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COMMUNICATIONS, TAXATION, AND FEDERALISM

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MAY 23, 2007

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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COMMUNICATIONS, TAXATION, AND FEDERALISM

WEDNESDAY, MAY 23, 2007

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 10:01 a.m. in room SR–253, Russell Senate Office Building, Hon. Daniel K. Inouye, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

The CHAIRMAN. Good morning.

This morning's hearing, titled "Communications, Taxation, and Federalism," explores the sometimes difficult intersection between our desire to encourage online commerce and our Constitutional responsibility to permit states and localities to manage their fiscal affairs.

The most prominent issue before us is the pending expiration of the Internet access tax moratorium. Absent Congressional action, this law will sunset on November 1, 2007. However, as we consider legislation to extend this moratorium, either on a permanent or temporary basis, it is essential that we carefully examine the ambiguities existing in current law, in the hope of avoiding unintended consequences.

Indeed, following our most recent extension, in 2004, a report conducted by the Government Accountability Office reveals that fundamental differences of opinion remain as to the interpretation of key terms in the current moratorium. Failing to address these ambiguities will only fuel, rather than resolve, ongoing confusion between industry and State and local governments as to the proper scope of services protected by the Internet access moratorium.

The significance of these disputes is magnified by rapid changes occurring in the nature of Internet access services and the ease with which providers of Internet access might bundle Internet access with goods and services otherwise available for purchase online.

In light of these potential developments, Congress should clarify its intent before permanently codifying such ambiguities, and similarly should ensure that any extension deals fairly with those State and local tax laws that have been expressly allowed since the adoption of the initial moratorium in 1998.

Finally, our actions must consider the substantial interests of states and localities in managing their fiscal affairs.

As Americans increasingly turn to the Internet to conduct transactions online, Main Street businesses will increasingly be placed at a competitive disadvantage. While many debate the size of the sales tax revenue currently lost from the growth in Internet commerce, most observers agree that the tax loss is significant, and will grow robustly over time.

As pressures on State treasuries increase, the effects of such policies will increasingly be felt by teachers, firefighters, police, and others on the front lines of providing State services. As a result, it is important that we encourage ongoing efforts to simplify State tax codes in the hope that such action may facilitate further Congressional action that would permit states to treat online and offline sales transactions in a nondiscriminatory fashion.

With that, let me welcome the panel assembled here this morning, and we look forward to your testimony.

Do you wish to make a statement, sir?

Senator CARPER. If it's possible.

The CHAIRMAN. Senator Carper?

STATEMENT OF HON. THOMAS R. CARPER, U.S. SENATOR FROM DELAWARE

Senator CARPER. Thanks, Mr. Chairman. Let me just add to what you've said and to welcome our colleagues.

This is, in a sense, a déjà vu, looking out at this panel. And welcome, Representative Eshoo, to the Senate.

This is an unlikely issue to provoke strong passions, but it seems to, on both sides. And I want to just take a moment and go back to the 1990s.

The Internet was young, and I think the rest of us were younger. With the introduction and growth of the Internet, a number of State and local governments saw an opportunity to raise some of the revenues that they needed to run their schools, to run their hospitals, to help meet their police and fire service needs. Some of them passed laws to place a tax on consumer access to the Internet, and it was described as a tax on the time on people's AOL bills. But, as the number of states and cities grew doing that, so did the concerns that the tax burden that was being placed would become so great that the potential of the Internet could be snuffed out, or at the very least would be impeded. And, as a result, the Congress passed a law in 1998, grandfathering in State and local governments that already imposed a tax, but essentially saying to the rest, "Sorry, but you've missed your chance."

As it turns out, the growth of that infant, the Internet, continued unabated in all the states, even in states and localities that had imposed a tax on Internet access. And today I think most of us would say that the Net is doing just fine, our earlier concerns notwithstanding.

Every few years since 1998, that original moratorium has been extended, as the Chairman mentioned, first in 2001, then again in 2004, after lapsing for a while in 2003. About 3 years ago, we had a donnybrook here in the Senate, and we ended up extending the moratorium through November of this year, although a majority of Congress voted to broaden the definition of what State and local governments could not tax. And, while states and local governments didn't like that change very much, they won at least a partial victory when Congress chose not to prevent them from raising revenues in conjunction with a new technology, called VoIP. At the time, it was being used, I think, by some 150,000 customers or subscribers.

Three years later, VoIP is being used I'm told, by 18 million subscribers to deliver largely telephone services, services which State and local governments have traditionally used to raise significant portions of the revenues that they need to provide further services to their residents.

This year's VoIP is spelled IPTV, Internet Protocol Television, and dramatic IPTV growth is expected, so that by sometime in the next decade, I'm told that subscribers could number as many as 100 million. That's a lot. If IPTV is bundled by voice and Internet and other services, State and local governments that rely on cable taxes and fees could face what they describe as a "financial tsunami." That's why as more and more products and services move to the Internet, I just think we need to be very careful before we extend tax exempt status at all levels of government for any business that bundles its services online.

Let me just say, in closing, if I could, if you look at the Senators over here most involved in this issue over the past 6 years on the side of the State and local governments, not surprisingly they used to run State and local governments. Senator Enzi was Mayor of Gillette. Dianne Feinstein was Mayor of San Francisco. Byron Dorgan was Commissioner of Revenues for North Dakota. George Voinovich was Mayor of Cleveland and Governor of Ohio. Lamar Alexander was Governor of Tennessee. I was privileged to be Governor of Delaware. None of us liked it very much when the Federal Government would come in and tell us how to spend money, but not give us the money to spend. A good example of that is "No Child Left Behind." None of us liked very much the idea of the Federal Government coming in and taking away our ability to raise revenues, but not supplanting or replacing those revenues.

We complained so much, in fact, that Congress passed a law, about a decade ago, called the Unfunded Mandates Law, that said, basically, "We're not going to do that to the states. We're not going to tell them how to spend their money without giving them money. We're not going to tell them they can't raise money in certain ways, without replacing that money." But yet, we continue to try to nip at that, and chip away at that, through this matter.

