Staff Information Report
(SR-5)

Estimates of Revenue Potential from State Taxation of Out-of-State Mail Order Sales

September 4, 1987

Advisory Commission on Intergovernmental Relations
Washington, D.C.

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Preface and Acknowledgments

State tax administrators have been unable to collect sales taxes from out-of-state mail order firms since the Supreme Court's 1967 *National Bellas Hess* decision. In that ruling, the Court held that out-of-state mail order houses could not be required to collect state and local sales and use taxes for states in which their only business presence consists of distributing catalogs and other advertising materials.

In 1984 and 1985, the staff of the Advisory Commission on Intergovernmental Relations undertook a study of state and local taxation of out-of-state mail order sales. The results of the staff study were presented to the Commission in the spring of 1985, and two public hearings were conducted to give interested parties an opportunity to express their views.

On September 20, 1985, a majority of the Commission voted to recommend to Congress that legislation be enacted negating the *National Bellas Hess* decision by requiring mail order vendors to collect state use taxes on interstate sales delivered in any state in which the vendor engaged in regular or systematic sales solicitation. Because the Commission was keenly aware of the compliance costs which the recommendation would impose upon mail order vendors, particularly the small companies, it recommended that Congress ease these problems by incorporating a substantial *de minimis* provision and a single state-local tax rate provision in the legislation. Six members of the Commission filed a strong dissent from the recommendation. The Commission's recommendations, the dissent from the recommendations, and the staff study were published in April 1986 as *State and Local Taxation of Out-of-State Mail Order Sales* (A-105).

Since the publication of the Commission report, there has been considerable interest in the subject at both the state and the national levels. At the national levels, legislation has been introduced in the last two sessions of Congress, and hearings have been held. At the state level, during the summer of 1987, the National Governors' Association endorsed the principle of federal legislation allowing states to require collection of taxes on out-of-state mail order sales. In addition, many state revenue officials have launched aggressive campaigns to collect use taxes owed on out-of-state mail order purchases through interstate agreements and stepped-up enforcement activities.

Because several years had elapsed since publication of the original estimates of revenue potential from taxation of mail order sales, representatives from several state government organizations asked ACIR to update them. The ACIR then commissioned Professor Holley Ulbrich of Clemson University, who prepared the original report, to undertake this effort. She has refined her original methodology and prepared new estimates for 1985, 1986, and 1988. This ACIR staff working paper presents the new estimates and a description of the methodology.

The ACIR is grateful to James L. Martin and the National Governors' Association for their assistance in providing working materials needed to prepare the estimates and for reviewing them, to the National Association of Tax Administrators and their Executive Secretary Leon Rothenberg for reviewing the new estimates and circulating them to their members for review, and to Jerry Miller and the National Association of State Budget Officers for reviewing the estimates. As always, full responsibility for the accuracy of this study rests with the ACIR.

At the ACIR, Susannah E. Calkins directed the project, coordinated the review of the estimates, and prepared the final document.

John Shannon
Executive Director

Estimates of Revenue Potential from State Taxation of Out-of-state Mail Order Sales

These revised estimates of revenue potential from taxation of mail order sales by out-of-state vendors follow a procedure similar to that used in the estimates which appeared in the 1986 ACIR publication *State and Local Taxation of Out-of-State Mail Order Sales*, A-105. However, several refinements were made in the methodology:

1. Estimates of total sales again were based on the "bible" for the direct marketing industry—Fishman's *Guide to Mail Order Sales*; the ACIR estimates are based on the 1985 figures appearing in the *Guide* published in 1986. The *Guide* is used in preference to the *Census of Retail Trade* because the latest *Census* data available is for 1982 and does not include many firms for which mail order is a secondary rather than the primary classification.

2. More refined adjustments were made for newspapers, magazines, and business purchases.

3. All services are excluded from the base, because the bills currently before the Congress exclude services.

4. Only those local taxes which are imposed at a minimum uniform rate throughout the state are included. Local taxes are included on this basis for five states: California, North Carolina, Utah, Virginia, and Washington.

The estimates probably err on the low side. They are based on conservative estimates of the growth in mail order sales; no estimate could be made of the impact of fast growing TV catalog sales on mail order revenues (some industry sources predict growth rates of as much as 400 percent a year in the near future); and there was no attempt made to estimate the additional amount of revenue that could be lost in 1988 if states continue to increase their sales tax rates.

