Statement of Steve DelBianco,

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For the

United States House of Representatives Committee on the Judiciary

Hearing on:

Examining the Wayfair Decision

and its Ramifications for Consumers and Small Businesses

July 24, 2018

Chairman Goodlatte, Ranking Member Nadler, and members of the Committee: Thank you for holding a hearing on *Examining the Wayfair Decision and its Ramifications for Consumers and Small Businesses.*

NetChoice is a trade association of leading e-commerce and online companies promoting the value, convenience, and choice of Internet business models. Our mission is to make the Internet safe for free enterprise and for free expression.

NetChoice has been deeply engaged on Internet tax issues for 18 years, including testimony before this committee in several hearings, and policy debates in the *Wall Street Journal*, on CNBC, CSPAN, CNN, and PBS. Since 2004, we have participated in meetings of the Streamlined Sales Tax Project (SSTP), a long-term effort to simplify state sales tax systems in response to the *Quill* ruling of the U.S. Supreme Court.

NetChoice is also a founding member of TruST, the coalition for True Simplification of Taxation (TrueSimplification.org), along with the American Catalog Mailers Association (ACMA) and the Direct Marketing Association (DMA).

Over the last two years, NetChoice and ACMA filed lawsuits challenging new Internet tax laws and regulations in South Dakota, Tennessee, Indiana, Wyoming, Massachusetts, and Ohio. Our lawsuits were largely based on the Supreme Court's physical presence standard in *Quill v. North Dakota*[1], which was discarded by the Court last month in *South Dakota v. Wayfair*[2], by the narrowest of margins.

The *Wayfair* decision erased the bright-line test of physical presence, leaving uncertainty as to whether a demand by a foreign state tax collector represents an undue or discriminatory burden, based on the constitution's commerce clause. Resolving this new test depends on facts examined on a case-by-case basis considering each state law and business taxpayer. And because of the Tax Injunction Act, these cases must be brought in state courts—leading to disparate decisions across the country. As a result, businesses now have no clear test to determine whether they are obligated to pay a foreign state's sales tax.

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[1] *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

[2] *South Dakota v. Wayfair*, 585 U.S. ___ (2018).

The seller's dilemma is whether to collect tax at significant expense, or to forego tax collection and risk later being responsible for a tax that was not its obligation in the first place—plus interest and penalties.

American businesses using e-commerce now confront the unencumbered power of states to impose sales tax burdens beyond their borders. State tax overreach is abundantly evident to customers and businesses on the Internet: a business located in a single jurisdiction is now subject to rules and audits from 46 states and several hundred home-rule cities, plus over 10,000 differing tax rates in local jurisdictions. Yet it is American consumers who will bear the true cost of this complexity in the form of fewer choices (as fewer small businesses can afford multistate compliance burdens) and higher prices (as costs of tax compliance are passed on to consumers).

Despite pleas for restraint from National Conference of State Legislators, we've already seen states demand sales tax – including for periods before the *Wayfair* decision -- with little regard for simplification. Massachusetts, for example, is not a member of the SSTP but is demanding taxes from online sellers dating back to October 2017.[3] Hawaii initially sought back-taxes from online sellers dating back six-months before the Court ruled in *Wayfair*.[4]

Fortunately, the Court acknowledged in *Wayfair* that Congress retains its Article 1 constitutional authority over interstate commerce. In fact, Chief Justice Roberts' dissent emphasized that this issue can and should be addressed by Congress and not the Court – "We postulated that 'the better part of both wisdom and valor [may be] to respect the judgment of the other branches of the Government.'"[5]

The question is, what should Congress do in response to the *Wayfair* decision?

On that question, consider the experience of Congress over the last twenty years as it enacted multiple renewals of the Internet Tax Freedom Act (ITFA) and made that law permanent

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[3] *See* Statement of Massachusetts Department of Revenue - *U.S. Supreme Court Releases Decision on Wayfair Online Sales Tax Case - Regulation 830 CMR 64H.1.7 Remains in Effect* (May 22, 2018). "The Department of Revenue's existing regulation 830 CMR 64H.1.7 (Vendors Making Internet Sales), *which took effect in October 2017*, continues to apply and is not impacted by the Supreme Court's decision." (emphasis added).

