

Testimony of George S. Isaacson, Esq.
Tax Counsel for the Direct Marketing Association
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Finance Committee
Subcommittee on International Trade
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***WHY THE STREAMLINED SALES AND USE TAX AGREEMENT IS
FUNDAMENTALLY FLAWED AND DOES NOT JUSTIFY JEOPARDIZING
CORE AMERICAN PRINCIPLES OF FEDERALISM
AND FREE-FLOWING INTERSTATE COMMERCE***

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, the DMA today has over 4,700 member companies in the United States and 53 foreign countries.

As an attorney practicing in the area of sales and use tax law for more than 25 years, and an instructor in Constitutional Law at Bowdoin College, I have been a keen observer of the tension inherent in our federal system of government between, on the one hand, the sovereign taxing authority of state and local governments and, on the other hand, fundamental American ideals of free-flowing interstate commerce. The advent of the Internet and the development of a truly global economy have only intensified that dynamic. I commend the Committee for exploring this important public policy issue which goes to core principles of the American constitutional system, and which has a real-world impact on America’s ability to sustain its economic preeminence in the information age.

Our Federal System Requires Recognition of Jurisdictional Limitations on State Taxing Authority.

As to the question “How Much Do Borders Matter?: Tax Jurisdiction in the New Economy,” it is my view that borders for purposes sales and use tax jurisdiction remain extremely important. Defining the appropriate reach of the sovereign authority of state and local governments is central to the American system of government. 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 solution devised by the Constitution’s Framers was a federal system of dual national and state sovereignty, in which the Commerce Clause served, notably, to prevent state and local tax laws from hindering and suppressing the growth of interstate commerce. Needless to say, this plan has worked remarkably well for more than two hundred years.

The genius of our federal system of government is that each state is sovereign within its own borders and can adopt those tax and regulatory policies that best suit its particular needs and reflect the political preferences of its citizens. In this regard, each state is a separate and independent civic laboratory, where innovations in government programs and tax strategies can be tried out. If a chosen policy does not work well, only one state – and not the entire nation – is the subject of that experiment. If the voters object to how a certain policy initiative (for example, a new tax obligation) affects them, they have the ability to change that policy by electing new representatives. As a nation, we have benefited greatly from this federal structure of government.

In the area of state taxes, the federal system works especially well – so long as states respect the territorial limits of their sovereignty. Each state is free to craft how its

taxes are structured and administered within its own borders. A federal system permits, even invites, great variations in tax policy among the states. We certainly see that variety in the sales/use tax field. 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. The recognition of jurisdictional boundaries allows the American federal system to accommodate such numerous and varied exercises of state sovereignty.

Federalism does not work, however, when a state (or locality) attempts to export its tax system across state borders. At that point, the state is visiting its experiment on businesses that have no connection – or nexus – with the taxing state. Such an arrangement is not only chaotic as a matter of both tax administration and compliance (fifty state governments and thousands of localities imposing their myriad different tax systems on businesses in each of the forty–nine other states), but the out–of–state companies have no way to influence the very state tax burdens that are imposed on them. In the most real sense, this is "taxation without representation."

The Streamlined Sales Tax Project is, in many ways, a prime example of how the states struggle with our federal system of government. As with most governments, the states seek to maximize their taxation opportunities and leverage. It is always politically attractive to impose additional tax obligations on people who do not vote (e.g., imposing higher property taxes on vacation homes, higher sales tax rates on hotel lodging, meals,

and car rentals). This is constitutionally acceptable, so long as the target of the tax obligation is physically located within a state's borders. The temptation to impose tax burdens on non-resident companies may be irresistible, however, even if the state must reach beyond its borders to do so. At this juncture, however, the principles of federalism are clearly violated. Moreover, the adverse consequences are neither abstract nor theoretical, "taxation without borders" results in cost, complexity, confusion, and conflicts.

States could, of course, favor taxation over federalism by pressing Congress to adopt a single uniform national sales tax and distribute the proceeds among the states. Alternatively, states could agree on a truly uniform tax base, a single common tax rate, a single reporting and audit procedure, etc. These ideas have been suggested by law professors and tax policy academicians. The immediate response of the states to such proposals, however, is that such a coordination among states (and localities) would constitute a surrender of state sovereignty over state tax policy, and they are not willing even to consider the idea. The states cannot have it both ways. They cannot shout "sovereignty" and "state rights" when there are calls for real uniformity in state tax systems, and then turn around and argue that state borders should not restrict the scope and reach of state tax jurisdiction.

