Legislative Analysis

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COLLECT TAXES ON INTERNET SALES

Senate Bill 658 (S-3)
Sponsor: Sen. Jim Ananich

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Sponsor: Sen. Jim Ananich
House Committee: Tax Policy
Senate Committee: Economic Development

Complete to 12-17-14

A SUMMARY OF SENATE BILLS 658 & 659 AS PASSED BY THE SENATE 12-11-14

The bills address the topic of the taxation of remote sales, include sales that are attributable to e-commerce.

Senate Bill 658 (S-3) would amend the General Sales Tax Act (1933 PA 167) to put into statute several presumptions concerning when a person selling tangible personal property is "engaged in the business of making sales at retail" in Michigan.

Under the General Sales Tax Act, a tax is levied upon and collected from all persons "engaged in the business of making sales at retail," by which ownership of tangible personal property is transferred for consideration; the sales tax rate is six percent.

Senate Bill 659 (S-3) would make a complementary amendment to the Use Tax Act (1937 PA 64). Under the bill, a person selling tangible personal property would have to register with the Department of Treasury to collect the use tax, and would be personally liable for the tax, when the conditions of the presumptions are met.

The bills are essentially the same as the versions of House Bills 4202 and 4203 that are on Third Reading in the House of Representatives.

Related Person Presumption
Under the bills, a person who sells tangible personal property to a customer in Michigan (i.e., a "seller") would be presumed to be engaged in the business of making sales at retail in Michigan if the seller or a person, including an *affiliated person*, other than a common carrier acting as a common carrier, does any of the following in the state:

- Sells a similar line of products as the seller and does so under the same, or similar, business name as the seller.

- Uses its employees, agents, representatives, or independent contractors in the state to promote or facilitate sales by the seller to purchasers in this state.

– Maintains, uses, or occupies an office, distribution facility, warehouse, storage place, or similar place of business in this state to facilitate the sale or delivery of tangible personal property sold by the seller to the seller's purchasers in this state.

– Uses trademarks, service marks, or trade names in this state that are the same or substantially similar to those used by the seller, with the sellers consent or knowledge.

– Delivers, installs, assembles, or performs maintenance or repair services for the seller's purchasers in this state.

– Facilitates the sale of tangible personal property in this state to purchasers in this state by allowing the seller's purchasers to pick up or return tangible personal property (sold by the seller) at an office, distribution facility, warehouse, storage place, or similar place of business maintained by the person in this state.

– Shares management, business systems, business practices, or employees with the seller, or in the case of an *affiliated person*, engages in intercompany transactions related to activities occurring with the seller to establish or maintain the seller's market in this state.[1]

– Conducts any other activities in Michigan that are significantly associated with the seller's ability to establish and maintain a market in the state for the seller's sales or tangible personal property to purchasers in this state.

This presumption could be rebutted by demonstrating that a person's (including an affiliated person's) activities in the state were not significantly associated with the seller's ability to establish or maintain a market in the state for the seller's sale of tangible personal property to purchases in the state.

As provided above, "affiliated persons" would be subject to the sales and use taxes if they meet certain criteria. An "affiliated person" would be defined as (1) any person that is part of the same controlled group of corporations as the seller, or (2) any other person or entity that, notwithstanding its form of organization, bears the same ownership relationship to the seller as a corporation that is a member of the same controlled group of corporations.

Agreements-with-Residents Presumption

A seller would be presumed to be engaged in the business of making sales at retail if the seller enters into an agreement (directly or indirectly) with one or more Michigan residents whereby the resident, for a commission or other consideration, directly or indirectly, refers potential customers to the seller (whether by a link on an internet

[1] One reference notes that an "intercompany transaction" is a transaction in which "one unit of an entity is involved in a transaction with another unit of the same entity. While these transactions can occur for a variety of reasons, they often occur as a result of the normal business relationships that exist between the units of the entity. These units may be the parent and a subsidiary, two subsidiaries, two divisions, or two departments of one entity. It is common for vertically integrated organizations to transfer inventory among the units of the consolidated entity." See, Dennis M. Bline, Mary L. Fischer, and Ted D. Skekel. (2004), *Advanced Accounting*, John Wiley and Sons, Inc.; Hoboken, NJ.

website, in-person oral presentation, or otherwise), if both of the following conditions are met:

- The cumulative gross receipts from sales by the seller to purchasers in Michigan who are referred to the seller by all residents of the state with an agreement with the seller are greater than $10,000 during the prior 12 months.

- The seller's total cumulative gross receipts from sales to purchasers in the state exceed $50,000 during the prior 12 months.

