

**MAKING THE INTERNET TAX FREEDOM ACT PERMANENT IN THE FORM  
CURRENTLY PROPOSED WOULD LEAD TO A SUBSTANTIAL REVENUE LOSS  
FOR STATES AND LOCALITIES**

By Michael Mazerov

**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.<sup>1</sup>

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.)<sup>2</sup>
- 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 “telecommunications 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.<sup>3</sup> 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.

## Introduction

On September 17th, the House of Representatives approved H.R. 49, the “Internet Tax Non-Discrimination Act of 2003.” If enacted into law, this bill would expand and make permanent a federally-imposed “moratorium” on state and local taxation of sales of “Internet access” services. All state 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.

H.R. 49 changes the Internet Tax Freedom Act in three key ways.

- H.R. 49 changes the temporary “moratorium” on state and local taxation of Internet access services into a permanent prohibition on such taxes.
- H.R. 49 repeals ITFA’s “grandfather clause,” which had allowed approximately 10 states and a small number of cities that had taxed Internet access service prior to October 1, 1998 to continue doing so.
- H.R. 49 expands the definition of tax-exempt “Internet access” to include all telecommunications services “used to provide Internet access.”

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.

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. 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.

The most serious impacts of both bills on state and local revenues would occur in a five to ten year time frame, and would largely result from making permanent the original, flawed ITFA definition of tax-exempt “Internet access.”

### **Revenue Impacts of H.R. 49/S. 150 Occurring in the First Three Years after Enactment**

Revenue losses to states and localities that would occur within the first three years after enactment of H.R. 49/S. 150 flow from the following new limitations on state and local taxation of Internet access that the bills would put in place.

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## **“Internet Access” and “Telecommunications” Are Separate Services**

When ITFA was enacted in 1998, the vast majority of Internet users accessed the Internet using “dial-up” service. (This is true even today for most non-business users.) Most Internet users are familiar with dial-up access. A modem connects the user’s computer to a regular telephone wire. The user’s modem dials a modem owned by an “Internet service provider” (ISP) using that telephone wire, and when the connection is made, the user’s computer transmits the “packets” of data created by software resident on the computer over the phone line to the modem and other equipment owned by the ISP. The ISP’s equipment then routes the data packets onto the wider Internet. If the transmission involves a request for the “download” of a World Wide Web page or an e-mail message sitting on the ISP’s e-mail server, the ISP’s equipment also routes the packets containing that data back over the phone line to the user’s computer.

A clear conceptual distinction can be made between the basic transmission of the packets between the user’s computer and the ISP’s equipment, on the one hand, and the various services provided by the ISP itself on the other. Indeed, in the case of dial-up access the two services usually are provided by two entirely different companies. The transmission component of Internet access is done over the customer’s regular phone line, and the local phone company is not even aware that a data transmission rather than a voice conversation is occurring. The ISP usually is a separate business entity and provides the package of services that constitute “Internet access” in the typical user’s mind: an electronic mailbox, the ability to send and receive e-mail and instant messages, the ability to access and interact with software and content posted on World Wide Web servers, and an allotment of some space on the ISP’s server in which a user’s personal files can be stored. Many small ISPs provide no more than this bundle of services. However, many larger ISPs, like America Online, also enable their subscribers to access vast amounts of proprietary, “digitized content” — on-line magazines, stock photos, bulletin-boards, “streaming” video and music, and similar information and entertainment.

The distinction between basic transmission of data packets between an end-user’s computer and the ISP and Internet access services becomes slightly blurred in the context of new, high-speed forms of Internet access, such as DSL and cable modem access. This is primarily attributable to the fact that the ISP is much more likely to own the facilities that provide both the basic transmission and the “Internet access” services and charge one price for the combination of both. Nonetheless, a clear conceptual distinction between the two remains. More importantly, at this point in time a clear legal distinction between transmission to the ISP and the “Internet access” services provided by the ISP remains, even in the context of DSL and cable modem service. While the Federal Communications Commission has formal staff proceedings underway to consider removing that distinction, a recent Ninth Circuit Court of Appeals decision appears to make it much more likely that the distinction between “Internet access” and telecommunications will be maintained for the foreseeable future barring some change in the federal Communications Act itself. That has important implications for some of the proposed changes in ITFA’s definition of Internet access, which are discussed on pp. 8-12 of this report.

- The repeal of ITFA's "grandfather clause" would take away revenues that ten states and a small number of local governments are currently receiving from taxing regular, "end user" Internet access services.
- The expansion of the definition of tax-exempt "Internet access" to encompass telecommunications services "used to provide Internet access" would take away revenues that at least 27 states are currently receiving from taxing high-speed Digital Subscriber Line telephone services.
- The same expansion of the definition of Internet access to encompass Internet-related telecommunications services would take away revenue that a substantial number of states are receiving from taxing high-speed telephone lines used by Internet access providers to link their computer equipment to the Internet "backbone."

*Repealing "Grandfathered" Taxes on Internet Access Services*

One of the compromises reached during the development of ITFA in 1997-98 was an agreement to permit states and localities that were already taxing Internet access service to continue doing so. That policy was implemented by ITFA's "grandfather clause," which preserves "taxes on Internet access . . . imposed and actually enforced prior to October 1, 1998." While several of the grandfathered states repealed their sales taxes on Internet access service after ITFA was enacted, some ten states and an unknown but relatively small number of local governments continue to tax Internet access. According to the Congressional Budget Office, the states that continue to tax Internet access are Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington, and Wisconsin. Some local governments in some of these states also tax Internet access, as do some local governments in Colorado.

Both H.R. 49 and S. 150 would repeal ITFA's grandfather clause. The enactment of H.R. 49 would immediately begin inflicting revenue losses on state and/or local governments in these eleven states (including Colorado) in the midst of the worst fiscal crisis in decades. According to the Congressional Budget Office, the aggregate revenue losses would be between \$80 million and \$120 million annually. CBO's revenue loss estimate would be larger but for the fact that a number of Internet access providers are not charging sales taxes to their subscribers in some or all of these states because they claim they are not obligated to do so because of provisions of state law and/or provisions of federal law other than ITFA. For example, America Online has been in litigation with Tennessee for a number of years asserting that Internet access service is not taxable under Tennessee sales tax law. (AOL also claims that it could not be required to charge Tennessee sales tax in any case because it lacks sufficient physical presence or "nexus" in the state.)

Revenue losses from the repeal of ITFA's grandfather clause would begin to occur immediately were H.R. 49 to be enacted; all changes to ITFA made by H.R. 49 take effect upon enactment. Under S. 150, however, the grandfather clause would not be repealed until October 1, 2006. Members of the Senate Commerce Committee may have adopted this effective date for

the repeal of the grandfather clause in hopes that state and local fiscal conditions would be improved at that time. In any case, such a delay would give the affected states and localities time to make other adjustments in their spending or tax policies to absorb the loss of revenue.

- Many state and local governments continue to confront serious budget gaps due to the weak economy and such federal actions as the phase-out of the federal estate tax.<sup>4</sup> It would undermine the purposes of the federal fiscal relief Congress enacted last year to deprive state and local governments of any revenues they currently have a right to receive. Congress recognized preemption of state and local taxing authority to be an “unfunded mandate” under the Unfunded Mandates Reform Act of 1995.
- There is no credible evidence that the relatively modest taxes on Internet access services currently in place are having an effect on the rate at which consumers sign up for the service. A forthcoming study by economists at the University of Tennessee finds that there is no statistically significant difference in the rate of Internet access adoption between the states not taxing the service and the states that are still taxing it because they had been grandfathered by ITFA to do so.<sup>5</sup>

#### *Expanding the Definition of Tax-exempt Internet Access to Encompass DSL Phone Service*

The second major change to ITFA that would be made by both H.R. 49 and S. 150 would be an expansion of its definition of tax-exempt “Internet access” to encompass certain Internet-related telecommunications services. Like repeal of the grandfather clause, this change would begin to reduce state and local revenues almost immediately upon enactment; it would prohibit a large number of states and localities that currently tax high-speed “Digital Subscriber Line” telephone service from continuing to do so. The nationwide state and local annual revenue loss from a new prohibition on taxation of DSL is likely to be on the order of \$70 million annually at present.<sup>6</sup>

ITFA’s current definition of “Internet access” is shown below in regular text. Both H.R. 49 and S. 150 would add the text shown in italics, which is the language that effectively prohibits — and is intended to prohibit — taxation of DSL:

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 offered to consumers. Such term does not include telecommunications services *except to the extent such services are used to provide Internet access.*

Understanding the objectives and the significance of the italicized language to be added by H.R. 49/S. 150 requires some historical background on ITFA itself.

When ITFA was introduced in 1997, state and local government representatives expressed great concern about the proposed law’s potential to eliminate their ability to tax conventional telecommunications services. Such services are needed by an end-user to access

the Internet (see the text box on page 6) and also underlie the Internet itself at all levels. Sponsors and proponents of ITFA said repeatedly that it was not their attention to preempt any state or local telecommunications taxes or fees.<sup>7</sup> Sponsors assured state and local government organizations that they only wished to block taxation of the traditional package of services that constitute “end-user” Internet access — e-mail, Web access, and a limited amount of digital “content.” (Even with respect to taxation of Internet access, the prohibition was only to be temporary; see the box on the following page.)

