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MAKING THE "INTERNET TAX FREEDOM ACT" PERMANENT COULD LEAD TO A SUBSTANTIAL REVENUE LOSS FOR STATES AND LOCALITIES

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Background

On May 23 and July 26, 2007, the Senate Commerce Committee and the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, respectively, held hearings on the "Internet Tax Freedom Act" (ITFA). ITFA was enacted in 1998 and renewed in 2001 and 2004. The law generally bars state and local taxation of "Internet access" services. That means that state and local governments may not levy their normal sales taxes on the typical $10-$50 monthly charge that households and businesses pay to a company like America Online, Comcast or Verizon to be able to access the World Wide Web and use email. State and local taxes on Internet access that were in effect prior to 1998 were "grandfathered" by ITFA, however, and this provision was maintained in both the 2001 and 2004 renewals. The 2004 legislation extending ITFA also broadened it by barring state and local taxation of most telecommunications services involved in obtaining or providing Internet access, including high-speed "DSL" telephone lines.

ITFA sunsets on November 1, 2007. As was the case in 2001 and 2004, bills have been introduced in both houses of Congress to make ITFA a permanent prohibition and to eliminate the grandfathering of pre-1998 taxes on Internet

KEY FINDINGS

Making the 1998 "Internet Tax Freedom Act" permanent — as proposed by S. 156/H.R. 743 — could adversely affect state and local government revenues, and therefore the availability of funds for important services like education, health care, and law enforcement, in three ways:

- Potentially block states and localities from extending their normal sales taxes to music, movies, and television programming delivered over the Internet, which is rapidly becoming a major marketplace for such services.
- Allow Internet access providers to try to escape a host of general taxes that other businesses must pay, such as sales taxes on equipment purchases;
- Deprive nine states of $80m-$120m in annual revenues from non-discriminatory and heretofore grandfathered taxes on Internet access services;

The enactment of this legislation is unwarranted:

- Studies by GAO and U. of Tennessee economists show that existing taxes on Internet access have not adversely affected household subscriptions to access or the availability of broadband access in particular locations.
- All of the 14 developed nations that outrank the U.S. in broadband adoption do tax Internet access services. Taxation is not the issue.

access. The identical bills are H.R. 743/S. 156, the "Permanent Internet Tax Freedom Act of 2007" (PITFA). The sponsors of PITFA are Representative Anna Eshoo and Senator Ron Wyden. Mark-ups of both bills could be scheduled at any time.

On May 23rd, the "Internet Tax Freedom Extension Act," S. 1453, was introduced by Senators Tom Carper and Lamar Alexander as an alternative to PITFA. S. 1453 would extend ITFA for four more years, but it would retain the grandfather provision and modify the definition of tax-exempt "Internet access" to address concerns long raised by state and local officials about the definition's scope.

ITFA Does Not Prohibit Taxation of Physical Goods Sold Over the Internet

The primary effect of the Internet Tax Freedom Act is to prohibit states and localities from applying their taxes to Internet access services — such as a sales tax on the $20 monthly fee that Verizon charges its customers for high-speed access. This is the focus of the debate.

There is often confusion about whether ITFA also bars state and local governments from applying their sales taxes to physical goods ordered over the Internet — such as a book purchased from Amazon. ITFA does *not* prohibit a sales tax on such a transaction, assuming that the tax would equally apply to the item if purchased in a local store.

Most people are aware, however, that state and local sales taxes often are *not* charged on goods ordered over the Internet. This is due to a 1992 U.S. Supreme Court decision that held that a state cannot require an out-of-state merchant to charge sales tax to the state's residents unless the seller has a physical presence, such as a warehouse or call center, within the state's borders. Even if the merchant is not required to charge the tax, the purchaser is legally obligated to self-remit the tax to the state revenue department. Of course, many purchasers are unaware of this requirement or choose to ignore it.

The Effects on State and Local Government Revenues of a Permanent ITFA

Making ITFA permanent and eliminating the grandfathering of existing taxes on Internet access could have three distinct, adverse impacts on the ability of state and local governments to raise revenues needed to fund health care, education, public safety, and other critical services:

- **The current, extremely broad definition of "Internet access" in ITFA arguably encompasses virtually all goods and services *delivered over* the Internet. Keeping this definition in a permanent ITFA could prevent states and localities from extending their conventional sales taxes to online music, movies, games, television programming, and similar products.**

  A serious flaw in ITFA's original definition of tax-exempt "Internet access" potentially would allow sellers of valuable "digital content" and similar services delivered over the Internet to avoid any state/local sales taxation of such content and services. Two separate readings of ITFA's "internet access" definition lead to such a conclusion.

  First, many sellers of such content, even if they do not truly provide an end-user with a connection to the Internet, arguably are selling "Internet access" as defined in ITFA: "a service that enables users to access content, information, electronic mail, or other services offered over the Internet. . ." For example, the "Rhapsody" service sold by RealNetworks, Inc. streams an unlimited amount of music on demand to a subscriber for a fixed monthly fee. Real Networks literally is providing "a service that enables users to access content. . . over the Internet."

Accordingly, the company could take the position that the Rhapsody service is tax-exempt "Internet access" under ITFA's definition and refuse to charge tax on it.[1]

Second, the definition of "Internet access" includes "access to proprietary content, information, and other services as part of a package of services offered to consumers." Nothing in this definition places any limits on the type or quantity of such "content, information, and other services." Thus, any Internet access provider could achieve tax-exempt status for such content and services by "bundling" them with "Internet access" as conventionally understood and selling the package for a single, combined price.

States and localities likely receive hundreds of millions of dollars in annual revenue from their sales taxation of conventional cable TV service and the hard-media versions of music, movies, software, and computer games sold in stores. As is illustrated by the rapid growth of Apple Computer's iTunes music service, the majority of such "digital content" is likely to be distributed over the Internet eventually. The same is likely with respect to the majority of television programming, which in some parts of the country is already being distributed via so-called "Internet Protocol TV" (IPTV). Accordingly, a permanent ITFA with a definition that seems to encompass all online content and services and that places no limits on what a telecommunications or cable TV company bundles with tax-exempt Internet access is likely to lead to a serious long-term drain on sales tax revenues.

(See pp. 8-16 for an expanded discussion of this problem.)

- **Eliminating ITFA's grandfather clause could invalidate a wide array of state and local taxes currently paid by companies providing Internet access, such as sales taxes levied on their equipment purchases.**

Eliminating ITFA's grandfather provision could have far-reaching, unintended consequences. ITFA defines a "tax on Internet access" as "a tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access." Because of the inclusion in the definition of taxes on Internet access *providers*, state and local officials have long been concerned that Internet access providers could take the position that a wide variety of taxes to which all types of businesses are subject constitute *indirect* taxes on Internet access services and are therefore banned by ITFA. Acknowledging the legitimacy of such concerns, language was added to ITFA in 2004 expressly "carving-out" from the definition of a "tax on Internet access" four categories of taxes imposed on Internet access providers — taxes on "net income, capital stock, net worth, or property value." However, this list by no means covers all of the types of taxes Internet access providers may have to pay. For example, it does not include sales taxes on computer servers purchased by such companies or state unemployment compensation taxes.