The Imposition of Limits on State Taxing Authority Remains Vital to the American Economy.

Of equal weight in Congress' consideration of this issue is the economic importance of setting territorial limits on the exercise of state and local tax jurisdiction. The United States Constitution – and the Commerce Clause in particular – has been the guardian of this country's open market economy. A central purpose of the Commerce

Clause was to prevent state taxation from hindering and suppressing the free flow of interstate commerce. More than 200 years before the establishment of the European Union, the Framers of the United States Constitution created a common market on this continent through the Commerce Clause, and their foresight powered the greatest economic engine the world has ever known.

As we move forward in the era of electronic commerce, it is imperative that public policy not impede its growth or hinder the ability of American companies to maintain their leadership position in this vital sector of the world's economy. Markets must remain open and accessible, and entry into those markets must not be restricted by disparate, confusing and parochial state tax laws that extend far beyond their jurisdictional borders. There has never been a time when it has been more important for Congress and the Supreme Court to support the original intent of the Commerce Clause, which was to create one national marketplace in which goods and services move freely.

Today, digital products and services can be delivered instantaneously and anonymously across vast distances, both within the U.S. and from beyond our shores. Consumer empowerment, instantaneous transactions, and open access are defining features of electronic commerce. Many states and localities have responded to this new economy by expanding their sales and use tax bases to include the taxation of digital goods and services. Unfortunately, some of these measures have saddled electronic commerce with tax and regulatory burdens designed for another era, and the adverse consequences are potentially dire.

The recent and encouraging rebound of the U.S. economy has been driven, in large part, by a rejuvenated technology sector, which would be negatively affected by

new tax burdens on electronic commerce. With high energy prices threatening the current economic recovery, now is not the time for the federal or state governments to throw a wet blanket on the Internet.

Expanding state and local tax jurisdiction would also imperil American competitiveness in the global electronic marketplace. Until recently, U.S. companies have been dominant in the field of electronic commerce. Increased foreign competition, however, means that American businesses, and their national government, cannot take for granted this leadership position. Expanding state jurisdiction to impose new tax collection obligations on domestic electronic merchants will have the effect of advantaging their foreign competitors, on whom state and local tax collection obligations could never be effectively imposed. Moreover, cumbersome and expensive tax burdens would inevitably drive emerging American Internet businesses to offshore locations.

The Streamlined Sales and Use Tax Agreement Has Not Adequately Reformed the System of State Sales and Use Taxes to Warrant Sacrificing Core American Constitutional and Economic Principles.

I hope that the members of this Committee recognize that legislation to expand state and local tax jurisdiction implicates vital public policy concerns regarding federalism and American competitiveness. Unrestricted state taxing jurisdiction is simply bad tax policy, because it would result in a nationwide transaction tax system of enormous complexity. More significantly, however, the proposals before the Senate to extend state tax jurisdiction beyond state borders undermine the principle of federalism on which the theory and vitality of American government rests, and such legislation would remove 200 years of constitutional protection of America's open marketplace. The Supreme Court has been vigilant in maintaining the principles of federalism mapped

out in the Constitution, especially as it relates to the Court's Commerce Clause jurisprudence. It would be unwise for Congress to accept the short-sighted invitation of state tax administrators to weaken the existing constitutional limitations on state taxing authority.

At a minimum, Congress should be insistent on setting the bar for state tax reform very high before removing constitutional restrictions on state tax jurisdiction. Elected leaders should be certain, before they surrender core constitutional and economic principles that have undergirded two centuries of prosperity, that the system they allow to replace it will protect and foster continued economic growth.

Unfortunately, the SSUTA falls far short of this standard. The Streamlined Sales and Use Tax Agreement, in its current form, is a misnomer. It does not achieve its professed objective of simplifying state taxes and, to the contrary, in many respects it worsens, and further complicates, the “crazy quilt” of differing state and local sales and use tax laws. Some of the most glaring shortcomings of the Streamlined Sales and Use Tax Agreement include:

- 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 true 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 SSTA’s blind-faith in still unproven 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 or money order, which especially affects America’s older and less affluent population;
- The failure to guarantee fundamental fairness with respect to vendor compensation for tax collection;
- The failure to provide an effective and enforceable mechanism to assure continuing compliance with the Agreement by member states;
- The failure to afford out-of-state businesses with the right to challenge tax assessments that violate the Agreement before a fair and impartial federal tribunal; and
- The open willingness of states to “game the system,” sacrificing simplification and uniformity in favor of protecting parochial state concerns.

