

Internet tax-free zone?

Michigan and Ohio are among 45 states with sales and use taxes puzzling over how to get buyers of online goods to pay their fair share of taxes.

BY LAURA A. TOMAKA

Laura A. Tomaka is program manager, CSG Midwestern office. This article appeared in Stateline Midwest, February 2000.



Have you kept a careful record of purchases made online or from mail-order catalogs? This year, before sitting down to prepare their state income tax forms, some Michigan residents may search a little harder than in the past to locate all those remote sales receipts. At least that's what the state Treasury Department hopes.

The reason? A new line has been added to the state income tax form that asks for the amount of use tax (also known as the remote sales tax) owed on merchandise purchased from out-of-state sellers who did not collect a sales tax.

This is not a new form of taxation

for Michigan residents, just a new way of collecting it. In the past, Michigan has, as have the 44 other states with a

sales tax, used a separate form for taxpayers to list purchases made through companies without a physical presence (nexus) in the state.

"This tax has been on the books for 60 years," said Michigan Sen. Joanne Emmons, chair of the Finance Committee. But with Internet sales climbing to an all-time high last year — a trend expected to continue for the foreseeable future — states

are faced with the challenge of collecting unpaid use taxes in amounts never before imagined.

"The Internet has really brought it into sharper focus because it's grow-



Michigan Sen. Joanne Emmons

ing exponentially and the revenue lost is much higher than it has been in the past with just mail-order catalogs," said Bridget Medina, press secretary for the Michigan Treasury Department.

In fiscal 2000, Michigan estimates it might lose \$173 million in revenue because of unpaid and uncollected use taxes — \$125 million of which is estimated to be from Internet purchases. By fiscal 2005, Treasury Department estimates project the total revenue loss due to remote sales to be more than \$300 million.

Medina said 80 percent of the state sales tax goes to education funding.



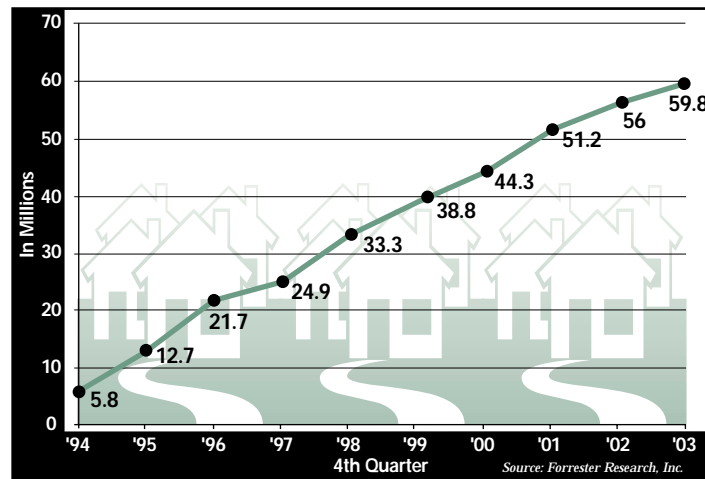
Ohio Sen. Richard Finin

"And while it's not a revenue issue this year, years down the road it could be."

Emmons agreed. This year's impact is expected to be about 3 percent of total revenues — "a pittance," said the Republican from Big Rapids. "But you give 5 percent next year and another 5 percent the year after, you begin to notice [the revenue loss]. And if your economy turns down at the same time, it's going to be an even bigger problem."

In addition to launching a public awareness campaign last fall, the Michigan Treasury Department included an explanation of the use tax and a worksheet for calculating the amount owed with the 1999 tax forms. The state also provided a list of companies — catalog and Internet — that do and do not collect Michigan sales tax.

U.S. Households with Internet Access



"Main Street retailers are quite happy that we are picking up on their dilemma," Medina said. "But there's a little bit of confusion here for the individual. They think it's a new tax that's being added, or they've never heard of it before."

In an interview with *The Wall Street Journal*, Michigan Treasurer Mark Murray said the state is only trying to collect a tax owed under existing legislation.

"[This] law must be enforced to ensure a fair, competitive environment for our in-state Main Street retailers," he said. "It must also be enforced to ensure that our schools and local units of government receive critical funding."

Searching for solutions

The Treasury Department estimates that about 2 percent of taxpayers have complied with the use tax law in past years.

Emmons is not optimistic about the chances of more use tax dollars being collected. "I see it as a [way] to help educate people that the tax is even there," she said. "Are they going to pay it? Probably not, but that was not the point. The point was to begin to educate people."

The Internet Tax Freedom Act, passed by Congress in 1998, placed a three-year moratorium on new taxes

on Internet access and e-commerce. The moratorium, though, does not prohibit states from collecting the sales and use taxes already applicable to e-commerce.

The Advisory Commission on Electronic Commerce, charged with submitting a report to Congress in April, will list its recommendations on state sales and use taxes as they apply to Internet sales.

