Testimony of George S. Isaacson, Esq.
Concerning the Hearing Before the
United States House of Representatives
Judiciary Committee
March 4, 2014

EXPLORING ALTERNATIVE SOLUTIONS ON THE INTERNET SALES TAX ISSUE: A BASE-STATE SOLUTION

Chairman Goodlatte and Members of the Committee, thank you for the opportunity to submit written testimony on this important issue. I am an attorney with a nationwide practice representing catalog companies and Internet merchants in regard to state tax matters for over 30 years. I have testified in the past before both the House Judiciary Committee and the Senate Finance Committee on bills relating to sales/use tax collection by remote sellers, and I regularly advise direct marketers concerning their tax obligations.

I am tax counsel to the Direct Marketing Association and a member of the Executive Committee of TruST (True Simplification of Taxation), but submit this testimony in my personal capacity as a long-time tax practitioner and frequent author of articles on state and local taxation. I am not writing on behalf of either of the above organizations or on behalf of any of my other clients. As a lawyer who has spent more than two decades involved with this issue, I would like to be a constructive contributor in exploring a new approach consistent with the objectives of this Committee hearing. The Judiciary Committee has requested interested organizations and individuals to submit proposals that would meet the seven tax simplification principles announced by Chairman Goodlatte in September of 2013, and satisfy both the interests of state revenue departments for increased collection of sales/use taxes and of direct marketers not to be burdened with compliance obligations and different rates for over 9,000 state and local tax jurisdictions. Indeed, the United States is the only industrialized nation with such a large

number and wide variety of state and local tax jurisdictions, with differing rates, taxable goods and services, and administrative procedures. Chairman Goodlatte has aided all parties, including state governments, big-box retailers, and catalog/Internet merchants, by setting the simplification bar for federal legislation. The Chairman's seven principles can, in fact, readily be achieved if a genuine and collaborative effort is made to reform the existing tangle of disparate administrative requirements.

The current state sales and use tax system is a "crazy quilt" of state laws, regulations and procedures. To date, all state government proposals, including the Marketplace Fairness Act passed by the Senate, are primarily reliant on the notion that free software developed and provided by each one of the state revenue departments will resolve the problem of complexity. If the Affordable Care Act has taught the public anything, it is that software solutions are not magic bullets, especially when developed and operated by government agencies. Instead, it makes more sense for Congress to look to an existing and proven method for simplifying the collection and remittance of taxes for companies engaged in interstate commerce. I believe that such a successful model is the International Fuel Tax Agreement (IFTA).

The IFTA was developed to overcome the complexity associated with interstate trucking companies having to register, file returns, and remit taxes to multiple states and Canadian provinces. The IFTA established a base-state model, by which interstate carriers file a single return with just one state and remit all taxes to that state (even though the tax amount is determined by miles traveled in multiple states, using the applicable tax rates for the states where the miles were traveled). The base-state then distributes the tax revenues to the participating states for their respective allocations. The result is that states get their tax revenue, and trucking

companies benefit from a simplified reporting system (a single spreadsheet return). The base-state conducts one audit on behalf of all the participating states and provinces.

A similar system could readily be adapted for state sales/use tax collection by remote sellers. The following is an outline for legislation entitled **A Base-State Model for Simplified State Sales Tax Collection**, which includes a graphic flow chart depicting how the proposed system would operate. Under this proposal, the retailer collects tax at the destination state rate (*i.e.*, the rate for the state where the customer resides and the goods are delivered), but the administrative aspects of remittance and audit are handled by a single base state, which is then responsible for distribution of the tax revenues to the respective participating states. Key to administrative efficiency and reduced burdens are [1] a single combined state and local tax rate for remote sellers (which is no greater than the lowest combined rate within each state); and [2] a uniform set of definitions adopted by all participating states to determine taxable and tax exempt goods and services (something that the Streamlined Sales Tax Project has long endorsed). Absent legislation requiring such reform measures, Chairman Goodlatte's principles for simplification and fairness simply cannot be achieved.

A base-state model is, by no means, a panacea for direct marketers, and it would require those companies to assume obligations that remain more costly than for point-of-sale retailers, who must comply with only one state's rate and tax base. Nonetheless, I believe that the base-state approach represents a reasonable compromise and is responsive to Chairman Goodlatte's principles.

