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SFA BILL ANALYSIS

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Senate Bill 433 (Substitute S-4 as passed by the Senate)
Sponsor: Senator Joanne G. Emmons
Committee: Finance

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RATIONALE

The growing use of the Internet by individuals to make purchases has heightened states' awareness of potential tax revenue losses. Forty-five states and the District of Columbia levy sales tax on nonexempt purchases made within their jurisdictions. Traditionally, states have required sellers (retailers) to collect sales tax on taxable sales and remit the tax to the states for transactions within an individual state's borders. States have been less successful in establishing an effective method to collect use tax. Each state that has a sales tax also has a similar use tax, which requires buyers who use, consume, or store items in-state that were purchased out-of-state to pay the tax. Historically, voluntary compliance with the use tax has been extremely low because individuals are unaware that the tax exists or they ignore it. Further complicating the matter, attempts by various states to require a remote seller (a business outside a state's borders) to collect and remit use tax on merchandise sold to a state's residents have been restricted since 1967 by two key U.S. Supreme Court decisions (described in **BACKGROUND**). This means that the states generally have to rely on the voluntary compliance of remote sellers or their residents to remit the tax.

For many years, the inability of states to collect use tax was troublesome, though not critical to state budgets. In recent years, however, the growth of transactions made over the Internet has substantially increased the incidence of remote sales, and a further increase in remote sales via the Internet is widely considered likely. In order to develop a state-based solution to this problem, in 2000 over 25 states joined the Streamlined Sales Tax Project developed by the National Conference of State Legislatures (NCSL) in conjunction with state governors, tax administrators, and legislators. The mission of the project is to develop and implement a uniform simplified sales and use tax system that would encourage voluntary participation by remote sellers, and thus increase use tax compliance. The simplified system would be implemented through a multistate agreement developed by the project. While Michigan has had representation at meetings of the project, to participate in development of the agreement a state must become a "participating state", that is, commit itself to participate in the project. It has been suggested that Michigan do this through legislation.

CONTENT

The bill would create the "Streamlined Sales and Use Tax Administration Act" to do the following:

- **-- Allow the State to enter into a multistate streamlined sales and use tax agreement.**
- **-- Create a board of governance that could represent this State in meeting with other states that were authorized by statute to enter into the agreement.**
- **-- Provide for the registration of sellers, who would have to select a method for the collection and remittance of sales and use taxes.**
- **-- Allow sellers to contract with certified service providers for the collection and remittance of taxes; and establish qualifications for certification as a service provider.**
- **-- Provide for the use of an automated system that would calculate each jurisdiction's tax on a transaction; and establish requirements for certification of an automated system.**

-- Limit the liability of a seller for taxes on transactions made before the seller's registration.
-- Provide for consumer privacy.

The bill would repeal the proposed Act effective December 31, 2002.

Agreement Requirements and Components

The bill would require the Department of Treasury, with the approval of the board of governance, to enter into the streamlined sales and use tax agreement with one or more states, "...to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance for all sellers and for all types of commerce". The Department could not enter into the agreement until legislation that substantially complied with the requirements of the agreement was enacted. The Department also could not enter into the agreement unless it required each signatory state (a state that had entered into the agreement) to abide by the following requirements.

The agreement would have to do the following:

-- Set restrictions to achieve more uniform state rates through limiting the number of state rates; eliminating caps on the amount of state tax due on a transaction; and eliminating thresholds on the application of state tax.
-- Establish uniform standards for the sourcing of transactions to taxing jurisdictions; the administration of exempt sales; the allowances a seller could take for bad debts; and sales and use tax returns and remittances.
-- Require signatory states to develop and adopt uniform definitions of sales and use tax terms. The definitions would have to enable a signatory state to preserve its ability to make policy choices that were substantially consistent with the uniform definitions.
-- Provide a central electronic registration system that allowed a seller to register to collect and remit sales and use taxes for all signatory states.
-- Provide that registration with the central registration system and the collection of sales and use taxes in the signatory states would not be used as a factor in determining whether the seller had nexus with a state for any tax.
-- Outline any monetary allowances to be provided by the signatory states to sellers or certified service providers (described below).
-- Require each signatory state to certify compliance with the terms of the agreement before joining, and to maintain compliance under the laws of the member state with all provisions of the agreement while a member.
-- Require each signatory state to adopt a uniform policy for certified service providers that protected the privacy of consumers and maintained the confidentiality of tax information.
-- Provide for the appointment of an advisory council of private sector representatives and an advisory council of nonmember state representatives to consult with the signatory states in the administration of the agreement.

