

H.R. 49 – Extension of Internet Tax Nondiscrimination Act

**Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives**

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Outline of Testimony
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My name is Harley T. Duncan. I am the Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal tax administration agencies in each of the 50 states, the District of Columbia and New York City. We are headquartered in Washington, D.C.

The policies of the Federation are established through resolutions adopted by the members at the Annual Meeting or by action of the 18-member Board of Trustees. The Federation has adopted two policy statements relevant to the issue at hand:

- Resolution 18 adopted in 2001 is a general policy statement that urges the Congress and U.S. government agencies to refrain from enacting measures, taking actions or making decisions which would abrogate, disrupt or otherwise restrict states from imposing taxes that are otherwise lawful under the U.S. Constitution or from effectively administering those taxes.
- Resolution 22 adopted in 2001 states that if Congress determines to extend the provisions of the Internet Tax Freedom Act, it should do so in accord with the following parameters:
 - The Act should be extended for not more than five years to insure that its impact on state and local revenues is examined periodically and that unintended consequences are not occurring.
 - Any extension of the Act should preserve the ability of those states currently imposing a tax on charges for Internet access to continue to do so if they so choose.
 - The definition of Internet access contained in the Act should be rewritten in such a manner that it does not create avenues to bundle otherwise taxable content, information and services into a single package of Internet access in a manner that would prevent states and localities from imposing their taxes on the otherwise taxable content, information and services.
 - The definition of discriminatory taxes contained in the bill should be amended to insure that it does not create a situation in which a seller could avoid a tax collection obligation in a state even though the seller has a substantial nexus in the state.

Extension of the Act

As a general proposition, FTA opposes federal legislation that preempts the authority of states to structure and administer their taxes within the confines of the U.S. Constitution unless there is a compelling showing of unfairness, compliance or economic harm from the manner in which that power is being exercised. The Internet Tax Freedom Act was originally passed in 1998 (and renamed the Internet Tax Nondiscrimination Act and extended for two years in 2001) to provide the new electronic commerce industry with short-term protection from what some thought could become a burdensome and discriminatory system of state and local taxation. Any consideration of extending the Act should be accompanied with a re-examination of this stated purpose.

We would submit that the “fledgling industry” argument is no longer relevant. Electronic commerce is becoming a mature and important part of the U.S. and international economy. In particular, the continued prohibition on the imposition of new taxes on charges for Internet access should be evaluated. In our estimation, there has been no showing that the purchase or supply of Internet access services in the states that tax the services has been adversely affected. Neither has there been a showing of an undue compliance burden on Internet service providers that would justify the preemption. Continuing the preemption simply provides a special position for this particular communications medium. As discussed below, the preemption is beginning to discriminate among firms in the Internet access and communications sector.

We also believe it is clear that concerns about states rushing to impose burdensome taxes on the electronic commerce sector were misplaced and unfounded. While states have had to determine the manner in which existing taxes should be applied to Internet services and electronic commerce, there was no headlong rush to devise new schemes of taxation that in some fashion targeted the electronic commerce industry. To the contrary, states have worked diligently to provide incentives to the Internet service industry and to consumers in efforts to increase access to Internet services. To my knowledge, the Internet Tax Nondiscrimination has not been used as a defense in a single reported case involving the application of state taxes to electronic commerce.

In short, we would urge the Committee to examine closely the continued need for a federal law governing the subject matter covered by the Internet Tax Nondiscrimination Act.

Grandfather Clause

H.R. 49 would repeal the “**grandfather clause**” in the current Internet Tax Moratorium that preserves state taxes on charges for Internet access that were in place in 1998 when the original Internet Tax Freedom Act was enacted. The Federation opposes a repeal of the grandfather clause.

- According to our records, nine states currently impose taxes that are protected – New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington and Wisconsin. Repealing the grandfather would disrupt the revenue stream of these states at a time when nearly every state is struggling to balance its budget. Repealing the preemption would constitute an intergovernmental mandate under the Unfunded Mandate Reform Act.

- The taxation of charges for Internet access is a legitimate exercise of state taxing authority and should not be preempted. In most of those states currently taxing access, the tax is consistent with their overall policy of taxing most (or at least a large number of) service transactions. The tax on access charges can in no way be considered a “money grab” by the states, but is instead a simple extension of their existing tax policy.
- There is no showing that the imposition of taxes on charges for Internet access has affected the growth of electronic commerce or the Internet industry. Neither is there any showing that administration of the tax on charges for Internet access has imposed undue burdens on the industry or has in any other way proved to be incapable of being administered.
- The grandfather clause was part of the terms of the original Internet Tax Freedom Act. If the other parts of the Act are to be continued, there has been no demonstration of why the grandfather clause should not be continued.