The language in ITFA’s definition of tax-exempt Internet access that says “such term does not include telecommunication services” accomplishes this constantly-repeated policy goal. While ITFA renders end-user Internet access tax-exempt in all but the “grandfathered” states, “telecommunications services” remain fully taxable by all states and localities. “Telecommunications services” are defined elsewhere in ITFA as having “the meaning given such term in . . . the Communications Act of 1934 . . . and includ[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 Telecommunications 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.

H.R. 49/S. 150, however, would substantially abrogate the commitments made to state and local governments when ITFA was enacted with respect to taxation of telecommunications. Both bills add language barring states and localities from taxing telecommunications “to the extent such services are used to provide Internet access.” One effect of this language would be to block state and local taxation of telecommunications services purchased by an end-user solely to access the Internet, such as the high-speed Digital Subscriber Lines discussed below. “Plain old [voice] telephone service,” however, would not be included in (tax-exempt) “Internet access.”<sup>8</sup>

The major impetus for the proposed change in the taxation of Internet-related telecommunications services under ITFA was a desire to ensure that the entire monthly charge for Internet access obtained through the use of a Digital Subscriber Line be exempt from all state and local sales taxes (and similar taxes and fees). This objective, in turn, was motivated by a desire to ensure that Internet access obtained through Digital Subscriber Lines and cable TV lines be taxed equally.

DSL is a technology allowing high-speed data transmission over regular copper telephone wires, and the only reason it normally would be purchased would be to obtain high-speed Internet access. Telephone companies that sell DSL service bundle it with what is normally thought of as end-user Internet access — an electronic mailbox, the ability to send and receive e-mail, the ability to access and interact with software and content posted on World Wide Web servers — and sell the two combined services for one price.

## **Making ITFA Permanent: A Breach of Faith with State and Local Governments**

When the Internet Tax Freedom Act was introduced in 1997, its moratorium on the taxation of Internet access service was justified as a temporary “time out” to ensure that a variety of complex administrative and definitional issues that can arise in the taxation of this service could be addressed carefully and uniformly by state and local governments. For example, sponsors objected to the fact that Internet access was taxed as a “telecommunications service” in some states and as an “information service” in others. They also raised concerns about potential double-taxation of Internet access by people who connected to their service provider in multiple states.

In the nearly two years that it took to enact ITFA, these aims were restated many times by proponents in both Congress and the private sector. At no time did ITFA supporters suggest that Internet access was deserving of or needed permanent tax-exempt status.

- In July 1997 testimony, Michael Liddick, director of taxes for AOL, stated: “The Act provides the opportunity for federal and state policymakers, Industry members and other concerned citizens to work together to develop a uniform, fair and simple state tax system that will be administratively feasible for industry members and other affected taxpayers. . . . AOL believes that the temporary moratorium provided by the Act . . . will allow the development of effective tax policies that maximize the welfare of all concerned persons in the context of a process which respects the rights of states to determine their individual tax policies *subject only to normal constitutional limitations*. [emphasis added]
- A year later, Jill Lesser, AOL Director for Law and Public Policy, testified: “We are also not here to avoid paying taxation [sic] or to set up a system ultimately that basically holds the Internet as a tax-free zone. We are here to talk about Internet tax neutrality. . . [W]e hope at the end of the discussions. . . that there will be a uniformed [sic] system of taxation, one that gives guidance about, for example, what it means to be providing Internet access. . . In addition, where customers should be taxed [and] how we should collect. Once we solve all of those problems, all of the revenues that I spoke about will actually I imagine be subject to some kind of taxation.
- The Senate Commerce Committee report on ITFA expressed similar goals: “Most State and local commercial tax codes were enacted prior to the development of the Internet and electronic commerce. Efforts to impose these codes without any adjustment to Internet communications, transactions, or services. . . will lead to State and local taxes that are imposed in unpredictable and overly burdensome ways. . . [A] temporary moratorium on Internet-specific taxes is necessary to facilitate the development of a fair and uniform taxing scheme.”

Now, five years later, the fears of state and local government representatives about this “temporary time-out” have been substantiated. After having made virtually no effort in the intervening years to implement the stated goal of ITFA to “facilitate the development of a fair and uniform taxing scheme” applicable to Internet access, Congress is poised to permanently ban taxes on this service. States and localities may continue to impose their sales taxes on long-distance phone calls and faxes, voice mail, cable TV, and a host of other services for which Internet access is a close substitute. Little or no justification has been put forth to support such tax discrimination.

Consistent with its status in federal law as a “telecommunications service,” state and/or local governments in at least 27 states and the District of Columbia have begun requiring companies providing Internet access via DSL to separate-out the DSL component of the service and pay applicable sales and telecommunications taxes on that service.<sup>9</sup> (See the text box on

page 2 for a list of the states in which DSL is taxable.)<sup>10</sup> It does not appear that there have been any legal challenges to taxation of DSL based on the argument that the service is tax-exempt under ITFA; at least some DSL providers are complying with the taxes.<sup>11</sup>

DSL competes with high-speed Internet access provided over cable TV lines by local cable TV companies using “cable modems.” Like DSL, cable modem Internet access service effectively bundles the “transmission” of packets of data from a subscriber’s computer to equipment owned by the cable company (which routes the packets onto the Internet) with the e-mail and World Wide Web access that constitutes end-user Internet access. Until recently, however, there was no *legal* distinction between “transmission” and “Internet access” in the context of cable modem service. Accordingly, state and local governments in the “non-grandfathered” states accepted that the entire monthly charge for cable modem service was for “Internet access” and exempted it from taxation as a result of ITFA.

Such unequal tax treatment of DSL and cable modem Internet access was of obvious concern to the DSL-based access providers who are in competition with cable modem providers. They convinced ITFA supporters to amend H.R. 49/S. 150 to include in tax-exempt Internet access “telecommunications services . . . to the extent such services are used to provide Internet access.” This new language would permanently block any state or local government from taxing the entire charge for Internet access obtained via DSL — “leveling the playing field” with cable modem providers by implementing a complete state and local tax exemption for both forms of service.<sup>12</sup>

Beyond the fact that it is a reversal of ITFA’s original policy, there are two major problems with blocking state and local taxation of DSL in order to “level the playing field” with cable Internet access.

- A total tax exemption for DSL service now appears to be unnecessary with respect to its primary objective of achieving equivalent state and local tax treatment of DSL and cable modem Internet access. On October 6, 2003, the Ninth Circuit Court of Appeals affirmed an earlier decision by its three-judge panel that, like DSL Internet access, cable modem service *also* involves the provision of both a “telecommunications service” and an “information service” as those terms are defined by the federal Communications Act. This decision overturned a contrary ruling by the Federal Communications Commission.<sup>13</sup> Accordingly, consistent with ITFA as presently worded, states that tax the DSL component of DSL-based Internet access could ensure neutral tax treatment of DSL and cable Internet access by requiring the cable providers to break out a separate charge for the “telecommunications service” component of their Internet access service and impose applicable taxes on that as well. Congress could guarantee that result by amending ITFA to mandate equivalent treatment of cable- and DSL-based Internet access.<sup>14</sup>
- Blocking state and local taxation of DSL creates “horizontal” inequities in the tax treatment of different Internet access customers. Many households living in areas where DSL is unavailable lease two regular voice telephone lines to be able to

access the Internet and receive phone calls at the same time. Such a household will remain liable for any applicable state and local taxes on both lines.<sup>15</sup> A household that can get DSL service (and can afford its somewhat higher cost as compared to a second regular voice line), however, will be able to make a telephone call and use the Internet at the same time without paying any additional taxes for that ability if ITFA is amended as proposed.<sup>16</sup>

- Moreover (and as will be discussed below), services are already available that allow DSL subscribers to purchase long-distance telephone service free from any state and local taxes because the phone service itself is provided over the Internet and at present also may be considered tax-exempt “Internet access.” In contrast, lower-income households unable to afford more than a single phone line for both telephone calls and Internet access will be subject to all applicable taxes on long-distance calls.

In sum, it appears that amending the definition of tax-exempt “Internet access” in ITFA to encompass all “telecommunications services . . . to the extent such services are used to provide Internet access” will reduce the sales tax and telecommunications tax revenues of state and local governments in at least 27 states and the District of Columbia that currently are taxing DSL service.<sup>17</sup> It has not been possible up to now for the Congressional Budget Office to estimate the revenue loss because telecommunications providers sell many types of services and generally are not required to separate out for reporting purposes the information that would be needed to make such an estimate. Nonetheless, the revenue losses likely would be significant and come at a time when state and local governments already face difficult fiscal situations. Based on the fact that there were 6.5 million DSL lines in use in the United States as of the end of 2002, the annual state and local revenue associated with taxing those lines likely would be on the order of \$70 million.<sup>18</sup>

Despite the impact on state and local revenues and the various equity issues involved, it appears that most members of Congress support prohibiting state and local taxation of DSL service at this time in order to ensure that DSL and cable modem Internet access are taxed alike. Even if that is the case, two changes to H.R. 49/S. 150 seem warranted.