The Shortcomings of the SSUTA Measured Against the Core Constitutional Values It Would Threaten.

To assist the Committee in understanding how much state borders for sales and use tax jurisdiction still matter in our federal system, and why the SSUTA does not render obsolete the essential constitutional objectives of the Commerce Clause, the answers to the following questions are intended to demonstrate the fundamental shortcomings of the SSUTA:

- **Is the Commerce Clause nothing more than a Constitutional loophole?**

Absolutely not. State tax administrators may complain bitterly about restrictions on their taxing authority because of Supreme Court cases such as *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), but the constitutional requirement that a company must have “substantial nexus” with a state before that state has the authority to impose tax obligations is consistent with the central tenet of the Commerce Clause to protect interstate commerce. Congress should be highly suspect of any argument that trivializes well-established Constitutional protections.

- **Do catalog companies and electronic merchants have an unfair advantage over traditional retail stores, including “big box” retailers?**

Not at all. First, let’s be clear: sales and use taxes are consumption taxes, for which payment is ultimately due from the buyer. The issue in controversy is how states collect those taxes from their residents. The Supreme Court has consistently held that if a retailer is located within a state and benefits from state–provided services (e.g., police and fire protection, utility services, job training programs, etc.), it is reasonable for the state to require the in–state retailer to collect sales tax. On the other hand, where a company has no physical presence within a state and receives no benefits from state and local government services, it is improper for the state to delegate the tax collection responsibility to the out–of–state company. Instead, the state must collect any tax due directly from its residents.

Large “big box” retailers are regularly granted substantial tax breaks and incentives by states and localities, such as tax increment financing, to lure those companies to locate stores within the relevant jurisdiction. These are benefits that are not available to out-of-state merchants. For example, one large, well–known retail chain recently secured tax breaks of upwards of \$40 to \$50 million in each of several states where it proposes to open a store, an enormous tax advantage not available to remote sellers. In addition, non–tax advantages are heaped on large chain store retailers by states and localities in the form of municipal bond financing, infrastructure construction, and even the use of eminent domain. These are examples of public financial assistance enjoyed solely by in–state retailers.

Nor do catalogers and Internet vendors have a *competitive* advantage over retail stores because remote sellers are not obligated to collect sales/use tax. There are inherent

differences in the cost of doing business for in-state and out-of-state merchants that have much more of an impact on their relative competitiveness than does collection of sales tax—most obviously, an out-of-state vendor must recoup delivery costs through shipping and handling charges, usually in an amount considerably greater than the applicable use tax.

For these and other reasons, allegations of an “unlevel playing field” that favors catalog/Internet sellers over bricks-and-mortar retailers are distorted and misleading.

- **Is the Internet a threat or an opportunity for “Main Street” retailers?**

Unquestionably, it is an opportunity. Somewhat cynically, proponents of the SSUTA claim to champion local “Main Street” merchants who must collect sales tax on their over-the-counter sales. The real competition for “Main Street” shopkeepers comes not from out-of-state sellers, but from the large chains of “big box” stores that have emptied America’s downtowns, while also garnering enormous tax and other public benefits from state and local governments. It is the Wal-Marts, Targets, and Costcos that have driven the traditional local department and hardware store out of business.

More significantly, there are countless stories of old line “Main Street” merchants, as well as local niche marketers, who have used the Internet to develop new markets for their goods across the country and around the world. It is hardly surprising that the retail giants are the main advocates for increased tax obligations on electronic merchants. These are the companies that would be the real beneficiaries of a tax system that imposes new tax and regulatory burdens on their Internet competitors.

- **Advocates for expanded state tax jurisdiction argue that most electronic commerce transactions avoid state taxes; is this true?**

No. The perception that electronic commerce is tax free is wildly inaccurate. The vast majority — by all accounts 85 to 90 percent — of electronic commerce is comprised of business-to-business (“B-to-B”) transactions. Because companies typically self-report use tax, and are subject to periodic use tax audits by states and localities, most electronic commerce is subject to applicable sales and use taxes.