This presumption could be rebutted by demonstrating that the resident (with whom the seller has an agreement) did not engage in any solicitation or any other activity in the state that was significantly associated with the seller's ability to establish sales of tangible personal property to customers in the state. Evidence to rebut the presumption could include written agreements prohibiting all residents (with whom the seller has an agreement) from engaging in any solicitation activities in the state on the seller's behalf or good faith written statements from all residents (with whom the seller has an agreement) stating that they did not engage in any such solicitation or other activities on the seller's behalf during the preceding year.

An agreement under which a seller purchases advertisements from a person delivered through television, radio, print, the internet, or any other medium would not be an agreement described in the bill unless such advertisement revenue paid to the person consists of commissions or other consideration based upon completed sales of tangible personal property.

Application Date
The bill would apply to transactions occurring on or after the bill's effective date (October 1, 2015), irrespective of the date the seller and resident entered into any referral agreement (as described above). For the purposes of sales/use tax obligation on sales made via a referral agreement with residents, the 12 months before the bill's effective date would be included as part of the 12-month period to determine the amount of cumulative gross receipts.

FISCAL IMPACT:

According to the Department of Treasury, an estimated $444.5 million in sales and use tax revenue resulting from remote sales will be uncollected in FY 2014-15, $281.6 of which is attributable to e-commerce (about 63%). In FY 2015-16 the loss increases to $463.1 million, with $304.3 (65.7%) representing online purchases. The estimated sales and use tax due on all remote sales has been increasing by approximately 6% per year, due primarily to the very strong growth in e-commerce. Beginning with tax year 1999, the State included a line on the individual income tax return to encourage taxpayers to voluntarily remit the use tax owed. Based on tax returns processed through the first week of December, approximately $6.64 million has been collected from 116,430 tax returns reporting a use tax liability in 2014.

As written, the bills could generate some additional sales and/or use tax revenue for the state, estimated to be around $50 million per year with a large margin of error. Major online retailers (Amazon, Overstock, eBay, etc.) can avoid nexus in Michigan by eliminating affiliate partners and/or relocating warehouses located in Michigan to other states, a practice that has been adopted in the past when online vendors have faced similar laws elsewhere. If this were to occur, the bills could bring in $0 additional revenue.

It appears as if the bills have been structured so that the majority of any revenue collected would be classified as sales tax, although it would ultimately depend on how it is remitted by the taxpayer. One-third of use tax revenue is earmarked to the School Aid Fund (SAF), while the remaining two-thirds is General Fund/General Purpose (GF/GP) revenue. Roughly 73% of sales tax revenue is earmarked to the SAF and approximately 10% is dedicated to Constitutional revenue sharing; the remainder accrues to the general fund.

BACKGROUND INFORMATION:

The following was provided as Background Information in the summary of House Bills 4202 and 4203 dated September 9, 2013. It has not been updated for this document.

In 1937 Michigan enacted the Use Tax Act (Public Act 94) as a companion to the General Sales Tax Act. Where the sales tax is a tax on retail sales of personal property (unless exempt) made inside the state, the use tax is levied, generally speaking, on remote sales (such as those made though the Internet or mail order catalogues) and on out-of-state purchases of products that are then brought back into the state for storage, use, and consumption. The use tax is a necessary supplement to the sales tax, as many taxpayers could otherwise avoid the sales tax by making purchases in other states. (The need for this was greater when the act was originally enacted, as there were fewer states with a sales tax). The use tax does not apply to transactions that are subject to the sales tax, and the taxpayer receives a credit for taxes paid to other states, so that a Michigan resident who purchases a product in another state and pays an equivalent amount of sales tax in that other state is not liable for the use tax in Michigan.

While the sales and use taxes are in some ways very similar - and easily confused – they differ significantly in their administration and rate of compliance. The statutory incidence of the sales tax is on retailers, as the tax is technically a tax on the privilege of doing business in the state. Although retailers can shift the incidence of the tax to consumers, by adding the tax to the purchase price of products, they are legally obligated to file a sales tax return and remit the appropriate amount of tax to the state.

In general, the statutory and actual incidence of the use tax, by contrast, falls on consumers.[2] For the most part, the tax is self-reported by the taxpayer, and the state is limited in its ability to enforce the tax. The state does enforce collection of the use tax in cases where purchases subject to the tax are required to be registered, such as automobiles, boats, and airplanes, but as a practical matter, compliance with the use tax

[2] A seller is subject to the use tax collections responsibility of the Use Tax Act if it has nexus with the state. Department of Treasury Revenue Administrative Bulletin 1999-1, *Use Tax Nexus Standards*, (May 12, 1999) describes the criteria to be used in determining whether a seller has a use tax collection responsibility. See, http://www.michigan.gov/documents/rab99-1_109054_7.pdf. Once nexus is established a seller has a responsibility to register with the Department of Treasury and collect the use tax from consumers (MCL 205.95). Sellers, then, are also personally liable for any amount of use tax they failed to collect (MCL 205.99).

in other cases has been considered voluntary. The problem of noncompliance with the use tax is far from new, although it has grown in importance with the advent of the Internet and the expansion of "e-commerce." In 1999, the state income tax form was amended to include a line for taxpayers to use in reporting any use tax due on products purchased in the tax year as a means of improving enforcement and collection.