Further, the agreement would have to provide for reduction of the burdens of complying with local sales and use taxes through the following:

-- Restricting and eliminating variances between each signatory state's tax base and the local tax bases within that state.
-- Requiring signatory states to administer any sales and use taxes levied by local jurisdictions within those states so that sellers collecting and remitting the taxes would not have to register or file returns with, remit funds to, or be subject to independent audits from local taxing jurisdictions.
-- Restricting the frequency of changes in local sales and use tax rates, and setting effective dates for the application of local jurisdictional boundary changes to local sales and use taxes.
-- Providing notice of changes in local sales and use tax rates, and of changes in the boundaries of local taxing jurisdictions.

Board of Governance/Department of Treasury

The bill would create a board of governance to represent this State in all meetings that were limited to only those states that also were authorized by statute to enter into a streamlined sales and use tax agreement. The board could vote on behalf of the State and represent the State's position in all matters related to the adoption or amendment of the agreement.

The board would have to recommend to the committees responsible for reviewing tax issues in the Senate and the House of Representatives, each year, what State statutes were required to be amended to be substantially in compliance with the agreement.

The board would consist of one member appointed by the Senate Majority Leader, one member appointed by the Speaker of the House of Representatives, the State Treasurer or his or her designee, and one member appointed by the Governor.

Further, the bill would create a business advisory council to advise and make recommendations to the board. The council would consist of six members: two who were retail sellers domiciled in Michigan appointed by the Governor; two who were large national retail sellers domiciled outside the State (licensed to do business in Michigan) appointed by the Governor; and one retail seller and one manufacturer domiciled in the State appointed by the other four members.

The Department could act jointly with other signatory states to establish standards for certification of a "certified service provider" and "certified automated system" and to establish performance standards for multistate sellers. (A "certified service provider" would be an agent certified jointly by signatories to perform all of a seller's sales and use tax functions, other than the seller's obligation to remit tax on its own purchases. A "certified automated system" would be computer software certified jointly by the signatories to calculate the tax imposed by each jurisdiction on a transaction, determine the amount of tax to remit to the appropriate state, and maintain a record of the transaction.)

The Department also could take other actions reasonably required to implement the bill, including promulgation of rules, and the joint procurement of goods and services with other signatories in furtherance of the agreement.

<u>Seller Registration/Collection Models</u>

A person could participate under the bill only by registering in the central registration system provided for by the agreement. The Department would have to participate in an online registration system with other signatory states that allowed sellers to register online. (A "person" would be an individual, trust, estate, fiduciary, partnership, limited liability company, limited liability partnership, corporation, or any other legal entity. A "seller" would be any person who sold, leased, or rented tangible personal property or services to another person.)

A seller registered under the agreement in Michigan would be considered registered in each of the signatory states, and a seller registered under the agreement in any other signatory state would be considered registered in Michigan. A seller could choose to register directly with other signatory states. A seller could cancel its registration under the agreement at any time, according to the agreement. A seller that canceled its registration, however, would remain liable for remitting taxes collected to the appropriate states. By registering, a seller would agree to collect and remit sales and use taxes according to the agreement for taxable sales in all signatory states, including states that adopted the agreement after the seller registered.

The bill specifies that registration of a person under the agreement and collection of sales and use taxes by that person in signatory states would not provide nexus with any signatory state, and could not be used as a factor in determining nexus with a signatory state for any tax purpose.

A registered seller would have to agree to one of the following models for purposes of collecting and remitting sales and use taxes under the agreement:

-- Model 1. A seller that had contracted with a certified service provider to act as its agent to perform all of the seller's sales and use tax collection functions, other than the seller's obligation to remit sales or use tax on its own purchases.
-- Model 2. A seller that had selected a certified automated system to perform part of the seller's sales and use tax collection functions, but retained responsibility for remitting the tax.
-- Model 3. A seller that had sales in at least five signatory states, had total annual sales of $500 million or more, had a proprietary system that calculated the amount of tax due in each taxing jurisdiction, and had

entered into a performance agreement with the signatory states establishing a tax performance standard for the seller. (In model 3, a seller would include an affiliated group of sellers using the same proprietary system.)