Furthermore, even as to business-to-consumer (“B-to-C”) Internet transactions, the belief that most of those transactions are tax free is also inaccurate. There are many multi-channel retailers (i.e., retailers with both retail stores, Internet websites, and, in some cases, catalog operations) that collect sales/use tax on their Internet and other remote sales because they have nexus due to the presence of their stores throughout the country. Indeed, the perceived “problem” of catalog/Internet vendors not collecting use tax has proven to be largely self-correcting. As remote sellers grow, most of them embark on a multi-channel sales strategy, which includes opening retail stores. Thus, numerous catalog/Internet retailers have begun to collect state sales/use taxes voluntarily. In other words, recent history shows that successful Internet retailers will grow their businesses by adopting a parallel retail store strategy, and, upon doing so, commence sales and use tax collection on all sales (including Internet sales) to residents in states where the stores are located.

- **Have state governments overstated the amount of tax revenue they are losing as a result of current constitutional restrictions on their taxing power?**

Yes. State revenue departments’ dire predictions of revenue “losses” resulting from allegedly untaxed e-commerce transactions have proven to be grossly exaggerated.

State tax administrators frequently cite a University of Tennessee study (“UT Study”) conducted in 2000, and updated in 2001 and 2004, in support of such claims. The UT Study, even as updated, suffers from several flaws: (1) it does not sufficiently account for online B-to-B sales, most of which are either non-taxable sales for resale or are sales for which a use tax is generally reported directly to the state by the business purchaser; (2) it grossly overestimates the total amount of online B-to-C sales; (3) it fails properly to account for the portion of B-to-C commerce that is not subject to sales tax (principally sales of non-taxable services); (4) it underestimates the level of B-to-C sales on which sales tax is collected (such as online travel sales); and (5) it does not take account for the increase in tax collection by Internet sellers that also have retail stores. Indeed, Dr. Peter A. Johnson, a Senior Economist with the DMA, conducted an analysis in 2002–2003 based on actual Commerce Department data that showed how earlier, predicted “losses” in state revenue had not materialized.

- **Are there ways for states to collect use taxes directly from their residents (who are the persons liable for the tax) without imposing burdensome tax collection obligations on remote sellers?**

Yes. It is now common for states, from Maine to Louisiana to California, to include a section on individual state income tax returns for reporting use tax due on out-of-state purchases. This tax collection procedure is straightforward, simple to calculate, and inexpensive.

- **What is the current fiscal condition of the states? Are they suffering major shortfalls in state budgets?**

Quite the contrary. With the economy recovering, most states are benefiting from budget surpluses. For fiscal 2006, the Wall Street Journal reported that 37 states had revenues in excess of projections, 10 other states met their projections, and only 2 states

reported revenues below budget. Now is not the time for Congress to enact measures that will dampen the economic recovery, particularly in the crucial electronic commerce and technology sector, by extending burdensome state tax obligations. Indeed, somewhat ironically, state budgets would likely be one of the first victims of such federal legislation.

- **Just how complicated is the current system of state and local sales taxes in the United States?**

It is enormously complicated. There are over 7,500 jurisdictions in the United States imposing transaction taxes, and the number grows every year. Moreover, among these jurisdictions there is enormous disparity in rates, exemptions, filing requirements, etc. Local sales and use taxes appear in the form of municipal taxes, county taxes, school district taxes, transportation district taxes, sanitation district taxes, sports arena district taxes, and the list goes on. Moreover, the thousands of state and local jurisdictions frequently change their rates, exemptions, filing requirements, etc., so that they are literally a moving target in terms of vendor compliance. The recent phenomenon of short-term sales tax “holidays” — during which tax is suspended on some but not all products — adds a new dimension of complexity.

- **When the Streamlined Sales Tax Project started out in 2000, it set high goals for true simplification of state sales and use taxes; why did the states abandon their effort to achieve “high bar” reform of their tax systems?**

Building on the recommendations of two earlier joint government/industry projects (the National Tax Association Communications and Electronic Commerce Tax Project, and the Congressionally-established Advisory Commission on Electronic Commerce) whose mandate was to examine the measures necessary to simplify the

existing sales and use tax system, the Streamlined Sales Tax Project presented itself in 2000 as a bold initiative by state legislators and tax administrators to simplify, harmonize and modernize state and local sales and use tax laws. The shared understanding of 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 spirit, the DMA contributed suggestions from the outset, setting forth in a letter to Project leaders in August 2000 a comprehensive list of reform proposals. 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 fully adopted only two (centralized registration and uniform bad debt provisions).

Unfortunately, the high ideals of SSTP organizers, which offered the promise of genuine and dramatic sales and use tax reform, were eroded by the political realities of having to gain the endorsement of state legislatures, municipal officials, and political constituencies. 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 dramatic tax reform and consistently rejected, or diluted, provisions that would have produced substantial uniformity among the states. The result is a "low bar" Agreement that contains only minor, and in many instances cosmetic, tax reform measures. Rather than a truly uniform system, the SSUTA perpetuates, and in many respects aggravates, a taxation system of tremendous complexity.

