State Notes

TOPICS OF LEGISLATIVE INTEREST

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Sales and Use Tax Collection on Internet Purchases
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The rise of the internet has brought about the rise of internet commerce. This has led to ambiguity and controversy regarding sales tax collection. Generally, online retailers are not required to collect sales tax in states where they have no physical presence. That means that many large online retailers do not have to collect sales tax on most of their sales. Brick and mortar retailers say this puts them at a competitive disadvantage. They claim customers walk into the store, ask questions and try out products, and then purchase them online because there is no sales tax.

On the other hand, some retailers claim that it is unreasonable to make them collect taxes on sales from every jurisdiction. Michigan is relatively unique in that local entities are not allowed to impose their own sales taxes. Most other states with a sales tax do allow local units to impose their own, and each local unit could have its own rate as well as its own exemptions to the tax. It is difficult to determine exactly how many different sales and use tax jurisdictions exist in the country, but estimates hover around nearly 10,000.

Besides variances in the rate charged, jurisdictions may differ on their tax administration, such as due dates, the governmental entity to which the tax return must be sent, and the manner of remitting payment or claiming exemptions. They also may have different audit procedures, and vary in the manner of determining where a sale takes place, or "sourcing". When a person buys something in a brick and mortar store, there is no question about where the sale takes place. However, when a person in Michigan buys a product online from a seller headquartered in California, completes the transaction on a server located in Colorado, and has the product shipped from a warehouse in Texas, there is a question as to where the sale actually occurs.

To further complicate matters, sometimes local taxing jurisdictions do not coincide with political or geographic boundaries. For example, a sale made on the north side of a particular street in a community may be subject to the state sales tax, a county sales tax, and a special transportation district sales tax. On the south side of the street, a sale might still be subject to the state and county sales taxes, but not the special transportation tax.

Also, tax statutes often have different definitions for the same terms, which can substantively change the administration of the sales and use taxes. For example, State 1 and State 2 both exempt "food" and tax "candy". State 1 defines candy to include cookies coated with chocolate (e.g., Twix bars) and imposes tax on those cookies. State 2 does not consider cookies coated with chocolate to be candy and exempts them as food. Some states may even treat chocolate-covered cookies differently than cookies that have stripes of chocolate.

Assuming a transaction is taxable, however, if the sales tax is not collected by the retailer, the buyer is still liable to pay use tax, which is a complement to the sales tax. While sales tax is owed for purchasing an item, use tax is owed for using an item where the sales tax has not been paid. It is meant to ensure uniformity of taxation and prevent people from avoiding sales tax by purchasing items from another state with lower or no sales tax. Michigan, like every other state with a sales tax, has a use tax with the same rate as the sales tax. Michiganders who are not charged sales tax on their online purchases are required to pay this tax when they file their State income tax forms, but compliance is very low and it is difficult to enforce. The Michigan Department of Treasury has estimated that $444.0 million in sales and use tax revenue from remote sales will go uncollected in fiscal year 2014-15.[1]

Through recently enacted legislation, Michigan may be able to collect approximately $60.0 million in sales and use taxes per year that it otherwise could not. To put this in perspective, the State collected more than $7.1 billion in sales and use tax in FY 2012-13.

This article will discuss the Michigan legislation in more detail, as well as the constitutional issues involved in collecting tax on out-of-state sales, and other state and Federal legislation on the subject.

Constitutional Issues

Although the internet has led to a vast increase in out-of-state sales, the issue of collecting tax on such transactions is not new. As early as 1827, the United States Supreme Court addressed constitutional limitations on the states' ability to tax interstate commerce.

In order for a state to impose a tax collection requirement on an out-of-state seller, the law must satisfy the Due Process Clause and the "dormant" Commerce Clause.[2] Both require there to be some type of connection, or "nexus", between the state and the remote seller before the state can impose obligations on the seller. The Due Process Clause requires a sufficient nexus so that the state has provided some benefit for which it may ask something in return, and so that the seller has fair warning that its activities may be subject to the state's jurisdiction. The dormant Commerce Clause requires a nexus to ensure that the tax collection requirement does not impermissibly burden interstate commerce.

One of the first prominent decisions on the subject is *National Bellas Hess v. Department of Revenue* (386 U.S. 753), which involved sales by a mail order house. In its 1967 opinion, the U.S. Supreme Court essentially held that, under both the Due Process Clause and the Commerce Clause, a seller had to have a physical presence in a state in order to be required to collect tax on sales made in that state.

In *Quill v. North Dakota* (504 U.S. 298), the Court revisited the issue. This 1992 decision remains the controlling law on interstate taxation. In *Quill*, the Court stated, "[T]o the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings…". The Court supported a flexible approach, in which a seller may have nexus if it has directed purposeful contact at a state's residents. With respect to the Commerce Clause, however, the Court retained the requirement of physical presence in order for an activity to have substantial nexus.