I'm pleased to be on this Committee, pleased to serve with you. In the end, I'm not interested in taxing access to the Internet any more than any of my colleagues are, and our friends in the House are. Today, Senator Alexander and I have introduced along with Senator Enzi and others, legislation that seeks to provide for a real clear definition of what we want to do. We don't want to tax access to the Internet. We don't want to tax people's access to e-mail, to instant messaging, that kind of thing. At the same time, we want to try to be fair to State and local governments as they face the burden of, how do they fund their schools? How do they pay for their hospitals? How do they provide for fire service? How do they provide for police service?—that we don't tie their hands for them. It's all well and good for us to say how we're going to raise Federal revenues, but I think we've got to be real careful when we turn to State and local governments and say, "This is how you can raise yours, or how you cannot raise yours," particularly at a time when we don't have a sales tax in my State; and the states that do have State and local sales taxes, that money is going away. It is going away. Because what people are doing, is buying over the Internet. We do it. And, frankly, I guess most of the people in this room do that, as well. As that source of revenue is undermined for State and local governments, we've just got to be real careful that we don't somehow further damage the situation by the actions that we take here today.

Thank you.

The CHAIRMAN. Thank you.

Senator Sununu?

STATEMENT OF HON. JOHN E. SUNUNU, U.S. SENATOR FROM NEW HAMPSHIRE

Senator SUNUNU. Thank you very much, Mr. Chairman.

And I welcome my colleagues. And, having been in that position before, it's never a lot of fun to have to listen to your colleagues speak before you get to offer your testimony, so I apologize. But I don't know how much I'm going to help you in that regard. I do want to make a few comments before we begin.

Let me begin by emphasizing why we have this idea of a moratorium, or a ban, on Internet access taxes in the first place, and that's because we view the Internet in general as an interstate service. It's a national service, it's a global system. We do have a responsibility, at the Federal level, to try to reasonably protect interstate commercial activity, and interstate services, like this from either fragmented regulations or burdensome taxes. That's the idea here. The Internet has been an engine of economic growth, of productivity improvements across the entire country, across the entire world. And those, like Senator Wyden and like me, who support a prohibition on Internet taxes, are recognizing the value of this system as an engine of interstate national and global economic growth, and also recognizing a very basic principle: When you tax something, when you burden it with taxes, you're going to get less of it. I think that is a particularly important point in an environment where we hear legislators and public servants, Senators, House members, Governors, local representatives, talk about broadband deployment all the time, "We need better broadband deployment. Went need better penetration. We need better access to the Internet. And we need more high-speed access." And then, at the same time, they turn around and start talking about ending this ban on Internet access taxes, raising taxes on the Internet, which would have just the opposite effect, making it much more difficult to improve Internet access for high-cost areas, for rural areas.

Senator Carper says, "Well, we don't really have any—no interest in taxing Internet access." But if you stand in the way of a prohibition, then you're going to allow cities and towns and counties and others to tax Internet access. You might say, "We have no interest in having taxes on e-mail," but if we allow the prohibition on Internet taxes to expire, then you open the door for cities and town and states to tax e-mail or other aspects of Internet access.

So, I think we need to be, sort of, honest about what we're endorsing and what we're opposing. And I think it certainly makes sense, given the national and global nature of the Internet, to say, "In this particular case, and with good, clear definition, that those cities, towns, and states cannot tax Internet access."

Senator Carper points out that we clarified the definitions with regard to voice service so that VoIP is treated the way other voice services are treated. And I think that was an appropriate approach that we took. But where access to the Internet, access to broadband is concerned, cities, towns, states shouldn't be imposing taxes that will discourage investment in innovation, raise prices for consumers, slow down the pace of deployment and access to those high-cost rural areas.

This is a very important debate. I think, unfortunately, we're going to be talking about sales taxes, as well, in this debate, which is a separate issue, one that I think is very problematic, because it certainly penalizes states without a sales tax, because it creates an approach for the Federal Government to force small businesses in New Hampshire to collect taxes for other states. But we'll address those in the question and answer period.

I thank you very much, Mr. Chairman, for holding the hearing on this important issue, because over the next couple of months, consumers are going to wake up to the fact that, unless we make this moratorium on Internet taxes permanent, then the Internet taxes are going to be imposed and start expanding across the country, November of this year.

The CHAIRMAN. Now it's my privilege to call upon my distinguished colleagues.

May I first call on Senator Ron Wyden.

Senator Wyden?

STATEMENT OF HON. RON WYDEN, U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you. Thank you very much, Mr. Chairman.

Having given a lot of orations in this room on this particular subject, I thought I'd spare you, this morning and—I'm just thrilled to be here with Senator Enzi, Representative Eshoo, Senator Sununu, all of you, to debate and just make a few comments.

I'm always sad when I walk in the door, because I miss serving on this Committee so much, and being part of these debates. This is one of the great committees. And I know we can tackle this issue once again.

When we started this discussion in this room, Congressman Cox and myself and Senator McCain, we tried to make clear that this was not about giving the Internet a free ride. Nobody should get a free ride. This has always been a question, because we all agree that we want the Internet, as an engine of so much good in our society, to keep that engine discrimination-free. The bill has always been about preventing discrimination on the Net.

And let me give you the example we used, Mr. Chairman and colleagues, 10 years ago. We found, 10 years ago, that there were certain publications, at that time, that, if you bought the online edition, you paid a big tax, but if you bought the snail-mail edition, you paid no tax. We said, "That's discrimination against technology. That's discrimination against the Net. We shouldn't allow it." And that has remained the bedrock principle of this whole debate for the last decade, that we should not allow discrimination.

So, when our friend from Delaware—we've had this discussion many times—talks about not letting people generate revenue at the State and local level, all that this law has said for the last 10 years is that what you do online cannot be more punitive than what you do offline. I personally think we ought to make this permanent now. I'll come back here as long as the good people of Oregon are willing to let me serve in the Senate and keep working on this. Our ancestors were told the Spanish-American War phone tax was temporary, and I think it's time to take this out of temporary status and make it permanent, embed the principle that we don't want discrimination online.

Now, if you want to figure out how much discriminatory taxes could be, the best reference is the phone bill, because taxes and government fees already add as much as another 20 percent to people's phone bills.

Here's the kind of scenario that we could have if you allow the Net to be opened up in this discriminatory way. Right now, if you take a gallon of milk to the checkout counter and pay tax on the purchase, the clerk can't turn around and charge you another tax if you're going to use the milk in your cereal and another tax if you're going to put milk in your coffee. But that's what can happen if you open up the Net to multiple taxes, and discriminatory taxes, and still pay all the phone taxes on digital subscriber lines, and all the franchise fees on cable, but, on top of those, you could pay even more taxes for the very same service.

Now, the other point I wanted to mention, Mr. Chairman, is, nobody has been able to show harm as a result of this law. Nobody has been able to show how the failure to allow discriminatory taxes on the Net has hurt them. My hope now is that we can get beyond a few of the myths about this discussion and make this law permanent.