In computing the amount of tax remitted to this State, a certified service provider under model 1 and a seller under model 2 could deduct a base rate that applied to taxable transactions processed through the certified automated system of the provider under model 1 or of the seller under model 2, in accordance with the terms of the contract entered into by the signatory states. A seller that took this deduction could not take a deduction under Section 4 of the General Sales Tax Act (which provides for a collection allowance, that is, allows a seller to deduct and keep a percentage of sales taxes collected from purchasers). A seller under model 3 could take only the deduction allowed under Section 4.

In addition to the deduction allowed under the bill, for up to 24 months following a voluntary seller's registration, the voluntary seller also could deduct a percentage of tax generated in Michigan by the voluntary seller in accordance with the terms of the contract entered into by the signatories. (As used in this provision, "voluntary seller" would mean a seller that was not required to register to collect tax for this State.)

Liability Limitations

The bill provides that a person who registered as a seller would not be liable for any uncollected or nonremitted sales or use tax on transactions with purchasers in Michigan before the date of registration, if the seller were not licensed under the General Sales Tax Act or the Use Tax Act in the 12-month period preceding the date the State entered into the agreement. The seller also would not be responsible for any penalty or interest that could be due on those transactions. These provisions would not apply to the following:

-- Any tax liability of the registered seller for transactions that were subject to sales or use tax in Michigan in which the registered seller was the purchaser.
-- Any sales or use taxes already paid or remitted to the State.
-- Any transactions for which the seller received notice of the commencement of an audit that was not finally resolved, including related administrative or judicial processes.

The liability limitations would apply to a seller absent the seller's fraud or intentional misrepresentation of a material fact if the seller continued to be registered and continued collection and remittance of applicable sales and use taxes in Michigan for at least 36 months. The statute of limitations applicable to assessing a tax liability would be tolled during that time.

Certified Service Provider/Automated System

The bill specifies that a certified service provider would be the agent of a seller, with which the provider had contracted for the collection and remittance of sales and use taxes. As the seller's agent, the provider would be liable for sales and use tax due each signatory state on all sales transactions it processed for the seller, except as provided in the bill. A seller that contracted with a provider would not be liable to this State for sales or use tax due on transactions processed by the provider, unless the seller made a material misrepresentation of the type of items it sold, or committed fraud. In the absence of probable cause to believe that the seller had committed fraud or made a material misrepresentation, the seller would not be subject to audit on the transactions processed by the provider. A seller would be subject to audit for transactions not processed by the provider. The signatory states acting jointly could perform a system check of the seller and review the seller's procedures to determine if the provider's system was functioning properly, and the extent to which the seller's transactions were being processed by the provider.

The Department, acting jointly with the signatory states, could certify a person as a certified service provider if the person met all of the following requirements:

-- Used a certified automated system.
-- Integrated its certified automated system with the system of a seller for which the person collected tax, so that the tax due on a sale was determined at the time of the sale.

-- Agreed to remit the taxes it collected at the time and in the manner specified by the signatory states.
-- Agreed to file returns on behalf of the sellers for which it collected tax.
-- Agreed to protect the privacy of tax information it obtained.
-- Entered into a contract with the signatory states and agreed to comply with the terms of the contract.

The Department, acting jointly with the signatory states, could certify a software program as a certified automated system if the signatory states determined that the program met all of the following requirements:

-- It identified the applicable state and local sales and use tax rate for a transaction based on the uniform sourcing provision established under the agreement.
-- It identified whether an item was exempt from tax.
-- It identified the amount of tax to be remitted for each taxpayer for a reporting period.
-- It could generate reports and returns as required by the signatory states.
-- It could meet any other requirement set by the signatory states.

The Department, acting jointly with the signatory states, could establish one or more sales tax performance standards for multistate sellers that met the eligibility criteria set by the signatory states and that had developed a proprietary system, to determine the amount of sales and use tax due on transactions.