- **Did the SSUTA adopt the recommendation of both the E–Commerce Tax Project and the Congressional Advisory Commission that there should be only one sales and use tax rate per state?**

No. The SSUTA allows two state–level sales and use tax rates per state (the second rate is for food, food ingredients and drugs) and also allows every local jurisdiction to have its own separate rate. Both the E–Commerce Project and the Advisory Commission found that one rate per state for all commerce, i.e., no separate local tax rates, is an absolute requirement for any meaningful reform of state sales and use tax systems. The failure of the SSUTA to adopt the one rate per state principle substantially defeats the goal of simplification from the outset.

- **What has the SSUTA done to reduce the number of local tax jurisdictions, over 7,500 at last count?**

Nothing. Once again, this is a fundamental failing of the Agreement. Reduction in the number of taxing jurisdictions in the United States is the core requisite of sales/use tax reform. The Supreme Court in *Quill* (and in prior decisions), as well as 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. No limit on the ever–increasing number of local jurisdictions is contained in the SSUTA.

- **Does the SSUTA’s so–called menu of definitions mean states have achieved substantial uniformity?**

No. Under the SSUTA, each state continues to determine which products and services are taxable and which are exempt from tax in that state. The SSUTA includes some “uniform” definitions, but the number of defined products and services is very limited. 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.” Since the number of defined products and services is small, the taxability of given products and services from state to state continues to vary widely. As states increasingly move to impose transaction taxes on services, including services delivered electronically, the disparity in state tax bases will become even more pronounced.

Even as to those definitions contained in the Agreement, the SSUTA 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. Every state is thus allowed to have its own “grey area” with respect to each term defined in the Agreement. Furthermore, 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.

- **Have the states at least agreed to a uniform method for consumers and businesses to compute the applicable sales tax for each state?**

No. The SSUTA’s so-called “uniform” definition of the term “sales price” does not require member states to adopt a uniform measure of tax, but rather allows each state to include or exclude each of a number of different components, requiring sellers to track different definitions of “sales price” in every state.

- **Does the SSUTA minimize the number of audits by state revenue departments to which remote sellers will be subject?**

No, to the contrary, it increases them. The state representatives to the SSUTA rejected proposals for joint audits (*i.e.*, one audit conducted on behalf of all Member States). If state tax jurisdiction is expanded, a direct marketer selling to customers

throughout the country will need to file tax returns each month for all states (the SSUTA representatives also rejected a proposal for a single nationwide tax return), and they will be subject to audit by each one of those states. As a result, businesses will literally be under perpetual audit. Moreover, if a retailer disagrees with the outcome of such an audit, it will be required to pursue administrative and judicial appeals in a remote state, all at considerable expense.

- **The increasingly popular practice of state legislatures adopting sales tax “holidays” for short (several days) time periods introduces considerable complexity for catalog companies, who may feel compelled to explain in their catalogs the effect of those tax holidays on their customers’ tax obligations. Does the SSUTA bar sales tax holidays?**

No. The Agreement allows states to continue to adopt sales tax holidays. To make matters worse, the Agreement allows states to establish “thresholds” during state tax holidays, so some items are exempt during the holiday only to the extent that the transaction exceeds a threshold item price or purchase amount. This can only add confusion on top of complexity.

- **Even if the SSUTA does not go far enough, must states at least conform strictly with the modest uniformity provisions of the Agreement?**

Sadly, the answer is no. Even with the watered-down standards of the SSUTA, i.e., “low bar” tax reform, the Agreement does not require strict compliance with those standards. For example, a member state is deemed to be in compliance with the Agreement if “the effect of its laws, rules, regulations and policies is substantially compliant with each of the requirements of the Agreement.” Since only the overall “effect” of a state’s tax policies is required to comply “substantially” with the Agreement, state tax regimes may vary from the specific terms of the Agreement in countless ways.

- **Critics also accuse SSUTA members of “bending the rules” to meet their own objectives? Is this true?**

Absolutely, and this practice should raise substantial concerns in Congress about approving a system whose administrators play “fast and loose” with their own standards. Let me offer three examples.