The very limited coverage of the tax carve-out language added to ITFA in 2004 did not overly-concern state and local officials, because virtually all of the significant taxes on Internet access providers potentially at risk had been enacted prior to 1998. Accordingly, ITFA's general grandfather clause served as a back-stop to the explicit protection added in 2004. With the grandfather clause eliminated, however, all state and local taxes on Internet access providers other than the four types carved-out in the 2004 provision could be at risk. It is not at all clear that states could convince a court that any taxes except for the four types explicitly named are still legal when applied to an Internet access provider. If anything, the fact that *some* taxes on Internet access providers were explicitly preserved might create an inference on the part of a court that Congress intended to ban all *other* taxes on providers.

(See pp. 16-19 for an expanded discussion of this problem.)

- **If ITFA's grandfather clause were repealed, state and local governments in nine states would lose existing revenues from currently protected taxes on Internet access services.**

  If ITFA's grandfather clause were repealed, Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington, and Wisconsin — and some of their local governments — would lose collectively between $80 million and $120 million in annual revenue flowing from previously-grandfathered taxes on Internet access services. These figures were developed by the Congressional Budget Office at the time ITFA was last renewed in 2004 and are still believed to be a reasonably accurate estimate of the current *direct* revenue loss from eliminating the grandfather provision.[2] Revenue losses of this magnitude are sufficient to trigger the provisions of the Unfunded Mandates Reform Act of 1995, which classifies federal preemptions of state and local taxing powers as an unfunded mandate. Most of the taxes directly affected by repeal of the grandfather clause are conventional state and local sales taxes that apply to a wide array of goods and services in addition to Internet access.

  In and of itself, the *direct* impact of repeal of the grandfather clause on revenue in the affected states is not significant. In combination with the other impacts discussed above, however, state finances would be adversely affected. Due to balanced-budget requirements, these nine states and their affected local governments would either have to reduce state services or increase other taxes to compensate for the lost revenue.

A Permanent Extension of ITFA Is Unnecessary and Unwarranted

Apart from the damage that would be done to state and local government finances, there is no justification for either eliminating ITFA's grandfather clause or making ITFA permanent:

- Ten years ago, Internet commerce was still in its infancy, and high-speed Internet access was just beginning to become available to individual households. In considering ITFA, Congress needed to balance the interests of state and local governments in being able to finance essential services and its desire to encourage the development of the Internet industry. Even in 1998, Congress decided that striking that balance entailed grandfathering existing taxes and prohibiting new taxes on Internet access only temporarily.

  Today, almost 70 percent of American households subscribe to Internet access services, and hundreds of billions of dollars worth of commerce is done over the Internet annually. These facts raise significant questions as to whether there is any need to continue treating the Internet as an "infant industry" and exempting it from state and local taxes that other industries must

Sales Taxes Are a Critical Revenue Source for State and Local Governments

Sales taxes are a vital source of revenue for state and local governments. The possibility that ITFA might interfere with applying normal sales taxes to online "digital content" and services in the future creates a major risk for the ability of states and localities to provide the education, infrastructure, public safety, and health care services for which they are responsible. Sales taxes comprised 24 percent of combined state and local tax receipts in 2005. They represented 33 percent of state taxes and 11 percent of local government taxes.

Sales taxes are especially important to Florida, Nevada, South Dakota, Washington, and Wyoming, which have no state income taxes, and to New Hampshire and Tennessee, which have only limited income taxes. In Florida, for example, sales taxes provide 34 percent of all state and local tax receipts. Sales taxes are also important to local governments in many states because the only other significant tax they are permitted to levy under state law is the property tax.

The few states that were grandfathered under ITFA to continue taxing Internet access are often criticized for targeting or singling-out Internet access for taxation. This accusation is inaccurate. Sales taxes are intended to be broad taxes on consumption, on what people spend their money on. Grandfathered states typically apply their sales taxes equally to cable TV and Internet access, for example. Indeed, non-grandfathered states are discriminating *in favor of* Internet access; it is arguably unfair to impose a sales tax on a person who chooses to allocate $40 of her monthly budget to cable TV service while exempting someone who chooses to spend $40 of her budget on high-speed Internet access.

If ITFA is to be extended, it is critically important that its definition of tax-exempt "Internet access" be amended to ensure that digital goods and online services that do not constitute true Internet access — that is, a *connection* to the Internet — cannot be considered sales-tax-exempt. Otherwise, the inequity already created by the tax exemption for Internet access described above could be compounded further: people who choose to rent DVDs or video games at the local video store will pay sales taxes, while people who download them online will be tax-exempt.

pay. But even if Congress wishes to renew ITFA, surely the Internet's 2007 vitality demands that it be granted tax treatment no more favorable than what it received in 1998 — temporary protection, with pre-1998 taxes still grandfathered.

- Making ITFA permanent would represent a fundamental breach of faith with state and local government officials. As documented in the text box on the next page, when ITFA was first considered in 1997-98, Internet industry representatives and the adopting committees alike disavowed any intention to make the Internet a permanent "tax-free zone." ITFA has repeatedly been described as a "moratorium" on state and local taxation. A "permanent moratorium" is a contradiction in terms.[3]

- Studies by both the Government Accountability Office and economists at the University of Tennessee find that the existing, low taxes on Internet access in the grandfathered states have not had an adverse impact on either household decisions to purchase Internet access services ("uptake") or industry decisions concerning where to make "broadband" (high-speed) Internet access services available ("deployment").[4] Both studies use statistical techniques that correct for differences between the taxing and non-taxing states in income and education levels, population density, and other factors that might affect Internet uptake (by consumers) and deployment (by providers). The studies find that the existing taxes on access in the grandfathered states have

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 defined 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 ITFA 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*." [Emphasis added.]

- The House Judiciary Committee report on ITFA stated: "[T]his is the appropriate time. . . to pause and examine the welter of issues raised by electronic commerce and to create a coordinated and rational subfederal tax structure. For this proposition, the Committee finds support in the Clinton Administration's *Framework for Global Electronic Commerce*. That document . . . recommends that '[b]efore any further action is taken, states and local governments should cooperate to develop a uniform, simple approach to the taxation of electronic commerce, based on existing principles of taxation where feasible.'"

Now, ten years later, the fears of state and local government representatives about this "temporary time-out" have been substantiated. After having made little 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 again considering permanently banning taxes on this service. States and localities may continue to impose their sales taxes on long-distance phone calls and faxes, voice mail, cell phone text messages, cable TV, and a host of other services for which Internet access and e-mail are close substitutes. Permanently enshrining such tax discrimination in federal law would be unwise.