A person that provided a certified automated system would be responsible for the proper functioning of that system, and would be liable to this State for underpayments of tax attributable to errors in the functioning of the system. A seller that used a system would remain responsible and liable to the State for reporting and remitting tax.

A seller that had a proprietary system for determining the amount of tax due on transactions and had signed an agreement establishing a performance standard for that system would be liable for the failure of the system to meet the performance standard.

Consumer Privacy

A certified service provider would be prohibited from retaining or disclosing a consumer's "personally identifiable information", that is, information that identified a specific person. A provider's system would have to be designed and tested to assure the privacy of consumers by protecting their anonymity.

A provider would have to give clear and conspicuous notice of its information practices to consumers, including what information it collected, how it collected the information, how it used the information, and whether it disclosed the information to signatory states. A provider also would have to provide the necessary technical, physical, and administrative safeguards to protect personally identifiable information from unauthorized access and disclosure.

A provider's retention or disclosure to signatory states of personally identifiable information would be limited to exemption claims because of a consumer's status or intended use of the goods or services purchased, to investigations of fraud, and to the extent necessary to ensure the reliability of the provider's technology. If personally identifiable information were retained for these purposes in the absence of exigent circumstances, persons would have to be given reasonable notification of that retention and afforded reasonable access to their own data, with a right to correct inaccurately recorded data.

The bill specifies that this privacy policy would be subject to enforcement by signatory states' attorneys general or other appropriate authorities.

The agreement would not enlarge or limit the signatory states' authority to do any of the following:

-- Conduct audits or other review as provided under the agreement and state law.
-- Provide records pursuant to a signatory state's freedom of information act, disclosure laws with governmental agencies, or other regulations.
-- Prevent, consistent with state law, disclosures of confidential taxpayer information.

-- Prevent, consistent with Federal law, disclosures or misuse of Federal return information obtained under a disclosure agreement with the Internal Revenue Service.
-- Collect, disclose, disseminate, or otherwise use anonymous data for governmental purposes.

Other Provisions

The bill specifies that payment, collection, and remittance of the sales and use tax under the bill would be subject to the provisions of the General Sales Tax Act and the Use Tax Act. Further, the bill contains the following statement:

> Noting in this act shall be construed to expand the tax base of the sales tax or use tax or to eliminate exemptions, but rather, this act simplifies and modernizes the sales tax and use tax administration in order to substantially reduce the burden of tax compliance for all sellers and for all types of commerce.

The bill specifies that the agreement authorized by it would bind and inure only to the benefit of this State and the other signatory states. No person, other than a signatory state, would be an intended beneficiary of the agreement. Any benefit to a person other than a signatory state would be established by the law of this State and the other signatory states and not by the terms of the agreement.

The bill provides that a person would not have any cause of action or defense under the agreement because of the State's approval of the agreement. A person could not challenge, in any action brought under any provision of law, any action or inaction by any department, agency, or other instrumentality of the State or any political subdivision of the State, on the ground that the action or inaction was inconsistent with the agreement. A seller registered under the agreement would have all the rights and remedies provided to taxpayers under the revenue Act. (That Act created the Revenue Division in the Department of Treasury and prescribes its powers and duties as the revenue collecting agency of the State.)

The bill also specifies that a law of this State, or the application of a law, could not be declared invalid as to any person or circumstance on the ground that the provision or application was inconsistent with the agreement. No provision of the agreement authorized by the bill in whole or in part would invalidate or amend any provision of State law; adoption of the agreement by the State would not modify or amend any State law.

The bill provides that implementation of any condition of the agreement in the State, regardless of when implemented, would have to be by an action of the State.

BACKGROUND

In 1967, the U.S. Supreme Court ruled that an Illinois statute that required an out-of-state mail-order business to collect and pay use tax on goods purchased for use in Illinois violated the Due Process Clause of the U.S. Constitution and created an unconstitutional burden on interstate commerce (*National Bellas Hess, Inc*. v *Department of Revenue of Ill*., 386 U.S. 753).

