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Taxation of Mail Order Sales

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Consumers' desire to save time and the application of new technologies allowed the mail order sales industry to grow to an estimated 14 percent of the retail sales market by 1987. The convenience of mail order shopping, however, carries a hidden cost to state and local governments in the form of unpaid use taxes.[1] *Due primarily to past judicial decisions, mail order firms are not required to collect the tax unless they have a physical presence in the state in which the purchase is made, placing the responsibility for remitting the levy on the purchaser. Because of the large number of buyers and the relatively small size of most individual purchases, it is nearly impossible for states to enforce the tax; the liability, therefore, largely is evaded, resulting in revenue losses estimated at nearly $3 billion nationwide for fiscal year (FY) 1988, $70.7 million of which was in Michigan.*[2] *To recapture these lost revenues, state and local fiscal officers are working to change existing law with the goal of requiring mail order firms to collect and remit use taxes to the states. They are joined in their efforts by in-state companies, who assert that mail order firms operate with an unfair price advantage because they are not required to collect these taxes. We examine these issues below as well as review pending legal and legislative action.*

INTRODUCTION

The days of mail order purchases being strictly for clothing ordered from a 10-pound, two-inch-thick Sears catalog are long past. Today, a multitude of items, from the traditional clothing, books, and sporting goods to photo processing, jewelry, appliances, food, and even legal services, can be purchased and delivered through the mail. Technological advances have made catalogs only one of a number of methods used to promote mail order sales. These transactions are now facilitated by shop-at-home television shows, toll-free "800" numbers, computer terminal "catalogs," and sales programs that can be accessed by home computers. Given the ease with which these transactions now can be made, coupled with the hectic pace of today's society and its associated time constraints, mail order sales have become a billion-dollar industry, with total sales growing from $94 billion in 1985 to $111.3 billion in 1987. Sales to households accounted for $69.7 billion of the 1987 total, while the remaining $41.6 billion were business purchases.[3]

Retail sales made within a state are subject to the prevailing state and local sales tax, collectible by the seller. On most interstate purchases, states cannot levy a sales tax (as legally defined) and, therefore, levy a "use" tax, a tax on goods purchased in another state. Purchases made from mail order firms located

1 A use tax is indistinguishable from the sales tax in economic terms, although a legal differentiation is made between the two.

2 Computations by the National Association of State Budget Officers, December 8, 1988, based on 1987 Advisory Council on Intergovernmental Relations' (ACIR) estimates.

3 Economic Analysis Center, Texas Comptroller of Public Accounts, *Fiscal Notes*, Issue 89, no. 6 (June 1989), pp. 3-5.

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in other states are subject to this use tax, which is equal to the combined state and local sales tax rate in the jurisdiction of the buyer. Most purchasers of mail order goods are liable for declaring and remitting use tax obligations themselves, but because of the ease with which the tax may be avoided, most of these levies are never paid. The amount of revenue lost from the nonpayment of this tax is thought to be quite substantial; nationally, the figure for FY 1988 was estimated to be $2.99 billion.

Currently, mail order firms are liable for the collection of use taxes on sales in states where they have a "physical presence" such as a retail outlet, staff, or frequent deliveries of goods made by company trucks. The physical presence requirement was the outcome of the Supreme Court's decision in the 1967 landmark case *National Bellas Hess* v. *the Illinois Department of Revenue*. The Court ruled that because the business conducted by Bellas Hess (whose outlets were in Missouri and Delaware) in Illinois was limited to the distribution of catalogs and flyers by mail or common carrier, requiring the firm to collect and remit the use tax would be a violation of the due process and interstate commerce clauses of the U.S. Constitution.

