



CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

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A PERMANENT BAN ON INTERNET ACCESS TAXATION RISKS SERIOUS EROSION OF STATE AND LOCAL TELEPHONE TAX REVENUE AS PHONE CALLS MIGRATE TO THE INTERNET

By Michael Mazerov

Summary

The “Internet Tax Nondiscrimination Act of 2003,” S. 150, could be brought to the Senate floor for a vote at any time. If enacted into law, this bill would reinstate, broaden, and make permanent a federally-imposed “moratorium” on state and local taxation of “Internet access” services. State and local governments would be permanently barred from charging sales taxes on the \$10-\$50 monthly charge that households and businesses pay to an Internet service provider 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. The House has already approved its version of a permanent ban on Internet access taxation, H.R. 49.

- In addition to barring taxes on monthly access charges, S. 150/H.R. 49 would steadily erode and could eventually eliminate state and local taxes on local and long-distance telephone service as such service migrates to new “voice over Internet protocol” (VoIP) technologies. According to the industry’s own statistics, taxes on telecommunications services generate approximately \$12 billion in revenue for state and local governments annually.¹ All of this revenue potentially is placed at risk by S. 150/H.R. 49, because VoIP appears to qualify as tax-exempt “Internet access” under the expanded definition of this term that would be put in place by this legislation.
- VoIP telephone service is rapidly entering the marketplace. According to a recent analysis by the Wharton School at the University of Pennsylvania: “Just a few weeks into 2004, signs of VOIP’s quickening pulse are everywhere. Phone carriers are practically tripping over each other to announce aggressive VOIP strategies aimed at both consumers and businesses. Not to be outdone, Time Warner Cable, Cox Communications, and Comcast have trumpeted their own forays into the VOIP market.”²
- Given the rapid evolution of telecommunications and Internet technology, it is difficult to predict with certainty the full ramifications of federal legislation regulating state and local taxation of these services. Accordingly, it seems advisable that any such legislation be temporary. S. 150/H.R. 49 proposes a

permanent ban on the taxation of Internet access and Internet-related telecommunications, but the Alexander-Carper alternative proposes a more prudent, two-year extension of the moratorium.

Wording of S. 150/H.R. 49 Threatens Taxes on Internet-based Telephone Service

In October 2003, the Center published an analysis of the adverse impact that S.150/H.R. 49 would have on the ability of state and local governments to raise revenue by taxing the receipts of Internet and telecommunications companies.³ One of the issues discussed in the report was the potential impact on the taxability of voice telephone calls transmitted over the Internet — so-called “voice over Internet protocol” or “VoIP.” The likelihood that S. 150/H.R. 49 would render VoIP telephone service exempt from state and local taxation was cited as probably the most damaging result of the provisions of the legislation that broaden the definition of Internet access and convert ITFA’s temporary moratorium on access taxation into a permanent prohibition.

The report explained why the wording of S. 150/H.R. 49 threatens the taxability of VoIP telephone service:

- S. 150 and H.R. 49 retain the first sentence of the definition of tax-exempt “Internet access” contained in the original Internet Tax Freedom Act. This sentence defines Internet access as a “service that enables users to access content, information, electronic mail, or other services offered over the Internet. . .” VoIP appears to satisfy that definition; it is a “service that enables users to access. . . [an] other service. . . offered over the Internet” — namely, voice telephone service.
- S. 150/H.R. 49 would *expand* the definition of tax-exempt “Internet access” in such a way that VoIP telephone service would almost certainly be included in the exemption. The proposed new definition modifies the second sentence of the definition of “Internet access” in the original ITFA, which had *preserved* state and local taxes on all “telecommunications services.” The new language to be added by S. 150/H.R. 49 would include in the definition of tax-exempt “Internet access” telecommunications services “used to provide Internet access.”⁴ As a telecommunications service that uses the Internet, VoIP inherently “provide[s] Internet access” to a VoIP user, and therefore appears to be rendered tax-exempt by the amended definition.⁵

The Congressional Budget Office concurs with the conclusion that S. 150/H.R. 49 threatens the ability of state and local governments to tax VoIP telephone service. In a November 5, 2003 letter to Senator Lamar Alexander, CBO Director Douglas Holtz-Eakin wrote that if S. 150 were enacted:

Substantial revenue losses . . . could result from. . . the inability of state and local governments to collect transactions taxes (including sales and use taxes and gross receipts taxes) on certain types of telecommunications services. For example, if technological

change shifts traditional telecommunications services to the Internet, those services — for example local and long distance phone calls — could be included, for free, when a customer purchases Internet access. . . . CBO does not have sufficient information to estimate these revenue losses, but we believe they could grow to be large.