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[1] Michigan Department of Treasury - *http://www.michigan.gov/documents/treasury/Sales_Use_Tax_Report_2013_September2014_468579_7.pdf*.

[2] The Due Process Clause is found in Section 1 of the 14th Amendment, which prohibits states from denying any person life, liberty, or property without due process of law. The Commerce Clause, in Article 1, Section 8, gives Congress the power to regulate commerce among the states. The "dormant" Commerce Clause is the implicit prohibition against states' passing legislation that discriminates against or excessively burdens interstate commerce.

Determining whether physical presence exists is an issue that the Court addressed in earlier cases. In 1960, for example, the Court ruled that having in-state salespeople or agents was sufficient contact to establish a physical presence.[3] Also, physical presence is clearly established when a company has "brick and mortar" retail stores or offices in the state, even if the in-state offices are not related to the sales activity in question.[4]

Other State Actions

Some companies, such as Amazon.com, have been able to avoid the requirement to collect state sales taxes even though they have corporate offices, fulfillment and warehouse operations, customer service or other facilities in a state. They do this by creating wholly owned subsidiaries for non-sales operations so the subsidiaries' offices do not constitute a physical presence for the parent company that is making sales. This could be prevented if the U.S. Congress required sales or use tax collection for all out-of-state sellers, thus bypassing the physical presence standard. The Court pointed out in *Quill* that Congress has that power as long as the new standard complies with due process.

In the absence of Federal legislation, states have enacted their own laws to require collection from these and other companies that sell to their residents. The laws typically come in one of two types: "click-through" nexus laws and notification requirements.

Click-through nexus statutes require an online retailer to collect use taxes on sales to customers located in the state of the retailer's associates or affiliates, even if the retailer does not have a physical presence in the state. More than 15 states have enacted such laws. The term "click-through" refers to what takes place when an individual or business (called an associate or affiliate) places a link on its website directing internet users to an online retailer's website. For example, Amazon.com has the Amazon Associates program, where website owners can place links for products on their site and earn a referral fee when customers follow the link and buy from Amazon.com.

Arguably, this type of law complies with the *Quill* decision by targeting only internet retailers whose affiliate programs create some degree of physical presence in the state and whose affiliates solicit on the retailer's behalf. On the other hand, one could argue that the one-time action of placing a link on a website does not qualify as ongoing sales activity. A click-through nexus law also could be found unconstitutionally burdensome because it requires remote sellers to potentially monitor thousands of affiliates in order to determine whether the nexus requirements have been met.

The term "affiliate" also can refer to a person or organization that conducts certain activities that are significantly associated with a seller's ability to establish and maintain a market in a state, such as selling a line of products similar to the seller's, operating under the same business name as the seller or a similar name, or maintaining a place of business in the state to facilitate the sale or delivery of products for the seller. This definition is used in many of the laws enacted to prevent companies from avoiding the requirement to collect sales tax by using wholly owned subsidiaries for non-sales operations.

[3] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).
[4] *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977).

The first such law was enacted by New York in 2008. It requires collection by any entity that solicits business through employees, independent contractors, agents, or other representatives. This includes a "seller [that] enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller", if the seller does more than $10,000 in annual sales.

In 2013, the New York State Court of Appeals (the state's highest appellate court) rejected a challenge to the law.[5] According to the court, "[T]hrough this statute, the legislature has attached significance to the physical presence of a resident website owner. The decision to do so recognizes that, even in the Internet world, many websites are geared toward predominately local audiences…such that the physical presence of the website owner becomes relevant to Commerce Clause analysis…Essentially, through these types of affiliation agreements, a vendor is deemed to have established an in-state sales force." The court also found that "a brigade of affiliated websites compensated by commission" was sufficient to meet *Quill's* standard of "continuous and widespread solicitation within a state". The ruling was appealed to the United States Supreme Court, which declined to hear it.

State laws that take the "notification" approach require remote retailers to provide information to the state and customers, rather than requiring the retailers to collect the taxes themselves. Colorado enacted a notification requirement in 2010. The law imposes three duties on any retailer that does not collect Colorado sales tax, if the retailer's gross sales in Colorado exceed $100,000. The retailer must inform Colorado customers that a sales or use tax is owed on certain purchases and it is the customer's responsibility to file a tax return. The retailer also must send each Colorado customer a year-end notice of the date, amount, and category of purchases made during the year along with a reminder that the state requires taxes be paid and returns filed for certain purchases. Finally, the retailer must provide an annual statement to the Colorado department of revenue for each in-state customer showing the total amount paid for purchases during the year.