A Base-State Model for Simplified State Sales Tax Collection

As mentioned above, the following "base-state" proposal is modeled after the International Fuel Tax Agreement, which dates back to 1983 and was developed to simplify the reporting of fuel use, and the associated remittance of state and provincial taxes, by motor carriers that operate in more than one state or Canadian province. Prior to the IFTA, each state and province had its own fuel tax system, and a trucking company was required to register, and file tax returns, with each state in which it operated. The IFTA has proven to be extremely popular with both states and the trucking industry. States have increased their fuel tax revenues, and truckers have benefitted from substantially less burdensome tax-related obligations.

A model base-state tax collection system for remote sales by catalog companies and electronic merchants that lack traditional "physical presence" in a state should include the following features:

1. TAX STRUCTURE

a. **Rate simplification for remote sales**

i. One rate per state for all remote sales into the state

ii. The single rate could be no higher than the lowest combined state and local sales tax rate in the state

Result: Instead of having to comply with varying tax rates for 9,000 different state and local sales/use tax jurisdictions, the number of potentially differing rates for remote sellers would be reduced to 46.

b. **Tax base simplification for all sales**

   i. Establish a single comprehensive menu of potentially taxable and exempt products and services

      - Developed jointly by industry and the Streamlined Sales and Use Tax Project
      - Uniform product definitions for all participating states
      - No dollar amount ceilings or thresholds – products either are taxable or they are not

   ii. Each participating state is free to select from the menu those goods and services subject to tax in that jurisdiction

Result: States retain the right to determine their own tax base, but there is uniformity of definitions (*e.g.*, "clothing" or "snack foods" have the same definition in all participating states).

c. **One common designated time period for state sales tax holidays**

   i. Once a year, for a fixed period, a state has the option of suspending sales tax on certain products

   ii. State can select from the menu which goods are included in the suspension

   iii. No dollar amount ceilings or thresholds in connection with the tax holiday

Result: Electronic merchants and catalog companies are not confronted with differing time periods and complex rules for when states switch on and off their taxes. Consumers still get the benefit of an annual sales tax holiday.

2. ADOPTION OF A BASE-STATE TAX ADMINISTRATION MODEL.

a. **Sales tax is collected at the destination state's single rate, using the destination state's selected tax base.**

b. **The tax collected from all sales to consumers in participating states is remitted to a single base-state selected by the remote seller, using a simple spreadsheet tax return form showing the amount of tax collected for each state.**

c. **The base-state is then responsible for distributing the remitted sales tax to the various states, based upon the sales information in the spreadsheet tax return.**

d. **The base-state charges an administrative fee to the other participating states** (*i.e.*, retains a small amount of the remitted taxes to cover its administrative costs).

e. **Only the base-state is permitted to conduct an audit of the remote seller on behalf of all participating states.** (The base-state may charge other states an audit fee for its services.)

Result: All participating states would receive the proper amount of sales tax revenue resulting from sales by the remote seller to consumers in those states, using each state's own applicable sales tax rate and base. Businesses would be required to file only a single tax return with just one state. In addition, businesses would be subject to only one sales/use tax audit conducted on behalf of all states.

3. FAIR RESOLUTION OF TAX DISPUTES

a. **There must be a fairer and quicker way to resolve tax controversies for companies engaged in interstate commerce.** Currently, a company that protests a tax assessment because it believes the state revenue department has acted beyond its authority and is in violation of federal constitutional or statutory law must,

nonetheless, pursue its appeal through arcane and expensive procedures before state administrative hearing officers and state court judges. These individuals often lack knowledge of federal law and frequently tilt in favor of the state revenue department when dealing with out-of-state companies. If federal legislation will require remote sellers to collect taxes for states even though the company has no physical presence in the state, then those retailers should not have to struggle their way through state protest/appeal procedures in order to assert their constitutional rights and obtain the protection of federal laws.

b. The suggested measures for inclusion in federal legislation are:

   i. **Access to non-binding mediation before an independent alternative dispute resolution (ADR) organization conducted in the base-state** for any tax protest resulting from an assessment by a participating state. The reality is that the vast majority of contested tax disputes will be resolved in mediation if conducted by a skilled neutral.

   ii. **United States District Court jurisdiction** over a remote seller's claim that a state tax assessment violates federal constitutional or statutory law. An interstate merchant with no physical presence in a state should have access to federal courts on issues of federal law. Therefore, as part of the *quid pro quo* for expanded state tax jurisdiction over interstate commerce, Congress should repeal the Tax Injunction Act (28 USC § 1341), or at least make it inapplicable to legal challenges brought by companies with no physical presence in a taxing state. Providing federal court jurisdiction is the only

meaningful way to protect those companies' constitutional rights and enforce federal statutory limitations on the scope of state taxing power.

iii. **Elimination of so-called "pay to play"** tax protest provisions, by which a state requires a taxpayer to pay a disputed assessment before the taxpayer is entitled to an administrative or court hearing for its challenge.

