

**Extension of the Internet Tax Nondiscrimination Act**

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

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**On Behalf of the**

**Federation of Tax Administrators  
Washington, D.C.**

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**Testimony**  
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My name is Jerry Johnson. I am the Vice Chairman of the Oklahoma Tax Commission and am testifying today on behalf of the Federation of Tax Administrators of which I am First Vice President. The Federation is an association of the tax administration agencies in each of the 50 states, the District of Columbia, Puerto Rico, and New York City. We are headquartered in Washington, D.C.

The Federation urges the Congress to refrain from enacting measures that abrogate, disrupt or otherwise restrict states from imposing taxes that are otherwise lawful under the U.S. Constitution. The current prohibition on the imposition of taxes on charges for Internet access as contained in the Internet Tax Nondiscrimination Act (the moratorium) is the type of law that should be avoided, especially on a permanent basis.

**Summary of Position**

The Federation urges Congress not to extend the Act because it is disruptive of and poses long-term dangers for state and local fiscal systems. Moreover, the General Accountability Office and other researchers have found that the moratorium is not effective in achieving its purported purpose of expanding the availability of Internet access to the American public and bridging what has been termed as the “digital divide.”

If, however, Congress believes the Act should be extended we believe there are three principles that should be followed:

- The definition of “Internet access” in current law must be changed. As currently written, we believe that an Internet service provider could bundle virtually all types of Internet services, content and information (some of which may be currently taxable) into a package of “Internet access” and claim that the state would be preempted from taxing any part of that package. The danger to state and local fiscal systems over the long term from the current expansive definition is considerable.
- Any extension of the Act should be temporary in nature. The nature of the online world and the manner in which the public accesses and uses that world continues to change rapidly. The long-term impact on state and local finances is still evolving. Given what everyone acknowledges will be continuing rapid change, it seems only prudent that any extension be temporary and that Congress revisit the policy and its impact in a few years.
- The provision of the Act preserving those taxes on Internet access that were “generally imposed and actually enforced” prior to 1998 should be continued if the Act is extended. The intent when the original Internet Tax Freedom Act was passed in 1998 was not to disrupt existing practices and that commitment should be maintained.

**Impact of the Moratorium**

Congress was responding to several concerns when it originally passed the Internet Tax Freedom Act in 1998. Among these was that the Internet and electronic commerce were “fledgling industries” that should be protected from state and local taxation for fear that the taxes would be burdensome and complex and somehow prevent the growth and survival of the industry. In addition, there was a belief that preempting state and local taxation of charges for Internet access would provide a financial incentive to U.S. households to subscribe to Internet services and would encourage the Internet industry to deploy services to underserved areas.

While the goals are laudable, the economic evidence is that state taxation of Internet access charges has little or nothing to do with the adoption of Internet services by consumers or the deployment of services by industry. The Government Accountability Office (GAO) was required to perform a study on the deployment of broadband service in the United States when the Moratorium was last extended.<sup>1</sup> The key findings regarding taxes in their report reads as follows:

- “Finally, using our econometric model, we found that imposition of taxes was not a statistically significant factor influencing the deployment of broadband.”
- “Using our model, we found that the imposition of the tax was not a statistically significant factor influencing the adoption [by consumers] of broadband service at the 5 percent level. It was statistically significant at the 10 percent level, perhaps suggesting that it was weakly significant factor. However, giving 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.”

GAO found that factors such as the education level of the head of a household and the income of the household influenced the purchase of broadband services. A household headed by a college graduate was 12 percentage points more likely to purchase broadband than those headed by a person who did not graduate from college. High-income households were 39 percent more likely to adopt broadband than lower-income households.

A study by economists at the University of Tennessee likewise found that taxation of Internet access had “no empirical evidence that Internet access rates are lower in state that have levied a tax on Internet access, all else being equal.”<sup>2</sup>

Concern about the moratorium and its extension should not be interpreted as suggesting that states and localities do not recognize the importance of the Internet industry and the benefits improved service and utilization can provide to the citizens. The GAO report referenced earlier

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<sup>1</sup> Government Accountability Office, “Telecommunications – Broadband Deployment is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas” (GAO-06-426). In the GAO study, the term “deployment” refers to the offering of broadband services by various types of providers and the term “adoption” refers to the use of broadband services by consumers.

<sup>2</sup> See also Donald Bruce, John Deskins and William F. Fox, “Has Internet Access Taxation Affected Internet Use,” *State Tax Notes*, May 17, 2004, pp. 519-526.

highlighted several examples of state and local programs aimed at providing assistance and incentives for the deployment of Internet technologies, including:

- The Texas Telecommunication Infrastructure Fund begun in 1996 that committed to spend \$1 billion on telecommunications infrastructure.
- Connect Kentucky is an alliance of technology-focused businesses, government entities, and universities that work together to accelerate broadband deployment.
- Virginia Tobacco Indemnification and Community Revitalization Commission is designed to stimulate economic development opportunities by encouraging the creation of new technology-based business and industry.