TABLE 1: RATES OF BROADBAND ADOPTION AND TAXATION IN COUNTRIES WITH HIGHER BROADBAND ADOPTION THAN THE UNITED STATES		
Country	**Broadband Subscribers Per 100 Inhabitants, 2006**	**Rate At Which Broadband Subscription Fees Are Taxed, 2005**
Denmark	31.9	25.0%
Netherlands	31.8	19.0%
Iceland	29.7	24.5%
Korea	29.1	10.0%
Switzerland	28.5	7.6%
Norway	27.7	25.0%
Finland	27.2	22.0%
Sweden	26.0	25.0%
Canada	23.8	6.0% to 16.6%, depending upon province
Belgium	22.5	21.0%
United Kingdom	21.6	17.5%
Luxembourg	20.4	15.0%
France	20.3	19.6%
Japan	20.2	5.0%
United States	19.6	Generally 0%. In 9 states, 4.0% to 8.9%

Sources: Organization for Economic Cooperation and Development, *OECD Broadband Statistics to December 2006*, April, 2007, available at www.oecd.org/sti/ict/broadband; OECD, *Consumption Tax Trends, 2006*, January 2007, Tables 3.5, 3.7, and 3.8. To the best knowledge of staff at the OECD, Internet access services are taxed at the standard (highest) value-added tax or other general consumption tax rate in all OECD countries (email communication to the author from Stéphane Buydens, Administrator, VAT Unit, OECD Centre for Tax Policy and Administration, May 28, 2007).

not had statistically-significant impacts on either uptake or deployment. (See the Appendix for a more detailed description of both studies.)

- All of the 14 developed nations that have achieved a higher rate of household broadband adoption than has the United States subject Internet access services to the normal consumption taxes that apply to household purchases. These taxes are often imposed at rates that are 2-3 times higher than typical combined state and local sales tax rates; indeed, the world leader in broadband penetration, Denmark, taxes Internet access at a 25 percent rate. (See Table 1 above.) Clearly (and as verified in the GAO and University of Tennessee reports cited above), non-discriminatory taxation of this service is consistent with healthy rates of household broadband adoption.

It is questionable whether *any* extension of ITFA is warranted. Originally justified on the grounds of preventing alleged tax discrimination against the Internet, ITFA has instead fostered discrimination in favor of it. A business that pays $50 per month for a conventional phone line attached to a fax machine pays state and local taxes on the phone line and long-distance calls; a business that pays $50 per month for a DSL phone line used to transmit as e-mail attachments the exact same kinds of documents is exempt from state and local taxes on the DSL line. A person who sends a message as a conventional cell phone text message on a Blackberry pays state and local taxes on the message; if she sends the exact same message on the exact same phone as an e-mail or Internet “instant message” the transmission is tax-exempt. Such a state of affairs can hardly be characterized as “technological neutrality” — the long-time mantra of many ITFA proponents.

The Choice Confronting Congress

There are three choices that Congress could make this year:

- Congress could enact the Wyden-Eshoo bill (S. 156/H.R. 743), with its permanent prohibition in all states of the taxation of “Internet access” — as expansively defined in ITFA.
- Congress could enact the Carper-Alexander bill (S. 1453), with its temporary ITFA extension that preserves the current grandfather clause and begins to address the problems with ITFA’s definition of “Internet access.”
- Congress could allow ITFA to expire and return the decision as to whether to tax Internet access services to the discretion of state and local elected officials.

The best policy would be to allow ITFA’s prohibition on taxation of Internet access to expire. If that is not possible, the Carper-Alexander bill is the better of the remaining two options. Carper-Alexander will fully maintain the existing ITFA moratorium on state and local taxation of Internet access for four more years. It will preserve the grandfather clause, ensuring that routine taxes on Internet access providers will not be unintentionally invalidated. It will, for the first time since 1998, reform the definition of Internet access and limit it to its original conception of encompassing a direct connection to the Internet and closely associated services (like email and instant-messaging). It will compel Congress to reevaluate both ITFA’s continuing relevance and its impact on state and local governments in 2011 in light of what seems likely to be a very different Internet economy in existence at that time.

The Unaddressed Problem of ITFA’s Expansive Definition of “Internet Access”

The most immediate and certain impact of ITFA was the prohibition of new state and local sales taxes on customer fees for Internet access services (for example, Verizon’s current $19.99 monthly charge for “digital subscriber line,” or DSL, Internet access). However, flawed drafting of ITFA's “Internet access” definition has created a loophole. If that definition is made permanent, it is likely to block future state and local 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 the ability to view and interact with World Wide Web pages and to send and receive e-mail and instant messages. 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 could potentially include downloaded computer software, music, movies, audio books, TV programming, games, magazines, information databases, and similar "digital goods." The "other services" included in the definition could include on-line dating services, music "streaming," multi-player gaming, file storage, photo sharing, and personal web page hosting, among many others already available or under development.

At present, a minority of states tax digital "goods" and services if they are delivered over the Internet. Computer software is the most widely taxed such product. Yet 17 of the 45 states with sales taxes still do not impose them on downloaded software even though these 17 states do tax software sold on a physical disk. Only 19 states tax any type of downloaded "information" other than computer software.[5]

The fact that most states do not currently impose their sales taxes on downloaded music, movies, games, and other "proprietary content" probably has had a relatively minor impact on state and local sales tax revenues until recently. However, the revenues forgone are likely to grow significantly within a few years:

- An estimated 47 percent of American adults already have high-speed Internet connections at home, and that share will undoubtedly continue to increase steadily.[6] A high-speed or "broadband" connection is necessary to access most online multimedia content in a practical manner.

- Mobile Internet access through Blackberries and other types of "smart phones" is growing even more rapidly. Nielsen Media Research estimated that more than 33 million people used mobile phones to access the Internet during 2006.[7]

- Companies are developing a wide array of services to deliver digital content to customers with high-speed connections. Already, for example, there are at least eight services selling downloaded music and seven selling downloaded movies.[8]

- It seems quite likely that most forms of software, information, and entertainment that are capable of being distributed in digital form will be widely sold and delivered over the Internet within five years. Consumption of such services will grow as the high-speed connections needed to access multi-media content proliferate and the industry develops simpler technologies for viewing such content on TV screens.[9]

- The number of mobile Internet-based services is also likely to increase, ranging from television shows viewable on smart phones to services that identify particular restaurants or other types of businesses near a person's current location.[10]

Eventually, most states and localities that now tax information and entertainment when it is sold as a printed magazine, audio CD, or DVD, or when it is delivered as conventional cable TV, will decide to tax the Internet-delivered versions as well. They will have little choice. As such services displace currently-taxable forms of consumption, state and local sales tax bases will erode if the base is not modernized to encompass new forms of household spending. However, if ITFA's prohibition on taxation of "Internet access" has been made permanent in its current form, 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: 1) true "Internet access" providers, and 2) other companies that do not themselves provide customers with connections to the Internet but that sell digital goods and services that are *delivered* over the Internet.