The first myth is that in some way this law has kept State and local governments from taxing online sales. I've already made the point that the State and localities can do anything they want online, as long as the same thing happens offline. And the law specifically states that any sales tax that can be collected from an out-of-state phone or catalog order today can be collected from an Internet sale. The Act does not affect those abilities of states and localities.

The second myth that has been out there is that the law somehow slows down a related project—not the same one, but a related project—called the State Streamlined Sales Tax Project. This is an effort by Senator Enzi. He's been doing good work. And certainly, I and others are willing to look at that whole effort.

What this has largely been about—and former Governor Cellucci testified—I believe it was in this room, when we wrote the original law—is that states are not very comfortable forcing their citizens to pay taxes they owe on out-of-state purchases. And former Governor Cellucci testified before Congress that he just wasn't going to station State patrol officers at the New Hampshire border to search every returning Massachusetts car for items purchased in New Hampshire. That is the heart of the problem. And I don't understand why we should allow discriminatory taxes on the Net in order to deal with what is, to some extent, a question of political will.

The Streamlined Sales Tax Project is going to consider—at some point, the Congress will decide whether to move from 7,500 different taxing jurisdictions to 43,000 five-digit Zip Codes or 30 million nine-digit Zip Codes. We'll see if the Congress considers that simplification. But there is nothing in the Internet tax law that will in any way hinder the Streamlined Sales Tax Project.

As Senator Carper said, and you touched on, Mr. Chairman, we all want broadband to be as available and widespread as we possibly can. But it just seems to me that to allow for multiple and discriminatory taxes online is going to make it harder for this Committee to go forward with its very constructive agenda to expand broadband into every nook and cranny of the country.

Mr. Chairman, I thank you for the opportunity, and see a number of colleagues who have been involved in this debate over the years, and look forward to working with you on this.

The CHAIRMAN. I thank you very much, sir.

And I'm now pleased to recognize Senator Michael Enzi.

STATEMENT OF HON. MICHAEL B. ENZI, U.S. SENATOR FROM WYOMING

Senator ENZI. Thank you, Mr. Chairman. I appreciate you holding this hearing. It covers some extremely critical things, particularly to State and local governments. And I do intend to talk about both sales taxes and the moratorium on Internet access.

I would ask that my whole statement be a part of the record.

The CHAIRMAN. Without objection.

Senator ENZI. Thank you.

I've been working on the Streamlined Sales Tax Project and the sales tax fairness issue since joining the U.S. Senate in 1997. As a former small business man, it's important to level the playing field for all retailers—in-store, catalog, and online—so an outdated rule for sales tax collection does not adversely impact small businesses and main-street retailers.

Yesterday afternoon, I introduced the Sales Tax Fairness and Simplification Act, a bill that will treat all retailers in a similar fashion, so each retailer has the same sales tax collection responsibility. All businesses and their retail sales should be treated equally. By addressing this collection inequity, the bill will also help states ensure the viability of the sales tax as a major revenue source for State budgets by closing a growing loophole that encourages tax avoidance.

My bill is not about new taxes. In fact, it is likely that states' dependency on Federal dollars could be offset by an increased collection at the State level. If Congress fails to authorize states to collect taxes on remote sales, and electronic commerce continues to grow as predicted, are we implicitly blessing a situation where states will be forced to raise other taxes, such as income or property taxes, to offset the growing loss of sales tax revenue? I do want to avoid that.

The Sales Tax Fairness and Simplification Act accomplishes tax simplification in an unprecedented manner. It goes well beyond what Senator Wyden has mentioned. I won't go into all the details.

The bill will help relieve the expensive burden by requiring states to meet the simplification standards outlined in the Streamlined Sales and Use Tax Agreement. Working with the business community, the states developed the Agreement to harmonize State sales tax rules, bring uniformity to definition of items in the sales tax base, significantly reduce the paperwork burden on retailers, and incorporate new technology to modernize many administrative procedures. This historic Agreement was approved by 34 states and the District of Columbia on November 12, 2002.

Now, Senator Byron Dorgan of North Dakota, and I have worked tirelessly to assist sellers and State and local governments to find true simplification in almost every aspect of sales and use tax collection and administration. For the past 2 years, we worked with all interested parties to try to find a mutually agreeable legislative package to introduce. Many hours have been dedicated in trying to find the right solution to address all concerns, especially the small business exception. And we're still working on it. That's what we do.

I'd also like to take this opportunity to briefly mention my support for Senators Carper and Alexander's bill, that it would extend the current Internet access tax moratorium. This legislation represents a commonsense approach to the extension of the Internet Tax Freedom Act, and recognizes that there may be changes in uniformity out there that we never anticipated. The first time that we discussed the—uniformity, we didn't talk about Voice over Internet Protocol. We have now.

As the former Mayor of Gillette, Wyoming, and a former State legislator, I want to talk for a moment about the impact of this moratorium on State and local governments. I fully recognize the right of State and local governments to tax and collect revenue. State and local governments provide essential services to their communities, and they need to have revenue to pay for those services.

While I agree that Internet access must remain tax-free, Congress must make sure that this definition of what constitutes Internet access is not expanded to unfairly limit the ability of State and local governments to provide essential services, such as police, firefighters, teachers, and road construction crews. You can't drink water from the Internet. You can't flush your toilet on the Internet. You can't drive your car on the Internet. Do you want to unfairly limit local government as they provide necessary services? I believe that Senators Carper and Alexander's legislation finds the right balance with the definition of "Internet access." This bill makes sure that e-mail and instant messaging remains tax-free, while allowing states the ability to continue to collect revenue for essential services. It encourages increased use of the Internet, but still provides that future uses, if they have conflicts, can be resolved with future legislation.

I urge my colleagues on this Committee to support the Internet Tax Freedom Extension Act of 2007. And I appreciate this opportunity to testify.

[The prepared statement of Senator Enzi follows:]

PREPARED STATEMENT OF HON. MICHAEL B. ENZI, U.S. SENATOR FROM WYOMING

Thank you, Chairman Inouye and Ranking Member Stevens, for allowing me to testify this morning about the importance of imposing uniformity, simplification, and fairness concerning the taxation of remote sales over the Internet. I also intend to briefly discuss the current moratorium on the Internet access tax.

I have been working on the Streamlined Sales Tax Project and sales tax fairness issue since joining the U.S. Senate in 1997. As a former small business man, it is important to level the playing field for all retailers—in-store, catalog, and online—so an outdated rule for sales tax collection does not adversely impact small businesses and Main Street retailers. Yesterday afternoon, I introduced the Sales Tax Fairness and Simplification Act, a bill that will treat all retailers in a similar fashion so each retailer has the same sales tax collection responsibility. All businesses and their retail sales should be treated equally.

