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Committee on Finance

Presentation of

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On Behalf of
The Direct Marketing Association ("DMA")
And
The Internet Tax Fairness Coalition ("ITFC")

Cybershopping and Sales Tax: Finding the Right Mix

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Introduction

Good morning. My name is Frank Julian. I am Operating Vice President and Tax Counsel for Federated Department Stores, Inc. in Cincinnati, Ohio. Federated is one of the nation's leading department store retailers. We operate more than 450 department stores in 34 states, plus Puerto Rico and Guam, under the names of Bloomingdale's, Macy's, Burdines, Goldsmith's, Lazarus, Liberty House, Rich's, and The Bon Marché. Federated also has a significant direct mail catalog and electronic commerce business with its Fingerhut, Bloomingdale's By Mail, bloomingdales.com, Macy's By Mail and Macys.com subsidiaries.

Although Bloomingdale's By Mail, bloomingdales.com, Macy's By Mail and Macys.com are each separate subsidiaries, they collect sales tax on sales into any state where Bloomingdale's and Macy's, respectively, have department stores.

I am here today on behalf of The Direct Marketing Association ("DMA"). The DMA is the leading and largest trade association for businesses interested in interactive and database marketing, with almost 5,000 members from the United States and 53 other nations. I chair the DMA's Use Tax Steering Committee. The DMA is a member of the Internet Tax Fairness Coalition ("ITFC").

Summary of Position

The DMA firmly believes that the moratorium against new and discriminatory taxes on the Internet should be extended, and the moratorium against taxes on Internet access should be made permanent.

While there is widespread support for extending these moratoria, many have urged Congress to make collection of sales tax by remote sellers a *sine qua non* to extending the moratoria. We do not believe that these two issues are so intertwined that the moratoria cannot be extended without addressing the sales tax issue. However, to the extent Congress is inclined to address the sales tax collection issue, we believe it is imperative for Congress to require the states to substantially simplify their sales tax systems, and then to evaluate the states' simplification efforts, before granting the states the authority to require remote sellers to collect their sales tax.

The myriad of confusing and inconsistent state and local sales tax systems in existence today places tremendous burdens interstate commerce and the economy. The DMA supports the following objectives for reducing the tax burdens imposed on interstate commerce that thwart the development of a borderless marketplace:

- Establish simple and uniform sales and use tax rules that reduce compliance burdens for all taxpayers, and provide a reasonable collection allowance to compensate all sellers for the burdens they must incur in collecting the tax.
- Enact nexus standards for business activity taxes that eliminate uncertainty and the potential for double taxation.
- Promote availability of the Internet to all by prohibiting taxes on access fees.
- Prevent multiple and discriminatory taxation by extending the application of established nexus rules to remote commerce.

The DMA supports neutral tax treatment of electronic commerce; it does not support the creation of a "tax-free" zone for electronic commerce. However, the DMA believes that Congress should not pass any legislation that would give states "prior approval" to a simplification compact before the details of the simplification are known and evaluated by Congress.

Discussion

The burdens that the current sales tax systems place on interstate commerce have been well documented. The Supreme Court recognized these intolerable burdens on interstate commerce in its 1967 decision in *National Bellas Hess v. Department of Revenue*, and again in 1992 in *Quill Corp. v. North Dakota*. In *National Bellas Hess*, the Court found that the "many variations in rates of tax, in allowable exemptions, and in administrative and record keeping requirements could entangle … interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'"

The hearings conducted by the Advisory Commission on Electronic Commerce ("ACEC") raised an awareness, in an unprecedented manner, of the level of complexity and burdens imposed by the current sales tax systems. By the time the ACEC completed its work, there was near universal agreement that the disparate state sales tax systems in place today must be substantially simplified and unified—as they apply to **all** sellers—if they are to survive.

Federated collects and remits more than $1 billion per year in sales tax for the state and local governments where we do business. We incur substantial costs in collecting and remitting these taxes, and in administering the many audits that follow.

While this is a steep burden for us, it is not one that will put us out of business. The same may not be said, however, for some smaller companies or those less financially stable. In those cases, such a burden could put them out of business.

