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PROPOSED "VOICE OVER INTERNET PROTOCOL REGULATORY FREEDOM ACT" THREATENS TO STRIP STATES AND LOCALITIES OF BILLIONS OF DOLLARS IN ANNUAL TAX REVENUES

Bill Abrogates Compromise on VOIP in Pending "Internet Tax Nondiscrimination Act"

By Michael Mazerov

The Senate Commerce Committee is scheduled to mark up S. 2281, the "VOIP Regulatory Freedom Act of 2004" on July 22. Sponsored by Senator John Sununu, S. 2281 would limit the application of existing federal and state telecommunications regulations to new "voice over Internet protocol" (VOIP) technologies. In a variety of ways, these technologies use the Internet itself or the Internet's underlying "language" to carry telephone calls. As is the case with e-mail and World Wide Web "pages," VOIP breaks voice phone calls into small digital "packets" that are transmitted over various public and private telecommunications networks and then reassembled into voice at the receiving end.

S. 2281 does not address only regulatory issues, however. Section 7 of the proposed legislation provides that "No state or political subdivision [thereof] shall impose any tax, fee, surcharge, or other charge for the purpose of generating revenues for governmental purposes on the offering or provision of a VOIP application." This is a major problem because it is widely anticipated that all or nearly all voice communication eventually will be transmitted using Internet protocol-based technologies. If enacted into law, this language would:

- *Eliminate billions of dollars in currently-collected state and local revenues generated by taxing telecommunications services*. According to the Congressional Budget Office, states and localities currently collect approximately $10 billion in revenue annually by taxing the *sale* of telecommunications *services*. These taxes generally take the form of traditional sales taxes or telecommunications-specific gross receipts taxes. The enactment of S. 2281 could eventually eliminate a substantial share of these revenues, because voice traffic that is expected to migrate to VOIP generates a large majority of this revenue. In February 2004, CBO estimated that current projections of the rate at which VOIP phone calls would displace traditional "circuit-switched" phone calls implied a revenue loss to states and localities of up to $3 billion annually within 5 years.[1]

[1] Letter to Senator Lamar Alexander from CBO Director Douglas Holtz-Eakin regarding S. 150, the "Internet Tax Nondiscrimination Act," dated February 13, 2004.

- *Threaten additional state and local revenues generated by taxing the profits, equipment purchases, and property of telecommunications providers.* According to CBO, these types of taxes currently generate approximately $7 billion in annual revenues for state and local governments. In the future, a significant portion of these revenues are likely to flow from taxing profits generated by the provision of VOIP services and taxing equipment purchases and property used to carry VOIP phone calls. Such taxes could be considered to be indirect taxation of "the offering or provision of a VOIP application" and therefore banned by S. 2281.[2]

- *Compel state and local governments either to raise taxes on other individuals or businesses to make up the revenue loss from the exemption of VOIP services and providers or to reduce the provision of such services as education, health care, and public safety*. The large majority of the state and local taxes on VOIP services that would be banned by S. 2281 would flow into state and local "general funds," which finance these types of services.

- *Reverse an explicit policy choice expressed less than three months ago by an overwhelming majority of the Senate to preserve the authority of states and localities to tax voice communications as these migrate to VOIP technologies.* Concern that the proposed renewal of the ban on state and local taxation of Internet access services could prevent states and localities from taxing VOIP phone calls was a major factor that delayed Senate action on S. 150 (the "Internet Tax Nondiscrimination Act") for nearly six months beyond the ban's expiration date in October 2003. Ultimately, Senator McCain offered a Manager's Amendment to S. 150 that included a provision stating that "Nothing in the Act shall be construed to affect the imposition of tax on a charge for voice . . . service utilizing Internet protocol. . ." This language was included in S. 150 as enacted by the Senate on April 29, 2004 on a 93-3 vote. Approval of S. 2281 in its current form by the Commerce Committee thus would abrogate a key compromise that ultimately enabled S. 150 to garner support from Senators who had vigorously opposed it for over six months. It therefore seems likely that S. 2281 would generate similar opposition if the Section 7 ban on state and local taxation were to stay in the bill.

Whatever the Congress may ultimately decide about the appropriate federal and state regulatory treatment of VOIP services, there is no need to dictate a ban on state and local taxation now. There is no evidence that state and local governments are seeking to discriminate against VOIP services; they simply wish to apply the same categories of taxes that apply to traditional phone calls and telecommunications providers to VOIP services and providers. Cellular telecommunications grew extremely rapidly in the 1980s and 1990s without a federal ban on state and local taxation, and, to the extent that VOIP is perceived to fulfill consumer

[2] The sponsors of S. 150, the pending "Internet Tax Non-discrimination Act," were willing to acknowledge that state and local taxes imposed on the profits and property of Internet access providers could be considered indirect taxation of the Internet access service itself, and they accepted the inclusion in the bill of an explicit provision preserving such taxes.

wants and needs, it can similarly expect to enjoy rapid growth — state and local taxation notwithstanding.[3]

If the Commerce Committee wishes to align S. 2281 with the policy expressed in S. 150 that preserves the authority of states and localities to tax VOIP services, the best course of action would be to strip Section 7 from the bill and substitute explicit language like that contained in S. 150 that preserves both taxes on the sale of VOIP services and taxes on the property and profits of VOIP providers. Merely eliminating Section 7 is not sufficient, because language elsewhere in the bill preventing state and local government "burdens" on VOIP could be construed as banning taxation. This could lead VOIP providers to challenge the legality of most state and local taxes on VOIP services, even if no specific ban on state and local taxation were included.

If the Commerce Committee is not prepared to add language to S. 2281 explicitly preserving the taxability of VOIP services and providers, however, it could simply delete Section 7. This would likely ensure the continued collection of most state and local taxes applicable to VOIP services until such time as litigation answered the question as to whether the regulatory provisions of S. 2281 independently banned state and local taxes.

[3] This is not to say that there may not be an appropriate role for Congress at some point in the future in regulating *how* states and localities tax VOIP services. The growth of mobile telecommunications engendered certain ambiguities and inconsistencies in state and local taxation that proved troublesome for the industry and state/local governments alike. These were resolved through the joint industry-government development and ultimate approval by Congress of the Mobile Telecommunications Sourcing Act (MTSA), which provides for a place of primary use-based system of taxing cellular phone calls and other mobile communications. No significant evidence has yet emerged that the advent of VOIP raises tax administration questions beyond those already addressed by the MTSA, but should such questions arise in the future it could be appropriate for Congress to address them.