POLICY BRIEF
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Use Tax Collection on Income Tax Returns in Other States

The use tax is a complement to the sales tax. Individuals owe the use tax on goods and services purchased outside their state of residence, by mail order, or over the Internet, but it is difficult for states to enforce compliance. Several states provide for individuals to report use tax liability on the individual income tax return. This policy brief explains the use tax, other states' efforts to collect it via the income tax return, and options for Minnesota to use the income tax return to increase use tax reporting and collections.

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The Use Tax and Collection Methods

All states with a general sales tax have also enacted complementary use taxes. In general, a use tax is due on a transaction in which the sales tax is not collected and the good or service is used in the jurisdiction imposing the tax. For example, if a Minnesota resident travels to a jurisdiction that does not have a sales tax and purchases items to bring home for use in Minnesota, or orders nonexempt items by mail or over the Internet, a use tax is due to Minnesota on those purchases. The use tax is intended to put in-state merchants on an equal competitive footing with merchants in lower tax jurisdictions.

Minnesota allows individual taxpayers a de minimus exemption from the use tax. Individuals whose total purchases subject to use tax do not exceed $770 in a calendar year are not subject to use tax.[1] The exemption amount of $770 equals the amount of purchases necessary to generate $50 of use tax liability, at Minnesota's state sales and use tax rate of 6.5 percent. Minnesota is one of two states with a de minimus exemption for individuals.[2]

Of the 45 states with sales and use taxes, 38 also have an individual income tax. Of these 38 states, 16 provide for taxpayers to report use tax obligations on the individual income tax return, and another eight provide information about the use tax in the individual income tax booklets. The experience in other states and past Department of Revenue estimates suggests the following results for eliminating the de minimus exemption and/or providing for collection on the individual income tax return:

- Eliminate de minimus exemption and provide for individuals to pay use tax on the income tax return. Revenue raised: between $1.0 million and $2.0 million per year
- Eliminate de minimus exemption and require individuals with purchases of less than $770 to file use tax returns. Revenue raised: $100,000 per year
- Retain de minimus exemption and provide for individuals with purchases greater than $770 to pay use tax on the income tax return. Revenue raised: minimal

Minnesota's Use Tax and the de Minimus Exemption

The use tax complements the general sales tax and is due on transactions in which the sales tax is not collected, but the good or service purchased is used in the jurisdiction imposing the sales tax.[3] Use tax typically applies to goods that an individual purchases in one state but uses in

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[1] Minn. Stat. § 297A.67, subd. 21.

[2] Colorado has a de minimus exemption of $100 in purchases per year for individuals (Colo. Rev. Stat. § 39-26-203); however, the use tax reporting form for individuals does not mention the de minimum exemption.

[3] The use tax applies to taxable tangible personal property and taxable services that were not subject to the *Minnesota* sales tax. Minn. Stat. § 297A.63, subd. 1 (2002). Thus, even if sales tax is paid to the state in which the sale took place, the use tax still technically applies. However, the rate of the use tax is reduced to the difference between the Minnesota rate and sales tax rate in the state in which the tax was paid. Minn. Stat. § 297A.80 (2002).

another, either by traveling to another state, or by purchasing the good remotely either by mail-order or over the Internet.

An excerpt from Form M-1 Instructions for Minnesota income tax filers

Did you know you have to pay Minnesota sales tax when you buy something out of state or out of the country?

It's true, only we give it a different name: use tax. It applies to taxable items bought through the Internet, mail order, radio or TV ads, or directly from out-of-state companies.

If you weren't charged sales tax at the time of purchase, you'll have to pay Minnesota's 6.5 percent rate. Otherwise you'll pay the difference between the rate you were charged and Minnesota's rate. In either case, you need to file Form UT-1, *Individual Use Tax Return.*

Generally, if your total purchases subject to use tax are less than $770 in a calendar year, you don't have to file the return (*This does not apply to purchases by businesses.)*

For more information, you can download Form UT-1 and Fact Sheet 156, *Use Tax for Individuals*, from our website:
www.taxes.state.mn.us
Or you can get information by calling
651-296-6181

Source: Form M-1 Instructions, Minnesota Department of Revenue

An alternative to the use tax would be to require businesses that make sales through catalogs or over the Internet to collect the sales tax at the time a sale is made. However, two U.S. Supreme Court rulings have prevented the states from requiring businesses to collect sales tax unless the business has a physical presence in the state.[4] Because of the complexity of state sales tax laws, the court considered a collection requirement to be an undue burden on interstate commerce. A group of states is working to simplify state sales taxes in the hopes of being able to require tax collection by remote sellers in the Streamlined Sales Tax Project. In the meantime, collecting the use tax directly from consumers of goods purchased while traveling, on-line, or through a catalog is the states' only alternative to simply foregoing tax revenue owed on remote sales.

