall agreement and the companies who have already voluntarily registered with SST. It is a situation that bears watching as its effects could possibly change the intent of SST.

Streamlined Sales Tax – What Makes It a Good Thing?

Having identified the SST issues that must still be resolved, it is also important to point out that as it is currently defined by its participant states, SST offers some appealing incentives to companies that choose to voluntarily register including:

1. Amnesty

If you choose to voluntarily register with SST, you may do so anonymously through a Certified Service Provider (CSP). The CSP will handle all aspects of the registration transaction on your behalf. As long as you are registering for the first time or you have not been registered in a given state within the past 12 months, the states have agreed not to look back at what you might have in the way of unfulfilled sales tax liabilities from the past. Your slate is essentially wiped clean in exchange for your agreement to collect and pay the SST states' sales taxes in the future.

2. Access to a Certified Service Provider

As a voluntary SST participant, if you choose to engage the services of one of SST's certified service providers (CSP), your CSP can also handle all aspects of sales tax management on your behalf. The CSP will calculate your tax liability and will fulfill the filing and remittance functions for you as well. This is expected to save time and resources for most small and mid-sized businesses.

3. Relief

If you sign on for a 'full compliance package', SST grants you audit relief, liability relief, and state funding. Certified Service Providers will be validated by the states as being correct in calculating sales taxes including jurisdiction assignment, product taxability, and customer exemptions. Therefore, using a CSP to handle all aspects of sales tax management on your behalf means that:

- You are no longer liable for sales tax errors in SST states. However, please note that some SST states are currently unable to offer full liability protection due to constraints within their own laws. In these cases, a CSP customer will have to assume liability until state law has been changed. These states are now actively changing their laws to provide full liability protection, and have to make this change by January 1, 2008. Please see the

Appendix of this document if you are interested in reviewing the full legal text surrounding this issue,

- If mistakes are made on your sales tax calculations, the states assume liability to the fullest extent that their law will allow,
- None of the SST states will audit your books,
- For sales tax transactions in SST states where you don't have nexus, the cost of your CSP service is covered by the Streamlined Sales Tax states.

4. *Timing*

Sales tax amnesties are open until at least September 2006, and according to the SST Agreement, each new state that joins SST will have to offer its own 12-month amnesty also. This gives you a reasonable amount of time to get your tax situation in order.

Engaging an SST Certified Service Provider

To date, SST has certified the company TaxWare as a service provider and by June 30, 2006, it expects to have certified two more – most likely Avalara, Inc., and Exactor, Inc.

If you have chosen to voluntarily register with SST, and plan to engage the services of an SST certified service provider, these are the tasks your CSP will complete for you:

- a) Calculate your sales taxes in all of the SST states in which you have conducted business,
- b) Generate your monthly, quarterly and annual sales tax returns,
- c) Electronically submit your returns,
- d) Pay the sales tax owed to each state. You will pay your CSP a single aggregate amount and the CSP will ensure that the individual states are paid correctly and on time,
- e) For the Streamlined Sales Tax states where you do business but do not have nexus, your CSP's processing fees are paid by the SST states.

The cost of hiring a CSP varies, but is generally charged on a per transaction basis. The services provided and the fees charged by the CSP are not regulated by SST, so you'll want to compare the service providers and their levels of service. Some of the major factors that differentiate the organizations currently working to qualify as CSPs are their costs, the size of company their solution is designed for, and the interfaces they have built to customer billing, accounting, and eCommerce systems.

The Downside – Sales Tax Simplification Creates CHANGE

While SST brings some specific and desirable benefits as listed above, it is also the catalyst for significant change as companies work to comply with new taxability definitions and new SST sales tax rules in member states.

For example, prior to SST, there existed 23 taxability definitions for marshmallows. Because the SST states agreed to standardize their terms and definitions, there is now one uniform definition and one taxability rule for marshmallows across all 19 SST states. Sounds better right? In the long term it is, but in

the short term, 22 of the 23 former marshmallow definitions no longer apply and will have to be changed in the sales tax systems of all companies working with an outdated definition.

Multiply the marshmallow situation by the large numbers of products and services that currently have several taxability definitions, and you can see that a lot of sales tax system overhaul is going to be required in the business sector to comply with SST.

