Legislative Analysis

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COLLECT TAXES ON INTERNET SALES

House Bill 4202 (H-1)
Sponsor: Rep. Eileen Kowall

House Bill 4203 (H-1)
Sponsor: Rep. Rob VerHeulen

Committee: Tax Policy
Complete to 4-30-13

A SUMMARY OF HOUSE BILLS 4202 (H-1) AND 4203 (H-1) AS SUBSTITUTED

House Bill 4202 (H-1) 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.

House Bill 4203 (H-1) 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.

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 another person (other than a common carrier acting as a common carrier) has a physical location in the state, conducts business activity in the state, or is otherwise subject to the sales tax or use tax, and that other person, directly or indirectly, does any of the following:

- 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 or facilities in the state to advertise and promote or facilitate sales by the seller to customers in this state.

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

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

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

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

Affiliated Person Presumption

Under the proposed legislation, a person who sells tangible personal property to a customer in this state would be presumed to be engaged in the business of making sales at retail in this state if any "affiliated person" has substantial nexus with this state. 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 with one or more Michigan residents where the resident, for a commission or other consideration, directly or indirectly, refers potential customers to the seller (whether by a link on an internet website, in-person oral presentation, or otherwise), if the cumulative gross receipts from sales by the seller to customers referred under all such agreements is greater than $10,000 during the prior 12 months. (A seller meeting this presumption would be required under the Use Tax Act to register and collect the use tax and would be personally liable for the tax.)

Rebutting the Presumptions

The presumptions described above could be rebutted by demonstrating that the person or resident 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 good faith written statements from all persons and residents stating that they did not

engage in any such solicitation or other activities on the seller's behalf during the preceding year.

FISCAL IMPACT:

According to the Department of Treasury, for FY 2012-13, an estimated $460 million in use tax is due on consumer remote sales; however, most of the tax is not collected or remitted. Beginning with tax year 1999, the State included on the state income tax form a line to encourage taxpayers to remit the tax owed. Approximately 107,000 taxpayers reported $5.68 million in use tax on their Michigan income tax forms for 2011. The estimated use tax due on remote sales has been increasing by approximately 6.0% per year, which is due primarily to the very strong growth in e-commerce. 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.

As written, it is unlikely the bills would generate much revenue unless federal legislation is enacted. Currently, major online retailers (Amazon, Overstock, eBay, etc.) can avoid nexus in Michigan by eliminating their affiliate partners and relocating warehouses located in the state. Amazon and Walmart have recently begun supporting federal legislation to provide for uniform collection of sales taxes resulting from remote sales, although other major online retailers remain in opposition.

BACKGROUND INFORMATION:

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.

The statutory and actual incidence of the use tax, by contrast, falls on consumers. 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 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)[1] and *Quill Corp. v. North Dakota* 504 U.S. 98 (1992).[2] 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.[3]

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[1] 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."

[2] 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."

[3] 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

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 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.[4] 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.[5] States have enacted three basic approaches aimed at improving compliance (and increasing collections): referrer-nexus, related-entity nexus, and information-reporting requirements.[6] 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.[7]

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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.

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

[5] See, for example, Steven Maguire, *State Taxation of Internet Transactions*, Congressional Research Service, Report R41853 (April 19, 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.

[6] 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.

[7] 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*

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.[8] 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, although the Colorado law was ruled to be unconstitutional in federal district court.[9]

Recent news accounts indicate that a vote in Congress on S. 743, titled the Marketplace Fairness Act of 2013, on final passage of the bill is imminent after earlier "test votes" on the subject received significant approval by the Senate.[10] 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.

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

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.

[8] 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).

[9] 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.

[10] An amendment to the Senate FY 2014 budget resolution indicating support for the measure was approved 75-24 last month. See, Jonathan Weisman, "Push to Require Online Sales Tax Divides the G.O.P.", *New York Times* (online), April 28, 2013, http://www.nytimes.com/2013/04/29/us/politics/bill-on-sales-tax-for-internet-purchases-divides-republicans.html.