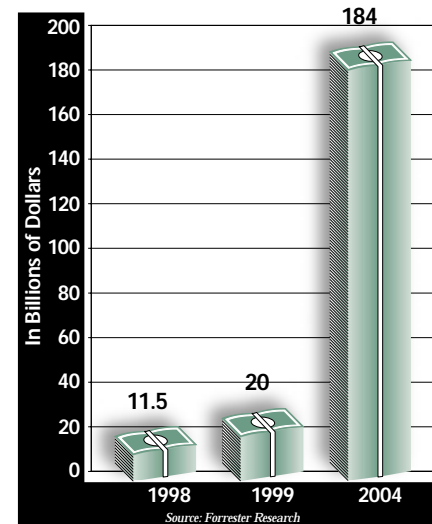
Emmons said the Legislature has no interest in

applying any new taxes to Internet sales. "Michigan never even entertained the idea," she said. "It's never, ever been a topic here. I am not interested in new taxes. I am interested in an equity for retail establishments in the state of Michigan."

Other states have taken note of Michigan's approach. Ohio, which is expected to lose \$206 million in uncollected remote sales taxes during this fiscal year, will follow the lead of its neighbor to the north.

"We are very concerned about the lack of public awareness of use tax liability," said Carol Bessey, Ohio's

Volumes of E-Commerce: Business-to-Customers



deputy tax commissioner.

"We do plan next year to include a line on the income tax return — not really with the hopes that it will bring in large amounts of revenue, but from an education standpoint. We think it's important that folks be aware that this responsibility exists."

For all 45 states that rely on a sales tax, the tremendous growth of the Internet and electronic commerce raises a question about the viability of

state sales tax systems.

Under the existing structure, can states fairly and efficiently administer the collection of taxes from purchases made over the Internet?

Ohio Senate President Richard Finan said this question goes to the heart of the problem. "We have to be able to collect the sales tax," said the Republican from Cincinnati. "If we don't, the sales tax will go down as a state revenue source. I don't believe

you can continue to have the Main Street businesses with a 6 percent or 7 percent disadvantage."

And while Finan is supportive of adding the use tax line to the state income tax form, he ultimately views that approach, along with general public awareness campaigns, merely as "stop gap" measures.

He advocates, as do many state policy-makers across the nation, for a voluntary "zero burden" system and believes that there are Internet retailers who would participate in such a program. Zero burden would use advanced information processing technologies to simplify the sales tax system for all businesses. States and local governments would be responsible for paying costs associated with the new computerized system. ★

CSG opposes tax-free zone

The Council of State Governments opposes a plan that dramatically would impact schools and emergency services and severely penalize hundreds of thousands of Main Street retailers. Members of the federal Advisory Commission on Electronic Commerce, studying Internet issues such as taxation, were sent a plan in February that would pre-empt the current tax law of 10 states and hand over significant tax system benefits to e-commerce retailers at the expense of Main Street retailers.

Private sector e-commerce groups on the committee drafted the plan that would cripple or end the ability of states to collect sales taxes. "To permanently prohibit state taxation of goods and services already taxed, would erode our tax base and raise serious tax fairness issues for business and consumers," said Kentucky Gov. Paul Patton, CSG president. People receive many of their essential services, such as school funding and emergency aid services, from state governments.

"The draft plan would allow delays and permit prohibitions on taxing some items purchased over the Internet," said Illinois Rep. Tom Ryder, CSG chairman. "This allows larger, and often wealthy, Internet companies to avoid being taxed themselves and to avoid charging taxes to customers. Yet, local, loyal Main Street retailers pay these taxes and may be crippled in their competitiveness if the plan were adopted.

"Ultimately, the plan can have severe implications for essential services provided to local taxpayers, for Main Street retailers, and for consumers' abilities to obtain goods and services near home," Ryder said.

The proposal would:

- eliminate existing sales taxes on items now sold in local stores — the plan says the "functional equivalent" of "digitized goods and services" should be tax free for five years. This may include anything from photo finishing and digital music to cable services and newspapers, pre-empting current tax law in many states;
- create loopholes allowing e-commerce companies to avoid paying income, property and other taxes by affiliating with companies in nontax states; and
- permanently prohibit taxation of Internet access charges, pre-empting state law in 10 states.

"We cannot accept this proposal as it would permit the federal government to further intrude on state tax and finance policy and seriously destabilize state finances," Patton said.

For more information, call Kristin Cormier, CSG Washington, D.C., office, (202) 624-5460.

CSG resources

With half of all U.S. households expected to have Internet access by 2003, retail sales over the Internet are expected to climb to \$184 billion by 2004, according to Forrester Research.

Citing statistics such as these and actions by the federal government that threaten state and local collection of sales and use taxes on e-commerce, a new report by The Council of State Governments suggests actions for states to take. *Electronic Commerce: Revenue Implications for States* suggests ways states can reform sales tax systems to deal more effectively with e-commerce. These include uniform policies on tax rates, simplified state and local sales and use taxes, use of new software to collect sales taxes on e-commerce and adoption of uniform legislation among states to govern e-commerce transactions. The report, C2000-9900, is available for \$20 from publications sales, (800) 800-1910, or CSG's online store, or on CSG's STARS on www.csg.org.