Content "Bundling" by True Internet Access Providers

True Internet access providers like Verizon, Comcast, and AT&T clearly have free rein under ITFA's "Internet access" definition to sell proprietary content and online services free from sales taxes by "bundling" them with Internet access service as conventionally understood and selling the package for a single price. As currently written, ITFA's definition of tax-exempt "Internet access" places no limits whatsoever on the quantity or types of "proprietary content, information, and other services" that Internet access providers can include "as part of a package of services offered to users. . . ." In recent congressional testimony, the Government Accountability Office asserts that the definition allows only "reasonable" bundling.[11] Such a limitation clearly does not appear in ITFA. More tellingly, the GAO statement provided no guidance whatsoever as to how the line could be drawn between what is and is not "reasonable." This omission occurred despite the availability of numerous real-world examples of what already is being included in tax-exempt Internet access services. Furthermore, as discussed in the text box on the next page, anti-bundling language was added to ITFA in 2004, but it does not prevent bundling of services *delivered over the Internet*.

Three recent *Wall Street Journal* articles confirm that content bundling is a key strategy that the major broadband Internet access providers are implementing to drive demand for their services and thereby recoup very costly investments in their high-speed networks:

- "Verizon executives see the new [high-speed, fiber-optic] network, called FiOS, as a chance to reposition the telecom giant into more of an Internet-based company — one that can supply a raft of digital services under one roof. The plan is to offer a host of new services to run on FiOS, some of which are still in the development stages. The company is targeting everything from online games and local news shows to movie downloads and music-mixing sites. . . . 'We're not going to hit a home run' with any one new service or product,' says Robert Ingalls, Verizon's executive vice president and chief marketing officer, who is helping oversee the initiative. 'We've got to have *hundreds of applications and capabilities*.'"[12] [Emphasis added.]

- "Telecom giants such as Comcast Corp., Verizon Communications Inc., and AT&T have started to launch a wide range of Web sites that offer the latest in videos, games and other features that work best with high-speed connections. . . . Comcast has loaded up its home page, Comcast.net, with a wide range of video content, making it the 41st most visited domain on the Web. . . . Comcast also has some of the most ambitious plans when it comes to launching Web sites and trying to integrate them into the company's other video and telecommunication services. . . . This summer, Verizon plans to launch yet another site, VerizonSurround, which will offer news, gaming, sports, music, movie trailers and other features that highlight the value of broadband. . . . A Verizon spokeswoman says the company plans to *keep some content exclusive to its broadband customers* and leave the rest open."[13] [Emphasis added.]

ITFA's New Anti-bundling Provision Doesn't Apply to Content/Services *Delivered Over* the Internet

Concerns have long been raised by state officials about the ability of Internet access providers to obtain tax-exempt status for sales of digital content and online services under ITFA by bundling them with true Internet access services and selling the package for one combined price. In response, some e-commerce industry representatives have cited a 2004 amendment to ITFA that they allege solves this problem.

The 2004 amendment reads as follows:

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

This language does not solve the bundling problem. It only prevents the bundling with Internet access of "charges for telecommunications services or other charges that are subject to taxation," that, is, charges for goods and services that *do not themselves constitute "Internet access."* As discussed in the body of the report, digital goods and services delivered over the Internet *do* likely satisfy the definition. Again, ITFA's definition of "Internet access" is:

> 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. . . .

Read literally, this definition places no limit whatsoever on the types of "proprietary content, information, and other services" that can be included in a "package of [Internet access and other] services offered to users". Indeed, if "offered over the Internet" were interpreted to mean "offered *for sale* over the Internet," then an Internet access provider could sell a package including true access service and a voucher for $50-worth of dry cleaning services and claim that the latter thereby became tax exempt. Obviously, a court is unlikely to give such an absurd reading to the statute. However, it seems quite likely that a court would seek to place some limits on bundling by interpreting "offered over the Internet" to mean "made available over the Internet." ("Make available" is one definition for "offer" in the Merriam-Webster dictionary.)

In short, the most restrictive interpretation that a court is likely to give to the types of "proprietary content, information, and other services" that are included in the definition of "Internet access" when bundled with the service of connecting an end-user to the Internet is that the content/information/services must actually be *delivered* over the Internet. Under such an interpretation, the 2004 anti-bundling amendment to ITFA serves as a back-stop to prevent bundling of services that are not delivered over the Internet (like conventional cable TV). Nonetheless, the amendment provides no solution to the fundamental "bundling" problem that results from ITFA's Internet access definition. Once again, the problem is that the definition places no limits on the amount or types of *digital* goods and *online* services that an Internet access provider can render tax-exempt by selling them with "true" access — a connection to the Internet — for one combined price.

- "[A] turf war is looming between [wireless phone companies and cellphone manufactures], as lucrative new services such as video, games, and maps move onto mobile devices. Each camp wants to control the new offerings, and the gusher of revenue they could produce. . . . As the Web goes wireless, [cellular carriers] want to prevent a repeat of what happened when the Internet first arose. They provided access to it, but the businesses that thrived were others . . . that provided services over the Net. Carriers were reduced to what the industry calls 'dumb pipes.' To avoid that plight, wireless companies tightly control what services cellphone consumers can access, their cost, and who displays what on cellphone screens. . . . [For example], the carrier Verizon Wireless declined to offer its subscribers Apple's forthcoming

> iPhone, according to people familiar with the matter. Verizon wanted it to include Verizon's own music and video service along with Apple's, an arrangement unacceptable to Apple. . . ."[14]

In short, Internet access providers plan to provide more and more online services over their new high-speed networks. In light of these plans, states and localities are likely to suffer increasingly severe sales tax erosion in the years ahead if any digital good or service that an Internet access provider bundles with a true Internet access service and sells for one price thereby becomes tax-exempt.

The Threat to State and Local Revenues from Bundled "Internet Protocol Television"

State and local revenue losses from a permanent ITFA would be even greater if the major telephone companies that provide broadband Internet access were able to convince the courts that television services delivered using the Internet Protocol ("IPTV") are also encompassed in the definition of "Internet access." AT&T is already rolling-out its IPTV service, U-Verse TV, in many major cities in its service area to compete with incumbent cable TV providers. Verizon is doing the same with its FiOS TV:

> Verizon has built its Fios TV service on what's considered a hybrid network. It uses IP [Internet Protocol] to deliver video on demand and games. But it uses more traditional cable-like infrastructure to deliver broadcast TV. . . . Still, [Verizon Chief Technology Officer Mark Wegleitner] admitted that IP inherently provides more flexibility than traditional video infrastructure. And because of that fact, Verizon will migrate more video services onto IP over the next three to four years. *Eventually, he said the entire Fios TV infrastructure will run over an IP network, much like what AT&T is offering today.*[15] [Emphasis added.]

