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Subcommittee on Commercial and Administrative Law
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A PROMISE UNFULFILLED:
HOW THE STREAMLINED SALES TAX PROJECT FAILED TO MEET ITS OWN GOALS FOR SIMPLIFICATION OF STATE SALES AND USE TAXES

Mr. Chairman, Members of the Committee, on behalf of the Direct Marketing Association ("DMA") and its membership, I want to thank you for the opportunity to testify on this important issue. The DMA is the largest trade association for businesses interested in direct marketing to consumers and businesses via catalogs and the Internet. Founded in 1917, it today has over 4,700 members companies in the United States and 53 foreign countries.

I realize that many state tax officials hail the Streamlined Sales and Use Tax Agreement ("SSTA") as an epochal event in sales and use tax reform. The reality, however, bears little similarity to the hyperbole. The truth is that the Streamlined Sales Tax Project ("SSTP" or "Project") has woefully failed to fulfill its original goal of simplifying and harmonizing the existing morass of state and local sales and use tax laws. Indeed, the representatives of the states participating in the Project have, at every critical juncture, turned away from real and substantive tax reform in order to cling to the many diverse and unique features of their individual state tax systems. It is this disparity in state and local sales taxes that makes the existing tax regime so ill-suited to interstate

commerce. The Streamlined Sales and Use Tax Agreement, in its current form, falls far short of its professed objective of simplifying state taxes and, to the contrary, in many respects worsens, and further complicates, the “crazy quilt" of differing state and local sales and use tax laws.

It is important to note that the original stated purpose of the SSTP was to establish a purely <u>voluntary</u> system of simplified sales and use tax collection by catalog companies and Internet merchants. It is, therefore, especially disturbing that despite the Project’s failure to meet its own goals, the proponents of the SSTP nonetheless now come to Congress seeking federal legislation that would eliminate long-standing constitutional protections for interstate commerce and convert the SSTA into a <u>mandatory</u> use tax collection system for out-of-state merchants.

The jurisdiction-expanding legislation sought by state tax administrators would give states the unprecedented power to export their diverse tax systems beyond their own state borders, thereby imposing an extraordinary level of complexity on interstate marketers and consumers. The timing of this ill-conceived proposal could not be worse. New tax burdens on Internet retailers will suppress the growth of e-commerce when the dot-com economy is still struggling to rebound from its dramatic decline. Also, such legislation would give an advantage to foreign companies—especially electronic commerce vendors of digital products who are located far beyond state tax jurisdiction—at the expense of American businesses. The inevitable effect would be the loss of American jobs in the e-commerce sector and a drag on this country’s economic recovery.

In addition to its adverse economic impact, the Agreement would implement a new government-sanctioned system in which massive amounts of information concerning the details of consumer transactions would be gathered, retained, and disseminated among not only government agencies but also to private companies that are designated as "services providers" under the SSTA. The Agreement contains no safeguards against disclosure or misuse of such confidential information. Congress should not approve a new tax system that would imperil the privacy of millions of American consumers.

In short, the SSTA provides little simplification of the current tax system; it creates numerous new burdens on business and consumers; and it endangers the privacy of millions of Americans. Congress should reject this misguided call to abandon constitutional protections and expand state tax powers. Instead, Congress should encourage the states to return to the drawing board and address the critical areas of tax simplification and fairness to retailers and consumers that the Project chose to bypass in its effort to achieve consensus among the participating states.

My testimony will highlight some of the most glaring shortcomings and striking adverse consequences of the Streamlined Sales and Use Tax Agreement, including:

- The failure to adopt the fundamental principle of "one rate per state" for all commerce, which would have eliminated the problem of merchant compliance with literally thousands of local tax jurisdictions;

- The failure to establish uniformity of definitions with respect to taxable and exempt products;

- The failure to reduce, in any meaningful way, the burdens of tax collection, reporting, remittance and audits for interstate marketers;

- The SSTP's blind-faith in yet-to-be-developed tax compliance software as the "silver bullet" that will solve the overwhelmingly complex tax compliance problems presented by the multi-state sales and use tax system described in the Agreement;

- The failure to consider the Agreement's impact on consumers ordering products by mail and paying for their purchases by check;
- The failure to guarantee fundamental fairness with respect to vendor liability and vendor compensation;
- The failure to provide an effective and enforceable mechanism to assure continuing compliance with the Agreement by member states;
- The failure to provide oversight of the member states by an independent entity or tribunal;
- The failure to provide even basic privacy protections for the personal and financial information of millions of American consumers;
- Imposition of new taxes on consumers in connection with member states' adoption of so-called SSTA conformity legislation; and
- Coupled with jurisdiction-expanding legislation, the imposition of enormous new burdens upon interstate and electronic commerce, at a time when the nation's economy, and particularly the e-commerce industry, is struggling to make a recovery.

I. STATE TAX ADMINISTRATORS ARE ASKING CONGRESS FOR AN UNPRECEDENTED EXPANSION OF STATE TAXING AUTHORITY.

The question of whether states should be permitted to impose their state and local tax requirements on businesses operating outside their borders goes to the heart of the founding principles of our Constitution. Such time-honored legal protections should not lightly be set aside. The Constitution's Commerce Clause has consistently been interpreted as barring states from imposing tax obligations on companies and individuals located beyond a state's borders and who have no physical presence in the taxing state. Indeed, the Constitutional Convention of 1787 was initially called to address the problem of individual state legislatures imposing taxes and duties on trade with other states, a practice which was pushing the young country into a depression. The Commerce Clause was intended by the Framers to prevent state and local tax laws from hindering and

suppressing interstate commerce. It has worked remarkably well. More than 200 years before the establishment of the European Union, the Framers created a common market on this continent through the Commerce Clause, and it powered the greatest economic engine the world has ever known.

There can be no question, as even the leaders of the SSTP have acknowledged, that the existing patchwork of different state and local sales and use tax laws creates an inordinate complexity that is excessively burdensome on interstate businesses. There are literally thousands of different sales and use tax jurisdictions in the United States. Of the 30,000 state and local jurisdictions with authority to impose sales and use taxes, more than 7,500 have adopted this kind of tax, and the number grows every year. These thousands of different jurisdictions generate an enormous variety of tax rates, taxable and exempt products, excluded transactions, filing requirements, audit arrangements and appeal procedures. Moreover, these rates and exemptions are frequently changed by the governing jurisdictions, so they are literally a moving target in terms of vendor compliance. Indeed, it was this dizzying complexity that prompted the Supreme Court, in its 1992 decision in *Quill Corp. v. North Dakota*,[1] to reaffirm its long-standing position that the Commerce Clause bars states from imposing such taxation requirements on interstate commerce.[2]

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[1] 504 U.S. 298 (1992).

[2] Since the Supreme Court issued its decision in *Quill* in 1992, the sales and use tax system has only gotten more complex. From over 6,000 state and local tax jurisdictions in 1992, there are now more than 7,500. The last ten years have seen the introduction of thousands of new sales and use taxes, new filing requirements, new exemptions, new rates and rate changes, and new filing and audit requirements. Moreover, states and localities have created, and increasingly relied upon, innovative tax provisions designed to accomplish targeted public policy goals, such as so-called tax "holidays," caps and thresholds, which add tremendously to the complexity of tax compliance for retailers. In sum, the sales tax system has gotten far more complicated than it was when the Supreme Court issued its ruling in *Quill* more than a decade ago.

Congress should exercise great caution before removing over 200 years of constitutional protection of America's open market place. Such an encroachment of state tax sovereignty into the realm of interstate commerce is without precedent. Congress should be insistent on setting the bar of state tax reform very high before it endorses an expansion state tax jurisdiction. Certainly, the SSTA does not achieve such high-bar tax reform; to the contrary, the SSTP participants repeatedly chose to lower their standards and reject fundamental reforms.

II. THE SSTP FAILED TO MEET ITS OWN STANDARDS FOR A STREAMLINED SALES AND USE TAX SYSTEM.

When it was organized in 2000, the Streamlined Sales Tax Project presented itself as a bold initiative by state legislators and tax administrators to simplify, harmonize and modernize state and local sales and use tax laws. The stated goal of the SSTP was to create a new "streamlined" sales and use tax system for the 21st Century, with substantial uniformity among state sales and use tax regimes. Historically, the sales tax has always had a decidedly local flavor, with varying rates and requirements among state and local tax jurisdictions. Unfortunately, when the Project representatives were confronted with the difficult task of surrendering the unique features of their state and local tax systems, they repeatedly retreated from original proposals for real tax reform and consistently rejected, or diluted, provisions that would have produced true uniformity among the states.