[4] Because of pressure from NCSL, Hawaii's Department of Revenue revered its original approach and on July 20, 2018 announced that remote seller tax collection commenced on July 1, 2018. But if a remote seller hits the $100K/200 sales threshold by December 31, 2018 the remote seller is responsible for "catch-up" tax payment back to July 1, 2018. Nonetheless, the mercurial nature of states shows a need for certainty created by Congress.

[5] *Wayfair* at 7 (Roberts, C J dissenting).

in 2016. Congress long ago recognized that commerce over the Internet is uniquely interstate, and that its fundamental benefits would be disrupted if every state and local jurisdiction could take a bite out of it. The decentralized architecture of the Internet, now as then, makes it uniquely susceptible to multiple and discriminatory taxation across a confusing patchwork of thousands of state and local taxing jurisdictions. That is why federal law in the form of the ITFA prohibits state and local governments from imposing "discriminatory" taxes on online activity.

In the Appendix we include a detailed statement from former Congressman Christopher Cox, outside counsel to NetChoice and co-author of the ITFA. Mr. Cox's statement describes the congressional intent behind ITFA and its implications for state efforts to extinguish the court-ordered physical presence rule for imposing sales taxes on interstate commerce.

In this statement, we are reminding Congress that it has thoroughly considered and acted on the physical presence question. We ask Congress to use its constitutional authority to protect interstate commerce by restoring the physical presence rule that the Court has recently rescinded, while also allowing states to impose sales tax on remote businesses -- but only if states adopt minimum simplifications stipulated by Congress.

In his majority opinion in *Wayfair*, Justice Kennedy placed great value on the SSUTA but perhaps failed to grasp that SSUTA can be amended by the Governing Board of SSTP, a body comprised only of state legislators and tax administrators. In fact, the SSTP Governing Board has repeatedly de-simplified SSUTA in order to make it easier for new states to join. For this reason, SSUTA must be subject to a Congressionally mandated "floor" of minimum simplifications that must be maintained. In essence, this would codify what the Court assumed was the case when it abrogated *Quill* in deference to the Streamlined Sales Tax Project.

Justice Kennedy's opinion also cited the small business exception in South Dakota's law as a necessary element to address undue burdens on interstate commerce. Immediately after *Wayfair*, several states copied South Dakota's threshold of $100,000 in annual sales or 200 transactions for their own laws and regulations. But with its tiny fraction of population and economic activity, South Dakota's $100,000 threshold is equivalent to $38 million in nationwide annual sales[6]. The Congressional response to *Wayfair* should require a national small business threshold that adequately protects small businesses from compliance costs and audit risks.

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[6] South Dakota law has a Small Business Exception (SBE) of $100K for annual sales into the state. That is equivalent to an SBE of $38.5 million in national sales ($19 trillion for the US Gross Domestic Product (GDP) / $48 billion in SD GDP

Moreover, the Court in *Wayfair* appears to have misinterpreted SSUTA's ability to protect American businesses from the risks and costs of sales tax audits by 46 states and hundreds of home-rule cities and counties. At p.23 of Justice Kennedy's opinion is an *errant* assumption about audit protections:

> Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement. This system standardizes taxes to reduce administrative and compliance costs: It requires a single, state level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the State. Sellers who choose to use such software are immune from audit liability. See App. 26–27.

In the Court's citation from South Dakota's Joint Appendix ("App."), we see why the Court erroneously assumed that sellers using SSTP software "are immune from audit liability." The state incorrectly described SSUTA's audit protections:

> Accordingly, a taxpayer can comply with the obligations of the Act using the Streamlined system at little to no personal cost (apart from actually remitting the taxes collected from consumers), and with little to no concern regarding audits or errors in compliance.

But in reality, the audit liability absorbed by certified service providers (CSPs) *is limited to errors in the software* – whether by the CSP or by the states providing erroneous data. As explained on the SSTP website[7]:

> e. Liability Relief – Sellers that contract with a CSP are not liable for errors in calculating the incorrect tax that result from the seller or the CSP relying on erroneous data provided by a member state on tax rates, boundaries, taxing jurisdictions or incorrect data in the library section of the state's taxability matrix.

The most frequent error made by a seller is in "mapping" their entire inventory of products and services to the categories used by each individual state and local jurisdiction across the country. For example, a seller may have coded his yeast products as "food" instead of "food items used in brewing." A provider of online interactive training courses could code her

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* $100,000). 2016 GDP data from the World Bank, at https://en.wikipedia.org/wiki/List_of_U.S._states_and_territories_by_GDP

7 "What are the benefits of using a Certified Service Provider?", page captured from Streamlined Sales Tax website on 19-Jul-2018, at https://www.streamlinedsalestax.org/index.php?page=csps3

courses as “Digital Audio-Visual Works“ or as “Online Training” service—which is taxable in only a handful of states[8].

