

Michigan Sales Tax Collection and the Internet: A Need for Fairness

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Introduction

Over the past decade the Michigan state budget has faced many challenges, and several principal factors have played a role. The first is the decline in employment in Michigan during the past decade. During calendar year 2000, Michigan wage and salary employment averaged 4.7 million jobs. During calendar year 2010, Michigan wage and salary employment averaged only 3.9 million jobs.¹ This decade-long decline in employment of 815,000 jobs, or 17.4 percent of the job base, had a severe impact on the level of state revenues available for the state budget.

The second factor is declining state revenues, especially compared to inflation. During fiscal year (FY) 1999–2000, Michigan state revenues totaled \$24.4 billion. A decade later, in FY 2009–10, Michigan state revenues totaled only \$24.3 billion.² Michigan state revenues declined by \$97.3 million over this ten-year period while inflation, as measured by the Detroit Consumer Price Index, increased by 21.6 percent over the same period.³ The decline in revenue over this decade is linked to the loss of jobs, plus a shrinking tax base in the state.

The third factor helped accelerate the decline in state revenues—Michigan’s tax base has been shrinking. The majority of this shrinking tax base is related to exemptions, credits, and exclusions from various taxes that have been enacted by the legislature. These exemptions, credits, and exclusions are commonly referred to as tax expenditures. The Michigan Department of Treasury estimates that the amount of state tax revenue lost as a result of these tax expenditures increased from \$14.1 billion in FY 1999–2000 to \$26.2 billion in FY 2009–10.⁴ The estimated amount of revenue lost from state tax expenditures in FY 2009–10 now exceeds the total amount of state revenue collections in the same fiscal year.

Another component of the shrinking tax base—and one that has received considerable attention— involves the growth of purchases made by consumers through remote vendors such as catalogue sales, Internet sales, and other types of mail-order purchases of goods. While these sales are subject to sales tax collection, due to legal rulings by the U.S. Supreme Court, remote vendors that do not have a physical building located within a state are not required to collect and remit sales taxes to those states. Although not legally required to do so, some remote vendors around the country voluntarily collect and remit sales taxes. But both the number of vendors doing so and the amount of sales taxes collected are relatively minor.

This analysis discusses the complex legal issues involving the collection and transmittal of state sales taxes by remote vendors. The major implication of this sales tax issue is an uneven playing field for a Michigan-based vendor and a remote vendor competing for the same purchase. When a consumer buys a taxable good from a Michigan-based retailer, the 6.0 percent state sales tax is collected. If that same consumer purchases the same item from a remote vendor, it is not a certainty that the 6.0 percent sales tax is collected and remitted. This uneven playing field reduces economic activity in the state and reduces the level of employment in the retail sector in Michigan.

¹ See Michigan Senate Fiscal Agency webpage: www.senate.michigan.gov/sfa/Economics/US&MichiganWage&SalaryEmployment.pdf. (Accessed 6-21-11.)

² See Michigan Senate Fiscal Agency webpage: www.senate.michigan.gov/sfa/Publications/Bud/Updates/ConsensusRevExecSum.pdf. (Accessed 6-21-11.)

³ See Michigan Senate Fiscal Agency webpage: www.senate.michigan.gov/sfa/Economics/DetroitCPI.pdf. (Accessed 6-21-11.)

⁴ Michigan Department of Treasury, “Executive Budget Appendix on Tax Credits, Deductions and Exemptions, FY 2010,” see: www.michigan.gov/documents/treasury/ExecBudAppenTaxCreditsDedExempsFY10_302899_7.pdf. (Accessed 6-21-11.)

When a remote vendor is selling a taxable good into a state and does not collect the sales tax on the purchase, it is the responsibility of the purchaser of the good to remit the tax to the state. This tax is commonly referred to as a use tax. Most consumers are not aware that the use tax is owed to the state in this situation and the state has no solid mechanism to enforce the law. The state is unable to enforce the law because it does not have a record of the purchase between the remote vendor and the citizen of the state. This leads to a situation of voluntary compliance with a tax law without any threat of action for noncompliance.

The inability to collect all of the sales taxes owed on certain purchases from remote vendors places the Michigan-based retail industry at a competitive disadvantage compared to the remote vendors not collecting the sales tax. This disadvantage leads to a smaller retail sector in the state and, therefore, fewer jobs in that sector. Based on data from the Bureau of Labor Statistics, a total of 738,540 Michigan residents were employed in various retail operations in 2010. This includes 406,700 jobs in retail stores (10.8 percent of Michigan's employment) and 331,840 jobs in restaurants and taverns (8.9 percent of Michigan's employment).⁵ This competitive disadvantage for such a large portion of the Michigan economy is an important public policy issue that needs to be discussed in the state.

The Michigan Retailers Association (MRA) asked Public Sector Consultants (PSC) to undertake a study of this issue. PSC's analysis includes a discussion of the fairness issue and the legal history of states' taxation of sales by remote vendors, efforts by the Streamlined Sales Tax Project to deal with this problem, and specific initiatives undertaken by certain states. The paper also provides an estimate of the projected revenue loss in Michigan from the failure to collect sales and use tax on all taxable purchases made in the state, and a discussion of the economic impact on the retail sector in Michigan from the lost sales tax revenue. This study is designed to provide public policymakers with an update on efforts to level the playing field for Michigan-based retailers and remote vendors in the state.