Recent Events Heighten Concerns about the Impact of S.150/H.R. 49 on Taxation of VoIP

Developments since the October release of the Center’s report on S. 150/H.R. 49 have greatly heightened the concerns of state and local officials about the potential for the legislation to severely erode telecommunications tax revenues as voice telephone service moves to the Internet:

- *Rapid VoIP deployment.* There has been an explosion in announcements from major companies in the telecommunications and cable TV industries that they have begun offering Internet-based voice telephone service in some of their service areas or plan to roll it out regionally or nationally in the next 6-18 months. Three of the four regional “Baby Bells,” two of the largest cable TV providers, and all three of the largest long-distance telephone companies have made such announcements in the past three months. It is increasingly clear that VoIP is moving rapidly from technology and market testing to widespread commercial deployment. (See the text box on page 4 and Appendix I.)
- *Sponsor silence on the intended tax treatment of VoIP.* On November 6-7, S. 150 was debated for several hours on the floor of the Senate before being pulled from the floor by leadership prior to a vote. Several Senators opposed to S. 150 explicitly cited the likelihood that VoIP phone service would be rendered tax exempt as one of the major reasons ITFA should be extended only temporarily.⁶ Neither during the floor debate nor at any time since have the lead sponsors of S. 150, Senators Allen, Wyden, and McCain, offered any assurances that they do not intend the legislation to prohibit state and local governments from taxing VoIP telephone service. On several occasions they have stated that the bill does not preempt taxes on “traditional” telecommunications, failing to acknowledge that the “packet-switching” technology used by VoIP is fundamentally different from the traditional “circuit-switched” technology used for the vast majority of voice telecommunications today.⁷
- *A Managers’ Amendment that failed to preserve taxation of VoIP.* For several weeks in late October and early November, sponsors of S. 150 circulated drafts of a proposed “managers’ amendment” to the bill ostensibly aimed at addressing some of the concerns raised by state and local officials about the legislation. In response to these drafts, state and local officials issued a number of analyses of the managers’ amendment explaining why it failed to address most of their concerns. One of the major problems identified by government representatives was the failure of the managers’ amendment to preserve existing state and local

VoIP Phone Services Are Rapidly Coming to Market

Recently there has been a barrage of announcements by major communications companies that they have begun offering commercial VoIP services or plan to roll them out in the next 6-18 months. All of the following VoIP-related developments have occurred since the beginning of November 2003:

- Three of the four regional “Baby Bells” have announced VoIP service rollouts.
 - On November 17, Verizon announced that by the end of March 2004 it would offer unlimited, flat-fee VoIP telephone service to its high-speed digital subscriber line (DSL) customers. (Ben Charny, “Verizon Details Internet Phone Plans,” CNET News.com, November 18, 2003.) On January 7, 2004, Verizon announced a five year plan for conversion of its nationwide wireline network to the “packet-switching” technology used by VoIP, calling it the “largest ever telecommunications transformation undertaken by a telecommunications company.” (Ben Charny, “Verizon Begins Last Leg of VoIP Journey,” CNET News.com, January 7, 2004.)
 - On November 20, SBC Communications began offering VoIP phone service to mid-size businesses in 18 cities and announced plans to offer it in most metropolitan areas in the U.S. by the end of 2004. (Almar Latour, “SBC Telecom Plan Is Set to Take on Regional Bells,” *Wall Street Journal*, November 20, 2003.)
 - Qwest began offering VoIP phone service to its Minneapolis-St. Paul DSL customers on December 10 and announced plans to offer it to additional residential and business customers during the first half of 2004. (Company press release, December 10, 2003.)
- The three largest long-distance telephone companies announced plans to offer VoIP telephone service — either themselves, or in partnership with local cable broadband providers.
 - On December 11, AT&T announced plans to begin offering VoIP to cable and DSL subscribers in the 100 largest metropolitan areas in the U.S. by the end of the first quarter of 2004. (Margaret Kane and Scott Ard, “AT&T to Offer Internet Calling,” CNET News.com, December 11, 2003.)
 - On December 8, Sprint and MCI announced that they had signed contracts with Time Warner Cable to provide VoIP service to that company’s high-speed Internet access subscribers in 27 states by the end of 2004. (Peter Grant and Shawn Young, “Time Warner Cable Expands Net-Phone Plan,” *Wall Street Journal*, December 9, 2003.)
- Two of the largest local cable TV companies announced plans to offer VoIP to their cable modem Internet access customers in some or all of their market areas.
 - As noted above, Time Warner Cable announced plans to expand a trial of residential VoIP in Portland, Maine to all of its service areas by the end of 2004.
 - On December 15, Cox Communications launched a trial of VoIP telephone service for residential customers in Roanoke, Virginia. (Ben Charny, “Cox Communications Dives into VoIP,” CNET News.com, December 15, 2003.)

