

The *Wayfair* Decision: How Michigan Policymakers Should Respond

By Andrew Moylan and Andrew Wilford

Introduction

The U.S. Supreme Court's ruling in *South Dakota v. Wayfair* last June overturned decades of precedent governing which businesses states could subject to collection and remittance requirements for sales taxes. Prior to the decision, states were restrained by an ironclad rule: businesses had to have some form of "physical presence" in the state, be it a warehouse, retail outlet, or locally based sales representative, in order to be held liable for collection and remittance of sales taxes. By overturning this precedent, the Supreme Court opened the floodgates to allow states to tax businesses all across the country regardless of where they may be located.

In place of the physical presence standard, the Court effectively gave its blessing to so-called "economic nexus" laws, such as the one in South Dakota that was challenged in the *Wayfair* case. Economic nexus laws establish tax collection and remittance requirements for businesses that exceed certain transaction thresholds within a state.

This looser standard grants states much more tax power and threatens to encourage aggressive cross-border taxation that can harm interstate commerce

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and undermine the delicate constitutional framework of limited government and federalism. That's why free-market advocates have been warning about such a system for nearly two decades.¹

After the Court's ruling, many states were eager to break down the barrier of the physical presence requirement and generate some extra revenue. Michigan was one of those states. But states should proceed more carefully as there are important ramifications from implementing a new standard that should be considered first.

This does not appear to have happened in Michigan. Rather than take the time to allow the Legislature in Lansing to hold hearings and discuss legislation to implement what is a substantial and complex new tax rule, the state's Department of Treasury simply issued two and a half pages of guidance meant to implement a broad and sweeping new tax policy.²

The Michigan Legislature is just now considering how to modify Michigan statute to make use of this new standard. This report offers guidance on how best to achieve that end, raising important questions that lawmakers should consider before subjecting new businesses and entrepreneurs to new tax collection requirements.

¹ Lawrence W. Reed, "Internet Purchases: To Tax or Not to Tax, Here Are the Questions" (Mackinac Center for Public Policy, March 31, 2000), <https://perma.cc/EW7K-YBXX>

² Revenue Administrative Bulletin 2018-16, Sales and Use Tax Nexus Standards for Remote Sellers" (Michigan Department of Treasury, Aug. 1, 2018), <https://perma.cc/FEK4-U53A>

What *Wayfair* Means for Businesses

To fully understand the problems with Michigan's approach, it must be put in the broader context of how the Court's decision in *Wayfair* created new hassles and complexity for businesses.

The *Wayfair* decision immediately created a significant new compliance challenge for small and medium-sized businesses. Despite the fact that South Dakota has the fourth smallest state economy in the U.S., many states have simply copied its transaction thresholds.³ The South Dakota Legislature decided that a firm that has 200 transactions or \$100,000 in sales had an economic nexus in the state. These same thresholds were declared the standard for Michigan by the Treasury's edict.⁴ In other words, most states have chosen to implement the bare minimum "safe harbor" to sell into their state without facing the new collection and remittance requirements, ensnaring more small businesses than perhaps the Court intended.

And small businesses are the ones in the most danger as a result of these changes. Despite the fact that economic nexus laws were once colloquially referred to as "Amazon taxes," larger online retailers, such as Amazon and Walmart, already collected and remitted taxes nationwide well before the *Wayfair* ruling came out, as they already had a physical presence in most states in the form of warehouses or retail outlets.⁵ Most affected by economic nexus legislation will be smaller retailers that sell across the country but previously only had to collect taxes for sales in their home jurisdiction. Now they will have to contend with as many as 12,000.⁶

Unfortunately, small businesses are the least equipped to deal with these new compliance requirements.⁷ Where larger retailers can call upon armies of tax

professionals, smaller firms, even those meeting South Dakota's de facto transaction threshold, can be small enough to not even have an accountant on staff.