Why the Sales Tax Is Important

According to the U.S. Census Bureau, during FY 2009, state sales tax collections totaled \$227.9 billion.⁶ This made the state sales tax the second largest source of state revenues behind the income tax. Only five states—Alaska, Delaware, Montana, New Hampshire, and Oregon—do not levy a statewide sales tax. In the other 45 states and the District of Columbia, the state sales tax is a critically important revenue source. State sales tax rates range from a low of 2.9 percent in Colorado to a high of 8.25 percent in California.⁷

Michigan, like most other states, has relied on the sales tax as a major portion of state revenue for many years. Public Act 167 of 1933 imposed the first statewide sales tax in Michigan. From its beginning, the Michigan sales tax has levied a percentage tax on certain purchases by individuals and businesses in the state. The Michigan sales tax has been set at 6.0 percent since 1994. During FY 2011–12, the State of Michigan is expected to collect approximately \$6.6 billion from the sales tax.⁸

Collecting State Sales Tax from Remote Sellers: The Fairness Issue

Over the years a considerable number of changes have occurred in the rate and the base of the Michigan sales tax. The Michigan tax generally exempts most services from the tax base. Prescription drugs and

⁵ U.S. Department of Labor, Bureau of Labor Statistics, "May 2010 State Occupational Employment and Wage Estimates, Michigan," see: www.bls.gov/oes/current/oes_mi.htm. (Accessed 6-21-11.)

⁶ U.S. Bureau of the Census, State Government Finances 2009, "2009 Annual Survey of State Government," revised January 2011.

⁷ Data from Federation of Tax Administrators, February 2011, see: www.taxadmin.org/fta/rate/sales.pdf. (Accessed 6-21-11.)

⁸ Based on phone discussion with David Zin, senior economist, Michigan Senate Fiscal Agency.

food for home consumption were exempted from the tax base as a result of a state constitutional amendment approved in 1974. The Michigan Constitution and state law outlined the requirements for transactions that were subject to the sales tax and those that were exempt.

This sales tax model worked very well in Michigan for many years. Problems regarding the collection of the Michigan sales tax emerged when consumers and businesses began to purchase goods from remote vendors. Remote vendors are sellers of goods that are not based in Michigan, but are selling goods in the state. The goods are then delivered to Michigan consumers by mail or common carrier.

Because of U.S. Supreme Court rulings in 1967 and 1992, states have had a difficult time enforcing the collection of sales tax owed on sales made in the state by remote vendors. Essentially, the Supreme Court has ruled that unless a remote vendor has a *physical* presence in a state, it cannot be forced to collect sales tax on sales made to consumers or businesses in that state. The Supreme Court ruled that it was an undue burden to expect remote sellers to comply with 45 different state sales tax structures (as well as hundreds of local sales taxes).

These rulings have led to a significant fairness issue regarding the sales tax: Michigan firms selling taxable goods in the state must compete against certain remote vendors that may have a 6.0 percent price advantage on their sales in Michigan (i.e., the amount of Michigan sales tax that the remote vendors are not required to collect on sales made to Michigan consumers).

Collecting State Sales Tax from Remote Sellers: The Legal Background

On May 8, 1967, the U.S. Supreme Court rendered a decision in *National Bellas Hess v. Department of Revenue*. This decision struck down an Illinois law that attempted to collect sales tax from the National Bellas Hess Company for sales made in Illinois. National Bellas Hess was a mail order seller of various consumer products. The company was based in Missouri and owned no property in Illinois and did not have any employees in the state. The company sold its products in Illinois and in other states through catalogues that it sent to its customers. The goods ordered by the customers were then delivered by mail or common carrier.

The Supreme Court ruled that the Commerce Clause of the U.S. Constitution prohibits a state from imposing the duty of sales tax collections on a vendor whose only connection to customers in the state is by mail or common carrier.⁹ The Court ruled that a company had to have a physical location or “nexus” within a state in order to be forced to collect the sales tax. The Court’s decision was based on the Commerce Clause, as well as the belief that collecting the sales tax owed would place a burden on the companies forced to collect the tax due to the complex nature of sales tax structures in 45 different states and numerous local governments. This important decision eliminated an important and growing part of the state sales tax base from the state revenue base.

The Supreme Court reaffirmed the principles established in the National Bellas Hess ruling on May 26, 1992, when it rendered a decision in *Quill Corporation v. North Dakota*. This decision struck down a North Dakota law that attempted to collect sales tax from the Quill Corporation for sales made in North Dakota. Quill Corporation was a mail-order seller of various office products. The company was based in Delaware, owned no property in North Dakota, and did not have any employees in the state. The company sold its products in North Dakota through catalogues, flyers, and advertising in national publications. The goods ordered by customers were then delivered by mail or common carrier.

In 1987, North Dakota had amended its state law to define a retailer as any person who engages in the regular solicitation of a consumer market within the state. This law required all remote vendors selling

⁹ The Commerce Clause states that the U.S. Congress shall have power “To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” *U.S. Constitution*, Article I, Section 8, Clause 3.

products in North Dakota to collect and remit sales taxes to the state. The Quill Corporation challenged the law in state court and the North Dakota Supreme Court upheld the state law.¹⁰ The Quill Corporation took the case to the federal courts and was successful in its arguments before the Supreme Court.