The notification law raises several constitutional questions.[6] Since any company with a physical presence in the state would already be required to collect Colorado sales tax, the law applies only to out-of-state companies. This could violate the Commerce Clause because it imposes duties on out-of-state businesses that the state does not require of Colorado businesses. Also, since the law applies to companies that do not have a physical presence in the state, the notification requirements would have to be distinguishable from the use tax collection requirements in *Quill*.

A Federal district court struck down the law in 2012, finding that the notification requirements were "inextricably related in kind and purpose to the burdens condemned in Quill", and these burdens would unconstitutionally interfere with interstate commerce.[7] In August 2013, the Tenth Circuit Court of Appeals dismissed the case, after finding that the Taxpayer Injunction Act prevented Federal courts from hearing it.[8] That law states, "The district courts shall not enjoin, suspend or

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[5] *Overstock.com v. New York State Dept. of Taxation & Finance*, 20 NY3d 586 (2013).

[6] *"Amazon Laws" and Taxation of Internet Sales: Constitutional Analysis*, Congressional Research Service, 11-28-2014.

[7] *Direct Marketing Association v. Huber*, No. 10-cv-01546-REB-CBS (D. Colo. 3-30-2012).

[8] *Direct Marketing Association v. Brohl*, 735 F.3d 904 (10th Cir. 2013).

restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."[9]

This decision was appealed to the United States Supreme Court. On March 3, 2015, the Supreme Court ruled that lawsuit was *not* barred by the Taxpayer Injunction Act, finding that the relief sought would not "enjoin, suspend or restrain the assessment, levy or collection of any tax under State law". The Court reversed the judgment of the Court of Appeals and expressed no view on the merits of the claims.[10]

Even if the statutes are ultimately found to be legal, there is still the concern that a retailer may end its affiliate relationships in a state in order to avoid having to comply. Amazon.com has already ended its associates program for residents of Arkansas, Colorado, Maine, Missouri, Rhode Island, and Vermont in response to their legislation. When this happens, the state loses the economic activity that is generated from the relationships, as well as the resulting tax revenue.

Michigan Legislation

On January 15, 2015, Governor Snyder signed into law Public Acts 553 and 554 of 2014, commonly called the "Main Street Fairness" Acts. These laws, which will take effect on October 1, 2015, amend the General Sales Tax Act and Use Tax Act, respectively, to establish affiliate nexus standards for the purpose of requiring out-of-state sellers to collect sales and use taxes for the State.[11] In this way, the laws resemble New York's "click-through nexus" law.

Under Public Acts 553 and 554, a seller that sells to a purchaser in Michigan will be presumed to be engaged in the business of making retail sales under the General Sales Tax Act, or to have a nexus with the State under the Use Tax Act, if the seller or a person (including an affiliated person) conducts certain activities in Michigan that are significantly associated with the seller's ability to establish and maintain a market in this State. Examples include selling a line of products similar to the seller's and doing so under the same business name as the seller or a similar business name, and maintaining a place of business in Michigan to facilitate the sale or delivery of products for the seller.

In addition, a seller will be presumed to be engaged in the business of making retail sales of tangible personal property in this State, or to have a nexus with the State, if the seller enters into an agreement with one or more Michigan residents under which the residents refer potential purchasers, whether by a link on an internet website or otherwise, to the seller, as long as certain thresholds for gross sales are met.

Both presumptions may be rebutted as provided in the Acts.

The Senate Fiscal Agency estimates that this legislation may annually increase State General Fund revenue by approximately $10.0 million, School Aid Fund revenue by approximately $44.0 million, and local unit revenue by approximately $6.0 million, assuming that the legislation is applied broadly and that affiliate networks are not dissolved or restructured in response to the amendments.

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[9] 28 U.S.C. §1341.
[10] *Direct Marketing Association v. Brohl* (575 U.S. ___).
[11] See *http://legislature.mi.gov/doc.aspx?2013-SB-0658* for a more detailed description.

Streamlined Sales and Use Tax Agreement

To encourage voluntary collection and remittance of taxes by out-of-state vendors, the National Governors Association and the National Conference of State Legislatures came together in 1999 to simplify and modernize sales and use tax collection. The product of their work is the Streamlined Sales and Use Tax Agreement (SSUTA). It is a voluntary agreement among member states designed to make it easier for sellers in the states to collect sales tax from residents of all other member states in exchange for simplifying their sales tax laws. To become a member, a state must take measures such as setting its rates at one general rate per state, with a second rate on food and drugs, and a single local rate per jurisdiction. The state also must agree to uniform definitions for categories of goods, adopt common state and local tax bases within the state, and agree to a uniform sourcing rule for goods and services and state-level administration of local sales and use taxes. There are many other features of the agreement not discussed here.

