

# State Implications of a Permanent Internet Tax Freedom Act

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**Michael Mazerov, Senior Fellow**

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# Implications of a Permanent ITFA: Overview

- 6 states taxing Internet access services under ITFA grandfather lose  $\approx$  \$500M in existing annual S/L sales tax revenue
- 39 other sales tax states & DC have  $\approx$  \$6.5B in potential annual S/L sales tax revenue permanently kept out of their potential sales tax base
- All states at risk of having numerous pre-1998 taxes imposed on Internet access providers challenged/voided as indirect taxes on Internet access service
- All states at risk of having numerous taxes challenged/voided as discriminating against e-commerce

# Internet Tax Freedom Act (ITFA)

- Enacted as a “temporary moratorium in 1998; renewed 2001, 2004, 2007, 2014, 2015 (through 10/30/16)
- Bans “multiple” and “discriminatory” S/L taxation of “electronic commerce”
- Bans new (post-1998) taxes on “Internet access”
- Grandfathers existing S/L sales taxation of monthly fees for Internet access service in 7 states: HI, NM, ND, OH, SD (state law phasing out), TX, WI
- Extended in 2007 to ban S/L taxes on purchase/use/sale of telecommunications services used to provide/obtain Internet access (backbone and end-user, e.g., DSL)

# ITFA's Access Tax Preemption: Original Rationale

- Senate Commerce: *“temporary moratorium on Internet-specific taxes is necessary to facilitate the development of a fair and uniform taxing scheme.”*
- House Judiciary: *“this 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.”*
- AOL: *“We are not here to set up a system that holds the Internet as a tax-free zone. We hope at the end of the discussions there will be a uniform system of taxation, one that gives guidance about, for example what it means to be providing Internet access. Once we solve those problems, all [Internet access] revenues will, I imagine, be subject to some kind of taxation.”*

# ITFA's Internet Access Tax Preemption: New Rationale

- By 2001, ITFA proponents offered new rationale:
  - all S/L taxes needed to be kept off Internet access service to keep cost of broadband access lower – to encourage consumer adoption and provider deployment, and to close the “digital divide.”
- Ignored GAO study that found no significant differences in broadband adoption/ deployment in states taxing access under ITFA grandfather and those not taxing

# Permanent Internet Tax Freedom Act (PITFA)

- ITFA's new rationale has led to numerous bills proposing permanent ITFA and elimination of grandfather
- Bills in current Congress include S. 431 (Thune/Wyden); H.R. 235 (Goodlatte/Eshoo)
- Passed House by voice vote in June
- Added in early December to House/Senate conference report on customs enforcement bill; House approved
- Objections from MFA proponents forestalled immediate Senate consideration of conference report, but still very likely to occur in coming weeks
- MFA proponents will seek point of order to strip PITFA from report and continue push to have ITFA extension only considered in conjunction with MFA/RTPA

# Automatic Effects of PITFA

- 7 states levying sales taxes on Internet access fees lose ≈ \$500M in annual S/L revenue from repeal of grandfather (effective 7/1/20 in customs report version)
- 38 states not currently applying sales taxes to Internet access service have ≈ \$6.5B in potential annual S/L revenue permanently removed from tax base
- Loss of actual/potential revenue will grow substantially over time as more communication and entertainment moves from taxable conventional phone and cable TV service to ITFA-exempted broadband
- Local govts disproportionately affected because of reliance on telecom and utility taxes

# All States at Risk of Revenue Loss from Grandfather Repeal

- S/L taxes on purchases by Internet access providers (e.g., sales tax on purchases of fiber optic cable; real estate transfer taxes on cell tower sites) could be construed as indirect taxes on access service
- Public finance theory recognizes concept of indirect taxation:

IRS: indirect tax is “tax [that] can be passed on to another person or group. A business may recover the cost of the taxes it pays by charging higher prices to customers.”

# All States at Risk of Revenue Loss from Grandfather Repeal

- Some support in legislative history for claim that ITFA intended to ban indirect taxation of access service:
- Ban on access taxes in current ITFA applies “regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access.”
- As introduced, ITFA barred states from taxing access “directly or indirectly.” Now only bars “taxes on Internet access” -- leaving ambiguous application to indirect taxes.
- ITFA states: “The term ‘tax on Internet access’ does not include a tax levied upon. . . net income. . . or property value” -- providing some evidence that other taxes on ISPs not explicitly preserved are banned

# All States at Risk of Revenue Loss from Grandfather Repeal

- Virtually all taxes that could be challenged as indirect taxes on Internet access were levied pre-1998, and so protected by grandfather
- But if grandfather disappears, states at considerable risk that some aggressive ISP will test this issue in court
- See history of 4-R Act litigation: railroads almost immediately brought challenges to S/L taxes they had disavowed when law was under consideration
- Even if ITFA is made permanent, it is essential that grandfather clause also be permanently preserved to prevent this scenario from playing out

# All States at Risk of Revenue Loss from Permanent Ban on “Discriminatory” Taxes

- No one objects in principle to ITFA’s ban on “multiple” and “discriminatory” taxes
- But definition of latter is very broad and vague:

“any tax that is not generally imposed. . . on transactions involving similar property, goods, services, or information accomplished through other means

“any tax that is not generally imposed. . . at the same rate. . . on transactions involving similar property, goods, services, or information accomplished through other means” . . .