- The prohibition on taxation of DSL should be rewritten to make it more narrow and specific.<sup>19</sup> As will be discussed in the next section, the prohibition in H.R. 49/S. 150 of taxes on all telecommunications services “used to provide Internet access” affects far more taxes than those levied on DSL.
- A sunset date should be added to the prohibition on taxation of DSL. As discussed above, current litigation may soon determine definitively that cable modem service also includes a “telecommunications service” component. In that event, Congress could ensure “tax neutrality” between DSL and cable Internet access by reverting to the current Internet access definition in ITFA and allowing states and localities to tax the “telecommunications service” component of *both* forms of access. Without a sunset date on the DSL tax prohibition, Congress will have little incentive to revisit the law to consider this option.

*Expanding the Definition of Tax-exempt Internet Access to Encompass Telecommunications Services Purchased by Internet Service Providers*

As discussed in the previous section, H.R. 49/S. 150 would amend ITFA's definition of tax-exempt "Internet access" to include all telecommunications services "used to provide Internet access." In addition to prohibiting states and localities from taxing telecommunications services used to access an ISP — such as DSL — this language prohibits state and local taxation of any telecommunications services that are purchased to provide "Internet access" at any physical level or tier of this "network of networks." To simplify the discussion, such telecommunications services might be referred to generically as "telecommunications purchased by an Internet Service Provider to link to the Internet backbone;" however, such services can also be sold from one "backbone" provider to another. There are a wide variety of participants involved in "creating" the "Internet," and the physical connections and financial transactions among them are complex, varied, and not described with any standard terminology.

Although the original motivation for the proposed change in the language referring to "telecommunications services" in ITFA's "Internet access" definition may have been to ensure tax neutrality between DSL and cable access, both the House Judiciary Committee and the Senate Commerce Committee have stated that the new language also is intended to prohibit state and local taxation of telecommunication services purchased by ISPs. The Senate Commerce Committee report on S. 150, for example, states:

The Committee intends for the tax exemption for telecommunications services to apply whenever the ultimate use of those telecommunications services is to provide Internet access. Thus, if a telecommunications carrier sells wholesale telecommunications services to an Internet service provider that intends to use those telecommunications services to provide Internet access, then the exemption would apply.<sup>20</sup>

It is ironic that Internet Service Providers like America Online are on the verge of success in convincing Congress to prohibit state and local taxation of the telecommunications services they purchase. When ITFA itself was being debated, ISPs used the *existence* of such taxes as a justification for a prohibition on the taxation of *end-user* Internet access services — arguing that allowing states and localities to tax both resulted in unfair "double taxation."<sup>21</sup> An interchange that occurred at a July 16, 1998 Senate Finance Committee hearing on ITFA typified this argument:

Senator Chafee: I am just not quite sure why you are here, why we are all here, to tell you the truth. I do not see why the suggestion is that you should not be taxed and yet telephone taxes are perfectly all right. Every state imposes telephone taxes. . . . As does the Federal Government. . . .

Jill Lesser, Director, Law and Public Policy, America Online: . . . [W]ith respect to your question about telecommunication taxes, I think it is important [to] note that . . . most if not all of America Online's access is done through telephone lines. And so telephone lines are either leased or purchased. . . from two ends, both at the consumer end for a line to get online and at America Online's end. *Our telecommunications charges total over*

*\$1 billion per year. And we pay taxes on all of those charges as do our customers. So in terms of accessing the Internet. . . we do pay taxes over the use of telecommunications when we use them as users. And we believe that with the current system, particularly when some States are also calling us telecommunication services, that it would result at this point in double taxation. [Emphasis added.]*<sup>22</sup>

It is also clear that ITFA's proponents assured state and local government representatives that they had no intention to prohibit states and localities from imposing taxes (and applicable user fees) on telecommunications services purchased by ISPs.

- An analysis of an interim draft of ITFA by the Committee on State Taxation (an organization representing major multistate corporations) gave an example of the effect of the language preserving state and local telecommunications taxes and fees: "For example, ABC Co. provides both telecommunications and Internet access services. *The fact that ABC Co. may use its lines as a backbone to provide Internet access does not cause such lines to be exempt* from telecommunications 'right of way' franchise fees." [Emphasis added].
- ITFA created an "Advisory Commission on Internet Commerce" (ACEC). ACEC examined appropriate long-term federal policy with respect to state and local taxation of both Internet access services and telecommunications. In November 1999, a coalition of 12 major telecommunications companies submitted to ACEC "A Proposal for State and Local Taxation of the Telecommunications Industry." This statement does not advocate in any way that Internet "backbone" telecommunications services or telecommunications services purchased by end-users to access the Internet be exempted from state and local taxes.

H.R. 49/S. 150 would now abrogate the commitments made to state and local governments when ITFA was enacted and bar them from taxing high-speed telecommunications services purchased by an Internet Service Provider to link its equipment to the Internet backbone. The Congressional Budget Office was not able to identify which states and localities would be affected by this prohibition or estimate its impact on state and local revenues. In its report on H.R. 49 required by the Unfunded Mandates Reform Act, however, CBO stated:

Depending on how the language [in H.R. 49] 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.]<sup>23</sup>

It is not surprising that CBO was unable to estimate the impact on state and local revenues of this prohibition; 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, such as financial institutions. Nonetheless, it seems likely that a very large number of state and local governments would lose revenue from this prohibition; state and local taxes that are levied on all gross receipts of telecommunications service providers are quite widespread.<sup>24</sup> As with the proposed new prohibition on the taxation of DSL services, there likely would be a

timing difference between H.R. 49 and S. 150 with regard to this prohibition; most of the adverse revenue impact likely would be delayed for three years if S. 150 were enacted rather than H.R. 49.<sup>25</sup>

### **The Severe Long-run Revenue Impacts of H.R. 49/S. 150**

All of the adverse impacts on state and local revenues of H.R. 49/S. 150 discussed to this point in the report would occur within the first three years following enactment of the legislation. If H.R. 49 were enacted, all of the revenue losses arising from repeal of the grandfather clause and the expansion of the Internet access definition to include Internet-related telecommunications that have been discussed would begin to occur almost immediately. If S. 150 were enacted, on the other hand, most of the revenue impact would be delayed until October 1, 2006, when the grandfather clause repeal would go into effect.<sup>26</sup>

The most severe impacts on state and local revenues that would result from the enactment of H.R. 49/S. 150 actually would occur somewhat further in the future, probably in a five to ten year time frame. As will be discussed in this section, two of the most serious impacts result from the fact that both bills would make ITFA permanent. In so doing, they lock into place serious flaws in the original ITFA definition of “Internet access.”

- The existing definition of Internet access in ITFA makes it fairly doubtful that states and localities have the legal authority to impose sales and telecommunications taxes on voice telephone services provided over the Internet, because the services appear to *qualify* as “Internet access.” Such “Voice over Internet Protocol” (VoIP) technology is expected to substantially displace traditional voice telephone service within a decade. Accordingly, locking in the current definition of Internet access places a major source of state/local revenue at risk. Moreover, making permanent the expanded definition of Internet access in H.R. 49/S. 150 would make it all but certain that VoIP services could not be taxed.
- Making permanent the current ITFA definition of Internet access would place a substantial portion of the potential tax base of state and local governments beyond the reach of sales taxation. Sellers of valuable “digital content” (such as music, movies, and computer software) and providers of online services (such as financial planning) could avoid any state/local sales taxation of such content and services by “bundling” them with Internet access service and selling them as a package. Eventually, the vast majority of music and movies are likely to be distributed online rather than in the form of “hard” media, and many new on-line services are likely to be developed. Thus, if ITFA is made permanent with the Internet access definition that exempts bundled content/services from taxation in place, it will cause a serious long-term drain on state and local sales tax revenue.

Finally, a serious *potential* long-run impact H.R. 49/S. 150 arises from repeal of the “grandfather clause.” When the grandfather clause is no longer in place to protect all taxes on Internet access

that had been in force prior to October 1998, Internet access providers (including telecommunications companies providing VoIP and other Internet-related telecommunications services such as DSL) could seek to establish in the courts that state and local taxes on their property and profits are prohibited *indirect* taxes on access service. Opening the door to such claims clearly is unintended, but to date the relevant Senate committees have been unwilling to add language to S. 150 (which is still pending) to eliminate any possibility of such litigation.

### ***ITFA + VoIP = Severe Erosion of State and Local Telecommunications Tax Revenues***

There has been a barrage of press coverage in recent weeks noting the rapid progress of technology that provides voice telephone service over the Internet or using the Internet communications “language.” The generic term for these technologies is VoIP — “voice over Internet protocol.”