Legislative History of H.R. 49 Implies Congressional Intent To *Prohibit* State and Local Taxation of Internet-based Voice Calls

State and local government representatives have repeatedly raised concerns about the future viability of their telecommunications tax structures if ITFA is made permanent and VoIP displaces traditional voice telephone service that currently is subject to sales taxes and telecommunications excise taxes. As noted in the body of this report, the Senate sponsors of the legislation have declined repeatedly to clarify whether they intend to prevent states and localities from taxing VoIP phone calls. Legislative history of the bill in the House, however, suggests that state and local officials are justified in their concerns about the taxability of VoIP. The only explicit reference to VoIP in any hearing, committee report, or mark-up session related to H.R. 49/S. 150 occurred in the House Judiciary Committee mark-up. There, Representative Steve King of Iowa made the following statement:

[T]he piece that I really want to address . . . is [the] situation of voice over IP. . . We're on the cusp of having that blossom out across our country and our economy. And *if we prohibit the taxation of voice over IP*, then that sets the land line traditional long distance services at a disadvantage to voice over IP. So I support the bill. I support the policy, but I just would like to point out to the Committee that there will be a day, if voice over IP is developed the way it's anticipated, that we'll have to take this issue back up again. . . [Emphasis added.]

In other words, Representative King appeared to have interpreted H.R. 49 as *prohibiting* state and local taxation of VoIP services. King's interpretation was apparently shared by at least one other committee member, Representative Chris Cannon. He responded to King's comment by stating: "The fact is, technology is evolving. This language . . . [is] pretty good for where we are today, and clearly this will be an issue that we may have to deal with in the future." Most telling of all, the interpretation of Representatives King and Cannon that H.R. 49 barred taxation of VoIP phone service was not contradicted by any other members of the House Judiciary Committee.

Given this history and the unwillingness of the sponsors of S. 150 to clarify their intentions with respect to the taxability of VoIP, state and local officials and senators opposed to S. 150 seem justified in interpreting the bill as blocking taxation of VoIP phone calls.

telecommunications taxes as they might be applied to VoIP telephone service.⁸ Before S. 150 was pulled from the Senate floor, the managers' amendment was filed — *without* being changed to ensure that telecommunications taxes can be levied on VoIP service. In other words, the sponsors of S. 150 had an opportunity to preserve the taxability of VoIP service and declined to do so. (See Appendix II for an explanation of why the managers' amendment does not preserve taxes on VoIP.)

- *An FCC Chairman who sees VoIP as just another component of "Internet access."* At a December 1, 2003 Federal Communications Commission forum on VoIP, FCC Chairman Michael Powell stated that he does not believe that VoIP should be treated for federal regulatory purposes the same as traditional voice telecommunications. More recently, he has said that he views VoIP as a component of Internet access, just as e-mail and instant messaging are.⁹ The FCC is expected to issue a notice of proposed rulemaking on the regulatory treatment

of VoIP on February 12. ITFA's original wording preserved existing state and local taxes on telecommunications services *as that term is interpreted by the FCC*.¹⁰ If Chairman Powell's view prevails and the FCC holds that VoIP is not a "telecommunications service" for federal regulatory purposes, then it is highly unlikely that states and localities would be able to continue taxing it under the definition of tax-exempt "Internet access" in the original ITFA — let alone under the expanded definition of Internet access in S. 150/H.R. 49 that explicitly encompasses Internet-related telecommunications. If either definition of tax-exempt "Internet access" becomes a permanent feature of federal law, with no "sunset" date, then Congress will have little incentive to revisit the issue and undo the damage to state and local telecommunications tax revenues that such an FCC determination would cause.¹¹