State and local governments claim that the application of technological advances, whose existence and pervasiveness could not have been foreseen at the time of the 1967 ruling, have made the Court's minimum physical presence requirement obsolete. In response, they now are passing legislation aimed at broadening the concept of presence, or nexus, to one encompassing an economic presence, rather than merely a physical one, and litigating against noncomplying firms to have the *Bellas Hess* decision overturned in the courts. The states also are lobbying Congress in an effort to have federal legislation enacted that would circumvent the need to overturn previous court rulings by directly empowering the states with the ability to collect mail order taxes from firms.

Loss of revenue to the states is not the only issue in the debate on taxation of mail order sales; questions of economic equity, efficiency, and competition arise because in-state retailers and wholesalers are required to collect and remit sales taxes, while mail order firms are not.

Mail order firms have fought every effort to require them to collect and remit use taxes, claiming that any attempt to do so would violate their rights under the due process and interstate commerce clauses of the U.S. Constitution, as well as the benefits principle of taxation, and would be overly burdensome because of the large number of taxing jurisdictions involved.

These issues are discussed below, and a recommendation is given for resolving the problem.

FISCAL IMPLICATIONS

Sales taxes are levied within a state and/or locality on the sale of goods at the retail level and are collected by the seller. To prevent the erosion of the sales tax base and restore equal competition between in-state and out-of-state firms, most states have enacted a use tax payable by the consumer. There is no economic difference between the sales tax and the use tax, but because manner of collection is different and use taxes cross interstate boundaries, the courts have made legal distinctions between the two.

The sales tax is the second largest state revenue source, exceeded only by the income tax (see Exhibit 1). In FY 1989, Michigan sales taxes revenues accounted for approximately 30 percent of total tax revenues (see Exhibit 2). Due to the decline in federal aid to states and localities, as well as the reliance

EXHIBIT 1

State Revenues, Selected Sources and Years (dollars in millions)

Fiscal Year	Total State Revenues	Federal Funds to States	Federal Funds as % of Total Revenues	Total State Tax Revenues	General Sales and Use Tax Revenues	Sales and Use Taxes as % of Total Tax Revenues
1980	$276,962	$61,892	22.3%	$137,075	$43,168	31.5%
1981	310,828	67,868	21.8	149,738	46,412	31.0
1982	330,899	66,026	20.0	162,658	50,357	31.0
1983	357,637	68,962	19.3	171,440	53,643	31.3
1984	397,087	76,140	19.2	196,795	62,564	31.8
1985	438,954	84,469	19.2	215,893	69,633	32.3
1986	481,174	92,666	19.3	228,054	74,927	32.9
1987	516,941	95,463	18.5	246,933	79,228	32.1

SOURCES: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism,* 1988 edition, Vol. 2, #M-155 (Washington D.C.: ACIR, July, 1988) p. 64 and 1989 edition, Vol. 1, #M-163 (January 1989), p. 13; and Census Bureau., U.S. Department of Commerce

EXHIBIT 2

Michigan Sales and Use Tax Revenues (dollars in thousands)

Fiscal Year	Sales and Use Tax Revenues	Total Tax Revenues	% Change from Previous Year		Sales Tax as a % of Total Tax Revenues
			Sales/Use Tax	Total Tax	
1984	$2,233,905	$8,151,002	14.8%	22.8%	27.4%
1985	2,466,686	8,337,496	9.5	2.3	29.3
1986	2,647,247	8,741,125	8.2	4.8	30.3
1987	2,736,041	8,775,294	3.3	0.4	31.2
1988	2,880,386	9,696,886	5.3	10.5	29.7
1989[a]	3,054,000	10,200,000	6.0	5.2	30.0

SOURCE: Michigan Department of Treasury, *Annual Report of the State Treasurer. Fiscal Years 1985–86 and 1987–88,* p. 30.