First, in order to become a member of the SSUTA, a state must conform its laws to the terms and requirements of the Agreement. In theory, this assures adequate uniformity among the member states (although, as I noted, the Agreement’s conformity standard itself is weak). However, as SSUTA participants have readily acknowledged at public meetings, each state is allowed to determine *for itself* which of its tax laws will be made subject to the requirements of the Agreement. In other words, rather than extending the scope of the Agreement to all state and local transaction taxes, states are able unilaterally to decide that the Agreement applies only to those taxes they choose to denominate as “sales and use” taxes. Incredibly, state tax officials and SSUTA delegates have emphasized to skeptical state legislators considering SSUTA conformity legislation that the legislature can selectively exclude state taxes from the purview of the SSUTA, simply by not designating the tax a “sales” tax and by not submitting it for scrutiny by the SSUTA’s Governing Board. In fact, every SSUTA member state has transaction taxes that it has unilaterally decided not to subject to SSUTA requirements.

Second, the Agreement, by its terms, was only to take effect when at least ten states comprising at least twenty percent of the total population of all states imposing a state sales tax were determined to be in conformity. SSUTA delegates were apparently so concerned in April 2005 that they would not secure membership of enough states to meet their self-imposed threshold, that they quickly adopted a new provision allowing for

so-called Associate Members, which are states that the Project participants acknowledge have not yet conformed their laws to the Agreement, but which states will, nonetheless, be counted toward the critical mass necessary for the SSUTA to become effective. State representatives to the SSUTA have publicly acknowledged that the provisions regarding Associate Members were adopted in haste, without careful consideration of all of the ramifications of creating this second class of members on other parts of the Agreement, in order to “meet the quota” necessary for the Agreement to take effect.

Third, the SSUTA Governing Board has recently determined that it is not required to expel from the Agreement an Associate Member, Utah, whose legislature in 2006 repealed a large number of laws which had originally been enacted to bring the state into SSUTA compliance. The repeal legislation clearly put that state out of compliance with multiple SSUTA requirements. Although no longer in compliance with the Agreement, Utah remains a member, accepting SSUTA vendor registrations, participating on SSUTA committees, and voting on matters with other Associate Member states.

If states are willing to compromise even the most fundamental SSUTA standards – those for determining conformity with the Agreement – how can Congress have any confidence that the SSUTA representatives will not bend other standards when domestic political pressures or bureaucratic preferences lead them to do so?

- **Have individual SSUTA Member States, in fact, avoided the uniformity requirements of the Agreement by simply re-naming non-complying taxes or using other legislative devices to “game the system”?**

Yes. For example, under prior law, Minnesota — a Full Member in the SSUTA — exempted most items of clothing, but imposed sales/use tax on fur coats. The SSUTA, however, requires that a state exemption must apply to an entire defined category of

goods, in this case clothing. Indeed, such categorization of taxable products is a much ballyhooed part of the Agreement. Because furs are deemed “clothing” under the Agreement, Minnesota would have been required to include fur coats in its sales tax exemption for clothing. Rather than conform its laws to the requirements of the SSUTA, the Minnesota Legislature simply enacted a new “special fur clothing tax,” outside of its sales and use tax statutes. The Minnesota Department of Revenue then omitted the new “fur tax” from its SSUTA membership petition. The other SSUTA state representatives were well aware of this maneuver when voting to grant Minnesota Full Member status. They chose to ignore it.

Open approval of this sort of gamesmanship leads other states to follow suit. For example, the legislature in New Jersey, another “Full” SSUTA Member, has just enacted, effective July 15, 2006, its own version of the “fur tax.” The New Jersey law creates a new gross receipts tax on fur clothing, because New Jersey could not, consistent with its membership status in the SSUTA, impose a sales tax on such apparel, because New Jersey otherwise exempts “clothing” (as defined in the SSUTA) from its sales tax. It is also worth noting that the New Jersey fur tax applies at a rate of 6 percent, although New Jersey just raised its general sales and use tax rate to 7 percent, so the fur tax arguably flaunts not only the definitional requirements of the SSUTA, but also the requirements that members have only one state-level sales tax rate (other than food and drugs).

Tennessee (an Associate Member) has engaged in similar legislative end-runs around the SSUTA requirements. Rather than conform to the requirements of a single state rate (for all items other than food and drugs), Tennessee adopted certain “special user privilege taxes” which impose disparate tax rates on the sale of select products and

services. Here again, the state simply renamed an existing tax to avoid application of the Agreement, rather than accepting the uniformity required under the SSUTA.

How can states talk about uniformity, and simplification of their tax systems, when “beating the rules” involves nothing more than creative name–changing? Clearly, states will resort to imposing “excise” and other “special” taxes on various items to avoid the conformity requirements of the SSUTA. Even worse, their brethren SSUTA states allow them to get away with it. 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.

