
FISCAL FOCUS

MICHIGAN AND INTERNET TAXATION

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February 1998



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February 17, 1998

TO: The Members of the House of Representatives

Over one million Michigan residents currently use the Internet, and that number surely will grow. Although Internet commerce is in its infancy, it is clear that the sale of products and services via the Internet will continue to increase significantly. Relevant questions for Michigan legislators pertain to how current Michigan tax laws apply to Internet commerce and whether the State's revenue system should be adjusted to compensate for state revenue losses attributed to Internet commerce.

This **Fiscal Focus** responds to these important tax policy questions. *Michigan and Internet Taxation* assesses the legal and fiscal aspects related to state taxation of Internet-based commerce. It examines some of the methods used by other states to impose sales and use taxes on goods and services sold through the Internet, and it explains how existing Michigan tax law applies to this relatively new form of commerce. Also discussed are possible solutions to questions surrounding state and local taxation of the Internet.

Michigan and Internet Taxation was prepared by Mitchell Bean, Senior Economist, and Marjorie Bilyeau, Tax Attorney. The report was formatted for publication by Jeanne Dee, Administrative Assistant.

Please call us should you have questions on this report.

James J. Haag, Director

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GLOSSARY

Cyberspace

A slang term for the Internet that originated in the novel *Neuromancer*, by William Gibson.

Electronic Commerce

A term used to refer to sales or business conducted over the Internet.

Internet

A connection of computers and communications networks.

World Wide Web

A service that allows computer users to view text, images, or video, and hear audio over the Internet.

INTRODUCTION

The Internet, once used only for military and academic research, has become a fixture of everyday life for many people in Michigan. Most would agree that it benefits Michigan's citizens, and there is no question that its use will continue to grow. But at the same time, Internet use in Michigan poses difficult questions for lawmakers who must, inevitably, make policy decisions as to how Michigan should tax Internet-based commerce; and for multi-state taxpayers concerned with multiple taxation and the lack of uniformity among states in the way that Internet commerce is taxed.

Many states are already seeking ways to capture and preserve portions of this revenue-rich source, which promises to increase in importance over the next decade. Unless Congress decides to preempt the field of Internet taxation, Michigan may eventually have to decide whether and how to tax this fast-growing economic sector.

In general, there are three main potential sources of state revenue related to Internet commerce: taxation of tangible goods purchased through cyberspace, taxation of online information services, and utility-type taxes on Internet service providers. There is wide variation among state and taxing jurisdictions as to the type of taxes currently imposed on Internet commerce. Some states have even taken steps to exempt Internet commerce from taxation; for instance, New York has agreed to exempt Internet services from sales tax. Other states, such as Connecticut, specifically target the taxation of Internet or information services.

While Michigan does not exempt Internet commerce, neither does it impose any special taxes on it. Instead, Michigan superimposes existing tax laws onto this relatively new form of doing business. Therefore, in theory, the

majority of Michigan taxes from Internet commerce come from sales and use taxes from the sale of tangible goods made over the Internet, as well as from single business taxes generated from those sales. Because Michigan does not impose sales tax on most services, Internet-based services, for the most part, escape sales taxation. Also, Michigan does not impose Internet access charges, taxing only the underlying phone call made to reach the Internet service provider.

This **Fiscal Focus** will discuss various methods that states use to impose sales and use taxes on Internet commerce, and will examine how existing Michigan tax law applies to this relatively new form of commerce. It will also discuss some of the solutions that recently have been offered with regard to state and local taxation of Internet commerce.

BACKGROUND TO THE INTERNET

The Internet is a connection of computers and communications networks operating through a larger communications network. The Internet actually began in 1969, evolving from an experimental military project created by the United States Department of Defense. Known as "ARPAnet," this original network linked computers operated by military organizations, defense contractors, and university labs, and was designed to maintain communications among those entities in the event of a nuclear attack.

In the 1980s, the National Science Foundation (NSF) developed a high-speed network tying together universities and governmental agency systems. The NSF network completely replaced ARPAnet in 1990, becoming the backbone of the Internet.