By addressing this collection inequity, the bill will also help states ensure the viability of the sales tax as a major revenue source for state budgets by closing a growing loophole that encourages tax avoidance. It will help both consumers and states by reducing the burden on consumers and providing a mechanism that will allow states to systematically and fairly collect the taxes already owed to them. At a time when states are increasingly turning to the Federal Government for program funding, it is logical that Congress would instead authorize the states to collect their own revenue instead of raising the Federal tax burden to then distribute money back to the states.

My bill is not about new taxes. In fact, it is likely that the states' dependency on Federal dollars could be offset by any increased collection at the state level. If Congress fails to authorize states to collect tax on remote sales, and electronic commerce continues to grow as predicted, are we implicitly blessing a situation where states will be forced to raise other taxes —such as income or property taxes—to offset the growing loss of sales tax revenue? I want to avoid that. That is why we need to implement a plan that will allow states to generate revenue using mechanisms already approved by their local leaders.

The Sales Tax Fairness and Simplification Act accomplishes tax simplification in an unprecedented manner. As the Supreme Court identified in the *Quill* versus *North Dakota* decision in 1992, a multitude of complicated and diverse state sales tax rules made it too onerous to require retailers to collect sales taxes unless they had a physical presence in the state of the buyer. Local brick-and-mortar retailers collect sales taxes, while many online and catalog retailers are exempt from collecting the same taxes if they can argue that they do not have physical presence in the state. This is not only fundamentally unfair to Main Street retailers, most of whom are small businesses, but it is costing states and localities billions of dollars in lost revenue.

The bill will help relieve the expensive burden by requiring states to meet the simplification standards outlined in the Streamlined Sales and Use Tax Agreement. Working with the business community, the states developed the Agreement to harmonize state sales tax rules, bring uniformity to definitions of items in the sales tax base, significantly reduce the paperwork burden on retailers, and incorporate new technology to modernize many administrative procedures. This historic Agreement was approved by 34 states and the District of Columbia on November 12, 2002.

The states have made tremendous progress in changing their state tax laws to become compliant with the Agreement. Already, 19 states have enacted legislation to change their tax laws and implement the requirements of the Agreement and over 350 businesses have voluntarily signed up to begin collecting sales tax under the simplified set of rules.

While the states have made great progress, the *Quill* decision held that allowing states to require collection is an issue that, "Congress may be better qualified to resolve, and one that it has the ultimate power to resolve." The states have acted. It is now time for Congress to provide states that enact the Streamlined Sales and Use Tax Agreement with the authority to require remote retailers to collect sales taxes just as Main Street retailers do today.

Senator Byron Dorgan of North Dakota and I have worked tirelessly to assist sellers and state and local governments to find true simplification in almost every aspect of sales and use tax collection and administration. For the past 2 years, we worked with all interested parties to try to find a mutually agreeable legislative package to introduce. Many hours have been dedicated in trying to find the right solution to address all concerns, especially the small business exception. Although I introduced the bill yesterday, I will continue to work with Senator Dorgan, my Congressional colleagues, and all interested parties to attempt to find compromise on all of the policy issues of concern to the stakeholders. Some of the outstanding policy issues we will attempt to address include modification of the small business exception, telecommunications services provisions, governance and judicial review, and the definition of sourcing. Bill introduction does not stop us from negotiating and working together to improve the final product that should be enacted into public law. It is how I always work.

The Sales Tax Fairness and Simplification Act provides states that implement the Streamlined Sales and Use Tax Agreement with the authority to collect sales or use taxes equally from *all* retailers. Adoption of the Agreement *and* Congressional authorization will provide a level playing field for brick and mortar and remote retailers. I strongly urge my colleagues on this Committee to support the Sales Tax Fairness and Simplification Act.

I would also like to take this opportunity to briefly mention my support for Senators Carper and Alexander's bill that would extend the current Internet access tax moratorium, also called the Internet Tax Freedom Extension Act of 2007. This legislation represents a common sense approach to the extension of the Internet Tax Freedom Act. Internet access provides countless opportunities for schools and businesses throughout our Nation, and I want to ensure that this access remains free from unfair and burdensome taxation. That is why I support this legislation to extend the moratorium on taxation for an additional 4 years.

As the former Mayor of Gillette, Wyoming and a former state legislator, I want to talk for a moment about the impact of this moratorium on local and state governments. I fully recognize the right of state and local governments to tax and collect revenue. State and local governments provide essential services to their communities and they need to have revenue to pay for these services.

While I agree that Internet access must remain tax free, Congress must make sure that this definition of what constitutes Internet access is not expanded to unfairly limit the ability of state and local governments to provide essential services, such as police, firefighters, teachers, and road construction crews. You cannot drink water from the Internet. You cannot flush your toilet on the Internet. You cannot drive your car on the Internet. Do not unfairly limit local governments as they provide necessary services. I believe that Senators Carper and Alexander's legislation finds the right balance with its definition of Internet access. This bill makes sure that e-mail and instant messaging remains tax free while allowing states the ability to continue to collect revenue for essential services. I urge my colleagues on this Committee to support the Internet Tax Freedom Extension Act of 2007.

Thank you again, Chairman Inouye and Ranking Member Stevens, for the opportunity to outline the importance of my bill, the Sales Tax Fairness and Simplification Act, and the Internet Tax Freedom Extension Act of 2007. I look forward to working with you, your staff, and the rest of the Commerce Committee on these two policy initiatives in the future to ensure swift passage of both bills later this year.

The CHAIRMAN. I thank you very much.

And now it's my pleasure to welcome our next witness to the Senate, the Honorable Anna Eshoo, Representative from the State of California.

STATEMENT OF HON. ANNA G. ESHOO, U.S. REPRESENTATIVE FROM CALIFORNIA

Representative ESHOO. Good morning, Mr. Chairman and members of the Committee. Thank you for having me here to testify on legislation that I've introduced in the House, with Congressman Bob Goodlatte. And I hope he'll be able to join us this morning. He's been a great advocate for this.

The bill is H.R. 743, the Permanent Internet Tax Freedom Act of 2007. It has a strong bipartisan support in the House, with 70 cosponsors to date.

When this issue first came to prominence in the late 1990s, my Congressional district, which is home to Silicon Valley, was bustling with activity in the burgeoning Internet sector. From the end of 1997 to the end of 1998, in 1 short year, the number of Internet users more than doubled, from 70 million to 147 million, and the 2 millionth domain name was registered in May 1998. In September 1998, a small startup company was also incorporated in a garage in Menlo Park: Google, Inc.