For instance, a specialty jewelry company could surpass \$100,000 of sales into a state with just a few transactions. A high-volume business selling inexpensive items like stickers could surpass 200 transactions with less in total revenue than is produced by your average neighborhood estate sale. Neither of these examples constitute businesses of scale sufficient to easily handle significant tax compliance burdens in Michigan, and yet the standard of 200 transactions or \$100,000 in sales would create significant tax collection burdens that may be too much for them to bear.

Were each state to implement a sales threshold of \$100,000, a business with just \$5 million in total revenues could theoretically trigger thresholds in a dozen states, or more, if their sales are more widespread. While a firm with \$5 million in revenue may seem capable of handling the requirement to collect, remit and comply with the tax codes of a dozen different jurisdictions, it is in fact a very small business by most standards. If the business runs with a gross margin of 20%, that's less than \$1 million with which to pay all bills and salaries, an amount which likely supports only about 10 employees.⁸ This falls short of the Small Business Administration's definition of a small business. Firms engaged in retail trade, the type of businesses most likely affected by these new tax requirements, are considered a small business if they have revenue between \$7.5 million and \$38.5 million, depending on the type of good they retail.⁹

Online retailers, particularly those falling below the SBA threshold, should not be forced to grapple with thousands of different tax definitions, rates,

3 U.S. Bureau of Economic Analysis, Total Gross Domestic Product for South Dakota, retrieved from FRED, Federal Reserve Bank of St. Louis <https://fred.stlouisfed.org/series/SDNGSP>, May 31, 2019.

4 Andrew Wilford, "America's New Sales-Tax Mess," *National Review Online*, Sep. 12, 2018, <https://perma.cc/PPJ8-UML8>.

5 Nick Statt, "Amazon Will Start Collecting Sales Tax Nationwide Starting April 1st" (The Verge, May 24, 2017), <https://perma.cc/23T3-VM23>.

6 Robert Barnes and Abha Bhattarai, "Supreme Court Considers Whether States Should Have Power to Tax All Online Sales," *The Washington Post*, April 15, 2018, <https://perma.cc/F7WB-F7DV>.

7 Bruce Edward Walker, "Bad for Business: Internet Sales Tax Legislation" (Mackinac Center for Public Policy, May 6, 2013), <https://perma.cc/6ZWL-MG4O>.

8 Patrick Thibodeau, "In Online Sales Tax Debate, \$1M Business Is 'Mom and Pop,'" *Computerworld*, March 22, 2013, <https://perma.cc/H6VJ-DBER>.

9 "Table of Small Business Size Standards Matched to North American Industry Classification System Codes" (U.S. Small Business Administration, 2017), <https://perma.cc/E4KF-5JZJ>.

exemptions, and administrative quirks across the country when attempting to comply with tax obligations. Tax compliance is already significantly more expensive for small businesses than larger ones. The National Association of Manufacturers estimated in 2014 that tax compliance costs businesses with more than 100 employees nearly \$700 per employee, but it costs businesses with fewer than 50 employees over \$1,500 per employee.¹⁰

Small businesses will also have to contend with a sales tax landscape that is more complex than it necessarily has to be. While 23 states, including Michigan, are members of the Streamlined Sales and Use Tax Agreement, 26 others and the District of Columbia still are not.¹¹ The SSUTA member states work toward standardized tax definitions, simplified rates and streamlined administration.¹²

While these simplification efforts are valuable, two-thirds of Americans live in states that do not abide by this agreement.¹³ This includes the six largest states: California, Texas, Florida, New York, Pennsylvania and Illinois.

Michigan's Hasty Administrative Action

It is in this context of complexity and sudden new obligations for small businesses that the Michigan Department of Treasury introduced their new tax guidance on complying with the *Wayfair* decision. This ill-advised action creates several problems for small businesses.

First and foremost, tax policy has an enormous impact on Michigan's economy, impacting thousands of businesses and millions of employees. Major changes to the tax code should be arrived at through a comprehensive process led by duly elected legislators. The idea that a small group of bureaucrats should implement significant changes to Michigan tax policy

seems to call into question which branch of government maintains the ultimate authority to determine how Michigan's tax system works.