At its outset, the SSTP program was intended to be a voluntary program from the perspective of both tax officials and those businesses subject to sales and use tax obligations. In theory, the participating states undertook the task of modernizing and harmonizing their tax systems as a matter of good public policy, not as a prelude to

expanded tax jurisdiction. In this regard, the Project expressed its hope to achieve a degree of simplification and standardization that would encourage retailers with no legal obligation to collect sales and use tax outside of their home states to register nonetheless in all participating states.

The shared understanding of all concerned, tax administrators and retailers alike, was that the existing system was one of daunting complexity, and that true simplification would require radical reform. In this regard, the SSTP organizers took note of the fact that their new initiative was preceded by two separate joint government/industry projects whose mandate was to examine the measures necessary to simplify the existing sales and use tax system and make it more accommodating to the needs of electronic commerce. They were: (1) the National Tax Association Communications and Electronic Commerce Tax Project ("E-Commerce Tax Project"), and (2) the Congressionally-established Advisory Commission on Electronic Commerce ("Advisory Commission"). Both groups were composed of representatives of state government and industry. Moreover, the need for major revisions to state sales and use tax codes was beyond dispute. For example, the Final Report of the Advisory Commission stated:

> [C]learly the need for substantial simplification is necessary in this emerging digital economy. In the course of the Commission's examination of the impact of e-commerce on sales and use tax collections, there was general agreement among the Commissioners that the current sales and use tax system is complex and burdensome. Most, if not all, of the Commissioners expressed the view that fundamental uniformity and simplification of the existing system are essential.[3]

In order to remedy the complexities of the existing system, leaders of the SSTP committed themselves to creating a new, simplified and uniform sales and use tax

[3] Advisory Commission on Electronic Commerce ("Report to Congress") p. 19; *see also* National Tax Association Communications and Electronic Commerce Tax Project Final Report (1999) ("NTA Final Report"), Introduction, p.7.

system, and they accordingly adopted high standards from the outset. The SSTP committed itself to achieving:

- Greatly simplified tax rates and tax bases;
- Uniform and simplified definitions for taxable and exempt products;
- The incorporation of new technologies to automate the tax collection and reporting process;
- Simplified administration, including centralized registration, simplified returns remittances, and audit procedures;
- Fair treatment of all retailers, and a sharing of the burdens of tax compliance between states and retailers; and
- The highest degree of security and privacy for consumer transactions.[4]

The SSTP undertook to pursue these goals ostensibly with industry input, although without industry participation in decision-making. The DMA contributed suggestions from the outset, setting forth in a letter to Project leaders in August 2000 a comprehensive list of reform proposals. (A copy of the letter, dated August 4, 2000, accompanies my written testimony.) The fate of the DMA's proposals in the SSTP process is telling, both with respect to the weight industry positions actually carried with the Project leaders and the states' failure in achieving their original goals. Of more than 30 specific reform proposals offered by the DMA, the Agreement approved by the states in November 2002 fully adopted only two (centralized registration and uniform bad debt provisions).

During the course of drafting the Agreement and deliberating on its provisions, when the member state representatives had the opportunity to tackle the major problems of tax complexity (*e.g.*, multiplicity of tax jurisdictions and rates), they elected instead to

avoid controversy and yield to any member state that raised an objection to a reform proposal. The result is an Agreement that contains only minor, and in many instances cosmetic, tax reform measures. The Agreement leaves intact the myriad of peculiarities and prerogatives of individual state and local tax jurisdictions which characterizes the current system. In particular, the SSTP: (1) rejected real rate simplification by affirmatively maintaining all 7,500 local taxing jurisdictions; (2) failed to identify functional tax compliance software, because none exists; (3) abandoned its commitment to consumer privacy; (4) failed to reduce tax compliance and audit burdens on sellers by rejecting centralized administration; (5) failed to perform a promised cost-of-collection study to determined the costs to retailers of complying with the SSTA; and (6) so diluted the SSTA's state law compliance standard that it destroyed any possibility of even modest uniformity among member states. As a result, rather than a uniform system, the SSTA perpetuates, and in many respects aggravates, a taxation system of tremendous complexity.

A. The SSTP Rejected Real Rate Simplification By Summarily Dismissing The Principle of "One Rate Per State," The Most Fundamental Reform Necessary For a Simplified Sales/Use Tax System.

Rate simplification through the reduction in the number of taxing jurisdictions in the United States is at the core of required reforms. The Supreme Court in *Quill* (and in prior decisions), as well as both joint government-industry groups that preceded the SSTP, recognized that the complexity of the existing system derives, in large measure, from the staggering number of local taxing jurisdictions. Indeed, the United States is the only economically developed country in the world with a system of sub-state transaction

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[4] *See, e.g.*, Streamlined Sales Tax Project, Press Releases of April 5, 2000, April 17, 2000 and May 2, 2000

taxes. Without a substantial reduction in the number of tax jurisdictions, a catalog or Internet retailer subject to the SSTA would be required to stay abreast of, and collect and remit taxes for, not only its home state (and any other states where it has a physical presence), as current law requires, but every one of the more than 7,500 state and local taxing jurisdictions.

Local sales taxes appear in the form of municipal taxes, county taxes, school district taxes, transportation district taxes, sanitation district taxes, sports arena district taxes, etc. These local taxes often are piled one atop another, resulting in a state tax and several local jurisdiction taxes applying to the sale of a single product. Elimination of multiple local tax rates could be achieved by permitting only one tax rate for all transactions in a state (the so-called "one rate per state" proposal). That rate would be a single, statewide combined rate covering the state tax and a uniform local tax rate (which could be divided among as many local government entities as the state chose). The fundamental necessity of "one rate per state" reform was recognized by both previous simplification projects. Participants from both industry and government groups, including representatives of the National Governors Association, the National Conference of State Legislatures, and the U.S. Conference of Mayors, unanimously agreed in the Final Report of the NTA's E-Commerce Project that there should be only one rate per state for all commerce.[5] A majority of the Advisory Commission also recommended that any simplification proposal limit sales and use tax rates to one per state.[6]

Leaders of the SSTP committed themselves at the outset to achieving substantial rate simplification. Given the recommendations of both the NTA E-Commerce Project

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(available at www.streamlinedsalestax.org/press_rel.html).

[5] NTA Final Report, Introduction, p. 3.

and the Advisory Commission that one rate per state is an absolute requirement for any meaningful reform of state sales and use tax systems, the SSTP could reasonably have been expected to adopt this proposal, as well. Despite the recommendations of the two previous study groups, however, the SSTP deemed the proposal too politically unpalatable for state legislatures, and dismissed the "one rate" proposal after its first round of meetings.

Further dilution of rate simplification efforts followed. Three days after the approval of the first draft of the SSTA in January 2001, the National Conference of State Legislatures ("NCSL") approved a competing form of agreement, which omitted considerable portions of the SSTA and proposed alternatives to some provisions.[7] In particular, the NCSL version allowed states to adopt a second state rate for some products.

Under pressure from states with multiple state tax rates, some of whom warned SSTP leaders that failure to permit an additional state rate would prevent their continued participation in the Project, the SSTP buckled and conformed the Agreement to the NCSL's version. The SSTA, as presented to Congress, permits a state to adopt a "single additional rate," different from the standard tax rate, for "food and food ingredients" and "drugs." Thus, not only has the Agreement failed to reduce the number of jurisdictions, it has also potentially doubled the number of different rates applicable to vendors of any product meeting the definitions of "food and food ingredients" and "drugs."

B. The SSTA Blindly Relies On Non-Existent Tax Compliance Software, But The SSTP's Own Test Shows Such Software Cannot Be Developed.

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[6] Report to Congress, p. 19.
[7] Streamlined Sales and Use Tax Agreement as Amended and Adopted on January 27, 2001 ("NCSL, 1/27/01 Agreement"), available at www.ncsl.org/programs/press/2001/web_agreement.html.

From early in the process, the SSTP envisioned the development of new tax compliance software that would allow multi-state marketers to automate tax collection and reporting requirements. This was described as a "vital element" of the new "streamlined" system.[8] Such fully-functional tax compliance software is the Project's "silver bullet" to slay the otherwise overwhelming complexities of differing state tax systems. To this date, however, no such system has been developed, nor is there any indication that such a system is even feasible.