The Supreme Court decision in *Quill Corporation v. North Dakota* was based on the same arguments that the Court used in ruling on *National Bellas Hess* in 1967. The Court ruled that the North Dakota law was in violation of the Commerce Clause of the Constitution, and upheld the prior decision that in order to collect state sales taxes, a corporation must have a physical presence or substantial nexus in the state. The Quill decision made it clear that Congress has the power to regulate commerce among the states.

Since the 1992 Quill ruling, the volume of retail sales coming from remote vendors has increased substantially. According to a recent release from comScore Inc., national retail sales through electronic vendors increased by 12 percent in the first quarter of 2011 from the same quarter in 2010.¹¹ ComScore also reported a 36 percent increase in electronic commerce sales from 2007. According to the Census Bureau, retail sales grew by 9.57 percent during the period from 2004 through 2009.¹² This continuing growth in the volume of remote sales is being driven primarily by Internet sales, but other types of remote sales, such as catalogue sales, continue to have an important place in the overall national retail sector.

Streamlined Sales Tax Project

During 1999, leaders of the National Conference of State Legislatures (NCSL) and the National Governor's Association (NGA) began meetings to talk about potential solutions to the growing loss of state sales tax revenue as a result of the Quill decision. These meetings led to the formation in 2000 of the Streamlined Sales Tax Project (SSTP). The SSTP consisted of a group of state legislators, governors, state tax administrators, and members of the retail industry. The SSTP group set out to develop a simpler, more uniform, and fair sales tax system across the country. The efforts of the SSTP resulted in approval of the Streamlined Sales and Use Tax Agreement, which was ratified by members of 35 states in November 2002.

The Streamlined Sales and Use Tax Agreement simplifies and modernizes sales and use tax collections and administration by adopting the following:

- Uniform product definitions, including definitions of food and digital products
- Uniform state and local tax bases within a state
- State-level tax administration
- Central registration for remote sellers
- Uniform returns and remittance of taxes
- Simplified exemption administration
- Uniform audit procedure
- Uniform privacy procedures
- Notice of requirements of changes in tax rates
- Uniform sourcing requirements
- Telecommunication sourcing implementation

¹⁰ Quill Corp. v. Heitkamp, 504 U.S. 298 (1992), see:

<http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=504&invol=298>. (Accessed 6-21-11.)

¹¹ "comScore Reports \$38 Billion in Q1 2011 U.S. Retail E-Commerce Spending, Up 12 Percent vs. Year Ago," see: <http://newsblaze.com/story/2011051011070200001.pnw/topstory.html>. (Accessed 6-21-11.)

¹² U.S. Bureau of the Census, Annual Retail Trade Survey, see: www.census.gov/econ/estats/2009/historical/2009ht5.pdf. (Accessed 6-21-11.)

- Uniform administrative functions
- Uniform rounding rules
- Elimination on caps and thresholds on sales
- Uniform standards for tax holidays

In order to participate in the Streamlined Sales and Use Tax Agreement, states were required to make statutory amendments to state laws to conform with provisions of the agreement. To date, 24 states have passed legislation that conforms to these requirements.¹³ These states have a total population of almost 93 million and represent a third of the U.S. population. The remaining 11 states that were part of the original agreement have yet to pass the necessary implementing legislation.

As part of the Streamlined Sales and Use Tax Agreement, software was developed to assist remote vendors by simplifying the collection of sales tax. The cost of the software development was shared by the participating states and private firms that supplied states with tax software. This software makes it relatively easy and efficient for remote sellers to collect the amount of sales tax owed in the 24 participating states. The SSTP asked remote sellers around the country to voluntarily begin collecting sales taxes in the participating 24 states using the software developed and provided. Approximately 1,400 remote selling retailers have begun to collect and remit sales tax under this voluntary system. Those 1,400 retailers have collected over \$700 million in sales tax for the participating states. While this voluntary effort has been successful, the amount of sales tax collected is a small portion of the estimates of sales taxes not collected by remote vendors across the country. The hope of the participating states was that once this system was in place, Congress would pass legislation mandating that all remote vendors collect and remit sales taxes to the states. As of this date, bills have been introduced in Congress to mandate the collection of sales tax from remote vendors but there has been no action on these bills.

The SSTP was also optimistic that a future Supreme Court ruling might overturn the Quill decision because the SSTP software eliminated the undue burden that a remote seller must overcome to collect sales tax in multiple states. A new ruling would only occur as the result of litigation regarding a new state law to force the collection of sales taxes by remote vendors. To date, the Supreme Court has not taken a case to review the Quill decision. It is possible that one of the many state laws attempting to force sales tax collections from all remote vendors could end up back in the federal courts and lead to a new decision by the Supreme Court.

State Revenue Impact from the Failure to Collect Sales Taxes on all Remote Sales

It is extremely difficult to attempt to estimate revenues lost by states as a result of the 1992 Quill decision. Such an estimate must do the following:

- Develop an accurate estimate of the amount of remote sales nationally
- Develop an accurate estimate of the amount of remote sales for which sales taxes are currently being collected and remitted to the states
- Estimate the growth in remote sales in the years ahead
- Estimate the amount of revenue lost in each state due to factors such as different sales tax bases

Over the past decade, the most respected estimates of the revenue impact on states from the failure to collect sales taxes from certain remote sales have come from researchers at the University of Tennessee.

