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ON BEHALF OF THE
DIRECT MARKETING ASSOCIATION
BEFORE THE
FINANCE COMMITTEE
SENATE OF PENNSYLVANIA
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I. Introduction

Mr. Chairman and members of the committee, thank you for the opportunity to testify today before the committee as it considers the issue of sales tax collection on remote sales. I am here today representing the more than 2,400 members of the Direct Marketing Association (DMA), the leading global trade association of businesses and nonprofit organizations using and supporting multichannel direct marketing.

A number of states have pursued legislation in the last several years that purports to "level the playing field" with regards to sales tax collection on remote sales. There has been little consistency in the approaches taken. However, there has been consistency in the results – no new revenue (with one exception, which I will explain), lost jobs and businesses and lawsuits. The concept might appear to be easy enough, just have anyone who sells into the state either collect sales tax or inform their customers of the obligation to pay use tax, but, to quote the writer H.L. Mencken, "[f]or every complex problem there is an answer that is clear, simple, and wrong." The "simple" solutions that have been pursued around the country to address remote sales tax collections tread into areas of settled and recently reaffirmed law with regards to what burdens states can place on businesses with no physical nexus in a state.

II. Federalism – The Framers of the Constitution Saw This Issue Coming

For the purposes of sales and use tax jurisdiction, borders are extremely important. Defining the appropriate reach of the sovereign authority of state and local governments is central to the American system of government. 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 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.

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. The federal system permits and even invites great variations in tax policy among the states and 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. 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 burdens of exporting individual state tax systems can be seen in figures from a recent report. In just the ten month period from January through October 2010, state and local departments of revenue around the country implemented more than 5,000 sales tax rate and rule changes. In November 2010 alone, taxing authorities in 26 states made 257 changes to their sales tax rates and rules. Foisting the combined sales tax collection systems of all the 7,500 taxing jurisdictions on every remote seller would cripple interstate commerce, exactly what the Framers affirmatively sought to avoid.

III. The Affiliate Nexus Experiment

Several years ago New York adopted a law that redefined nexus for the purposes of requiring collection of sales tax such that if a seller has an agreement with an in-state resident where referrals by the resident (i.e. an affiliate) to the seller result in compensation from the seller to the resident then the seller must collect sales tax on all transactions in the state, not just those from the referrals. The law was targeted at affiliate programs where sellers advertise, typically at the request of the affiliate, on websites or blogs. These affiliates do not create a market in the state for the seller and are nothing more than links from the affiliate's webpage to the seller's. As a result of the adoption of this law, virtually all affiliates in the state who advertised for sellers with no nexus saw their relationships terminated. Only one remote seller began collecting sales tax in New York, but that was solely for the purpose of having standing to sue the state over the law, which it did. The case is still proceeding through the legal process.

A few other states have pursued the affiliate nexus path, but have seen even poorer results as affiliate relationships in those states were terminated, the affiliates relocated to nearby states taking with them jobs and income taxes and no new tax revenue materialized for the states. Should Pennsylvania choose to pursue affiliate nexus legislation, it can be guaranteed the same results.

There are 8,500 affiliates in Pennsylvania who earned $575 million in 2009 and paid nearly $18 million in state income tax. Affiliate nexus laws put between 25-35% of affiliates' income at jeopardy, so it is easy to see why relocation is a viable alternative for them.

IV. The Use Tax Notice and Reporting Experiment

Equally problematic for states are use tax notice and reporting laws. By way of background, in 1992, the United States Supreme Court held in *Quill Corp. v. North Dakota* that a state cannot impose sales/use tax collection obligations on out-of-state vendors unless those retailers have a "physical presence" in the taxing state. The decision in *Quill* applied the holding of an even earlier decision in a 1967 case, *National Bellas Hess v. Dep't of Revenue*. So, the notion that states cannot force sales tax collection on remote sellers has been around for more than 40 years.

In January 2011, a federal district court judge in Colorado issued a preliminary injunction enjoining the Colorado Department of Revenue from enforcement of a law enacted last year that required remote sellers to notify customers of their obligation to pay use tax, required annual summaries of customers' purchases to be sent by the seller to the customer each January and required the seller to report to the department how much each Colorado customer purchased from them in the previous calendar year.

DMA brought suit against Colorado in June 2010 and subsequently filed a motion for preliminary injunction in August. Federal Judge Robert Blackburn determined that the Colorado purchase notice "imposed a notice and reporting burden on [these] out-of-state retailers and that burden is not imposed on in-state retailers." The concept of this disparate treatment between in-state and out-of-state companies is the basis of legislation of this type and puts it on questionable legal ground. Moreover, Judge Blackburn concluded that "these requirements likely impose on out-of-state retailers use tax-related responsibilities that trigger the safe-harbor provisions of [*Quill Corp. v. North Dakota*]."

Judge Blackburn found that the obligations being placed on remote sellers under the Colorado law, including the notice that use taxes are owed, are tantamount to enhancing the state's collection of use taxes and are therefore impermissible. While use taxes are indeed owed by residents, that tax relationship is between the taxpayer and the state, and remote sellers should not be conscripted into the process.

Beyond the legal and constitutional questions raised by notice bills, there are many practical considerations as to why tax notification requirements are unworkable. State requirements will vary, thereby requiring increasingly lengthy notices and technology challenges required to comply with such laws are complicated. It is likely that many smaller retailers do not develop their own software platforms and instead rely on "off-the shelf" or semi-customizable ecommerce tools. The ability to make the modifications required to be compliant would likely be limited, if even available at all. Another problem comes with the implication that by telling customers about particular tax information the retailer itself has the ability to assist the customer further on the issue. This disadvantages the retailer who likely will be incapable of offering assistance, and it disadvantages any customers who may be unclear as to what he or she should do with regards to compliance.

V. Conclusion – Ending the Taxing Arms Race

DMA is not arguing against use taxes nor suggesting that customers do not meet their obligations under state law to remit that tax, much as they do with property taxes or licensing fees or any number of other monies owed by citizens to the state. Where we diverge is in the attempt to export individual state-specific requirements to companies in the 49 other states. This taxing arms race will ultimately cause problems for all businesses, and there is no way to insulate those companies in a particular state who will have to comply with other states or who might have had to comply with Colorado, for example, but for the preliminary injunction. This issue is most properly addressed at the federal level.

Thank you again for the opportunity to testify and I would be happy to answer any questions.