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MAIL ORDER SALES: IS MICHIGAN GETTING ITS FAIR SHARE OF SALES AND USE TAXES?

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Questions concerning the collection of mail order sales and use taxes have become more prevalent with the evolution of the mail order industry over the past decade and the increase in mail order sales to Michigan customers from out-of-state sellers. It is estimated that Michigan currently loses approximately \$110 million a year from uncollected tax revenues from mail order sales.

Can anything be done legislatively to increase Michigan's share of revenues from mail order sales? To answer this question, it may be helpful to review the basic structure of sales and use taxes in Michigan.

Sales Tax

Sales tax¹ is imposed on a retailer selling tangible personal property in the state, and it represents a tax on the privilege of doing business in Michigan. In general, sales tax is imposed whenever tangible personal property is sold at retail within the state. A sale is considered to be made in Michigan when an order is accepted or shipped from within the state, or when title to goods passes within the state.

In most cases, collection of sales tax would not be required from an out-of-state mail order company unless such a company maintained a stock of goods, had a retail store or office within Michigan, or maintained a warehouse in Michigan from which it shipped goods within the state.

Use Tax

Use tax² is a tax on the consumer for the privilege of using, storing or

¹ MCL 205.51 *et seq.*

² MCL 205.92, *et seq.*

consuming tangible personal property within Michigan. The use tax complements the sales tax and is designed, among other things, to reach sales made outside the State of Michigan where sales tax cannot be constitutionally imposed.

Use tax puts in-state and out-of-state sellers on equal footing by neutralizing an in-state consumer's incentive to purchase the same item out of state to avoid paying sales tax—thus lowering the total price of the item.

As a practical matter, it is virtually impossible for the state to accurately identify purchasers who buy out-of-state goods for use in Michigan. Therefore, instead of relying solely on consumers' voluntary compliance to pay the use tax, Michigan imposes a duty on the out-of-state seller to collect the use tax and remit it to the state.

The responsibility of use tax collection, however, can be imposed on out-of-state sellers only when certain constitutional requirements exist. These requirements arise under the Commerce Clause of the United States Constitution and are designed to promote the free flow of interstate commerce.

Physical Presence Requirement

Requirements that must be satisfied before a state can constitutionally impose responsibility for use tax on an out-of-state mail order seller

were set forth by the United States Supreme Court in *Quill v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904 (1992).

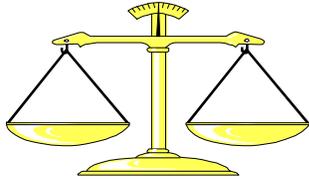
In that case, the Court established a test that must be met before any state can impose a responsibility on an out-of-state mail order company to collect use tax on purchases from in-state customers.³

The Court also announced a "bright-line" rule providing a safe harbor for out-of-state mail order companies. The "bright-line" rule states that when a seller's only connection with customers in a state is through common carrier or the United States mail, and when there is otherwise no physical presence (i.e., nexus) in the state, a company may not be required to collect and remit use tax.

Thus, because of this "physical presence" standard, an out-of-state mail order company that does no more than solicit sales to Michigan customers through catalogs and make shipments from out-of-state will not have

³ The Court used a four-prong analysis from *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977), used to test the constitutionality of state taxation of interstate commerce. A state tax will withstand scrutiny under a Commerce Clause challenge if it is applied to an activity which: 1) has a substantial nexus with a taxing state, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the state.

sufficient connection with Michigan for use tax to be collected.



Recent Litigation

The limitation imposed by the physical presence requirement, along with the difficulty faced by the Michigan Department of Treasury in collecting use taxes from out-of-state sellers, was illustrated by a recent Michigan Court of Appeals case, *Scholastic Book Clubs, Inc. v. State of Michigan* (__ Mich App __; __ NW2d __; Docket No. 189386, Rel'd. May 20, 1997). This case involved a Missouri company ("Scholastic") that sold books and other materials to schoolchildren throughout the United States by sending catalogs to teachers who collected orders and remitted payment.

Although Scholastic had no property in Michigan and maintained no employees in the State, the Department of Treasury sought to impose responsibility for use tax collection on the agency theory, which holds that a person who has received power to act on

behalf of another can "bind" the other contractually. It was argued that utilizing in-state teachers to take orders and deliver books on the company's behalf constituted physical presence in the State, thus triggering use tax collection responsibility.

The Michigan Court of Appeals disagreed with this view, and found physical presence lacking. The Court noted that there was no legal agency created by using the teachers, because the teachers had no power to "bind" Scholastic and Scholastic had no control over the teachers' actions.

Because the only contact Scholastic had with Michigan was through mail contacts with Michigan teachers, the responsibility for use tax collection was found to be constitutionally impermissible.

The Scholastic case demonstrates the difficulties faced by the Department of Treasury in its attempts to collect use taxes on mail order purchases. If the state wishes to find new ways to assert responsibility for use tax collection on out-of-state retailers, changes must be made on the federal level.

PROPOSED LEGISLATION

There have been a few failed legislative attempts in Michigan in recent years to

amend the Sales and Use Tax Acts to include sales made by out-of-state sellers to Michigan residents.⁴ However, the Supreme Court in *Quill* made it clear that changes which make it easier for states to capture revenue from out-of-state sales to in-state residents should be made by Congress, since Congress has the ultimate power under the Commerce Clause to regulate interstate commerce and resolve the use tax jurisdictional issue.

Attempts at the federal level have been made in recent years to change the physical presence requirement that now prevents states from collecting use taxes from many out-of-state vendors. Most recently, a bill known as *The Consumer and Main Street Protection Act of 1995* was introduced in the United States Senate. This bill would have authorized a state to require out-of-state mail order companies to collect sales/use taxes on tangible personal property sold/shipped to customers in the state, even when a mail order company's only contact with the state was through solicitation of business through catalogs.

Under this bill, the duty to collect the tax would have applied only to vendors selling at least \$100,000 a year in the state, or those that had more than \$3 million annual sales in the United States. The bill would have also changed the jurisdictional requirement of physical presence to one of

⁴ See HBs 5509/5510 introduced in 1994, and HBs 4164/4165 introduced in 1995.

“minimum contacts” with the taxing state.

If the bill had passed, solicitation of customers through mail order catalogs would have been enough to subject an out-of-state mail order company to the taxing jurisdiction of the state. The bill was introduced on March 13, 1995, and subsequently died in the Senate Finance Committee. There is currently no similar legislation pending in Congress.

CONCLUSION

Because of the constitutional limitations imposed by *Quill*, it is likely that attempts at the state level to statutorily expand Michigan's jurisdiction to impose responsibility for use tax collection (on out-of-state mail order companies) would successfully be challenged in the courts.

Any change in Michigan's ability to reach those companies having no physical presence in the State and doing no more than soliciting sales through catalogs, would have to come from Congress, which has the power to regulate interstate commerce under the United States Constitution.

It remains to be seen whether Congress will take such action and enable states to capture taxes on mail order sales made to its residents.

Unless and until Congress decides to make jurisdictional changes, many purchases made by Michigan residents

from out-of-state vendors will continue to escape taxation, and Michigan will continue to lose significant revenues from mail order sales.