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Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities

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Summary

On September 17th, the House of Representatives approved H.R. 49, the "Internet Tax Non-Discrimination Act of 2003." The Multistate Tax Commission estimates that the House bill (and its Senate counterpart) ultimately could reduce state and local revenues by $2 billion to $9 billion annually.[1]

If enacted into law, H.R. 49 would expand and make permanent a federally-imposed "moratorium" on state and local taxation of sales of "Internet access" services. States and local governments would be permanently prohibited from charging sales taxes on the $10-$50 monthly charge that households and businesses pay to a company like America Online, or to the local phone or cable TV company, to be able to access the World Wide Web and send and receive e-mail. The original moratorium had been established by the "Internet Tax Freedom Act" (ITFA) enacted in 1998 and later renewed through November 1, 2003.

In addition to making ITFA a *permanent* prohibition on state and local Internet access taxes, H.R. 49 makes two substantive changes in the law that could result in a much broader loss of revenue for states and localities.

- H.R. 49 eliminates a so-called "grandfather clause" that had preserved state and local taxes on Internet access "imposed and actually enforced prior to October 1, 1998."
- H.R. 49 expands the definition of "Internet access" to prevent states and localities from taxing telecommunications services "used to provide Internet access." The latter change is a reversal of commitments made to state and local governments at the time ITFA was enacted; the legislative history of the Act makes clear that state and local governments were to be allowed to tax telecommunications services underlying the Internet at all levels of this "network of networks."

The Senate counterpart to H.R. 49, S. 150, was approved by the Senate Committee on Commerce, Science and Transportation on July 31. As amended in committee, S. 150 is identical to H.R. 49 except that the grandfather clause is not eliminated until October 1, 2006. S. 150 was sequentially referred to the Committee on Finance, which is expected to discharge the bill on October 21st without marking it up. It could then move to the floor of the Senate at any time.

Both H.R. 49 and S. 150 would result in substantial revenue losses for state and local governments. The only difference is one of timing. The immediate elimination of the grandfather clause by H.R. 49 would quickly inflict revenue losses on many states and localities in the midst of their worst fiscal crisis in decades. S. 150 would have the same impacts, but in most cases they would be delayed for three years.

Both bills would have the following impacts on state and local taxes almost immediately after the grandfather clause became inoperative:

- State and/or local governments in some 11 states would lose collectively between $80 million and $120 million in annual revenue flowing from previously-grandfathered, non-discriminatory taxes on "end-user" Internet access services, according to the Congressional Budget Office. Those states are **Colorado**, **Hawaii**, **New Hampshire**, **New Mexico**, **North Dakota**, **Ohio**, **South Dakota**, **Tennessee**, **Texas**, **Washington**, and **Wisconsin**. That revenue loss estimate would be higher but for the fact that a number of Internet access providers are not paying these taxes because they claim they are not obligated to do so under *state* law. (For example, America Online has been in litigation with Tennessee for a number of years.)[2]

- In at least 27 states and the District of Columbia, the state and/or local governments would lose revenues they currently are receiving from sales and excise taxes levied on high-speed, "Digital Subscriber Line" (DSL) telephone service. (These states are listed in the text box to the right.) Since DSL is a "tele-communications service . . . used to provide Internet access," its taxation would be barred by the expanded definition of "Internet access" in H.R. 49/S. 150. The state and local revenue loss in these 27 states from this change could be on the order of $70 million annually.

- Many more state and local governments would lose their ability to tax telecommunications services purchased by the Internet access providers, such as the high-speed lines providers use to link to the "backbone" of the Internet. As noted above, state and local governments were given assurances that this extension of the tax ban would not occur. Nevertheless, the House Judiciary Committee and the Senate Commerce Committee reports on the bills both state

Where Is DSL Service Taxed by State and/or Local Governments?

Alabama
Alaska
Arizona
Colorado
Connecticut
D. of Columbia
Florida
Hawaii
Illinois
Indiana
Kansas
Kentucky
Louisiana
Minnesota
Mississippi
Missouri
New Hampshire
New Jersey
New Mexico
New York
North Carolina
Ohio
Rhode Island
South Carolina
Tennessee
Texas
Washington
Wisconsin

Source: Earthlink

States in which Internet access taxes also are "grandfathered" are shown in bold.

explicitly that the reversal of earlier policy preserving these telecommunications taxes is intended. CBO was unable to estimate the breadth or magnitude of the state and local revenue losses that would result from this change because telecommunications companies are not required to maintain records categorizing their sales by type of customer. Thus, it is not possible to distinguish sales of high-speed telephone lines to Internet access providers from sales of similar services to other business customers. CBO did state: "Depending on how the language altering the definition of what telecommunications services are taxable is interpreted, that language also could result in *substantial* revenue losses for states and local governments." [Emphasis added.]