Errors made by a seller in mapping their products and services to state codes are not the responsibility of CSPs, so the seller is indeed liable for all taxes, plus penalties and interest.

Moreover, the SSTP Governing Board is using the *Wayfair* Decision to trigger renegotiation of their contract to pay CSPs for providing services to businesses.[9] Unless Congress imposes a requirement on states, businesses could suddenly find themselves bearing all the costs of using software and service providers.

To remedy the Court’s flawed assumption that SSTP will maintain simplification standards and shield sellers from audit risks, Congress can enact legislation that requires these minimum simplifications — before states can mandate tax collection by sellers who lack a physical presence in their state:

Simplification	Explanation
1. Tax rates	A single tax rate for remote sales – no greater than a weighted average of state and local rates.
2. Tax base	Uniform definitions of taxable products, services, and exemptions.
3. Caps & thresholds	No caps or thresholds on taxable value of goods or services
4. Transaction terms	Uniform definitions of sales price, delivery charges, etc.
5. Refunds and discounts	Uniform rules for refunds, returns, discounts, and coupons.
6. Returns and tax remittance	Uniform return and electronic remittance form.
7. Rounding and bad debts	Uniform rule for rounding and for treatment of bad debts.
8. Tax holidays	Uniform dates and rules for sales tax holidays.
9. Exempt and direct-pay rules	A single Exempt Purchaser Certificate
10. Audit of sellers	Single audit on behalf of all participating states at option of seller.
11. No pay-to-play condition on appeal of tax assessments	Appeals of assessments through state court system without requiring prior payment of assessed amount.
12. Voluntary, non-binding, independent mediation	At taxpayer’s option, a non-binding independent ADR “evaluative mediation” of taxpayer protest.
13. Definition of “physical presence”	Precise definition of “physical presence” to avoid disputes over who is a remote seller and what constitutes a remote sale.

[8] Avalara Tax Codes Toolkit, at https://help.avalara.com/@api/deki/files/1675/AvaTaxTaxCodeToolkit.zip?revision=53

[9] Craig Johnson, Executive Director Streamlined Sales Tax Governing Board, *CSP Contract Issues* (July 19, 2018), *available at* http://www.streamlinedsalestax.org/uploads/downloads/Presentations/SST%20CSP%20Contracts%20by%20SST%20July%2019%202018.pdf.

Simplification	Explanation
14. Protection from retroactive taxation	No imposition of back-taxes on a remote seller who lacked the federal statutory definition of "physical presence."
15. Certification of participating states	Annual certification by an independent federal agency of state compliance with simplification measures.
16. Preemption of state mandates on remote sellers	No state or local tax authority may impose sales tax, gross receipts tax, or tax reporting obligation on a seller lacking federal statutorily defined "physical presence" except as provided in the federal legislation.
17. Vendor compensation	Vendor discount reflecting true cost of tax collection and remittance. This is particularly important since SSTP states plan to renegotiate their contracts with Certified Service Providers (CSPs).
18. Judicial review	Federal district court exclusive jurisdiction over claims relating to non-compliance with simplification provisions of federal legislation.
19. Small Business Exception	A reasonable and permanent small business exception.
20. Customer who pay by mail order and check	Vendor protection from consumer error in computing sales tax.

As if Congress needed additional motivation to codify our previous physical presence standard, European governments have recently proposed a digital service tax on any American company who shows online advertisements to European citizens – even if the American company has no physical presence in that European country.

The Commerce Clause is just as necessary now as when the constitution was written. In the 18th century, individual states were impeding commerce among the states through regulatory and tax overreach. During the 1960s, some state tax collectors attempted to force out-of-state catalog retailers to collect in-state sales taxes. In response the U.S. Supreme Court, relying on the Commerce Clause, held that states cannot impose taxes on out-of-state businesses "whose only connection with customers in the State is by common carrier or the United States mail."[10]

In 1992, the Supreme Court revisited the issue of remote taxation, this time in the case of an office products catalog seller, Quill.[11] In *Quill*, the Supreme Court was <u>not</u> moved by the state's argument that computer technology created the necessary simplification. While

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[10] *Nat'l Bellas Hess, Inc.* v. *Dept. of Rev. of Ill.,* 386 U. S. 753, 758 (1967).

