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Internet Taxation: Issues and Legislation in the 108th Congress

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Summary

The Internet Tax Freedom Act (ITFA), enacted in October 1998 and extended for two years in November 2001, expired on November 1, 2003. The federal moratorium prohibited state and local governments from levying new taxes on Internet access and any multiple or discriminatory taxes on electronic commerce. Taxes on Internet access that were in place before October 1, 1998, were protected by a grandfather clause.

The House approved H.R. 49 by voice vote under a suspension of the rules on September 17, 2003. H.R. 49 as passed would permanently extend the moratorium, eliminate the grandfathering protection, and exempt from state and local taxes any form of telecommunications used to provide Internet access. The bill introduced by Representative Cox was replaced by a technical amendment in the Subcommittee on Commercial and Administrative Law and further amended by the Judiciary Committee to provide for neutrality in the tax ban across all modes of Internet access.

S. 150 was amended and ordered reported by the Senate Commerce Committee on July 31. S. 150 as amended would permanently extend the moratorium, continue the grandfathering protection for three more years, alter the definition of Internet access (as would H.R. 49) to provide for technological neutrality involving the moratorium, and clarify that the ITFA does not prevent the federal government or the states from imposing or collecting fees or charges on telecommunications used to finance the universal service program. The bill was reported by the Commerce Committee on September 29 and discharged from the Finance Committee on October 29. The Senate began debate on S. 150 on November 6. The bill was pulled on November 7 for further negotiations on the definition of Internet access.

The Congressional Budget Office (CBO) found that eliminating the grandfathering protection under either H.R. 49 or S. 150 would impose an intergovernmental mandate. S. 52 was the companion to H.R. 49 as introduced. It would make the moratorium permanent and remove the grandfathering protection. H.R. 1481 would extend the current moratorium for five years. S. 2084 would extend the moratorium two years, until November 1, 2005. The Bush Administration supports permanent extension of the moratorium.

An issue previously raised in connection with the Internet tax moratorium is streamlined sales taxes and remote tax collection authority. Companion bills H.R. 3184 and S. 1736 would grant states that comply with the Streamlined Sales and Use Tax Agreement (a multistate compact) the authority to require remote sellers to collect state and local taxes on interstate sales. A related issue is whether and how to have Congress set the nexus standards under which a state is entitled to impose its business activity tax (BAT, e.g., corporate income tax) on a company located outside the state but with business activities in the state. H.R. 3220 would establish a physical presence standard for business activity taxes. This report will be updated as legislative events warrant.

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Background

The Internet Tax Freedom Act (ITFA) was enacted on October 21, 1998, as Title XI of Division C of P.L. 105-277, the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999.[1] The ITFA placed a three-year moratorium on the ability of state and local governments to (1) impose new taxes on Internet access or (2) impose any multiple or discriminatory taxes on electronic commerce. The Act grandfathered the state and local access taxes that were "... generally imposed and actually enforced prior to October 1, 1998 ...."

This Internet tax moratorium expired on October 21, 2001. The Internet Tax Nondiscrimination Act, P.L. 107-75, was enacted on November 28, 2001. It provided for a two-year extension of the prior moratorium, through November 1, 2003. It also continued the grandfathering protection for pre-existing Internet access taxes. The moratorium has expired.

The House passed H.R. 49 on September 17, 2003. The Senate began consideration of S. 150 on November 6, 2003; the bill was pulled on November 7 for further work on the definition of Internet access. Each bill would extend the moratorium permanently and make other changes to the ITFA.

Issues

The five main issues surrounding Internet taxation are:

- the moratorium on Internet access taxes, either temporary or permanent extension, if retained at all;
- whether to grandfather the moratorium for states that imposed taxes on Internet access before the moratorium was imposed (if the moratorium is retained);
- defining Internet access and discriminatory taxes to the satisfaction of all stakeholders;

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[1] Title XII was also part of S. 442, 105th Congress, the underlying ITFA legislation. Titles XI and XII, 112 Stat. 2681-719 through 728 (1998). Title XI is codified as the ITFA in 47 U.S.C. 151 note. Title XII is codified as 19 U.S.C. 2241 note.

- granting states the authority to require remote sellers to collect use taxes if the states adopt a streamlined sales tax system; and

- Congressional codification guidelines for establishing whether or not a business engaged in interstate commerce has nexus in a jurisdiction for purposes of business activity taxes (BATs, e.g., corporate income tax) liability.[2]

The Moratorium: Permanent vs. Temporary Extension, or Sunset?

The intent of the Internet Tax Freedom Act enacted in 1998 was to prevent state taxes on Internet access, to ensure that multiple jurisdictions could not tax the same electronic commerce transaction, and to ensure that commerce over the Internet would not be singled out for discriminatory tax treatment. Supporters of the moratorium felt that the Internet should be protected from the administrative and financial burdens of taxation to encourage the advance of Internet technology and associated economic activity. Opponents contended that a federal moratorium infringed on the states' independent authority to levy taxes and that Internet transactions and services should not be afforded differential tax treatment.