[a]Estimates by Public Sector Consultants based upon Department of Treasury data.

of the federal government on the income tax and local governments on the property tax, states' dependence on the sales tax as a revenue source has gradually increased. This has caused state governments to search for methods to increase revenues from this source and to limit erosion of the existing base. Between 1984 and 1989, sales tax rates have increased in twelve states and declined in two (in neither to a rate lower than the 1984 level).[4]

In light of states' reliance on the sales tax, any erosion of the base is a major concern to state fiscal officers. Estimated revenue losses due to nonpayment of use taxes to states and localities in FY 1988 range from a high of $388.6 million in California to $4.2 million in Vermont. In Michigan, revenue losses are estimated at $70.7 million. Exhibit 3 shows the estimated revenue loss to states and localities for each of the 50 states.

ECONOMIC ARGUMENTS

Arguments based on economic principles of taxation are used by both those who favor and oppose collection of use taxes by mail order firms. Those in favor base their case on the principles of equity or fairness, economic efficiency, and ease of enforcement and administration. Those opposed to the tax also use arguments based on principles of efficiency and equity.

Firms operating in states levying a retail sales tax argue that mail order companies have a competitive advantage because in-state firms are required to collect the tax, while mail order firms are not. This allows mail order firms a price advantage equal to the amount of the tax levied within the state and/or locality in which the sale is made. The extent to which a price advantage actually exists depends upon the combined state-local tax rate and the degree to which goods that are purchased from in-state firms may be substituted for goods purchased through direct marketers.

Mail order firms will have a greater price advantage over firms that operate in jurisdictions where combined state-local tax rates are relatively high, for example, municipalities in Louisiana, New York, Illinois, Alabama, and Texas (see Exhibit 3). This is particularly true for sales of big-ticket items such as appliances and furniture and in the case of border sales (sales made in a nearby state that are sent by mail into an adjoining state).

The substitutability between locally sold and mail order goods is an issue directly related to competitive markets and the degree to which price differentials play a part in determining a market's competitiveness. In making a purchase, a consumer tends to consider the extent to which the goods offered by sellers are alike. Barring any other considerations (such as loyalty to a particular seller), if the goods offered by each of the firms are identical (or nearly so), the consumer will tend to purchase from the firm that offers the good at the lowest price. If the consumer feels that a distinction can be drawn among the goods offered by various firms, price will tend to play a smaller role in the purchase decision. We, therefore, can infer that goods that are highly substitutable tend to be more sensitive to price disparity, while commodities that are less similar tend to be less sensitive to differences in price. Any price advantage that can be gained by the nonuniform application of a tax will result in a substantial competitive disadvantage to firms

4 Advisory Commission on Intergovernmental Relations, *Signficant Features of Federalism*, 1989 edition, Vol. I, #M-636 (Washington, D.C.: ACIR, January 1989), p. 56.

EXHIBIT 3

State Sales/Use Tax Rates, Selected Combined State-Local Rates, and Estimated Revenue Loss Due to Nonpayment of Use Taxes on Mail Order Sales, 1988
(revenues in millions of dollars)