Alexander-Carper Alternative to S. 150 Would Renew ITFA for Only Two Years

In sum, there is substantial evidence to support the concern raised by state and local government representatives that enactment of S. 150/H.R. 49 combined with the migration of voice communication to VoIP would lead to serious erosion of telecommunications taxes that generate \$12 billion in revenue annually:

- The industry announcements of recent months strongly suggest that VoIP-based telephone services are coming to market rapidly and are likely to displace a significant share of traditional voice telecommunications over the next few years. (See the text box on page 4 and Appendix I.)
- The broadened definition of tax-exempt "Internet access" in S. 150/H.R. 49 almost certainly encompasses VoIP phone service. This would be true of S. 150 even if it were amended by the proposed managers' amendment (see Appendix II).
- Legislative history on the House side (see the text box on page 5) indicates that H.R. 49 is intended to and *would* encompass VoIP telephone service in the definition of tax-exempt Internet access.
- The sponsors of S. 150 have declined to clarify whether or not they intend the legislation to prohibit state and local governments from taxing this service, let alone amending the bill in a way that would unambiguously preserve taxes on telephone calls using VoIP technology.
- Telecommunications taxes are an essential component of the revenue base that states and localities use to fund critical education, health care, and public safety services; they are particularly important to many local governments whose only alternative source of significant revenue may be the property tax.

Given the anticipated growth in VoIP service, Congress will be doing serious damage to the ability of states and localities to fund public services if it enacts a permanent ban on Internet access taxation without clearly preserving the ability of these governments to impose existing telecommunications taxes on telephone service provided via VoIP technology. There is a viable alternative to a permanent ban. Legislation introduced by Senators Alexander and Carper on February 11, 2004, would renew the Internet Tax Freedom Act for only two years — just as Congress did in 2001. A temporary extension would ensure that Congress would revisit the taxation of Internet access two years from now, when it seems likely that a clearer picture will have emerged of how VoIP technologies will be used, how widely VoIP will substitute for traditional phone service in the marketplace, and how VoIP will be regulated. With all these matters in flux, it does not seem prudent to lock in a permanent prohibition on state and local taxation of VoIP service.

Appendix I: Telecommunications Industry Experts Predict Rapid Growth for VoIP Telephone Services

“[C]ustomers soon will expect VoIP to be a basic component of Internet access, says Vinton Cerf, a senior vice-president of MCI and the co-inventor of Internet protocol, the technology standard for sending and retrieving data over the Web that VoIP uses.” (Olga Kharif, “For Whom the VoIP Bell Tolls,” *Business Week* online, January 6, 2004.)

“ ‘This is an aggressive move by Verizon to deliver on the industry’s vision of convergence, and a testament to Nortel Networks global vision of transforming networks, eliminating boundaries, and offering service providers a foundation for value-rich services prized by both consumers and businesses,’ said Sue Spradley, president, Wireline Networks, Nortel Networks. ‘We are on the edge of a new era in telecommunications – one in which superior delivery of integrated voice, video, and data will enhance how, when and where people communicate with full mobility. Our VoIP and multimedia technology will enable Verizon’s customers to make a video call, share electronic documents and send text messages in one environment with ease.’ ” (“Verizon Picks Nortel for Class 5 VOIP,” press release, January 7, 2004.)

“[T]he number of Internet-based phone lines could grow from well under a million subscribers in 2002 to more than 5 million by the end of next year [2004], according to Boston management consultant Adventis Corp. To lure all those customers, cable and telcos are likely to engage in intense competition, each offering consumers a ‘triple play’ of voice, Net access, and TV, all on one bill.” (Peter Burrows and Roger O. Crockett, “Net Phones Start Ringing Up Customers,” *Business Week* online, December 29, 2003.)