[11] *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

acknowledging the lower court's finding that advances in computer technology had eased the burdens of tax collection, the Court still found the requirement of tax collection unduly burdensome.[12] Observing the patchwork of rates and rules for several thousand sales tax jurisdictions, the Court again held that requiring out-of-state companies to pay sales taxes would place an unreasonable burden on interstate commerce. [13]

Quill protected local businesses with websites or catalogs from overbearing tax compliance burdens imposed by scores of foreign states where the business had no physical presence. At the same time, it required every business, large or small, to collect and pay sales tax in the same way in every state where the business had an actual physical presence.

Fundamental fairness dictates that those who would bear the tax, regulatory, and compliance burdens of a state should have the right to protest against unfairness in the imposition of those burdens. Citizens of a state have such recourse against their government, but out-of-state businesses normally do not.

By restoring the physical presence rule of *Quill*, Congress will be enforcing the Commerce Clause for the benefit of the entire national market. The benefits of this will extend to every consumer in the nation.

Congressional action is urgently needed to restore the bright-line physical presence test – unless states conform with minimum simplifications necessary to protect interstate commerce.

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[12] *Id.* at 313.

[13] Moreover, *Quill* was not concerned with "fairness" to individual tax collecting states, as some have argued, but with the burden on interstate commerce that results from multiple tax collection and compliance burdens. "[T]he Commerce Clause and its nexus requirement," the Court said, "are informed not so much by concerns about fairness for the individual [state] as by structural concerns about the effects of state regulation on the national economy."

Appendix to NetChoice Statement

Statement of former Congressman Christopher Cox, outside counsel for NetChoice, regarding the Internet Tax Freedom Act (ITFA)

Our national experience with the Internet Tax Freedom Act (ITFA) is instructive as Congress considers what to do in the wake of *Wayfair*. Twenty years ago, Congress recognized that commerce over the Internet is uniquely interstate, and that its fundamental purpose would be disrupted if every state and local jurisdiction could take a bite out of it. The decentralized, packet-switched architecture of the Internet, now as then, makes it uniquely susceptible to multiple and discriminatory taxation across a confusing patchwork of thousands of state and local taxing jurisdictions. That is why federal law in the form of the ITFA prohibits U.S. state and local governments from imposing "discriminatory" taxes on online activity.

The ITFA categorizes taxes targeted specifically to the Internet itself or to online commerce as "discriminatory." Discriminatory taxes are outlawed by the ITFA. This has been true throughout the two decades that the law has been in effect. (While it was originally enacted as a limited-time moratorium on discriminatory taxation of electronic commerce, the law was subsequently extended on multiple occasions by Congress, and in February 2016 became permanent.) The original ITFA and the permanent version are identical as concerns the prohibition on discriminatory taxes.

In particular, the ITFA has always prohibited any state or political subdivision from imposing "discriminatory taxes on electronic commerce." ITFA Sec. 1101(a)(2). The prohibition applies to "any tax imposed by a State or political subdivision thereof on electronic commerce." A tax is banned if it "imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means" than via the Internet. ITFA, Sec. 1105(2)(iii). This provision of the law is plainly aimed at preventing states from establishing unique tax rules for Internet transactions.

Yet this is precisely what several states are now doing. In Alabama, South Dakota, Ohio, Massachusetts, Hawaii, South Carolina, Minnesota, and other states, e-commerce is being singled out for unique obligations to remit sales taxes.

At the time Congress was developing the ITFA, the State of Texas was claiming that because email and other messages were being routed through computer servers in that state, this activity met the physical presence test in *Quill*. On July 11, 1997, at a House Subcommittee on Telecommunications hearing on ITFA, Texas tax director Wade Anderson argued that if the web page of an out-of-state company were present on a server in Texas, this would establish tax presence. (A short time later, Texas abandoned the idea of using the location of the server to create nexus for an out-of-state vendor not otherwise physically present in the state.)

It was in direct response to such sweeping assertions of state jurisdiction over out-of-state activity and persons that ITFA gained so much support in Congress.

It is therefore remarkable now to see other states, 20 years after ITFA became law, making the same types of arguments that Texas did back then. Claims that cookies, software "apps," and server files should constitute nexus were explicitly considered and affirmatively rejected by Congress in the ITFA. This is now and has been for years the law of the land.