State	State Rate	Combined State and Local Rate[a]	Estimated Revenue Loss	State	State Rate	Combined State and Local Rate[a]	Estimated Revenue Loss
	Sales/Use Tax Rates				Sales/Use Tax Rates		
Alabama	4.00%	8.00%	$ 44.4	Montana	0.00%	0[b]	na
Alaska	0.00	4.00	nav	Nebraska	4.00	5.50%	$15.7
Arizona	5.00	7.00	43.4	Nevada	5.75	6.25[c]	12.8
Arkansas	4.00	6.00	18.1	New Hampshire	0.00	0[b]	na
California	4.75	6.50	388.6	New Jersey	6.00	0[b]	107.1
Colorado	3.00	7.10	45.5	New Mexico	4.75	5.38	14.6
Connecticut	7.50	0[b]	65.0	New York	4.00	8.25	334.3
Delaware	0.00	0[b]	na	North Carolina	3.00	5.00	47.3
Florida	6.00	0[b]	137.0	North Dakota	5.50	6.00[d]	8.4
Georgia	3.00	5.00	53.6	Ohio	5.00	7.00	111.2
Hawaii	4.00	0[b]	10.2	Oklahoma	4.00	8.50	44.9
Idaho	5.00	0[b]	9.4	Oregon	0.00	0[b]	na
Illinois	5.00	9.00	164.2	Pennsylvania	6.00	0[b]	127.8
Indiana	5.00	0[b]	54.2	Rhode Island	6.00	0[b]	11.0
Iowa	4.00	5.00	22.1	South Carolina	5.00	0[b]	29.6
Kansas	4.00	6.00	27.2	South Dakota	5.00	6.00	8.0
Kentucky	5.00	0[b]	33.8	Tennessee	5.50	7.75	62.4
Louisiana	4.00	9.00	55.6	Texas	6.00	8.00	329.2
Maine	5.00	0[b]	10.2	Utah	5.09	6.25	18.5
Maryland	5.00	0[b]	56.4	Vermont	4.00	0[b]	4.2
Massachusetts	5.00	0[b]	65.4	Virginia	3.50	4.50	63.1
MICHIGAN	4.00	0[b]	70.7	Washington	6.50	8.10	71.0
Minnesota	6.00	7.00	47.6	West Virginia	6.00	0[bd]	19.4
Mississippi	6.00	0[b]	23.4	Wisconsin	5.00	5.50	44.8
Missouri	4.23	6.23	59.6	Wyoming	3.00	5.00	3.5
				Average[e]	4.30	nav	59.9
				Median[e]	5.00	nav	44.4
				Total	na	na	$2,994.4

SOURCES: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1989 edition, Vol. 1, #M-163 (Washington, D.C.: ACIR, January 1989), pp. 56–62 and National Association of State Budget Officers.

na: not applicable
nav: not available
[a]For states with more than one local rate, the highest combined rate is listed.
[b]No local sales tax (combined rate is equal to the state rate).
[c]State rate includes a state-mandated local tax of 3.75 percent and a 2 percent sales tax.
[d]State rate decreased to 5 percent on July 1, 1989.

operating in markets where goods are most similar. This effect will be lessened in markets where consumers feel that goods are dissimilar and, therefore, not highly substitutable.

Price advantages and the substitutability of goods between in-state and mail order firms is important in determining the efficiency of the use tax. To be efficient, a tax, among other things, must treat each firm in a neutral manner; that is, the presence of the tax, in and of itself, should not be the impetus for altering a consumer's choice of firm. The failure to tax mail order sales clearly violates the basic economic principle of efficiency.

Mail order firms argue that price competition is not a major determinant of sales in the mail order market. Instead, factors such as the reliance on catalogs (versus showrooms and salesclerks), the amount of time between order and receipt of the goods, and the inconvenience of returns distinguish the mail order sales market from the retail sales market. They argue that these factors cause less substitutability between mail order goods and those purchased locally, reducing the importance of price competition. Also, additional costs incurred by mail order customers (such as shipping and handling charges), lessen the effect of any price advantage caused by the nonpayment of use taxes. These charges, they further argue, must be weighed against any tax advantage to arrive at the total price advantage incurred from direct mail purchases, and, coupled with mail order inconvenience, these costs largely erase any competitive advantage that mail order firms may have due solely to differential tax treatment.

Claims that shipping costs, which are considered transactions costs, can be weighed against the tax are based on the assumption that the two are basically identical and perform the same function. Transactions costs, however, are a normal cost of doing business, much like the costs of a sales staff or display area incurred by retail businesses, and therefore should be considered a part of the purchase price. A tax is not an internal cost of doing business, making comparison impossible.

Another argument against the requiring mail order firms to collect and remit use taxes is based on the benefits principle of taxation, which is grounded in the idea that a tax should not be levied unless the entity being taxed receives some benefits from the levying jurisdiction. Those opposed to the tax claim that mail order firms receive no such benefits from states in which they have no physical presence. In opposition, states and localities assert that these firms in most cases do receive benefits, such as banking, credit, and collection services from financial institutions within the state, as well as from the general exploitation of the market.

