

Statement of

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The logo for NetChoice, featuring the word "NetChoice" in a bold, blue, sans-serif font. The "Net" is in a darker blue, and "Choice" is in a lighter blue. The logo is centered on a light blue rectangular background.

Testimony before the

United States Senate Committee on Finance

Tax Reform: What It Means for State and Local Tax and Fiscal Policy

April 25, 2012

Chairman Baucus, Ranking Member Hatch, and members of the committee: thank you for holding this hearing on federal tax reform and its impact on state and local governments. My name is Steve DelBianco, and I serve as Executive Director of NetChoice, a coalition of leading e-commerce and online companies promoting the value, convenience, and choice of Internet business models. NetChoice members include industry leaders such as eBay, Expedia, Facebook, LivingSocial, NewsCorp, VeriSign, and Yahoo, plus several thousand small online businesses.

In this testimony we are addressing just the portion of this hearing that examines the impact of current Senate legislation that would authorize states to impose sales tax obligations on out-of-state businesses (S.1832 and S.1452).

Why don't online retailers pay sales tax to every state?

Last November, the editors of the Wall Street Journal asked NetChoice whether all online retailers should have to pay sales tax to every state. My published essay began with this:

Should online retailers have to collect sales tax? Yes, and they already do.

Just like all retailers, online stores must collect sales tax for every state where they have a physical presence. That's why Amazon.com adds sales tax to orders from customers in the 5 states where it has facilities. But Amazon and online retailers aren't required to collect tax for other states, leaving those customers to pay a "use tax" that states rarely enforce against individual taxpayers. This framework frustrates state tax collectors and businesses that compete with online retailers. But when we learn how this physical presence requirement evolved, it becomes clear why we should retain this standard for imposing new tax collection burdens on online retailers.¹

As members of this committee know, today's physical presence standard is based on Article One of the United States Constitution, created 225 years ago to stop states from impeding interstate commerce. The so-called Commerce Clause was a necessary condition to unite the independent colonies, since they had a legacy of imposing customs duties and trade barriers to favor in-state businesses over out-of-state competitors.

¹ Steve DelBianco, *Should States Require Online Retailers To Collect Sales Tax?*, Wall Street Journal (Nov. 14, 2011) (emphasis added).

Fast-forward to the 1960s, when state tax collectors wanted catalog retailers to collect their sales taxes, even where those catalogs had no operations in the state. The US Supreme Court relied on the Commerce Clause in deciding that states could not impose tax collection requirements on catalogs “whose only connection with customers in the State is by common carrier or the United States mail.”²

In 1992, the Supreme Court took another look at tax collection by an office products catalog company by the name of Quill. Seeing a patchwork of rates and rules for several thousand sales tax jurisdictions, the Court again held that requiring out-of-state companies to collect and remit taxes was so complicated that it presented an unreasonable burden on interstate commerce.

Moreover, the Supreme Court was not moved by the state’s argument that computer technology created the necessary simplification. Instead, the Supreme Court acknowledged the lower court’s finding that advances in computer technology had eased the burdens of tax collection, but still found the requirement of tax collection unduly burdensome.³

And *Quill* was not about “fairness.” While some argued fairness as justification for the collection requirement, “[i]n contrast, the Commerce Clause and its nexus requirement are informed *not so much by concerns about fairness* for the individual [state] as by *structural concerns about the effects of state regulation on the national economy.*”⁴

Quill is the law of the land today, protecting American businesses from sales tax imposition by states where that business has no physical presence. *Quill* also made it clear that states could simplify their sales tax systems and come back to the Supreme Court and show that they have truly eliminated the unreasonable burden on interstate commerce.

But instead, a handful of states chose to skip the harsh judgment of the Court and go directly to Congress to request the power to impose these burdens on out-of-state businesses. Their efforts began a decade ago with the Streamlined Sales Tax Project (SSTP).

² *Nat’l Bellas Hess, Inc. v. Dept. of Rev. of Ill.*, 386 U. S. 753 at 758 (1967).

³ See *Quill Corp. v. North Dakota*, 504 U.S. 298 at 313 FN 6 (1992).

⁴ *Id.* at 312 (emphasis added).

