Statement of the
Direct Marketing Association
Regarding the
Committee on Finance
of the
United States Senate
Hearing on
Tax Reform: What It Means for State and Local Tax and Fiscal Policy
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I. Introduction

The Direct Marketing Association (DMA) thanks Senator Baucus, Chairman, Senator Hatch, Ranking Member, and members of the Committee on Finance for this opportunity to present its views on the efforts of states to impose tax and tax collection obligations on retailers who are located outside of their states and who have no physical presence in that state. The states are asking Congress to grant them authority to conscript non-citizen businesses to become their tax collectors. These efforts are not federal tax reform—they are not state tax reform. They represent states seeking to impose a 1930's tax regime on 21st Century commerce rather than reforming their tax regimes and seeking Congressional help. In addition states are imposing business activity taxes upon companies with no presence, no employees, and no political voice in the state. These efforts combined are attempts to extend the taxing reach of states far beyond their borders. This undermines and regulates interstate commerce.

DMA is the leading global trade association of businesses and nonprofit organizations using and supporting direct marketing via channels including mail, telephone, direct TV, radio and the Internet. Founded in 1917, the DMA currently has over 2,000 member companies across the United States and 53 foreign countries.

DMA would like to discuss specifically state efforts to require remote (out-of-state) sellers to become unpaid tax collectors for states under the Streamlined Sales and Use Tax Agreement (SSUTA) and to pay business activity taxes.

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II. Streamlined Sales and Use Tax Agreement

The U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), ruled that without specific authorization from Congress, states could not impose tax collection burdens upon remote sellers that have no "physical presence" as this would interfere with interstate commerce.

Moreover, if allowed by Congress, the myriad of state tax jurisdictions with resulting variance in rates, definitions, and audits would create a complex and administratively costly nationwide sales tax collection system. The costs of that collection are a tax on the out-of-state business. It is significant that these remote sellers' businesses do not receive police or fire protection from those states—they are not present in them. Their employees and their families do not receive educational or social services from those states—the businesses have no employees located in those states.

Governments, as well as businesses, face challenging financial decisions in these economic times. State legislatures have very difficult budget determinations and are looking at both cutting costs and increasing revenues. However, proponents of the SSUTA have cited grossly exaggerated revenue estimates of uncollected sales and use taxes due to remote sales. In particular, proponents have cited a 2000 University of Tennessee study that includes unbelievable estimates as to the amount of the uncollected sales tax. A revised Tennessee study lowered its initial estimate from $45 billion to $24 billion, even the revised estimates will not be realized.

It is important to note that the Tennessee study rests on a number of faulty assumptions and is not based on U.S. Government data. Further, the study's implication that states are "losing" a substantial portion of their sales tax revenues to electronic commerce is simply false. The vast majority of e-commerce transactions are not with consumers, but rather with businesses, and such business transactions almost always are subject to tax collection or direct payment of use taxes by the purchaser.

In contrast, the independent firm, Forrester Research, has estimated that the loss of tax revenue due to state residents not paying use taxes for remote sales is $3 billion nationwide—a fraction of the $24 billion estimated in the revised Tennessee study. A 2007 DMA-commissioned study, based on U.S. Commerce Department data, estimates that in 2006 uncollected sales tax nationally totaled $4.2 billion. There is no $24 billion pot of gold.

In light of the *Quill* decision, the states began a project to simplify the sales tax regimes that a remote seller would face if required to become the foreign state's tax collector. The SSUTA goal was to remove that complexity and create a 21st century, Internet-friendly tax regime to encourage economic growth throughout the national marketplace. However, the SSUTA has failed to either remove complexity or create that 21st century tax policy standard. To be blunt, the SSUTA is a document drafted by tax administrators, and, as might be expected, it has resulted in little in the way of tax simplification.