Congress and President Clinton recognized the promise of the Internet and the need to foster its growth and development by maintaining an open architecture, with limited barriers to entry and minimal regulatory and administrative burdens. Of particular concern was the potential for Internet access and services to become a target for government taxing authorities seeking new sources of revenue. We recognized, at that time, that it would not serve our country well to interfere with the growth of this exciting and invaluable tool for information, communications, and commerce, and we prohibited new and discriminatory taxes on the Internet.

I think the moratorium has served our country well. The Internet is now an integral part of everyday life in our Nation. Americans utilize the Internet for communication, commerce, business, education, and research. So, I don't think now is the time to reverse this course and kill, essentially, "*GoldenGoose.com*." It's more critical now than at any time since the moratorium was established to protect the Internet from new taxes and fees.

The country that invented the Internet no longer leads the world in Internet access and use. According to the most recent data, our country now ranks 15th in broadband penetration amongst all industrialized countries. I believe Congress should make a commitment to provide universal broadband access to all Americans. Universal broadband isn't just something we should do, it's something we must do if we're to remain competitive in the 21st century and the global economy. Broadband services are expanding, and more American consumers are subscribing to it, but we still lag behind most of our global competitors, particularly regarding true high-speed broadband service that will allow our country to remain a leader in communications strategies.

Access to these high-speed services and applications will revolutionize business, healthcare, entertainment, and education in our country, but only if all Americans have access to advanced broadband service that's affordable. I can't think of a faster way to retreat from this important goal than to permit new taxes on Internet access and services. I think it will widen the breach of the digital divide.

Some have argued that we should enact another temporary moratorium rather than establish the certainty that a permanent moratorium would provide. I think the basis for these arguments seems to be that State and local taxing authorities should be given time to streamline and simplify the various sales taxes assessed by the 7,500 taxing jurisdictions throughout the country. I don't think these arguments really hold water.

First, nothing in this bill prohibits State and local governments from collecting use taxes from their residents on purchases made on the Internet, over the phone, or by mail order. It simply leaves in place the *status quo,* that distant businesses cannot be forced to calculate and collect these taxes for them.

The promise of streamlining—and I thought there was promise for streamlining and simplification, but I think, today, it's illusory, most frankly—the discussions that have been underway—and I know Senator Enzi has done a great deal of work on it, but when you look at where we are now, the discussions have been underway for over a decade, and little or no progress is evident. In fact, the multi-state discussions on a simplified nationwide sales tax system have dwindled to 15 states, and they don't even include any of the Nation's six most populous states—my State of California, Texas, New York, Florida, Illinois, and Pennsylvania. So, it's hard to see how these discussions will bear fruit, and it's difficult, I think, to justify tying the enactment of a permanent moratorium on new and discriminatory Internet taxes to this debate.

So, I think it's important for Congress—I think it's critical for Congress—to do three things: reflect our commitment to universal broadband in America; two, provide certainty to the entire Internet community that access to the Net will remain tax free; and, three, to ensure that e-commerce in our country will remain free of discriminatory taxes.

Thank you, again, for having me here today. It's an honor to share the podium with my colleagues and to be with you, this distinguished Committee.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank you very much.

Do you have any questions?

[No response.]

The CHAIRMAN. If not, I thank the panel very much. Thank you.

Our next panel consists of Dr. James White, Director of Tax Policy and Administration of the GAO; Mr. David Quam, Director of Federal Relations, National Governors Association; Mr. Harley Duncan, Executive Director, Federation of Tax Administrators; Ms. Annabelle Canning, Vice President, State Tax Policy, of Verizon; and Mr. Jeff Dircksen, Director of Congressional Analysis, National Taxpayers Union Foundation. Welcome to the Committee.

May I first recognize Dr. White.

STATEMENT OF DR. JAMES R. WHITE, DIRECTOR, TAX ISSUES AND STRATEGIC ISSUES, GAO

Dr. WHITE. Mr. Chairman, Mr. Vice Chairman, and members of the Committee, I'm pleased to participate in today's hearing, and will focus on two issues: the scope of the moratorium on taxing Internet access and the impact of the moratorium, if any, on State and local revenues. These issues are of concern because of controversy over exactly what taxes are covered by the moratorium passed as part of the 1998 Internet Tax Freedom Act.

First, regarding the scope of the moratorium as it applies to Internet access, what I say here is based on our reading of the plain language of the statute. The moratorium bars taxes on the service of providing Internet access to users, including whatever is reasonably bundled in the access package.

My first graphic, which is also on page 19 of my statement, illustrates what can reasonably be bundled into an Internet access package. The graphic shows an Internet access provider, such as an American Online or Comcast, at the top, on the right, and a wire or a cable connecting the Internet service provider to a user in a home or a business. The pie chart is a cross-section slice of the wire, showing the various services that a provider sells to users. One of those services is Internet access, defined in the law as a service that enables users to access content, information, electronic mail, or other services offered over the Internet. Such an Internet access package is subject to the moratorium, making it tax exempt. Internet service providers may sell other services. These include video and POTS, perhaps my favorite acronym, Plain Old Telephone Service. These are not covered by the moratorium, they are taxable.

My second graphic, which is on page 20 of my statement, is another way of showing what is subject to the moratorium on taxing Internet access. At the right is the end-user, a home, business, or school, just as in the first graphic. In the middle is the Internet service provider. As I have described, the sale of Internet access—the sale of an Internet access package by a provider to an end-user is covered by the moratorium and not subject to tax. On the left is a seller of various services to an Internet service provider. The services acquired by the Internet service provider could include leases of high-speed communications capacity to carry traffic to the Internet backbone. Purchases of such acquired services may be subject to taxation, depending on State law, because the moratorium only applies to taxes on Internet access. In other words, it is the service of providing Internet access to end-users, the transaction on the right, that is subject to the tax moratorium. Acquiring services from suppliers, the transaction on the left, is not subject to the moratorium.

Some providers and State officials have construed the moratorium as barring taxation of acquired services, reading 2004 amendments to the 1998 Act as making acquired services tax exempt. However, as indicated by the language of the statute, the 2004 amendments did not expand the definition of "Internet access"; rather, they amended the exception from the definition of Internet access to allow certain telecommunications services to qualify for the moratorium if they are part of the service of providing Internet access to users.

A tax on acquired services, the transaction on the left in the graphic, is not a tax on the service of providing Internet access to users, that transaction shown on the right.