- **If Member States are already cheating (even while they are seeking congressional authority to expand their tax jurisdiction), is there an independent agency to oversee and enforce compliance?**

No. All matters of interpretation and compliance with the Agreement are decided by the SSUTA’s Governing Board (a non–profit corporation, established under the laws of Indiana), which is made up of representatives of the SSUTA member states, who must be either state revenue officials, other executive branch representatives, or state legislators. In other words, the SSUTA is a system developed “by state tax administrators and for state tax administrators.”

- **Even with its reduced, or “low bar,” reform measures, have state legislatures been eager to conform their laws to the SSUTA?**

No. There are only 13 Full Member states in the SSUTA (recall that Associate Member states have not yet fully conformed their laws). Several state legislatures, including those in Florida, Virginia, Wisconsin, Maine, Hawaii and Washington have rejected conformity legislation. Numerous other state legislatures, including those in large states such as California, New York, Illinois and Pennsylvania, have not introduced

conformity bills for consideration. One SSUTA Associate Member state, Utah, has repealed many of the changes that were necessary to bring its laws into conformity with the Agreement. There is hardly consensus among state legislatures on the wisdom or merits of the SSUTA. Indeed, some state legislators have expressed skepticism about Congress involving itself with state tax systems. They are concerned that federal legislation could be a two-edged sword that restricts state tax prerogatives just as it expands state jurisdiction.

- **Advocates of the SSUTA claim that in the 21st Century computers are the answer to all the complexities associated with use tax collection. Is software an easy solution to the tax collection issue?**

No. Tax compliance software was to be the SSUTA's "silver bullet" to address the otherwise overwhelming complexities of differing state tax systems, but to this date there is no system yet proven, through actual use by a vendor, that accurately calculates and reports sales and use tax under the SSUTA. In fact, the SSUTA Governing Board — more than three and one-half years late — has only recently (as of June 1, 2006) approved the first software package it claims enables accurate collection for all SSUTA member states. There was, however, no independent testing or auditing of the third-party software approved by the Governing Board. Of course, software companies have claimed for years that they can accurately calculate and report sales tax for every jurisdiction, but retailers know that such systems have never reliably overcome the inordinate complexity of being integrated with their existing computer systems. System compatibility and scalability challenges present a real world hurdle to the use of the SSUTA's one approved software package. If this sole software system were made mandatory, hundreds of thousands of retailers in the United States would need to rely on

a single software provider. The vendor of this software readily admits that integration with legacy systems and software with which that vendor does not ordinarily interface makes integration difficult, if possible at all. The potential disruption to businesses would be substantial.

- **State tax administrators have proposed that third party intermediaries — so called Certified Service Providers — be responsible for tax collection, remittance and reporting. Is this a simple solution?**

No. The use of such intermediaries is a totally unproven experiment, and there is no basis for believing that this approach will be the answer to the daunting complexity of an unreformed tax system. The SSUTA Governing Board — again more than three and one-half years late — only recently (effective of June 1, 2006) approved the first two intermediary companies, and they have not yet begun providing the service to any retailer. As with software, there was no independent testing or auditing of the third-party systems approved by the Governing Board. The same compatibility, integration and scalability obstacles exist with respect to intermediary companies.

- **Doesn't the SSUTA require that states fully compensate retailers for the costs they incur in collecting use taxes?**

No. Clearly, expanded state tax jurisdiction would force retailers throughout the country to bear considerable additional expense to collect use taxes on behalf of states and localities. It is only fair that sellers should receive appropriate compensation. The SSUTA, however, contains no guarantees of fair compensation for these additional duties.

The Agreement vaguely provides that states “anticipate” establishing compensation measures for businesses, either intermediaries, retailers, or both, that incur compliance costs in connection with collecting and remitting use tax to the participating

states. The Agreement, however, contains no guarantees of compensation to retailers, and the states and intermediary companies do not yet know whether the compensation promised to the two approved intermediaries by the states will be adequate to cover their costs. But even the “anticipated” compensation does not extend beyond the first twenty-four months of a retailer’s tax collection under the Agreement, although the retailer will obviously incur ongoing compliance costs. After the first two years, retailers are left to the whims of the individual member states, few of which currently provide a meaningful amount of vendor compensation, if they offer it at all. 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.