Specifically, the SSUTA:

- Has not reduced the number of sales tax jurisdictions in the Nation, which currently number over 9,000;
- Has not reduced the number of state and local sales tax rates;
- Has not reduced the number of audits to which an interstate seller would be subject (each state revenue department would still conduct its own independent audit);
- Has not established a long-promised uniform vendor compensation to cover the

substantial cost of tax collection; and

- Has not established a single remittance procedure.

Moreover, the Governing Board of SSUTA has granted exceptions to its feeble simplification initiatives to win approval of the states. Recently, the Board granted an exception from the SSUTA-defined rule for Massachusetts when calculating the sales tax on articles of clothing over $100. SSUTA will continue to grant exceptions that will increase the complexity of sales tax collection. States are enacting sales tax holidays—some for all purchases under a capped price; others for specific products (such as hurricane preparedness) on a specific date. Those actions, while important for the state and its citizens, further complicate a nationwide sales tax collection regime.

As you can see, tax collection has not been simplified since the inception of SSUTA. In fact, SSUTA is "streamlined" in name only.

To better appreciate the failings of the SSUTA, it is instructive to consider its history. The Streamlined Sales Tax Project was launched in 2000 on the heels of two earlier joint government/industry initiatives: the National Tax Association (NTA) Communications and Electronic Commerce Tax Project, and the Congressionally-established Advisory Commission on Electronic Commerce. Both projects had concluded that the existing state sales tax system was one of daunting complexity, and that true simplification would require sweeping reforms.

Perhaps most emblematic of the SSUTA's failure to achieve genuine sales tax reform was the early demise of the single-most important step toward simplification: the adoption of a single sales tax rate per state for all commerce (both over-the-counter sales and interstate sales). Had the SSUTA adopted this so-called "one rate per state" proposal, this single act could have eliminated the problem of merchant compliance with thousands of local tax jurisdictions with different tax rates.

To put this "one rate per state" issue in perspective, the United States is the only economically developed country in the world with a system of sub-state transaction taxes, not only for counties and municipalities, but also for school districts, transportation districts, sanitation districts, sports arena districts, and other local jurisdictions. In light of this wildly complex system, the adoption of the "one rate per state" standard was the *unanimous* recommendation of the NTA's E-Commerce Project (which included delegates of the National Conference of State Legislatures, National Governors Association, and US Conference of Mayors) and was in the majority report recommendation of the Congressional Advisory Commission.

Those failings increase the burden on out-of-state sellers. Being subject to 45 separate state audits requires a tax department. Those businesses would be required to have multiple state registrations and multiple remittance procedures. The cost stemming from tax collection would be passed to consumers, constituting an anti-stimulus at a time when our nation is working to stimulate the economy. Moreover, remote sellers with locations only in states that do not impose sales taxes, and that, in turn, have no process in place to collect any sales taxes, would be required to create an entirely new tax department within their company and establish entirely new accounting and ordering protocols. Those remote sellers would face even greater burdens.

Any discussion of tax reform concerning non-citizen companies becoming tax collectors for states, should require tax reform in terms of simplification of state sales tax regimes. Only after that reform should Congress consider granting additional interstate taxing authority to the states with the *proviso* that the tax regime simplification must remain in place.

III. BUSINESS ACTIVITY TAXES

Broad imposition of business franchise, corporation net income, and gross receipts taxes (commonly called Business Activity Taxes) on small and mid-sized out-of-state remote direct marketers would constitute a tremendous new tax compliance burden. Currently, there are at least 3,300 separate state and local business activity taxes imposed by state and local governments and over 12,600 jurisdictions have the authority to collect such a tax. Just as the Supreme Court found in its *Quill* decision, precisely the same burdens created if sales and use tax obligations were imposed by the nation's over 9,000 sales and use tax jurisdictions would also result from allowing the thousands of state and local jurisdictions that have the authority to impose a business activity tax to extend their taxing authority across state borders to businesses with no stores, offices, factories or employees within their territories.