In the summer of 2000, the SSTP invited software providers to participate in a pilot program to develop tax compliance software which would perform the function of sales tax administration for a retailer required to collect and remit sales/use tax in four different states ("Pilot Program"). The Project awarded contracts to three vendors in September, 2000. The results of the Pilot Program raise serious doubts about the viability of developing tax compliance software under the SSTA.[9]

First, the Pilot Program did not test the multi-state system envisioned under the SSTA. The program was limited to testing compliance with the laws and reporting requirements of only four states (Kansas, Michigan, North Carolina, and Wisconsin), not all forty states, including thousands of local tax jurisdictions, now participating in the SSTP. At the time of the test, which was conducted primarily in 2001, the SSTA was not yet approved, and thus none of the state systems being tested had adopted laws purportedly conforming to the requirements of the SSTA. Indeed, each of the four states

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[8] SSTP Press Release of May 2, 2000, www.streamlinesalestax.org/press_rel.html ("We know that the incorporation of technology into the tax collection process is a *vital element in the development of any new system*. This technology can be harnessed and applied in a cost-effective way *to radically streamline the tax collection process* for vendors while increasing the accuracy of sales tax collections.") (emphasis added).

maintained a unique payment and returns processing system. Moreover, basic features of the SSTA, such as electronic filing, were not available to the pilot states. In sponsoring the Pilot Program, the SSTP simply did not perform a relevant test.

The results of the Program, however, demonstrate that viable tax compliance software for a system such as the SSTA remains a figment of the SSTP's imagination. The Pilot Program failed to develop software that could successfully administer the tax systems of only four of the states participating in the program. Of the three vendors initially awarded contracts, only two produced a system that performed well-enough on the limited number of transactions tested by the participating states to be provisionally certified by the states as approved service providers. Of these two vendors, one never used its system to perform actual transactions on behalf of a retailer and later that vendor withdrew from the project in October, 2002. The remaining vendor secured approval from four retailers to collect and remit tax using its system, but ultimately was able to perform such functions for only a single retailer.

Even more telling than the failure of the vendors to develop successful software, however, are the inherent institutional and systemic obstacles the Program revealed to development of a tax compliance software solution for the problems of collecting and reporting tax in a multi-state environment. System compatibility and integration challenges present an enormous hurdle. The Program showed that states will have to adapt their processing systems to accommodate a CSP's reporting and remittance processes. With 40 SSTP states potentially facing compatibility issues for every new Service Provider and for every retailer that develops its own software in-house, this problem alone is likely to cripple the system. In addition, software vendors participating

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[9] *See generally* SSTP Pilot Status Report (March 26, 2003), www.streamlinedsalestax.org/pilot3_03.html.

in the Program reported substantial difficulties in integrating the vendors' software with the computer systems of potential retailers. Such problems were so substantial that some retailers backed-out of the Pilot Program because such issues could not be resolved. If vendor-retailer integration proved a significant problem for the handful of retailers that participated in the Pilot Program, imposing mandatory tax compliance upon the hundreds of thousands of retailers in the United States that would be subject to the SSTP would surely prove a nightmare.[10]

Even if pervasive system compatibility and integration issues did not threaten to cripple the SSTA system, the Pilot Program showed that the lack of adequate provisions for testing and certifying compliance software would doom it to catastrophic failure. The SSTA grants the Governing Board, composed of member state representatives, rather than an independent technology firm, the responsibility for certifying Service Providers and Automated Systems.[11] There is no basis for believing that a Governing Board of state tax administrators has the expertise to assess such new technology. Indeed, the States participating in the Pilot Program reported that their representatives lacked the expertise necessary in software design and development to do any more than test whether the program accurately calculated tax on a limited number of sample transactions. (Even this extremely limited review revealed Service Provider errors.)

Independent and verifiable testing and certification of CSPs and CASs should be required. Under the SSTA, the Governing Board will be called upon to certify systems it is not capable of evaluating, and then expect retailers to use those systems in the

[10] The compatibility/integration problems proved so pervasive in the Pilot Program that one vendor even reported integration difficulties between it and the subcontractors it engaged for the program.
[11] *See* SSTA, Sections 507(a), 806.

operation of their businesses. System failures and rampant errors are inevitable. The SSTP blithely ignores the massive business disruptions that are certain to occur.

Not surprisingly, both retail and computer industry representatives have expressed serious doubt that development of a technological solution to the problem of multi-state sales and use tax collection is feasible. States have yet to prove through independent sources that a system can be developed that is "business friendly." Nonetheless, Congress is now being asked hastily to bless the SSTA, and expand state tax jurisdiction, even though the keystone of the Project, *i.e.*, fully-functioning compliance software, is still nowhere in sight. Having made technology the lynchpin of its program from the start, it is incredible that the SSTP would come to Congress without a fully-developed, fully-tested software solution. Certainly, such a compliance system should be "road tested" before the states ask Congress to impose mandatory tax collection duties on interstate merchants.

C. The SSTP Abandoned Its Commitment to Protect Consumer Privacy.

Privacy and the confidentiality of personal information are of fundamental, and increasing, concern to Americans. At the outset of the Project, protecting consumer privacy was one of the principle objectives of the SSTP.[12] The Project leaders initially considered a set of privacy standards designed to protect consumers, which standards would apply to all participants in the system. The SSTP's commitment to consumer privacy proved fleeting, however. The standards were soon dropped, and the final version of the Agreement includes only vague statements regarding privacy.[13] In its

[12] SSTP Press Release, April 17, 2000 (stating that SSTP would provide for "the highest degree of security and privacy").
[13] *See generally* SSTA, Section 321.

current form, the SSTA represents an unprecedented threat to the private personal and financial data of millions of American consumers.

To enable tax reporting and remittance, as well as the performance of audit functions, the SSTA system will collect massive amounts of information regarding consumer transactions. That information will be retained and made available not only to state tax auditors (who are authorized to share the information with their colleagues in other states) but also to the private companies that are designated to act as "Certified Service Providers." Consequently, confidential on-line customer transaction information will be distributed widely both within various state government agencies and among private companies.

The Agreement contains no substantive confidentiality standards or privacy protections, and it allows the Certified Service Providers to self-certify the adequacy of their privacy safeguards under this standardless structure.[14] The Agreement contains no mechanism for monitoring treatment of confidential customer information, such as a compliance review by an independent auditing firm. The Agreement provides no enforcement provisions or consumer remedies for breaches in protecting confidential information.[15] By itself, these inadequacies represent a shocking disregard for consumer privacy on the part of the SSTP member states; and in light of the proliferation of credit card fraud and identity theft crimes in recent years, the SSTA poses a new threat to millions of American consumers.

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[14] SSTA, Section 321(D).

[15] *See Id.*, Section 321(I) (Although privacy policies are "subject to enforcement by member states' attorney general or other government authority" the Agreement does not require member states to so empower government officials, nor does it prescribe any remedies for breach, rendering the reference to enforcement by the Attorney General ineffective).

The Agreement should include, at a minimum, (1) detailed provisions restricting access to consumer information and requiring that such information should be purged after tax payments have been properly credited, (2) supervision of every public agency and private entity that collects or has access to such information by an independent monitor, and (3) strict penalties—including criminal sanctions—for breach of privacy standards. Americans are entitled to know that their state governments are doing the utmost to protect their privacy in connection with information turned over to the government. Congress should refrain from endorsing the widespread dissemination of consumer transaction information in the absence of stringent privacy protections.

D. The SSTA Fails To Reduce Administrative Burdens On Retailers.

Genuine uniformity and simplification through a multi-state compact should include extensive centralization of administrative functions, including not only registration, but also tax reporting, remittance and audit procedures. Although originally committed to simplifying administration of sales and use taxes for sellers, the participating state representatives repeatedly abandoned reforms that would have made the system more uniform. For example, adoption of a uniform sales tax return was rejected because it would have required participating states with more complicated information-rich reporting requirements to simplify their sales and use tax returns.[16] Early proposals for joint audits (*i.e.*, audits conducted on behalf of more than one state) are not included in the Agreement. Even the vendor registration requirements are left open-ended. The Agreement purports to require a single registration procedure for all participating states, but then in a separate provision the SSTA provides that retailers may

[16] Member states will purportedly revisit the issue of developing a uniform return. *See* SSTA, Section 318(D)(4).

be required to provide additional information "[i]n member states where the seller has a requirement to register prior to registering under the Agreement."[17] This provision gives states a license to demand additional registration information from sellers.