Finally, in 1995, NSF operations were essentially turned over to private network companies with established links or "gateways" to the Internet. Using a computer with a modem and software, individuals or businesses can now connect to the Internet by contacting a "host" computer with a dedicated link to all other networks through which data are then transferred.

Web technologies have developed rapidly over the last few years, making it easier for users to access information. For example, the "World Wide Web," invented in 1989, is a software application allowing consumers to view text, images, video, and audio data. In 1993, the first "browser" system was introduced. This permits users to find specific web sites and facilitates the exchange of information over the Internet.

Use of the Internet in North America has been increasing at astounding rates. Over one million Michigan residents currently use the Internet, and that

number continues to grow. Today, the Internet is used for everything from academic research to video games. A growing part of the cyberspace world is electronic commerce, including the exchange of goods and services over the Internet. For example, consumers can now browse through "cybermall," purchasing goods with credit cards and electronic cash. This type of business activity raises questions about how to apply existing state tax laws to this new form of commerce.

INTERNET SALES OF TANGIBLE GOODS

As the Internet has grown, there has been a notable increase in online shopping. It is estimated that nationwide sales of tangible goods over the Internet will reach between \$7.0 and \$22.0 billion by the year 2000.¹ The collection of taxes generated from purchases made over the Internet is, therefore, a potential source of significant revenue for the state, as well as a major concern for companies selling goods over the Internet to Michigan customers. Such taxes are generally in the form of sales and use taxes,² as well as single business taxes.³

Sales and Use Taxes

The sales and use tax base is a particularly important part of Michigan's fiscal structure. In Fiscal Year 1996-97, revenues from sales and use taxes were approximately \$6.2 billion. As more and more purchases are made over the Internet, how Michigan will be able to collect sales and use taxes from Internet sales of tangible goods is an issue that will become increasingly important.

¹ Penelope Lemov, *The Tax-Free Zone in Cyberspace*, GOVERNING, June 1997 at 25.

² Sales tax in Michigan is imposed at the rate of 6 percent on purchases made in the state, and is collected by the state from the retail seller for the privilege of making sales of tangible property in the state. MCL 205.51 *et seq.* Use tax is a companion to the sales tax and is levied at the same rate. MCL 205.92 *et seq.* However, it is technically a tax on the consumer or purchaser who acquires tangible personal property outside the state for use in Michigan, and prevents someone in Michigan from purchasing the goods out-of-state and avoiding sales tax in Michigan. For administrative reasons, when there is sufficient jurisdiction to tax, the state attempts to impose use tax collection responsibility on out-of-state retailers.

³ MCL 208.1 *et seq.*

Despite the tremendous revenue-generating potential of Internet commerce, problems exist with both technology and the law that make it a challenge for the state to collect taxes on transactions from out-of-state sellers, such as catalog companies, operating over the Internet. There are three main reasons why capturing these revenues is difficult.

- ***Administrative Difficulties***

First, it is administratively difficult to determine what sales are made to Michigan customers over the Internet. Because the Internet is not segmented into geographic areas, interstate purchases (and the taxes that are owed) are difficult for the government to track.

Another administrative problem concerns payment made for products ordered and paid for over the Internet. Due to security and privacy concerns, many businesses are seeking ways to "encrypt" transactions made over the Internet. This presents obvious tax-collection problems for states trying to enforce tax laws. New software has recently been introduced that may solve part of the problem.⁴ This software can track where a consumer is located. Such technological advances may change the way sales and use taxes are collected on Internet purchases.

- ***Digitalization, Personal/Intellectual Services, and Erosion of the Sales/Use Tax Base***

The second problem with collecting sales and use taxes from Internet sales of tangible goods is "digitalization" — the conversion of tangible products (generally taxable in Michigan) into an intangible form (not generally taxable in Michigan). From the government's perspective, it is a difficult task for the state to track the sale of intangible items sold over the Internet. For example, when an otherwise tangible product is converted into an intangible form,

⁴ See *MTC Dialogue Highlights Breakthrough in Taxation of Online Sales*, *State Tax Notes*, Nov. 13, 1995, p. 1397, referenced in R. Scot Grierson, *Sales and Use Tax Nexus on the Information Highway: Constitutional Limits*, *TAX NOTES TODAY*, March 18, 1996, p. 48.

revenue to the state is potentially lost. As more and more conversions of products from tangible to intangible forms occur, the potential danger of an erosion of the sales and use tax base will increase.