States have historically viewed the use tax on individuals as impractical to enforce—the tax typically involves a small amount owed on a large number of transactions for which the individual has not kept records, and the costs of collection could easily exceed the revenues collected. In 1996 the Sales Tax Advisory Council recommended that Minnesota adopt a de minimus exemption from the use tax, recognizing that most taxpayers are unaware of the tax and the Department of Revenue is unlikely to collect the tax due to high administrative costs. The legislature adopted the council's recommendation, and the exemption took effect in 1997. Individuals with less than $770 in purchases during a calendar year are exempt from the tax, and able to make incidental purchases by mail order, over the Internet, or while traveling without keeping records for the use tax. With Minnesota's 6.5 percent sales and use tax rate, $770 is the amount of purchases necessary to generate $50 of tax. At the same time Minnesota began including information on the use tax in the individual income tax instructions, directing individuals with purchases in excess of the de minimus exemption amount to file a use tax return. The box to the right reproduces the information provided in Minnesota's 2001 individual income tax form.

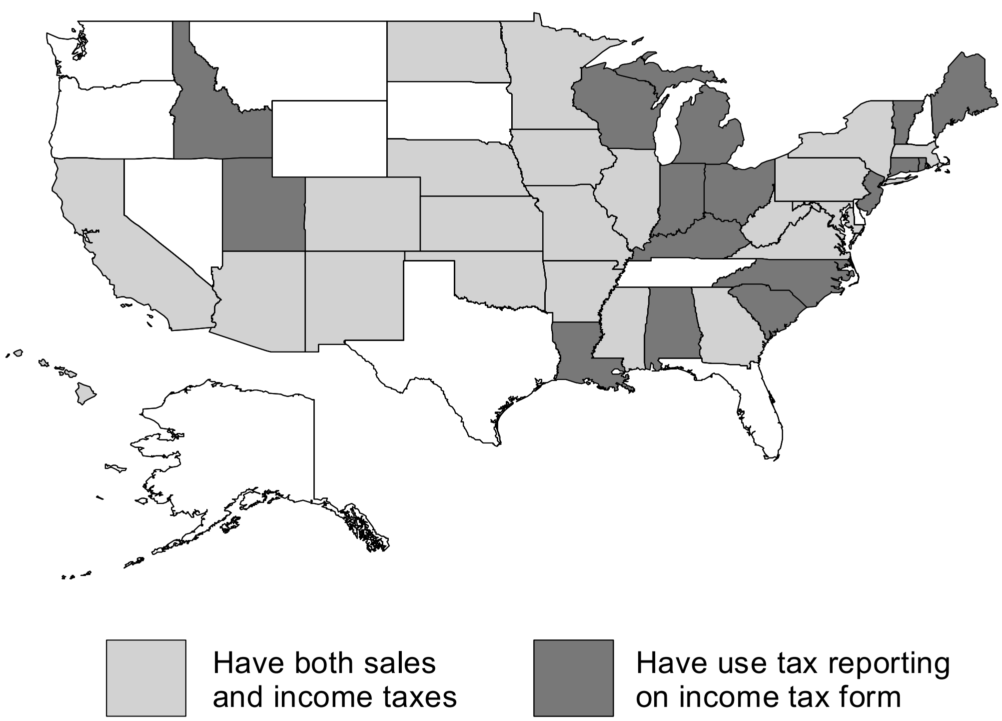
No tax is owed if the sales tax paid was as high or higher than the Minnesota sales (both state and any applicable local) tax. As a practical matter, most remote sales (catalog and Internet) are not subject to sales tax in the seller's state. Thus, the offset for taxes paid to another state rarely applies.