Substantial simplification of the sales tax systems will make it much easier for the states to administer and enforce the tax, and will make it much easier for sellers to comply with tax collection requirements.

Guidelines for Simplification and Uniformity

DMA believes that simplification and uniformity must be at a level that eliminates undue and discriminatory burdens on interstate commerce. The ITFC has developed draft federal legislation that it believes would encourage the states to simplify and unify their sales and use tax systems so as to eliminate undue burdens on interstate commerce. The DMA is fully supportive of the ITFC's draft legislation. Some of the specific items in that draft that we believe are crucial to achieving such a goal include:

1. A centralized, one-stop, multi-state registration system for sellers.

2. Uniform definitions for goods or services that could be included in the tax base.

3. Uniform and simple rules for attributing transactions to particular taxing jurisdictions.

4. Uniform rules for the designation and identification of purchasers and transactions exempt from sales and use taxes, including a database of all exempt entities and a rule ensuring that reliance on such a database shall immunize sellers from liability for both under-collection and over-collection of tax.

5. Uniform procedures for the certification of software upon which sellers may rely to determine applicable sales and use tax rates and taxability, and immunity from liability for under-collection and over-collection of tax for sellers who rely on such software.

6. Uniform bad debt rules.

7. Uniform tax returns, remittance forms, and filing and remittance dates.

8. Uniform electronic filing and remittance methods.

9. State administration of all sales and use taxes in such state.

10. Uniform audit procedures, including a provision giving a seller the option to be subject to no more than a single audit per year using those procedures; provided that if the seller does not comply with the procedures to elect a single audit, any state can conduct an audit using those procedures. If elected, however, the single audit binds other states.

11. Reasonable compensation for tax collection by all sellers.

12. Exemption from use tax collection requirements for remote sellers falling below a specified de minimis threshold of less than $5,000,000 in prior-year gross annual sales, or less than $100,000 in any state during that prior-year. This exemption would not, however, operate to exempt a seller with less than $5,000,000 in prior-year gross annual sales for any obligation to collect and remit sales or use taxes imposed by the state in which that seller is located.

13. Appropriate protections for consumer privacy.

14. A single, uniform statewide sales and use tax rate and base on all transactions on which a sales or use tax is imposed.

15. For those states that impose a sales or use tax on digital products, an origin state default rule, for transactions where the location of the customer is not disclosed during the transaction, that permits the seller to rely upon information given by the customer during the transaction.

16. Appropriate bright-line nexus standards for business activity tax nexus purposes that limit business activity tax nexus to sellers that lease or own substantial tangible personal property, or have a number of employees or actual agents, in the taxing jurisdiction for more than 30 days during the taxable year.

17. Uniform dates, not to exceed two (2) in any calendar year, on which changes to sales and use tax rates may become effective, and a requirement that a state give at least 120 days' notice before any change in its sales or use tax rate becomes effective.

18. Allows the Untied States Court of Federal Claims to resolve conflicts that arise with regard to interpretation of similar sales and use tax provisions of the different states.

19. Such other features that will achieve a simplified and uniform sales and use tax system.

Of these 19 principles of simplification, however, two that are among the most important to the business community are the two that state and local governments have opposed most vigorously: One sales and use tax rate and base per state, and nexus standards for business activity taxes. A third very important principle, uniform definitions for goods and services, also seems to be a very difficult pill for state and local governments to swallow.

Two bills have been introduced in the Senate which would establish certain simplification parameters. S. 288, introduced by Sen. Ron Wyden and Sen. Patrick Leahy, and S. 512, introduced by Sen. Byron Dorgan. We are pleased that S. 288

contains virtually all of the simplification parameters contained in the ITFC's draft legislation. DMA fully supports S. 288. The level of simplification called for in S. 512, on the other hand, is inadequate and would result in intolerable burdens being placed on remote sellers.

One Rate and One Base Per State

There are more than 7,600 different sales tax jurisdictions in the United States today, each with its own tax rate, and many with their own tax base and rules and regulations. I should also note that in 1967, when the Supreme Court ruled in *National Bellas Hess* that it was an unconstitutional burden on interstate commerce to require sales tax collection in states where the seller did not have a physical presence, there were "only" 2,300 jurisdictions to deal with. This proliferation of taxing jurisdictions is symbolic of the ever-increasing complexity of the existing sales and use tax systems.

