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RENEWING THE “INTERNET TAX FREEDOM ACT” COULD HAVE AN ESPECIALLY ADVERSE IMPACT ON KENTUCKY, MICHIGAN, OHIO AND TEXAS

By Michael Mazerov

Congress is again considering whether to renew the “Internet Tax Freedom Act” (ITFA). Enacted in 1998 and temporarily renewed in 2001 and 2004, ITFA banned new state and local taxes on “Internet access” services. The primary goal of the law was to bar states and localities from imposing their sales taxes on the typical \$10-\$50 monthly fee that companies like AOL, Comcast, and Verizon charge their customers for connecting them to the Internet and enabling them to use communications services like email and instant messaging.

ITFA sunsets on November 1, 2007; legislation has been introduced to renew it. The “Permanent Internet Tax Freedom Act” (S. 156/H.R. 743) sponsored by Senator Ron Wyden and Representative Anna Eshoo would make ITFA permanent. The “Internet Tax Freedom Extension Act” (S. 1453) sponsored by Senators Tom Carper and Lamar Alexander would extend ITFA for four more years.

Why Kentucky, Michigan, Ohio, and Texas Would Be Disproportionately Affected by a Renewal of ITFA

Although the primary aim of ITFA was to block state and local taxes on *consumers* of Internet access services, ITFA defines a prohibited tax on Internet access as “a tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access.” If ITFA is renewed by *either* the Wyden-Eshoo bill or the Carper-Alexander bill, this language likely would have a disproportionately adverse impact on the state tax revenues of Kentucky, Michigan, Ohio, and Texas.

KEY FINDINGS

- Kentucky, Michigan, Ohio, and Texas have recently enacted gross receipts taxes. It is likely that these taxes cannot be legally imposed on Internet access providers because the taxes appear to satisfy the definition of a prohibited “tax on Internet access” under the Internet Tax Freedom Act (ITFA).
- The new gross receipts taxes in these four states serve as general business taxes. They substitute for or supplement a corporate income tax. Corporate income taxes serve as the general business tax in the vast majority of the other 46 states.
- There is an explicit protection in ITFA for corporate income taxes imposed on Internet access providers, but not for gross receipts taxes.
- Accordingly, these four states would suffer a disproportionate loss of revenue if ITFA is, as expected, renewed.
- If Congress wished to prevent such an outcome, it would have to add explicit protection for these four states’ taxes to ITFA.

The Wyden-Eshoo Bill Also Threatens Washington's Gross Receipts Tax

Ordinarily, the State of Washington would face the identical threat to its revenues as Kentucky, Michigan, Ohio and Texas; its general business tax is also a gross receipts tax. However, ITFA contains an across-the-board "grandfather clause" that preserves all state and local taxes on Internet access if they were imposed prior to 1998. Since Washington's Business and Occupation Tax has been in existence for many decades, ITFA's general grandfather clause preserves this tax.

However, the Wyden-Eshoo bill (S. 156/H.R. 743) proposes to repeal the grandfather clause. Were this to occur, Washington would be in the exact same position as Kentucky, Michigan, Ohio, and Texas, with a gross receipts tax that likely could not be imposed on business receipts attributable to providing Internet access. Many other state and local general business taxes that Internet access providers are obligated to pay would also be at risk were ITFA's grandfather clause to be repealed. See: Michael Mazerov, "Making the Internet Tax Freedom Act Permanent Could Lead to a Substantial Revenue Loss for States and Localities," Center on Budget and Policy Priorities, July 11, 2007, pp. 16-19. Available at www.cbpp.org/7-11-07sfp.pdf.

All four of these states have recently enacted taxes that apply to nearly all large businesses in the state — including Internet access providers. These states would be disproportionately affected because the general business taxes levied in most other states — taxes on corporate income (profits) — are *explicitly protected* by a provision of ITFA. That provision, however, does *not* cover the new taxes levied in these four states. States with corporate profits taxes are explicitly allowed to impose them on profits realized in providing Internet access services, but there is no similar protection for the type of general business taxes levied by Kentucky, Michigan, Ohio, and Texas.