A permanent extension of the moratorium would eliminate the need for Congress to revisit the issues surrounding Internet taxation when a temporary moratorium expired. Permanent extension presumably could also provide both the producers and consumers of Internet services greater certainty about state and local taxation of the Internet. Opponents contend, however, that a permanent extension does not address the underlying issue of federal restrictions on state taxation and the clarification of the definition of Internet access.

In contrast, a temporary extension of the moratorium would allow Congress to review the conditions of the moratorium and the effect of the moratorium on the states. The reassessment could be made in the context of developments in computer technology and business organization, as well as state and local government revenues. A temporary extension would also provide time for the states to simplify further their sales and use taxes. (See the discussion below on *Streamlined Sales Taxes and Remote Collection Authority*.)

Allowing the moratorium to sunset would permit the states to tax Internet access, although, in practice, the trend has been for states to repeal their Internet access taxes. As Internet technology continues to change the telecommunications industry, however, state and local governments will likely have to modify how the

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[2] The issues remain similar to those considered in 2001, when the Internet tax moratorium was temporarily extended for two years. For a longer discussion of the extension of the moratorium, grandfathering of existing access taxes, and collecting sales and use taxes on interstate sales — in relation to bills introduced in the first session of the 107th Congress — see CRS Report RL31177, *Extending the Internet Tax Moratorium and Related Issues*, by Nonna A. Noto.

telecommunications industry is taxed. A sunset of the moratorium could induce states to address the taxation of telecommunications more broadly.

Grandfathering of Existing Access Taxes

The Internet Tax Freedom Act exempted taxes on Internet access that were "... generally imposed and actually enforced prior to October 1, 1998...." from the moratorium. When ITFA legislation was being considered in the spring of 1998, 10 states and the District of Columbia were already applying sales and use tax to Internet access services.[3] Subsequently, Connecticut, Iowa, and the District of Columbia eliminated their tax on Internet access, and South Carolina has not enforced the collection of its tax during the federal moratorium. This left seven states imposing a sales and use tax on Internet access as of April 2003: New Mexico, North Dakota, Ohio (on businesses only, not consumers), South Dakota, Tennessee, Texas (on monthly charges over $25), and Wisconsin.[4] In addition, Hawaii levies its general excise tax, New Hampshire its communications services tax (imposed on all two-way communications equipment), and Washington state its business and occupation tax (a gross receipts tax levied on business) on Internet access.

The grandfathering protection was continued when the ITFA moratorium was extended for two years in 2001. The issue now is whether the grandfathering will be continued if the moratorium is extended beyond the November 2003 expiration, either temporarily or permanently.

In the 107th Congress, bills to temporarily extend the moratorium typically extended the grandfathering protection. In contrast, bills to permanently extend the moratorium were divided between those retaining the grandfathering and those eliminating it. In the 108th Congress, H.R. 49, as passed by the House, would eliminate the grandfathering protection. S. 150, as reported by the Senate Commerce Committee, would extend the grandfathering protection until September 30, 2006.

Removing the grandfathering protection would ban all state and local taxes on Internet access. In its cost estimates for H.R. 49 and S. 150, the Congressional Budget Office (CBO) determined that eliminating the grandfathering protection would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA, P.L. 104-4, 2 U.S.C. 1501-1571). Both bills would eventually prohibit the taxes on Internet access that are currently being collected in up to 10 states and a few local jurisdictions in six states, totaling approximately $80 million to $120 million per year. This estimate alone exceeds the UMRA threshold of $59 million in 2003, in the case of H.R. 49, and $64 million in 2007 (adjusted annually for inflation), in the case of S. 150. CBO noted that additional state and local

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[3] National Conference of State Legislatures, "Which States Tax Internet Access?" March 25, 1998, available at [http://www.ncsl.org/programs/fiscal/intertax.htm].

[4] Vertex, Inc., *Tax Cybrary*, available at [http://www.vertexinc.com].

revenues could be lost if more telecommunications services and information content were redefined as Internet access.[5]

The proposed expansion of the moratorium to include some telecommunications services (through redefining Internet access) *except to the extent such services are used to provide Internet access*, could affect those states that currently tax digital subscriber line (DSL) services. A recent study reported that 27 states and the District of Columbia are currently collecting taxes on DSL Internet access services.[6]

Definitions

The ITFA tax moratorium prohibits new taxes on Internet access and multiple or discriminatory taxes on electronic commerce. The Act's definitions of Internet access and of discriminatory tax, in particular, have been the source of some concern and legal uncertainty for state and local governments, providers of new-technology Internet access service, telecommunications companies offering bundled communications and information services, supporters of federal and state universal service programs, and companies with "dot.com" subsidiaries.