Rather than simplifying the administrative burdens faced by multi-state marketers, the SSTA would actually extend the burdens of use tax administration to a whole new class of merchants. A direct marketer doing business nationwide will need to file not one, or perhaps a few, returns each month, but instead will be required to file returns in every one of the 45 states, and the District of Columbia, that impose sales and use taxes.[18] Worse still, the interstate merchant will be subject to audit at any given time by forty-six different revenue departments.[19] For multi-state retailers, the obligation to file literally dozens of sales tax returns each month, and then be subject to audit by every state, will be enormously burdensome and expensive. Indeed, many retailers will find themselves in a state of perpetual audit. How is this tax reform? A fair system would permit a single audit on behalf of all member states and local tax jurisdictions (*e.g.*, by the revenue department of the state where the vendor is headquartered). The DMA proposed to the SSTP that the states appoint a vendor's "home" state to conduct the audit function on behalf of all of the other member states. This request went unanswered.

The problem is not limited to a business being subject to as many as 46 separate audits each year. Should a company disagree with the auditor's conclusions, the retailer must pursue administrative appeals, and possibly litigation, in a distant forum. The costs of contesting tax assessments will be prohibitive. Businesses will be forced to decide at what threshold dollar amount a challenge to a distant state's tax assessment even makes

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[17] *Id.*, Section 401(C).
[18] *Id.*, Section 318(A) (single return per state).

sense. For example, does a company headquartered in Florida challenge an assessment by the California Board of Equalization in the amount of $10,000? $20,000? $50,000? In many instances, it will simply make more sense for the retailer to swallow hard and pay the assessment, rather than hire legal counsel and spend the time and money to contest the issue in a hostile administrative forum far from its home state.

E. The SSTP Failed To Conduct A Promised Cost Of Collection Study, Necessary To Evaluate The True Costs of The Expanded Tax Collection System It Seeks To Impose On Interstate Marketers.

The SSTA would draft thousands of remote sellers into the role of tax collection agents for the participating states. Sellers incur substantial expense in collecting and remitting sales and use taxes to states. The variety and inconsistency of state tax systems makes compliance expensive for all multi-state retailers, but especially for low volume merchants. A study by a major accounting firm reported that for companies selling products nationally with collection responsibilities in all of the 45 states that have sales and use taxes, the costs of compliance ranged from 14 percent of the sales taxes collected for large retailers, to 48 percent for medium-sized retailers, to 87 percent for small retailers.[20] States and municipalities do not reimburse multi-state retailers for their real costs incurred in collecting use taxes. Indeed, in most states, reimbursement rates, in the form of vendor discounts, are either non-existent or nominal.

The SSTP published a proposal for a Public-Private Sector Study of Cost of Collecting State and Local Sales and Use Taxes in 2001. The project was put to bid in late 2001, and subsequently awarded to a major accounting firm. Although the proposal

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[19] *Id.*, Section 301 (each member state may conduct audit).
[20] Cline and Neubig, "Masters Of Complexity And Bearers Of Great Burden: The Sales Tax System and Compliance Costs For Multistate Retailers," Ernst & Young Economics Consulting and Quantitative Analysis, September 1999.

required the contractor to report to the SSTP within 180 days of the award of the contract, or by July 2002, no cost study has ever been performed.

The SSTA "anticipates" that member states will provide a limited measure of compensation for remote sellers.[21] The SSTP, however, still has no idea what compliance costs the new system will impose on remote sellers. These costs could conceivably outstrip the tax amounts collected by retailers. If compensation by the states is inadequate, those collection costs will be passed on by retailers to their customers in the form of increased prices. The SSTP is asking Congress to approve a system whose true costs to retailers, and, by extension, to consumers, it simply does not know.

F. The SSTA Fails To Ensure Compliance With The Terms Of The Agreement By Member States.

Even with the watered-down standards of the SSTA in its current form, *i.e.*, "low bar" tax reform, the Agreement does not require strict compliance with those standards by participating states. The first draft of the Agreement provided that a member state's laws "must comply" with the requirements of the Agreement. The National Conference of State Legislatures, however, took exception with the strong compliance language in the SSTP version. Rather than requiring strict compliance, the NCSL proposed that states need only "substantially comply" with the Agreement to become and remain a member.[22]

Not to be outdone, the SSTP adopted an even weaker and more ambiguous compliance standard for member states. Now a member state is in compliance with the Agreement if "<u>the</u> <u>effect</u> of its laws, rules, regulations and policies is <u>substantially</u>

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[21] SSTA, Sections 601(A), 602(A), 603(A).
[22] NCSL, 1/27/01 Agreement.

compliant with each of the requirements of the Agreement."[23] This vague compliance standard does nothing to guarantee that a state has simplified its laws even to the limited extent contemplated under the Agreement. Moreover, since only the overall "effect" of a state's tax policies is required to "substantially" comply with the Agreement, state regimes may vary from the specific terms of the Agreement in countless ways. The SSTA assures no uniformity at all even for its modest standardization provisions.

II. THE DILUTED AGREEMENT ADOPTED BY THE SSTP IS NOT MEANINGFUL SIMPLIFICATION AND IS FUNDAMENTALLY UNFAIR TO RETAILERS.

The SSTP's total retreat from its own standards for a truly simplified system is reason enough for Congress to ask the states to return to the drawing board. A comprehensive review of the SSTA, however, reveals not only a failure to achieve the Project's original objectives, but, in addition, the inclusion of many other features that would deny fundamental fairness to interstate marketers.

A. The Agreement Means Enormous New Obligations Compared To The Present System, So It Is Not Simplification At All.

Although the proponents of the SSTP tout the Agreement as tax simplification, if the Agreement is coupled with a legislative repeal of *Quill*, it is just the opposite. Under the current constitutional standards embodied in *Quill*, retailers without a physical presence in a state have no sales/use tax collection responsibilities to that state. Under the Agreement, however, retailers will be confronted with an entirely new obligation to collect tax for over 7,500 jurisdictions. The Agreement thus creates an enormous increase in the complexity of doing business for interstate marketers, certainly not a move towards simplification.

[23] SSTA, Section 805 (emphasis added).

B. There Is No Reduction In The Number Of Tax Jurisdictions, And The Number Of Tax Rates Could Go Even Higher.

As I explained in Section II.A of my testimony, the Agreement does not reduce the number of tax jurisdictions, the fundamental cause of complexity in the current system.[24] In addition, because the Agreement allows each state to adopt a second rate at the state level,[25] when coupled with the existing variations in local rates, the current number of different tax rates could increase, not decrease, under the Agreement.

Other provisions of the SSTA allow a state to craft even more non-standard rates. The Agreement allows states to continue the popular practice of sales tax "holidays,"[26] creating temporary additional "zero rates" for designated items.[27] To make matters worse, the Agreement allows the states to establish "thresholds" during state tax holidays, so some of the additional zero rates will only apply above a threshold item price or purchase amount.[28] The Agreement also contains no restrictions on the duration of tax holidays, so a state may manipulate the system to create additional exemptions, or to impose permanent thresholds, in violation of other provisions of the Agreement. The number of rates and their possible variations is unlimited.

C. The Agreement Does Not Require Uniform Definitions For Taxable Products.

Under the SSTA, states would to continue to determine which products are taxable and which are exempt from tax. The states' "solution" to the vast differences among the states with respect to what products are taxable and what products are exempt

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[24] SSTA, Section 308(B) (local rates retained).
[25] *Id.*, Section 308(A) (second rate for "food and food ingredients" and "drugs").
[26] Sales tax "holidays" are the temporary suspension of sales and use tax on a particular product or class of products, such as clothing. Sales tax "holidays" have become popular among state legislatures as a way to promote consumer purchases and thereby stimulate the economy. States have enacted sales tax "holidays" on clothing, school supplies, and even computers.

is to establish "uniform" definitions which create a "menu" from which states can pick and choose what to tax and what to exempt.[29] (Localities can continue to define and set their own tax base of taxable and exempt goods, separate from that of the state in which they are located, until 2005.)[30]

SSTA proponents proudly claim that the "uniformity" of definitions results in substantial tax simplification, but the wiggle-room for states is considerable. The Agreement only requires that the state adopt definitions which are "in substantially the same language" and are "not contrary to the meaning of" the definitions contained in the Agreement.[31] Every state is thus allowed to have its own "grey area" with respect to every term defined in the Agreement. This is hardly uniformity. How is a retailer to interpret the nuanced differences in definitions among the states?

Many of the so-called "uniform" definitions crafted by the SSTP allow participating states to carve-out a variety of sub-categories of products, creating endless possible variations from state to state.[32] Furthermore, the Agreement permits a state to enact exemptions without restriction if the Agreement "does not have a definition for the product or for a term that includes the product."[33] This provision is an open invitation to states to impose their own interpretations of whether the Agreement "has a definition" for particular products, and it will inevitably lead to widely varying exemptions from state to state.