Although the IPTV services of Verizon and AT&T are delivered over private fiber-optic networks, not the "public Internet," they are or eventually will be linked to the Internet to permit customers to access other Internet services and content (such as videos from the popular YouTube site). Indeed, AT&T's U-Verse TV already allows subscribers to access personal photographs stored on Yahoo's Web site. Since these services use the Internet Protocol networking "language" to deliver video programming, and since the companies' networks are linked to the public Internet, courts could easily interpret them to be a form of tax-exempt "Internet access" for the purposes of ITFA. With one forecast estimating that IPTV will be in 11 million homes within four years, such an interpretation of ITFA could be costly for the roughly half of states and numerous local governments that currently tax conventional cable TV service.[16]

Could Any Content or Service *Delivered* over the Internet Qualify as "Internet Access"?

A wide array of companies in addition to true 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 digital content over the Internet arguably is providing "Internet access" under the first part of ITFA's definition read literally. For example, it would seem that a company that has a Web site at which music may be downloaded, such as iTunes, is "providing a service that enables users to access content . . . offered over the Internet." In short, any company delivering digital goods or services over the Internet has a strong legal case that it does not have to charge sales tax on its receipts — even if the company is not an Internet access provider that owns the cable, DSL, telephone, or wireless infrastructure that actually connects customers to the Internet. In any case, acquiring enough such infrastructure to qualify as an "Internet access provider" under ITFA need not be expensive. Given that the provision of e-mail accounts is recognized as a key component of "Internet access," a company selling music downloads on the Web would arguably qualify as an Internet access provider simply by offering a Web-based e-mail service that requires no physical infrastructure other than a relatively inexpensive Web-mail server. Once deemed to be an access provider, such a company would be free to bundle its content with its email service and sell the content free from sales taxes. If a company has valuable content to sell, incurring modest costs to qualify as a seller of "Internet access" would be well worth the investment.

In sum, if the ITFA moratorium were made permanent with no change in its "Internet access" definition, state and local governments would be at substantial risk of being unable to apply their sales taxes to a variety of information- and entertainment-oriented products and other services that are already being widely sold and delivered over the Internet and that will increasingly displace their physical world counterparts in coming years. This would punch another large hole in the sales tax base of states and localities. It would also compound the already-substantial tax-based competitive disadvantage of Main Street retailers vis-a-vis their online competitors.[17] Legislation that was originally justified as a means of preventing tax discrimination against online sale of goods and services could instead 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 — would continue to pay sales taxes. At the same time, more affluent Internet users would be able to avoid sales taxes by buying their information and entertainment services in forms delivered over the Internet.

Are Companies *Already* Interpreting ITFA as Barring Taxation of Online Content?

A large number of companies are already selling various types of online content and services, and some clearly are charging applicable state and local sales taxes on them. For example, Apple Computer's well-known iTunes online music store charges sales tax on downloaded songs in 19 states.[18] Likewise, although AT&T sells its U-Verse Internet protocol television service in a bundle with high-speed Internet access, it charges applicable taxes on the TV service. Accordingly, it could be argued that the preceding analysis of the potential for ITFA's Internet access definition to be interpreted in a way that would relieve both companies of an obligation to charge these taxes has no basis in reality. If ITFA *could* be interpreted in this way, surely these companies *would* already be interpreting it this way in order to avoid having to add tax to their customers' bills.

Such an argument ignores two issues. First, ITFA continues to contain a sunset date. Second, many members of Congress who have voted for ITFA in the past likely would not have supported it if they knew that it would be interpreted to prevent taxation of IPTV, online music, and similar services. Opponents of ITFA have raised concerns about the potential impact of ITFA's broad definition of Internet access from the very beginning of the debate on this legislation in 1997. With ITFA not yet permanent, members of the e-commerce industry have had a strong interest in not legitimizing these arguments by giving opponents concrete examples to cite of services that are escaping taxation because of such an expansive interpretation of the law.

Were the sunset date to be removed and ITFA made a permanent prohibition, however, it is almost inevitable that some companies would test the law's limits.[19] As discussed above at length, ITFA's language clearly provides a substantial basis upon which to build a legal case that many sellers of online content and services do not have to charge applicable state and local sales taxes. It would take only one or two court cases immunizing such a seller from tax collection responsibility on the basis of ITFA to unleash a wave of companies claiming tax-exempt status based on the same legal analysis. If one company declared itself free of an obligation to charge sales tax, its competitors might well feel compelled to take the same position to avoid losing sales.[20]

Were this scenario to play out after a sunset date has been eliminated from ITFA, it could be very difficult to correct. Congress has enacted several laws permanently preempting state and local taxing powers. One of them, the so-called "4-R Act" restricting state and local taxation of railroads, has had serious, unintended adverse consequences for states and localities.[21] Another one of these laws — Public Law 86-272, which restricts state corporate income taxation — has spurred substantial amounts of litigation during its nearly 50-year history because it was so vaguely drafted. Notwithstanding the serious problems that these two ITFA-like laws have caused, Congress has never even held an oversight hearing on them, let alone considered fixing them. Based on this track record, state and local government representatives would have a high hurdle to overcome in convincing Congress to undo any damage resulting from court cases interpreting ITFA's Internet access definition as encompassing online content and services. Moreover, legislation aimed at narrowing ITFA back toward its stated goal of preventing taxation of true Internet access services likely would have to achieve a filibuster-proof majority in the Senate.

It may well be the case that companies other than true Internet access providers are, in fact, already taking the position that ITFA relieves them of an obligation to charge sales taxes on their sales of "digital goods" and Internet services. Many online companies do not charge sales tax on such goods and services in *any* state. Assuming that the company has at least a few customers in *every* state, there are three reasons why such a company might not be charging sales tax anywhere:

- The company (correctly or incorrectly) could be interpreting state sales tax laws as not applying to the particular types of goods or services it sells.

- The company (correctly or incorrectly) could be taking the position that it is not obligated to charge sales tax in the states in which the good or service *is* taxable under state law because the company does not have a "taxable nexus" in such states. The U.S. Supreme Court has ruled that a company cannot be required to charge and remit sales tax in any state in which it does not have a "physical presence."

- The company could be taking the position that ITFA does indeed relieve it of the obligation to charge sales tax.

It usually is not difficult for an outside observer to determine in which states an online merchant is and is not charging sales tax; companies frequently explicitly name the states on their Web sites. It is impossible, however, for an outside observer to determine whether one, two, or all three of the possible explanations for the lack of sales tax collection actually applies to a particular company. Such information is only available to those in the company responsible for its sales tax compliance. Thus, it could well be true that some — perhaps many — companies are not charging sales tax in states in which they have a taxable nexus and in which what they sell is taxable solely because they have been advised by their tax attorneys that ITFA relieves them of such an obligation.