Taxation of Internet Access. The taxation of Internet access most commonly refers to the application of state and local sales taxes to the monthly charges that subscribers pay for access to the Internet through Internet service providers (ISPs) such as America Online (AOL), Microsoft Network (MSN), or EarthLink. Some examples can help illustrate the size of the tax burden at issue. If the tax were levied at a combined state and local sales tax rate of 7%, the tax on a dial-up modem service costing $22 per month would be $1.54 per month or $18.48 per year. On a cable modem service costing $40 per month, the tax would be $2.80 per month or $33.60 per year. On a DSL (digital subscriber line) service costing $55 per month, the tax would be $3.85 per month or $46.20 per year.[7]

Bundling of Services. According to Section 1104(5) of the Internet Tax Freedom Act,

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[5] Congressional Budget Office, "Cost Estimate for H.R. 49, Internet Tax Nondiscrimination Act," as ordered reported by the House Committee on the Judiciary on July 16, 2003, Washington, July 21, 2003, and "Cost Estimate for S. 150, Internet Tax Nondiscrimination Act," as ordered reported by the Senate Committee on Commerce, Science, and Transportation on July 31, 2003 (Washington: Sept. 9, 2003). Available at [http://www.cbo.gov], visited Oct. 8, 2003, and in the LIS (Legislative Information Service) entry for each bill under CBO Cost Estimates.

[6] Michael Mazerov, "Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Loss for States and Localities," Center on Budget and Policy Priorities, Oct. 20, 2003.

[7] Monthly prices from the 2003 Internet Service Provider (ISP) Directory, *Washington Post*, Feb. 2, 2003, p. H10. Common state-local sales tax rate selected from Federation of Tax Administrators, Comparison of State and Local Retail Sales Taxes, Jan. 2003. Available at [http://www.taxadmin.org/fta/rate/sl_sales.html]. Calculation of sample tax bills by CRS.

> 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. Such term does not include telecommunications services.

The breadth of the definition in the first sentence gives rise to concern on the part of state and local revenue departments that the tax-protection of Internet access may extend to "bundled" products and services that might otherwise be taxable if purchased on their own. These could include data and information services, cable television, books, magazines, games, music, video on demand, and Internet telephony. These types of products and services can be offered online and sold as part of an Internet access service that is protected from taxation.

Telecommunications Industry Concerns. There is concern on the part of telecommunications carriers that Internet access offered through some technologies, such as DSL or wireless services, might not be treated as exempt, while access offered over other technologies, such as cable modem, would be exempt. In an attempt to address these claims, both H.R. 49 as passed by the House and S.150 as ordered reported by the Senate Commerce Committee would provide that all forms of telecommunications services used to provide Internet access would be exempt from state and local taxes.[8]

State and local governments are concerned, however, that the revised language would broaden the current tax exemption far beyond Internet access. The expanded definition could also exempt not only the services that connect the consumer to the Internet, but also all of the telecommunications services that compose the Internet backbone. While not quantifying the likely cost, CBO indicated that this interpretation of H.R. 49/S. 150 could adversely affect state and local revenues enough to create an unfunded intergovernmental mandate.

A report issued on September 24, 2003, by the Multistate Tax Commission (MTC) estimated that H.R. 49 would cost state and local governments from $4 billion to $8.75 billion annually by 2006. This estimate does not include potential losses from bundling of services. It does include the reduction of sales, excise, income, property, and other business taxes on Internet access and telecommunications. In contrast, if the moratorium were limited to sales taxes on solely Internet access to customers, including broadband, and removing the grandfathering, the cost would be limited to approximately $500 million in 2006.[9]

In a study released October 20, 2003, the Center on Budget and Policy Priorities estimated that 27 states and the District of Columbia could lose approximately $70

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[8] For more information, see: U.S. Congress, Senate Committee on Commerce, Science, and Transportation, *Internet Tax Non-discrimination Act of 2003*, Report on S. 150, S.Rept. 108-155, 108th Cong., 1st sess., Sept. 29, 2003 (Washington: GPO, 2003).

[9] Dan Bucks, Elliott Dubin and Ken Beier, "Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act" (Washington: Multistate Tax Commission), Sept. 24, 2003, available at [http://www.mtc.gov].

million per year if they could no longer tax DSL telephone service. The telecommunication services used by Internet access providers to link to the Internet "backbone" could no longer be taxed. In addition, with the growth of Internet telephony (voice over Internet protocol, VOIP), there would be less traditional telephone service (POTS) remaining in the tax base. Currently, state and local taxes on voice telephone services produce $12 billion in annual revenues.[10]

Funding Universal Service. Some members of Congress are concerned about protecting the financing source for the Universal Service Fund (USF).[11] The USF is administered by the Universal Service Administrative Company, an independent not-for-profit organization under the auspices of the Federal Communications Commission (FCC). The USF is financed by mandatory contributions from interstate telecommunications carriers.[12] A company's USF contribution is a percentage[13] of its interstate and international end-user revenues. Some states also levy charges on the intrastate retail revenues of telecommunications carriers for their state's universal service fund.[14]

Supporters of the universal service programs are concerned that efforts to protect Internet access and associated telecommunications services should not reduce the funding base for universal service. S. 150 as reported by the Commerce Committee states that the ITFA does not prevent the federal government or the states from imposing or collecting the fees or charges on telecommunications that are used to finance the universal service program codified (in 1996) by Section 254 of the Communications Act of 1934. At the Commerce Committee markup of S. 150 on July 31, 2003, Chairman McCain agreed to hold a hearing on the future of the USF.