Despite a decade of effort, the actual simplification achieved by the SSTP is not nearly sufficient to justify having Congress abandon its role in protecting interstate commerce. Rather, the SSTP has shown that *simplification has become just a slogan – not a standard.*

Most critics cite the fact that SSTP originally promised just one tax rate per state, but now accommodates over 9,600 local jurisdictions,⁵ each with its own tax rate and sales tax holidays. Moreover, consider these examples of how the simplification campaign has come unraveled:

SSTP abandoned a destination-sourcing scheme to accommodate both origin and destination based taxes at the same time.

One foundational principle of simplification was to use the delivery destination of any shipment to determine which state's rates and rules should apply. But that was deemed too troublesome for states that base their sales tax on where shipments *originate*, not where they are delivered. To help those origin-based states join the SSTP, the Governing Board now lets states use origin-based rules for intrastate shipments while requiring out-of-state sellers to collect sales tax based on the destination jurisdiction.

States are systematically undermining their promise to simplify definitions and rules.

Member states have already strayed from the library of definitions in their Agreement and have allowed states to retain non-conforming definitions by calling them something other than a sales tax. Moreover, states now want to allow tax thresholds on individual sale transactions, which was one of the major complexities that SSTP was designed to eliminate.

Despite these concessions, less than half of eligible states have joined SSTP (only 21 full member states in SSTP out of 46 states that have sales and use tax).

Why was SSTP losing momentum among states that were told they would receive billions of dollars in new tax revenue? Possibly because non-member states are reluctant to let unelected tax administrators make decisions about tax rules and determine compliance. More likely, SSTP was losing momentum because states began to see the revenue estimates as wildly

⁵ See Scott Drenkard, *State & Local Sales Taxes in 2012*, Tax Foundation Fiscal Fact No. 291, Feb. 14, 2012, at <http://www.taxfoundation.org/news/show/27967.html>.

inflated. According to a study by economists Robert Litan and Jeffrey Eisenach, uncollected sales tax on e-commerce in 2012 is about \$3 billion nationwide, which is only 1/3 of one percent of total state and local tax revenue.⁶

Recently, despite flagging momentum and diminishing revenue estimates, members of this committee have surely noticed increased lobbying efforts to overturn *Quill's* physical presence test and authorize states to collect from remote retailers. Aside from the usual tax proponents in state government, the renewed push is coming from big-box retailers.

Big-box retail chains are pushing hard for federal legislation for a simple and predictable reason: it serves *their* interests. Even a little simplification helps a big-box retailer who must already collect tax for most states. Big-box retailers now have expansive web-stores of their own and give customers the convenience of doing pickups and returns at their local stores. These chains use plenty of local public services wherever they have stores, so they must collect sales tax in all their states – as required under current law. The Eisenach study described above looked at sales collection practices for the top 500 e-retailers, and found that 17 of the top 20 already collect in at least 38 states.

Top 20 e-Retailers with their Collection and Remittance of Taxes

Company	States
Amazon.com	5
Staples	44
Dell	46
Office Depot	46
Apple	46
OfficeMax	46
Sears	46
CDW	46
Newegg	3
Best Buy	46
QVC	46
SonyStyle.com	46
Walmart.com	46
Costco Wholesale	38
J.C. Penney	46
HP Office	46
Circuit City Stores	29
Victoria's Secret	45
Target	46
Systemax	5

Another way that overturning *Quill* would also help big-box retailers is that it would force tax collection costs on their biggest online competitor, Amazon. Big-box retailers have aggressively gone after Amazon in the states, lobbying for new “Amazon Tax” laws declaring that Amazon already has physical presence by virtue of its advertising affiliates, distribution centers, or other

⁶ Eisenach & Litan, *Uncollected Sales Taxes On Electronic Commerce: A Reality Check*, Empiris LLC (Feb. 2010), available at <http://bit.ly/EisenStudy>.

subsidiaries in the state. The big-box retailers also lobbied for a new tax reporting law in Colorado, which was recently overturned by federal court as a violation of the Commerce Clause.⁷

Despite the setback in Colorado and pending court challenges of the “Amazon Tax” in New York and Illinois, this aggressive and expensive state lobbying campaign has succeeded in creating well-publicized tax compliance problems for Amazon. Those problems have helped to drive Amazon to support federal legislation such as S.1832 and S.1452.