Definition of Internet Access

The current **definition of Internet access** has not kept pace with the manner in which the electronic commerce has evolved and discriminates among various types of Internet service providers. It should be amended to insure equity among various types of access providers and among types of communications services. It should also be amended so as to avoid an unintended erosion of state tax bases.

- The Act’s current 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. Such term does not include telecommunications services.”
- The current definition effectively allows a broad range of content and other services to be bundled with Internet access and potentially be considered as protected under the prohibition on the imposition of new taxes on Internet access. The range of content and service that can be bundled with Internet access is virtually unlimited. It includes all manner of printed material, video material, voice communications and other services.
- By excluding “telecommunications services” from the definition of access, the act discriminates against some telecommunications services providers (particularly wireless providers) that provide access as part of a package of telecommunications services and therefore cannot exclude a portion of the total charge from taxation.
- Firms that are providing content, voice, video, or other services that compete with those provided by Internet service providers will face a discriminatory and unfair competitive situation if those services when provided as part of Internet access are protected from state and local taxation, but services provided outside a bundle that includes access are subject to state and local taxes. The convergence of technologies, the advent of services

such as Internet telephony, and the consolidation in the communications industry suggest that this discrimination will be a real issues “sooner rather than later.”

- The current definition allows a growing proportion of the state and local tax base to be effectively put “off limits” by federal legislation with such a broad definition of Internet access. We do not believe this was the intent of Congress when it originally passed the Internet Tax Freedom Act three years ago.
- By attempting to provide protection to one industry and one type of service provider, Congress has necessarily established a regime that discriminates against similar service providers that are not also Internet access providers. This was perhaps not a major issue when the Act was originally passed 4 1/2 years ago. However, with the advent of advanced forms of access, the convergence of technologies and the realignment of businesses within the communications and entertainment industry, the definition of Internet access is on the cusp of creating serious discrimination and base erosion issues.
- Congress must in any consideration of extending the Internet Tax Nondiscrimination Act reconsider the definition of Internet access to insure that it does not discriminate and does create consequences beyond what was intended.

Suggested Definition

The issue then is how to define Internet access in a fashion that achieves the Congressional goal of protecting access to the medium of the Internet without being so broad as to create the inequities and distortions described above by including all the services and products that may be accessed via the Internet. This is a difficult task.

- One approach for Congress to consider is a variation of the approach taken by the state of Texas, which exempts up to \$25 of a bill for Internet access (under current law.) We would suggest deeming a set dollar amount of each bill from an Internet service provider to be attributable to exempt Internet access, while the rest of the bill is deemed to be attributable to other services that may or may not be taxable, depending on the laws of the specific state. Possible language for such a provision is available on request.
- The only other workable alternative would be to require Internet service providers to state separately the charges for each particular service sold as part of the access package. We believe such an approach could be burdensome for the providers and lead to a number of disputes regarding the manner in which the charges are disaggregated.
- If Congress is not comfortable adopting the “modified Texas approach” outlined above, we would strongly encourage it to establish at the outset some mechanism to examine and respond to the issues of bundling and convergence. It should, at a minimum, commission an examination of the nature of the issue, expected near-term technological developments, and alternatives for addressing the issue.

Definition of Discriminatory Taxes

The definition of discriminatory taxes contained in the Act provides that certain activities when performed by an Internet service provider on behalf of a retailer will not be considered in determining substantial nexus for tax collection purposes. Any extension of the moratorium should examine these issues carefully.

- The provisions were intended to insure that merely accessing products of an out-of-state seller via an in-state service provider would not be considered to create nexus for the out-of-state seller. When enacted as part of a short-term moratorium, these provisions were not considered problematic.
- The definition, when read in conjunction with other provisions, could be interpreted to allow a seller to avoid a collection obligation even though it has substantial activities and presence in the state. As the electronic commerce industry has evolved, the potential for this issue to arise has grown.
- If the Internet Tax Nondiscrimination Act is to be extended, however, these provisions should be examined carefully.

Conclusion

- Any extension of the Internet Tax Nondiscrimination should be accompanied by a serious examination of its actual consequences and an assessment of whether it is needed in the future.
- There has been no showing of a reason to repeal the grandfather clause. Any extension should preserve the right of those affected states to continue to impose taxes on charges for Internet access.
- Any extension of the Internet Tax Nondiscrimination Act should include amendments to the definition of Internet access that will insure that it is nondiscriminatory among types of service and content providers and will not unintentionally erode state and local tax bases.
- Any extension of the Internet Tax Nondiscrimination Act should also examine the definition of discriminatory tax to insure that it does not have unintended consequences.