- In a September 10, 2003 interview, Vint Cerf, widely regarded as the “father of the Internet” and currently an executive with telecom giant MCI said: “We want to get 25 percent of our calls over an [I]nternet [P]rotocol backbone by the end of the year. We’re at 10 percent now. We want to move all of it over by 2005. . . . It’s a lot less [costly] than expected. We’ve already had a huge investment in our Internet backbone, and we have a huge capacity . . . we don’t have to go and build a gigantic new Internet backbone to support this.
- On October 9, 2003, a front-page story in the *Wall Street Journal* observed: “Currently, VoIP accounts for less than 3% of global voice phone calls. . . . But a number of trends are working in its favor, say industry executives: the boom in demand; the evolution of the technology, which permits companies to offer services beyond the reach of conventional phones; and the spread of broadband connections, which make VoIP much easier to use. Given all that, some industry executives predict that VoIP will eventually replace the circuit-switch technology that telephone networks have used for more than a century.” The article noted that there are several smaller companies, such as Vonage and Packet8, that already offer nationwide VoIP service to anyone with cable modem or DSL Internet access. It also reported that in some local markets both Time Warner Cable and Cablevision Systems already are selling VoIP services to their cable modem customers, with a much wider roll-out planned.
- On October 12, 2003, the *New York Times* wrote: “VoIP will lead to fundamental changes in the industry. ‘VoIP is going to change everything,’ says Jeff Kagan, a telecommunications consultant based in Atlanta. ‘The big telecom companies worry that VoIP could completely undermine their business within 12 months,’ says Berge Ayzajian, a senior research fellow at the Yankee Group.

There is a strong probability, then, that over the next decade VoIP telephone service will increasingly displace telephone service offered over the traditional “public switched telephone network.” The growth of VoIP represents a serious threat to the viability of state and local taxes on telecommunications services, with or without a change to ITFA’s “Internet access” definition.

It is fairly doubtful that states and localities have the authority to tax VoIP services even under the *current* wording of ITFA:

- VoIP arguably is a “service that enables users to . . . access services offered over the Internet,” which is one part of the current ITFA definition of “Internet access.”
- It is not certain that VoIP qualifies under the current wording of ITFA as a (taxable) “telecommunications service,” since neither the FCC nor the IRS has yet issued a ruling declaring VoIP to be a telecommunications service.
- On October 16, 2003, a Minnesota federal district court judge issued a decision holding Vonage, a leading VoIP provider, to be an “information service” provider under the federal Communications Act — the same category that encompasses Internet access providers — rather than a “telecommunications service” provider.<sup>27</sup>

Regardless of whether the current ITFA definition permits state and local governments to tax VoIP services, the language in H.R. 49/S. 150 that would expand the definition of “Internet access” to include Internet-related telecommunications services would make it much more difficult or impossible for states and localities to tax VoIP. Even if the FCC were eventually to rule that VoIP is a telecommunications service, state and local governments would still have to prove that VoIP is *not* a “telecommunications service . . . used to provide Internet access” in order to tax it if this phrase were added to ITFA by H.R. 49/S. 150.<sup>28</sup> This would be difficult to prove, since the technology accesses the Internet to make voice telephone calls. An objective reading of the proposed language in H.R. 49/S. 150 leads to the conclusion that the taxability of VoIP services at the very least would be subject to serious question were H.R. 49/S. 150 to be enacted.

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 telecommunication excise taxes. These concerns essentially have been dismissed or ignored. In a recent press release, for example, Mark Beshears, Vice President of State and Local Tax for Sprint Corporation, made a somewhat puzzling assertion that under H.R. 49/S. 150

A company that is selling voice service. . . not used to provide Internet access would still be required to collect telecommunications taxes, even if that service is provided using the Internet protocol. Both the statutory language and the language of the House Judiciary Committee report on H.R. 49 state Congressional intent on this issue.<sup>29</sup>

In fact, the “statutory language” is highly ambiguous at best (as explained above). More importantly, the only reference to VoIP in the House Judiciary Committee report on H.R. 49 implies Congressional intent regarding state and local taxation of VoIP services exactly opposite

to that asserted by Mr. Beshears. In the mark-up session, 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.<sup>30</sup> His interpretation was not contradicted by other members of the committee present at the mark-up. 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."

State and local taxes on sales of telecommunications services generate almost \$13 billion in annual revenues for state and local governments.<sup>31</sup> A permanent prohibition on the ability of states and localities to impose their sales and telecommunications taxes on voice telephone services provided over the Internet is likely to lead to deep erosion of this revenue source. If Congress does not wish to see that happen, it would appear to have two options with respect to H.R. 49/S. 150.

- If Congress intends right now to preserve the ability of state and local governments to impose telecommunications and sales taxes on VoIP services, as Mr. Beshears of Sprint claims, then that intention needs to be made clear through the inclusion of additional language in ITFA expressly stating that VoIP services are not included in tax-exempt "Internet access."
- If Congress intends to block taxation of VoIP services for now, then no more than two year extension of ITFA seems warranted. Without such a "sunset" on ITFA, Congress will not have sufficient incentive to revisit the issue and examine the impact that the prohibition is having on the ability of state and local governments to raise critical telecommunications-related revenues.

*The Unaddressed Problem of "Digitized Content" and Online Services  
"Bundled" with Internet Access*

The most immediate and certain impact of ITFA was the prohibition of new state and local taxes on monthly customer fees for Internet access services (for example, America Online's \$25 per month fee for unlimited dial-up modem access). However, flawed drafting of ITFA's "Internet access" definition has created a loophole that, if made permanent, is likely to block future sales taxation of a wide range of products and services that can be delivered over the Internet.

The definition of Internet access under the current wording of ITFA is extremely broad. It encompasses far more than what the average person thinks of as “Internet access” — the ability to send and receive e-mail and instant messages and to view and interact with World Wide Web pages. Internet access is defined as “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 offered to users. . . .” The “proprietary content” included in the definition may include downloaded computer software, music, movies, games, magazines, encyclopedias, and similar “goods.” The “other services” included in the definition could include on-line bill paying, game-playing, and investment portfolio management, among many others already available or under development.

At present, relatively few states tax digital “goods” and services if they are delivered over the Internet. Computer software is the most widely taxed such product, yet 18 of the 45 states with sales taxes do not impose them on downloaded software even though these 18 states do tax software sold on a CD-ROM. Only 19 states tax any type of downloaded “information” other than computer software.<sup>32</sup>

The fact that only a minority of states currently impose their sales taxes on downloaded music, movies, games, software, and other “proprietary content” probably has had a relatively minor impact on state and local sales tax revenues so far. However, the revenues foregone are likely to grow significantly within a few years. An estimated 20 percent of American households already have high-speed Internet connections; that number is predicted to grow to 37 percent by 2007.<sup>33</sup> Companies are developing a wide array of services to deliver digitized content to such customers. Already, for example, there are seven major services selling downloaded music and two services selling downloaded movies.<sup>34</sup> It seems quite likely that most forms of software, information, and entertainment that are capable of being produced in digital form will be widely sold and delivered over the Internet within five years. The same can be said of an increasing number of household services, from security alarm monitoring to restaurant location services for people with wireless Internet access.

When that happens, many states and localities that now tax such digital content when it is sold as a software, audio, or video disk will want to be able to tax the downloaded versions as well. State and local governments will want to preserve both their sales tax bases and the competitiveness of their local book, music, and video stores. However, if ITFA's prohibition on taxation of “Internet access” has been made permanent in its current form — as proposed by H.R. 49/S. 150 — state and local governments will be stymied in their efforts to extend their sales taxes to proprietary content and services delivered over the Internet. ITFA's “Internet access” definition could block future sales taxation of downloaded material and online services sold by two different categories of companies.

First, true “Internet access” providers like America Online clearly would have free reign to sell proprietary content and online services free from sales taxes by “bundling” them with Internet access service as traditionally understood. Now that America Online is merged with Time Warner, the company could supplement AOL's existing \$25 monthly service with a service

package for \$35 per month that also includes the right to download a number of Warner Music audio recordings, another deluxe package for a higher monthly fee that includes additional Warner Home Video movie downloads, and so on. All of Time Warner's valuable and extensive collection of media properties could be bundled with AOL's access service and sold free from sales tax.<sup>35</sup> This prohibition could have a significant adverse revenue impact on states and localities, because Internet access providers like AOL have a physical presence in most states (with modem banks and other equipment constituting their local "points of presence") and otherwise would be obligated to charge sales tax.

A much wider array of companies than Internet access providers might be able to avoid future sales taxation of their digital wares by claiming that ITFA's "Internet access" definition also covers them. Every company selling and delivering digitized content over the Internet arguably is providing "Internet access" under ITFA's definition read literally. For example, it would seem that a company that has a Web site at which music may be downloaded is "providing a service that enables users to access content . . . offered over the Internet," which is part of the definition of "Internet access" in ITFA. In short, a company delivering digital "goods" over the Internet would have a strong case that it would not have to charge sales tax, even if the company is not an Internet access provider like America Online that controls local access telephone numbers, banks of modems, and similar infrastructure. Acquiring such infrastructure is not expensive, in any case. A company selling music downloads on the Web could easily qualify as a provider of "Internet access" by leasing a few modems in a single city that some of its customers could dial into directly if they wished.<sup>36</sup>

In sum, if the ITFA moratorium is made permanent with no change in its "Internet access" definition, states and local governments are unlikely to be able to apply their sales taxes to a variety of information- and entertainment-oriented products and other services that are likely to be widely sold and delivered over the Internet within five years. This would punch another large hole in the sales tax base of states and localities and compound the already-substantial competitive disadvantage of Main Street retailers vis-a-vis their e-commerce rivals. Legislation that was originally justified as a means of preventing tax discrimination against online sale of goods and services is poised to create permanent tax discrimination against many goods and services sold in brick-and-mortar stores. People who shop in those stores — many of them lower-income individuals without the resources to shop online — will continue to pay sales taxes that more affluent Internet users will be able to avoid.