Finally, mail order companies claim that the large number of jurisdictions imposing retail taxes (6,955 nationwide in FY 1988) would make compliance with the levy very costly and especially burdensome to small firms. The costs associated with explaining the tax to customers (more space in catalogs, processing costs, tax forms and periodic remittances to each jurisdiction, and so forth) would put mail order firms at a relative disadvantage to in-state firms, who must deal with one state and one or two local rates at most. Those in favor of the tax point out that computer software that would aid in compliance already exists, and that companies that currently are required to remit the tax (Sears, J.C.Penney, Montgomery Ward), have had no difficulty in doing so. The cost to small firms could indeed be burdensome, but that problem could be dealt with by exempting firms with sales below a certain amount.

LEGAL ISSUES

The levy of any tax must meet the conditions of the due process clause and the interstate commerce clause of the U.S. Constitution. Decisions by the courts have stated that due process requires that the entity on which the tax is imposed benefit in some way from the state or locality that is levying the tax, and that some link or connection exist between the state and the entity or transaction on which the tax is imposed. In the case of a tax on mail order sales to be collected by the selling firm, due process requires that (1) the seller benefit in some way from the state in which the purchaser resides and (2) there be some physical connection between the vendor and the state in which the purchaser resides. The interstate commerce clause prevents states from imposing an undue burden on interstate commerce and requires that the benefits principal be met in order for the tax to pass constitutional muster.

The linkage, or nexus, requirement on interstate mail order sales was established in 1967 by the Supreme Court's decision in the *Bellas Hess* case, in which the court ruled that the firm must have some physical presence (such as a retail outlet) in the state seeking tax revenues. The disbursement of catalogs and flyers to potential customers and the receipt of goods by Illinois residents (by means of either the U.S. mail or a common carrier) were ruled to be insufficient to establish a minimum link between the state and the seller, and the attempt by the state to collect taxes on goods received from the National Bellas Hess outlet in Missouri was ruled unconstitutional.

Subsequent court decisions have ruled on the extent to which physical presence constitutes adequate nexus. In two cases, one in which infrequent deliveries by a company vehicle were the sole physical link to the state and another in which national advertising, an 800 telephone number, and catalog mailings were the only connections, the courts ruled that insufficient linkage existed to establish nexus. Conversely, in a case involving the presence of independent brokers hired by the out-of-state firm and in one involving intensive advertising and employee delivery of merchandise, nexus was ruled to exist, and the levy of the tax was declared to be constitutional.

The nexus requirement was narrowed by the California Supreme Court when it used a "slightest presence test" in its 1977 finding that linkage did exist in the case of a mail order firm with offices in the state that were used to sell advertising, but this test was not adopted or rejected by the U.S. Supreme Court (although they affirmed the California court's ruling).[5]

The Court did adopt a four-part analysis that it used to confirm the constitutionality of a Mississippi privilege tax in its ruling in *Complete Auto Transit* v. *Brady*. In that decision, the Court considered the following factors as a test of whether the tax complied with the commerce clause: the tax

- must be imposed only on a seller that has substantial nexus within the taxing state;
- must correspond to the benefits bestowed by the state;
- cannot favor local firms over out-state firms; and

5 An excellent summary of court decisions relevant to this issue can be found in an article by Thomas C. Pearson and Dennis R. Schmidt, "Why States Can Circumvent National Bellas Hess and Collect Use Taxes from Most Mail Order Houses," *Journal of State Taxation* 7, no. 3 (Fall 1988), pp. 243-254.

- if imposed on the firm by more than one jurisdiction, must establish apportionment of the tax among jurisdictions.

This analysis was used in subsequent cases to establish whether the levied tax was in violation of the interstate commerce clause.

Pending Judicial Decisions

Two suits with diametrically opposed goals are currently in the court system. The ultimate aim of one is to overturn the *Bellas Hess* decision; the other hopes to declare California's new use tax legislation on mail order sales unconstitutional.

