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HOW STATE REGULATORY OVERREACH UNDERMINES FEDERALISM, IMPEDES ECONOMIC GROWTH, AND RESULTS IN RAMPANT BUREAUCRATIZATION TO THE DETRIMENT OF AMERICAN BUSINESSES AND CONSUMERS

Chairman Marino and Members of the Committee, thank you for the opportunity to submit written testimony on this important issue. I am an attorney with a nationwide practice representing catalog companies and electronic merchants in regard to state tax matters for over 35 years. I have testified in the past before both the House Judiciary Committee and the Senate Finance Committee on bills relating to sales/use tax collection by remote sellers.

I am tax counsel to the Data & Marketing Association and successfully represented the DMA before the United States Supreme Court (*DMA v. Brohl*) and have appeared in federal and state courts throughout the country on behalf of catalog companies and electronic merchants. I am also counsel to the American Catalog Mailers Association and NetChoice. In 2011 and 2013, *State Tax Notes* selected me as one of the "top 10 individuals who influenced tax policy and practices," and in 2016, it recognized me as its "Person of the Year."

I teach courses on Constitutional Law at Bowdoin College and speak frequently before business groups and trade associations regarding taxation of interstate transactions and electronic commerce. I am a co–author of "Eyes on eCom

Law," a blog that reports on legal developments of interest to catalog companies and online sellers and am the author of numerous articles regarding the scope and application of the Constitution's Commerce Clause.

The Greek mathematician, Archimedes, is quoted as saying:

> *"Give me a lever long enough and a fulcrum on which to place it, and I shall move the world."*

The contemporary analogue is the effort by state legislatures to leverage the consumer market in their states to extend the state's regulatory reach beyond its borders and impose obligations on companies located in other states. It is one thing for a state to assure that products entering the state do not pose a health or safety risk to that state's residents. It is quite another thing for a state to take the position that if a company accepts orders via a website and subsequently delivers product to consumers throughout the United States by means of the Postal Service, UPS or FedEx, then that business must conform its conduct to the dictates of each state in which it has customers, even though the company has no facilities or employees in the state. Such regulatory requirements may range from waste disposal, to treatment of farm animals, to environmental standards, to employment practices, to contemporary social mores, to taxation.

Warning flags should go up not only over current instances of "beyond-borders" regulation, but also in regard to the likely extension of this dangerous practice to new areas, if the current trend of regulatory overreach continues. For example, as part of its global warming initiative, California now regulates in-state ethanol sales based on the manner in which the ethanol was produced and distributed in other states. In a similar fashion, to advance its policy regarding the humane treatment of animals, California prohibits the sale of eggs produced out-of-state by chickens kept in cages smaller than that prescribed by California law. The Wisconsin legislature enacted a waste disposal law that prohibited the use of Wisconsin landfills by non-Wisconsin companies unless out-of-state municipalities adopted Wisconsin's recycling standards. The result was that all businesses in those non-Wisconsin communities would be required to adhere to the Wisconsin standards whether or not they had any contact with Wisconsin.

The current uncertain state of the law regarding restrictions on the extra-territorial reach of state regulatory authority could easily result in state legislatures prohibiting the entry of goods into their states unless:

- a manufacturer conforms to the destination-state's carbon emission standards;
- an oil company complies with fracking restrictions in connection with the extraction of natural gas that is ultimately transported and sold within the state;
- a corporation pays a "living wage" to all of its employees involved in the production and distribution of products sold within the state;
- a retailer selling goods over the internet employs a minimum percentage of minorities and women in managerial positions.

The apparent theory, weak as it may be, underlying such an ever-expanding extension of state regulatory authority is that the state is granting a "privilege" to an out-of-state company to sell its products to the state's captive consumer population; and, therefore, the state can condition that privilege, as it deems proper, to advance its policy agenda. The problem is that such an expansion of state regulation beyond state borders dangerously undermines the federal structure of our government and the free flow of commerce guaranteed by the Constitution.

Federalism, which is the division of sovereignty between the state and federal governments, is the cornerstone principle of the United States Constitution. Within their borders, states are sovereign. As a general rule, they can regulate and tax their inhabitants as they choose, including corporations located within their jurisdiction. What prevents (or at least constrains) state legislatures abusing their regulatory and taxing authority is the democratic process. Citizens, and the companies that employ them, are usually an effective check on legislative excesses. Tax too much, or regulate beyond reason, and those who are unfairly taxed and regulated will rise in democratic opposition. That is the genius of the American system of "no taxation [or regulation] without representation."

So, for example, New York State is free to impose whatever regulations it may choose on companies operating within its borders, be they environmental, financial, labor-related, etc., so long as they are not preempted by federal legislation and do not constitute a violation of constitutionally protected liberties (e.g., freedom of speech, religion or equal protection). However, the New York legislature has absolutely no regulatory authority over companies in neighboring New Jersey and Connecticut, or, for that matter, in New Mexico or Arizona. Those companies have no political influence over New York legislators, and out-of-state businesses are vulnerable to regulatory schemes that prejudice them. If, in fact, there are regulatory regimes that require national scope, it is the business of Congress – not individual state legislatures – to adopt those measures, relying upon the federal legislature's sensitivity and expertise regarding the health of the overall economy and the commercial interests to be affected. Indeed, the Commerce Clause (Art. 1, §8, cl. 3) assures that it is Congress alone that has the power to regulate interstate commerce.