[4] *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967) and *Quill Corp. v. Heitkamp*, 504 U.S. 298 (1992).

Other States—Reporting

Other states have taken steps to make the use tax more visible, rather than exempting a flat amount of purchases. Sixteen of the states with both an income tax and a sales tax provide for use tax reporting on individual income tax returns. In 1974, Vermont added a line for use tax reporting to its income tax return, followed by a number of states, including Wisconsin, in the early 1980s. Additional states provided for use tax reporting on the income tax form in the following years, and six have added use tax lines since 1999 (Alabama, Louisiana, Michigan, North Carolina,[5] Ohio, and South Carolina), perhaps in response to the perception of tax base erosion due to electronic commerce. Map 1 shows the states with both an income tax and a sales tax, and highlights those that provide for use tax reporting on the income tax return.

States with Use Tax Reporting on Individual Income Tax Return



House Research Graphics

In addition to the 16 states that collect use tax on the income tax return, eight (including Minnesota) provide information about the use tax in the income tax instruction booklet.

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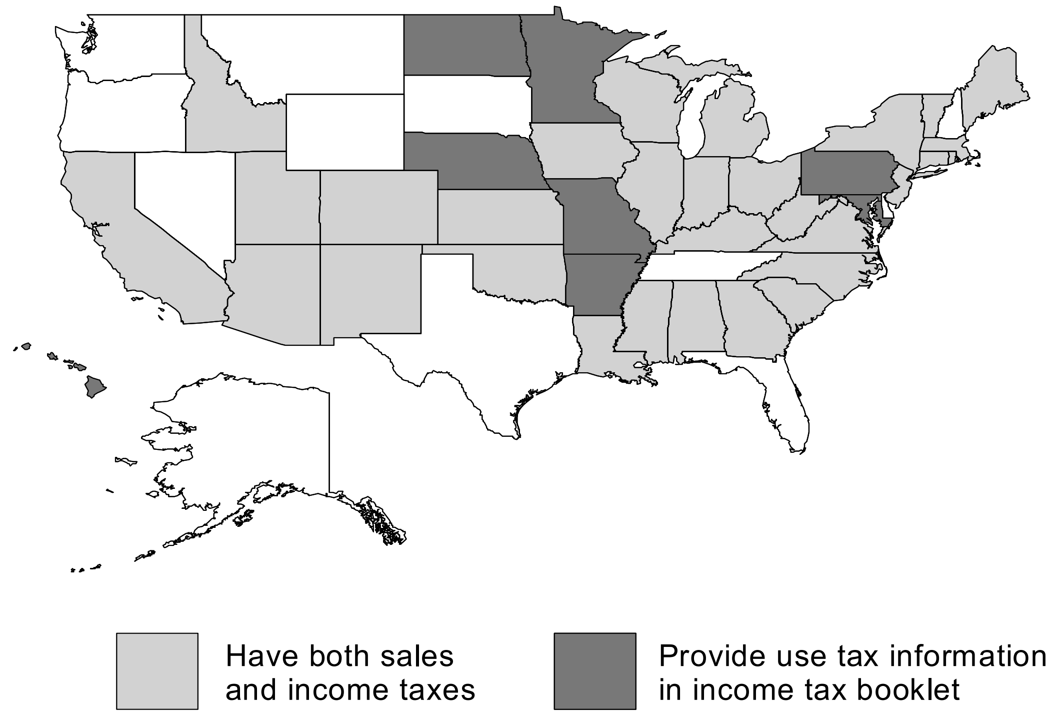
[5] North Carolina's use tax line on the income tax return was added administratively and it is unclear how long it will remain on the form.

States with Use Tax Information in Individual Income Tax Booklet



House Research Graphics

The two maps shows a concentration of states in the central part of the country taking steps to make individual taxpayers aware of use tax obligations, either by providing for payment through the income tax or by providing information on how to file an individual use tax return.

Other States—Collections

The information in this section is based on data obtained from 14 of the 16 states that collect use tax on the income tax return. Alabama does not track the amount of use tax collected on income tax returns; the total amount of use tax collections is estimated at $100,000 to $200,000. South Carolina data was omitted from the analysis as unreliable; the totals reported far exceeded amounts reported in other states. South Carolina analysts think taxpayers may be mistakenly reporting the contribution deduction on the use tax line. The data for 12 of the 14 states is for the most recent year available. Connecticut and New Jersey reported significant use tax payments by a small number of individuals, believed to relate to the purchase of artwork. For these two states data from the previous year was used in order to provide a more typical representation of use tax collections.