Table 1 presents estimates on a nationwide basis for unadjusted estimates of potential revenue from taxation of mail order sales; the estimates adjusted for nexus; and the estimates adjusted for both nexus and for *de minimis* thresholds of $5 million and $12.5 million, the amounts contained in proposed legislation.

The nexus adjustment is necessary because certain mail order firms such as Sears have a physical presence in most states and therefore collect state sales taxes on out-of-state purchases. The revenue potential figures are reduced to account for current taxation of sales of Sears, Ward, and Penney as well as some of the sales of other large general merchandise vendors of consumer products (those most likely to have nexus in more than on state). This adjustment was estimated at 11.25 percent of total mail order sales.

The two *de minimis* adjustments reflect amounts proposed in legislation currently before Congress. To minimize compliance costs, proposed legislation exempts mail order firms below a specified level of gross sales from collecting the sales tax—the *de minimis* or threshold provision. The threshold adjustment is derived from both Census and Fishman data on size distribution of mail order firms with less than $5 million in sales. The mail order sales tax revenue estimates were reduced by the 21.7 percent of sales estimated to be made by firms with sales of less than $5 million, and the 29 percent of sales estimated to be made by firms with sales of less than $12.5 million.

Table 2 presents the unadjusted estimates of revenue potential from taxation of mail order sales on a state-by-state basis. Sales were distributed by state solely on the basis of state personal income data, whereas the previous estimates had been allocated both on that basis and on the basis of sales by Sears, Ward, and Penney. The changing nature and composition of mail order activity suggests that those retailers' experience with state-by-state sales may not adequately represent the experience of the rest of the industry.

State-by-state figures adjusted for nexus and *de minimis* are not presented in this paper. Nexus-adjusted estimates by state prepared for this study were sent to state tax administrators for review. Their comments indicate that substantial differences exist between the estimates and actual state experience in collecting taxes on out-of-state mail order sales. Discussions with the state tax administrators have identified two major factors which may be responsible for these discrepancies. One is that the number of establishments for mail order firms may have increased since the *1982 Census of Retail Trade*, which provides the only set of base figures on establishments. An increase in the number of establishments indicates that more mail order firms may have nexus in more than one state. State tax administrators also have pointed out that many mail order firms have set up warehouses in the larger states. A second factor is that many states have instituted aggressive collection policies which have enabled them to increase their collections of these revenues. The ACIR, with the assistance of the Federation of Tax Administrators, is in the process of collecting more information on actual state experience with collection of taxes on out-of-state mail order sales. This data may make it possible to develop realistic state-by-state estimates on a nexus-adjusted basis. The information will also cast some light on the accuracy of our nationwide estimate for the nexus adjustment.

Tax administrators can use the ACIR unadjusted estimates of revenue to arrive at their own nexus-adjusted figures by simply subtracting the amount of tax revenue collected by their state from out-of-state mail order firms from the unadjusted state figure shown in *Table 2*. The figure thus derived can also be adjusted to reflect the alternate *de minimis* provisions by subtracting 21.7 percent to determine the effect of the $5 million de minimis, and 29 percent for the $12.5 million *de minimis*.

Methodology and Explanation

1985 Estimates

The revenue potential estimates appearing in A-105 have been updated, and the methodology refined. The revisions in the 1985 figures are accounted for by several factors:

1. In 1985, when the original ACIR estimates were made, the latest information on mail order sales from Fishman's *Guide to Mail Order Sales* was for 1983. The ACIR projected 1985 estimates started with the Fishman estimate for 1983 and adjusted it to reach 1985 by a conservative growth rate of 9 percent a year, derived from the average annual rate of growth of mail order sales between 1972 and 1982 in the *Census of Retail Trade*. Actual figures for 1985 indicate that the growth rate in mail order sales has been slightly higher than the projected 18.8 percent two-year compounded growth rate for 1983 to 1985 used in A-105. The revised estimate for 1985 reflects the higher actual rate of growth.

2. Actual state sales tax rate increases effective for 1985 are also reflected in the revised 1985 estimate. The A-105 estimates used 1984 tax rates, because they were the latest tax rate figures available at that time.

3. Actual personal income data by state for the third quarter of 1985 are used to allocate mail order sales among states.

4. The new 1985 estimates were reduced by the elimination of those local sales taxes which did not have minimum uniform rates throughout the state, and by the elimination of that portion of mail order services which had been included in the base in the A-105 estimates.