Now, I want to discuss the revenue impact of the moratorium. The moratorium's impact on State and local revenues is unclear. Some taxes have been collected under a grandfather clause, but the amounts are small. One estimate is that states with grandfathered Internet access taxes collected something on the order of .1 percent of their total tax revenue from such taxes. This is consistent with information we, at GAO, obtained in case studies of eight states and interviews with Internet service providers. While we know that the amount actually collected from grandfathered Internet access taxes is small, it is difficult to predict what states would have done in the absence of the moratorium passed in 1998. As states and localities saw increased Internet use, they might have taxed Internet access if no moratorium had been in place.

Any future impact of the moratorium will vary by state and also depend on whether grandfathering is continued. Some states might choose not to tax Internet access, even in the absence of a moratorium, but types of taxes states might impose would also vary. In our case studies, some states taxed only services delivered to retail customers, some taxed acquired services, some taxed both, some taxed neither, and some provided exemptions—for example, to residential consumers.

Mr. Chairman, Mr. Vice Chairman, this completes my statement, and I'd be happy to answer any questions.

[The prepared statement of Dr. White follows:]

PREPARED STATEMENT OF DR. JAMES R. WHITE, DIRECTOR, TAX ISSUES AND STRATEGIC ISSUES, GAO

Chairman Inouye, Vice Chairman Stevens, and members of the Committee:

I appreciate this opportunity to discuss the moratorium on taxing access to the Internet. According to one study, at the end of 2006 about 92 million U.S. adults used the Internet on a typical day.[1] As Internet usage grew from the mid-1990s onward, state and local governments imposed some taxes on it and considered more. Concerned about the impact of such taxes, Congress extensively debated whether state and local governments should be allowed to tax Internet access. The debate resulted in legislation setting national policy on state and local taxation of access.

In 1998, Congress enacted the Internet Tax Freedom Act,[2] which imposed a moratorium temporarily preventing state and local governments from imposing new taxes on Internet access or multiple or discriminatory taxes on electronic commerce. Existing state and local taxes were "grandfathered," allowing them to continue to be collected. Since its enactment, the moratorium has been amended twice, most recently in 2004, when Congress included language requiring that we study the impact of the moratorium on state and local government revenues and on the deployment and adoption of broadband technologies.[3] Such technologies permit communications over high-speed, high-capacity media, such as that provided by cable modem service or by a telephone technology known as digital subscriber line (DSL).[4] This year, bills have been introduced in both Houses of Congress to make the moratorium permanent.

My remarks today are based on the first of two reports we issued responding to the mandate that we study the impact of the moratorium. Issued in January 2006, that report focused on the moratorium's impact on state and local government revenues.[5] Its objectives were to determine (1) the scope of the moratorium and (2) the impact of the moratorium, if any, on state and local revenues. In determining any impact on revenues, the report explored what would happen if grandfathering of access taxes on dial-up and DSL services were eliminated, what might have happened in the absence of the moratorium, and how the impact of the moratorium might differ from state to state. The report did not focus on taxing the sale of items over the Internet. A second report discussed the impact that various factors, including taxes, have on broadband deployment and adoption.[6]

To prepare the first report, we reviewed the language of the moratorium, its legislative history, and associated legal issues; examined studies of revenue impact done

[1] Pew Internet & American Life Project, *Daily Internet Activities* (Washington, D.C.: Jan. 11, 2007).

[2] Pub. L. 105–277, 112 Stat. 2681–719 (1998), 47 U.S.C. § 151 Note.

[3] Internet Tax Nondiscrimination Act, Pub. L. 108–435, § 7, 118 Stat. 2615, 2618 (2004).

[4] DSL is a high-speed way of accessing the Internet using traditional telephone lines that have been "conditioned" to handle DSL technology.

[5] GAO, *Internet Access Tax Moratorium: Revenue Impacts Will Vary by State,* GAO–06–273 (Washington, D.C.: Jan. 23, 2006). See the report for more details than this testimony provides about revenue impacts and for more appendixes, including one showing comments from telecommunications industry officials.

[6] GAO, *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 (Washington, D.C.: May 5, 2006).

by the Congressional Budget Office (CBO) and others; interviewed representatives of companies and associations involved with Internet access services; and collected information through case studies of eight states. We chose the states to get a mixture of those that did or did not have taxes grandfathered for different forms of access services, did or did not have local jurisdictions that taxed access services, had high and low state tax revenue dollars per household and business entity with Internet presence, had high and low percentages of households online, and covered different urban and rural parts of the country. We did not intend the eight states to represent any other states. In the course of our case studies, state officials told us how they made the estimates they gave us of tax revenues collected related to Internet access and how firm these estimates were. We could not verify the estimates, and, in doing its study, CBO supplemented estimates that it received from states with CBO-generated information. Nevertheless, based on other information we obtained, the state estimates we received appeared to provide a sense of the order of magnitude of the dollars involved. We did our work from February through December 2005 in accordance with generally accepted government auditing standards. A later section of this testimony contains a complete discussion of our objectives, scope, and methodology.

Let me begin by summarizing the major points of the report:

The Internet tax moratorium bars taxes on Internet access, meaning taxes on the service of providing Internet access. In this way, it prevents services that are reasonably bundled as part of an Internet access package, such as electronic mail and instant messaging, from being subject to taxes when sold to end-users. These tax-exempt services also include DSL services bundled as part of an Internet access package. Some states and providers have construed the moratorium as also barring taxation of what we call acquired services, such as high-speed communications capacity over fiber, acquired by Internet service providers and used by them to deliver access to the Internet to their customers. Because they believed that taxes on acquired services are prohibited by the 2004 amendments, some state officials told us when we were preparing our report that their states would stop collecting them as early as November 1, 2005, the date they assumed that taxes on acquired services would lose their grandfathered protection. However, according to our reading of the law, the moratorium does not apply to acquired services since, among other things, a tax on acquired services is not a tax on "Internet access." Nontaxable "Internet access" is defined in the law as the service of providing Internet access to an end-user; it does not extend to a provider's acquisition of capacity to provide such service. Purchases of acquired services are subject to taxation, depending on state law.