Two states that recently placed a use tax line on the income tax return reported significant increases in collections. Louisiana's use tax line first appeared on its income tax form in 2000, and Michigan's in 1999. Both states previously provided use tax information in the income tax package sent to filers. Louisiana's collections via individual filings increased from about $20,000 per year prior to 2000 to over $500,000 reported on the income tax form in 2000. Michigan collections increased from $240,000 in 1998 to $2.9 million in 1999.

The states that collect use tax on the income tax form use different techniques to try to maximize voluntary reporting by taxpayers. Three states provide taxpayers with look-up tables for estimating their use tax liability (Maine, Michigan, North Carolina). Two states require taxpayers to clearly indicate if no use tax liability is owed (Connecticut and Louisiana). Two states have sent information about the use tax to a random sample of taxpayers, resulting in higher collections in following years (Indiana[6] and Rhode Island[7]).

Look-up tables provide estimates of use tax liability by taxpayer income. Liability is assumed to represent a percentage of income. The percentage is intended to represent average use tax liability of taxpayers. The three states using look-up tables did not have records of how the percentages they use were determined, but there is some indication that they may have been derived from federal tables used prior to 1987 for estimating sales tax liability of taxpayers claiming the itemized deduction for sales tax paid. The tables make compliance with the tax more convenient for taxpayers who know they have made untaxed purchases, either while traveling, through catalogs, or over the Internet, but have not maintained records of those purchases. Taxpayers with large purchases must report those separately from the use tax calculated using the look-up table, and those who did not make any purchases subject to use tax are not required to use the look-up table and may report liability equal to $0.

States that provide look-up tables for estimating liability have higher participation rates. About 1 percent of taxpayers report use tax across all states with use tax reporting on income tax returns. A handful of states have higher reporting rates: Louisiana at 6 percent, Maine at 8 percent, North Carolina at 4 percent, and Michigan at almost 2 percent. Three of the four states with higher participation rates—Maine, North Carolina, and Michigan—allow taxpayers to estimate use tax liability as a percentage of either state taxable income or state income tax liability. The higher reporting rate in the fourth state—Louisiana—may result from the requirement that taxpayers either report liability or check a box labeled "no use tax owed." Maine's exceptionally high 8 percent participation rate may be the result of its previous practice (through 1999) of assuming liability equal to 4 percent of income if none was reported; taxpayers who in past years received a use tax bill from the state may now choose to use the look-up table provided.

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[6] In 1993, Indiana identified taxpayers who had not reported use tax and had incomes above a certain level, and sent educational letters explaining the use tax to a random sample of taxpayers identified, with the purpose of improving compliance.

[7] In 1995, Rhode Island sent letters explaining the use tax to about 15,000 taxpayers who had not reported use tax liability in 1994. This action was in response to low compliance with the use tax after the use tax line first appeared on the income tax return. The mailings resulted in negative publicity and have not been repeated.

States with look-up tables collect less use tax per return than do states without look-up tables. Individuals who report use tax liability pay $36 on average across all states with use tax reporting on the income tax return. The amount collected per return reporting use tax is lower in states that provide a look-up table than in those that don't: $30 compared with $46. Maine, which provides a look-up table, collected $23 on average from returns reporting use tax, the lowest per return of any state. States with high per-return collections are led by Connecticut with $108 per return, and Rhode Island with $76 per return; neither of these states provides a look-up table. This suggests that individuals may tend to report large purchases but omit smaller ones, especially when the return doesn't have a look-up table for estimating taxable purchase amounts.

Amounts collected per return depend both on the total amount of out-of-state taxable purchases and on the state's sales and use tax rate. States with look-up tables have lower per-return taxable purchases—$509—than do states without look-up tables ($788 of taxable purchases, on average). State tax rates range from 4 percent to 7 percent in states collecting the use tax on income tax returns.