In a case brought by the state of North Dakota against the Quill Corporation of Linconshire Nebraska, the state is suing for remuneration of taxes levied under its new, stringent use tax law and, in the process, hopes to overturn *Bellas Hess*.[6] In a California case backed by the Direct Marketing Association, Sturbridge Yankee Workshop, Inc., of Westbrook, Maine, is hoping to overturn California's collection of use taxes under new legislation (see below).[7]

LEGISLATIVE ACTION

Federal Legislation

Because Congress has the power to pass legislation relating to interstate commerce, the problems that states have experienced in the courts with respect to their inability to impose taxes under this clause could be solved by passage of enabling federal legislation. Since the early 1960s, the mail order tax issue has been, both directly and indirectly, the subject of four congressional hearings and numerous efforts to pass legislation,[8] none of which has resulted in new law due to the linking of interstate sales and use taxation with the taxation of multistate corporate income. This connection was broken recently, however, and new federal legislation is pending in Congress.

In 1959, legislation was passed relating to nexus standards (defined in terms of a firm's physical presence in a given state) required for the taxation of interstate corporate income.[9] These standards later were applied, by the Congress and the courts, to the taxation of all interstate commerce, including retail sales, thus establishing the link between interstate income and mail order sales taxes. While the concepts

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6 The case is similar to one brought by North Dakota against Spiegel Inc. of Chicago, Illinois, which the state hoped would result in overturning *Bellas Hess*. The Spiegel case was recently settled out of court, with the firm agreeing to collect and remit taxes in all states in which it does business.

7 Scott R. Schmedel, "Tax Report," *The Wall Street Journal*, August 2, 1989, p. A1.

8 For a summary of hearings and legislation relating to the taxation of interstate corporate income and sales and use taxes, see Advisory Commission on Intergovernmental Relations, *State and Local Taxation of Out-of-State Mail Order Sales*, #A-105 (Washington, D.C.: ACIR, April 1986), pp. 57-64.

9 Corporate income was not subject to state taxation if the activities of the firm were limited to the solicitation of sales that were to be processed and filled outside the state.

associated with these two levies are considered both legally and economically separable, the link between the two taxes was difficult to break for political reasons. On the corporate income side, the federal government was pushing for more stringent requirements (on states) of unitary taxation.[10] On the sales and use tax side, broader nexus requirements, which would benefit the states, were the issue. State tax administrators were willing to accept stiffer corporate tax rules in exchange for broader nexus requirements on the use tax; for states to accomplish this, the link between the two taxes had to remain intact. Therefore, legislation and hearings addressing the issue of interstate use taxes alone were unsuccessful.

Today, unitary taxation of corporate income seems close at hand, and the focus of state tax administrators has shifted to federal legislation that would broaden the linkage conditions necessary for states to impose a levy on mail order sales. State governments hope to widen nexus requirements to include all mail order firms with an economic presence in any given state, most likely defined by some minimum sales level.

The "Equity in Interstate Competition Act of 1989" [House Resolution (HR) 2230], currently before the House Judiciary Committee would, if passed, overturn *Bellas Hess* by empowering state governments to impose the use tax on mail order firms. The bill limits collection of the tax to firms with gross sales of $12.5 million or more nationally, or $500,000 within a state, and enables states to pass legislation outlining the method by which localities would be reimbursed for their portion of the tax.

Currently languishing in subcommittee, there has been little movement on the bill since last summer due to opposition by groups representing local governments, such as the U.S. Conference of Mayors. Local governments originally supported the bill, but withdrew their backing when a promised clause was excluded. The clause would have guaranteed local taxing jurisdictions their share of collected revenues, estimated to amount to between $200 million and $500 million, by outlining the method by which the states would be required to remit these funds. The exclusion was at the behest of the bill's sponsor, Representative Jack Brooks (D-Texas), the chair of the House Judiciary Committee considering the bill, who claims that addition of the clause would make the bill too complex to insure passage and could be in violation of some states' laws.