In a subsequent use tax collection case, North Dakota filed an action in state court to require an out-of-state mail-order house to collect and pay use tax on goods purchased from it for use in North Dakota. The case eventually went to the U.S. Supreme Court, which affirmed its earlier ruling in *Bellas Hess*; held that to collect sales or use tax a business must have a physical presence (nexus) in the state; and found that Congress could legislate a solution because it had the constitutional authority to regulate commerce among the states (*Quill Corp*. v *Heitkemp*, 504 U.S. 298 (1992)).

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

There is concern among many of the 45 states (and the District of Columbia) that levy sales and use tax that the ever-increasing volume of purchases over the Internet and by mail order is seriously eroding sales and use tax revenue, and that this erosion will grow dramatically over time. Documents from the NCSL state

that business-to-consumer electronic-commerce sales amounted to $3 billion in 1997 and $45 billion in 2000, and are projected to total $140 billion by 2003. A widely reported study by the National Tax Association and the University of Tennessee projects that the 45 states with sales tax will forgo over $10 billion in uncollected tax on "e-commerce" transactions in 2003. In states that rely heavily on sales and use tax revenue, the combination of increased remote sales and a continuing inability to tax those sales presents a threat to those states' budgets. In Michigan, approximately 35% of total State tax revenue is from sales and use taxes, and 73% of sales tax revenue is dedicated to the State School Aid Fund.

Many states, including Michigan, that wish to address this problem have joined together to attempt to develop a simplified sales and use tax levy and collection system that would be fair to remote sellers, customers, and the states. For over a year work has progressed through the Streamlined Sales Tax Project to develop a multistate agreement. The bill would allow Michigan officially to join the project as a participating state, in order to be represented and have input during development of the agreement.

Supporting Argument

Because of the U.S. Supreme Court decisions regarding the use tax, states have been prohibited from collecting the tax from remote sellers. This puts retailers in Michigan at a competitive disadvantage to remote sellers who offer similar products; that is, since a Michigan retailer must collect 6% of the sales price on a transaction, and a remote seller with no physical presence in the State does not, the remote seller has a pricing advantage if purchasers do not voluntarily pay the use tax. Over time, as more and greater remote sales take place, the brick-and-mortar retailers in Michigan will fall behind remote sellers who have no investment in the State other than the solicitation of customers. The bill would allow the State to work collectively with other states to facilitate the collection of use tax on remote sales, which if accomplished, would make imposition of the sales tax more equitable for in-State businesses.

Response: Although customers might avoid the sales tax by ordering merchandise on-line, the amount of unpaid tax is usually more than offset by shipping and handling costs, which serve to eliminate any competitive advantage that out-of-State retailers may have. Furthermore, retailers without any physical presence in Michigan should not have to collect tax for the State, because they do not benefit from Michigan government or infrastructure except for the roads used to deliver their packages--and their shippers already pay gas taxes and license fees. Also, Internet retailers, including those in Michigan, do pay taxes where they are based, directly in property and business taxes, and indirectly via income tax on employee earnings. Despite the loss of sales or use tax revenue, all states benefit from the prosperity brought by electronic commerce.

Opposing Argument

Article 9, Sections 1 and 2 of the State Constitution provide that, "The legislature shall impose taxes...sufficient to pay the expenses of state government", and "The power of taxation shall never be surrendered, suspended or contracted away". Under the bill, the board of governance could represent the State and vote on behalf of the State in all matters relating to a streamlined sales and use tax agreement. This would appear to usurp the power of the Legislature to tax.

Response: While the board would be authorized to represent the State with other states authorized by statute to enter into an agreement, it would not be able to alter Michigan law. The board would be required to recommend to the Legislature changes to State laws needed to attain compliance with the agreement, but the Legislature itself would be responsible for following or not following the recommendations. Further, the bill specifies that no provision of the agreement authorized by the bill would invalidate or amend any State law, and that adoption of the agreement by the State would not amend or modify any State law.

Opposing Argument

If a substantial number of states agree to and adopt a streamlined sales and use tax system, remote sellers would be expected to comply with a complicated array of hundreds of taxing jurisdictions across the country. While Michigan levies a simple, one-rate tax across the State, many states have allowed local units to impose sales tax, the levels of tax vary from one jurisdiction to the next, and tax exemptions in one state may not apply in

another. This would create a costly new burden for out-of-State retailers; in effect, it would impose on them a new tax. What is needed, instead of the agreement, is more and better enforcement of the existing use tax.