Clearly this situation imposes a significant burden on small and mid-sized companies (SMBs). The question remains, how can this burden be reduced? Various proposals have been offered including subsidizing the cost of converting SMBs to SST-compliant tax systems or exempting SMBs from collecting tax across state lines. To date, this problem has not been resolved.

The Implications of Voluntarily Registering for SST

Perhaps you've considered these facts and have decided to beat the rush, take advantage of the amnesties, and join the SST bandwagon. Before you jump in, here are some things you should first carefully evaluate:

1. Is your state income tax situation clean? If you think you have a **sales tax issue** that would benefit from an amnesty, chances are, you will also have a **state income tax issue** that needs cleaning up. However, the SST amnesty **does not** extend to state income taxes.
2. If you do believe you have a state income tax issue, clear that first through the Multistate Tax Commission before you register for SST. If you don't, you risk incurring a state income tax liability that potentially goes back several years, and there is nothing to stop a state from going after you for all of those unpaid taxes plus interest and penalties as well.
3. Evaluate the scope and value of benefits to your company for voluntarily registering for SST. Then compare these to the potential risks and costs associated, such as paying sales tax in every state in which you have nexus, plus your potential state income tax liabilities.

Avalara's Technology-based Sales Tax Solution

One of the sponsors of this event, Avalara Inc. is currently in the process of qualifying for SST certification. It expects to be one of the three national CSPs certified by June 2006.

Avalara provides a Web-service-based sales tax management solution that instantly and accurately calculates sales tax for small and mid-sized companies in all of the 8,000+ taxing jurisdictions in North America. The service provides detailed, real-time reporting and automatically generates pre-populated sales tax returns. As a result, Avalara eliminates the need to do rate look-ups, tax detail research, or create tax schedules. The company also files sales tax returns and remittances.

Designed specifically for small and mid-sized businesses, Avalara's AvaTax software integrates with accounting systems including QuickBooks, Sage Software's MAS products, ACCPAC, iScala, Microsoft Dynamics GP (formerly Great Plains) and Microsoft Dynamics NAV (formerly Navision).

Avalara also offers a ‘Software Developers’ Kit’ that integrates with unique ecommerce and accounting applications so that companies can accurately and cost-effectively calculate, track, and remit their sales and use taxes, and eliminate audit risk penalties.

Headquartered on Bainbridge Island near Seattle, Washington, Avalara is working to develop innovative and affordable sales tax solutions for small and mid-sized businesses.

Chamberlain Hrdlicka’s Tax Expertise

Event sponsor Chamberlain, Hrdlicka, White, Williams & Martin is a highly-regarded commercial law practice with offices in Atlanta and Houston. One of its core strengths is tax law. Many Chamberlain Hrdlicka tax lawyers have worked with the IRS or Department of Justice. Additionally, its tax group includes lawyers who are board-certified in tax law, hold advanced degrees in tax law, are certified public accountants, or have worked as in-house tax counsel for large multi-national corporations.

Chamberlain Hrdlicka’s clients include privately held businesses, public companies, individuals, trusts, estates, and tax-exempt organizations. They advise and represent clients on all phases of tax planning and controversy, and routinely guide transactions through the most complex and difficult tax rules, having successfully defended clients in the United States Tax Court, the Federal District Courts, the Court of Federal Claims, the United States Courts of Appeals, and the United States Supreme Court, as well as before state taxing authorities and state courts. Chamberlain Hrdlicka lawyers are a nationally recognized force in defending taxpayers against the IRS in both civil and criminal tax disputes. It is this track record that gives the firm and its employees first-hand experience with how governmental agencies and the courts interpret and enforce the tax laws, as well as a unique perspective on the Streamlined Sales Tax Agreement and its ongoing implementation.

Conclusion

Although the Streamlined Sales Tax Agreement is primarily a tool for collecting previously uncollectible sales taxes, it is also a step forward in creating fairer, more uniform taxing codes in the U.S. In addition, SST offers worthwhile benefits to those who decide to voluntarily comply, and it may even be setting the stage for additional tax simplification in the future, possibly in the realm of personal income tax.

What remains to be seen is how the states will manage the Agreement such that definitions are not expanded and changed over time, and such that new states joining SST agree to adhere to the rules and standards that have already been set.

One of SST’s biggest challenges will be to reduce the significant burden it imposes on SMBs in the short term as they work to comply with new sales tax requirements in all SST states.