In the State of Texas alone there are 1,109 separate city tax rates and 119 county tax rates. In addition, there are 67 "special" tax jurisdictions, ranging from crime control districts to library districts; 27 of these special jurisdictions have geographical boundaries that do not correspond to any city or county boundary. When combined with the state rate, this results in 1,296 different taxing jurisdictions in the State of Texas.[1]

Is it fair to require a direct marketer with presence only in Montana to know which combination of these 1,296 rates applies to every item of merchandise it sends to a customer in Texas, and then to collect and remit the proper amount of tax to the Texas authorities, when that same direct marketer is not required to collect any sales tax on behalf of its home state of Montana[2]? Add to this the fact that there is a zero margin of error for the seller: If the seller under-collects the tax from its customer, the seller must pay the tax out of its pocket and is subject to interest and penalties by the taxing authorities. If the seller over-collects the tax, it is subject to class action law suits from its customers, as well as consumer fraud actions from state attorneys general. This puts the seller in an untenable position.

The states will argue that this problem can be fixed by using software that calculates the applicable sales tax rate by ZIP Code. We submit that this is not an acceptable solution. There are hundreds of five digit ZIP Codes across the country in which there are multiple taxing jurisdictions; moreover, there are scores of nine digit ZIP Codes in which there is

[1] Although Texas was used for illustration purposes here, there are several states in which the burdens imposed by the local taxing jurisdictions are significantly greater than in Texas.

[2] Montana is one of five states in the country that does not have a sales tax. The others are Alaska, Delaware, New Hampshire and Oregon.

more than one taxing jurisdiction. Thus, even if software existed that could provide an accurate nine digit ZIP Code for every order placed with a remote seller, the seller still might not be able to accurately collect the proper amount of sales tax.

It should also be noted that none of the proposed "software solutions" will alleviate the problems faced by sellers whose customers pay by check.

The states have suggested alternatives that would use the Census Bureau's "FIPS" Code, or would create a unique 10-character coding scheme for each separate taxing jurisdiction.[3] None of this very sophisticated technology exists today. However, under the best of circumstances, forcing remote sellers to collect tax for 7,600 different taxing jurisdictions will saddle interstate commerce with substantial burdens. The DMA believes that Congress should do everything in its power to eliminate undue burdens on this vital segment of America's economy.

In 1999, the National Tax Association ("NTA") conducted a Communications and Electronic Commerce Tax Project, the precursor to the ACEC, which included all the major state and local government organizations and electronic commerce industry trade associations. **The only tax reform measure to receive unanimous agreement from the Project's participants was "There should be one rate per state which would apply to all commerce involving goods or services that are taxable in that state."**

S. 512 recommends that there be one statewide "average" tax rate per state for remote commerce only, and that in-state businesses continue to collect all of the local jurisdictions' taxes. The NTA Project participants considered, and rejected, this proposal. The DMA agrees that such a proposal is ill-advised for the following reasons:

The DMA strongly advocates "channel neutrality" in the treatment of commerce. To achieve channel neutrality, and to avoid favoring one business medium over another, the sales tax rate applicable to a particular item must be the same regardless of whether the purchase was made from an Internet vendor or from an in-state brick and mortar store.

The ITFC also strongly believes that there should only be one tax base per state. Allowing local jurisdictions within a state to separately determine the taxability of items sold in, or shipped to, their jurisdictions adds immeasurable confusion and complexity. If the State of Colorado exempts widgets from sales tax, the City of Denver should not be allowed to impose a sales or use tax on that same widget.

Congress has a duty under the Commerce Clause to facilitate the flow of commerce among the states. Incorporated in this duty is Congress' responsibility to limit the

[3] For example, a remote seller sending merchandise to a customer who lives in the Dripping Springs Community Library District in Texas would need to know that the customer lives in Tax Jurisdiction Number 48DLI21424.

imposition of barriers to the free flow of commerce. Insisting that there be no more than one tax rate and one tax base per state, for **all** types of commerce, before requiring remote sellers to collect sales tax in states where they lack a physical presence is wholly consistent with Congress' duty under the Commerce Clause.