There are no easy solutions to the content/services "bundling" dilemma that ITFA's Internet access definition has created; the "horse is already out of the barn." Once it has been accepted that tax-exempt "Internet access" service includes any content beyond perhaps bare-bones news headlines and an Internet navigation guide, and any services beyond e-mail, it is very difficult to draw a line between one form of content and another. Bits are bits, and Internet access providers are already providing their subscribers with a wide array of text-, audio-, and video-based "content" and on-line financial, entertainment, and communication services. If a substantial share of the potential sales tax base of states and localities is not going to be put beyond the reach of sales taxation, there seem to be three basic options.

- Allow ITFA's prohibition on Internet access taxation to expire, and once again allow sales taxation of "Internet access" and whatever is bundled with it. Congress could still mandate that the taxation of Internet access and online content and services be done in a non-discriminatory manner. For example, the law could mandate that a state would not be allowed to tax Internet access unless it also taxed long-distance telephone, voice mail, magazines, newspapers, and cable TV, for which the typical "Internet access" package offered by an ISP is a functional substitute.
- Prevent unlimited bundling by identifying some specific online services and content that would not be considered to be included in tax-exempt "Internet access," such as downloadable movie and music files and voice telephone service. This is far less than a perfect solution, because drawing and enforcing such lines would be quite arbitrary, and the law likely would be several years behind the content and services that were actually being sold on the Internet.
- Prevent unlimited bundling of content by defining basic Internet access services in terms of price rather than content. That is, set a reasonable price ceiling for "basic Internet access" based on what is being charged for a particular limited-content package in the marketplace. Any amount charged monthly or yearly for Internet access above that amount would be subject to sales tax. This is the approach adopted by Texas, which exempts the first \$25 in monthly Internet access fees from taxation. Of course, different ceilings could be set for various kinds of broadband access, and the ceilings could be indexed for inflation. They also could be reset periodically based on market practice.

Acknowledging that the first option is unacceptable to most members of Congress at this time, various forms of options two and three have been put forward by state and local government representatives many times. Unfortunately, they have been more-or-less categorically rejected as well. If ITFA is made permanent with no change to the Internet access definition aimed at the "bundling" problem, it would seem that serious sales tax base erosion is in the offing within a decade at most.

One final observation on the bundling issue is in order. It is curious that there appear to be many staunch supporters of making ITFA permanent who also support proposed federal legislation that would empower states to require non-physically-present Internet merchants to charge sales taxes when they sell physical goods across state lines. The possibility that most "digital content" could be sold free of sales tax because of ITFA runs counter to the goals of such legislation. Even if states are empowered 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.<sup>37</sup> It does not appear that many supporters of the proposed "Streamlined Sales Tax" legislation authorizing sales taxation of Internet purchases realize that the goals of that legislation will be partially counteracted if the current ITFA definition of Internet access including bundled content is made permanent.

***Repeal of ITFA’s “Grandfather Clause”:  
A Risk to Taxes on the Profits and Property of Internet Access Providers***

ITFA’s grandfather clause preserves state and local “taxes on Internet access” that were “generally imposed and actually enforced prior to October 1, 1998.” As previously discussed, the purpose of this clause was to enable about a dozen states (and an unknown number of cities) that were taxing Internet access service prior to that date to continue doing so. H.R. 49 and S. 150 would both repeal this clause — H.R. 49 immediately and S. 150 on October 1, 2006. The goal of repeal is to ensure that no state or local government may ever again tax Internet access services.

State and local government organizations have expressed concern that if the grandfather clause is repealed, Internet access providers could stop paying property, income, net worth, and perhaps other state and local taxes and seek to convince a court that such taxes are barred by ITFA because they represent *indirect* taxes on Internet access *service*. The grandfather clause prevents most such claims at present, because even if such taxes do constitute indirect taxes on Internet access service, they are permitted if they were in force before October 1, 1998. All state taxes on corporate profits, for example, were in effect well before 1998.

The sponsors of H.R. 49/S. 150 have made clear that it is not their intention to bar property and income taxes applicable to Internet access providers, and the Commerce Committee report on S. 150 even includes an explicit statement to that effect. Nonetheless, state and local representatives have been rebuffed to date in their efforts to add specific language to H.R. 49/S. 150 explicitly preserving their ability to tax the property and profits of Internet access providers.

There is a substantial risk that repeal of the grandfather clause *would* open the door for Internet access providers to challenge property taxes and income taxes, and committee report language expressing a contrary intention is of little or no value in reducing this risk.

- When ITFA was first introduced, it stated that “no State or political subdivision thereof may impose, assess, or attempt to collect a tax *directly or indirectly* on . . . the Internet or interactive computer *services*.” The italicized language demonstrates that the sponsors of ITFA themselves were aware that a particular tax can be an indirect tax on a service and wished to bar both types of taxes on online services. The fact that ITFA as enacted bars “taxes on Internet access” leaves ambiguous whether or not indirect taxes are included in the prohibition.
- There is a well-accepted concept of “indirect taxes” in public finance. For example, a glossary of tax terms on the IRS website defines an “indirect tax” as a “tax that can be shifted to others, such as business property taxes.” ISPs could use such language to claim that state and local taxes on their property, and state and local sales taxes on the goods they purchase, are “indirect” taxes on the Internet service they sell, since ISPs must recover those costs in what they charge for access service in order to stay in business.

- ITFA as adopted defines a tax as “any charge imposed by any governmental entity for the purpose of generating revenues for governmental purposes. . .” and goes on to define “tax on Internet access” as “a tax on Internet access, including the . . . application of any new tax on the sale. . . of Internet services. . .” The fact that “tax” is defined so broadly in ITFA and that a “tax on Internet access” *includes* a new sales tax *but is not limited to a sales tax* may create an inference that non-sales taxes — such as income and property taxes — may constitute “taxes on Internet access.”
- Committee report language would likely be of little or no value to state and local governments in defending non-sales taxes challenged by Internet access providers under ITFA. Unlike the situation with a law that changes federal taxation, there is no interpretive agency like the IRS that will issue regulations aimed at fleshing-out congressional intent regarding the application of ITFA. The only way that the scope of a federal law preempting state and local taxing authority is determined is through litigation; taxpayers will stop paying taxes they believe have been barred by the federal law, state and local tax officials will seek to enforce those taxes, and courts will determine whose interpretation of the statute is correct. In such litigation, courts will do everything they can to interpret the language of the statute itself and avoid looking at legislative history if at all possible.
- The history of court decisions applying the “4-R” Act, a federal law regulating state and local taxation of railroads, provides powerful validation of concerns about the potential impact on property and income taxes of the repeal of ITFA’s grandfather clause. In interpreting the 4-R Act, the courts have voided many state and local tax laws and policies that Congress clearly intended to protect; the courts ruled against the state taxes because the language of the 4-R Act itself did not clearly preserve them.<sup>38</sup>

Congress’ refusal to date to include language in H.R. 49 and S. 150 explicitly preserving property taxes, income taxes, and other “non-transactional” taxes when the grandfather clause is repealed is surprising.<sup>39</sup> In drafting ITFA itself and in enacting other federal laws preempting state and local tax powers, Congress has almost always been willing to include language preserving state and local taxes it did not intend to prohibit.

- As originally introduced, for example, ITFA stated that the law “does not apply to taxes imposed on or measured by net income derived from . . . Internet . . . services. . . [or] to fairly apportioned business license taxes. . .”
- By the time ITFA was approved by the Senate Commerce Committee, the moratorium on Internet access taxes explicitly did not apply to “taxes imposed on or measured by net income. . . value-added, net worth, or capital stock; . . . fairly apportioned business license taxes;. . . taxes paid by a provider . . . of Internet access as a consumer of goods and services;. . . property taxes imposed or assessed on property owned or leased by a provider or user . . . of Internet access service; . . . taxes imposed on or collected by a common carrier. . . acting in its

capacity as a common carrier; [or] . . . taxes imposed on or collected by a provider of telecommunications service. . .” None of these protections were included in the final enacted version of ITFA because the grandfather clause preserving all state and local taxes “on Internet access” in force before October 1, 1998 rendered such specific protections largely superfluous.

- In at least two other federal laws regulating state and local taxes on specific services (passenger airline and cellular telephone), Congress has recognized the legitimacy of these concerns and included a “savings clause” making clear that the regulation only applies to taxes imposed directly on the service. The prohibition on state and local taxes on airline passenger service, for example, says explicitly that it does not apply to “property taxes, net income taxes, franchise taxes, and sales or use taxes on the sale of goods or services.”<sup>40</sup>
- The federal law regulating state and local taxation of cellular telephone service does a particularly careful job of spelling out the taxes to which it does and does not apply. It does apply to “any tax, charge, or fee levied by a taxing jurisdiction as a fixed charge for each customer or measured by gross amounts charged to customers for mobile telecommunications services, regardless of whether such tax, charge, or fee is imposed on the vendor or customer of the service and regardless of the terminology used to describe the tax, charge, or fee.” It does not apply to “(1) any tax, charge, or fee levied upon or measured by the net income, capital stock, net worth, or property value of the provider of mobile telecommunications service; (2) any tax, charge, or fee that is applied to an equitably apportioned amount that is not determined on a transactional basis; (3) any tax, charge, or fee that represents compensation for a mobile telecommunications service provider's use of public rights of way. . . [or] (4) any generally applicable business and occupation tax that is imposed by a State. . .”