- **Does the SSUTA deal with consumers who pay for their catalog purchases by check or money order?**

No. 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 SSUTA is unworkable where payment is made by check, and this problem is significant. According to the Federal Reserve, as of 2003, checks still accounted for 45 percent of all non-cash payments. Catalog customers paying by check must self-compute the applicable tax. In order to accommodate such customers under the SSUTA, a catalog would need to contain a tax table covering every state and local tax jurisdiction in order to (1) determine the appropriate tax rate; (2) inform the customer which products are taxable and which are exempt; and (3) alert customers to sales tax holiday periods. The likelihood for consumer frustration and error are obvious. Moreover, the Agreement

leaves the retailer liable for the tax even if the consumer errs in calculating it. This is not tax simplification.

- **Are some states using the SSUTA as an excuse to increase sales and use taxes?**

Yes. In fact, several provisions of the SSUTA will allow, or even require, states to increase their sales and use taxes when conforming their laws to the Agreement. The SSUTA 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.

Member states that have (or formerly had) either caps or thresholds, or both, must eliminate them from state law (except in the context of a sales tax holiday) in order to conform to the Agreement. Some tax increases have already been enacted as a result. Tennessee had several thresholds for selected goods and services (from caskets to cable television) which exempted 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, subjecting its residents to new taxes. There will be many more examples of new taxes, or increased tax rates, resulting from adoption of the SSUTA.

- **If Congress authorizes the expansion of a state's tax jurisdiction to reach businesses in other states, will those business taxpayers be able to go to federal court to challenge tax assessments that violate their federal constitutional and statutory rights?**

No, and this is an issue of major concern. The sole arbiter of all disputes under the SSUTA is the Governing Board. If states, through federal legislation, are freed from existing constitutional limitations on the scope of their jurisdiction and are able to impose

tax collection obligations on companies located in other states, then those companies should have access to federal court to contest tax assessments that violate the provisions of the new federal legislation and, for that matter, any remaining constitutional protections such companies may have. Current federal law, however, bars taxpayers from going to federal court to challenge state tax assessments.

The Tax Injunction Act, 28 U.S.C. § 1341,¹ was enacted to permit states to administer their tax systems within their own borders without interference by federal courts. This rationale would no longer apply in the situation where states are enforcing their tax systems on sellers outside of their borders and pursuant to authority granted under federal legislation. Moreover, only federal courts can assure consistent interpretation and application of the SSUTA among all the states. Accordingly, any legislation that would override the existing constitutional restrictions on state taxing authority should be accompanied by a repeal of the Tax Injunction Act.

- **The SSUTA places enormous authority for interpreting the Agreement, hearing petitions and resolving disputes in an unelected Governing Board – do its rules and procedures meet fundamental standards of fairness and due process?**

So far, the Governing Board has been unresponsive to taxpayer requests for interpretation and complaints regarding state compliance. Moreover, the procedures and rules of the Governing Board and its committees remain unclear and their proceedings difficult to monitor. The delegation to the SSUTA from California, which is not a member state, but instead monitors the project through participation on the so-called State and Local Advisory Council (SLAC), recently wrote to the Governing Board to

¹ 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.

complain that meeting materials for the SLAC meetings were so consistently late in being distributed that the California delegation was not able to make such materials available to its citizens in a manner consistent with California sunshine laws. The California delegation indicated that it might have to withdraw its participation if the problem were not corrected, but SSUTA administrators informed the California representatives that no change in procedures was likely. Similarly, the Governing Board has an official website, but most sections of it are so seldom updated that it is not a reliable source of information for taxpayers on most matters. Put simply, SSUTA oversight responsibilities have been entrusted to state tax administrators who seek expanded powers from Congress, but who have demonstrated little discipline, responsiveness, or openness in the performance of their tasks.

Conclusion

Clearly, the SSUTA has numerous flaws in both its substance and implementation. Most significantly, the Agreement fails to address the key complexity of sales and use tax administration —thousands of tax jurisdictions and a multitude of tax rates. The early incidents of state legislatures circumventing the SSUTA conformity requirements, along with the Governing Board’s unwillingness to do anything about it, should raise serious concerns in Congress. Is it reasonable to expect that state legislatures and state tax administrators will be more committed to conformity after Congress unleashes state tax systems from current constitutional restraints?

Most critically, it is important to remember what is at stake. Both the structure of federalism and the protective role of the Commerce Clause should not be lightly swept

aside. These are core constitutional values, and any argument for disregarding them should be compelling and urgent before Congress abandons these principles.

Thank you for giving me this opportunity to appear before you.