The revenue impact of eliminating grandfathering in states studied by CBO would be small, but the moratorium's total revenue impact has been unclear and any future impact would vary by state. In 2003, CBO reported that states and localities would lose from more than $160 million to more than $200 million annually by 2008 if all grandfathered taxes on dial-up and DSL services were eliminated, although part of this loss reflected acquired services. It also identified other potential revenue losses, although unquantified, that could have grown in the future but that now seem to pose less of a threat. CBO's estimated annual losses by 2007 for states that had grandfathered taxes in 1998 were about 0.1 percent of the total 2004 tax revenues for those states. Because it is difficult to know what states would have done to tax Internet access services if no moratorium had existed, the total revenue implications of the moratorium are unclear. The 1998 moratorium was considered before connections to the Internet were as widespread as they later became, limiting the window of opportunity for states to adopt new taxes on access services. Although some states had already chosen not to tax access services and others stopped taxing them, other states might have been inclined to tax access services if no moratorium were in place. In general, any future impact related to the moratorium will differ from state to state. The details of state tax law as well as applicable tax rates varied from one state to another. For instance, North Dakota taxed access service delivered to retail consumers. Kansas taxed communications services acquired by Internet service providers to support their customers. Rhode Island taxed both access service offerings and the acquisition of communications services. California officials said their state did not tax these areas at all.

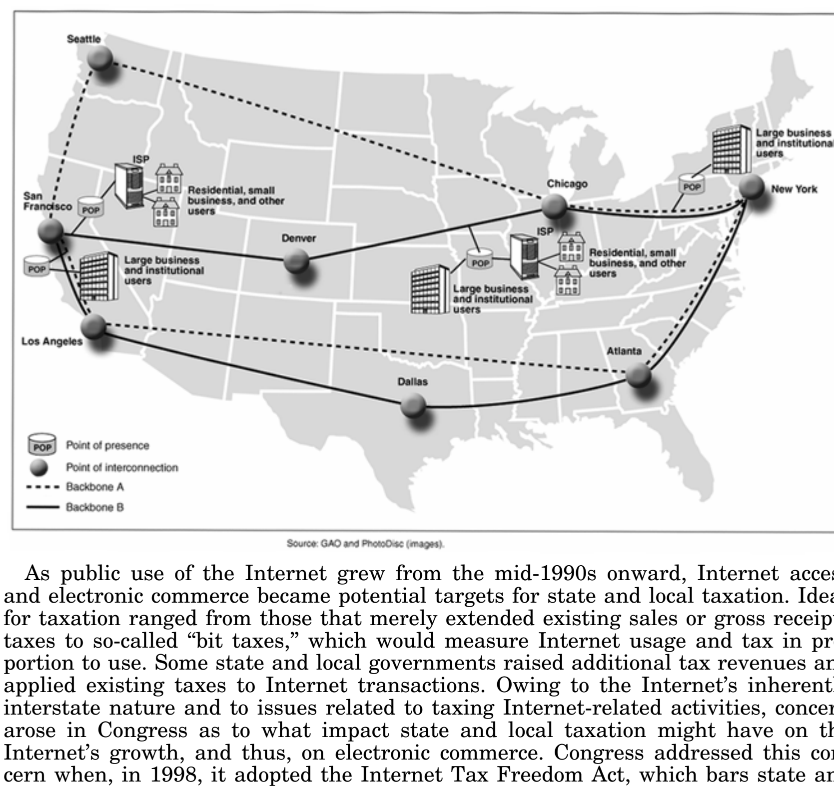
In oral comments on a draft of our January 2006 report, CBO staff members said we fairly characterized CBO information and suggested clarifications that we made as appropriate. Federation of Tax Administrators (FTA) officials said that our legal conclusion was clearly stated and, if adopted, would be helpful in clarifying which Internet access-related services are taxable and which are not. However, they expressed concern that the statute could be interpreted differently regarding what might be reasonably bundled in providing Internet access to consumers. A broader view of what could be included in Internet access bundles would result in potential revenue losses much greater than we indicated. However, as explained in the Appendix, we believe that what is bundled must be reasonably related to accessing and using the Internet. In written comments, company representatives disagreed with GAO by commenting that the 2004 amendments make acquired services subject to the moratorium and therefore not taxable, and that the language of the statute and the legislative history support this position. While we acknowledge that there are different views about the scope of the moratorium, our view is based on the language and structure of the statute.

We made no recommendations in the report, and we are not making any recommendations in this testimony.

Background

As shown in figure 1, residential and small business users often connect to an Internet service provider (ISP) to access the Internet. Well-known ISPs include America Online (AOL) and Comcast. Typically, ISPs market a package of services that provide homes and businesses with a pathway, or "on-ramp," to the Internet along with services such as e-mail and instant messaging. The ISP sends the user's Internet traffic forward to a backbone network where the traffic can be connected to other backbone networks and carried over long distances. By contrast, large businesses often maintain their own internal networks and may buy capacity from access providers that connect their networks directly to an Internet backbone network. We are using the term access providers to include ISPs as well as providers who sell access to large businesses and other users. Nonlocal traffic from both large businesses and ISPs connects to a backbone provider's network at a "point of presence" (POP). Figure 1 depicts two hypothetical and simplified Internet backbone networks that link at interconnection points and take traffic to and from residential units through ISPs and directly from large business users.

Figure 1: Hypothetical Internet Backbone Networks with Connections to End Users



Source: GAO and PhotoDisc (images).

As public use of the Internet grew from the mid-1990s onward, Internet access and electronic commerce became potential targets for state and local taxation. Ideas for taxation ranged from those that merely extended existing sales or gross receipts taxes to so-called "bit taxes," which would measure Internet usage and tax in proportion to use. Some state and local governments raised additional tax revenues and applied existing taxes to Internet transactions. Owing to the Internet's inherently interstate nature and to issues related to taxing Internet-related activities, concern arose in Congress as to what impact state and local taxation might have on the Internet's growth, and thus, on electronic commerce. Congress addressed this concern when, in 1998, it adopted the Internet Tax Freedom Act, which bars state and local taxes on Internet access, as well as multiple or discriminatory taxes on electronic commerce.[7]

Internet usage grew rapidly in the years following 1998, and the technology to access the Internet changed markedly. Today a significant portion of users, including home users, access the Internet over broadband communications services using cable modem, DSL, or wireless technologies. Fewer and fewer users rely on dial-up connections through which they connect to their ISP by dialing a telephone number. By 2004, some state tax authorities were taxing DSL service, which they considered to be a telecommunications service, creating a distinction between DSL and services offered through other technologies, such as cable modem, that were not taxed.