HR 2230 allows, but does not require, state governments to pass legislation defining the method and rate at which localities would be reimbursed for their share of tax revenues. To make compliance and collection of the tax less burdensome to firms, the federal bill does not allow states to require mail order firms to collect taxes at more than one combined state and local rate. States may allow firms the choice of either collecting at a rate equal to the combined state rate plus an "in-lieu" local rate or the state rate plus the actual local rate. (The in-lieu rate would be no greater than the weighted average of all local sales tax rates levied within the state.) This means that firms would not have to deal with more than one rate

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10 Unitary taxation refers to the application of similar jurisdictional requirements to like tax bases (interstate corporate and personal income) by the states.

for any given state. Localities do not trust the states to pass such legislation, while states have indicated that they would remunerate localities even in the absence of federal legislation requiring such reimbursement.[11]

Legislation and Actions in Other States

Efforts by state governments to deal with the problem of collecting taxes on mail order sales have increased in both breadth and number. At least nineteen states[12] recently have enacted legislation that expands the definition of conditions necessary for firms to be required to collect and remit use taxes. These actions have triggered several court cases that could result in overturning *Bellas Hess*.[13] Most of the enacted legislation expands the definition of presence to include an economic presence ("the regular or systematic solicitation of sales") by the firm in the state. While legislation in some states has been enacted in anticipation of federal legislation, other states, most notably North Dakota, California, and Illinois, are actively enforcing their new laws.

North Dakota loses an estimated $8.4 million per year in unpaid use taxes. Because the tax was largely evaded and difficult to enforce, the state realized less than $100 per year in use tax collections on mail order sales.[14] In response, North Dakota passed legislation in 1987 that broadly expands its nexus requirements to include any business that systematically solicits sales within the state by a myriad of means, including catalogs, flyers, various media (television and newspapers, for example), computer database, and telephone.[15] In addition, the state began to pursue aggressively large firms that did not comply with the new law, resulting in several court cases. It is too soon to tell whether these actions will result in a large increase in mail order tax revenues, although early estimates by the North Dakota Department of Revenue predict FY 1990 income of about $200,000 from this source.

In 1987 legislation, California, with the highest estimated state use tax revenue losses, expanded its definition of nexus to include firms that use any in-state financial services, including the acceptance by mail order firms of credit cards issued by California banks. After passage, the state informed the largest direct marketers doing business in California of their responsibility to register with the state and pay the state's use tax. By the following year, $25 million in revenues were realized from the 70 firms that had registered with the state by that time. In response, the mail order firms instituted legal actions with the goal of declaring the California law unconstitutional. This case is still pending.

The state of Illinois has taken a somewhat different tack by attempting to identify purchasers of luxury items who have not remitted any state or local use taxes. In a much publicized event, the state Department of Revenue billed 198 Illinois residents for sales taxes owed on the purchase of furs, jewelry, and other luxury items from out-of-state firms, including $1.6 million worth of yachts bought from an Indiana boat

11 Joe Davidson, "Officials Split on Issue of Tax on Mail Orders," *The Wall Street Journal*, May 19, 1989, p. C13, and Jacqueline Frank, "It's Back to Square One on the Issue of Collecting Mail Order Taxes," *Governing* 2, no. 11 (August 1989), pp. 21-25.

12 Arkansas, California, Connecticut, Florida, Iowa, Kentucky, Louisiana, Massachusetts, Minnesota, Mississippi, Nebraska, North Carolina, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Tennessee, and Texas.

13 Christopher Zimmerman, "Taking Matters into Their Own Hands," *State Legislatures* 15, no. 2 (February 1989), p. 14.

14 Dennis Camire, "States Hoping to Sell Plan to Collect Lost Taxes," *Lansing State Journal*, February 12, 1989, p. 10A.