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[27] *Id.*, Section 322 (tax holidays are permitted)
[28] *Id.*, Section 322(B) (thresholds permitted during tax holiday).
[29] *Id.*, Section 302 (tax must be the same for all jurisdictions, state and local, within a state, after December 31, 2005); Section 316 (states free to adopt exemptions of their choosing for products defined in the Agreement).
[30] *Id.*, Section 302.
[31] *Id.*, Section 327(A).
[32] *See e.g.*, SSTA, Appendix C (Library of Definitions), Part II (Product Definitions), definitions of "Food and Food Ingredients," "Prepared Food," "Drug."

Put simply, even on as basic a simplification measure as uniform definitions, the Agreement comes up short. It does not provide a comprehensive listing of goods subject to, or excluded form, taxation by participating states. Examples of products for which the Agreement has no definition include such common items as farm/garden equipment and products. Under the SSTA, states will remain free to adopt disparate exemptions with respect to any "undefined" product, creating uncertainties and confusion for remote sellers and their customers. Furthermore, the Agreement is unclear as to whether whole defined categories of goods or services must be exempted during sales tax holidays, or whether individual items within a definition can be selectively exempted.[34] The end result is that in the area of uniform definitions, supposedly the jewel in the crown of the SSTP process, the terrain remains rough and muddy for remote sellers.

D. The Agreement's "Uniform" Definition Of "Sales Price" Permits Every Member State To Use A Different Measure, So That The Taxable Amount Of A Sale Transaction Will Differ From State to State.

Another fundamental complexity of the current system is that sellers must not only track the myriad of taxes and exemptions from state to state in order to determine whether their products are taxable in each state, but they must also determine the amount of each transaction that is subject to tax. This is especially problematic for remote sellers, who often add shipping and handling charges to the product's sale price. Under the current system, states treat such charges in a variety of ways, making calculation of the tax due in each state difficult for both the merchant and its customer. Uniformity

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[33] *Id.*, Section 316(B).
[34] *See* SSTA, Section 322(A)(1) (sales tax holidays limited to "items … specifically defined in the Agreement").

among states with respect to the measure of sales and use tax is an important requirement of simplification.

The SSTA's so-called "uniform" definition of the term "sales price," however, does not require member states to adopt a uniform measure of tax. The Agreement provides that "sales price" means the "total amount of consideration ... for which personal property or services are sold," including not only the product price, but also (1) any charges necessary to complete the sale, (2) delivery charges, (3) installation charges, (4) the value of any exempt property that may have been "bundled" with the taxable product as part of a single sale, and (5) the value of any property given by the purchaser as a "trade-in."[35] The SSTA, however, allows each state to exclude from the measure of "sales price" the amount received for any, or all, of these five items, if they are "separately stated" on the invoice to the customer,[36] creating dozens of possible permutations of "sales price." Rather than a "uniform" definition of the taxable measure of sale from state to state, sellers must track different definitions of sales price in every state.

Delivery charges are by far the most common surcharge receiving disparate state tax treatment. Taxation of delivery charges varies from state to state depending upon the nature of the charge (*e.g.*, does it cover only transportation charges, or other related costs, as well), its description (*i.e.*, a "shipping & handling" charge may be taxed differently than a "shipping" charge), whether it is "separately stated" on the invoice, and other factors. In order to simplify the difficulties of administering different rules on the taxation of delivery charges, the DMA proposed to the SSTP that all delivery charges be

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[35] SSTA, Appendix C (Library of Definitions), Part I (Administrative Definitions).
[36] *Id*.

made exempt under the SSTA. Again, the SSTP rejected simplification in favor of permitting each state to cling to its existing rule, even adopting a definition of "sales price" that accommodates every state's particular way of defining the measure of tax.

E. The Agreement Ignores Its Impact On Consumers Who Order By Mail And Pay For Their Purchases By Check.

The Agreement ignores its impact on consumers (especially the elderly and persons with low incomes who cannot obtain credit cards) who, either by choice or necessity, order by mail and pay by check or money-order. The system envisioned by the SSTA is unworkable where payment is made by check, and this problem is significant. According to the Federal Reserve, as of 2000, checks still accounted for nearly 60 percent of all non-cash payments.[37]

A simple example demonstrates the "real world" shortcomings of the SSTA. Let's assume a generous grandmother at Christmas decides to send several of her grandchildren located in different states the same flannel shirt (in different sizes), plus a gift basket of chocolates, chosen from a mail order catalog. When she fills out the catalog order form and attempts to pay by check, she will be required to self-compute the applicable tax. In order to accommodate her, a catalog will need to contain a tax table covering every state and local tax jurisdiction to determine the appropriate rate for her purchase. The catalog will also need to inform her which products are taxable and which are exempt in each state. (Clothing is excluded from sales tax in some states; food and/or candy is also exempt in some states.) The SSTA's "sourcing" rules provide that the tax rate for the jurisdiction where the recipient is located, not where the donor is located,

[37] Geoffrey R. Gerdes and Jack K. Walton, II, "The Use of Checks and Other Non-Cash Payment Instruments in the United States," Federal Reserve Bulletin, p. 360-61 (August 2002).

applies,[38] so she must calculate the correct tax, even on identical items, at four different tax rates. If her grandchildren happen to live in localities that impose one or more local sales taxes, she must be able to identify and apply up to four additional local tax rates, as well.

The Agreement permits every state to have a second, additional tax rate for food items. Now this buyer must determine not only whether the basket of chocolates is taxable, but whether it is taxable at a different rate than the shirt she is purchasing. (A single basket of chocolates may be subject to two different rates, one for the food/candy and another for the decorative container.) The SSTA allows states to exclude "candy" from the definition of "food." Now she must determine if "candy" is treated differently than "food" and, if so, whether it is exempt from tax or whether it is taxable at the standard state tax rate.

Now imagine that the state has adopted a sales tax holiday for one or more of the items she is ordering. (Many states, for example, have sales tax holidays that exempt clothing for short periods of time, usually from four to seven days.) This shopper must be made aware of the relevant sales tax holidays in the states where her grandchildren live in order to properly calculate her tax. Furthermore, if the sales tax holiday includes a tax threshold, she must also know the level of the threshold, and apply tax if the amount of her purchase exceeds the threshold.[39] If, because she misunderstands or is unaware of the sales tax holiday, she over-calculates tax and overpays the retailer, the retailer now has the additional burden of deciding how to handle the overpayment. Should it be remitted to the state or returned to the customer?

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[38] SSTA, Section 310.
[39] *Id.*, Section 322(B) (thresholds permitted during sales tax holiday)

The likelihood for consumer frustration and error are obvious, but the SSTA totally ignores the burdens it will impose on consumers. Moreover, the Agreement leaves retailers liable for the tax even if the consumer errs in calculating it.[40] This is not tax simplification.

F. The Agreement's Provisions Concerning Taxation of Digital Products Are Unworkable And Unfairly Expose Retailers to Liability.

Increasingly, electronic commerce involves the sale of digital products that can be ordered and delivered over the Internet. The SSTA, however, fails to provide a workable system for taxing digital products that will be used in multiple jurisdictions. The Agreement requires purchasers of digital goods and services to allocate the use of such digital products across multiple jurisdictions and to provide the retailer a new document called a Multiple Points of Use Form.[41] Such allocations will not only be extremely complicated for consumers, but, in addition, there is no reason why a purchaser will feel obligated to complete such a form. The retailer, however, will only be relieved of liability for the tax if it is successful in obtaining the completed Multiple Points of Use Form from the purchaser.[42] Retailers of digital products will inevitably be assed for uncollected use taxes in multiple jurisdictions because their customers fail to provide the proper form. Under the SSTA, a single sale of digital product could subject an Internet marketer to sales tax liability in multiple states.

G. The Provisions For Compensating Retailers And Certified Service Providers Are Woefully Inadequate.

Clearly, the SSTA, if approved by Congress as the basis for expanded state tax jurisdiction, will force retailers throughout the country to bear considerable additional

[40] *See id.*, Section 306 (relief from liability only where state provides erroneous information).
[41] *Id.*, Section 312.

expense to collect use taxes on behalf of states and localities. It is only fair that they should receive appropriate compensation, and protection from liability, for these new responsibilities. The SSTA, however, contains no guarantees of fair compensation for these additional duties.

The Agreement vaguely provides that states "anticipate" establishing compensation measures for businesses, either Certified Service Providers, retailers, or both, that incur compliance costs in connection with collecting and remitting use tax to the participating states.[43] The Agreement, however, contain no guarantees of compensation to either retailers or CSPs. Even the "anticipated" compensation does not extend beyond the first twenty-four months of a retailer's collection of tax under the Agreement,[44] even though the retailer will incur ongoing compliance costs. After the first two years, retailers are left to the whims of the individual member states,[45] few of which currently provide a meaningful amount of vendor compensation, if they offer it at all. It is telling that no state that has passed legislation to conform its tax code to the SSTA's requirements has yet enacted new provisions for adequate vendor compensation.