States with look-up tables collect more per capita than do states without look-up tables. States with look-up tables collect $0.46 per capita when the total use tax collected on income tax returns is divided across the entire population. Those without look-up tables collect less than half that amount per capita: $0.17. The higher participation rate in the states with look-up tables outweighs the smaller amounts of liability reported by those using the look-up tables. The highest per capita collections are in Maine, at 83 cents; the lowest are in Utah, at about 7 cents per capita.

Maine's look-up table provides amounts of liability by income ranges, with liability representing 0.04 percent of the taxpayer's Maine adjusted gross income. The percentage is intended to represent average use tax liability of Maine residents. For example, a taxpayer with $10,000 of Maine adjusted gross income would report use tax liability of $4. Current staff at Maine Revenue Services think the percentage may have been derived from federal tables used prior to 1987 for estimating sales tax liability for individuals claiming itemized deductions.

Michigan's look-up table gives estimated use tax liability by income ranges up to $100,000. Estimated liability equals 0.05 percent of the taxpayer's Michigan adjusted gross income. Taxpayers with incomes over $100,000 are instructed to multiply their income by 0.0005 to obtain an estimate of use tax liability. Only taxpayers with purchases totaling less than $1,000 may use the look-up table to estimate use tax liability.

North Carolina, like Michigan, only allows taxpayers with purchases of less than $1,000 to use its look-up table to estimate liability. The look-up table amounts represent 0.0625 percent of taxable income. The percentage used is higher than in the other two states with look-up tables, but is applied to a more narrow tax base—taxable income, which is income after all deductions and exemptions, rather than adjusted gross income, which is typically income before deductions and exemptions. Taxpayers with incomes over $48,800 are instructed to multiply their income by 0.000625 to estimate use tax liability.

Six states collect local as well as state use tax on the income tax return. Five states (North Carolina, Ohio, South Carolina, Utah, and Wisconsin) provide a table listing the combined state and county (or city) rate and instruct taxpayers to use the rate for their jurisdiction. The sixth state, Louisiana, instructs taxpayers to multiply taxable purchases by 8 percent, of which 4 percent represents state use tax liability, and the remaining 4 percent is in lieu of the actual local rate, which ranges from 3 percent to 5 percent.

Most states that collect local use tax on the income tax return distribute a portion of collections to the local jurisdictions. Ohio and Wisconsin distribute amounts collected to counties and other jurisdictions based on taxpayers' county of residence as reported on the income tax return. North Carolina and Utah distribute use tax collected on the income tax return to counties based on each county's proportionate share of sales tax collections. Louisiana distributes the local share of use tax collections to all 64 parishes, including the one parish that does not impose a sales/use tax, on a per capita basis. The parish tax collectors then distribute their share of use tax collections to tax-levying authorities within the parish, based on the previous year's pro-rata share of actual sales tax collections. The local portion of South Carolina's use tax that is collected on the income tax is directed to a local option supplemental revenue fund, used to provide a minimum amount to all counties with local sales and use taxes.

Options for Minnesota

Three options that could increase use tax collections in Minnesota are:

- Eliminate the $770 de minimus exemption and provide for use tax reporting on the income tax return (either with or without a look-up table)
- Eliminate the $770 de minimus exemption and require taxpayers to file use tax returns
- Retain the de minimus exemption and provide for use tax reporting on the income tax return

Option #1: Eliminate de minimus exemption and require reporting on the income tax return

Experience in other states suggests that Minnesota could increase use tax collections by repealing its de minimus exemption requirements and placing a use tax reporting line on the individual income tax return. Additional collections could equal about $2.0 million if Minnesota included a look-up table for taxpayers to use in estimating liability, and about $1.0 million without a look-up table. Estimates depend on Minnesota taxpayers reporting use tax liability at similar rates to taxpayers in other states; the experience in other states that apply the sales tax to clothing was adjusted to reflect Minnesota's exclusion of clothing from the sales tax base.[8]

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[8] Average purchases reported in states that tax clothing were adjusted downward by 15 percent, to reflect Minnesota's exclusion of clothing from the tax base. The adjustment was calculated based on the share that clothing comprises of remote sales, as reported by U.S. Census Bureau's 2000 Annual Retail Trade Survey.