But there’s another reason for Amazon’s about-face: the company is changing its business model by adding distribution centers in new states, placing drop-boxes in convenience stores, and offering coupons for local merchants. As a result, Amazon will have physical presence in eleven states by 2014⁸ – requiring Amazon to collect sales tax for more than a third of all Americans. Like the big-box stores, Amazon will soon see a benefit to overturning *Quill* in return for a bit of simplification and for burdening its smaller online-only competitors with new tax collection costs.

To impose expensive collection burdens on small sellers would be grossly unfair, which brings us to the aspect of “fairness” in the debate over new Internet sales taxes.

Is this debate really about “fairness”?

The Constitution’s Commerce clause has nothing to do with fairness. As explained above, it was all about preventing unreasonable barriers to interstate commerce, such as the customs duties imposed by the independent states before they united. In fact, *Quill* explicitly dismissed the fairness argument, saying the “Commerce Clause and its nexus requirement are informed not so much by concerns about fairness” but rather “the effects of state regulation on the national economy.”⁹

⁷ See Order of Ct., *The Direct Marketing Ass’n v. Huber* (U.S. Dist. Ct. Colo. Mar. 30, 2012), and see 1 Colo. Code Regs. § 201-1:39-21-112.3.5 (2010).

⁸ By 2014 Amazon will collect and remit sales taxes in the following states California, Indiana, Kansas, Kentucky, North Dakota, New York, Pennsylvania, South Carolina, Tennessee, Virginia, and Vermont.

⁹ *Quill*, 504 U.S. at 312.

“Fairness” is what you get *when everyone plays by the same rules*. And today, with *Quill* in place, all online and offline businesses play by exactly the same rule: all retailers collect sales tax for every state where they choose to have a physical presence.

Ironically, in many states the fairness argument cuts the other way. A retail store on main street collects sales tax for just the one jurisdiction where it’s located. But an online retailer operating right upstairs must collect and remit for each of the local towns and counties whenever it ships within the state. In some states that means collecting for several hundred local tax jurisdictions, each with its own rates and rules. Yet when customers from surrounding towns walk in the door, the store collects and files only in the local jurisdiction.

Again, all retailers collect sales tax for every state where they choose to have a physical presence. I say, “choose” because it is the business that chooses whether to be just an online retailer or to operate physically in multiple states. When a business chooses to open stores or put sales reps in another state, it accepts the obligation to collect that state’s sales tax.

There’s actually little evidence that retailers who *do* collect sales tax are losing significant sales to online retailers who aren’t required to collect sales tax. That makes sense, since sales tax and shipping costs aren’t added until a consumer’s online shopping cart goes to checkout. So comparison shoppers are usually comparing prices *before* adding any tax and shipping charges. Moreover, online shoppers usually pay shipping and handling charges that offset any tax that’s not collected on most commodities. Small and expensive electronics are a notable exception; however, SSTP proponents have shown us no studies indicating that significant numbers of electronics shoppers deliberately choose out-of-state online retailers just so they can avoid paying sales tax.

e-Commerce is the best hope for Main Street to compete with Big-Box Stores

Those who make the fairness claim about online versus offline are missing the far greater fairness concern of small retailers competing against big-box chain stores.

For decades, “main street” retailers have been getting battered by Walmart and other national chains. To survive, many main street retailers have gone online with their own web stores or with e-commerce platforms to serve repeat customers and to find new customers across the country. For example, the specialty retailer SilverGallery.com has a warehouse and store—located on Main Street—in Waynesboro, Virginia. SilverGallery, which was featured in a Wall

Street Journal article last year, does some walk-in trade, but most sales come from their web store and other online channels.¹⁰ Online sales growth enabled SilverGallery to buy their building and increase employment, right there on Main Street.