The legislative intent of the ITFA was made very plain at the time. As the representative from the Energy & Commerce Committee, and in lieu of committee reports from the Judiciary and Energy & Commerce Committees (the two legislative committees that considered the bill in the House), I prepared a statement of author's intent which was published in the Congressional Record at 144 Cong. Rec. E1288-03 (June 23, 1998) ("Statement of Author's Intent"). No contrary statement of intent was ever made to my knowledge by any co-sponsor or supporter of the ITFA in either the House or Senate, either at the time of its original passage or on the several occasions of its subsequent extensions and ultimate permanent enactment.

As made clear in the Statement of Author's Intent, the prohibition on discriminatory taxes on electronic commerce in the ITFA is specifically "intended to prohibit States and localities from using Internet-based contacts as a factor in determining whether an out-of-State business has 'substantial nexus' with a taxing jurisdiction."

A specific example provided in the Statement of Author's Intent concerns a state's attempt to discriminate between Internet vendors, on the one hand, and catalog and direct mail sellers, on the other, for purposes of establishing nexus. ITFA intends to provide "certainty" that the rules of Quill's physical-presence test "will continue to apply to electronic commerce just as they apply to mail-order commerce, unless and until a future Congress decides to alter the current nexus requirements."

On this critical point, the Statement of Author's Intent could not be more clear. Citing the Texas position, it explains that the law is meant to expressly reject any theory of "substantial nexus" based on an Internet vendor's electronic contacts with another state, including customers in that state. I quote:

> [The non-discrimination provision] is a direct response to testimony from a State tax administrator [Wade Anderson of Texas], who offered his view to Congress at a July 1997 hearing that the *Quill* protections provided to remote sellers without a substantial in-State physical presence should not apply to businesses engaged in electronic commerce. During the hearing, the tax administrator acknowledged that if a resident of his State were to use the telephone to purchase a good from an out-of-State vendor, his State would not be permitted to impose its tax collection obligations on that vendor unless the vendor otherwise had a substantial in-State physical presence. The tax administrator further testified, however, that if instead the Internet were used to place the order, his State would attempt to require the out-of-State vendor to collect taxes. His rationale was that the flow of data over the Internet into his State, the "presence" of a web page on a computer server located in-State, [or] the supposed "agency" relationship between the remote seller and an in-State Internet access provider should be enough to give the remote seller a substantial physical presence in his State.
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> The Act rejects this approach. The promotion of electronic commerce requires faithful adherence to the U.S. Supreme Court's clear statement in *Quill* that a "bright-line" physical presence—not some malleable theory of electronic or economic presence—is required for a State to claim substantial nexus. Even without the Act, the courts, in light of *Quill*, are likely to view such arguments by State tax administrators with great skepticism. But the Act provides clarity and far greater certainty by specifically outlawing State or local efforts to pursue aggressive theories of nexus. This should result in decreased litigation which will benefit States, localities, taxpayers, and an often overworked court system.
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> [The ITFA] defines "Discriminatory tax" so as to make it clear that Congress considers the creation or maintaining of a site on the Internet to be so insignificant a physical presence that the use of an in-State computer server in this way by a remote seller shall never be considered in determining nexus. …

> [Even if an in-state service provider] provides these and other ancillary services (such as web page design or account processing) on an in-State computer server, the provider should not be considered an agent for purposes of taxation.

The explicit text of the ITFA outlaws a state's claim of nexus based on the presence of files on an in-state server not owned by the remote seller. Under the federal law, a tax is "discriminatory" and therefore prohibited if "the sole ability to access a site on a remote seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation." ITFA Section 1105(2)(B)(i). In other words, the use of an in-state server *may not even be taken into consideration*.

By specifying uniquely Internet-related factors as the very criteria upon which the Massachusetts sales tax collection and reporting obligations are based, Directive 17-1 has made itself a prime example of what the ITFA was meant to prohibit. As does the Ohio approach, its enunciation of aspects unique to Internet commerce such as cookies, apps, CDNs, and online marketplaces offends the plain terms of the ITFA. The express intent of the ITFA is that "electronic presence" or "economic presence" is not a sufficient basis to require an Internet vendor to submit to a state's taxing regime.

The issues here are purely commercial, where the rules require certainly and clarity. Sowing chaos through extralegal and extraterritorial regulation and taxation of commerce among the states is harmful to the U.S. national market that this Congress is vouchsafed to protect.