If a seller registers to collect sales tax under the agreement, the seller must collect tax from residents in all full member states, including states that become full members at a later date. The seller also may choose to collect tax for associate member states. An associate state is one that has signed on to the agreement, but is not yet in full compliance. Currently, there are 23 full member states, including Michigan, and one associate member state. In exchange for registering, the seller can receive amnesty from liability for prior sales, regardless of whether the seller had nexus with a particular state. The seller also has access to certified sales tax administration software that may be subsidized by the states, the simplicity of having one identification number to file and pay taxes in all member states, and a central location to update registration information with all the states at once.

Since SSUTA registration is voluntary, the supporters of the agreement have had only limited success signing up retailers. Federal action is necessary if collection by remote sellers is to be mandated. One of the primary goals of the SSUTA is to make sales tax collection simple enough to eliminate the argument by businesses that collection for other states is too burdensome. Eliminating that burden also could make it easier for the United States Congress to justify requiring sellers to collect and remit sales tax for customers in all states with the tax.

Federal Proposals

The United States Congress has taken up the issue of sales and use tax collection by out-of-state sellers several times since 2000. Most recently, two competing proposals have been introduced, one in the Senate and one in the House of Representatives. Each of the proposals attempts to make it feasible for businesses anywhere in the country to collect sales and use tax for any state in the union. The biggest difference between the proposals has to do with the sourcing of the sale.

There are two sourcing methods currently used with remote sales: destination sourcing (the sale is considered to take place in the location that the buyer takes possession of the merchandise) and origin sourcing (the sale is considered to take place in the location of the seller). There are philosophical reasons for each approach as well as practical concerns with implementation. Philosophically, when something is bought online, the question is whether the sale is taking place wherever the customer is using the internet, or whether he or she is virtually "traveling" to the store of the seller, much as a consumer might drive to a store in another state.

These philosophical differences as well as the practical matter of collection have led to two very different proposals. The Online Sales Simplification Act uses what it refers to as a hybrid-origin sourcing rule for sales and use tax collection. Under this proposal, remote sellers would collect sales tax at their local rate, regardless of the buyer's location. The only information they would be required to collect would be the amount of the sale, and the buyer's state and zip code. The sellers then would send the tax revenue to a clearinghouse within the state, which would determine how much tax was collected from residents of each state and send the appropriate amount of revenue to that state.

This proposal would simplify collection by requiring each seller to be familiar only with the sales tax requirements where it conducts business, and a seller could be audited only in its home state. However, several problems with this collection process have been identified. One is how to deal with sellers located in states that do not collect sales tax. If those businesses did not have to collect tax for out-of-state buyers, internet retailers would have an incentive to relocate to those states, which could lead to a "race to the bottom" among states with regard to sales tax rates. On the other hand, if a standardized collection rate were applied to sellers in those states for out-of-state buyers, the Federal government would be imposing a collection burden on the businesses that their home states decided they should not have. Arguably, the proposed law also could violate due process because if the sale takes place where the buyer is using the internet, that buyer may lack the minimum contact with the taxing state to justify being charged sales tax.

The other key proposal is called The Marketplace Fairness Act (MFA), and it passed the U.S. Senate in 2014. The proposal is different than Michigan's Main Street Fairness Act, which requires collection of sales tax from out-of-state sellers if they have sufficient nexus with Michigan. The MFA would allow any state to require sales tax collection by out-of-state sellers if the state "simplified" its sales tax system, either by becoming a member of the SSUTA or by adopting specific changes to its sales tax system. It is argued that calculation of sales tax on internet sales (particularly with the proposed simplifications) would be easily achieved with software. Mail-order retailers have complained, however, that since their customers must calculate sales tax manually, it would not be simple for them. Also, it is possible that the information that a seller would have to provide for all taxing jurisdictions could be larger than the catalogue to which it was attached. The legitimacy of this argument could depend on how successful the MFA was in reducing the number of tax rates and exemptions through its required simplification. Another major objection that has been raised is that the MFA would violate principles of federalism, imposing "regulation without representation", because retailers would be subject to burdens imposed by states in which they have no presence or political voice.

Neither of the proposals would require tax collection by firms located in other countries. They would require sellers located in one of the 50 states to collect and remit sales tax for the other states, but if a seller moved to another country, there does not seem to be a way to mandate collection. If sellers chose to relocate outside of the country to avoid collecting sales tax from buyers, even Federal legislation would be insufficient to force compliance.

Conclusion

A large amount of sales tax revenue is lost due to internet sales. While customers are required under current law to calculate and remit use taxes to their state on these sales, enforcement is difficult and compliance is very low. Many states, including Michigan, have taken action to collect a larger share of this revenue, but they are severely limited by the Constitution and judicial holdings. Action by the Federal government would overcome most legal obstacles, but there is considerable disagreement within Congress regarding the best way to organize that collection.