5. In the original A-105 estimates for 1985, a nexus adjustment was made for Sears, Ward, and Penney only. As mentioned above, the new 1985 nationwide revenue estimates in *Table 1* include a nexus adjustment in the mail order sales base for these three firms as well as some of the sales of other large general merchandise vendors of consumer products (those most likely to have nexus in more than on state). This adjustment was estimated at 11.25 percent of total mail order sales.

1986 Estimates

1. The unadjusted 1986 estimate of $2.079 billion shows an increase of 9.9 percent over the revised unadjusted 1985 estimate. It is based on a conservative rate of growth of mail order sales between 1985 and 1986 of 8.3 percent. (Fishman projects a growth rate in the range of 8-12 percent, based on past experience.)

2. The estimate uses actual state personal income figures for the third quarter of 1986 to allocate mail order sales among states, as well as actual state sales tax rates effective during 1986.

3. It should be noted that there is an interactive effect in the estimates between tax rate increases and changes in state personal income. States with above average rates of increase in personal income which chose to raise tax rates would show very sharp increases in potential revenue.

1988 Estimates

1. The 1988 estimates are a straight-line projection of 1986 mail order sales tax revenues at a rate of 17.3 percent, which is the two-year compound of the conservative 8.3 percent rate of increase in mail order sales used in the projecting revenues from 1985 to 1986.

2. No changes in state-by-state distribution of personal income are assumed.

3. No sales tax rate changes are assumed.

4. Increases in sales tax rates or faster growth in mail order sales would generate higher revenues.

Table 1

Estimated Revenue Potential from Out-of-State Mail Order Sales, 1985-88 Unadjusted, Adjusted for Nexus, and Adjusted for *De Minimis* Provisions of $5 Million and $12.5 Million,1985, 1986, 1988

	(in millions)		
	1985	**1986**	**1988**
Unadjusted	$1,892	$2,079	$2,439
Adjusted for Nexus	1,679	1,845	2,164
Adjusted for Nexus and $5 Million *De Minimis*	1,315	1,445	1,695
Adjusted for Nexus and $12.5 Million *De Minimis*	1,192	1,310	1,539

Table 2

Estimated Revenue Potential from Mail Order Sales Unadjusted for Nexus and *De Minimis* Provisions, 1985-88

(in Thousands)	1985 Est.	1986 Est.	1988 Est.
Alabama	$23,840	$25,260	$29,620
Arizona	27,580	30,850	36,190
Arkansas	12,960	13,730	16,110
California (L)	285,340	318,030	373,020
Colorado	18,240	19,410	22,770
Connecticut	48,390	51,890	60,860
Washington, DC	8,820	9,280	10,890
Florida	90,480	97,310	114,140
Georgia	30,980	34,250	40,170
Hawaii	8,110	8,700	10,200
Idaho	7,450	8,040	9,430
Illinois	98,430	103,760	121,690
Indiana	44,120	46,270	54,290
Iowa	18,650	18,840	22,100
Kansas	13,760	18,580	21,800
Kentucky	27,470	28,830	33,820
Louisiana	25,930	26,170	30,690
Maine	7,870	8,660	10,160
Maryland	44,510	48,110	56,430
Massachusetts	51,760	55,730	65,360
Michigan	57,590	60,300	70,730
Minnesota	39,240	40,590	47,610
Mississippi	18,590	19,920	23,360
Missouri	36,420	39,140	45,910
Nebraska	8,770	9,840	11,540
Nevada	9,830	10,910	12,800
New Jersey	83,300	91,340	107,130
New Mexico	7,820	10,280	12,050
New York	137,590	152,020	178,300
North Carolina (L)	37,390	40,330	47,300
North Dakota	5,780	5,170	6,070
Ohio	82,740	86,190	101,100
Oklahoma	16,790	18,420	21,600
Pennsylvania	103,530	108,950	127,790
Rhode Island	8,850	9,410	11,040
South Carolina	23,610	25,250	29,620
South Dakota	4,140	5,210	6,110
Tennessee	38,260	41,830	49,070
Texas	116,300	154,310	180,990
Utah (L)	12,230	13,840	16,230
Vermont	3,260	3,580	4,200
Virginia (L)	39,280	47,790	56,060
Washington (L)	53,770	58,470	68,580
West Virginia	13,660	13,810	16,200
Wisconsin	36,430	38,180	44,780
Wyoming	2,410	2,380	2,790
United States	1,892,270	2,079,170	2,438,640
Increase		85/86 = 9.9%	86/88 = 17.3%

(L)—Local sales tax levied at minimum uniform rate throughout state is included.

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