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[10] Michael Mazerov, "Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Loss for States and Localities."

[11] The USF subsidizes telephone service to low income consumers and to high-cost rural and insular areas. Through the E-rate or education-rate program instituted by the Telecommunications Act of 1996, the USF also subsidizes telecommunications discounts for schools and libraries. Also as a result of the 1996 Act, the USF subsidizes communications links between rural health care providers and urban medical centers. For further information on the E-rate program, see CRS Issue Brief IB98040, *Telecommunications Discounts for Schools and Libraries: The "E-Rate" Program and Controversies*, by Angele A. Gilroy.

[12] All telecommunications providers that provide service between states must contribute to the USF. This includes long distance companies, local telephone companies, wireless telephone companies, paging companies, and payphone providers.

[13] The percentage, known as the contribution factor, is set quarterly, and varies depending on the financing needs of the universal service programs. The federal universal service contribution factor for the third quarter of 2003 was 0.095 or 9.5%. The proposed contribution factor for the fourth quarter of 2003 was 0.092 or 9.2%. Federal Communications Commission, Contribution Factors and Quarterly Filings, available at [http://www.fcc.gov/wcb/universal_service/quarter.html].

[14] State charges are typically levied on the intrastate retail revenues of wireline carriers and, in some states, wireless carriers as well.

Multiple Taxes. In order to eliminate the possibility of double taxation of electronic commerce transactions, the ban on multiple taxes prohibits more than one state, or more than one local jurisdiction at the same level of government (i.e., more than one county or one city) from imposing a tax on the same transaction — unless a credit is offered for taxes paid to another jurisdiction. However, the state, county, and city in which an electronic commerce transaction takes place could all levy their sales taxes on the transaction. There has not been much controversy over this definition and restriction.

Discriminatory Taxes. In practice, the ban on discriminatory taxes on electronic commerce means that transactions arranged over the Internet are to be taxed in the same manner as mail order or telephone sales. Under the current judicial interpretation of nexus as applied to mail-order sales, a state cannot require an out-of-state seller to collect a use tax from the customer unless the seller has a physical presence in the taxing state.[15] (A use tax is the companion tax to the sales tax, applicable to interstate sales.) Congress or the Supreme Court would need to act to grant or approve the states' ability to require out-of-state tax collection, whether the transaction was arranged over the Internet or by mail-order, telephone, or other means.

The second part of the ITFA's definition of discriminatory tax lists conditions under which a remote seller's use of a computer server, an Internet access service, or online services does not establish nexus. These circumstances include the sole ability to access a site on a remote seller's out-of-state computer server; the display of a remote seller's information or content on the out-of-state computer server of a provider of Internet access service or online services; and processing of orders through the out-of-state computer server of a provider of Internet access service or online services. Some businesses have taken advantage of these nexus limits in the ITFA's definition of discriminatory tax to establish what are referred to as Internet kiosks or dot-com subsidiaries. The businesses claim that these Internet-based operations are free from sales and use tax collection requirements. Critics object that these methods of business organization are an abuse of the definition of discriminatory tax.

Streamlined Sales Taxes and Remote Collection Authority

In the 106th and 107th Congresses, the debate surrounding moratorium extension legislation was linked to the states' quest for sales and use tax collection authority. The issue was Congress's willingness eventually to grant states the authority to require remote (out-of-state) sellers to collect use taxes on interstate sales. States would need to simplify their state and local sales and use tax systems for Congress to grant this authority.

Under current law, a vendor with substantial nexus (usually defined as physical presence) in its customer's state collects the state (and local) sales tax on sales arranged over the Internet (or by telephone, mail order, or other means). In contrast,

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[15] For additional discussion, see CRS Report RS20577, *State Sales Taxation of Internet Transactions*, by John R. Luckey.

an out-of-state vendor without substantial nexus in the customer's state is not required to collect the sales tax.[16] Technically, the customer is required to remit a "use" tax to his or her state of residence.[17] In practice, however, use tax compliance by non-business purchasers is low. Because of this low compliance, many states have long wanted to require out-of-state vendors without physical presence in the respective states (referred to as remote sellers) to collect the use tax from the customer. This would apply to all interstate sales, whether arranged over the Internet or by catalog, telephone, or other means.