Take, for example, RealNetworks, Inc.'s Rhapsody online music service. Rhapsody does not charge sales tax anywhere; in contrast, and as noted above, Apple's iTunes service charges sales tax in 19 states.[22] RealNetworks is headquartered in Washington state, which should be sufficient to give it a taxable nexus there. Apple interprets Washington's sales tax law as requiring iTunes to charge sales tax on its sales of music downloads there. Now, RealNetworks' tax lawyers may have a different interpretation from Apple with regard to the taxability of music downloads in Washington. Or, RealNetworks' lawyers may believe that whatever subsidiary of the company sells Rhapsody does not have nexus in Washington despite the parent company's being headquartered there.[23] Or, in fact, the lawyers could be interpreting ITFA as immunizing the company from a sales tax collection obligation in Washington. There simply is no way of knowing. Those who raise concerns about the possibility that ITFA's Internet access definition could be interpreted to block taxation of online content and services have been challenged by ITFA supporters to provide concrete examples. Just because state and local officials cannot prove that this already happening does not mean that it is not — as the RealNetworks example illustrates.

Options for Addressing ITFA's Problematic "Internet Access" Definition

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 is accepted that tax-exempt "Internet access" service includes any content beyond perhaps a bare-bones "home page" and any services beyond e-mail and instant messaging, 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 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 four basic options:

- Allow ITFA's prohibition of taxes on Internet access to expire, and once again allow sales taxation of "Internet access" and whatever is bundled with it if states and localities so choose. Congress could still mandate that the taxation of Internet access and online content and services be done in a non-discriminatory manner. For example, Congress could require that Internet access service not be subjected to tax at a higher rate than the generally-applicable sales tax rate in the jurisdiction.

- Prevent all tax-exempt content bundling by redefining Internet access as the service of providing a *connection* to the Internet, together with closely-related Internet communications services such as email and instant messaging. If Internet access providers wished to continue providing more than a de minimis amount of content to their customers, they would have allocate a portion of their monthly charge to such content. States and localities would have the right to tax the allocated amount. This is the approach taken by the Carper-Alexander "ITFA Extension Act of 2007," S. 1453. This approach also would prevent content-selling companies that do not actually provide a connection to the Internet, such as RealNetworks, from claiming that their online services nonetheless satisfy ITFA's definition of "Internet access."

- Prevent unlimited tax-exempt 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 IPTV. As in the previous option, Internet access providers would have to identify the portion of their monthly charge that was for these specific categories of content, and states and localities would be free to tax the allocated amount. This is an imperfect solution, because drawing and enforcing such lines would be arbitrary, and because the law likely would be several years behind the content and services that were actually being delivered over the Internet. Nonetheless, a step in this direction was taken when ITFA was renewed in 2004 and all "voice over Internet protocol" telephone services were "carved out" from tax-exempt Internet access.

- 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. 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.[24]

Various forms of options two, three, and four have been put forward by state and local government representatives many times in acknowledgment of the fact that allowing ITFA to expire was unacceptable to many members of Congress. Unfortunately, Congress has not considered these options to date. If ITFA is made permanent with no change to the Internet access definition, it would seem that serious sales tax base erosion is in the offing within a few years.

Repeal of ITFA's "Grandfather Clause" Threatens to Invalidate — Unintentionally — Numerous Non-discriminatory Taxes on 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." The purpose of this provision was to authorize about a dozen states that were taxing Internet access services prior to that date to continue doing so. The Wyden-Eshoo "Permanent Internet Tax Freedom Act," (S. 156/H.R. 743) would repeal the grandfather clause. The goal of repeal is to ensure that *no* state or local government may ever again tax Internet access services. In actuality, however, repeal of the grandfather clause is likely to have more far-reaching — and unintended — impacts on state and local taxes. Repeal threatens to invalidate the application to Internet access providers of a wide variety of taxes that apply to most or all businesses, because ITFA's definition of a "tax on Internet access" expressly includes taxes on *providers* of Internet access services and not just consumers of such services.

Why Repealing the Grandfather Clause Threatens General Business Taxes

When ITFA was up for its second renewal in 2003, repeal of the grandfather clause was under serious consideration. At that time, state and local government organizations expressed concern that if the clause were repealed, Internet access providers could stop paying property, income, and many other state and local taxes for which they are liable and seek to convince a court that such taxes are barred by ITFA because they represent *indirect* taxes on Internet access services. The grandfather clause prevents most such claims at present, because even if such taxes do constitute indirect taxes on Internet access, they are permitted if they were in force before October 1, 1998. Nearly all existing state taxes on corporate profits, for example, were in effect well before 1998.

The concerns expressed in 2003-04 about the potential consequences of repealing the grandfather provision were — and remain — fully justified:

- 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 direct and indirect taxes on online services. The fact that ITFA as ultimately enacted bars "taxes on Internet access" and not just "*direct* 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." Internet access providers could use such language to claim, for example, that state and local sales taxes on the computer and telecommunications equipment they purchase constitute "indirect" taxes on the Internet service they sell, because the companies must recover those costs in what they charge for access service in order to stay in business.

- ITFA 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, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access." The fact that "tax" is defined so broadly in ITFA and that a "tax on Internet access" *includes* taxes on a "provider of Internet access" opens the door to claims that general business taxes imposed on Internet access providers constitute prohibited indirect taxes on "Internet access" services.

- Committee report language expressing a contrary intent would likely be of little or no value to state and local governments in defending taxes challenged by Internet access providers as indirect taxes on Internet access services under ITFA. Unlike the situation with a law that changes federal taxes, 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 restricting state and local taxation of railroads, provides powerful validation of concerns about the potentially far-reaching impact of repealing 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.[25]

Why New Language Preserving Some Business Taxes Doesn't Solve the Problem

In 2004, the sponsors of proposed legislation that would have made ITFA permanent and repealed the grandfather clause indicated that it was not their intention to bar property, income, and similar general business taxes applicable to Internet access providers. In tacit acknowledgment of the concerns raised by state and local officials about the potential consequences of repealing the grandfather clause, they agreed to add to ITFA the following statement:

> The term 'tax on Internet access' does not include a tax levied upon or measured by net income, capital stock, net worth, or property value."

That statement remained in ITFA when it was renewed in 2004, even though the grandfather clause ultimately was also retained.

This year, ITFA proponents again propose to make the law permanent and to repeal the grandfather provision. Once again, the repeal of the grandfather language threatens to invalidate general, non-discriminatory business taxes on Internet access providers on the grounds that such taxes constitute indirect taxation of Internet access services. Although the statement added to ITFA in 2004 protects from legal challenge several of the most significant general business taxes for which Internet access providers are potentially liable, it is by no means exhaustive. With the "backstop" of the grandfather clause gone, many additional state and local taxes on Internet access providers would be at risk. The threatened state and local taxes include (but are not limited to):

- sales and use taxes imposed on purchases of goods and services by Internet access providers, especially purchases of computer servers, routers, fiber optic lines, and other telecommunications equipment directly used to provide Internet access services;

- general business taxes (other than the corporate income, capital stock, and net worth taxes protected by the 2004 amendment), including the Washington Business and Occupation tax, the New Hampshire Business Enterprise Tax, and business license taxes imposed by local governments in numerous states;

- payroll taxes, for example, state unemployment compensation taxes;

- real estate transfer taxes;

- gasoline taxes.