The threatened taxes in the four states are levied on the gross revenues or receipts of businesses. (Certain limited subtractions from gross receipts are allowed in calculating tax liability in Kentucky, Michigan, and Texas.)¹ Many of the sales taxes on Internet access services that ITFA was clearly intended to ban are also structured as gross receipts taxes, for example, those of Hawaii and New Mexico.² There is no real consensus among state tax policy experts as to how to draw a line between sales taxes structured as gross receipts taxes and other forms of gross receipts taxes. Because the new business taxes in Kentucky, Michigan, Ohio, and Texas are essentially modified gross receipts taxes levied on "provider[s] of Internet access" (along with most other businesses), it is very likely they would fall under ITFA's definition of a banned "tax on Internet access."³ It is very *unlikely* that they would qualify as ITFA-protected corporate income taxes, because they do not allow taxpayers to deduct *all* reasonable business expenses incurred in generating gross receipts — the usual practice under corporate income taxes.

Accordingly, an Internet access provider like Verizon or Comcast might well decide not to pay the tax on its receipts attributable to providing Internet access service in these four states.⁴ (The companies would still have to pay the tax on receipts attributable to providing conventional telephone and cable TV services.) If the companies were to stop paying, the wording of ITFA suggests that courts would be likely to sustain their position that these gross receipts are, in fact, not taxable.

Solving the Problem

The most straightforward way to prevent a disproportionate adverse revenue impact for these four states would be to add explicit protection for the four relevant taxes to the same provision of

the Internet Tax Freedom Act that protects state corporate income taxes. That provision is to be found in the Act's definition of a "tax on Internet access." Alternatively, members of Congress might want to ensure that any state enacting a similar tax in the future would also be permitted to impose it on an Internet access provider. In that event, broader language would be needed to define a class of general business taxes imposed as a substitute for state corporate income taxes. If either alternative were desired, such language would have to be added to both the Wyden-Eshoo and Carper-Alexander bills.

Notes

¹ The four taxes are: the “Limited Liability Entity Tax” provided for under Section 141.0401 of the Kentucky Revised Statutes; the Michigan Business Tax imposed by Michigan Enrolled Senate Bill 94 of the 94th Legislature Regular Session of 2007; the Ohio Commercial Activities Tax imposed by Chapter 5751 of the Ohio Revised Code; and the Texas Franchise Tax imposed by Chapter 171, Title II, Tax Code, Texas Statutes (the new “margins tax”).

² The Hawaii General Excise Tax law provides: “There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income. . . .” Gross income is defined as “the gross receipts. . . of the taxpayer received as compensation for personal services and the gross receipts of the taxpayer derived from trade, business, commerce, or sales. . . .” The New Mexico Gross Receipts and Compensating Tax provides: “For the privilege of engaging in business, an excise tax equal to five percent of gross receipts is imposed on any person engaging in business in New Mexico.” Gross receipts are defined as “the total amount of money . . . received from selling property located in New Mexico . . . or from performing services in New Mexico.” Clearly, under both these gross receipts taxes, the legal incidence of the tax is on the seller of the service; they are not conventional sales taxes imposed on purchasers that are collected by the retailer.

As applied to Internet access providers, these two taxes are widely conceded to be taxes on Internet access that would be banned by ITFA but for its general “grandfather clause” that preserves all taxes on Internet access in force as of 1998. For example, they are identified as grandfathered taxes in a 2003 Congressional Budget Office analysis of ITFA required by the Unfunded Mandates Reform Act. See: Congressional Budget Office, “Congressional Budget Office Cost Estimate: S. 150, Internet Tax Nondiscrimination Act,” September 9, 2003, p. 3. The Washington Business and Occupation Tax, discussed in the text box on page 2 of this report, is also identified in the CBO analysis as a grandfathered gross receipts tax on Internet access.

³ The Kentucky and Texas taxes are written as substantial modifications of existing taxes rather than as entirely new taxes. Their application to Internet access providers therefore may be somewhat less vulnerable to legal challenge under ITFA than the completely new taxes in Michigan and Ohio.

⁴ The modified gross receipts taxes in Michigan and Texas have not yet gone into effect. In the other two states, Kentucky and Ohio, it is possible that some or all Internet access providers already are not paying tax on their receipts from sales of Internet access services because they have interpreted ITFA as freeing them from an obligation to pay. The taxes in those latter two states are of such recent vintage that it is unlikely that audits of most Internet access providers have been completed. Even if audits have been completed, any disputes about non-payment of taxes by access providers would likely still be in administrative appeals processes, which are confidential vis-à-vis the public. In short, it is unlikely that policymakers or the general public will know for several years whether Internet access providers in any of these four states are taking the position that they are not legally obligated to pay the four taxes discussed in this report.