Enforcement of the use tax has been a problem for Michigan and other states for some time. Many taxpayers are unaware of their use tax liability, while others simply ignore it altogether. Moreover, states have had limited success in court when trying to require remote sellers (those outside of the state) to collect and remit use taxes on purchases by state residents. The problem largely stems from two key United States Supreme Court cases, *National Bellas Hess, Inc. v. Department of Revenue of Illinois* 386 U.S. 753 (1967)[3] and *Quill Corp. v. North Dakota* 504 U.S. 98 (1992).[4] Generally speaking, the court, in *National Bellas Hess*, ruled that an out-of-state business with no physical presence ("nexus") in a state could not be required to collect and remit use tax on goods purchased by residents of that state. Requiring collection, the court held, would violate the Commerce Clause of the U.S. Constitution (Article 1, Section 8, clause 3). The *Quill* decision, as it relates to the Commerce Clause, reaffirmed the court's ruling in *Bellas Hess*, requiring physical presence.[5]

A new effort to improve compliance and collections began in earnest in 2000 with the development of the Streamlined Sales Tax Project (SSTP), which involved 32 states, including Michigan, and six observer states, as well as input from businesses and local

[3] Finding that both the due process and commerce clauses of the U.S. Constitution require "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax," [quoting Miller Bros. Co. v. Maryland], the Court held, "it is difficult to conceive of commercial transactions more exclusively interstate in character than the mail order transactions here involved. And if the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdiction with no legitimate claim to impose 'a fair share of the cost of the local government.' The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control."

[4] It held that a state could, in a manner consistent with the Due Process Clause, impose a tax on a particular taxpayer, even though such a tax could violate the Commerce Clause. The court recognized that its due process jurisprudence related to this matter in the years since *National Bellas Hess* had changed quite a bit. In this instance, the Court backed off on its due process requirement of actual "physical presence," requiring, instead, "connections with a State [that] are substantial enough to legitimate the State's exercise of power." In finding that the North Dakota tax violated the Commerce Clause, the Court added, "[t]his aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions…Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."

[5] In the years between *National Bellas Hess* and *Quill*, the Supreme Court held in *Complete Auto Transit, Inc. v. Brady* [430 U.S. 274 (1977)], that a state tax affecting interstate commerce will satisfy the requirements of the Commerce Clause if it meets four criteria: (1) the tax is applied to an activity with substantial nexus with the taxing state, (2) the activity - both in and out of the state - is fairly apportioned, (3) the tax does not discriminate against interstate commerce, and (4) the tax is fairly related to services provided by the state.

governments. The mission of the project was to develop and implement a simplified and uniform sales and use tax system that will encourage *voluntary* use tax compliance. This has proven to be a daunting task, as 34 of the 45 states with a sales tax allow local sales taxes, and 30 states have multiple rates. (The issue of multiple taxing jurisdictions within the states is particularly problematic.) Further, states often treat the same products differently and have different kinds of exemptions and definitions in their tax laws, all of which complicate the creation of a multi-state system.

In November 2002, several participating states, including Michigan, ratified an agreement specifying the changes in the sales and use taxes needed for each state to be in compliance with the agreement.[6] The agreement requires states to adopt a state-level administrative process, implement a common tax base, and provide a transparent system to notify vendors of tax rate and tax base changes. The agreement also contains uniform provisions related to sourcing nontraditional sales and telecommunication fees and taxes, and simplified administrative procedures, includes the treatment of exemptions, the filing of returns, and the recovery of bad debts. Public Acts 172-175 of 2004 allowed the state to become a participant in the SSTP and made the necessary changes to allow state tax law to be substantially in compliance with the agreement.