Examples of digitalization are found in the music and motion picture industries. While Michigan does impose sales tax on the retail purchase of a compact disc or movie video, the sale of the same music or video delivered via the Internet would be deemed an intangible sale, which is not subject to sales taxation in this state. Current technology allows, or will allow in the near future, "downloading" of music and videos from the Internet into home computers.⁵

A related problem from the government's perspective is the re-characterization of tangible personal property sales into sales of intellectual or personal services (which are not usually subject to sale and use taxes in Michigan). The Internet lends itself well to this type of transformation. For example, professional services such as those of a lawyer or accountant are now offered over the Internet with increasing frequency. Such services are not taxable in Michigan; but often what actually gets sold are packaged or preprinted documents which are taxable. To some extent, this problem has been addressed by the Michigan Department of Treasury in a Revenue Administrative Bulletin.⁶ Michigan, like many other states, considers whether the transfer of property in a transaction is merely inconsequential, or whether it is the "real object" of the transaction. This is a subjective test, and one that can be difficult to apply — particularly to Internet transactions.

⁵ See R. Scott Grierson, *State Taxation of the Information Superhighway; a Proposal for Taxation of Information Services*, 16 Loy. L.A. Ent. L.J. 603 (1996).

⁶ R.A.B. 95-1.

Due to Michigan's heavy reliance on sales and use tax revenue, there is potential for a serious revenue impact in the future as more and more products are converted into digital forms or provided in conjunction with intellectual services — and sold over the Internet.

- ***Constitutional Barriers***

The third, and perhaps most troublesome, issue surrounding the taxation of Internet sales is one that involves the United States Constitution.⁷ It is a problem that is also found in the collection of use taxes from mail order sales. In both cases, an out-of-state vendor cannot be charged with the collection of sales and use taxes for sales to Michigan customers, where the vendor has no substantial nexus (i.e., physical presence) with the state. This is because the Commerce Clause and Due Process Clause require that a state meet certain requirements before it taxes interstate commerce (such as Internet sales where the seller is out-of-state). The United States Supreme Court in *Quill v. North Dakota*,⁸ ruled that the imposition of a use tax on an out-of-state seller will violate the United States Constitution where it does not meet the four factors derived from *Complete Auto Transit v. Brady*.⁹ While there are several requirements that must be met, the issue usually boils down to nexus — or whether the out-of-state vendor has sufficient physical presence in the state.

It has never been made entirely clear what kind of activity is required to meet this physical presence standard. Based on existing case

⁷ U.S. Constitution, art I, '8, cl 3. The Commerce Clause, designed to prevent discrimination against interstate commerce or out-of-state interests in favor of local commerce or in-state interests, prohibits states from discrimination against economic entities, economic goods, services, or activities. A state's jurisdiction to tax is also limited by the Due Process Clause.

⁸ 505 US 298 (1992).

⁹ 430 US 274 (1977). The four factors are: (1) the activity taxed must have a substantial nexus to the taxing states; (2) the tax must be fairly apportioned; (3) it may not discriminate against interstate commerce; and (4) it must be fairly related to services provided by the taxing state.

law,¹⁰ however, an out-of-state company selling goods to Michigan consumers over the Internet (where no other contact is made in Michigan and where orders are accepted and shipped from another state) would in all likelihood be required to remit neither sales nor use tax.

If Michigan desires to increase its sales and use tax jurisdiction on out-of-state vendors selling over the Internet, the most obvious solution lies with Congress, which has the power to regulate interstate commerce and create laws doing away with physical presence requirements. Based on recently introduced federal legislation aimed at restricting states' powers to tax Internet transactions,¹¹ this may be an unlikely occurrence.