The last decade has seen another body blow delivered by big-box chains, who integrated their website operation with their stores in every city and town. Customers love the savings of doing in-store pickups to avoid shipping charges. And they love the convenience of returning online purchases to stores for exchange or credit – instead of packaging returns and standing in line at the post office. But small sellers like SilverGallery can't afford to open stores in every state. It's yet another advantage that big retailers have over small businesses with websites. The big chains also negotiate much lower rates for advertising, shipping costs, and health insurance, too.

Next comes the knockout punch for small retailers. Overturning *Quill* may be good news for big-box retailers with websites, since they already have to collect in nearly all states. But overturning *Quill* will definitely raise costs and prices for small businesses that compete – and survive – via their web and catalog sales.

What is the impact on small businesses if they are required to pay sales tax to 46 states?

What costs would a small business face if Congress forced them to pay sales tax to all 46 states? The SST Cost of Collection¹¹ study found that a small business (under \$1M in annual sales) spends 17 cents for every tax dollar it collects for states. And even if SST software works as promised, that only helps with 2 cents of the 17 cents in costs per dollar collected. That leaves small businesses with a 15% cost burden on every dollar they collect, for things such as:

- Paying computer consultants to integrate SST software into home-grown or customized software;
- Training customer support and back-office staff;
- Answering customer questions about the taxability of items, or sales tax holidays in remote jurisdictions;
- Handling audit questions from 46 states; and
- Paying accountants and computer consultants to answer all these questions.

¹⁰ See Angus Liten, *Sales-Tax Measures 'to Cost Us Big'*, Wall. St. Jo. (Dec. 1, 2011).

¹¹ Available at <http://www.netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf>.

These collection burdens will be a big problem for small catalog and online businesses that collect only their home-state sales tax today. Ask any small business, on Main Street or online, and you'll learn it's hard enough to collect sales tax for one state, let alone all 45 states with sales tax laws of their own.

With a full picture of what small online businesses would face from SST, it's easy to see why Senator Wyden and five co-sponsors introduced Resolution 309 to protect our nation's Internet entrepreneurs. S. Res 309 is titled "Supporting the Preservation of Internet Entrepreneurs and Small Businesses." Its main point is this simple pledge:

Congress should not enact any legislation that would grant State governments the authority to impose *any new burdensome or unfair tax collecting requirements on small online businesses* and entrepreneurs, which would ultimately hurt the economy and consumers in the United States.¹²

The bottom line on "fairness" is that big-box retailers have wielded that term for their own benefit to the detriment of any small retailers they haven't already extinguished.

Is it a new tax? Yes.

State sales tax laws put obligations on both buyers and sellers in order to maximize revenue collection. States levy a sales tax on sellers within their jurisdiction, and it's up to the seller whether to pass that tax along to buyers. Most sellers do pass the tax along to buyers, whether at the cash register, online, or over the phone. But after an audit, a seller is liable for any sales tax they were obliged to collect but failed to do so, even when the seller can't recover the tax from those previous customers. This demonstrates how sales tax is due from *sellers* whose activities or locations create enough of a physical presence for a state to impose collection obligations.

If Congress overturns the *Quill* physical presence standard, retail businesses would be forced to pay a new tax to states where they have no physical presence. Most of those businesses would pass the tax along to their customers, but, make no mistake about it, the states will demand that businesses pay the new tax — whether or not their customers were charged.

¹² S. Res. 309, 112th Cong. (2011) (emphasis added).

Congress can take the time to require real simplification

In truth, the actual simplification required in S.1452 and S.1832 is not nearly sufficient to convince Congress that it should abandon its Constitutional role in protecting interstate commerce.

Fortunately, Congress can afford to take the time to design legislation that requires real simplification and makes states accountable to these requirements. As noted above, the uncollected taxes are far lower than tax advocates have claimed: uncollected sales tax on consumer e-commerce is only 1/3 of one percent of all state and local taxes, as explained above. And the uncollected amounts are not growing as fast as tax advocates have claimed, since the fastest growth in e-commerce is among multi-channel retailers who already collect for all states where they have stores. In fact, 17 of the top 20 e-retailers already collect for at least 38 of the 46 sales tax states.¹³

However, if Congress is determined to overturn Constitutional protections for interstate commerce, it must exempt small businesses, require states to adopt minimum simplification requirements, and create fair procedures to resolve sales tax disputes between states and taxpayers.