The Department of Treasury's guidance illustrates the pitfalls of hasty administrative action. In short, it is not specific enough, leaving businesses that need to comply in a difficult position. For example, it does not clarify collection requirements for all types of businesses that could conceivably be required to collect the state's tax. Further, out-of-state businesses seeking to sell into the state may not have access to affordable software that allows them to meet these obligations. And even if they are able to access software, it is not clear what their liability will be if they are found in error of their tax obligations. A more comprehensive review of Michigan law with regards to these matters is necessary to make it more feasible for these businesses to comply with this new requirement.

Additionally, Michigan's administrative guidance cannot appropriately handle unique cases that do not fit neatly into a simplistic rule. For instance, one significant point of controversy across the country as states have pursued post-*Wayfair* laws is the treatment of so-called "marketplace facilitators," businesses that offer platforms connecting buyers and sellers to one another. This includes services like Amazon Marketplace, auction sites like eBay, and even, potentially, travel booking sites like Priceline or classified advertising platforms like Craigslist. The legislative process, properly followed, would allow lawmakers a chance to protect such businesses from expensive or even duplicative tax requirements.

Proceeding administratively also forecloses opportunities to hear from businesses and individuals of all types about the impact new collection rules might have on them. This could include brick-and-mortar businesses that are well-represented in

10 W. Mark Crain and Nicole V. Crain "The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business" (National Association of Manufacturers, Sept. 10, 2014), 2, <https://perma.cc/2MUL-TN2K>

11 Tennessee is an "associate member" of the Streamlined Sales and Use Tax Agreement "State Information" (Streamlined Sales Tax Governing Board, Inc., 2018), <https://perma.cc/HV49-ZV5E>.

12 "FAQs - General Information About Streamlined" (Streamlined Sales Tax Governing Board, Inc., 2018), <https://perma.cc/DZ89-T3CY>

13 "State Information" (Streamlined Sales Tax Governing Board, Inc., 2018), <https://perma.cc/HV49-ZV5E>.

Michigan, but also online sellers and the consumers who buy from them. There are thousands of businesses that will be impacted by changes to Michigan's tax code, and getting this policy right — or wrong — will have lasting implications for years as the online economy continues to grow in prominence. Public feedback through hearings is necessary both to help tailor the policy to the challenges of the day and to help it earn the legitimacy and durability that administrative actions lack.

Additionally, bypassing the legislative process shortens the timeframe in which businesses can prepare to respond to policy changes. As much as legislative inertia is criticized, it serves a purpose by subjecting major policy shifts to a deliberative process that takes time to complete — online retailers are at least forewarned of the new policy and given time to prepare as bills work their way through the Legislature.

In Michigan's case, the administrative bulletin announcing significant new tax compliance obligations was published Aug. 1, 2018, just over a month after the Supreme Court issued its decision in *Wayfair*. The new rules took effect two months later, on Oct. 1. That's good news for state tax bureaucrats looking to capture new revenue during the holiday season, but bad news for retailers expected to implement a significant new tax compliance infrastructure in the space of three months. Nearly one year after *Wayfair* was decided, many businesses are still struggling to adapt to these new tax requirements.

Proposed Michigan Legislation

On May 2, 2019, a package of bills — House Bills 4540, 4541, 4542 and 4543 — was introduced by Reps. Afendoulis, Webber, Tate and Yancey that would do two things. First, they would append to Michigan's sales tax code a new nexus requirement that subjects any business, no matter its location, to Michigan tax law if it sells more than \$100,000 in goods or if it makes 200 or

more transactions in the state. This is the same threshold South Dakota established despite the fact that Michigan's economy is more than 10 times larger.¹⁴ As a result, this law would ensnare significantly more small businesses compared to South Dakota.

Many states, like Michigan, have seized upon South Dakota's specific thresholds as having received "the Court's blessing." Yet the Court did not rule that each state must institute a specific threshold — the majority's opinion only indicated that the specific details of South Dakota's economic nexus law did not represent an undue burden on interstate commerce. The small seller exception was an important part of the Court's calculus, to be sure, but so was South Dakota's relatively broad, simple sales tax code, its membership in SSUTA, the provision of free tax compliance software to online sellers and other elements.