If similar language were added to H.R. 49 and S. 150, there would be no concern that property, income, and other taxes would be unintentionally abrogated. The language from the Mobile Telecommunications Sourcing Act cited in the final bulleted paragraph above would provide an excellent model.

### **The Morphing of ITFA: From Temporary Moratorium to Permanent Subsidy — Financed by State and Local Governments**

All three of the changes that would be made to the Internet Tax Freedom Act by H.R. 49/S. 150 — repeal of the grandfather clause, broadening the definition of Internet access to encompass Internet-related telecommunications, and making the law permanent — represent fundamental violations of commitments that were made to state and local officials at the time ITFA was enacted. In order to justify such extraordinary actions, ITFA’s proponents have formulated an entirely new rationalization for the law. By prohibiting state and local taxation of Internet access services in perpetuity, they seek to keep the price of Internet access low in order

to boost consumer demand — particularly for expensive high-speed or “broadband” access service, and particularly for low- and moderate-income households.

- In testimony on July 16, 2003, Joseph Ripp, Vice Chairman of America Online, urged enactment of S. 150 because it “will promote digital opportunities for the 50 percent of Americans who do not currently have Internet access services. Taxes would only increase their costs and frustrate the national goal of providing these services for all Americans. . . . [F]ailure to pass [S. 150] will raise the cost of Internet access services . . . and thereby suppress demand for broadband. . . .”
- In a May 14, 2003 letter to the House Judiciary Committee, Commerce Secretary Donald Evans and Treasury Secretary John Snow stated: “The Internet is an innovative force that opens vast potential economic and social benefits. . . . The next-generation, broadband Internet offers even greater impact, and this Administration strongly supports the deployment of broadband services. In this regard, government must not slow the roll-out or usage of Internet services by . . . imposing new access taxes.”
- The Senate Commerce Committee states: “There remains a need to ensure that taxes on Internet access will not pose a hurdle to the continued adoption of basic dial-up access or to the migration from basic Internet access to broadband Internet access. . . . To avoid impeding the growth of Internet use . . . the Committee believes that the ITFA’s Internet tax moratorium should be made permanent.

What is perhaps most striking about this after-the-fact transformation in the stated objective of ITFA’s ban on Internet access taxes is that no one appears to have asked a fundamental question: however laudable the goal of encouraging demand for Internet access by keeping it as inexpensive as possible may be, why should the federal government force states and localities to forgo revenues from non-discriminatory taxes to accomplish this purpose?

#### *An Unaccountable, Unfunded Mandate*

Not so many years ago, Congress sought to tie its own hands to avoid the temptation to achieve federal policy objectives by giving away the tax revenues of states and localities. In the Unfunded Mandates Reform Act of 1995, Congress included in the definition of the “direct costs of a federal “intergovernmental mandate” both “the aggregate estimated amounts that all State, local, and tribal governments would be required to spend” and the amount of money such governments “*would be prohibited from raising in revenues* in order to comply with the Federal intergovernmental mandate.” [Emphasis added.] Such self-imposed restraint was and remains consistent with fundamental principles of federalism and governmental accountability.

- If states and localities are prohibited from raising revenues associated with purchases of Internet access (and related telecommunications services and digital “content” distributed over the Internet), either some state and local services that would otherwise be provided will be curtailed, or someone else’s taxes will be higher to make up the forgone revenue. The same population to whom Congress

is so anxious to give tax-free Internet access may be more negatively affected by an increase in the state general sales tax rate or a hike in state university tuition than it would be by paying sales tax on Internet access. It is state and local officials, not members of Congress, who will be held accountable for such outcomes. Accordingly, while it may be a legitimate strategy to stimulate demand for Internet access by not imposing state and local taxes on this service, and while it may even be reasonable for federal officials to actively encourage state and local officials to implement such a policy, it is not reasonable for the federal government to impose this unfunded mandate on state and local governments.

- Permanently preempting state and local taxes on such services with the explicit aim of stimulating demand sets a dangerous new precedent that invites open-ended federal interference with legitimate state and local tax policy choices. There are numerous federal policy objectives that arguably are impeded by state and local taxes. The federal government wishes to encourage greater rates of homeownership on the part of low-income families; why not preempt local property taxes on their homes? The federal government wishes to encourage more young people to enter teaching; why not enact a law barring state income taxation of their salaries for a few years? Clearly, the cost of a \$500 computer is far more of an obstacle to low-income households getting on the Internet than is a \$10-15 monthly fee for dial-up access; why not bar state and local sales taxes on computers? Or property taxes on computer manufacturers, for that matter? There is no obvious reason why encouraging access to the Internet is a more preeminent federal policy objective than many others.

Barring state and local taxes in the name of stimulating demand for a particular service is an extremely slippery slope. Congress should reject that rationale for making ITFA a permanent prohibition on state and local sales taxation of Internet access services. Congress should embrace the original justification of the law and maintain the moratorium only for the limited amount of time that is necessary to develop a reasonable set of rules governing how states and localities may tax access services under traditional sales taxes and similar broad-based, non-discriminatory taxes on service transactions.

#### *An Unnecessarily Costly Means of “Closing the Digital Divide”*

The dubious new justification for ITFA discussed in the preceding section often includes the argument that a permanent prohibition on state and local taxation of Internet access services is needed to facilitate greater access to the Internet by low-income families and individuals. In this context, it is worth noting that the Bush Administration sought, unsuccessfully, to eliminate the only two small federal programs that are explicitly aimed at closing the “digital divide” and helping low-income families gain access to the Internet and become sophisticated Internet users.<sup>41</sup>

A blanket prohibition on the taxation of Internet access is unlikely to be a cost-effective strategy for closing the “digital divide.” It is true that almost all sales taxes are regressive, that is, they require lower-income households to devote a greater share of income to paying the tax than

upper-income households must devote. Sales taxes on Internet access share this drawback of other consumption taxes. There are more effective ways, however, to help low-income families.

- This problem can be addressed by state and local governments themselves through such mechanisms as income tax credits to offset sales taxes paid by low-income households — not only on Internet access, but on all taxable goods and services such households buy. Such credits can be provided at far lower cost in forgone revenue than a permanent, blanket prohibition on taxation of Internet access purchased by rich and poor alike.
- The overwhelming majority of the tax savings from a ban on taxation of Internet access and associated telecommunications would be reaped by businesses and upper-income families purchasing high-speed Internet access, which often costs many times as much as the typical dial-up account likely to be purchased by low- and moderate-income households.<sup>42</sup>

It hardly seems credible that the prospect of paying 60 cents or a dollar of sales tax on a \$10 monthly access fee is having any measurable impact on the rate at which low-income Americans decide to go online. Low-income households face much greater barriers to Internet use:

- The cost of a computer and the access fee itself obviously is far greater than the applicable sales tax.
- It still is difficult to sign up for an Internet access account with many discount providers without a credit card, which many low-income households lack.
- Considerable research has documented that the primary barriers to Internet use on the part of non-users are a lack of relevant content, knowledge of how to use the technology, and a lack of awareness of the potential benefits of being online.<sup>43</sup>

Being permanently barred from raising sales tax revenue from relatively affluent Internet users will impair the finances of states and localities. This in turn will limit such governments' ability to provide the kinds of direct training programs, library facilities, and enhanced on-line governmental services (such as drivers license renewals) that are much more likely than a small tax savings to provide meaningful opportunities and incentives for low-income people to go online.

Finally, it seems a particularly dubious notion that the federal government should be keeping Internet access services free from non-discriminatory state and local transactional taxes as a means of encouraging the purchase of high-speed or "broadband" Internet services. More than 32 million households have declined even to purchase dial-up access at typical monthly costs of \$10-\$25.<sup>44</sup> It defies common sense to suggest that these people will somehow be encouraged to spend an additional \$10-\$30 per month to purchase this service by the fact that they will be able to avoid a few dollars in sales tax on the additional charge.

At present, there is substantial excess transmission capacity in the Internet infrastructure. Internet service providers and the telecommunications industry would like to fill that “dark fiber” with movies, digital photographs, and other types of content and online services that realistically will only be sought by households with high-speed connections. Given the excess capacity, it is understandable that the industry is worried that the rate of growth in demand for broadband is slowing and would like Congress to help them keep their prices as low as possible by blocking state and local taxation.<sup>45</sup> It is curious, however, that so many officials who celebrate free consumer choice, eschew federal “industrial policy,” and advocate state sovereignty in other contexts now seem anxious to violate all three principles by trying to artificially boost demand for high-speed Internet access by interfering with legitimate state and local tax policy choices.