Acknowledging administrative complexity as a major obstacle to remote collection, the states began a concerted effort to simplify state and local sales and use tax through the Streamlined Sales Tax Project (SSTP). The project commenced in March 2000, midway through the initial ITFA moratorium (October 1998 - October 2001). The SSTP continued its work after the moratorium was extended in November 2001. On November 12, 2002, 34 states and the District of Columbia approved a model interstate agreement to simplify their sales tax systems, known as the Streamlined Sales and Use Tax Agreement. The agreement establishes uniform definitions for taxable goods and services and requires that a participating state and local government have only one statewide tax rate for each type of product by 2006. Each state would retain the power to define taxable products and establish the tax rate. The agreement provides for streamlined tax administration and audit requirements for sellers.

During their 2003 SSTP sessions, individual state legislatures considered legislation to bring their own state and local sales tax laws into conformity with the model tax agreement. For the agreement to come into effect, at least 10 states representing at least 20% of the combined population of the 45 states with state sales taxes were required to petition for membership into the agreement and be found to be in conformance with the agreement. (There is some question about whether in order to qualify as conforming, 10 states must simply approve the agreement or must actually change the administration of their sales tax systems to conform with the agreement.) As of January, 2004, 20 states had enacted legislation conforming with all or part of the agreement.[18] The combined population of these 20 states represents approximately 30% of the population of states with sales taxes.

Separately, a coalition of a few nationwide sellers reached agreements with 38 states and the District of Columbia to begin collecting their use taxes voluntarily, starting February 3, 2003, in exchange for amnesty on previously uncollected taxes.

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[16] In 1967 and again in 1992, the Supreme Court concluded that the complexity of the state and local sales tax systems imposed an undue burden on interstate commerce. See the following decisions for more: National Bellas Hess, Inc., *v.* Illinois Department of Revenue, 386 U.S. 753 (1967) and Quill Corp. *v.* North Dakota, 504 U.S. 298 (1992).

[17] The use tax is the companion tax to the sales tax and was created to ensure that cross border transactions are not favored in the state tax code.

[18] Streamlined Sales Tax Project, State Legislative Status of Streamlined Sales and Use Tax Agreement (as of January 2004). Available at [http://www.streamlinedsalestax.org] under St. Legislative Status.

Among the retailers participating initially were Wal-Mart Stores Inc., Target Corp., and Toys R Us Inc. Other retailers have entered into similar voluntary agreements.

In the 106th and 107th Congresses, bills were introduced that enumerated criteria for a simplified sales and use tax system and procedures for Congress to grant tax collection authority — in conjunction with an extension of the moratorium. In the 108th Congress, the sales tax issue is being pursued separately from the moratorium. Companion bills H.R. 3184 (Istook and Delahunt) and S. 1736 (Enzi) would grant states that comply with the Streamlined Sales and Use Tax Agreement the authority to require remote sellers to collect state and local use taxes on interstate sales.

The chairmen of the committees of jurisdiction in both the House and Senate have indicated that they want to pursue the moratorium extension independently from the sales tax issue. Representative Cannon, Chairman of the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, and Senator McCain, Chairman of the Senate Committee on Commerce, Science, and Transportation, each indicated that his committee would hold a hearing on the sales tax issue, in addition to the hearing held on the moratorium extension. The House Subcommittee on Commercial and Administrative Law held an oversight hearing on October 1, 2003, titled "The Streamlined Sales Tax Agreement: States' Efforts to Facilitate Sales Tax Collection from Remote Vendors."

Business Activity Tax (BAT) Nexus Standards

The possibility that states could be authorized to require remote vendors to collect sales and use taxes on interstate sales has raised concerns that states would then attempt to impose income and other business taxes on those vendors. In response, some multistate businesses have asked Congress to clarify nexus standards for state and local business activity taxes (BATs).[19] Past court decisions and the landmark P.L. 86-272 established physical presence as the standard for sufficient nexus – but only for the sale of tangible goods.

Congress clarified nexus in P.L. 86-272 by identifying those activities which would *not* establish nexus. Generally, soliciting the sale of tangible goods in a state for shipment by common carrier from locations outside the state, would not be sufficient to trigger nexus. Thus, for products shipped across state lines, state net corporate income taxes are levied at the *source*, not the *destination*, of the product.

Proponents of federally defined nexus standards contend that current federal law does not sufficiently define substantial nexus. The issue before Congress is whether to codify nexus rules for all goods and services, not just tangible goods. Currently, each state independently implements rules for economic activities – which are not covered by P.L. 86-272 – that establish nexus. Although state rules are very similar for many services and activities, there is still significant variation from state to state

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[19] Business activity taxes are commonly thought of as corporate income taxes, but may also include franchise taxes, business license taxes, business and occupation taxes, apportionable gross receipts taxes, value-added taxes, single business taxes, and capital stock taxes.

on the threshold for establishing nexus. In theory, Congress could establish uniform federal standards for the imposition of state business activity taxes on out-of-state businesses.

Some representatives of state and local governments, however, are concerned that enacting nexus guidelines could restrict their ability to levy corporate income taxes (or other BATs) on business activities conducted in their state. For example, if Congress implemented thresholds at the midpoint level of all existing state nexus rules, by definition, many states would lose taxpayers that did not meet the new standard for substantial nexus. The states with the lowest thresholds would fare the worst under such a scenario.

