Congressional Research Service

Internet Taxation
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The Internet Tax Freedom Act (ITFA) was enacted as part of the Omnibus Consolidation and Emergency Supplemental Appropriations Act, P.L. 105-277. The act imposed a three-year moratorium on new Internet taxation and established the Advisory Commission on Electronic Commerce (ACEC, the commission) in October of 1998. The final report of the commission, presented in April 2000, is available on the ACEC web page. The Internet tax moratorium prohibits the taxation of Internet access and the multiple or discriminatory taxation of Internet commerce. In the 107th Congress, the moratorium was extended through November 1, 2003 (the moratorium has expired) by the Internet Tax Nondiscrimination Act, P.L. 107-75. On April 29, 2004, the Senate passed S. 150, a bill to allow a four year extension of the moratorium (through November 1, 2007). The House has not yet taken action on the Senate bill, but the chambers apparently reached agreement on the measure through informal bicameral negotiations. The changes agreed to in the negotiations were embodied in S.Con.Res. 146, a resolution to amend the enrolled version of S. 150. The Senate passed S.Con.Res. 146 on November 17, 2004.

The moratorium does not preclude states from requiring vendors with substantial nexus in the state from collecting sales and use taxes on products purchased over the Internet. However, the moratorium would preclude state and local governments from levying taxes on Internet access services. The appropriate definition of Internet access as been the subject of significant debate in Congress. As the ITFA is currently written, state and local taxes on telecommunications services would not be included in the tax moratorium. The Federal Communications Commission (FCC) defines a digital subscriber line (DSL) as a telecommunication service, thus, several states (27) impose taxes on Internet access delivered through DSL. The recently passed moratorium extension allows these states to continue to tax DSL through November 1, 2005.

Current Issues

The Moratorium. On January 7, 2003, Senator Wyden and Representative Cox introduced identical legislation, S. 52 and H.R. 49 respectively, that would make the Internet tax moratorium permanent. H.R. 49 was referred to House Judiciary Committee and the Committee reported out H.R. 49 on July 24, 2003. H.R. 49 passed the House under suspension of the rules on September 17, 2003. H.R. 49 would repeal the grandfather clause in the ITFA that allows states that imposed taxes on Internet access taxes at the time of ITFA passage to continue collecting the tax. The states that are collecting Internet access taxes would then lose that revenue source. At a hearing on H.R. 49, the Federation of Tax Administrators (FTA) testified that "...nine states currently impose taxes that are protected -- New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington, and Wisconsin." In the same testimony, FTA argues that "...repealing the preemption would constitute an intergovernmental

mandate under the Unfunded Mandate Reform Act." The Congressional Budget Office estimates that H.R. 49 would impose an intergovernmental mandate on state an local governments that would cost between $80 million and $120 million for those states that were taxing Internet access before the original moratorium was passed.

In the Senate, Senate Commerce Committee held hearings on making permanent the Internet tax moratorium and eventually reported (see S.Rept. 108-155) S. 150 (Allen, et al). After the Commerce Committee reported out S. 150, it was referred to the Senate Finance Committee for consideration for a period not to exceed 30 calendar days. S. 150 was discharged from the Finance Committee and placed on the Senate calendar on October 29. After considering several amendments, the final version of S. 150 (including the modifications contained in S. Con. Res.146), which passed (93-3) on April 29, would: (1) impose a four-year moratorium (through November 1, 2007) on multiple and discriminatory taxes and on Internet access taxes; (2) grandfather pre-1998 Internet access taxes for four years (through November 1, 2007); (3) grandfather pre-2003 Internet access taxes (primarily DSL taxes) for two years (through November 1, 2005); (4) exempt voice over the internet protocol (VOIP) technology from the moratorium; and (5) instruct the GAO to conduct a study of the effect of the moratorium on the "...revenues of State and local governments and on the deployment of broadband technologies for Internet access...."

The definition of Internet access was an important part of the negotiations between the House and Senate on the final version of a moratorium bill. Generally, the definition of Internet access in H.R. 49 is broader than the definition in S. 150. Some have argued that if the definition is too broad, otherwise taxable telecommunications services could be swept into the moratorium. Proponents of the broadest definition possible counter that Congress does not intend to include otherwise taxable services in the moratorium and that a broad definition is necessary to ensure that Internet access is 100% tax free. The Nati onal Governor's Association contends that a broadened definition Internet access could cost the states between $4 billion and $9 billion by 2006. The CBO estimated that "Other states are currently imposing taxes on charges for the portions of DSL [digital subscriber line] services they do not consider Internet access. Those states would lose at least $40 million in the sales and use taxes on DSL services in 2004, and at least $75 million by 2008."