Business Activity Tax Nexus

The ability of a jurisdiction to impose a tax should be governed by one fundamental principle: A government has the right to impose economic and administrative burdens only on taxpayers that receive meaningful benefits or protections from that government.

In the context of business activity taxes[4], this guiding principle means that businesses that are not physically present in a jurisdiction, and are therefore not receiving significant tangible benefits or protections from the jurisdiction, should not be required to pay a business activity tax to that jurisdiction.

In its Commerce Clause jurisprudence, the Supreme Court has ruled that a business must have "substantial nexus" in a state before a state can constitutionally subject that business to its taxing power. For purposes of requiring a business to collect a state's sales and use tax, the Supreme Court has ruled that substantial nexus requires "physical presence" in the state.

Although the Supreme Court has not had occasion to address the requisite level of nexus for a state to impose a business activity tax, several state courts have addressed the issue. Many of these state courts have affirmed that the nexus standard for business activity taxes can be no less than the "physical presence" standard for collection of sales and use taxes. For example, one state court has held that the retention of credit cards by an out-of-state credit card issuer was insufficient to give the issuer physical presence for state income tax purposes. Unfortunately, courts in some states have reached the opposite conclusion.

Litigation and uncertainty in this area continue to proliferate. If remote sellers are required to begin collecting and remitting sales tax in every state, then those states will have a road map by which to aggressively pursue these same sellers for business activity

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[4] "Business activity tax" refers to tax imposed directly on businesses and not generally passed directly on to consumers. These include corporate income taxes, franchise taxes, single business taxes, capital stock taxes, net worth taxes, gross receipts taxes, use taxes and business and occupational taxes.

taxes. Many small and medium-sized sellers lack the resources to challenge spurious claims for state income taxes.

If Congress is going to exercise its authority under the Commerce Clause to require remote sellers to collect sales tax in states where they have no physical presence, then Congress should, at the same time, protect those sellers from being subjected to business activity taxes in those same states. The manner in which to provide this protection to business, and to put and end to the litigation and uncertainty, is for Congress to enact a bright line nexus standard that requires physical presence in a state before a company can be subjected to a state's business activity tax. Sen. Judd Gregg and Sen. Herb Kohl have introduced a bill, S. 664, that appropriately addresses this issue.

All Sellers Should Receive a Reasonable Collection Allowance

We believe that all sellers should receive a reasonable collection allowance to compensate them for the costs they incur in collecting sales tax.

Obviously, the more simplification measures that are enacted, the more the collection costs incurred by sellers will be reduced, thus reducing the amount of collection allowance that will be required.

Studies have shown that the average cost to collect sales tax exceeds 3% of the amount of tax collected. Of the 45 states with a sales tax, however, only seven provide for an uncapped collection allowance of greater than 1%. For a company like Federated, this amounts to tens of millions of dollars a year in expenses we incur to serve as a tax collector for the states. This number will clearly grow if we are forced to collect tax on behalf of every state in the country. For smaller businesses, and for those with tight budgets, the unreimbursed cost of collecting sales tax is yet one more large straw on the camel's back. In today's economic times, it could be the fatal straw for many companies.

Several members of the business community and representatives from certain state and local government organizations are in the preliminary stages of jointly commissioning a new, independent study to determine the cost of collecting sales tax. Such a study should prove very helpful to Congress in determining the amount of collection allowance to which sellers are entitled.

We are pleased that both S. 288 and S. 512 recognize the need for such a collection allowance.

Congress Must Provide the Framework for Simplification

The Commerce Clause vests in Congress the authority to regulate interstate commerce, and to guard against interference with interstate commerce. This is a serious responsibility that Congress should not abdicate to the states.

For this reason, DMA believes it is incumbent upon Congress to (1) establish the parameters of simplification and uniformity that must be enacted before states are given the right to require remote sellers to collect their tax, and (2) review and evaluate the measures which the states enact—**before** granting them extended tax collection authority—to ensure that the states actually have met the Congressionally mandated standards. The failure of S. 512 to call for affirmative Congressional review of the states' simplification efforts prior to approving the compact amounts to giving the foxes the keys to the hen house.