The remote collection authority bills offered in earlier Congresses typically provided that out-of-state vendors that collected sales and use taxes, would not then be subject to business activity taxes by virtue of their tax collection for the state. Thus far in the 108th Congress, as in the past, the BAT nexus issue is being addressed separately from both the extension of the Internet tax moratorium and the sales tax simplification issue.

Action in Congress

Moratorium Legislation

Four bills to extend the Internet tax moratorium were introduced in the first session of the 108th Congress. H.R. 49 was amended and reported by the House Judiciary Committee on July 16, 2003, and approved by the House on September 17. S. 150 was amended and reported by the Senate Commerce Committee on July 31 and was sequentially referred to the Finance Committee on September 29 for up to 30 days and was discharged. S. 150 was then pulled on November 7 for further negotiations on the definition of Internet access. S. 52 (Wyden) was the companion bill to H.R. 49 (Cox) as introduced. H.R. 1481 (Lofgren) would extend the current moratorium temporarily, for five years.

Both H.R. 49 and S. 150 would make the moratorium permanent. The two bills differ on the treatment of existing Internet access taxes. H.R. 49 would immediately remove the grandfathering protection offered under current law to states that had Internet access taxes in place prior to October 1, 1998. S. 150, in contrast, would remove the grandfathering after three years, on October 1, 2006. H.R. 49 and S. 150 would amend the definition of Internet access in an attempt to make the tax moratorium technologically neutral. S. 150 clarifies that the ITFA does not prevent the collection of federal or state fees for the universal service program.

H.R. 49. The House Judiciary Committee, Subcommittee on Commercial and Administrative Law, held a hearing on H.R. 49 on April 1, 2003. Subcommittee consideration and markup occurred on May 22, 2003. A technical amendment in the nature of a substitute was approved by voice vote. The amended H.R. 49 was forwarded to the full committee after approval by voice vote.

On July 16, 2003, the House Judiciary Committee held a markup of H.R. 49, approved one amendment, and reported the amended H.R. 49 to the full House. The approved amendment was introduced on a bipartisan basis by Representative Watt and Subcommittee Chairman Cannon.[20] It is intended to provide technological neutrality in the exemption from taxes on Internet access, without regard to the means by which Internet access is delivered. The amendment added to the definition of Internet access (in Section 1104(5) of the Internet Tax Freedom Act) the phrase shown below in bold type:

> (5) INTERNET ACCESS. — 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. Such term does not include telecommunications services, **except to the extent such services are used to provide Internet access.**[21] [Emphasis added.]

The amendment intended to treat all Internet access services, e.g., DSL, wireless services (WiFi), or satellite, the same as Internet access service delivered via dial-up connections. However, the language of the amendment could also exempt underlying telephone and cable services used to provide Internet access. These underlying telecommunications services are often taxed by state and local governments. Furthermore, with the removal of the grandfather clause that protects taxes on Internet access that were generally imposed and actually enforced prior to October 1, 1998, the moratorium might also be interpreted to include business activity taxes, such as income and property taxes, on Internet access providers.

In its cost estimate of July 21, 2003, the Congressional Budget Office (CBO) determined that H.R. 49, as ordered reported by the House Judiciary Committee, would impose an intergovernmental mandate. CBO estimated that repealing the grandfather clause would lead to revenue losses (on Internet access) totaling $80 million to $120 million per year for the group of approximately 10 states and several local governments in the states that currently tax Internet access. This amount alone exceeds the threshold of $59 million in 2003 established by the Unfunded Mandates Reform Act (UMRA). In addition, amending the definition of Internet access (with the Watt-Cannon amendment) could exempt some telecommunications services used to provide Internet access that are otherwise subject to state and local taxes under

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[20] The language of the Watt-Cannon amendment that was approved in the full Judiciary Committee was different from the Watt amendment introduced but withdrawn in the Subcommittee on Commercial and Administrative Law.

[21] The highlighted phrase was also added to the definition of Internet access services in Section 1101(e)(3)(D) of the Internet Tax Freedom Act. This pertains to the exception to the moratorium for making communications for commercial purposes that include material harmful to minors, if access by minors is not restricted. The addition of the phrase keeps the definition of Internet access service similar to the definition of Internet access in the ITFA. However, in this section the phrase may be redundant, because under Section 1101(e)(2) neither (A) a telecommunications carrier engaged in the provision of a telecommunications service, nor (B) a person engaged in the business of providing an Internet access service, is considered as making a communication of material for commercial purposes.

current ITFA law.[22] The presence of an unfunded intergovernmental mandate in excess of the threshold amount means that a point of order may be raised when a bill is considered on the House or Senate floor.[23]

H.R. 49 was brought to the House floor on September 17, 2003, under a suspension of the rules. This procedure, designed for noncontroversial bills, provides for an up-or-down vote with no floor amendments and requires a two-thirds majority vote. Despite objections from representatives of states with grandfathered Internet access taxes, the House passed H.R. 49, as reported by the Judiciary Committee, by voice vote.[24]

H.R. 1481. Internet Growth and Freedom Act of 2003. H.R. 1481 would temporarily extend the moratorium imposed by the Internet Tax Freedom Act for five years, until November 1, 2008. The bill would continue the grandfather protection for pre-existing Internet access taxes. H.R. 1481 was introduced March 27, 2003 and referred to the Committee on the Judiciary.