Response: The U.S. Supreme Court decisions effectively prevent the mandatory collection of use tax from remote sellers, and those decisions were based in large part on the reasoning that the current sales and use tax system, with its multiple jurisdictions, rates, and exemptions, created an undue burden on interstate commerce. The goal of the Streamlined Sales Tax Project is to reduce, not increase, these complications, so that compliance with the taxes imposed by the various states would be simple and uniform. Since it would be necessary for a seller to register voluntarily in order to collect and remit taxes according to the agreement, sellers would not be forced to meet burdensome requirements. Also, the bill would not cause the imposition of a new tax. States have had in place sales and use tax laws for many years, though they have been and continue to be unable to collect the vast majority of the revenue on remote sales. Projected increases in remote sales exacerbate the urgency for states to find a solution to the collection problem.

Opposing Argument

Although the bill itself would not change tax law in Michigan, it could lead the way to tax increases, if State law were revised to conform to the multistate agreement ultimately reached by participating states. For example, a model tax law could weaken Michigan's broad industrial processing exemption, which allows manufacturers to avoid paying taxes on materials at the beginning of the manufacturing process. In addition, it could be necessary to tax residential use of electricity, natural gas, and heating fuel at the standard 6% rate, rather than the 4% rate that now applies. Furthermore, the bill could open the door to the taxation of services, such as those of a doctor, plumber, or tailor, by including "a person to whom...a service is furnished" in the proposed definition of "purchaser", and including "any person who sells...services to another person" in the definition of "seller".

Response: The bill specifies that it could not be construed to expand the tax base of either the sales or the use tax or eliminate exemptions. Expansion of the sales tax to services could not occur unless the General Sales Tax Act were amended, and expansion of the use tax could not occur unless the Use Tax Act were amended. In the past, suggestions that either tax be extended to services have been consistently rejected.

Opposing Argument

Because of the enormous complications inherent in the sales tax systems across the country, it simply is not feasible that an interstate agreement could be reached to make these systems uniform and simple. Remote sellers will never be required to comply with sales and use tax requirements unless Congress adopts a nationwide solution that applies to all sellers. In fact, the Supreme Court in *Quill* stated that Congress has the power to resolve the issue.

Response: Congress could have dealt with the issue for many years, but has not. The states need to solve this problem, and attempting to enter into a common agreement that would ease the collection burden for states and sellers is a worthwhile endeavor.

Legislative Analyst: G. Towne

FISCAL IMPACT

The fiscal impact of this bill cannot be identified at this time. While the State currently is not collecting anywhere from $100 million to $300 million in sales and use taxes from taxable Internet and mail order transactions, this bill by itself would not solve this collection problem. This bill does, however, propose a major step toward possibly solving this problem. Under the bill, the State would be allowed to join a multistate compact whose intended purpose would be to simplify and streamline the sales and use taxes among the states and to develop a uniform collection process that would not be burdensome to businesses or consumers. The scope of this potential compact among the states, as outlined in the bill, could require Michigan eventually to make changes in its sales and use tax bases, particularly in regard to adopting uniform definitions of particular goods and services, which could have both positive and negative fiscal impacts. In addition, the State potentially would have to eliminate its current special reduction in the tax rate, from 6.0% to 4.0%, granted on residential use of electricity, natural gas, and

home heating fuels. Any additional sales and use tax revenue that this bill eventually would help collect primarily would benefit the School Aid Fund, local revenue sharing, and the General Fund/General Purpose budget. About 73% of the sales tax is earmarked to the School Aid Fund and most of the remaining sales tax revenue is distributed to local governments. The use tax is distributed to the School Aid Fund (33%) and the General Fund/General Purpose budget (67%).

The Department of Treasury would need to acquire the capacity for electronic acceptance of tax registration information and the electronic collection of sales and use taxes. The Department estimates this cost at $2 million. The first $1 million of this cost was included in the FY 2000-01 appropriation to the Department of Treasury. The remaining $1 million is requested in the appropriation for FY 2001-02.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.