Moreover, once states have obtained congressional authority to impose use tax collection obligations on remote sellers, state legislatures will have every incentive to decrease, or eliminate altogether, the compensation they provide, in order to maximize state revenues. Indeed, one member state with a pre-existing vendor compensation provision (Kentucky) recently slashed vendor compensation for fiscal year 2004. At the same time, CSPs can be expected to charge higher and higher administrative fees to

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[42] *Id.*; *see also* Section 306.
[43] *Id.*, Sections 601(A), 602(A), 603(A).
[44] *Id.*, Sections 601(B)(2), 602(A), 602(B)(1).
[45] *Id.*, Sections 602(B)(2), 603(B).

retailers as the state reimbursement to the CSPs diminishes. A system that fails to provide guaranteed compensation for the new and ongoing costs of tax compliance is simply unfair.

As if failing to provide a guaranty of adequate compensation were not enough, the Agreement also provides that states may refuse compensation to a retailer that already had "a requirement to register to collect the tax."[46] What does this mean? States will undoubtedly claim that marketers were required to collect the tax anyway, and thus are not entitled to collection cost compensation. Is the *Quill* nexus standard to be litigated over this continuing qualification controversy?

H. Retailers Bear All The Burdens Of Compliance, But Receive No Protection From Liability For Tax Collection Errors.

SSTA protection of vendors from liability for tax collection errors is strikingly narrow. Vendors are relieved of liability only if a tax collection error results from erroneous information supplied by the state.[47] Vendors are not relieved of liability if a state fails to give, or the vendor fails to receive, adequate notice of a change in the tax rate or jurisdictional boundary. The Agreement also contains no provision relieving sellers of liability for errors due to certified software errors or system failures by CAS's or CSP's. Given the total lack of adequate tax compliance software, this omission by the SSTP is astounding.

Although imposing massive new burdens on retailers to collect use taxes in over 7,500 jurisdictions, the Agreement includes no protection for retailers from consumer lawsuits for collection errors committed in good faith by the retailer or by Certified Service Providers or as a result of software errors and malfunctions. A fair system would

[46] *Id*., Section 601(B)(2), 602(B)(1), 603(A)

include protection from consumer lawsuits for a retailer collecting tax in good faith on behalf of thousands of jurisdictions. Indeed, class actions against direct marketers alleging over-collection of use tax are not uncommon. Instead of protection from suits, the Agreement contains only a cryptic provision which requires consumers to demand a refund from the retailer and give the retailer sixty (60) days to respond before bringing suit.[48] Rather than protecting sellers, this provision arguably creates a new cause of action for consumers and exposes retailers to lawsuits in jurisdictions where consumers' only previous remedy was a refund claim against the state.

I. The Agreement's Governance Provisions Allow The States To Police Themselves.

Enforcement of member state compliance with the requirements of the SSTA, under the Agreement's weak "substantially compliant" standard, is left to a self-regulating Governing Board.[49] The contemplated SSTA Governing Board will be composed primarily of state tax administrators, who obviously have no incentive to declare a fellow member state out of compliance with the Agreement. Moreover, by the terms of the Agreement, the Governing Board is given sole and final authority to interpret the Agreement.[50] There is no role for judicial review of decisions of the Governing Board, either as to issues of member state compliance or interpretation of supposedly uniform standards.

In the unlikely event that the Governing Board finds a member state to be out of compliance, it is not required to deny that state continued participation in the SSTA or

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[47] Agreement, Section 306.
[48] *Id.*, Section 325 (optional provisions for consumer refund procedures).
[49] *Id.*, Section 806 (authority to administer Agreement vested in Governing Board of appointed officials from member states).

even to sanction the state in any way.[51] Moreover, a vote to sanction a state requires a three-fourths majority of the Board.[52] Needless to say, with so few enforcement mechanisms, and so little incentive for a state to remain in compliance, it is unlikely that states will adhere strictly to the terms of the Agreement.

J. The Agreement Has No Mechanism To Guarantee Consistency and Uniformity Over Time.

The SSTA is not self-executing. Individual states must pass legislation to bring their tax codes into conformity with the requirements of the Agreement. Even assuming that the initial legislation in each state brings the state into compliance with the Agreement (and that's a big assumption, even under the Agreement's soft "substantially compliant" standard), there will never be more "uniformity" among the states than on the first day the Agreement goes into effect. After that date, uniformity starts to fray. State revenue departments, as well as administrative tribunals and courts in each member state, will independently interpret and apply each state's purported conforming legislation. With numerous, independent decision-makers rendering their own interpretations of SSTA conforming legislation, divergent interpretations are inevitable. Thus, the "substantial uniformity" the Agreement purports to establish on day one will progressively deteriorate over time. The "streamlined" system envisioned under the SSTA will gradually fall apart.

K. The Agreement Allows No Judicial Review of Board Decisions.

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[50] *Id.*, Sections 1003 (decisions of Governing Board not subject to review); 1104 (determinations of Governing Board are final and not subject to appeal).
[51] *Id.*, Section 809 (sanctions optional).
[52] *Id.*

The Agreement's purported "solution" to the problem of inconsistent interpretation is to empower the Governing Board to issue interpretations of the Agreement and of its definitions, in response to a petition from a member state or any other person.[53] The Governing Board, however, is not required to act on any petition.[54] Moreover, because all actions by the Governing Board (including any failure to act) are final and not subject to further review, a retailer or taxpayer has no recourse from an adverse decision of the Governing Board. Even if a retailer or taxpayer obtains a favorable ruling from the Governing Board, the Agreement makes clear that no person, other than a member state, is entitled to benefit from the Agreement, and that neither the provisions of the Agreement, nor the actions of the Governing Board, afford any person affirmative rights under state law.[55] The states have made themselves, through the Governing Board, the sole and final arbiters of all matters under the Agreement, and they have insulated themselves from taxpayers' protests of assessments based on the argument that the state has failed to abide by the terms of the SSTA. The states are asking Congress to bless a system for which the states have provided no safeguards or oversight.

L. The System Envisioned By The SSTA Is Far From Operational and Certainly Not Ready To Form The Basis For Expanded State Tax Jurisdiction.

The list of tasks not yet completed by the SSTP, which are necessary to implement even the limited and inadequate reform measures contemplated by the Agreement, is lengthy. Most glaringly, as I have pointed out, there is no software in

[53] *Id.*, Sections 902 (Governing Board empowered to interpret Agreement); 903 (Governing Board may interpret existing definitions and issue new ones).
[54] *Id.*, Section 902 (Governing Board need not act on request for interpretation of the Agreement); 903 (Advisory Council may recommend to Governing Board that no action be taken on the request for interpretation of definition or issuance of new definition).
[55] *Id.*, Sections 1102, 1103 (Agreement benefits only member states, and does not otherwise adversely affect state law or grant rights to any person).

place for retailers to calculate tax properly under this new system, nor are there any Certified Service Providers to perform a retailer's multi-state tax collection obligations. The states have also not completed their cost of collection study. Few, if any, states have established required databases of tax rates and jurisdictions.[56] There is no basic registration form and not yet any system for centralized registration.

Although it is stating the obvious, it bears mention that since the Agreement is not yet in effect, there is no Governing Board. This is not a trivial matter. Rather than tackling a myriad of administrative issues in the Agreement itself, the states have glibly left these matters to be addressed by a still unconstituted Governing Board. As a result, there is no uniform model tax return, no model remittance form, no direct pay permit guidelines and forms, no taxability matrices, no procedures for the Governing Board itself, no rules regarding disputed issue resolution, and no advisory councils.[57]

Consideration by Congress is simply premature. Not only are numerous elements of the SSTA still undeveloped, but many other factors are not slated to go into effect for years. For example, the provisions for limiting the number of state rates to one rate plus one additional rate,[58] harmonizing state and local tax bases,[59] eliminating caps and thresholds[60] (outside of the tax holiday context, where they will continue to be permitted), and adopting a uniform rounding rule,[61] are not required to go into effect until December 31, 2005.[62]

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[56] *See Id.*, Section 305 (requiring that member states have databases for taxing local rates and boundary changes.)
[57] *See generally Id.*, Sections 318, 319, 326, 327, 806, 810-11, 1001.
[58] *Id.*, Section 308.
[59] *Id.*, Section 302.
[60] *Id.*, Section 323.
[61] *Id.*, Section 324.
[62] As a practical matter, many state law changes intended to conform existing law to the Agreement do not go into effect until January 2004 or later.