15 Zimmerman, "Taking Matters."

dealer. The $80,000 that the state eventually collected (including $18,798.60 in tax and interest from one Illinois yachtsman), was a far cry from the $164.3 million it is estimated is owed to the state for mail order sales. Nonetheless, the department is determined to continue its pursuit of large-scale tax evaders.

Legislation in Michigan

Legislation currently pending in the Michigan House of Representatives would force many mail order firms soliciting the sale of tangible property within the state to remit the state's use tax. Introduced in September 1989, House Bill (HB) 5044, sponsored by Representative William Bryant (R-Grosse Pointe Farms) would amend current law[16] by redefining "taxpayer" to include any mail order merchant benefiting from state infrastructure in the operation of its business. Benefits are defined to include "any banking, financing, debt collection, telecommunication, or marketing activities" taking place in the state. The bill also encompasses mail order firms using facilities located in the state that are authorized to install, service, or repair their goods.[17] By broadening the definition of taxpayer in this manner, any mail order firm doing systematic business in the state would have to obtain a retail sales license and remit taxes accordingly. If enacted, this legislation would incorporate economic presence in the definition of "business presence" (as opposed to physical presence only). HB 5044 currently is in the House Committee on Taxation, although no movement on the bill is scheduled to occur anytime soon.

CONCLUSION

The issue of mail order sales taxation is not a question of whether to impose a new tax, but rather what party, the buyer or the seller, should be held responsible for collecting and remitting the tax. Firms that do not have a physical presence in the state currently are not responsible for tax collections, which places the burden of remitting the tax on the purchaser. Because of the large number of buyers, states and localities cannot enforce the tax, resulting in substantial revenue losses. These revenue losses are especially troubling to state and local governments due to their increasing reliance on the sales tax as a revenue source and because of the decline in federal funds allocated to these jurisdictions. A related issue is the claim that mail order firms have a competitive price advantage over local firms because in-state firms are required to collect state and local retail taxes, and mail order firms are not.

Mail order firms' claim that compliance with such a tax would be excessively burdensome due to the number of taxing jurisdictions involved and especially difficult for smaller firms can be resolved by limiting collections to firms with some minimum sales level, either at the national level or within any given state. The number of rates imposed could be decreased if each state were limited to imposing one combined state and local rate. Computer software that can aid in the collection and remission process already has been developed, and firms that currently are required to remit the tax have reported no difficulties in the collection process. The response by mail order firms to the questions of competition and equity have been evasive. They claim that the transactions costs and inconveniences associated with mail order sales offset any price competition with local merchants. Transactions costs are not equivalent to a tax because these expenses are a normal cost of doing business, much like the costs of a sales staff and display area incurred

16 Public Act (PA) 167, section 1, of 1933 (as amended by PA 259 of 1987).

17 The inclusion of authorized repair and installation facilities, however, likely would meet the physical presence test required under *Bellas Hess*.

by retail businesses, and are a part of the purchase price. The argument that mail order firms should not have to collect use taxes because of this expense is analogous to an in-state firm requesting noncompliance because its rent costs were rising. Further equity concerns arise due to the fact that local companies, even very small firms, are required to collect state and local retail taxes, while mail order firms are not, resulting in uneven competiton between in-state and out-of-state firms.

These economic arguments have been compelling enough to result in efforts to change existing law at the state and national levels as well as within the courts. Because the main issues are the method of enforcement and administration (rather than the imposition of a new tax) and the competitive disadvantage for local businesses created by the uneven application of the tax, collection of use taxes from mail order firms likely will be acceptable to politicians, local businesses, and many consumers.

For all of these reasons (equity, economic efficiency, ease of enforcement and administration), we agree with the Advisory Commission on Intergovernmental Relations, the National Governor's Association, the National Association of Retail Dealers, and others that selling firms should assume the burden of collecting taxes on the sales of mail order goods. To ease the burden of compliance, each state should be limited to one combined state and local rate, and a minimum state and/or national level of sales should be set for firms that would be required to comply.