The states have begun efforts to simplify their sales tax systems. Beginning in March, 2000, an ever-growing number of state tax administrators has been working on the Streamlined Sales Tax Project ("SSTP")[5]. The SSTP was formed to develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes.

The ultimate goal of the Project is to develop a simplified sales tax system under which remote sellers without a presence in a state will voluntarily agree to collect sales tax on their sales into that state. In December, 2000, the SSTP released a model act and model agreement that it encouraged its member states to adopt.

The various state tax administrators who have been involved in the Project have worked tirelessly to accomplish their goal. They have included in their work product some of the important tax simplification standards that we believe are essential. Moreover, the SSTP proposals include elements of tax simplification that will be beneficial to brick and mortar sellers in collecting the tax in the states where they do business. However, many of the tax simplification provisions the SSTP has proposed are not even designed to become effective until 2006.

Before Congress authorizes the states to require remote sellers to collect tax in states where they lack a physical presence, the sales and use tax laws must be **substantially** simplified and made more uniform. The sales tax system developed by the SSTP, however, falls into the category of "simplification light." While it alleviates some burdens on all sellers, it would nonetheless result in undue burdens on interstate commerce if all sellers were required to collect in every state under this system.

[5] On behalf of the DMA, I have attended every SSTP meeting that has been open to the public. The DMA plans to continue working with the SSTP, throughout the duration of its existence, to try to find ways to simplify the existing sales tax systems.

Some of the particular shortfalls of the SSTP proposal include: (1) failure to require only one tax rate per state[6], (2) failure to call for business activity tax nexus standards, and (3) failure to provide simple definitions for items like "clothing." Moreover, many of the simplification provisions in the SSTP model do not even become effective until 2006.

In January, 2001, the National Conference of State Legislatures ("NCSL") met to discuss the legislation proposed by the SSTP. The NCSL was unhappy with several provisions in the SSTP's final proposals, so it made several significant modifications and created its own version of a model act and agreement. In particular, the NCSL version does not call for one tax base per state, and eliminated virtually **all** of the common definitions included in the SSTP model.

If the SSTP's proposal represented a first step toward the kind of simplification the business community believes could lead to a reduction in compliance burdens, the NCSL's proposal represents a step backwards.

The stated purpose for the NCSL's actions was to be able to have model legislation that would be likely to pass in many state legislatures this year. In our view, the goal should not be to propose legislation that will pass just for the sake of passing. The goal must be to achieve simplification and uniformity that will substantially reduce, not merely maintain, the current undue burdens on interstate commerce.

The result is that there are now competing versions of sales tax simplification in the states. According to the SSTP's web site, as of July 13, 2001, seven[7] states have passed some form of the SSTP's model legislation, six states have passed the NCSL version, and three states passed some hybrid version of legislation. (A printout of this portion of the SSTP's web site is attached as Exhibit A.)

For a topic in which the goal is tax uniformity, this smacks of chaos. The DMA believes that Congress should establish clear criteria that will enable states to direct their efforts toward a uniform simplification plan that works for all sellers.

Congress Should Extend the Moratorium and Ban Taxes on Internet Access

The moratorium contained in the Internet Tax Freedom Act on multiple and discriminatory taxes on electronic commerce should be extended, and taxes on Internet access should be permanently banned.

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[6] The SSTP calls for one tax base per state beginning in 2006.

[7] Of these seven, only two, Minnesota and Wyoming, adopted the SSTP Agreement, which is the piece that contains actual tax simplification. The remaining five only passed the SSTP Act, which merely manifests an intent to move forward on the project at some point in the future.

The purposes of the moratorium were to (1) ensure that the rules that apply to other forms of remote commerce also applied to electronic commerce, and (2) allow time for the ACEC to study ways to simplify the current complex state sales and use tax systems. The Internet Tax Freedom Act has never prevented the states from collecting sales and use tax otherwise due on goods and services purchased over the Internet.