Enactment of H.R. 49/S. 150 would have even more far-reaching implications for the ability of state and local governments to raise vital revenues over a five to ten year time horizon.

- Elimination of the grandfather clause could have unintended consequences. It risks preventing state and local governments from imposing taxes on the property and profits of Internet access providers. This is because such taxes could be construed by courts to be prohibited *indirect* taxes on Internet access services. Language was included in versions of ITFA approved by congressional committees in 1997-98 that expressly preserved income, property, and other "non-transactional" taxes such as corporate net worth taxes.[3] This language was dropped from the final legislation because the grandfather clause preserved *all* state and local taxes on Internet access in force before October 1, 1998, which meant the grandfather clause would protect such taxes. The repeal of the grandfather clause, however, makes the restoration of explicit language preserving the right of states and localities to tax the property and profits of Internet access providers essential to ensuring such taxes are preserved. The bills currently do *not* include such language.

- No state or local government would be permitted to tax DSL service in the future, despite its currently clear status in federal regulatory law as a "telecommunications service" that state and local governments were expressly permitted to tax under ITFA. As a result of this prohibition, consumers who choose to lease a second regular voice telephone line to access the Internet would be subject to all applicable state and local taxes, while those who purchase more expensive DSL service (which permits simultaneous use of the Internet and a voice telephone) would not be subject to taxes on the DSL service.

- The ban on state and local taxation of telecommunications services used to provide Internet access would effectively eliminate billions of dollars worth of taxes on voice telephone service as the provision of that service is migrated to the Internet – a process that is well underway. Within a decade there is likely to be no administrable distinction between "Internet access" and voice telecommunication for many users who will use their high-speed Internet connections to make phone calls as well. This trend will shift the burden of

telecommunications taxes to less affluent segments of the population who will remain subject to the various taxes levied on "plain old telephone service."

- Finally, neither bill fixes a serious flaw in ITFA's original definition of tax-exempt "Internet access" that allows sellers of valuable "digital content" such as music, movies, computer software, databases, and magazines to avoid any state/local sales taxation of that content. All the seller has to do is "bundle" the rights to download music or movies with "Internet access." Eventually, the vast majority of such content is likely to be distributed online rather than in the form of "hard" media. Thus, if ITFA is made permanent with the Internet access definition that exempts bundled content from taxation in place, it will cause a serious long-term drain on state and local sales tax revenue.

- The possibility that most "digital content" could be sold free of sales tax because of ITFA runs counter to the goals of proposed legislation empowering states and localities to require Internet merchants to charge sales tax on interstate sales of goods. Even if such legislation empowers states to require Amazon.com to collect sales tax on books, CDs, and DVDs, for example, Amazon could avoid that result by selling some of these items as digital "downloads" over the Internet.

Not enough time remains before the November 1, 2003 expiration date of ITFA to permit careful consideration of these issues and careful drafting of changes to the law that would avoid unintended adverse impacts on the long-term fiscal health of state and local governments. The best solution to this dilemma would be for Congress to extend ITFA in its current form for another six months to two years. Unless an expiration date on the moratorium is maintained, Congress will not have an adequate incentive to revisit the law and address the unintended adverse consequences for states and localities that already are eminently foreseeable.

[1] Dan Bucks, Elliott Dubin, and Ken Beier, "Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act," memorandum, September 4, 2003. Available at www.mtc.gov/ITFA.htm. The wide range in the MTC estimate is due to uncertainty regarding how courts would interpret which state and local taxes are prohibited by H.R. 49/S. 150. The low end of the range assumes that the law would be interpreted to bar only telecommunications excise and sales taxes on "end-user" Internet access services and a limited set of Internet-related telecommunications services. The upper end of the range assumes that a larger number of telecommunications services would be affected, and that the courts would also block the imposition of corporate income taxes, property taxes, and a few other business taxes on providers of Internet access and Internet-related telecommunications.

[2] AOL's challenge to Tennessee's tax on Internet access is also based in part on federal constitutional law, specifically, a claim that it has insufficient physical presence in the state to be subject to sales taxation.

[3] A "transactional tax" is one imposed on an individual sales transaction or the seller's receipts from that transaction.