In short, the list of open items is long. Congress should not endorse a tax system that is far from operational, especially when the endorsement carries with it an historically unprecedented expansion of state tax power.

IV. THE STATES HAVE FAILED TO CONFORM THEIR LAWS TO THE AGREEMENT.

While the inherent problems with the Agreement that I have described demonstrate that the SSTA, on its face, fails to achieve meaningful reform, the long descent away from true uniformity and simplification does not end there. Although some twenty states have passed purported conformity legislation, no state has, in fact, yet enacted legislation sufficient to bring its laws into conformity with the Agreement's requirements. As state after state misses the mark, the goal of uniformity grows ever more distant.

A. State Legislatures Consistently Omit Key Provisions of The Agreement.

The apparent shortcomings in state conformity legislation run the gamut. Often it is what a state has left undone, rather than what it has enacted, that causes the state to fall short. The most common omissions are both telling, and troubling. Numerous states have failed to enact provisions guaranteeing vendor compensation (including Arkansas, Iowa, Kansas, North Carolina, North Dakota, South Dakota, and West Virginia) and many have not adopted the (albeit weak) consumer privacy requirements imposed on states under the Agreement (including Indiana, Nevada, Tennessee, Utah and Washington). Other omissions include failure to adopt amnesty provisions for companies registering under the Agreement (North Carolina, Washington) and the establishment of required databases and matrices (Indiana). Texas and Washington, both states with local taxing jurisdictions, have failed to adopt the Agreement's destination-based sourcing rules.

Wyoming has adopted legislation that essentially contains none of the Agreement's requirements, but instead directs its tax administrator to adopt as-yet unfinished regulations to meet each of the requirements. West Virginia has adopted the Agreement verbatim, but has retained conflicting definitions from its existing statutes, providing only that the new definition shall control in the even of a conflict. The list goes on.

B. States Have Renamed Taxes And Crafted Other Creative Legislation To Circumvent The Agreement's Requirements.

In a development that may bode even greater ill for the goal of simplification, some states have already demonstrated their willingness to circumvent the requirements of the Agreement through legislative gamesmanship. Under prior law, Minnesota had an exemption for most clothing, but imposed sales/use tax on fur coats. The SSTA, however, requires that a state exemption must apply to an entire defined category of goods, in this case clothing. Because furs are deemed "clothing" under the Agreement, Minnesota would be required to include fur coats in its sales tax exemption for clothing. Rather than conform its laws, however, Minnesota enacted a separate "special fur clothing tax," outside of its sales and use tax statutes.[63]

Tennessee has engaged in similar legislative slight-of-hand. Rather than conform to the requirements of a single state rate (for all items other than food, food ingredients or drugs), Tennessee adopted certain "special user privilege taxes" which impose disparate tax rates on select products and services.[64] Here again, the state simply renamed an existing provision to avoid application of the Agreement, rather than accepting the modest measure of simplification required under the SSTA.

[63] Minn. Stat. § 295.60 (2002).
[64] Tenn. S.B. 899, Section 75 ("Special User Privilege Taxes") (2003).

The danger that states will resort to imposing individual “excise” and other “special” taxes on various items that would not be subject to sales tax under the Agreement’s terms is very real, as demonstrated by these examples of early circumvention tactics. The Agreement, by its terms, applies to sales and use taxes, but it nowhere defines either form of tax, leaving states free to game the system, and introduce still more complexity. Once Congress grants the states expanded tax jurisdiction, the incentive for state legislatures to yield to local pressures and evade uniformity strictures will only increase.

C. Conformity Legislation Is A Vehicle For State Tax Increases.

Purported state conformity legislation is being used by some states to impose tax increases on their residents. In fact, several provisions of the SSTA will allow, or even require, states to increase their sales and use taxes when conforming their laws to the Agreement. For example, at least four participating states (Illinois, Iowa, Kansas, Vermont) have a local sales tax (or the equivalent) but have no local use tax. Although the SSTA would permit this discrepancy to continue,[65] at least one state, Kansas, has used its conformity legislation to impose a new local use tax on consumers.

Other provisions of the SSTA will also result in tax increases as states conform their laws to the Agreement. The SSTA limits states to one state tax rate, plus one additional rate for food and food ingredients and drugs. States that tax other products at a rate lower than the standard state rate will be required to either exempt such products altogether, which is not likely, or increase the tax rate on those products. For example, agricultural equipment has been taxed at a lower rate by many of the states participating

[65] *See* 308 (B) (requiring that local sales and use tax rates be equal only if local jurisdiction impose both taxes).

in the SSTP (*e.g.*, Florida, Mississippi, Nevada, North Carolina, North Dakota, South Dakota, Wyoming). Unless those states adopt new exemptions and remove those items altogether from the tax base, farmers in those states can expect to pay higher sales and use taxes on purchases of agricultural requirement.

The elimination of caps and thresholds, a necessary step for simplification, will also result in tax increases. Numerous states participating in the SSTP have either caps or thresholds, or both, which must be eliminated from state law in order to conform to the SSTA. Some tax increases have already been enacted as a result. Arkansas's conforming legislation eliminated its "single item" cap of $2,500 (*i.e.*, no tax on the value of a single item over $2,500) on most items, thereby raising taxes enormously on many "big ticket" purchases. Tennessee had several thresholds for selected goods and services (from caskets to cable television) which exempt such items from tax on amounts below a specified threshold. Tennessee's conformity legislation provides for the repeal of at least some of these thresholds (*e.g.*, the $500 threshold for caskets will be eliminated), subjecting its residents to new taxes. There will be many more examples of new taxes, or increased tax rates, resulting from adoption of the SSTA.

V. THE AGREEMENT WILL HAVE HARMFUL, POTENTIALLY DISASTROUS, EFFECTS ON THE ECONOMY AND AMERICAN JOBS.

Small and medium-sized businesses will suffer most from the new burdens imposed by the SSTA. Start-up companies and existing store-front businesses that might otherwise seek to establish new markets for their products by selling over the Internet will be deterred from entering e-commerce because of the specter of nationwide tax collection responsibilities. In its current open-market form, the Internet is a spur to economic growth. It enables small businesses and niche retailers to compete with big

box mall merchants and sell their goods worldwide. Imposing new tax collection obligations on e-commerce will stifle the growth of the Internet and slow down this country's economic recovery which is dependent on a rebound of the information technology sector.

A. The SSTA Will Not "Level the Playing Field" Between In-State and Out-of-State Merchants.

Somewhat cynically, proponents of the SSTA claim to champion local "Main Street" merchants that must collect sales tax on their over-the-counter sales. These cries for a "level playing field" for in-state and out-of-state merchants are both misleading and short-sighted for the following reasons.

First, the cost of use tax collection and remittance is much greater for remote sellers, who must compute, collect and remit tax for thousands of jurisdictions, as compared to an in-state retailer who collects at just one tax rate. Second, direct marketers must "eat" the applicable tax if their customers fail to calculate the tax correctly -- a problem storefront retailers do not confront. Third, in-state retailers benefit from a wide variety of state and local government services and programs (including tax incentives) that are not available to out-of-state merchants. Fourth, there are inherent differences in the cost of doing business for in-state and out-of-state merchants that have more of an impact on their relative competitiveness than does collection of sales tax -- most obviously, an out-of-state vendor imposes delivery charges (usually in an amount considerably greater than the use tax) to get its product to the customer, while a vendor selling over-the-counter does not add a delivery surcharge to the price of its goods.

The real competition for "Main Street" shopkeepers comes, not from out-of-state sellers, but from retail behemoths in the form of big-box chain stores. Those are the

companies that have devastated America's downtowns. Indeed, the advent of the Internet has allowed traditional "Main Street" merchants to develop new markets for their goods across the country. It is not surprising that the retail giants, which seek a virtual oligopoly over consumer sales, are the main advocates for increased tax obligations on e-commerce transactions. Indeed, the Walmarts, Targets, etc. will be the real beneficiaries of a tax system that requires their Internet competitors to collect tax on every sale, regardless of location. America's economy, and its small and medium-sized Internet businesses, will be the losers.

B. The SSTA Will Hurt the Competitiveness of American Companies and Favor Foreign Firms, Hampering Economic Recovery and Causing the Loss of American Jobs.

Not only is the "level playing field" argument not valid as between in-state and out-of-state merchants, but, more significantly, the SSTA would slant competition in an entirely different direction, much to the detriment of American companies and to the benefit of their foreign competitors.