The Commerce Clause, appearing in the very first article of the Constitution, was no mere afterthought by the Framers. It was intended to remedy the acute problem of individual states under the Articles of Confederation restricting trade by imposing duties, tariffs, taxes, and restraints on commerce originating from other states. The resounding success of the Commerce Clause in creating a free trade zone among the former colonies produced the largest and most dynamic economic engine in the history of the world. State regulatory overreach, however, is now creating a crazy-quilt of confusing and conflicting requirements that threaten to cripple investment and innovation in the 21st Century American economy.

When states regulate beyond their borders, they usurp the regulatory authority of the states where companies, farmers, and individual entrepreneurs are actually located and engaged in business. The doctrine of federalism enshrined in the Constitution was intended not only to protect state sovereignty from encroachment by the federal government, but also to protect the sovereign rights of states from trespass by other states. The notion that sovereignty stops at the state border, but is supreme within state boundaries, is in the interest of state rights

Moreover, the danger associated with overreaching state regulation is not limited to its corrosive impact on the foundational principles of federalism and a single national market, it also causes gross confusion and excessive bureaucracy. Should national commerce be subject to regulation by fifty different legislatures, each with its own political dynamics and predilections?

The area of state taxation is a prime illustration of the problems associated with cross-border regulation. There are few undertakings of government that are more complex, confusing, and contentious than state taxes. The political process has been the primary check on what is an acceptable burden to the individuals and companies that are subject to the obligations of state tax laws. When states "export" their tax systems across their borders, however, the out-of-state parties that are directly affected have no voice – and certainly no vote – in restraining the appetite of state legislatures to impose obligations on persons and organizations that have no political ability to resist such measures.

A good example of this phenomenon is the recent spate of state statutes requiring out-of-state retailers (not their in-state competitors) to turn over to a state agency sensitive sales transaction information, including details regarding customers' purchasing history. This is not only an invasion of privacy (e.g., to which political journals does the customer subscribe and what kind of intimate apparel did a customer purchase and to whom was it delivered); but, moreover, the remote seller has no input into such harsh (and business-damaging) legislation. In other words, the parties most affected by the state legislation have no role in its adoption. This is blatant “regulation without representation.”

The confusion and complexity caused by cross-border overreach assumes enormous proportions in regard to state taxes. In-state companies must comply with only one state tax system. It may not be easy, but it’s manageable. A small company selling over the Internet, however, could find itself forced to confront the diverse requirements of 50 different state tax systems. Indeed, in the sales tax arena, the problem is even worse. There are over 12,000 state and local sales tax jurisdictions in the United States, with varying rates, tax bases, filing requirements, etc. Should the decision of an entrepreneur to engage in interstate commerce – an activity protected by the U.S. Constitution - subject that individual or company to 12,000 different tax regimes?

This cross-border overreach has serious adverse implications for the U.S. economy. Compare our transaction tax system, for example, to that of the European Union.

Among the EU’s 28 member states (soon to be 27 following Brexit), the European Commission has recognized that the disparate tax regimes “*may involve up to 28 different tax administrations auditing the same companies without any coordination*,” and that the current system imposes a significant risk of “*disproportionate administrative burdens on businesses*.” The Commission found that the complicated VAT system deters companies— particularly small businesses and new market entrants—from engaging in cross-border e-commerce. To address this problem, the European Commission has proposed to establish a "digital single market" by removing barriers to cross-border online sales. The Commission proposed a one-stop-shop for tax administration to reduce costs and administrative burdens. [1]

Compare the adverse impact on EU commerce resulting from 28 different tax regimes (with only 75 different VAT rates) to the impact in this country of 50 states that would like to impose their widely divergent sales taxes, corporate income taxes, gross receipts taxes, franchise taxes, and excise taxes on businesses located far beyond their borders - with no physical or political presence in the taxing state - not to mention the over 12,000 local tax jurisdictions, each of which would similarly like to impose its tax obligations on non-resident companies.

Take sales taxes for example. The attached color-coded map of the United States, which I prepared with the assistance of others in my office, depicts the gravity of the problem of states independently attempting to extend the regulatory reach of their tax systems. These laws – all of which are directed exclusively at companies with no stores, facilities or employees in the taxing state – are not only grossly overreaching, but also widely discrepant. Such laws are based on insubstantial jurisdictional tripwires; for example - selling as little as $10,000 worth of goods to consumers in the taxing state; using "cookies" in connection with Internet sales; receiving customer referrals from an unrelated party; or advertising

[1] *See* European Commission, "A Digital Single Market Strategy for Europe," Communication From the Commission to the European Parliament, the European Council, the European Economic and Social Committee, and the Committee of the Regions, COM(2015) 192final (May 6, 2015), available at http://bit.ly/1clD1tZ.

products on a marketplace website that is not even located in the taxing state. In other words, states have resorted to the thinnest of threads, and the most attenuated of legal theories, to assert such extraterritorial jurisdiction.

Unfortunately, the state of the law regarding “extraterritoriality” is ambiguous, at best, and Supreme Court precedent provides little clarity on the subject. Consequently, lower courts have not settled upon any consistent and uniform standard to limit state efforts to control the conduct of companies located beyond their boundaries. It is, therefore, appropriate for Congress, under its constitutional power "[t]o regulate Commerce ... among the several States” (Art. 1, §8, cl.3), to protect the national economy from regulatory Balkanization and to reinforce the structure and integrity of our federal system of government.

Over-Reaching Sales Tax Jurisdiction Laws And Regulations