S. 52. Internet Tax Nondiscrimination Act. S. 52 would permanently extend the moratorium imposed by the Internet Tax Freedom Act. This bill would remove the grandfathering protection for taxes on Internet access that were generally imposed and actually enforced prior to October 1, 1998, by removing from the ITFA the grandfather clause and the definition of generally imposed and actually enforced taxes. This bill is the companion to H.R. 49 and was introduced on January 7, 2003. S. 52 was referred to the Committee on Commerce, Science, and Transportation.

S. 150. On July 16, 2003, the Senate Committee on Commerce, Science, and Transportation held a hearing on the Internet tax moratorium. Chairman McCain indicated that he preferred that the legislation to extend the moratorium be independent from the sales tax simplification and collection issue. He said he expected to hold a separate hearing on the interstate sales tax issue later this Congress.

On July 31, 2003, the Senate Commerce Committee marked up S. 150. An amendment in the nature of a substitute offered by Senator Allen and co-sponsor of S. 150, Senator Wyden, was approved by voice vote and the amended bill was ordered reported favorably. On September 29, S. 150 was reported by the Commerce Committee (S.Rept. 108-155) and sequentially referred to the Finance Committee for a period of up to 30 days. The bill was discharged from the Finance Committee with no changes.

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[22] Congressional Budget Office, "Cost Estimate for H.R. 49, Internet Tax Nondiscrimination Act."

[23] For an explanation of congressional procedures required under UMRA, see CRS Report RS20058, *Unfunded Mandates Reform Act Summarized*, by Keith Bea and Richard S. Beth, Washington, Feb. 9, 1999, pp. 4-5.

[24] Alison Bennett, House Passes Permanent Extension Of Existing Internet Tax Moratorium, *Daily Tax Report*, Bureau of National Affairs, no. 81, Sept. 18, 2003, p. GG-1.

The first two sections of S. 150 as amended by the Commerce Committee are similar to H.R. 49 as passed by the House. The first section names the bill the Internet Tax Non-discrimination Act. The second section would permanently extend the moratorium, remove the grandfathering protection for existing taxes on Internet access, and make conforming amendments to remove the reference to grandfathered taxes elsewhere in the ITFA. It would add to the definitions of Internet access and Internet access services the phrase "...except to the extent such services are used to provide Internet access" following "telecommunications services," just as was added to H.R. 49 by the Watt-Cannon amendment in the House Judiciary Committee. Senators Allen and Wyden have agreed to refine the definition of Internet access to better reflect their intentions that it is Internet access that is protected from tax and not the underlying communications medium. They also intend that the moratorium be neutral with respect to whatever technology is used to provide Internet access. The Commerce Committee report on S. 150 spells out the committee's intentions with regard to the amended definition of Internet access.[25]

In addition, S. 150 as ordered reported includes a third section that would continue to grandfather existing taxes on Internet access for three more years, until September 30, 2006. A fourth section of the bill clarifies that the ITFA does not prevent the federal government or the states from imposing or collecting the fees or charges on telecommunications that are used to finance the universal service program authorized by Section 254 of the Communications Act of 1934.

For reasons similar to those given above with respect to H.R. 49, in its cost estimate of September 9, 2003 for S. 150, the Congressional Budget Office determined that the bill as ordered reported by the Senate Committee on Commerce, Science, and Transportation would impose an intergovernmental mandate, beginning in 2007, once the grandfathering protection was removed.[26] This means that a point of order could be raised when the bill is considered on the Senate floor. The Senate began consideration of S. 150 on November 6. The bill was pulled on November 7 for further negotiation on the definition of Internet access.

S. 2084. On February 12, 2004, Senators Alexander and Carper introduced S. 2084, which would: (1) extend the Internet tax moratorium for two years, (through October 31, 2005); (2) include in the moratorium taxes on Internet access delivered

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[25] The modified definition of Internet access is meant to clarify that, under the ITFA, neither Internet access nor the transmission component of Internet access is subject to taxation. (Neither the access nor transmission component of DSL would be taxable.) This definition is not meant to affect state and local taxation of traditional telecommunications and other services not used to provide Internet access. It is not meant to exempt from state or local taxation otherwise taxable products or services bundled with Internet access. The lapse of grandfathering protection is not meant to affect the authority of state and local governments to assess and collect traditional sales and use taxes, excise taxes, property taxes, corporate income taxes, gross receipts taxes, business and occupational taxes, and other such taxes generally applied and not enumerated in section 1101(a) of the ITFA. U.S. Congress, Senate Committee on Commerce, Science, and Transportation, report on S. 150, S.Rept. 108-155, pp. 2-4.