¹³ Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. From Streamlined Sales Tax Governing Board, Inc., see: www.streamlinedsalestax.org/index.php?page=fags. (Accessed 6-21-11.)

Donald Bruce, professor of economics, and William F. Fox, William B. Stokely Distinguished Professor of Business, have published state-by-state estimates of the sales tax revenue lost as a result of the Quill decision. The research of Dr. Bruce and Dr. Fox has focused mostly on electronic commerce sales, but they have also developed estimates of all remote sales.

In April 2009, Bruce and Fox, along with LeAnn Luna, associate professor of accounting at the University of Tennessee, released a paper entitled “State and Local Government Sales Tax Revenue Losses from Electronic Commerce.”¹⁴ This paper contained estimates through 2012 of the amount of sales tax not collected in each state due to the inability of states to collect sales tax from all electronic vendors. It also discussed the revenue losses to states from other forms of remote sales not completed electronically, such as catalogue and mail-order sales.

Exhibit 1 summarizes the key data on the amount of electronic commerce in the United States, estimates the amount of state sales tax collected on electronic commerce, and estimates the amount of state sales tax not collected. Based on this University of Tennessee study, the estimated amount of electronic commerce sales tax due to state and local governments in 2012 will be \$45.9 billion. The report estimates that \$34.5 billion of this total national amount will be collected and remitted to state and local governments. This puts the 2012 estimate of the amount of uncollected sales tax related to electronic commerce at \$11.4 billion.

EXHIBIT 1. National Total State and Local E-Commerce and Revenue Losses
(millions of dollars)

	2007	2008	2009	2010	2011	2012
Baseline E-Commerce Growth Scenario						
Total Business to Business	\$2,325,701	\$2,480,011	\$2,231,283	\$2,767,010	\$3,253,412	\$3,656,856
Total Business to Consumer	168,081	179,233	161,257	199,975	235,285	264,285
Total E-Commerce	2,493,782	2,659,244	2,392,540	2,966,985	3,488,697	3,921,141
Estimated Taxes Due	29,177	31,113	27,992	34,713	40,815	45,877
Estimated Taxes Collected	21,931	23,386	21,041	26,093	30,679	34,484
Estimated Total State and Local Revenue Loss	7,246	7,727	6,951	8,620	10,136	11,393

SOURCE: “State and Local Government Sales Tax Revenue Losses from Electronic Commerce,” Donald Bruce, William F. Fox, LeAnn Luna, University of Tennessee, released April 13, 2009.

The Streamlined Sales Tax Governing Board has published estimates of the total amount of state and local revenues not collected from both electronic and other remote sales. This data, shown in Exhibit 2, combines the University of Tennessee estimates of state and local sales tax revenues not collected from electronic sales with estimates of the amount of sales tax not collected from other types of remote vendors, for a total of \$23.3 billion in state and local sales tax that will not be collected from remote vendors in 2012 (\$11.4 billion from electronic remote sales and \$11.9 billion from other forms of remote sales including catalogue and mail-order sales). The total amount of sales tax not collected is approximately 10 percent of the total amount of sales tax that will likely be collected by all state and local governments in 2012.

¹⁴ Donald Bruce, William F. Fox, and LeAnn Luna, “State and Local Government Sales Tax Revenue Losses from Electronic Commerce,” University of Tennessee, April 13, 2009. See: www.cber.utk.edu/ecom/ecom0409.pdf. (Accessed 6-21-11.)

**EXHIBIT 2. Estimates of Uncollected Sales and Use
Taxes from all Remote Sales in 2012 (millions of dollars)**

State	Electronic Remote Sales	Non-Electronic Remote Sales	Total Electronic and Non-Electronic
Alabama	\$170.4	\$177.4	\$347.8
Alaska	1.5	1.6	3.1
Arizona	369.9	338.8	708.7
Arkansas	113.9	122.4	236.3
California	1,904.5	2,255.2	4,159.7
Colorado	172.7	179.9	352.6
Connecticut	63.8	88.5	152.3
District of Columbia	35.5	37.0	72.5
Florida	803.8	679.9	1,483.7
Georgia	410.3	427.4	837.7
Hawaii	60.0	62.5	122.5
Idaho	46.4	56.7	103.1
Illinois	506.8	552.0	1,058.8
Indiana	195.3	203.5	398.8
Iowa	88.7	92.3	181.0
Kansas	142.9	136.3	279.2
Kentucky	109.9	114.6	224.5
Louisiana	395.9	412.4	808.3
Maine	32.1	33.3	65.4
Maryland	184.1	191.8	375.9
Massachusetts	131.3	136.7	268.0
Michigan	141.5	147.5	289.0
Minnesota	235.3	219.9	455.2
Mississippi	134.9	168.4	303.3
Missouri	210.7	219.5	430.2
Nebraska	61.3	56.7	118.0
Nevada	168.9	176.1	345.0
New Jersey	202.5	210.8	413.3
New Mexico	120.5	125.5	246.0
New York	865.5	901.5	1,767.0
North Carolina	213.8	222.7	436.5
North Dakota	15.3	16.0	31.3
Ohio	307.9	320.7	628.6
Oklahoma	140.8	155.6	296.4
Pennsylvania	345.9	360.4	706.3
Rhode Island	29.0	41.5	70.5
South Carolina	124.5	129.8	254.3
South Dakota	29.8	31.2	61.0
Tennessee	410.8	337.7	748.5
Texas	870.4	906.7	1,777.1
Utah	88.5	92.1	180.6
Vermont	25.1	19.7	44.8