Obviously, the SSTA does not, and cannot, extend the jurisdictional reach of state and local taxes to foreign companies. Although, in the past, foreign retailers may have been at a competitive disadvantage in marketing products directly to American consumers, the delivery delays of prior years and the previous expense of overseas transportation no longer impedes international (cross-border) sales. Digital products and services can be delivered electronically to American consumers from anywhere in the world. Even tangible personal property can now be delivered via common carrier from such overseas locations as China and Ireland in times, and in many cases at rates, that are no different than for domestic deliveries. And since a foreign vendor is not required

under the SSTA to charge sales tax[66] or recoup from customers the cost of collecting it, the impact of the SSTA will be to drive Internet purchasers to foreign vendors for both digital products and hard goods. (Many consumer electronic products are manufactured in the Far East, and those goods could be delivered directly to American consumers from Asian warehouse/fulfillment centers without going through the additional distribution level of an American distributor. In fact, goods can be delivered from Asia to American households using the same common carriers, such as FedEx and UPS, as are used by U.S.-based retailers. The process would appear seamless to American consumers, with no loss of convenience to them.)

The long-term economic impact of the SSTA should not be underestimated. American retailers will lose market share to foreign competitors that already enjoy substantial advantages in labor costs. E-merchants and catalog companies will locate themselves where the costs of doing business and the tax environment are most attractive. Large sectors of the direct marketing industry are already under considerable pressure to move overseas. For example, many computer programming and data entry functions have been relocated to India. English-speaking call centers have also been set up in India to handle real-time orders from American consumers. Digital products can be sold and delivered to American consumers as easily from Bombay as from Silicon Valley.

Large fulfillment centers for delivering goods to American consumers are already up-and-running in foreign countries from Mexico to China. Whether the product is apparel or computers, consumer goods can be manufactured and delivered from integrated manufacturing/warehouse facilities in Tijuana or Taipei as easily as, and less

[66] Even if there were such a requirement for collection of state and local sales taxes by companies that receive and fulfill Internet orders from overseas locations, it would be effectively unenforceable.

expensively than, a facility in Tennessee. The loss of American jobs to foreign countries has reached near crisis proportions, and it denominates the "jobless recovery." It would be ironic for this Congress, which is attempting to reinvigorate the U.S. economy, to instead accelerate the flow of jobs overseas by imposing new burdens on the very economic sector in which the United States has been the unchallenged world leader, *i.e.*, electronic commerce.

Parochial state and local tax systems should not be permitted to hinder America's economic recovery and its continued leadership in the field of information technology. Any attempt to saddle electronic commerce with new state sales and use tax burdens would prevent electronic commerce from achieving its full potential. Sacrificing American Internet dominance at the alter of state taxes is simply bad public policy.

VI. DIRE PREDICTIONS OF STATE REVENUE "LOSS' FROM E-COMMERCE ARE GROSSLY OVERSTATED.

The current budgetary problems confronting many states have created an impetus for states prematurely to press Congress for legislation overriding *Quill* and authorizing an expansion of state tax jurisdiction. The dire predictions of revenue losses[67] resulting from allegedly untaxed e-commerce purchases, however, are based on unsubstantiated and grossly overestimated projections, which are refuted by recent data concerning e-commerce transactions released by the Department of Commerce.

The bleak revenue picture painted by SSTA proponents was based on a much publicized study prepared by the University of Tennessee's Center for Business and Research conducted in 2000 and updated in 2001 ("Tennessee study"). The Tennessee

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[67] Whether a state can count as "lost" revenue the inability to tax a transaction completed electronically or involving a remote e-commerce seller is debatable, but even assuming that questionable premise, the problem of unrealized sales tax revenues has been greatly exaggerated by the states.

study relied on proprietary projections from a private consulting group, Forrester Research, which both misunderstood the nature of business-to-business electronic commerce, and grossly overstated the future growth of e-commerce. First, the Tennessee study included in its measure of electronic commerce all business-to-business transactions conducted via electronic data interface ("EDI"), a system that has been in use for years. States already receive most of the tax revenue relating to EDI transactions, because these are all business-to-business transactions, and use tax is regularly self-reported on most B-to-B transactions. Consequently, the Tennessee study's estimate of revenue loss from consumer Internet transactions is greatly inflated.

Next, the Tennessee study assumed an annual growth rate for e-commerce of 38 percent. This staggering growth rate may have looked rational during the dot-com boom, but subsequent experience has brought growth projections for the Internet back to earth. Indeed, data subsequently published by the Department of Commerce debunks the assumption of phenomenal growth rates for e-commerce over the coming decade, deflating substantially the likely impact of e-commerce on state sales tax revenue. Projections from this year's Census Bureau data show that Internet commerce is growing at a much more modest 12.5 percent compound annual growth rate.

Dr. Peter A. Johnson, a Senior Economist with the DMA, conducted an analysis in late 2002 and early 2003, based on the new Commerce Department data ("Johnson Study").[68] The Johnson Study projects revenue losses for the states some 80 percent to 90 percent lower than those projected by the Tennessee study. For example, for 2001, based on Commerce Department data, the uncollected use tax from Internet sales

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[68] Peter A. Johnson, "A Current Calculation of Uncollected Sales Tax Arising From Internet Growth," (March 11, 2003).

amounted to approximately $1.9 billion for all states, rather than $13 billion, as projected by the Tennessee study. The Johnson Study further projects that uncollected sales tax in 2011 will not likely exceed $4.5 billion, or less than 10 percent of the $55 billion projected by the Tennessee study. (A copy of the Johnson Study is submitted with my testimony and is available at www.thedma.org/taxation/CurrentCalculationofUncollectedSalesTax.pdf.) In short, the states' claims of lost revenue from e-commerce sales are based on inaccurate transaction data and are grossly inflated. Congress should not rush to approve a new system of taxation whose adverse impact on the U. S. economy is likely to be far greater than any increases in state tax revenues.

VII. IF CONGRESS EXPANDS STATE TAX JURISDICTION OVER INTERSTATE COMMERCE, THE TAX INJUNCTION ACT SHOULD BE REPEALED AND FEDERAL COURTS SHOULD HAVE JURISDICTION OVER TAX DISPUTES ALLEGING VIOLATIONS OF FEDERAL LAW.

When, and if, the states present Congress with a truly streamlined sales and use tax system, Congress should include in any authorizing legislation federal court jurisdiction over tax disputes involving questions of federal law. If states, through federal legislation, seek to remove existing constitutional limitations on the scope of their taxing jurisdiction and to impose collection obligations on companies located in other states, then such companies should have access to federal court both to challenge decisions of the Governing Board and to contest tax assessments that violate the provisions of the new federal legislation or, for that matter, any remaining constitutional protections such companies may have.

Accordingly, legislation that would override the constitutional restrictions on state taxing authority reaffirmed in *Quill* should be accompanied by a repeal of the Federal

Tax Injunction Act, 28 U.S.C. § 1341,[69] as it applies to sales and use taxes administered under the Agreement. The Tax Injunction Act was enacted to permit states to administer their tax systems within their own borders without interference by federal courts. This rationale no longer applies in the situation where states are enforcing their tax systems on sellers outside of their borders and pursuant to authority granted by federal legislation. Moreover, only federal courts can assure consistent interpretation and application of the Agreement among all the states.

If the SSTP member states are sincere in their expressed desire for greater interstate uniformity, federal court jurisdiction would ensure both continuing state compliance and the ongoing consistency of interpretation necessary to achieve sustainable simplification of state sales and use tax systems. Moreover, judicial review of actions of the Governing Board, including its decisions to take no action when presented with a petition, is a fundamental safeguard to avoid creating a runaway tax bureaucracy designed by, enforced by, and adjudicated by state tax administrators. Access to federal court is a procedural bare minimum that Congress should require as a *quid pro quo* for expanded state tax jurisdiction.

Conclusion

In conclusion, I want to thank again the members of the Committee for the opportunity to offer this critique of the Streamlined Sales and Use Tax Agreement. I urge Congress to move cautiously in this area, as the consequences of removing constitutional protections for interstate commerce are dramatic and may cause permanent economic

[69] The Tax Injunction Act provides that "[t]he district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." 28 U.S.C. § 1341.

harm. Once approved, such an expanded state tax system would be difficult to repeal, even if it fails to provide meaningful simplification and harms America's national interests in other ways. Congress may have only one chance to "get this issue right." Until the states can demonstrate to Congress' complete satisfaction that they have developed a fair and fully functioning system that achieves more than superficial simplification, and that contains safeguards for marketers and consumers, Congress should decline to alter constitutional standards that have served this country well since its founding.