[26] Congressional Budget Office, "Cost Estimate for S. 150, Internet Tax Nondiscrimination Act."

through DSL; (3) grandfather all Internet access taxes that were imposed before November 1, 2003; (4) clarify the definition of Internet access services; and (5) implement an accounting rule that would allow the taxation of Internet access if access were offered as part of a bundled package and the access provider did not separate Internet access charges from the other services. The inclusion of DSL in the definition of Internet access services addresses the concern that the moratorium should be neutral with respect to technology. However, the grandfather clause would allow states that were already levying taxes on DSL Internet access to continue to collect the tax.

Table 1 succinctly compares the Internet tax moratorium bills introduced thus far in the House of Representatives and in the Senate. **Table 2** lists bills on related Internet tax issues introduced in the House and those in the Senate. All the bills are described in more detail in the text following the tables.

Table 1. Comparison of Internet Tax Bills in the House and Senate

Bill Number	Extension of Moratorium	Grandfathering Provisions	Other Issues
H.R. 49 passed in the House by voice vote 9/17/03	Permanent	No	Extends exemption from Internet access taxes to all forms of telecommunications used to provide access.
H.R. 1481	5 years, until Nov. 1, 2008	Yes	—
S. 52	Permanent	No	—
S. 150 as ordered reported by the Commerce Committee	Permanent	Until Sept. 30, 2006	Like H.R. 49, extends exemption from Internet access taxes to all forms of telecommunications used to provide access. Clarifies that the ITFA moratorium does not prevent collection of federal or state fees or charges used to finance the universal service program.
S. 2084	2 years, until Nov. 1 2005	Yes	Modifies the definition of Internet access services to include DSL.

Internet Commerce Related Legislation

H.R. 3184. This bill is titled the Streamlined Sales and Use Tax Act and is the companion to S. 1736. H.R. 3184 would grant states that are parties to the Streamlined Sales and Use Tax Agreement (a multistate compact approved November 12, 2002) the authority to require remote sellers to collect and remit state and local sales and use taxes, even if the seller does not have a physical presence in the taxing state. This bill enumerates 18 minimum simplification requirements that the agreement must meet. H.R. 3184 was introduced September 25, 2003, and referred to the Committee on Judiciary.

H.R. 3220. This bill is titled the Business Activity Tax Simplification Act of 2003. H.R. 3220 would (1) establish physical presence as the nexus standard for levying state and local business activity taxes on interstate commerce; (2) amend P.L. 86-272, approved September 14, 1959, which limits the power of states to impose net income taxes on interstate commerce; (3) generally require use of employees or property for more than 21 days per calendar year in a state to establish nexus; (4) enumerate exempt activities. The bill was introduced on October 1, 2003 and was referred to Committee on the Judiciary.

S. 1736. This bill is titled the Streamlined Sales and Use Tax Act and is the companion to H.R. 3184 (see the description of H.R. 3184). The bill was introduced October 15, 2003, and referred to the Committee on Finance.

Table 2. Bills on Related Tax Issues in the House and Senate

Bill Number	Issue
H.R. 3184	Would grant states that comply with the Streamlined Sales and Use Tax Agreement the authority to require remote sellers to collect state and local use taxes on interstate sales, subject to minimum simplification requirements for the agreement and is the companion to S. 1736.
S. 1736	Companion to H.R. 3184.
H.R. 3220	Would establish physical presence as the nexus standard for levying state and local business activity taxes on interstate commerce.

For Additional Information

Hearings in the 108th Congress

U.S. Congress. House. Committee on the Judiciary. Subcommittee on Commercial and Administrative Law. *Internet Tax Nondiscrimination Act.* Hearing on H.R. 49. Serial No. 13. 108th Cong., 1st sess., April 1, 2003. Washington: GPO, 2003. 102 p. Available at [http://www.house.gov/judiciary], visited October 23, 2003.

____. The Streamlined Sales Tax Agreement: States' Efforts to Facilitate Sales Tax Collection from Remote Vendors. Oversight hearing, October 1, 2003. Available at [http://www.house.gov/judiciary], visited October 23, 2003.

U.S. Congress. Senate. Committee on Commerce, Science, and Transportation. *Internet Tax Moratorium.* Hearing. 108th Cong., 1st sess., July 16, 2003. Not yet published. Written testimony available at [http://commerce.senate.gov], visited October 23, 2003.

CRS Reports

CRS Electronic Briefing Book, *Taxation*, Internet Taxation, "Taxing Internet Transactions," available at [http://www.congress.gov/brbk/html/ebtxr70.html].

CRS Report RL31177, *Extending the Internet Tax Moratorium and Related Issues*, by Nonna A. Noto. (Addresses issues raised in the 107th Congress.)

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

CRS Report RL31158, *Internet Tax Bills in the 107th Congress: A Brief Comparison*, by Nonna A. Noto.