State	Electronic Remote Sales	Non-Electronic Remote Sales	Total Electronic and Non-Electronic
Virginia	207.0	215.7	422.7
Washington	281.9	259.1	541.0
West Virginia	50.6	52.7	103.3
Wisconsin	142.1	146.9	289.0
Wyoming	28.6	33.2	61.8
Total	\$11,392.8	\$11,867.8	\$23,260.6

SOURCE: Streamlined Sales Tax Governing Board, Inc., Data presented by Scott Peterson, executive director, at a fall 2009 Governing Board meeting.

Based on the Streamlined Sales Tax Governing Board estimates, in 2012, Michigan will not be collecting \$141.5 million in sales tax from electronic remote sales and \$147.5 million in sales tax from other remote vendors, for a total projected tax revenue loss of \$289 million. This \$289.0 million of projected state revenue loss equates to \$4.8 billion of taxable retail sales being made in Michigan on which state taxes are not being collected. This amount equals approximately 4.4 percent of the estimated amount of sales tax to be collected in Michigan during fiscal year 2011–12. The amount of sales tax revenues not collected in Michigan from remote sales, as a percentage of total sales tax collections, is lower than the national average because of the relatively narrow base of Michigan’s sales tax compared to the sales tax bases of other states. For example, Michigan exempts from the sales tax base all food and prescription drugs, which is not the case in many states that have a sales tax. Michigan also exempts from the sales tax many purchases made by manufacturers of materials used in the production of goods.

National Retail and State Action on Remote Sales Tax Issue

While there has been no action by Congress to amend federal law to assist states in the collection of sales taxes owed by remote vendors, action has occurred in the national retail community and in several states. While these actions have not resulted in major changes in state tax policy, they have provided some new ideas in the ongoing efforts to collect sales tax from remote vendors.

The national retail community has formed an organization called the Alliance for Main Street Fairness (AMSF), whose primary purpose is to educate private citizens, small business owners, and elected officials about the need to collect sales tax from all remote vendors. The organization is advocating for changes to state tax systems that would level the playing field for businesses that collect sales tax and the remote vendors with which they compete that do not collect sales tax. According to the AMSF:

The truth is: a sale is a sale. Whether it takes place online or at a local business, a sale is made, a transaction has occurred and the sales tax is owed. The same rules should apply online that apply on Main Street. It is a question of fairness and evenhandedness. It is also important to note that small businesses—the nation’s top job creators—employ our families and are vital components of our communities. If they are unable to compete on a level playing field, additional job loss will occur further hurting our local and national economies.

Also, online only retailers are leaving individuals who purchase items on their Web sites exposed as these purchases are carrying an unmet tax liability. Due to the fact that these online retailers do not collect the tax at the point of sale and do not inform purchasers it is their responsibility to record the amount of sales tax due and pay it, their customers are carrying an unmet tax liability.¹⁵

¹⁵ See Alliance for Main Street Fairness webpage: <http://standwithmainstreet.com/about>. (Accessed 6-21-11.)

The AMSF is promoting two current methods of dealing with the uncollected sales tax from remote vendors across the country:

- **Sales by affiliates.** Many of the remote vendors that are not collecting and remitting sales tax base this decision on the fact that the company does not have a physical presence in the state from which the purchase was made. However, many of these remote vendors do have relationships with affiliate companies located in the state that use the remote vendor as a source of additional sales. The AMSF is advocating that states pass laws which require the collection and remittance of sales tax when the remote seller has affiliates within a state.
- **Consumer warnings.** The AMSF is also advocating legislation that would require all remote vendors that do not collect sales tax to issue a warning to their customers that it is the responsibility of the customer to remit the sales tax to the state.

Use of Affiliate Definition for Sales Tax Owed by Remote Vendors

In 2008, the State of New York passed a law that redefined when a remote vendor selling goods in New York was required to collect and remit sales taxes on these purchases. This law is often referred to as the “Amazon Tax” because it grew out of the State of New York’s attempt to collect sales taxes from sales made in the state by Amazon and similar remote vendors.

This law, Chapter 57 of the Laws of 2008, required a remote vendor to register for and collect sales taxes if the remote vendor solicits sales in New York through contractors, agents, or other representatives located in New York state. For example, if a remote vendor has affiliate relationships in New York state such that New York state businesses refer customers to the remote vendor’s website for additional sales, the law requires the remote vendor to collect sales tax on all purchases made by New York state residents. These affiliate relationships typically involve a local website that contains a link to the national vendor’s website. For example, if a person uses the local website and links into the national Amazon website for the purchase of goods, the local website receives some sort of payment or reimbursement from Amazon on these types of sales.

Amazon brought litigation against the New York state law and argued that the affiliates were merely advertising Amazon on their websites and were not directly affiliated with Amazon. To date, the New York courts have upheld the “Amazon Tax” law. Amazon is now collecting and remitting sales taxes on purchases made by New York state residents.