Single Business Taxes

This nexus standard also has relevance to the issue of whether a multistate taxpayer conducting sales over the Internet has single business tax liability in Michigan. There are two contexts that the issue could arise. First, under what circumstances is an out-of-state taxpayer doing business over the Internet, subject to Michigan's single business tax jurisdiction? Second, how are the Internet sales of a Michigan-based taxpayer, where such sales are made to out-of-state customers, apportioned for purposes of single business tax calculations? The answer to these questions is not clear. The Michigan Court of Appeals in *MagneTek Controls, Inc. v. Dep't of Treasury*¹² in applying the *Quill* decision held that the requirement of "substantial nexus" does not mean that physical presence in the taxing state be substantial, but only that it be more than the "slightest presence." Whether mere Internet presence in a taxing state would constitute more than "slightest presence" is unknown and has not yet been determined by the courts or by Congress.

¹⁰ *Id.*

¹¹ See *infra* Part IV.

¹² 221 Mich App 400 (1997).

The Michigan Department of Treasury is currently reviewing its nexus position and, so far, has not issued any formal revenue bulletins concerning Internet taxation.

INTERNET INFORMATION SERVICES

Some states obtain Internet-related revenue through the sales taxation of information services. This is in contrast to the taxation of the underlying telecommunications transmission, which is discussed later.¹³ An information service is a service that provides information or data. In the context of information services delivered over the Internet, examples range from commercial Internet services such as America Online, to professional services provided "online" such as tax preparation or legal work.

Despite the tremendous growth in Michigan's service sector over the past decade, Michigan, like the majority of states, does not impose a sales tax on most services. Data from the Census of Service Industries show that receipts from service industries in Michigan were \$35.1 billion in 1992, an increase of 47.2% since 1987. This trend reflects a change in the national economy, which is becoming increasingly service-oriented.

Electronically-based information service is a particularly fast-growing area, representing a significant source of state revenues; it is estimated that nationwide revenues for this type of service will reach \$4.0 billion by the year 2000.¹⁴ While it is difficult to estimate or project the precise volume of revenues that would be lost to Michigan by not taxing Internet services, there

¹³ Some states do not make the distinction between content-related services and transmissions-related services, and are criticized for not doing so. See Information Highway State and Local Tax Study Group, *Supporting the Information Highway: A Framework for State and Local Taxation of Telecommunications and Information Services*, STATE TAX NOTES, July 3, 1995, p.63.

¹⁴ 1996 GOVERNMENT FINANCE OFFICERS ASSOCIATION OF THE US AND CANADA, GOVERNMENT FINANCE REVIEW, Vol. 12, No. 4 (August 1, 1996).

is little doubt that taxation of Internet information services would be an ever-increasing potential revenue source for the state.

As a policy matter, the sales and taxation of services has historically been met with strong opposition.¹⁵ One argument against imposing sales tax on services in general, and Internet services in particular, is that it is difficult to define the precise location where services are rendered. For instance, while an online business could produce its information service from California, it could be received or "consumed" online in Michigan. Would the service be performed in California or Michigan for taxing purposes?

It would be a difficult task to administer a tax on Internet services, and audit problems would be inevitable as well. It is also argued that such taxes impede future development of the Internet by discouraging new business from entering the Internet market.

There are also policy arguments for imposing sales and use taxes on Internet services in Michigan. The most obvious point is that such taxation is a rich source of revenue for the state. With millions of Internet users in the United States (and that number is growing at an astounding rate), plus the likelihood of future services being offered in Michigan such as "interactive television," some contend that Michigan may miss out on significant revenues in the future if Internet services are not taxed. There is also the argument that a sales or use tax on Internet services is a fair tax, ultimately paid by consumers who can afford the services obtained online. Furthermore, it is asserted that taxing goods and but not services, discriminates against consumers choosing to pay for services over goods.¹⁶ Finally, it has been noted that implementing a policy of taxing Internet services while the industry

¹⁵ Due, John F. and John L. Mikesell, SALES TAXATION: STATE AND LOCAL STRUCTURE & ADMINISTRATION, 2D ED. (1994) at 92.