In recent years, a handful of states have enacted so-called "Amazon laws" (in reference to the online retailer) in an effort to collect some portion of the tax owed on purchases made over the Internet.[7] States have enacted three basic approaches aimed at improving compliance (and increasing collections): referrer-nexus, related-entity nexus, and information-reporting requirements.[8] These laws attempt to establish a nexus with the remote seller, creating a statutory responsibility for the seller to collect and remit sales and use taxes on remote purchases. Laws (such as a 2008 New York law) that establish referrer-nexus are also referred to as "click-through nexus," and impose a tax liability if the remote seller has an agreement with in-state residents under which the in-state resident, directly or indirectly, refers potential customers to the seller, getting some commission or other consideration in return. These laws may also impose a requirement that the seller's sales from these referrals exceeds certain limits, with the New York law, again, being an example.[9]

[6] http://www.streamlinedsalestax.org/

[7] See, for example, Steven Maguire, *State Taxation of Internet Transactions*, Congressional Research Service, Report R41853 (May 7, 2013), publicly available at, http://www.fas.org/sgp/crs/misc/R41853.pdf. This is likely a greater concern for Internet-only retailers, which collect and remit sales taxes in the few states where they have nexus. Many large, national hybrid stores – such as Staples, Wal-Mart, and Barnes and Noble – which have traditional bricks-and-mortar stores as well as online retail sites collect and remit sales taxes where applicable.

[8] See, David Gamage and Devin J. Heckman, "Vendor Compensation as an Approach for State 'Amazon' Laws: Part 1", *State Tax Notes*, August 6, 2012. See also, David Gamage and Devin Heckman, "A Better Way forward for State Taxation of E-Commerce," 42 Boston University Law Review 483. See also, Erika K. Lunder and Carol A. Pettit, *'Amazon Laws' and Taxation of Internet Sales: Constitutional Analysis'*, Congressional Research Service, Report R42629 (April 3, 2013), publicly available at, http://www.fas.org/sgp/crs/misc/R42629.pdf.

[9] In March 2013, the New York Court of Appeals (its highest court) upheld the New York "Amazon Law" as being facially constitutional under the Due Process and Commerce Clauses. See, *Overstock.com, Inc. v. New York State Department of Taxation and Finance* and *Amazon.com, LLC v. New York State Department of Taxation and Finance,* March 28, 2013, http://www.nycourts.gov/ctapps/Decisions/2013/Mar13/33-34opn13-Decision.pdf. Both cases were appealed to the U.S. Supreme Court in late August 2013, with the petitions for certiorari publicly available at http://www.floridasalestax.com/documents/Amazon-Petition[2].pdf and http://www.floridasalestax.com/documents/Cert-petition-Overstock-com-Inc-v-N-Y.pdf.

Related-entity nexus laws, also referred to as affiliate nexus laws, impose a use tax liability if the remote seller is controlled by or controls an in-state business or is under common control with an in-state business or when an in-state firm and the remote seller use identical or substantially similar names, trade names, trademarks, or goodwill to facilitate sales or coordinate their businesses.[10] This approach disregards the corporate structure, treating separate legal entities (e.g., a corporate parent and its wholly-owned subsidiary "dot-com") as a single unitary business group for taxation purposes.

The third approach, rather than imposing a responsibility to collect and remit taxes, requires remote sellers to provide information to state taxation departments on sales to in-state residents, to facilitate the payment of applicable taxes by customers. Colorado and North Carolina enacted such laws.[11]

On May 7, the U.S. Senate passed S. 743, titled the Marketplace Fairness Act of 2013 by a vote of 69(Y) – 27(N). The bill would authorize member states of the Streamlined Sales and Use Tax Agreement (or non-member states that enact legislation simplifying sales/use taxes) to require remote sellers with gross sales receipts in the U.S. above $1.0 million to collect and remit sales and use taxes. The bill was referred to the House Judiciary Committee, Subcommittee on Regulatory Reform, Commercial and Antitrust Law.

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[10] See, Andrew J. Haile, "Affiliate Nexus in E-Commerce", 33 Cardozo Law Review 1803 (2012), and John A. Swain, "Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?," 75 Southern California Law Review 419 (2002).

[11] See, *'Amazon Laws' and Taxation of Internet Sales: Constitutional Analysis* and David Gamage and Darien Shanske, "The Saga of State 'Amazon' Laws: Reflections on the Colorado Decision", *State Tax Notes*, July 16, 2012. The Colorado law was initially ruled by federal district court in Colorado to be unconstitutional. Last month, the 10th Circuit Court of Appeals overturned the district court decision, on jurisdictional grounds. See, Andy Young, "Colorado's Amazon tax law scores win in federal appeals court", *Denver Post* (on-line), August 21, 2013, http://www.denverpost.com/breakingnews/ci_23904271/colorados-internet-tax-law-scores-win-federal-appeals. See, also, Cara Griffith, "The Tenth Circuit's Questionable Use of the Tax Injunction Act", *State Tax* Notes, September 2, 2013. The appellate court's decision is available at, http://www.ca10.uscourts.gov/opinions/12/12-1175.pdf.