The New York State Amazon law was the first state law to use the affiliate approach in an effort to collect sales taxes from remote vendors. Rhode Island and North Carolina adopted similar laws in 2009. Following passage of the Amazon laws in these states, Amazon ended its affiliate relationships in Rhode Island and North Carolina. In early 2011, the State of Illinois enacted a similar law, Public Act 096–1544, which took effect on March 10, 2011. Amazon has reacted by stating that it will end its affiliate relationships in Illinois in order to avoid collecting and remitting sales tax on all sales made in the state. The State of California is the most recent state to enact a law using the affiliate approach in an effort to collect remote sales tax. This law was signed on June 28, 2011, and Amazon announced that it was ending its affiliate relationships in the state. It is not clear why Amazon ended its affiliate relationships in some states but continues its affiliate relationships in New York after a similar law was enacted.

State legislative bodies in Arizona, Hawaii, Louisiana, Minnesota, Mississippi, New Mexico, Tennessee, Texas, and Vermont are currently considering bills to follow the lead of New York and change their state laws to require collection of sales taxes owed by remote vendors using the affiliate method to establish nexus in a state. This type of legislation is the most current tactic used by states to begin to address state revenue loss from remote sales. The key factor in evaluating the effectiveness of this legislative approach is the reaction of the largest remote vendors, such as Amazon. States will gain revenue if the large remote vendors comply with the law, as is the case in New York state, but states will not likely see much of a

revenue impact if the large remote vendors simply end affiliate relationships, as Amazon has done in Illinois and other states.

Consumer Warnings

While states have a difficult time collecting sales taxes from certain remote vendors, it is clear under state laws that if the taxes are not collected by the vendor, they are the responsibility of the consumer purchasing the taxable items. Consumers, in this case, are expected to voluntarily keep track of these tax obligations and remit funds to the states. Due to the lack of a reliable method for states to enforce these laws, voluntary compliance on these purchases is extremely limited.

Since 1999, the State of Michigan has added a line to the individual income tax return allowing Michigan taxpayers to make voluntary payments for the amount of tax owed during the tax year from remote purchases that were not taxed. Based on Michigan Department of Treasury data, during tax year 2008, Michigan collected a total of \$4.1 million from 103,600 taxpayers as a result of this income tax requirement.¹⁶ In view of the estimates of almost \$289.0 million of uncollected sales tax in Michigan, this voluntary payment is certainly a very small percentage of the actual taxes owed. An additional problem with voluntary reporting of remote sales by consumers is that such a system requires extensive recordkeeping by consumers to keep track of all of their remote purchases for which state sales tax was not remitted.

The State of Colorado in 2010 took a more direct approach to the process of voluntary collection of sales taxes from remote vendors with the passage of House Bill 10-1193, Chapter 39-21-112(3.5), C.R.S. (2010). This bill, enacted on February 24, 2010, went after the remote sales tax issue on two fronts. First, as with the Amazon law in New York, the Colorado law stipulated that if the remote seller uses affiliates within the state it is responsible for collecting sales tax on all remote purchases in Colorado. (As it had done in Rhode Island, North Carolina, and Illinois, Amazon dropped its affiliate relationships in Colorado.)

The second line of attack in the Colorado bill involved the effort to force collections from Colorado consumers on taxable remote sales for which the sales tax was not collected. The Colorado law required remote sellers that are not collecting Colorado sales tax to send a notification to all purchasers stating the amount of sales tax they owe the state from purchases made over the past year, and to forward this information annually to the Department of Revenue in Colorado. The law also imposed a fine on remote sellers of \$5 per customer for failing to notify the customer of the tax owed, and \$10 per customer for failing to provide notice of the annual sales amount to the Department of Revenue.

In June 2010, the Direct Marketing Association filed a lawsuit in federal court seeking a motion for a preliminary injunction to stop the notice and reporting requirements of the Colorado law.¹⁷ In January 2011, Federal District Judge Robert E. Blackburn issued a preliminary injunction against the reporting requirements of the Colorado law. The ruling was based on the fact that the reporting requirements applied only to remote sellers and not to other retailers in the state. The ruling stated that this provision was in violation of the Commerce Clause of the Constitution.

On March 10, 2011, the State of South Dakota enacted SB 146 of 2011, which required remote sellers not collecting sales tax to notify purchasers of the taxable goods for which they are responsible for paying the taxes owed to the state. The effective date of this new law is July 1, 2011. Unlike the Colorado statute, this law had no provision requiring the remote vendor to share detailed information regarding remote

¹⁶ Michigan Department of Treasury, Office of Revenue and Tax Analysis, "Michigan's Individual Income Tax 2008," July 2010, see: www.michigan.gov/documents/treasury/ITT_2008_329111_7.pdf. (Accessed 6-21-11.)

¹⁷ Civil Case No. 10-cv-01546-REB-CBS, Robert E. Blackburn, United States District Judge, January 26, 2011.

purchases with the state. This law required only a warning to consumers at the time of purchase that sales taxes were owed to the State of South Dakota.

Distribution Centers and Remote Vendors

The continued growth of Amazon and other remote vendors leads to questions regarding the distribution of their products around the country and the need for increased distribution centers. Initially, Amazon operated out of its headquarters in the state of Washington. As its sales increased, Amazon was forced to develop distribution centers and office facilities in other states.