¹⁶ See John F. Due & John L. Mikesell, SALES TAXATION, STATE AND LOCAL, STRUCTURE AND ADMINISTRATION (2d ed. 1994).

is relatively new will be an easier task than attempting to institute such a policy later, once the industry is firmly established.¹⁷

From a legal standpoint, if Michigan decides to change its law and tax Internet information services, it is not clear under what circumstances it could constitutionally impose a use tax on out-of-state companies. As with the sale of tangible goods, the question may become whether a company would have sufficient contacts with the state for use tax to be imposed. It is inevitable that such a business would claim it has no physical contact with Michigan, and therefore could not be charged with the responsibility of collecting a use tax on behalf of consumers. In addition, it is a difficult administrative matter to determine the source of sale, as many service transactions involve providers located in several jurisdictions, which could potentially subject certain transactions to tax in multiple jurisdictions.

¹⁷ 17 See *supra* note 4.

INTERNET ACCESS CHARGES

Another way some states generate revenue is through imposition of a telecommunications charge on Internet connections. This approach views Internet access service as being similar to telephone service. States imposing a special telecommunications tax on Internet services include Connecticut, Iowa, Massachusetts, North Dakota, and Texas.¹⁸ Other states (including Michigan, Colorado, Florida, Georgia, Maine, Minnesota, Missouri, New Jersey, New York, North Carolina, Rhode Island, Utah and Wyoming) tax telecommunications services in general, but do not impose specific taxes on Internet telecommunication services.¹⁹ In these states, the underlying telephone call is taxed, but not the Internet service.

Those opposed to a tax on Internet transmission make several arguments. First, it is asserted that a telecommunications tax on Internet access amounts to double taxation. Because the telephone call placed to connect to the Internet provider is already taxed in most cases, opponents contend that taxing the Internet connection as an additional telecommunications service essentially taxes the same thing twice.²⁰

Furthermore, it is argued that Internet access is not a form of telecommunications service as defined by the federal Telecommunications Act

¹⁸ STATE TAX REVIEW, CCH, March 10, 1997.

¹⁹ *Id.* Maryland does not impose a tax on either the phone service nor the Internet service. Indiana views all telecommunications services as taxable retail transactions, but does not impose special taxes on Internet access.

²⁰ Sen. Ron Wyden, *Taxes on the Internet Could Kill Commerce*, ROLL CALL, July 28, 1997.

of 1996,²¹ and therefore cannot be taxed as such. Finally, it is alleged that it is unfair to tax the telecommunications aspect of Internet access because it is just a small component of a Cyberspace transaction, and does not represent the true essence of the Internet (for example, information transfer and file conversions).

Those advocating a telecommunications tax maintain that Internet access is analogous to a toll road.²² Trucks pay for the use of a toll road, regardless of what they haul; what they haul may also be taxed, irrespective of whether they use the toll road. According to this concept, value is added to a phone connection whenever Internet access occurs, and such added value should be taxable.

Applying telecommunications laws to interstate Internet transactions is another area that is constrained by the Federal Commerce Clause. The Supreme Court has held that an interstate service transaction can be taxed (i.e., there is nexus) where it originates or terminates within the state, and when it is either billed to an in-state billing address or paid within the state.²³ Application of this rule to an Internet connection is appropriate but problematic. For instance, how can an Internet "address" or location be necessarily determined? Advances in software technology may hold the key to solving this problem.²⁴

²¹ Under this Act, to be considered a "telecommunications service," three requirements of a transmission must be met: (1) it must be between or among points specified by the user; (2) it must consist of information of the user's choosing; and (3) the form or the content of the information as sent or received, must not be changed. According to an analysis written by the Task Force of the Interactive Services Association, an industry trade group, an Internet service does not meet all three of these requirements. See *Logging On to Cyberspace Tax Policy: An Interactive Services Association Task Force White Paper*, Interactive Services Ass'n, Dec. 1996.