Nowhere in the decision does the Court suggest that states are not free to define a higher threshold than South Dakota's.¹⁵ In effect, the majority created a floor below which states cannot go, but did not define a ceiling. In fact, several other states, such as Texas and California, have already set higher transaction thresholds, at \$500,000.¹⁶ Higher thresholds like this are likely to improve a state's chances for staving off expensive litigation that could result should a business bring a suit alleging that it oversteps the bounds laid out by the Supreme Court in *Wayfair*. In other words, a threshold higher than South Dakota's is likely on safer ground constitutionally. More importantly, though, it will ensure that the state does not impose burdensome collection obligations on businesses that are smaller operations than those exempted under South Dakota's law, simply by virtue of the larger size of Michigan's population and economy.

Should Michigan wish to comply with the spirit of the *Wayfair* decision and not merely the technical language, its thresholds would look very different.

14 U.S. Bureau of Economic Analysis, Total Gross Domestic Product for Michigan, retrieved from FRED, Federal Reserve Bank of St. Louis, <https://fred.stlouisfed.org/series/MINGSP>, May 31, 2019.

15 *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018).

16 "Texas Amends Rules for Remote Sellers to Establish Economic Nexus" (Sales Tax Institute, Jan. 11, 2019), <https://perma.cc/DPD7-LNDK>; "California Will Tax Sales by Out-of-State Sellers Starting April 1, 2019" (Avalara, Dec. 13, 2018), <https://perma.cc/RS7S-22XT>.

Given that Michigan's economy is roughly 10 times the size of South Dakota's, if it were to scale its thresholds proportionally, it would set the limit closer to 2,000 transactions or \$1 million in sales.

The second thing the package of bills would do is impose tax collection obligations on marketplace facilitators, again using a \$100,000 in sales or 200 transactions threshold. A marketplace facilitator is defined as a platform that meets each of three criteria: it receives fees of some sort from a seller, it communicates offers and acceptance between parties, and it collects and transmits payment to the seller. The proposed legislation also defines the term to not include travel booking services, if the provider of the accommodation is already registered to collect and remit taxes themselves. This language prevents imposition of tax obligations on most travel booking sites and on so-called "pure platforms," such as Craigslist. These services simply connect buyers and sellers and have no involvement in or knowledge of actual transactions.

However, subjecting other marketplace facilitators to a new tax requirement, especially when combined with Michigan's cap on the amount of money retained by a retailer as compensation for administering a tax, could push the compliance burden as a percentage of sales higher, discouraging sellers from doing business in Michigan lest they expose themselves to a web of compliance obligations and costs, which would ultimately harm interstate commerce.

Another issue with this package of bills is that it does not make any distinction between taxable and nontaxable sales. This means that wholesale businesses or others making largely tax-exempt sales might trigger collection and paperwork requirements despite making few, if any, taxable sales into the state. Imagine a wholesaler that makes 300 sales into Michigan, all of which are to businesses that will retail the items to consumers and thus aren't taxable. This company would surpass the 200 transaction threshold laid out in these bills and could be exposed to paperwork

requirements, and potentially an audit by the state, despite not making a single taxable sale into Michigan.

While this bill package addresses some of the gaps left by the Treasury's administrative rule, it does not do enough to provide comprehensive guidance and protection from complicated tax rules, especially from the perspective of small businesses.

For example, none of the bills contain protection for Michigan-based businesses facing unconstitutional collection or audit schemes from other states. Even if Michigan legislators check every box to ensure that the tax obligations they impose on out-of-state businesses will meet constitutional muster, that is no guarantee that other states will do the same. States that have overly complex sales tax codes (like Louisiana or Colorado), or with very low thresholds (like the \$10,000 threshold used for transaction reporting in Pennsylvania), or that choose to impose sales taxes retroactively (like Massachusetts) would be able to demand that Michigan-based businesses comply with their laws.