The model used by Amazon was to develop and have distribution centers owned around the country by subsidiary companies. This structure allowed Amazon to argue that even if a distribution center existed in a certain state, the facility was not owned by Amazon and Amazon did not have to collect sales taxes from purchases made by residents of that state. This distribution model seemed to work until the fall of 2010, when the State of Texas ruled that a distribution center in Dallas constituted a sufficient presence in Texas to force the collection of sales tax in the state. The Texas Department of Revenue, in the fall of 2010, presented Amazon with a tax bill of \$269 million for sales taxes owed. In response to this move by Texas, Amazon said it would close its Texas distribution center and cancel plans to build another Texas facility.¹⁸

A similar battle between the State of South Carolina and Amazon is currently under way regarding a proposed distribution center. In September 2010, then-Governor Mark Sanford and South Carolina economic development officials signed a deal with Amazon to build a distribution center in Lexington County, South Carolina. The deal included a commitment that the state would not attempt to collect sales taxes from Amazon sales made to South Carolina residents. In January 2011, however, newly elected Governor Nikki Haley announced that she did not support the tax break for Amazon, and in April 2011, the South Carolina House of Representatives approved a bill rejecting the Amazon tax break. Amazon then announced it was stopping construction on the distribution center in light of the potential change in tax treatment for the company.

The South Carolina House of Representatives passed another bill the following month, offering the tax break to Amazon in exchange for the continued construction of the distribution center. The bill is currently pending in the South Carolina Senate. Governor Nikki Haley has announced that she does not support the bill, but would not veto it if it is passed by the legislature.

Amazon is also now in the process of expanding existing distribution centers in Indiana. Amazon currently has two distribution centers in the state. They operate under an agreement with the State of Indiana stipulating that Indiana will not attempt to collect sales tax from Amazon for purchases made from the company by Indiana residents.

The type of distribution agreement granted to Amazon in South Carolina and Indiana has been opposed by traditional retailers in these states. As Amazon continues to grow, it is likely that these debates over the location of distribution centers and the collection of taxes from Amazon will continue. This debate also has implications for other electronic vendors that wish to establish warehousing facilities in states.

Estimated Michigan Revenue from a New York State-type Affiliate Law

The Michigan Retailers Association (MRA) has been advocating that the Michigan Legislature adopt a law similar to the New York State law that requires remote vendors that have affiliate relationships in the state to collect sales taxes on all purchases made by state residents from the remote vendor. In order to

¹⁸ “Amazon Pressured on Sales Tax,” *New York Times*, March 13, 2011, see: www.nytimes.com/2011/03/14/technology/14amazon.html?_r1&pagewanted=print. (Accessed 6-21-11.)

estimate the additional sales and use tax revenue that might be generated from such a law in Michigan, several assumptions need to be made:

- The most important assumption is that remote vendors using affiliate relationships in Michigan react to the law by beginning to collect sales taxes from purchases made by Michigan residents. This is the case in New York state, but in other states such as North Carolina, Illinois, and Rhode Island, additional state sales tax revenues have not been collected because certain remote vendors ended their affiliate relationship rather than collect the sales tax.
- The second assumption is that the response of remote vendors in Michigan would be similar to the response in New York state. This includes the number of remote vendors that agree to collect sales taxes on remote purchases. Since no other states that have passed a remote vendor affiliate law have seen increased revenue collections from the law, it is necessary to use the New York state experience as the basis for a Michigan estimate.
- The third assumption is that the base of the sales tax in Michigan is similar to the sales tax base in New York state. This means if remote vendors begin collecting taxes in Michigan, the amount of these taxes collected should be similar to New York state, adjusted for the level of these sales in each state.

By using these assumptions, PSC has developed an estimate of the potential Michigan sales and use tax revenue impact from the enactment of a remote vendor affiliate law similar to the law in New York state (see Exhibit 3). Based on data provided by the Office of Tax Policy Analysis, New York State Department of Taxation and Finance, New York sales and use tax collections increased by \$43.5 million in FY 2009–10 from the enactment and compliance with the remote vendor affiliate law. This represented a 0.44 percent increase in the overall amount of sales and use tax revenues collected by New York State during the fiscal year.

**EXHIBIT 3. Estimated Michigan Sales and Use Tax Revenue,
From Taxing Remote Vendors through Affiliate Law (millions of dollars)**

New York State Sales and Use Tax Base (FY 2009–10)	\$9,903.6
New York State Additional Revenue from Affiliate Law	\$43.5
Percentage Increase in New York State Sales and Use Tax from Affiliate Law	0.44%
Michigan Sales and Use Tax Base (FY 2012–13)	\$8,166.4
Increase in Sales and Use Tax Revenue from Affiliate Law (0.44% Increase)	\$35.9

SOURCE: Public Sector Consultants calculations based on data from the New York State Office of Tax Policy Analysis, New York State Department of Taxation and Finance, Michigan FY 2012-13 Sales and Use Tax estimates from consensus estimates, May 2011.

The Michigan sales and use tax base is estimated at \$8.2 billion in FY 2012–13. If the enactment of a remote vendor affiliate law were to increase sales and use tax revenues by the same percentage as in New York state, the increase in Michigan sales and use tax revenues would equal \$35.9 million. This potential increase in Michigan revenues is only a small percentage of the estimated revenues to be gained from full taxation of all remote vendor sales in Michigan, because taxing remote sales through the affiliate approach applies only to a small proportion of total remote sales. Most remote sales in Michigan and other states are not made through remote vendors that use affiliate relationships.