“Based on its recent survey of 250 corporations, tech consultancy Meta Group in Stamford, Conn., estimates that nearly 30% of U.S. businesses may move to VoIP within two years. Consumers won’t be far behind: By 2009, the Net will carry 40% of calls made in the U.S., estimates the New Millenium Research Council in a December report.” (Olga Kharif, “For Whom the VoIP Bell Tolls,” *Business Week* online, January 6, 2004.)

“ ‘[T]he planets are aligning for VoIP in 2004,’ says Joe Glynn, Qwest’s vice-president for product strategy. ‘This is clearly the way the industry is going.’ ” (Olga Kharif, “For Whom the VoIP Bell Tolls,” *Business Week* online, January 6, 2004.)

“U.S. broadband adoption [the prerequisite to residential VoIP] is growing at 40% a year, according to [telecom consultancy] RHK, so the threat to the phone companies could grow rapidly. That means that the established carriers will have to hop onto the VoIP bandwagon fast – or be left behind.” (Olga Kharif, “For Whom the VoIP Bell Tolls,” *Business Week* online, January 6, 2004.)

Sanford C. Bernstein & Co. forecasts that cable TV companies will have more than 12 million VoIP customers by the end of 2007. (Peter Grant, “Cable Giants Vie to Improve Online Phoning,” *Wall Street Journal*, January 9, 2004.)

“At the very least, telecom experts say, most business phone systems eventually will convert to VOIP for cost savings and the wide range of new features the technology offers, like improved conference calling, and combining voice and e-mail messages on one directory, and, eventually, video phones.” (Peter Grant, “Ready for Prime Time,” *Wall Street Journal*, January 12, 2004.)

“By the end of this year [2004], about 20% of the new phones being shipped to U.S. businesses will use VOIP technology, according to Yankee Group, a technology consulting firm based in Boston. By 2007 that figure should exceed 50%, and eventually almost all of the new phones shipped will use VOIP, Yankee Group predicts.” (Peter Grant, “Ready for Prime Time,” *Wall Street Journal*, January 12, 2004.)

“All of Jet Blue Airways’ reservations agents work from home using VOIP phones hooked into high-speed Internet connections.” (Peter Grant, “Ready for Prime Time,” *Wall Street Journal*, January 12, 2004.)

“Needham & Co. analyst Vik Grover says Comcast, Cox, Cablevision and other cable companies could sign similar deals [to the recent agreement under which Sprint and MCI will provide nationwide long-distance for Time Warner Cable’s VOIP subscribers.] ‘Everyone is ready to go on the cable side,’ Grover says. By spring, ‘You are going to see major, major rollouts.’ Paget Alves, president of strategic markets for Sprint Business Solutions, says, ‘We expect other relationships [similar to the one with Time Warner] will be established in the very near term.’ ” (Andrew Backover and Michael McCarthy, “Cable Firms Wired About Offering Net Phone Calls,” *USA Today*, December 10, 2003.)

“[T]he billions of dollars worth of copper phone wires spread across the country figure to gradually become obsolete. AT&T stopped investing in the old-style ‘circuit-switched’ infrastructure several years ago, opting instead to build only data networks. ‘[For VoIP] It’s not a question of if,’ said Forrester Research analyst Charles Golvin. ‘It’s a question of when.’ ” (Brian Bergstein, “Internet Phone Plans Herald Industry Revolution,” *USA Today*, December 15, 2003.)

“In that new world [of VoIP], clever Web interfaces will let you convert your voicemail messages to email, or your emails to voice; you’ll be able to call-forward in a myriad of ways, or switch to video or hi-fi voice if you want, or even agree to hear some number of commercials every day to lower your bill. In the end, the futurists will be right in one sense: you won’t be paying a measurable amount for the bits of voice you actually send. Instead, you’ll be paying a monthly fee for all the services wrapped around those bits. Your phone bill will morph into a connectivity bill. . . .” (Michael Rogers, “Will Telephone Calls, Be Free?” *Newsweek* online, December 16, 2003.)

“AT&T’s roll-out [of VoIP] would be the most aggressive of all the carriers. . . . ‘IP is a PacMan, and everything in its way is going to be eaten,’ said Hossein Eslambolchi, AT&T’s chief technology officer.” (James S. Granelli, “The New Phone Game,” *Los Angeles Times* online, January 1, 2004.)