The bills also do not make revisions to other parts of the tax code that might need updating as a result of the *Wayfair* decision. For instance, Michigan legislators should seek to simplify the process for a business to obtain an exemption certificate. These are used by companies that make business-to-business, or wholesale, transactions or otherwise sell products that are not subject to sales tax collection requirements. The exemption certificate serves as proof that no tax is required. Given that thousands of new businesses across the country might be subjected to Michigan's tax law for the first time, the state could benefit from simplifying its own standards and working with other states to streamline theirs as well.

Recommendations for Future Action

The first improvement Michigan policymakers could make to their economic nexus legislation would be to scale up the nexus thresholds it uses in order to avoid targeting small businesses without the means to adjust to this new compliance burden. The internet has been an effective tool for small businesses to reach the same markets as large corporate retailers, and Michigan should not be derail this great equalizer in the name of a small amount of added revenue.

Legislators should then be certain to clarify that remote retailers will receive protection from aggressive tax collection and audit procedures in the event of unintentional errors made by sellers, software providers, or government entities. Tax computing software and the people that are working to install and maintain it are still adjusting to this new and constantly shifting tax landscape as well, and mistakes are likely to be more common than usual. There is no need to punish retailers doing their best to correctly remit sales taxes for these growing pains.

Lansing legislators should also clarify that economic nexus standards apply only to sales tax collection on remote sales, and should not be construed to weaken nexus requirements already in statute for business income tax or individual income tax collection. Legislators should also distinguish between tax-exempt and non-tax-exempt sales for the purposes of threshold requirements, so that wholesale suppliers with no taxable sales are not required to report to the state.

A full legislative process could also explore methods of protecting Michigan businesses. For example, a Virginia law enables businesses to seek a declaratory judgment if another state requires them to collect and remit taxes where they do not have a physical

presence.¹⁷ Crutchfield, an electronics retailer, made use of such a law and brought suit against the state of Massachusetts and its “cookie nexus” law.¹⁸

That could be modified in a post-*Wayfair* world to grant a right to seek a judgment in Michigan courts against collection efforts on a Michigan business that fails to meet the standards laid out by the Supreme Court in its ruling. Those standards include such important measures as a significant safe harbor exempting small sellers, central administration of sales tax, and efforts to simplify sales tax rules, among others. Any state not meeting those standards should not be allowed to impose its tax laws on Michigan-based sellers.

A recent Supreme Court decision in a California tax dispute might change the contours of such a statute, but Michigan lawmakers should explore the concept at minimum and should work with fellow member states of SSUTA to encourage other states to follow a path of simplification.¹⁹

Conclusion

Michigan lawmakers can still take positive steps to ameliorate some of the issues associated with the hasty rules the Department of Treasury issued in response to the *Wayfair* decision. Lawmakers should work to reclaim legislative prerogative and replace the administrative guidance with new legislation that codifies these new tax compliance rules in statute. Lansing legislators have a duty to their constituents and to businesses to provide the specificity and fair process that all taxpayers deserve on complex matters such as tax law.

¹⁷ Va. Code § 8 01-184.1

¹⁸ Tracy Maple, “Crutchfield Sues to Block Massachusetts from Collecting Online Sales Tax,” *Digital Commerce 360*, Oct. 25, 2017, <https://perma.cc/4EQL-QYTH>.

¹⁹ *Franchise Tax Board of California v Hyatt*, 587 US ___ (2019).

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Issue Brief

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BY ANDREW MOYLAN & ANDREW WILFORD

States Should Exempt Non-Taxable Sales When Setting *Wayfair* Thresholds

As states across the country move quickly to impose new sales tax collection obligations after the Supreme Court's decision in *South Dakota v. Wayfair*, one detail has been overlooked by many lawmakers: the role that non-taxable sales play when establishing sales thresholds that trigger tax obligations. Unfortunately, most states have miscalculated the importance of excluding these tax-exempt sales from thresholds used to determine tax compliance.