²² See L.H. Fuchs, *Telecommunications Taxes in Florida*, Draft Paper presented at the Conference on Taxation of Telecommunications and Electronic Commerce, at 5-6 (Nov. 11-12, 1996), as quoted in E. Parker Brown, III, *State Taxation of Telecommunications: The New York Experience*, 47 SYRACUSE LAW REVIEW 987, 1022-23 (1997).

²³ *Oklahoma Tax Commission v. Jefferson Lines*, 115 S. Ct. 1331 (1995), citing *Goldberg v. Sweet*, 488 U.S. 252, 263 (1989).

²⁴ See *MTC Dialogue Highlights Breakthrough*, supra note 4.

TRENDS AND PROPOSED SOLUTIONS

Federal Legislation

Recently, there have been several federal bills introduced that would curtail or limit taxation of Internet commerce. Each of these bills is pending.

In connection with the taxation of Internet access or online services, H.R. 995, which would be known as the "Tax-Free Internet Act of 1997," was introduced in U.S. House of Representatives in March 1997. This bill would clarify the Internal Revenue Code and would specify that fees for Internet access or online services would not be subject to tax.

Two other Congressional bills are directed at the taxation of Internet commerce by states or local governments. Introduced in the Senate and the House of Representatives, S. 442 and H.R. 1054 would be referred to as the "Internet Tax Freedom Act." These bills are quite broad and would generally prohibit states or local governments from imposing a tax or fee on Internet transactions or interactive computer services for a period of five years. Both bills provide for certain exceptions, and would allow, for instance, state sales and use taxes to be imposed if collected in an identical way for mail and telephone orders. In addition, taxes on net income (or "fairly apportioned business license taxes") applied to businesses with a location in the taxing jurisdiction would be allowed.

What Passage of the Internet Tax Freedom Act Would Mean to Michigan

According to a recent analysis conducted by the Multistate Tax Commission (of which Michigan is a member), under the current version of the Internet Tax Freedom Act, companies such as America Online, CompuServe, Prodigy and Microsoft Network would be exempt from paying Michigan single business tax, and indeed any sort of corporate income, franchise, capital stock, or gross receipts tax in the majority of states.

As the bill is now worded, a business could, in all likelihood, exclude all receipts from Internet-related or online services in calculating its Michigan single business tax liability. The problem is that the bill preserves state taxes that are "fairly apportioned business license taxes," but does not define what that tax means.

Proponents of the bills, including Internet industry groups and President Bill Clinton, advocate a tax-free, electronic "free-trade zone" — which would promote future development of the Internet. Those against the legislative measures, such as the U.S. Conference of Mayors, assert that a tax shelter for electronic commerce would be unfair to local governments, and would eventually result in an eroding tax base as more and more sales were gradually diverted to the Internet.

Another argument against this legislation is that it "starv[es] state coffers of telecommunications taxes" by allowing the state taxation of basic phone service, but exempting taxes on more sophisticated "enhanced" communication services available through the Internet.²⁵ In addition, according to tax academics, the legislation runs counter to a commonly accepted tax policy principle that suggests that goods and services in

²⁵ See *'Tax Fairies' and the Fate of State Telecommunications Taxes*, STATE TAX NOTES, November 10, 1997 at 1193-1196.

electronic commerce should receive the same tax treatment as goods and service sold by more traditional means.²⁶

Recommendations from the Drafting Committee of the Communications and Electronic Commerce Tax Project

The National Tax Association (NTA) Communications and Electronic Commerce Tax Project²⁷ recently issued a 49-page report containing recommendations, suggestions and proposed legislation for the state and local taxation of local commerce.²⁸ The report was drafted with two principles in mind. First, under the idea of "competitive equality," it is assumed that electronic transactions should be treated for tax purposes in the same manner as transactions that are conducted under more traditional means. Second, state taxes on electronic taxes should be uniform among states.