Below are minimum simplifications that should be part of any federal legislation that overturns the *Quill* standard of physical presence for states to impose sales tax on remote businesses.

Minimum Simplification Requirements

- A robust exception for small sellers. Bills currently in Congress include small seller thresholds that are simply too low to be considered realistic. Previous Congresses pegged the small seller exception at \$5 million in annual remote sales, a figure that should be the bare minimum in any federal legislation. In fact, the small seller threshold should be higher than \$5 million, given that states are continuing to add new tax jurisdictions at the rate of 400 per year.
- There should be a single sales tax rate for remote sales made into each state, as was the original goal of the SSTP. State lawmakers would, of course, be able to allocate sales tax proceeds among local jurisdictions.
- States should compensate businesses for the reasonable cost of collecting sales taxes. This too was part of earlier federal legislation.
- A single set of definitions for taxable and exempt products for all states.

¹³ Eisenach & Litan, *Uncollected Sales Taxes On Electronic Commerce: A Reality Check*, Empiris LLC (Feb. 2010), available at <http://bit.ly/EisenStudy>.

- A single audit conducted by retailer's home state on behalf of all states.
- All states should accept a single sales tax return filed with a business' home state. The home state revenue department would be responsible for distributing funds to remote states.
- A single national rule for sourcing sales. The SSTP originally maintained destination sourcing for all sales tax transactions. But to accommodate origin-based states, SSTP's Governing Board voted to allow origin sourcing for in-state sales while requiring destination sourcing for remote sales. Such "dual sourcing" should not be permitted in federal legislation.
- Eliminate sales tax holidays or adopt a single uniform national sales tax holiday with uniform date and product exemptions.
- States must provide certified software for collection, filing, and remittance. Users of the software would be immune from civil liability for errors in taxes collected.
- Exclude businesses based in states that have no sales tax of their own (New Hampshire, Delaware, Montana, Oregon, and Alaska)

Furthermore, if Congress grants states the authority to impose sales tax on remote sellers, there is a critical need for mechanisms to hold states accountable to the minimum simplification requirements above. Under the Tax Injunction Act (28 USC§1341), taxpayers are forced to use state courts to litigate disputes with state tax collection authorities, even on questions of whether a state is following federal law. Out-of-state businesses should be able to challenge state tax assessments that violate federal statutes or the U.S. Constitution in federal court – not in state courts.

Conclusion: Congress could consider a multi-state compact – Not a national mandate.

Finally, Congress must maintain some form of market discipline to stop states from expanding the complexity of their sales tax systems and skirting the minimum simplification requirements. Fortunately, Congress has a simple way to enforce "tax competition" as part of any legislation that overturns the physical presence standard: Congress could authorize remote collections through a multi-state compact instead of a national mandate on *all* businesses.

Tax advocates seldom acknowledge that S.1452 and S.1832 would impose collection burdens on businesses in *all 50 states* – including those in states that don't join SSTP and those in states that don't even have a sales tax. To the contrary, pro-tax advocates reassure legislators that they would retain their state sovereignty, telling them, "you don't have to join SSTP" and "you can drop out any time you want."

But if Congress overturned *Quill's* physical presence standard, lawmakers in all 50 states would lose the sovereign right to protect their citizens and businesses from tax burdens imposed by other states.

If these new collection burdens are hurting businesses in a state, their legislators won't be able to rescue those businesses if Congress makes collection mandatory for all.

This comes as a surprise to many lawmakers who are just getting their arms around the SSTP and its accompanying Congressional mandate. And it will come as a complete shock to businesses all around the country if they have to start collecting for over 9,600 tax jurisdictions.

Contrast the national mandate with a multi-state compact. An optional compact would allow states to opt-in to the collection compact if they believed the new tax revenue justified the burdens on in-state business who would have to collect for remote states in the compact. By the same token, states could opt-out of the compact to protect their state businesses if remote state tax burdens become excessive. States that opt-out would forego their authority to force remote sellers to collect their own state's sales tax, but at least states would preserve their Constitutional right to protect their businesses from unreasonable burdens on interstate commerce.