With respect to the preservation of these types of taxes, the new 2004 ITFA language aimed at protecting corporate income and property taxes could actually be harmful. The fact that some taxes on Internet access providers were explicitly preserved might create an inference on the part of a court that Congress intended to ban all *other* taxes on providers.

In sum, if ITFA's grandfather clause were to be repealed, a wide variety of general state and local business taxes applicable to Internet access providers could be held by the courts to be barred indirect taxes on the service itself. If Congress wishes to eliminate that risk, it does not appear to be realistic to continue the approach taken in 2004 and explicitly "carve out" those taxes from ITFA's definition of a "tax on Internet access." There simply are too many potentially-affected taxes. The practical approach to avoiding unintended consequences is to preserve the grandfather clause. The grandfathering of modest taxes on Internet access services in a few states has had no adverse impact in those states on either the rate at which households subscribe to Internet access services or the decisions of Internet access providers to deploy high-speed, "broadband" services. (See the Appendix.) In light of that fact, Congress could choose to retain the grandfather clause without significant concern.

A Permanent ITFA Would Undermine the "Streamlined Sales Tax Agreement"

One final observation on ITFA's Internet access definition is in order. As discussed above, ITFA is often erroneously thought to be a prohibition on state sales taxation of physical goods sold over the Internet. The de facto tax exempt status of many such sales actually results from a 1992 Supreme Court decision that barred a state from requiring a merchant to charge sales tax to the state's residents if the merchant did not have a physical presence within the state's borders.

Many members of Congress support legislation that would reverse that decision, because it would remove a competitive price disadvantage for local stores that must charge sales tax to their customers. Such legislation was recently reintroduced by Senator Mike Enzi as the "Sales Tax Fairness and Simplification Act" (S. 34). It would authorize states that have implemented an interstate compact, the "Streamlined Sales Tax Agreement," to require most large Internet merchants to charge sales taxes on their interstate sales of goods. The Agreement harmonizes and simplifies state sales taxes in order to make it easier for remote catalog and Internet merchants to comply with state sales tax laws.

It may well be the case that some members of Congress support a permanent ITFA while simultaneously supporting the Enzi bill. However, the possibility that most online content could be sold free of sales tax due to ITFA's expansive Internet access definition runs counter to the goals of the Enzi legislation. For example, even if states were empowered to require Amazon.com to collect sales tax on books, CDs, and DVDs, Amazon might be able to avoid that result under ITFA by selling or renting these items as digital "downloads" over the Internet — a service it already offers.[26] Supporters of the proposed "Streamlined Sales Tax" legislation authorizing sales taxation of Internet purchases should appreciate that the goals of that legislation could be substantially undermined if the current ITFA definition of Internet access including "digital content" were made permanent.

APPENDIX
SUMMARIES OF TWO STUDIES OF THE IMPACT OF STATE TAXES ON INTERNET SUBSCRIPTIONS AND DEPLOYMENT

Has Internet Access Taxation Affected Internet Use?

Donald Bruce, John Deskins, and William F. Fox
Center for Business and Economics Research, University of Tennessee
Public Finance Review, *March 2004*

- "We find no empirical evidence that Internet access rates are lower in states that have levied a tax on Internet access, all else equal."

- The study examines whether the states that have taxed or still tax Internet access have lower rates of computer ownership, lower rates of household Internet access, or lower rates of Internet access among computer owners alone than do states that have never taxed Internet access. (Internet access was of any type, including both low-speed "dial-up" access and high-speed or "broadband" access.) By all three measures, the study found no statistically significant differences among the states that have and have not taxed Internet access after correcting for other factors that might theoretically explain differences in computer and Internet use, such as education levels and income.

- The study used several different statistical techniques to test the relationship between taxation of Internet access and the use of the Internet, and in no case found a statistically significant negative impact of taxes on Internet access.

- Their conclusion: "This study has attempted to understand whether Internet access taxation has affected Internet usage in any way. The United States has provided something of a laboratory for such an experiment given that 10 states have taxed Internet access at some point in recent history, whereas the other 40 have not. Regression analysis is conducted to compare Internet access, computer ownership, and Internet access conditional on computer ownership, between the taxing and non-taxing states. Results show that Internet access taxation has had no statistically discernible effect on any of those three measures. Furthermore, this general conclusion is found to be robust to a wide variety of econometric specifications."

- All three authors are professors of economics. Donald Bruce and William F. Fox in particular are prominent national experts on state taxation and its impact on the economy. Fox is a past president of the National Tax Association. The *Public Finance Review* is a leading, peer-reviewed journal in its field.

Broadband Deployment Is Extensive Throughout the United States, But It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas

U.S. Government Accountability Office, Report GAO-06-426

May 2006

- "The imposition of [Internet access] taxes was not a statistically significant factor influencing the *deployment* of broadband." [Emphasis added.] "Deployment" refers to the making available by a telecommunications or cable TV company of high-speed Internet access service in a particular geographic area.

- "The imposition of the tax was not a statistically significant factor influencing the *adoption* of broadband service [by consumers in their homes] at the 5 percent level [of statistical significance]. [Emphasis added.] It was statistically significant at the 10 percent level, perhaps suggesting that it is a weakly significant factor. However, giving [sic] the nature of our model, it is unclear whether this finding is related to the tax or other characteristics of the states in which the households resided." [Note: most peer-reviewed journals would reject the hypothesis that taxes affect consumer decisions to subscribe to broadband if results of the model did not satisfy a 5 percent test of statistical significance.]

- The study is based on a 2005 survey of approximately 1500 U.S. households by a private research firm that asked them whether *broadband* (DSL or cable) Internet access was available where they lived and whether they subscribed. GAO deleted some households from the sample if various types of other publicly-available data strongly suggested that the household had answered the availability question incorrectly. (For example, the household was deleted if it indicated that DSL was available at its location but the location actually was beyond the physical range at which DSL could, from a technological standpoint, normally be deployed.)

- In addition to the presence or absence of state taxation of Internet access services, the study correlated the availability (deployment) of broadband access at the survey respondent's location with such variables as urban/rural status, the distance to a major city, the age distribution of the population, population density, the local per-capita income, and a measure of the educational attainment of the population. In examining uptake of broadband services, the study first eliminated all households that did not have broadband service available. The decision to subscribe was then correlated with the number of competing broadband providers at the respondent's location; the respondent's income, race, age, college graduation status, household size, and occupation; whether there were children in the home; whether the home was in a urban or rural location; and, of course, whether or not Internet access service was taxed in the respondent's state.

- Again, at the standard for a test of statistical significance, whether or not broadband Internet access was taxed in the respondents' states did not affect either the decision of cable and telecommunications companies to deploy high-speed Internet access services or the decision of households to subscribe to them.