For individual companies, the decision to voluntarily register with SST must be carefully weighed against the cost and complexity such an act will have on one’s business. For any individual company considering voluntary SST registration, SST’s benefits should outweigh:

- a) the cost of converting your business’ existing sales tax set up, and
- b) the cost of resolving any outstanding state income tax liabilities you may have.

Call to Action – Determining your Next Steps

Now that you've had an overview on the Streamlined Sales Tax Agreement, you are likely wondering what, if anything, you should do next. Here are some suggestions:

1. Work with your accounting staff and professional advisors to determine your current and future sales tax liabilities for the states in which you do business, or plan to do business. Look at the cost of maintaining your current sales tax management system, including both the time and resources it requires versus the costs and benefits of using a CSP to accomplish this task under SST.
2. If you think you may benefit from registering under SST, work with your accounting staff and professional advisors to first determine if you have any outstanding state income tax issues that need to be resolved.
3. If you do have outstanding state income tax issues you want to address, contact the Multistate Tax Commission (www.mtc.gov) for information about its current programs. This commission currently offers an amnesty program, called the National Nexus Program, which allows taxpayers to resolve potential tax liabilities simultaneously with multiple states. Through this program, multistate businesses may anonymously approach any or all of the National Nexus Program Member States for state income taxes to propose settlement of potential state sales/use tax and/or income/franchise tax liabilities arising from past activities within the states. According to the Multistate Tax Commission, taxpayers benefit by resolving potential state tax disputes before states issue prior year assessments of taxes, interest and penalties. Also according to this Commission, multistate resolution saves time and money, and the Commission staff performs its work at no cost to the taxpayer.
4. If the benefits provided by SST fit your business strategy, evaluate the CSPs coming on line, as well as the services they offer to find one that best fits your needs.

About the Presenters

Anson Asbury

Anson Asbury is an attorney in the Atlanta office of Chamberlain Hrdlicka. He practices in the areas of state and federal taxation, with an emphasis on tax controversy. Mr. Asbury began his tax career in the New York City office of PricewaterhouseCoopers consulting with Fortune 500 companies on federal and state tax matters. He defended multi-jurisdictional sales and use tax audits for some of the largest companies in the United States and consulted on sales tax compliance and planning issues. Mr. Asbury also clerked for the Honorable Joseph Gale of the United States Tax Court. He has tried cases before military tribunals and in federal district court.

He is a graduate of Villanova University (B.A. 1992) and the Pennsylvania State University (J.D. 1998). He earned his LL.M. in taxation (with distinction) from Georgetown University in 2003. Mr. Asbury is also an Honors Graduate of the U.S. Army Judge Advocate General's School and a Captain in the U.S. Army Reserve.

Rory Rawlings:

Rory Rawlings is the Founder and Chief Tax Automation Officer of Avalara, Inc., a company whose mission is to transform and automate the sales tax process for small and mid-sized businesses. A widely-consulted expert on Streamlined Sale Tax and the technologies that can make it workable and equitable for all companies, Mr. Rawlings testified on the impact of SST before a Congressional Committee in February 2006.

As an accountant and CPA, Mr. Rawlings became expert in financial and business planning, profit analysis and tax research early in his career. He then earned proficiency in information technology and software development while at Boeing where he wrote custom financial applications, and at PowerCerv, a mid-market ERP provider, where he was a senior software developer and Director of Professional Services. Moving to Getty Images, Rawlings architected, designed, and successfully implemented several sales tax engines. In addition, he headed up Getty Images' enterprise architecture and business planning initiatives, and oversaw a multi-year custom ERP implementation. Rawlings is a certified PowerBuilder Developer and an Instructor in Object Oriented Analysis and Design (OOAD).