Appendix II: Why the Managers' Amendment to S. 150 Does Not Preserve the Taxability of VoIP Telephone Service

The sponsors of S. 150 have filed a proposed managers' amendment to the bill for consideration when it is brought to the Senate floor. As discussed on page 3, the sponsors themselves have never said explicitly that they intend to preserve the taxability of voice telephone service when it is provided via VoIP technology. Nonetheless, anonymous "white papers" have circulated on Capitol Hill that assert that the managers' amendment does indeed insure that VoIP phone service would remain taxable by state and local governments. Industry representatives have made similar statements.

A careful analysis of the wording of the managers' amendment demonstrates why the claim that the amendment preserves the taxability of VoIP is invalid:

- S. 150, together with the managers' amendment, would amend the definition of tax-exempt "Internet access" in ITFA so that it would read as follows:

The term "Internet access" means a service that enables users to access content, information, electronic mail, *or other services offered over the Internet*, and may also include access to proprietary content, information, and *other services* as part of a package of services provided to consumers. The term "Internet access" does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access. (Emphasis added.)

- If the second sentence in the definition were absent, there is little question that the first sentence would encompass within tax-exempt Internet access VoIP phone services. The first part of the first sentence suggests that any provider of VoIP service is providing "Internet access," a service that "enables users to access. . . [an] other service[] offered over the Internet" — namely, voice telephone service. Even a company like Vonage, which provides only VoIP and no other components of "Internet access" like e-mail and Web access, appears to be providing "Internet access" under this part of the definition, because the phrase "other services offered over the Internet" is preceded by the word "or."
- The second part of the first sentence goes even further, and says that "Internet access" "may also include access. . . to other services as part of a package of services provided to consumers." Even if one wished to argue that a "free-standing" VoIP service like Vonage would not qualify as tax-exempt "Internet access" under the first part of the first sentence, there is essentially no question that a broad-spectrum "Internet access" provider like America Online can bundle VoIP service in a service package that includes what everyone would concede to be basic "Internet access" and thereby obtain tax-exempt status for the VoIP component of that service.

- The next question becomes whether the second sentence of the definition affects in any way the conclusion that the first sentence encompasses VoIP telephone service within tax-exempt “Internet access.” The second sentence of the definition *in the original Internet Tax Freedom Act* read: “Such term [i.e., “Internet access”] does not include telecommunications services.” Elsewhere, “telecommunications services” was defined (in relevant part), as having “the meaning given such term in . . . the Communications Act of 1934. . .” Thus, so long as the FCC and the courts considered VoIP to be a “telecommunications service,” it could not be rendered tax-exempt by being sold with “Internet access.”¹²
- Whether or not some or all VoIP services qualify as “telecommunications services” under the Communications Act is a matter of uncertainty and dispute at present. For example, a federal district court in Minnesota ruled in October that Vonage’s VoIP service does *not* qualify as a “telecommunications service” but rather is an “information service” — the same regulatory category that includes “Internet access.” In any case, this uncertainty is irrelevant in determining whether the managers’ amendment preserves the taxability of VoIP, because the managers’ amendment goes on to include in tax-exempt “Internet access” telecommunications services “to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access.” Leaving aside the circularity of this definition — which says that Internet access includes telecommunications services used to provide Internet access — it seems clear that a VoIP service that uses the Internet to carry a phone call is, by definition, providing “Internet access” to its user or purchaser. In short, the language of the second sentence does not carve out from the definition of tax-exempt “Internet access” VoIP service.
- Finally, the managers’ amendment also proposes so-called “anti-bundling” language that some claim could take care of the VoIP problem. It does not do that, however, because the language only prevents the bundling of telecommunications and other services “that are subject to taxation” with tax-exempt “Internet access.” Since, as demonstrated above, the definition of Internet access already encompasses VoIP, VoIP is not “subject to taxation” and therefore can’t be “unbundled.”
- More specifically, the managers’ amendment proposes to add to S. 150 (and thereby to the Internet Tax Freedom Act) the following sentence:

If charges for Internet access are aggregated with and not separately stated from charges for telecommunications services or other charges *that are subject to taxation*, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business. (Emphasis added.)

