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 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.

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.

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