Additional Resources

Interesting in learning more about this topic? Check the following websites for information and updates:

- The Streamlined Sales Tax Website:
www.streamlinedsalestax.org
- The Multistate Tax Commission Website:
www.mtc.gov
- Avalara, Inc. Website:
www.avalara.com
- Chamberlain, Hrdlicka Website:
www.chamberlainlaw.com

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APPENDIX

Legal Text Surrounding State Liability for CSP Sales Tax Services

The following paragraphs are excerpted from the Streamlined Sales Tax Agreement:

E.3. Relief from Liability: Erroneous Data. Each Member State and Associate Member State shall, pursuant to the terms of SSUTA Sections 306 and 328, relieve the Contractor, and any Seller registered under the SSUTA with which the latter contracts, from liability to the states and their local jurisdictions for having charged and collected the incorrect amount of sales or use tax resulting from the Contractor or any of its SSUTA-registered contracting Sellers relying on erroneous data on tax rates, boundaries, or taxing jurisdiction assignments which have been listed in the state's rates and boundaries databases, and erroneous data provided in the taxability matrix provided by the Member State or Associate Member State pursuant to Section 328.

In accordance with SSUTA, each Member State and Associate Member State shall review and certify that the Automated System utilized by the Contractor determines accurately whether or not a category of items or transactions listed in the Automated System is exempt from tax in accordance with each state's law. Prior to January 1, 2008, to the extent allowed by the law of each Member State and Associate Member State, Member States and Associate Member States shall relieve the Contractor, and any Seller registered under the SSUTA with which the latter contracts, from liability to the state and their local jurisdictions for having charged and collected the incorrect amount of sales or use tax resulting from the Contractor or any of its SSUTA-registered contracting Sellers relying on certification of erroneous data on the taxability of a category of items or transactions. The Governing Board will publish on its Web site the status of the relief of liability provided by each Member State and Associate Member State for persons relying on the certification of erroneous data on the taxability of a category of items or transactions.

The Contractor shall have ten (10) days from the date of notification by a Member State or Associate Member State to revise the Automated System to conform with changes to: the tax rates, boundaries, or taxing jurisdiction assignments which have been listed in the state's rates and boundaries databases; the taxability matrix provided by the Member State or Associate Member State pursuant to Section 328 of the SSUTA; and the classification of the taxability of a category of items or transactions pursuant to Section 502 of the SSUTA. In the event the Contractor fails to make such changes, beginning on the eleventh day after notification the Contractor shall be liable for failure to collect the correct amount of Seller Taxes owed to the Member State or Associate Member State.

The Governing Board, Member States and Associate Member States are not responsible for mapping, which is defined as classification of an item or transaction within a certified category. The Contractor is liable for mapping errors resulting in failure to collect the correct amount of Seller Taxes owed to the Member State or Associate Member State. Nothing herein shall prohibit the Contractor from providing, in its contracts with Sellers, for indemnification from Sellers to reimburse the Contractor for liability resulting from mapping errors to the extent that such errors are due to the actions or inactions of a Seller.

E.4. Relief from Liability: Certification Compliance. The Contractor shall not be liable for the failure to remit Seller Taxes when due, or for any interest and penalties on such taxes, to the extent that (a) the

laws of a Member State or Associate Member State relieve the Contractor or the Seller from liability to the state and its local jurisdictions for having remitted the incorrect amount of sales or use tax and (b) the incorrect amount resulted from the Contractor's reasonable reliance on an issue not discovered in the certification process. If both (a) and (b) are satisfied, the Contractor's sole obligation and liability for such unpaid taxes shall be to correct the issue within a reasonable amount of time (not to exceed ten (10) days unless an extension is granted by the Executive Committee) from receipt of the Member State's and Associate Member State's notice of the incorrect amounts. In the event the Contractor is unable to correct the issue causing the incorrect amounts to be charged and collected, beginning on the first day after the time allotted in the previous sentence the Contractor shall be liable for failure to collect the correct amount of Seller Taxes owed to the Member State or Associate Member State.

If the incorrect amount resulted from the Contractor's reasonable reliance on an issue not discovered in the certification process but the laws of a Member State or Associate Member State do not relieve the Seller from liability to the state and its local jurisdictions for having collected the incorrect amount of sales or use tax, the Contractor shall be liable for failure to collect the correct amount of Seller Taxes owed to the Member State or Associate Member State, plus any interest and penalties. A Member State or Associate Member State that has not received the correct amount shall provide written notice to the Contractor. If the Member State or Associate Member State has not received the unpaid amount within ten (10) business days after receipt of the notice, the Contractor shall be in Breach of the Contract. Nothing herein shall prohibit the Contractor from providing, in its contracts with Sellers, for indemnification from Sellers to reimburse the Contractor for its liability under this paragraph.

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