Despite assertions that business activity taxes do not appear to cause the same degree of compliance burdens as sales and use tax collection, the reality is that compliance with state income taxes and gross receipts taxes is extremely complicated and varies greatly from state to state. Forty-five states, along with the District of Columbia, impose such a tax. States differ tremendously in how income is allocated and apportioned, in how the tax base is defined, in what tax rates apply and in a host of other issues.

States also have varying rules regarding reporting and filing procedures, including which corporations must file a return, whether related entities should file together or separately, what due dates apply for filing and remitting taxes, and whether federal extensions are accepted. Roughly half the states allow combined reporting, whereas and other half require or allow separate reporting by each entity within an affiliated group. Among the states that follow combined reporting of unitary businesses, there are dramatic differences regarding the level of combination.

Another cause of considerable complexity is the fact that the states have different rules for allocating and apportioning a multi-state corporation's income among the states in which it does business. Most states use a three-factor formula (i.e., sales, property and payroll) to apportion business income. Some states weigh all factors equally, other states double-weight the sales factor, and some states place even more emphasis on sales. Furthermore, while sales are typically assigned to a particular state based on a destination test, some states use a "throwback rule" that reassigns sales to the state of origin if the corporation is not taxable in the destination state. States also differ in their definitions of the tax base, with varying stances on what items of income and deduction are included in taxable income. States have different depreciation rules, rules for deduction of net operating losses, and the list goes on.
Large companies with accounting staffs and outside consultants may be able to navigate successfully through the labyrinth of state income tax compliance, but smaller companies do not have the resources to meet these compliance obligations. Further, the differing apportionment

standards among states place a business, especially a smaller company, at risk of duplicative over-taxation. This risk is increased by the fact that there is no centralized resource to which businesses can turn in determining, let alone meeting, their obligations.

Moreover, the prospect of challenging an incorrect assessment in a remote jurisdiction is daunting. For example, a small Montana business sells gourmet food products over the Internet. With a good website and a great set of recipes, there is no limit to the national – or even international – markets this start-up business could reach. However, if one of New Mexico's 100-plus taxing municipalities issued an assessment against the company for a local gross receipts tax based on sales made to its citizens, and the Montana business believed the measure of taxes was in error and challenges the assessment, it would have to hire local counsel familiar with local tax law, proceeding first through the administrative protest and, if unsuccessful, then through the judicial process. Furthermore, in many states, the business must pay the tax before it can challenge the assessment in state court; only then is it permitted to sue for a refund. Such a procedure would be inordinately expensive for a small retailer, which would be left with little choice but to pay the tax and forget its objections. Faced with potentially hundreds of such practically incontestable assessments, the small Montana food company could fall victim to "death by a thousand cuts." The detrimental impact on small business cannot be overstated.

IV. CONCLUSION

The bright-line physical presence test in *Quill* should remain for collection of sales and use taxes without significant simplification reform of state sales tax regimes. The burden of each on interstate commerce is large, and this is a time when our economy can ill afford such a burden.

Congress should not grant the states authority to expand business activity taxes or forced sales and use tax collection beyond their borders. Federalism does not work efficiently— or fairly— when a legislature attempts to export its tax laws across state borders. A system in which 50 state governments, and thousands of localities, impose their myriad sales and use tax regimes on businesses in each of the other 49 states would be chaotic, both as a matter of tax administration and business compliance. The end result of expanded nexus will be nothing less than a crazy quilt of non-uniform tax laws and compliance obligations that will further stagnate the consumer sector of the economy and aggravate an already grossly inefficient system of multi-state tax administration. The patchwork quilt of business activity taxes, rules, definitions, reporting, etc. will chill the one growing engine of our economy, Internet commerce, by burdening new start-up companies before they have the opportunity to grow.

DMA urges Congress both to uphold the physical nexus standard of *Quill* rather than extending taxing authority of states to include the collection of sales and use tax beyond their borders without significant simplification reform by the states, and to impose the *Quill* standard to states applying business activity taxes to remote sellers.