Repealing the de minimus exemption and placing a reporting line on the income tax return could result in an additional $1.0 million in use tax collections in Minnesota. The amount of revenue Minnesota would collect by repealing the use tax de minimus exemption and placing a use tax reporting line on its income tax return would depend on the participation rate and the average amount of use tax purchases reported by return. Table 1 shows the participation rate, and average purchases reported per return (adjusted for states that apply the sales/use tax to clothing), for each state collecting use tax on its income tax return. The final column shows the amount of use tax that Minnesota would collect if it experienced the same participation rate and average amount of purchases in each of the states listed. The estimates assume 2.4 million returns filed annually by resident taxpayers, the total for tax year 2000.

Table 1
Estimated Use Tax Collected on Income Tax Returns in Minnesota
(based on data from other states)

State	**Participation rate**	**Average purchases per return**	**Estimate of use tax collections for Minnesota** (in millions)
Connecticut	0.78%	$1,530	$1.8
Idaho	0.77	650	0.8
Indiana	0.87	690	0.9
Kentucky	1.09	660	1.1
Louisiana	0.59	580	0.5
Maine	7.96	390	4.9
Michigan	1.78	550	1.5
New Jersey	0.28	700	0.3
North Carolina	4.02	390	2.4
Ohio	1.06	440	0.7
Rhode Island	0.14	1,090	0.2
Utah	0.57	450	0.4
Vermont	1.47	861	2.0
Wisconsin	0.91	860	1.2

Applying experience in other states to Minnesota gives a wide range of estimates. Use tax collections in Minnesota would equal $4.9 million if Minnesota's experience corresponded to Maine's with nearly 8 percent of returns reporting average purchases of about $390. However, collections would only equal about $200,000 if Minnesotans behaved more like Rhode Islanders, with only 0.14 percent of returns reporting liability, but at a high average purchase per return amount of $1,090. What would actually happen in Minnesota would depend on how many Minnesotans make purchases subject to use tax, how much they purchase, and how well they comply with reporting use tax liability on the income tax return. To the extent those factors vary with geography, Minnesota results might be expected to be similar to the experience in Michigan and Wisconsin. Applying participation rates and average purchases from these two states implies collections of between $1.5 million and $1.2 million in Minnesota.

Use tax collections could be higher—up to $2.0 million—if Minnesota provided a look-up table for taxpayers to use in estimating liability. Table 2 shows the participation rates and average purchase amounts for all other states collecting use tax on the income tax return, and the amount of collections predicted for Minnesota. The table also shows rates and amounts when the states are grouped by whether or not they provide a look-up table for estimating liability. States with look-up tables tend to experience a higher participation rate and higher overall collections than states without look-up tables. The greater participation rate in these states overwhelms the effect of lower average purchases per return.

Table 2
Estimates of Minnesota Use Tax Collections Based on Experience in Other States Combined, and States With and Without Look-up Tables

	Participation rate	**Average purchases per return**	**Estimate of use tax collections for Minnesota** (in millions)
All states	1.49%	$525	$1.2
Without look-up table	0.77	680	0.8
With look-up table	3.0	430	2.0

If Minnesota were to employ a look-up table for use tax liability in the income tax instructions, collections could reach $2.0 million if Minnesota taxpayers behaved similarly to taxpayers in other states with look-up tables (Maine, Michigan, and North Carolina). Without a look-up table increased collections would be about $0.8 million. The actual amount collected would depend on whether Minnesota taxpayers complied with the reporting requirement at a similar rate to taxpayers in other states.

Option #2: Eliminate the de minimus exemption and require taxpayers to file use tax returns

Simply repealing the exemption without requiring reporting on the income tax return could result in about $100,000 per year in additional use tax collections. This would be a return to individual use tax reporting requirements as they existed prior to enactment of the de minimus exemption. Each individual would be required to file a use tax return if they made any purchases subject to use tax—through a catalog, on-line, or while traveling out of state. Many taxpayers would remain unaware of the use tax obligation, though technically even those with only small amounts of purchases would owe the tax. At the time the exemption was enacted, the Department of Revenue estimated the loss of about $100,000 annually through exempting the first $770 of purchases from the tax.[9]

[9] Minnesota Department of Revenue, Analysis of 1996 Tax Conference Committee Report, April 11, 1996.