- This anti-bundling provision is alleged by supporters of S. 150 to address the concerns raised by state and local representatives about the broad definition of “Internet access” contained in its first sentence. This broad definition would, for example, allow an Internet access provider like America Online to offer a “premium” access package, say, for \$75 per month. That package might include not only basic World Wide Web access and an e-mail box, but also the ability to make unlimited VoIP phone calls and the right to download a certain amount of music and movies each month — with the entire package of goods and services satisfying the definition of tax-exempt Internet access.
- That scenario is indeed one of the major reasons that state and local governments are opposed to making even the original ITFA definition of tax-exempt “Internet access” a permanent feature of federal law. The proposed anti-bundling language in the managers’ amendment does nothing to prevent it this scenario, however. In essence, the language says that if an Internet access provider does not maintain the records necessary to make it possible for a state auditor to determine that the provider has charged appropriate taxes on telecommunications services and charges for other goods and services “subject to taxation,” then the otherwise tax-exempt “Internet access” becomes “tainted” and subject to tax. This language does nothing to preserve the taxability of VoIP service, because, as demonstrated above, VoIP *satisfies* or is *encompassed in* the definition of tax-exempt “Internet access” and therefore is not “subject to taxation.”

In sum, neither the modifications to the definition of Internet access made by the managers’ amendment nor its anti-bundling provision do anything to ensure that states and localities can apply their existing telecommunications taxes to voice telephone service provided by VoIP technologies.

Notes

¹ Robert Cline, “Telecommunications Taxes: 50-State Estimates of Excess State and Local Tax Burden,” *State Tax Notes*, June 3, 2002, pp. 931-947. This report was prepared by Ernst & Young for the Telecommunications State and Local Tax Coalition, which included all four “Baby Bells” as well as long-distance providers AT&T, Sprint, and WorldCom. The \$12 billion does not include \$1 billion in emergency 911-related taxes.

² “Time to Redial: VOIP (Voice Over Internet Protocol) Makes a Comeback” Knowledge@Wharton online newsletter, January 2004.

³ Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, available at www.cbpp.org/10-20-03sfp.pdf.)

⁴ See the discussion in Appendix II of why the proposed managers’ amendment to S. 150, which would slightly modify the definition of Internet access in the bill as reported by the Commerce Committee, still does not preserve the taxability of VoIP phone service.

⁵ “Internet” is defined in ITFA as “collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocol, to communicate information of all kinds by wire or radio.” This definition does not confine the Internet to the pathways that carry e-mail and World Wide Web traffic; it says that interconnected communications networks that employ TCP/IP for communication thereby become part of “the Internet.” Although VoIP is already widely being used to make voice phone calls on closed networks walled off from the “public” Internet, widespread commercial VoIP service is likely to require the interconnection of private VoIP networks — so that, for example, a subscriber to Time Warner’s VoIP service can place a call to a Verizon VoIP subscriber. If such networks are interconnected and employ TCP/IP, they appear to be part of “the Internet” under the ITFA definition, and a communications company offering such a VoIP service appears to be providing “Internet access.” Moreover, many of the potential service offerings touted for VoIP — such as the ability to easily forward your home voice-mail messages to your office e-mail box — will require private VoIP networks to be connected to the “public” Internet, rendering them part of it under ITFA’s definition. Given the fact that the same physical wires coming into a person’s home would provide access to both the “public Internet” and VoIP telephone service from the same access provider, it would in any case be very difficult for a state to convince a court that the service provider is not providing tax-exempt “Internet access” when it is providing VoIP service.

⁶ For example, during the floor debate on S. 150, Senator Voinovich read a *Washington Post* editorial on S. 150 that observed, “[A]s the Internet becomes a more effective medium for providing phone service and delivering products, . . . the legislation could sweep such offerings within the ambit of services that states are prohibited from taxing.” Later, Senator Alexander cited a Congressional Budget Office letter that said that “substantial revenue losses” could result from S. 150 “when technological change shifts traditional communications services to the Internet — for example, local and long distance phone calls.”

⁷ For example, during the floor debate on S. 150 on November 6, Senator McCain stated: “I have worked closely with the co-sponsors of the legislation in an attempt to accommodate many of the concerns of the States and local governments. . . . I point in particular to our efforts to clarify that *traditional* telephone services would not become tax-exempt as a result of this legislation.” Later, Senator Allen said: “I want Members of this body to understand and be clear on the facts and the truth about this legislation. This bill does not affect *traditional* voice or long distance telephone services. . . .” (Emphasis added.) Such statements do not address the concerns of state and local representatives about the taxability of VoIP, which is not “traditional,” circuit-switched telephone service.