## Endnotes

<sup>1</sup> 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](http://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.

<sup>2</sup> 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.

<sup>3</sup> A “transactional tax” is one imposed on an individual sales transaction or the seller’s receipts from that transaction.

<sup>4</sup> See: Iris J. Lav, *Federal Fiscal Policies Contribute to the Severity of the State Fiscal Crisis*, Center on Budget and Policy Priorities, October 17, 2003.

<sup>5</sup> Donald Bruce, John Deskins, and William F. Fox, “Has Internet Access Taxation Affected Internet Use?” unpublished paper, June 2003. Forthcoming in the *Public Finance Review*.

<sup>6</sup> See note 18 below.

<sup>7</sup> The May 5, 1998, Senate Commerce Committee report on ITFA, for example, is quite clear on this. In its section-by-section analysis of the bill, it states: “Subsection (b)(6) preserves taxes imposed on a common carrier acting as a common carrier, and subsection (b)(7) preserves taxes imposed on a provider of telecommunications services to ensure that State and local telecommunications taxes, fees, and regulations are unaffected by the bill. The preservation of this taxing authority, *added to the original version of the bill*, is intended to apply to entities when they act as telecommunications service providers and not as Internet access or online service providers. For example, *a company that provides both telecommunications and Internet access service and uses its lines to provide Internet access does not cause such lines to be exempt from telecommunications taxes.* [Emphasis added.]

The July 30, 1998 Senate Finance Committee report on ITFA states: “Further, the restrictions on Internet access taxes and bit taxes do not preclude States from continuing to impose taxes on telecommunications services or cable television access.” Again, there is no language here suggesting the Committee intended to block taxes on telecommunications services used by either an end-user to access the Internet or by an ISP to access the Internet backbone.

For further examples, see the paragraphs in bullets on p. 10.

<sup>8</sup> Thus, even if a local telephone company sold a package of local telephone service and Internet access service for one price (as many of them do), that would not render the ordinary voice line tax-exempt; the company would still have to charge applicable state and local taxes on the voice line.

<sup>9</sup> Even before ITFA was adopted, the Federal Communications Commission treated Internet access via DSL as a service that combines a “telecommunications service” (the DSL phone line) with an “information service” (Internet access) — no different than the treatment of dial-up access over a regular phone line. In the FCC’s words:

An end-user may utilize a telecommunications service together with an information service, as in the case of Internet access. In such case, however, we treat the two services separately: the first service is a telecommunications service (*e.g., the xDSL transmission path*), and the second service is an information service, in this case Internet access. [Emphasis added.]

Source: *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, 13 F.C.C.R. 24,011 at 24,030 (August 7, 1998). Quoted in concurring opinion of Judge Thomas in *Brand X Internet Services v. FCC*, Ninth Circuit Court of Appeals, October 6, 2003. ITFA was signed into law on October 21, 1998, after the FCC *Deployment of Wireline* document was published.

The FCC had been studying whether to reverse its previous interpretation of the Communications Act that held that DSL is a telecommunications service; the *Brand X* decision appears to block further consideration of such a policy reversal.

<sup>10</sup> Earthlink, a major national Internet Service Provider, charges state and or local taxes on DSL service in 27 states. See: [support.earthlink.net/mu/1/psc/img/walkthroughs/other/taxbilling/8233.psc.html](http://support.earthlink.net/mu/1/psc/img/walkthroughs/other/taxbilling/8233.psc.html). In interpreting this table, note that the \$ .66 charge shown in a number of states represents the federal Universal Service fee. Thus, a state in which the minimum or maximum amount of taxes shown in the table is other than \$ .66 is a state in which Earthlink is charging state and/or local taxes on DSL service. If the minimum and maximum taxes in the table differ for a particular state, that suggests that some but not all local governments in the state are taxing DSL as well.

In the course of legislative action on H.R. 49/S. 150 this year, conflicting statements have been made regarding the extent of state and local taxation of DSL service. It is possible that Earthlink is charging tax on the service in states in which it is not obligated to do so. However, given its clear incentive to keep its service as inexpensive as possible and the possibility that its customers could bring a class-action lawsuit against the company if it were charging taxes unnecessarily, it seems likely that Earthlink has accurately assessed where such taxes are actually in effect.

<sup>11</sup> Earthlink, for example, announced in June 2003 that it would stop absorbing the applicable state and local taxes on the DSL component of its Internet access offering and begin passing them on to customers. A recent Earthlink bill in the District of Columbia breaks down Earthlink's \$49.95 monthly charge into \$17.95 for "Internet Access" and \$32.00 for "DSL Telecom Svc" and bills \$3.98 for the District's "Utility Receipts Tax" on the DSL service. This is no different from how a local telephone company would bill if it provided Internet access and leased a second conventional voice phone line to a consumer who used it only for Internet access.

<sup>12</sup> Telecommunications companies that provide Internet access using cell phones and other wireless devices also supported the expansion of the Internet access definition to encompass telecommunications "used to provide Internet access" and would receive the same exemption were H.R. 49/S. 150 to be enacted. It is less clear, however, that most wireless Internet access services are in substantial direct competition with DSL and cable modem services at this time. Wireless services more often are an adjunct to such "wireline" services rather than a substitute because of their generally slower speeds and the limited screen viewing areas wireless devices provide. Satellite-base Internet access is sufficiently more expensive and limited in its "upload" capabilities that it is usually only purchased where neither DSL nor cable modem access are available.

<sup>13</sup> If sustained, the decision also would seem to nullify FCC proceedings that are considering whether both DSL and cable modem Internet access should be classified under the Communications Act as entirely "Internet access" — an "information service" in the law's terminology — or as a bundle of Internet access and a "telecommunications service." See: Alex Salkever, "So Much for Michael Powell's Net Vision," *Business Week*, October 8, 2003.

<sup>14</sup> Such treatment might also be accorded various forms of wireless Internet access.

<sup>15</sup> The House Judiciary Committee report on H.R. 49 states: "The amendment further elucidated that 'POTS' ['plain-old telephone service'] is not included within the definition of 'Internet access.' The phrase 'are used to provide Internet access' is viewed from the perspective of the provider and POTS alone is not, indeed cannot be, used to provide Internet access."

<sup>16</sup> It appears that most DSL providers charge customers for a regular voice telephone line (including applicable taxes), and then add on an additional monthly charge for giving it DSL capability. It is this latter charge that would no longer be taxed if H.R. 49/S. 150 were enacted.

<sup>17</sup> In H.R. 49, the repeal of the grandfather clause and the expanded definition of Internet access to encompass Internet-related telecommunications take effect simultaneously upon the signing of the bill into law. Thus, if H.R. 49 were enacted, all state and local sales and telecommunications taxes on DSL service would stop immediately.

In theory, S. 150 might not affect some state and local revenues associated with DSL services for three years. Recall that the grandfather clause preserves state and local “taxes on Internet access. . . generally imposed and actually enforced prior to October 1, 1998.” If a state could demonstrate that it was taxing DSL service before that date, it could continue taxing the service until the grandfather clause is repealed – which under S. 150 is not until October 1, 2006. DSL service was not widely available before October 1, 1998, however, so it seems unlikely that many states had taken steps prior to that date to clearly inform telecommunications companies of their obligation to pay taxes on their DSL receipts. While in theory some such taxes may be preserved until October 1, 2006, when the grandfather clause repeal becomes effective under S. 150, it seems likely that most current taxes from DSL services will be repealed immediately when S. 150 is enacted and the expanded definition of Internet access takes effect.

<sup>18</sup> This estimate uses tax data posted its Web site by DSL access provider Earthlink (see note 10) and FCC data on the number of DSL lines in use as of December 2002. The state-by-state taxes listed there by Earthlink are based on Earthlink’s \$32 monthly fee for the DSL service itself. If one is willing to assume that the monthly charge for all DSL phone lines in each state averages \$32, multiplying the number of DSL lines in each state by the monthly taxes charged by Earthlink in that state and again by 12 leads to state-by-state estimates of the total taxes on DSL for that state. To avoid double-counting of taxes on DSL service that may have been included in CBO’s estimate of the loss of revenue from eliminating taxes on “Internet access” in the 10 grandfathered states, those states are not included here. Summing across the remaining states in which Earthlink collects taxes on DSL leads to a total of \$73 million.

The Earthlink data used in this estimate are the maximum amounts of tax charged anywhere in the state. That is, they assume that all DSL lines in a particular state are located in whichever local jurisdiction imposes the highest taxes. That biases the revenue loss estimate upward. However, the assumed \$32 per month charge for DSL biases the revenue loss estimate downward, because many DSL lines are leased by businesses that pay considerably more than households for higher-speed versions of DSL. Given these countervailing biases, an estimate of \$70 million in annual state and local revenues from existing taxation of DSL does not seem unreasonable. It also seems likely that there has been significant growth in the number of DSL lines in operation in the last nine months.

<sup>19</sup> One approach to a relatively narrow preemption of state and local taxation of DSL service that has been suggested would state that “Internet access” does not include telecommunications services, “except to the extent such services

- (i) are purchased directly by a retail purchaser of Internet access service solely for the purpose of connecting to an initial point of presence on the Internet, or
- (ii) are purchased by a provider of Internet access service for the purpose of being resold to the provider’s retail purchasers of Internet access service solely for the purpose of enabling those purchasers to connect to an initial point of presence on the Internet.”