The report made several points. Most significantly, it was suggested that statutory provisions be adopted that would create nexus over an out-of-state vendor based solely on the purchaser's billing address. This nexus would then be the basis for imposing use tax collection on the out-of-state vendor and would ensure that a state had the power to collect use tax on sales made to its residents over the Internet. A "throwback" rule would apply where the purchaser's billing address could not be determined. In such cases, the vendor would collect and remit tax to the state in which the vendor has its principal place of business, based on the tax rate in that state.

In the alternative, a "throwaround" rule would be applied where the billing address could not be determined. This would tax the transactions based on

²⁶ See *Electronic Commerce Project's Draft Panel Releases First Report*, STATE TAX NOTES, (November 17, 1997).

²⁷ The Communications and Electronic Commerce Tax Project is the industry-state tax initiative formed under the auspices of the National Tax Association (NTA) - an organization that attempts to provide a neutral forum. The Tax Project's goal is for industry and the states to develop a broadly available public report that identifies and explores the issues involved in applying state and local taxes and fees to electronic commerce, and that includes recommendations to state and local officials regarding the application of such taxes.

²⁸ For a copy of the full report, see STATE TAX NOTES, November 17, 1997 at 1255.

an average sales tax rate that is determined by looking at what the vendor collects on all sales of electronic commerce from the preceding year. Tax proceeds would then be remitted to the states in proportion to the vendor's sales and use taxes paid the previous year.

While there are many other suggestions contained in the report, perhaps the most important point made is that any effort to design uniform state tax laws for the Internet will depend upon Congress, which has the power, under the United States Constitution, to remove commerce clause impediments described previously in this **Fiscal Forum**. As it stands today, a state could probably not constitutionally impose use taxes on an out-of state vendor selling to an in-state resident, based solely on the purchaser's in-state billing address.²⁹ Ultimately, it is up to Congress to make the necessary changes that will fully enable states to collect sales and use taxes on Internet sales.

What States are Doing

Many states are in the process of formulating Internet taxation policies. For example, California recently released proposed regulations clarifying its position on what constitutes nexus with that state as it relates to the Internet. The proposed regulation provides that a web page does not create nexus in California for the purpose of taxation. In other words, an out-of-state company selling products to California residents through the Internet (where such items are shipped from out of state) would not be subjected to use tax collection responsibility.

Other states, such as Wisconsin, have been attempting to reach an agreement with the Direct Marketing Association, which includes mail order companies such as L.L. Bean and Land's End. The proposed agreement would result in the voluntary collection of use taxes on behalf of out-of-state purchasers located in the states signing the agreement. Although the agreement did not specifically target Internet sales, it is well known that

²⁹ See *Quill v. North Dakota*, 505 US 298 (1992).

these companies operate web sites and sell merchandise over the Internet. Negotiations for this agreement is on-going, and, if signed, it may have implications for other states where sales are made over the Internet.

Michigan's Department of Treasury is currently reviewing whether activity over the Internet, such as maintaining a web site, constitutes nexus with the state. So far, there have been no legislative or official administrative attempts with regard to Internet taxation. What position the state will take in the future may depend upon the outcome of pending federal legislation, and on the rate of future growth of electronic commerce.

CONCLUSION

Internet commerce is still in its infancy, but it is projected to increase in importance in the coming years.

From the Michigan's point of view, it is difficult to predict how much future state revenue could be at stake. Technological and legal hurdles will have to be solved before any significant taxes can be collected from sources of electronic commerce. Increased collection of use taxes to which they are already entitled, will depend on whether Congress passes legislation that does away with requirements (such as that of "physical presence") that now prevent not only the collection of state taxes from Internet commerce, but from general mail order sales as well. In addition, new and better tracking systems will have to be developed that can determine and capture the tax owed.

There is currently a movement in Congress, as well as in the Michigan House of Representatives, to impose a moratorium on any new Internet taxation. It is argued that any such taxes would impede the development of this new industry. Companies doing business over the Internet stress that a national policy will have to be established that will provide a more uniform manner of state taxation. The debate is not likely to end soon, and solutions will have to be worked out to protect the Internet industry from burdensome and multiple state taxation, while addressing the legitimate revenue concerns of state and local governments.



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