Option #3: Retain the de minimus exemption and allow for use tax payment on the income tax return

Minnesota would not be likely to collect any additional use tax by placing a line on the income tax return if the de minimus exemption provision were retained. House File 2682, introduced during the 1998 legislative session, proposed adding a line to the income tax return for use tax reporting, but left the exemption in place. The Department of Revenue estimate for this bill indicated that the revenue gain was "indeterminable, [but] it appears any impact would be small."[10] The same is likely to be true today.

Administrative costs

Revenue gains from adding a use tax line to the income tax return would be offset by administrative costs to the Department of Revenue. Inclusion of the use tax line would require an additional line on the individual income tax return and additional instructions in the booklet. The change would also require programming changes to account for the amount of use tax paid via the income tax return.[11] Earlier estimates prepared by the department did not detail the amount of these administrative costs.

[10] Minnesota Department of Revenue, Analysis of H.F. 2682, January 29, 1998.

[11] Ibid.

Appendix

Background information on states allowing use tax reporting on the income tax return

Maine gives taxpayers the option of multiplying Maine adjusted gross income by 4 percent or using a table showing estimated use tax by income level; but provides that use tax on items costing over $1,000 must be calculated separately and are in addition to the table amount. Maine also reserves the right to review reported amounts and require additional payments. Previously Maine assumed use tax liability equal to 4 percent of income tax liability for individuals who left the use tax line blank; this policy was discontinued in 1999. Maine has offered use tax reporting on its income tax return since 1997. Collections have dropped since 1999 when the automatic estimate of 4 percent of liability for those leaving the line blank was eliminated.

Michigan follows a similar approach, allowing taxpayers to use an income-keyed table to look up their use tax liability for items costing under $1,000. Use tax on items costing more than $1,000 is in addition to the table amount. Michigan also warns taxpayers that their return may be audited and the amount of use tax owed be determined to be greater than the table amount. Michigan has only offered use tax reporting on the income tax return during the last few filing seasons, but has not experienced a dramatic increase in collections since the first year the use tax line appeared on the income tax. In Michigan, collections increased from $2.9 million in 1999 to $3.1 million in 2000.

North Carolina provides two worksheets for the use tax. The first is for taxpayers with records of their purchases. The second worksheet directs taxpayers without records of their purchases to use a look-up table to determine their use tax liability. The look-up table assumes use tax liability equals 0.0625 percent of taxable income, resulting in low use tax amounts—only $16 of use tax for a filer with $25,000 of taxable income. Taxpayers who think the look-up table overstates their liability may make their own estimate. North Carolina has only offered use tax reporting on the income tax return during the last few filing seasons, but has not experienced a dramatic increase in collections since the first year the use tax line appeared on the income tax. In North Carolina, collections decreased from $4.9 million in 1999 to $4.7 million in 2000.

Louisiana requires taxpayers to either enter the amount of use tax owed on the income tax return, or to check a box labeled "no use tax owed." Similarly, **Connecticut** directs taxpayers to enter "0" on the use tax line if no tax is owed.

Rhode Island conducted a taxpayer outreach program for tax year 1995, in an effort to increase compliance. Returns that had not reported use tax liability in recent years were stratified into different income brackets. The Department of Revenue then prepared a sample made up of returns selected at random from each of the strata. Taxpayers in the sample received a mailing about the use tax line on the income tax form. The letters were sent to a few hundred taxpayers from each stratum for a final mailing of about 1,000 letters, resulting in a 254 percent increase in use tax collections from 1994 to 1995. However, the mailing also resulted in negative publicity for the Department of Revenue, and has not been repeated.

Indiana conducted a similar exercise in 1993, sending notices to a random sample of high-income taxpayers. Use tax collections via the income tax return increased over 50 percent in the following year, and have remained relatively constant in following years.

Kentucky reported that publicity about the use tax has a significant effect on collections, noting that fluctuations in use tax collections correspond to the amount of publicity given the use tax via public service announcements and the like. Other states giving use tax information prominent placement and providing use tax calculation worksheets in their income tax booklets are: Alabama, Connecticut, Indiana, Louisiana, Maine, Michigan, North Carolina, Ohio, South Carolina, Utah, and Wisconsin.

For more information about taxes, visit our web site, www.house.mn/hrd/issinfo/taxes.htm.