Clause (ii) is intended to allow an Internet Service Provider like Earthlink to buy “wholesale” DSL service from a telecommunications company, bundle it with the ISP’s Internet access service, and sell it to an end-user for one price.

<sup>20</sup> Similar language appears on page 3 of the House Judiciary Committee report on H.R. 49.

<sup>21</sup> During ITFA’s development it was also often argued that the taxation of both the local telephone service a consumer uses to access the Internet and the Internet access service itself constitutes unreasonable and unfair “double taxation.” This is a specious argument; it is tantamount to arguing that imposing a sales tax on both the purchase of a car and the gasoline it uses is “double taxation.” In fact, sales taxes are intended to be taxes on consumption. It requires purchases from both a telephone company and an Internet access provider to consume dial-up Internet access services, just as it now usually requires purchases from both a local phone company and a long-distance telephone company to consume residential long distance telephone services. No double taxation is involved.

On the other hand, most tax policy analysts would agree that taxing both the charge to the end-user for Internet access service and telecommunications or Internet access services purchased by an Internet Service Provider would constitute unfair and economically undesirable double taxation. See the following note.

<sup>22</sup> Lesser's argument that taxing both AOL subscribers' monthly Internet access fees and AOL's purchases of telecommunications services constitutes double taxation was entirely valid. The vast majority of economists would argue that the appropriate solution to this problem is to tax the end-user charge and exempt the purchase of the underlying telecommunications — the exact opposite of the tax policy mandated by ITFA as originally enacted. Just two years before ITFA was introduced, a consortium of major telecommunications companies issued a "white paper" endorsing the economically appropriate policy. When ITFA was introduced, many of them abandoned that earlier principled policy position and supported ITFA. (See: Michael Mazerov and Iris J. Lav, *A Federal "Moratorium" on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households*, Center on Budget and Policy Priorities, May 1998, pp. 7-10.) Now, some of the same companies that endorsed the white paper — Sprint, for example — are endorsing the proposed changes to ITFA that would exempt *both* end-user Internet access charges *and* charges for telecommunications services underlying the Internet from all state and local transactional taxation.

<sup>23</sup> The phrase "depending on how the language . . . is interpreted" is curious; in offering the Judiciary Committee amendment referred to in the previous note, Representative Watt stated clearly that the intention was to exempt telecommunications services used at all levels of the Internet — from the end-user all the way to the "backbone." See the House Judiciary Committee report on H.R. 49 at pp. 30-31.

<sup>24</sup> Committee on State Taxation, "Telecommunications Taxes: 50-State Estimates of Excess State and Local Tax Burdens," *State Tax Notes*, June 30, 2002.

<sup>25</sup> In contrast with the DSL situation discussed in the note 17, it seems likely that most telecommunications companies were clearly aware, prior to October 1, 1998, of their obligation to pay taxes on receipts arising from their leasing of high-speed lines to Internet Service providers. Accordingly, it seems likely that if S. 150 were enacted, such taxes would continue flowing until the grandfather clause is repealed in 2006. Under H.R. 49, of course, such taxes will also cease immediately upon the enactment of the legislation.

<sup>26</sup> Again, as discussed in notes 17 and 25, ITFA is written in such a way that the grandfather clause arguably "controls" the Internet access definition. Thus, even though S. 150 would expand the definition of tax-exempt Internet access in a way that would prohibit taxation of DSL services and telecommunications services purchased by an ISP, taxes on both types of services that were clearly in force prior to October 1, 1998 would appear to be preserved until the October 1, 2006 repeal of the grandfather clause. If H.R. 49 were adopted, on the other hand, taxes on both services would be voided immediately.

<sup>27</sup> Up to now Vonage has appeared to believe that ITFA does *not* protect the company from an obligation to charge state and local sales taxes on its service. Vonage assesses the federal telecommunications excise tax on its monthly service fees. Vonage also charges sales tax on its monthly service fees in its home state of New Jersey — perhaps to be consistent with ITFA's definitions that say that any service subject to the federal telecommunications tax is not tax-exempt "Internet access" but rather (potentially taxable) "telecommunications."

The fact that Vonage does not charge sales tax to its non-New Jersey customers likely is based on a claim that the company lacks sufficient physical presence or "nexus" in those states to be obligated to charge the tax rather than on a claim that the taxes are invalid because of ITFA. If the company acknowledges that the New Jersey sales tax on VoIP services is not barred by ITFA, it could not easily claim that other state sales taxes are prohibited.

<sup>28</sup> VoIP service would also qualify under ITFA as a "telecommunications service" if the Internal Revenue Service ultimately declares such a service to be subject to the federal telecommunications excise tax. But even if that occurred, states and localities would still have to prove that VoIP is not "used to provide Internet access" under the expanded definition of Internet access in H.R. 49/S. 150 if they wished to be able to tax it.

<sup>29</sup> Source: “Chicken Little Strikes Again: A Critical Look at the MTC ‘Study of Internet Tax Freedom Act Impact,’” Press release of Kimbell-Sherman-Ellis government relations firm, September 24, 2003. Similarly, a recent paper by Ernst & Young asserts unequivocally that VoIP telephone service would continue to be taxable if H.R. 49 were enacted: “[T]he actual revenue impact [of HR49] is independent of any future shift of local and long-distance telecommunications to the Internet. . . . H.R. 49 does not extend the ITFA exemption to these services provided over the Internet. . . .” Robert Cline, *Critique of Multistate Tax Commission’s State and Local Revenue Impact Estimates of H.R. 49*, Ernst & Young, October 1, 2003.

<sup>30</sup> Representative King foresees a need to revisit the issue of VoIP because of the potential adverse competitive consequences for traditional long distance companies. Those consequences would only occur if state and local taxation of VoIP were prohibited.

<sup>31</sup> Robert Cline, *Critique of Multistate Tax Commission’s State and Local Revenue Impact Estimates of H.R. 49*, Ernst & Young, October 1, 2003. This figure is for 1999; the actual revenues likely are higher today.

<sup>32</sup> See: [www.vertexinc.com](http://www.vertexinc.com).

<sup>33</sup> Yankee Group forecasts cited in Robert Atkinson, Shane Ham, and Brian Newkirk, *Unleashing the Potential of the High-speed Internet*, Progressive Policy Institute, September 2002, p. 7.

<sup>34</sup> See: Amy Harmon, “What Price Music?” *New York Times*, October 12, 2003. The movie download companies are Movielink and CinemaNow.

<sup>35</sup> This is already occurring to some extent, although it is not explicitly identified as offering premium service options with additional bundled content. In order to maintain subscribers as they increase prices over time, ISPs are forced to add additional content. AOL Time Warner, for example, has sought to maintain AOL subscribers by taking some content that had previously been available to anyone on Time Warner’s Web site (such as People magazine) and limited access to it to AOL subscribers. See: Matthew Rose, “More Subscribe After Time Ends Free Web Access,” *Wall Street Journal*, August 11, 2003.

<sup>36</sup> A significant number of AOL subscribers do not obtain “Internet access” from AOL; they use their own DSL or cable modem service and then pay AOL \$15 per month to access its software and “content” under AOL’s “bring your own access” subscription plan. Yet AOL does not appear to concede that it is not providing tax-exempt “Internet access” to its “bring your own access” subscribers. Nothing in the “terms of service” document covering the bring your own access plan indicates that AOL charges sales tax on the monthly fee for that service in the states that were grandfathered by ITFA to tax Internet access.

<sup>37</sup> There is nothing far-fetched about this scenario. Walmart is already an “Internet access provider;” it resells under its own brand name Internet access purchased from AOL. See: Jim Hu, “AOL Defends Kingdom with Cheaper Option,” CNET News, October 16, 2003.

<sup>38</sup> See: 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.

<sup>39</sup> See endnote 3 for a definition of “non-transactional” taxes.

<sup>40</sup> 49 U.S.C. 40116(e).

<sup>41</sup> The programs are the Community Technology Centers Program and the Technology Opportunities Program. See: Norris Dickard, *Federal Retrenchment on the Digital Divide: Potential National Impact*, Benton Foundation Policy Brief No. 1, March 2002.

<sup>42</sup> Even if Congress insisted on stimulating demand for Internet access services on the part of lower-income Americans by blocking state and local taxation, it could easily achieve this goal without a costly blanket prohibition.

Congress could require state and local governments to exempt from sales taxation the first \$X in monthly fees for dial-up service, setting “X” at a nationwide average charge or even the charge of the Internet access provider with the highest market share. Texas has adopted such a policy voluntarily, exempting the first \$25 in monthly charges for Internet access from taxation.

<sup>43</sup> See: Wendy Lazarus and Francisco Mora, *Online Content for Low-income and Underserved Americans: The Digital Divides New Frontier*, The Children’s Partnership, March 2000.

<sup>44</sup> See the source cited in note 33.

<sup>45</sup> Reuters, “FCC: High Speed Net Growth Slowing.” June 10, 2003.