# All States at Risk of Revenue Loss from Permanent Ban on “Discriminatory” Taxes

- Definition raises many questions;

What is “similar”? Is it discriminatory to exempt the hard-copy Wall Street Journal and tax the online version when the latter provides a host of services (full text archive search, links to other relevant articles and corporate financial data, etc.) that the former can’t?

What if there are no “similar” offline services? E.g., does ITFA bar states from taxing web hosting services because there is no offline equivalent?

Which tax rate? Nominal or effective? Is the effective sales tax rate on the sale of an e-book discriminatory if sale-for-resale exemptions don’t cover the same share of inputs as with a physical book?

# All States at Risk of Revenue Loss from Permanent Ban on “Discriminatory” Taxes

- Fact that ITFA has never been made permanent has suppressed ITFA-based legal challenges to S/L taxes
- Overly-aggressive litigation would have provided ammunition to ITFA opponents to push for fixes – or even repeal – at next ITFA renewal
- If ITFA is made permanent, this constraint disappears, and more ITFA-based litigation is highly likely
- Congress NEVER revisits S/L preemption legislation that lacks a sunset date no matter how serious the unintended consequences
- For this reason, ITFA should continue to include a sunset date

# Federal Ban on Non-Discriminatory S/L Taxation of Internet Access Is Not Justified

- Almost unprecedented for federal govt to flat-out bar states from taxing a good/service; only other major example is interstate airline and bus transportation.
- Current ITFA rationale – reducing the consumer cost of Internet access service by barring even non-discriminatory S/L sales taxation, in order to facilitate a federal policy goal of encouraging broadband adoption – is the type of unfunded mandate NCSL often opposes.
- Federal govt has no “skin in the game” here – e.g., is not forgoing federal corporate income tax from ISPs
- Whether to apply a non-discriminatory sales tax to Internet access services should be a S/L govt decision, not a federal govt decision

# State and Local Governments Should Apply Sales Taxes to Internet Access Charges

- In keeping with the principle that sales tax bases should be as broad as possible so that sales tax rates can be as low as possible (consistent with revenue needs) states/localities should tax household purchases of Internet access service – just as they should broadly tax other household services
- Failure to tax Internet access under sales tax is discriminatory and distorts market choices
  - HBO taxed, Internet access to stream Netflix isn't
  - Texts taxed, Internet access for WhatsApp isn't
  - Phone calls taxed, Internet access for Skype isn't

# Not Taxing Internet Access Not a Cost-Effective Way to Encourage Broadband Adoption

- Only 1/3 of non-adopters of broadband cite monthly cost of access as main reason they don't subscribe (Pew, 12/15)
- Major barriers are lack of: interest, appreciation of potential benefits, computer ownership/literacy, etc.
- Much better to raise the revenue and use some for more computers/trainers in public libraries, community centers
- Much better to raise the revenue and use some to make college more affordable (93 percent of college graduates subscribe to home broadband)

# Not Taxing Internet Access Not a Cost-Effective Way to Encourage Broadband Adoption

- Non-partisan Congressional Research Service:

“The subsidy offered through the tax moratorium helps low-income individuals afford Internet access, but it also provides a subsidy for upper- and middle-income individuals who would have likely purchased Internet access regardless of the subsidy. . . . Offering a more targeted subsidy exclusively to lower-income individuals would help ensure they have access to the Internet, while avoiding the inefficiencies generated by subsidizing individuals who would have purchased Internet access regardless of the tax moratorium.”

- FCC now proposing to directly subsidize monthly cost of access for low-income households through Lifeline

# The Case for the ITFA – Marketplace Fairness Act Linkage

- States/localities should have the authority to apply non-discriminatory sales taxes to Internet access service; it should be a state decision, not a federal one
- There are good policy reasons for states/localities to apply their sales taxes to Internet access service
- The rationale for not applying the tax is weak; it is a very inefficient subsidy for broadband adoption
- If, contrary to all this evidence, Congress insists on a continued ban, denying states/localities at least \$7b in potential revenue each year, Congress is obligated to offset the revenue hit
- Enacting MFA/RTPA is a reasonable offset, with its own compelling policy justifications

# If ITFA Is Extended (With or Without the MFA)....

- It should not be permanent
  - States/localities should have the authority to tax Internet access in a non-discriminatory way, and ITFA will never be repealed if a sunset date is eliminated
  - A permanent ITFA risks substantial litigation challenging many S/L taxes as “discriminatory”
- Even if it is permanent, the grandfather provision must be preserved
  - A permanent ITFA with no grandfather risks substantial litigation challenging many pre-1998 S/L taxes on Internet access providers as prohibited indirect taxes on Internet access service

**For more in-depth discussion, see:**

**“Congress Should End – Not Extend –  
the Ban on State and Local Taxation of  
Internet Access Service” 7/10/14**

**<http://www.cbpp.org/sites/default/files/atoms/files/7-10-14sfp.pdf>**



**Michael Mazerov**

mazerov@cbpp.org

www.cbpp.org

202.408.1080