Allowing the moratorium to expire would send a signal to the states that it is now permissible for them to treat electronic commerce differently from transactions using other channels. Extending the moratorium on discriminatory taxes thus is essential to ensuring neutral tax treatment for electronic commerce going forward. To the extent that state and local government groups oppose the moratorium suggests that they are poised to assert that the nexus rules that apply to mail order transactions do not apply to Internet transactions. If this is not the position of the state and local governments, then they have nothing to fear from an extension of the moratorium.

The DMA also supports a permanent ban on sales tax on Internet access charges. A majority of the ACEC recommended a similar ban.

The Internet has been a tremendous growth engine for our economy. Access to this very important medium should not be burdened with taxes. Moreover, imposition of sales taxes on Internet access will have a deterrent effect on the ability of lower income families to use the Internet. Elimination of these taxes will help to close the so-called digital divide.

The Sky Is Not Falling

During the past three years, many of my fellow retailers, as well as representatives from the shopping center industry, state and local government and others, predicted that there would be an explosive growth of electronic commerce, and that it would be detrimental to their interests. Remarkably, they argued to the ACEC and to Congress that if electronic commerce were not saddled with complex tax collection burdens, it could spell the end of traditional brick and mortar retail as we know it today.

Although I have a lot of respect and admiration for my fellow retailers, this is one instance where they were wrong: The sky is not falling on brick and mortar retailers. Many of the once feared “dot-com’s” have become “dot-bombs.” The demise of E-Toys is just one example of many recent failures in the electronic commerce world. Our weakening economy is having a profound negative impact on the fledgling electronic commerce sector.

Allowing state and local governments to unleash economic anarchy in the current environment could have long term, devastating effects on the economy, business and employment. We believe it is critical for Congress to protect this vital segment of our

economy from potentially fatal tax burdens by extending the moratorium against discriminatory taxes, and by demanding that the states significantly simplify their sales tax systems before being allowed to require remote sellers to collect their tax.

The Alleged Kiosk "Loophole"

Several members of Congress have been told that sales tax collection can be avoided if an Internet affiliate of a brick and mortar store places a kiosk in the store, at which customers can place orders for merchandise. This is simply not true.

Under existing law, a seller that has physical presence or "nexus" in a state, through property, employees, or agents, is required to collect sales tax on all of its sales made into that state. The presence of a remote seller's kiosk in a state, whether located in a store with a similar name or elsewhere, would constitute nexus in the state for the remote seller, thus legally obligating that remote seller to collect applicable tax on all its sales to customers in that state. The fact that the kiosk is located in a retail store is also likely to cause that store to be the agent of the remote seller, thus providing an additional basis for nexus.

To the extent there are remote sellers trying to take advantage of this perceived "loophole," the remedy is for the state revenue authorities to enforce existing law. It does not require an overturning of the Supreme Court's decision in *Quill*, or any act of Congress or the state legislatures.

Comparisons to the Federal Airline Ticket Tax

Some people have compared collecting sales and use tax on remote sales to collecting the Federal airline ticket tax. There is no legitimate basis for such a comparison. The Federal airline ticket tax is a single tax rate on a single commodity collected for one jurisdiction: the Federal government. Requiring remote sellers to collect sales tax under the current environment would involve collecting 7,600 tax rates on behalf of 7,600 different jurisdiction on millions of different products and services.

Conclusion

Congress should act now to extend the moratorium on new and discriminatory taxes on the Internet and to permanently ban taxes on Internet access charges. Granting the states the power to require remote sellers to collect sales tax should not be a condition precedent to extending these moratoria.

However, if Congress is going to address the sales tax issue, it must be cognizant of its duties under the Commerce Clause of the Constitution. Any grant of authority to the states to require remote sellers to collect their sales and use tax must insure that it does not interfere with, or place undue or discriminatory burdens on, interstate commerce.

To achieve this result, Congress must establish the parameters under which the state sales and use tax systems should be substantially simplified and made more uniform. Congress must then evaluate the states' efforts to be sure that the requisite level of simplification and uniformity has been attained. Only then should Congress grant the states the broad tax collection powers they now seek.

I sincerely appreciate the opportunity to testify before you today, and I will be happy to answer any questions.