### **Definition of Internet Access**

The current definition of Internet access was devised in large part in 1998 with “dial-up Internet access” in mind. It has not kept pace with the manner in which Internet technology and services and electronic commerce have evolved. While changes enacted in 2004 did much to remove discrimination among various types of Internet access providers, they did nothing to avoid a potential unintended erosion of state tax bases.

The current definition of “Internet access”<sup>3</sup> effectively allows a broad range of content, information and services to be bundled with Internet access and potentially be considered as protected under the prohibition on the imposition of taxes on Internet access. This results because the term “access” can be interpreted to mean a “right to use,” meaning a “right to use” all the information, services and content on the Internet as part of a package of access. The range of content and service that can be bundled with Internet access is virtually unlimited. It includes all manner of electronic books, movies, music, photographs, services, data bases, information services and the like.<sup>4</sup>

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 nearly nine years ago.

If the current moratorium with the current definition of Internet access is made permanent it would lead widespread tax avoidance and litigation that today does not occur because it is temporary. The temporary nature of the moratorium deprives companies of the long-term financial inducements to “push the edge of the envelope” in interpreting the law to maximize

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<sup>3</sup> Section 1105(5) of the original Internet Tax Freedom Act, at 47 U.S.C.A. §1105(5), provides: “The term ‘Internet access’ means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. The term ‘Internet access’ does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access.”

<sup>4</sup> The Moratorium’s accounting rule for separating individual fees would not come into play because all of the bundled content would be considered “Internet access.”

their competitive advantage over “bricks and mortar” businesses. If the current definition of Internet access were made permanent there would be a considerable opportunity to gain a long-term competitive advantage over traditional businesses that cannot be realistically denied.

The current definition of Internet access poses an issue not only for state and local governments, but for significant segments of the private sector. Firms that are providing content, 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 and the consolidation in the communications industry suggest that this discrimination will be a real issue “sooner rather than later.”

The Federation has worked and continues to work to develop a definition of Internet access that is acceptable to all parties and that is consistent with what we believe all parties actually understand the “intent” of the original bill to be. Our intent is to craft language that will allow Internet access packages consistent with those now offered to continue to be subject to the moratorium, but to avoid the bundling of other products and services into the package.

We have worked with Committee staff and have reached out to the Internet industry to develop such language. We look forward to continuing that effort if an extension of the moratorium moves forward.

### **Temporary Extension**

If the Act is to be extended, it should be done on a temporary, short-term basis – even if the definition of Internet access is amended. A short-term extension would insure that the Moratorium’s impact on state and local revenues is examined periodically and that unintended consequences are not occurring. This is necessary because of the continuing expansion of Internet availability and the expanding array of activities conducted on the Internet, which make it very difficult to predict the impact of restrictions. It is also desirable to insure that the industry has not changed in ways that somehow causes the moratorium to discriminate among Internet service providers. It was this sort of discrimination among providers that was, in fact, among the most contentious issues when the Act was last considered in 2003-2004. Finally, presuming a change in the definition of Internet access, it would be advisable to review the impact of that change in the near- to medium-term to insure that it is performing as intended.

### **Preservation of Taxes on Internet Access Imposed Prior to 1998**

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 stated intent when the original Internet Tax Freedom Act was passed in 1998 was not to disrupt existing practices. Given the economic evidence that taxation of charges for Internet access has not impact on the availability or use of Internet access by households in these states, we see no reason that commitment should not be maintained.

Nine states currently impose taxes that are protected – *Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin*. The Congressional

Budget Office estimated that in 2003, these states collected on the order of \$120 million from their taxes on charges for Internet access. Repealing the grandfathering protection would disrupt the revenue stream of these states – each of which must maintain a balanced budget. Repealing the preemption would constitute an intergovernmental mandate under the Unfunded Mandate Reform Act.

Preservation of the grandfather for pre-1998 taxes is an issue that is important not only to these states. The grandfather also covers a variety of general business taxes that may be imposed on a wide range of businesses (e.g., state and local gross receipts taxes, unemployment taxes, taxes on machinery and equipment purchases, real estate transfer taxes, etc.) that are not generally considered “taxes on Internet access” but would be subject to challenge under the Act if the grandfather clause is repealed.

### **Conclusion**

We submit that the “fledgling industry” argument for Internet services in the United States is no longer relevant. Electronic commerce is a mature and important part of the U.S. and international economy. The continued moratorium on taxing 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 those 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 and unfairly shifts the burden of taxation on to other activities.

If the preferential treatment of Internet access continues, three matters should be addressed:

- The scope of the preferential tax treatment (definition of Internet access) needs to be limited to protect businesses that compete with Internet companies;
- The Act should be made temporary to insure periodic of the Act and its consequences; and
- The original commitment to those states imposing taxes on Internet access should be continued.