Michigan is the latest example of a state wrestling with this issue. Back in June, NTUF partnered with the Michigan-based Mackinac Institute for Public Policy to draft a [policy paper](#)¹ recommending changes to the state's approach to economic nexus rules. Like many others, the Great Lakes State is considering legislation that would require a business to collect its sales tax once it surpasses a certain threshold of sales to consumers in the state. In draft legislation, that total would be 200 transactions or \$100,000 in sales.

¹ Moylan, Andrew and Wilford, Andrew. "The *Wayfair* Decision: How Michigan Policymakers Should Respond." National Taxpayers Union Foundation, September 1, 2019.

Key Facts:



Michigan's draft economic nexus law exempts small businesses that sell less than a specified threshold of sales within the state.



However, these thresholds do not differentiate between taxable and nontaxable sales, putting wholesalers at risk of major compliance and audit obligations.



Excluding nontaxable sales when calculating sales toward the threshold would ensure that wholesalers are not subject to crippling new tax rules despite having little or no actual tax owed to the state.

In addition to recommending a much higher threshold in order to account for the fact that Michigan's economy is many times the size of South Dakota's, another key suggestion in the paper was to exclude non-taxable sales from counting toward the sales threshold. As currently drafted, Michigan's legislation makes no such distinction. The result is that sellers with significant amounts of tax-exempt sales into the state might get dragged into tax compliance and audit obligations, despite having little (if any) actual responsibility to actually collect tax.

Non-taxable sales generally come in one of two forms. The first consists of business-to-business, wholesale, or "sale for resale" transactions. An example would be an out-of-state clothing manufacturer making a sale to a Michigan-based clothing retailer. That sale would not be taxable under Michigan law because it is a business-to-business transaction made with a so-called "resale certificate" that serves as proof that the Michigan-based retailer will be reselling the item in its own store. This is because Michigan's sales tax, like most states, only counts final sales made to consumers as taxable.

The second type of non-taxable sale is a business engaged in selling items that happen to be exempt from sales tax collection in the state's sales tax code. In Michigan, this generally includes most services, as well as some specified categories of tangible goods like groceries or prescription drugs.

The logic behind excluding tax-exempt sales from any post-*Wayfair* transaction threshold is pretty simple. If a sale isn't taxable for some reason under a state's rules, then it shouldn't count towards a retailer's transaction total for determining tax obligations. Businesses that make significant numbers of tax-exempt sales but little to no taxable sales into a state, such as wholesalers, could find themselves being held responsible for significant paperwork obligations and even audits if lawmakers do not fix this language.

Given that the purpose of economic nexus rules is to force collection of previously unremitted sales and use taxes, non-taxable sales are by definition not relevant to this goal. Failing to exempt these sales from threshold calculations accomplishes no policy objective, while at the same time creating an unnecessary compliance burden for remote businesses that engage in transactions prior to the final sale.

And these costs aren't restricted to the sellers directly affected by them. Should a wholesaler's payroll costs be affected by the need to retain staff to handle unnecessary tax filings, retailers and consumers can face artificially higher costs as a result. This cost is compounded each time a state fails to exempt tax-exempt sales from its threshold calculation.

Luckily, the solution to this problem is straightforward. In fact, it could be as simple as adding a single word to statute: "taxable." For example, if a state chose to proceed with a transaction threshold of \$500,000 and 1,000 sales into the state, it could simply add the word "taxable" before "sales" to ensure that wholesalers aren't swept up in audits and compliance obligations.

This simple change would ensure that only taxable sales are counted when calculating sales against the threshold, thus alleviating significant potential burdens. Michigan, and other states continuing to consider post-*Wayfair* laws, would be wise to incorporate it.

Andrew Moylan and Andrew Wilford lead the Interstate Commerce Initiative at the National Taxpayers Union Foundation (NTUF), a project which seeks to protect taxpayers from the pernicious effects of states attempting to exercise power outside their borders. NTUF is a nonpartisan research and educational organization that shows Americans how taxes, government spending, and regulations affect them.



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