In related legislation, Senator Sununu introduced S. 2281 on April 4, 2004, which would ban most state and local taxes on VOIP services. For more background on issues surrounding internet tax legislation in the 108th, see CRS Report RL31929, *Internet Taxation: Issues and Legislation in the 108th Congress*, by Steven Maguire and Nonna Noto.

Remote Vendor Tax Collection. The United States Supreme Court has held in 1992 (*Quill Corporation* vs. North Dakota) that a state has no jurisdiction to require a remote vendor to withhold that State's *sales* and *use* taxes unless the vendor has a nexus (loosely defined as physical presence) in the taxing state. The Court also has held that Congress, under its power to regulate interstate commerce, could authorize the states to require the collection of these taxes by remote vendors. This issue is important because Internet transactions do not have the sales and use tax levy included by remote vendors, thus Internet retailers are thought to have a

competitive advantage over traditional "brick and mortar" vendors who collect the tax. Note that interstate transactions are still taxable though the collection responsibility falls upon the consumer to voluntarily remit the appropriate taxes. In reality, compliance with this requirement is quite low.

The Streamlined Sales Tax Project (SSTP). A coalition of states is currently working to establish a simplified sales and use tax system. The participating states would ask Congress for the permission to compel out of state vendors to collect sales and use taxes if the simplified system were implemented. The 34 states (and the District of Columbia) participating in the simplification project are self identified as the Streamlined Sales Tax Implementing States (SSTIS). On November 12, 2002, the SSTIS approved (31 in favor, 3 absent, and 1 abstention) the model legislation identified as the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA goes into effect if 10 states representing at least 20% of the population in states that impose a sales tax enact the model legislation and are in compliance with the rules of the SSUTA. The National Governor's Association (NG A) supports the model legislation. H.R. 3184, the "Streamlined Sales and Use Tax Act," introduced on September 25, 2003, would grant SSTIS members the authority to compel out-of-state vendors to collect sales and use taxes. Hearings on the SSTP concept were held on October 1, 2003. In the Senate, Senator Enzi introduced S. 1736, which is similar to H.R. 3184, on October 15, 2003.

Through legislation like H.R. 3184 and S. 1736, Congress would authorize the SSUTA participating states to require that all vendors collect the sales and use tax based upon the customer's home State and local tax rates and base. Proponents of the SSUTA approach assert that administrative difficulties could be overcome with technology and simplified state and local government sales and use tax systems like the SSUTA. The SSUTA includes provisions that would require participating states to: (1) establish uniform tax base definitions; (2) impose uniform sales and use tax exemptions; and (3) limit the variation in local tax rates within the state. Opponents of the SSTA suggest that simplification measures will not sufficiently ease the collection burden on out-of-state vendors.

CRS Products

CRS Report RL31929, *Internet Taxation: Issues and Legislation in the 108th Congress.*

CRS Report RL31252, *Internet Commerce and State Sales and Use Taxes.*

CRS Report RS21537, *State Sales Taxation of Internet Transactions.*

Additional Reading

Council on State Taxation, "Report Card on Streamlined Sales Tax Implementing States' Agreement," *State Tax Notes*, November 11, 2002, p. 407.

Goolsbee, Austan, and Jonathan Zittrain, "Evaluating the Costs and

Benefits of Taxing Internet Commerce." *National Tax Journal,* vol. 52, no. 3 (September 1999): 413-428.

Michael Mazerov, "The Alexander-Carper Internet Access Tax Moratorium Bill, S. 2084: A True Compromise that Substantially Broadens the Original Moratorium," *Center on Budget and Policy Priorities*, March 15, 2004.

Charles McLure Jr., "SSTP: Out of Great Swamp, But Whither? A Plea to Rationalize the State Sales Tax," *State Tax Notes*, December 31, 2001, p. 1077.

National Tax Association Communications and Electronic Commerce Tax Project Final Report, September, 1999.

U.S. Congressional Budget Office, *Economic Issues in Taxing Internet and Mail-Order Sales*, (Washington: October 2003).

U.S. General Accounting Office, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses are Uncertain*, GAO Report OCE-00-165 (Washington: June 2000).