Result: One of the real problems associated with mandatory tax collection by remote sellers is the "home cooking" they would invariably receive from state tax administrators and state court judges – especially when attempting to assert federal constitutional and statutory defenses, which are often simply brushed aside. The above recommendations for tax protest procedures do nothing more than assure a quicker and fairer resolution of tax disputes.

4. Privacy Rights

a. **Require stronger protection of confidential consumer information.** As a general matter, the bar needs to be raised higher to protect consumer information that is gathered and maintained by government agencies. The lax privacy protection associated with the Affordable Care Act is a good example of the problem. Just as the ACA collects confidential information regarding individuals who choose to purchase health insurance on the federal and state exchanges, states may acquire sensitive consumer and business information in connection with audits of retailers and the filing of sales/use tax reports. Most state tax codes contain only general statements about the confidentiality of such information and include no standards to assure that such information is protected from inadvertent release or hacking.

b. **Independent security audit and certification**

i. Require an independent audit of each participating state's data breach security (anti-hacking) measures and privacy protocols/practices by a nationally recognized data security audit firm.

ii. Require each state to certify that the tools and procedures in place are at least equivalent to the Payment Card Industry Data Security Standard.

Result: A significant improvement in privacy standards would be in place before there is a radical expansion of state government access to confidential information that state revenue departments could acquire as a result of expanded tax authority.

5. Participation and Preemption

a. **Federal legislation would not force state participation.** A state would not be required to adopt the sales tax simplification measures described in this base-state model. However, a state choosing not to participate would not receive the revenue-enhancing benefits of the federal law. A non-conforming state would remain subject to existing Supreme Court "physical presence" nexus standards.

b. **Federal preemption of state nexus laws.** Federal legislation would include a provision preempting state laws attempting to expand traditional constitutional nexus standards (*i.e.*, "physical presence") through unconventional approaches, such as "click-through" nexus, affiliated-entity nexus, etc.

Result: State participation in the base-state system would be purely voluntary. A state that chooses to participate by simplifying the administration of its sales/use tax system for remote sellers would receive the reciprocal benefit of tax collection by those out-of-state companies. Because federal legislation would address the issue of expanded state

tax jurisdiction over companies engaged in interstate commerce, it should preempt state legislation that attempts to expand state tax authority over companies located beyond state borders.

In conclusion, it is unfair for states to want their cake (more tax revenue) and eat it too (not be forced to simplify, and make administratively more uniform, their tax systems). States are asking Congress to impose new and substantial burdens on businesses located beyond their borders that have been constitutionally protected from such state impositions in the past. In return for such expanded tax authority, state revenue departments should be willing to give something in return, *i.e.*, tax simplification.

Please see attached graphic depicting the operation of the base-state model.

A BASE-STATE MODEL FOR SALES TAX COLLECTION BY REMOTE SELLERS

BASE-STATE

* Receives All Collected Taxes
* Distributes Tax Revenue to Destination States
* Conducts Audit of Retailer
* Hosts Independent Mediation of Tax Disputes

Distribute Tax Revenue

To Participating States

One Tax Return

All Collected Sales Taxes

REMOTE SELLER

*Collects Tax for All Participating States

*Remits All Collected Taxes to Base-State

*Files a Single Spreadsheet Tax Return With Base-State

Product Sale

Sales Tax

DESTINATION STATE A

*One rate for remote sales

*Individual state tax base drawn from common menu

Product Sale

Sales Tax

DESTINATION STATE B

*One rate for remote sales

*Individual state tax base drawn from common menu

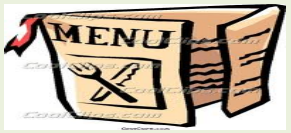
Product Sale

Sales Tax

DESTINATION STATE C

*One rate for remote sales

*Individual state tax base drawn from common menu



Distribution of Tax Revenues by the Base - State

Federal Court

Jurisdiction Over Tax Protests Involving Federal Issues

Prepared by George S. Isaacson, Brann & Isaacson