Likewise, the only discussion of the preservation of taxes on voice telephone calls in the House Judiciary Committee and Senate Commerce Committee reports on H.R. 49 and S. 150 refers to “traditional,” circuit-switched telephone service: “The net effect of this definition is to create a broad moratorium on taxation of Internet access, while still preserving the ability of States and localities to tax telecommunications services, including traditional telephone

service.” (House Judiciary Committee report on H.R. 49, p. 9.) “[T]he modified definition would not affect the taxability of voice telephony over the public switched telephone network (so-called “plain old telephone service” or “POTS”). (Senate Commerce Committee report on S. 150, p. 4.)

⁸ For example, a National Association of Counties analysis stated: “In the short term, we are concerned that S. 150 may provide an unfair tax break for local and long-distance telephone service that is provided over the Internet. In the long term, we are concerned that the moratorium may in fact apply to all telecommunications if the technology evolves so that all telecommunications services are eventually delivered over the Internet — which appears to be increasingly likely.” See: National Association of Counties, “County Officials Set the Record Straight on S. 150.” This two-page analysis was released after the circulation of the managers’ amendment and refers to it.

⁹ For example, at a December 1, 2003 FCC forum on VoIP, Powell stated “As one who believes unflinchingly in maintaining an Internet free from government regulation, I believe that IP-based services such as VoIP should evolve in a regulation free zone.” More recently, at a press conference at the World Economic Forum in Davos, Switzerland, Powell said, “If you’re going to say to me that Voice over IP is something that needs regulation, then you’re going to have to explain to me why e-mail isn’t also, or streaming video or instant messaging is not also.” (Reuters, “FCC Chief Plans No Internet Phone Regulation,” *USA Today*, January 23, 2004.)

¹⁰ “Telecommunications services” are carved out of the definition of “Internet access” in ITFA. “Telecommunications services” are defined as having “the meaning given such term in . . . the Communications Act of 1934 . . . and include[ing] telecommunications services (as defined in section 4251 of the Internal Revenue Code of 1986).” Effectively, this definition means that any telecommunications service that *either* satisfies the definition of “telecommunications service” under the Communications Act — including final interpretations of that definition made by courts — *or* is subject to the federal telecommunications excise tax, may continue to be taxed by state and local governments under ITFA. Given the Bush Administration’s support for S. 150/H.R. 49, it seems unlikely that the IRS would issue a ruling or regulation holding that VoIP services are subject to the federal telecommunications excise tax. Moreover, VoIP may not satisfy the definition of a service subject to the federal communications excise tax. (See: Martin A. Sullivan, “Will VoIP Telephone Service Be Subject to Telephone Taxes?” *State Tax Notes*, February 2, 2004.) Accordingly, if VoIP were once and for all determined not to be a “telecommunications service” under the Communications Act, it likely would not be taxable under the language of the existing Internet Tax Freedom Act. In October, 2003, in a case brought by VoIP provider Vonage, a federal district court in Minnesota held that at least one form of VoIP phone service does not qualify as a “telecommunications service” under the Communications Act.

¹¹ There are no examples in recent years of Congress amending a law preempting state and local taxing authority with the aim of narrowing the preemption — regardless of the unintended consequences for state and local finances that transpired after enactment. (See, for example, Michael Mazerov, *The “4-R” Act: A Cautionary Tale for the Proposed “Internet Tax Freedom Act,”* Center on Budget and Policy Priorities, April 24, 1998.) On the contrary, laws preempting state and local tax authority tend to be expanded over time because they usually create competitive advantages for certain taxpayers. Thus, S. 150/H.R. 49 proposes to broaden the preemption contained in the original ITFA by extending the definition of “Internet access” to encompass all Internet-related telecommunications services because of a competitive advantage created for cable modem Internet access as compared to DSL access. The business community also is currently making a major effort to expand the reach of a 1959 federal law preempting state corporate income tax authority because the law provides tax advantages to manufacturers that are not available to service businesses. (See: H.R. 3220.)

¹² See note 10.