Based on the University of Tennessee estimates discussed previously in this report, a \$35.9 million increase in Michigan sales and use tax revenues represents only a 12.4 percent share of the estimated sales and use tax revenues not collected from remote vendors selling goods in Michigan.

Impact on Michigan Economy from the Failure to Collect Sales Tax on all Remote Sales

This paper contains considerable discussion of the revenue implications of the state's inability to collect all of the sales tax owed from taxable purchases due to the legal issues regarding certain remote vendors. At the same time it is important not to overlook the impact on the retail sector in Michigan and the overall Michigan economy related to this issue.

The fact that Michigan-based retailers are at a competitive price disadvantage compared to certain remote vendors because of this sales tax issue distorts economic activity in the state. This price disadvantage results in (1) lower sales from Michigan-based retailers, (2) lower employment in the retail sector in Michigan, and (3) lower business and other state and local taxes paid by the Michigan retail industry.

The retail sector in Michigan is a very significant portion of the Michigan economy. As noted earlier, a total of 406,700 Michigan residents are employed in the retail stores.¹⁹ This represents 10.8 percent of the total employment base of Michigan. Based on data from the U.S. Department of Commerce, Bureau of Economic Analysis, the estimated annual earnings of employees in Michigan retail stores totaled \$15.4 billion in 2010. These earnings accounted for 3.9 percent of the total personal income of Michigan during calendar year 2010.²⁰

In April 2011 Robert P. Strauss, professor of economics and public policy at the Heinz College, Carnegie Mellon University, published a report entitled "The Impact of Not Collecting Sales and Use Taxes from Internet Sales into Pennsylvania."²¹ The Strauss study utilizes assumptions concerning the amount of sales tax not collected in Pennsylvania and the impact on the level of retail sales and employment in the retail sector in the state from the competitive price advantage enjoyed by certain remote vendors selling goods into the state. The Strauss study also estimates the decline in total retail sales in the state if remote vendors were forced to collect sales taxes on all taxable purchases made by state residents. This decline is a result of consumers having to pay sales tax on all taxable retail purchases.

In terms of the bottom line economic impact on the retail sector in Pennsylvania, the Strauss study estimates that sales at Pennsylvania retail stores would increase by between \$126 million and \$216 million per year if remote vendors were forced to collect sales tax on all taxable purchases. This estimate is based on assumptions that Pennsylvania consumers would increase their purchases in stores and reduce their purchases from remote vendors if the price advantage for remote vendors disappeared. The Strauss study then calculates that this increase in economic activity in Pennsylvania would result in increased employment in the retail sector of between 1,530 and 2,766 new jobs.

Although some differences must be noted, the Strauss study provides a good overview of the economic impact in Pennsylvania from the competitive price advantage enjoyed by certain remote vendors, and this information can be used to draw comparisons to Michigan. In many respects the structure of the state sales tax in Pennsylvania is quite similar to Michigan—both states have a 6.0 percent state sales tax and both exempt food and prescription drugs from the base of the tax. The overall Pennsylvania economy and the retail sector in the state are larger than in Michigan. Based on Bureau of Economic Analysis data, the

¹⁹ U.S. Department of Labor, Bureau of Labor Statistics, "May 2010 State Occupational Employment and Wage Estimates."

²⁰ U.S. Department of Commerce, Bureau of Economic Analysis, "Personal Income by Major Source and Earnings by NAICS Industry," March 2011, see: www.bea.gov/regional/spi/action.cfm. (Accessed 6-21-11.)

²¹ Robert P. Strauss, "The Impact of Not Collecting Sales and Use Taxes from Internet Sales into Pennsylvania," April 29, 2011, see: http://standwithmainstreet.com/sites/standwithmainstreet.com/files/pa_impact_study.pdf. (Accessed 6-21-11.)

size of the retail sector in Pennsylvania exceeds the size of the retail sector in Michigan by 41.6 percent.²² The PSC estimates use the Strauss study as the basis for developing Michigan estimates. The changes to the numbers in the Strauss study relate to adjustments comparing the size of the retail sector in Michigan with the retail sector in Pennsylvania.

By using the results of the Strauss Pennsylvania study, we can get an idea of the economic impact of full collection of sales tax in Michigan from remote vendors. Total sales at brick-and-mortar retail outlets in Michigan would increase by between \$39 million and \$126 million per year, and between 893 and 1,615 jobs would be created in the retail sector. While the numbers associated with this potential economic impact can be debated, there is no doubt that the retail sector in Michigan is suffering from this price disadvantage and would benefit from full collection of sales tax.

Clearly, the issue of the collection of sales tax from remote vendors is a complex legal issue. It is evident that the voluntary remittance of sales tax owed by consumers will not work. States have attempted to make it easier for remote vendors to collect the amount of sales taxes owed by implementing the Streamlined Sales Tax model. This effort has resulted in some success, but it appears that the only reasonable hope of forcing all remote vendors to collect state and local sales taxes owed rests with action by the Congress or the Supreme Court. In the meantime, states can continue to pass state laws dealing with the issue, but these laws are likely to have only a limited impact on this major state revenue problem.

²² Public Sector Consultants calculation using U.S. Department of Commerce, “Personal Income by Major Source and Earnings.”