Notes

[1] Rhapsody does not, in fact, charge sales tax on its service in any state. (E-mails from two different representatives at Rhapsody Customer Support dated May 24, 2007 and June 6, 2007.) It is not known whether this is due to the company's interpretation of ITFA, an interpretation that its service is not subject to tax in any state under state law, and/or an interpretation that it is not obligated to collect any applicable state sales tax because it does not have a physical presence in any state sufficient to create a taxable "nexus." See the expanded discussion of this issue on pp. 13-15.

[2] Congressional Budget Office Cost Estimate on S. 150, Internet Tax Nondiscrimination Act, September 9, 2003.

[3] The Merriam-Webster dictionary defines a "moratorium" as "a legally authorized period of *delay* in the performance of a legal obligation or the payment of a debt" or, alternatively, as "a suspension of activity." A "suspension" is further defined as a "*temporary* abrogation of a law or rule." Emphasis added.

[4] United States Government Accountability Office, *Broadband Deployment Is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas*, report GAO-06-426, May 2006, pp. 21-22, 31-32, and Appendix III. Donald Bruce, John Deskins, and William F. Fox, "Has Internet Access Taxation Affected Internet Use?" *Public Finance Review*, V. 32, No. 2, 2004.

[5] See: www.vertexinc.com/taxcybrary/internet/tax_table.asp. Apple's iTunes music store charges sales tax on music downloads in 18 states and the District of Columbia. See: www.apple.com/support/itunes/store/buy/.

[6] John B. Horrigan, "Broadband Adoption: Trends," unpublished Powerpoint presentation, Pew Internet & American Life Project, 2007.

[7] Associated Press, "Nielsen Examines Mobile Web Access," *Wall Street Journal*, June 7, 2007.

[8] See: Ethan Smith and Vauhini Vara, "Music Service from Amazon Takes on iTunes," *Wall Street Journal*, May 17, 2007; Michael Muchmore, "Broadband Cinema," *PC Magazine*, April 10, 2007; Michael Barbaro, "Wal-Mart Partners with Studios in Download Deal," CNET News.com, February 5, 2007.

[9] For a forthcoming example, see: Brad Stone, "Vudu Casts Its Spell on Hollywood," *New York Times*, April 29, 2007.

[10] For a recent article on cellphone video services, see, Louise Story, "Yes, the Screen Is Tiny, but the Plans Are Big," *New York Times*, June 17, 2007. A new service allows Sprint smartphone users to get real-time price quotes for products they are shopping for from stores in their immediate location using the Global Positioning System capability of their phones. See, Riva Richmond, "Sprint Puts Shoppers in Touch with Slifter," *Wall Street Journal*, June 7, 2007. For examples of "location-based services" that are already available for mobile phones, see Michelle Higgins, "A Guide to Anywhere, Right in Your Hands," *New York Times*, June 17, 2007.

[11] *Internet Access Moratorium: Revenue Impacts Will Vary by State*, Statement of James R. White before the Committee on Commerce, Science and Transportation, U.S. Senate, May 23, 2007.

[12] Dionne, Searcey, "Verizon's Network Bet Relies on Games, TV," *Wall Street Journal*, March 7, 2007.

[13] Samar Srivastava, "Broadband Battle: Cool Web Sites; Cable, Phone Titans Launch Flashy Offerings to Lure Subscribers, *Wall Street Journal*, May 31, 2007. See also: Jessica E. Vascellaro, "Is High-Speed Internet Growth Slowing? As Dial-Up Upgrades Level Off, Operators Offer New Services," *Wall Street Journal*, August 9, 2007. The article notes, "Comcast has compiled thousands of news, sports, entertainment and other videos in a feature it calls 'the fan,' *which is available only to its subscribers*." [Emphasis added.]

[14] Jessica E. Vascellaro, "A Fight Over What You Can Do on a Cellphone; Handset Makers Push Free Features for Which Carriers Want to Charge," *Wall Street Journal*, June 14, 2007.

[15] Maggie Reardon, "Verizon's CTO Talks," CNET News, June 18, 2007.

[16] *Telephony's Guide to IPTV*, March 2007, p. 5. The forecast is that of the Strategy Analytics firm.

[17] Store-based retailers are often at a tax-based economic disadvantage vis-à-vis online competitors because the former always must add sales taxes to their prices for taxable goods while the latter can often avoid such an obligation. In its 1992 *Quill* decision, the U.S. Supreme Court affirmed that a state cannot require an out-of-state merchant to collect and remit sales tax on sales to the state's residents if the seller has no physical presence within the state's borders.

[18] See the second source cited in Note 5.

[19] One way this seems quite likely to occur is in connection with litigation involving the question of whether a particular on-line seller has sufficient presence within a particular state to be obligated to charge that state's sales tax — that is, whether the seller has sales tax "nexus" in the state. Many such disputes are likely to occur in the future because of numerous unresolved questions about the application of nexus law to on-line transactions. A well-trained lawyer defending a client that sells "digital content" or services delivered over the Internet and issued an assessment for failing to acknowledge nexus and collect sales tax would certainly cite ITFA as a secondary reason why no tax was due.

[20] For example, a true Internet access provider might begin offering an online music service with its high-speed access service, charge one price for the package, and claim that the entire package constitutes tax-exempt Internet access under ITFA. A competing free-standing online music service (that is, one that is offered by a company that does not provide its customers with a connection to the Internet) obviously would prefer not to have to charge sales tax faced with a tax-exempt competitor. It might elect to stop charging sales tax and rely on the interpretation of ITFA discussed above that gives any seller of digital content delivered over the Internet legal grounds to claim that it is also tax exempt.

[21] 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.

[22] See the sources cited in Notes 1 and 5.

[23] In its most recent 10-K report to the Securities and Exchange Commission, RealNetworks, Inc. includes in its discussion of future risks the following:

> We may be subject to assessment of sales and other taxes for the sale of our products, license of technology or provision of services. Currently we do not collect sales or other taxes on the sale of our products, license of technology, or provision of services in states and countries other than those in which we have offices or employees. Our business would be harmed if one or more states or any foreign country were to require us to collect sales or other taxes from past sales or income related to products, licenses of technology, or provision of services.

This statement seems to indicate that a lack of physical presence nexus is the main explanation for why the company does not charge sales tax on its sales in most states. It does not explain why it is not charging sales tax in its headquarters state of Washington.

[24] Such an approach would have to be coupled with specific language clarifying that "Internet access" entailed providing a customer with a connection to the Internet. Otherwise (for example), a Web-based music-streaming service could still claim it was providing "Internet access" and seek to exempt the amount of its monthly subscription fee that was below the taxable "floor."

[25] See the source cited in Note 21.

[26] See the first source cited in Note 8 for a description of Amazon' forthcoming music download store. Amazon's "Unbox" service already rents downloaded movies.