Originally designed to postpone the addition of any new taxes while the Advisory Commission on Electronic Commerce studied the tax issue and reported to Congress, the moratorium was extended in 2001 for 2 years[8] and again in 2004, retroactively, to remain in force until November 1, 2007.[9] The 2001 extension made no other changes to the original Act, but the 2004 Act included clarifying amendments. The 2004 act amended language that had exempted telecommunications services from the moratorium. Recognizing state and local concerns about their ability to tax voice services provided over the Internet, it also contained language allowing taxation of telephone service using Voice over Internet Protocol (VoIP). Although the 2004 amendments extended grandfathered protection generally to November 2007, grandfathering extended only to November 2005 for taxes subject to the new moratorium but not to the original moratorium.

Objectives, Scope, and Methodology

To determine the scope of the Internet tax moratorium, we reviewed the language of the moratorium, the legislative history of the 1998 Act and the 2004 amendments, and associated legal issues.

To determine the impact of the moratorium on state and local revenues, we worked in stages. First, we reviewed studies of revenue impact done by CBO, FTA, and the staff of the Multistate Tax Commission and discussed relevant issues with Federal representatives, state and local government and industry associations, and companies providing Internet access services. Then, we used structured interviews to do case studies in eight states that we chose as described earlier. We did not intend the eight states to represent any other states.

For each selected state, we focused on specific aspects of its tax system by using our structured interview and collecting relevant documentation. For instance, we reviewed the types and structures of Internet access service taxes, the revenues collected from those taxes, officials' views of the significance of the moratorium to their government's financial situation, and their opinions of any implications to their states of the new definition of Internet access. We also learned whether localities within the states were taxing access services. When issues arose, we contacted other states and localities to increase our understanding of these issues.

We discussed with state officials how they derived the estimates they gave us of tax dollars collected and how firm these numbers were. We could not verify the estimates, and CBO supplemented estimates that it received from states. Nevertheless, based on other information we obtained, the state estimates appeared to provide a sense of the order of magnitude of the numbers compared to state tax revenues.

We did our work from February through December 2005 in accordance with generally accepted government auditing standards.

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[7] A tax is a multiple tax if credit is not given for comparable taxes paid to other states on the same transaction; a tax is a discriminatory tax if e-commerce transactions are taxed at a higher rate than comparable nonelectronic transactions would be taxed, or are required to be collected by different parties or under other terms that are more disadvantageous than those that are applied in taxing other types of comparable transactions. Generally, states and localities that tax e-commerce impose comparable taxes on nonelectronic transactions. States that have sought at one time to require that access providers collect taxes due—a process that might have been thought to have been discriminatory—have backed away from that position. Moreover, although interstate commerce may bear its fair share of state taxes, the interstate commerce clause of the Constitution requires there to be a substantial nexus, fair apportionment, nondiscrimination, and a relationship between a tax and state-provided services that largely constrains the states in imposing such taxes. *Quill Corp.* v. *North Dakota*, 504 U.S. 298, 313 (1992). In any case, our report did not focus on taxing the sale of items over the Internet.

[8] Internet Tax Nondiscrimination Act, 2001, Pub. L. 107–75, § 2, 115 Stat. 703.

[9] Internet Tax Nondiscrimination Act, 2004, Pub. L. 108–435, §§ 2 to 6A, 118 Stat. 2615 to 2618.

Internet Access Services, Including Bundled Access Services, May Not Be Taxed, but Acquired Services May Be

The moratorium bars taxes on the service of providing access, which includes whatever an access provider reasonably bundles in its access offering to consumers. On the other hand, the moratorium does not prohibit taxes on acquired services, referring to goods and services that an access provider acquires to enable it to bundle and provide its access package to its customers. However, some providers and state officials have expressed a different view, believing the moratorium barred taxing acquired services in addition to bundled access services.

Internet Access Services, Including Bundled Broadband Services, May Not Be Taxed

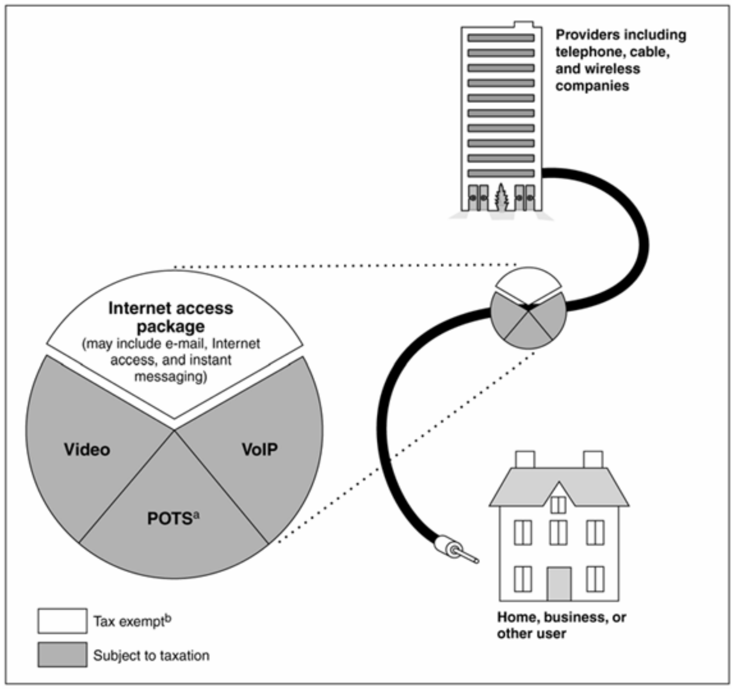
Since its 1998 origin, the moratorium has always prohibited taxing the service of providing Internet access, including component services that an access provider reasonably bundles in its access offering to consumers. However, as amended in 2004, the definition of Internet access contains additional words. With words added in 2004 in italics, it now defines the scope of nontaxable Internet access as:

> "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.*" [10] (italics provided):

As shown in the simplified illustration in figure 2, the items reasonably bundled in a tax-exempt Internet access package may include e-mail, instant messaging, and Internet access itself. Internet access, in turn, includes broadband services, such as cable modem and DSL services, which provide continuous, high-speed access without tying up wireline telephone service. As figure 2 also illustrates, a tax-exempt bundle does not include video, traditional wireline telephone service referred to as "plain old telephone service" (POTS), or VoIP. These services are subject to tax. For simplicity, the figure shows a number of services transmitted over one communications line. In reality, a line to a consumer may support just one service at a time, as is typically the case for POTS, or it may simultaneously support a variety of services, such as television, Internet access, and VoIP.

[10] 47 U.S.C. § 151 Note § 1105(5).

Figure 2: Simplified Illustration of Services Purchased by Consumers



Source: GAO and PhotoDisc (images).

[a]Traditional wireline telephone service, commonly referred to in the communications industry as "plain old telephone service" (POTS).

[b]May become taxable if not capable of being broken out from other services on a bill.

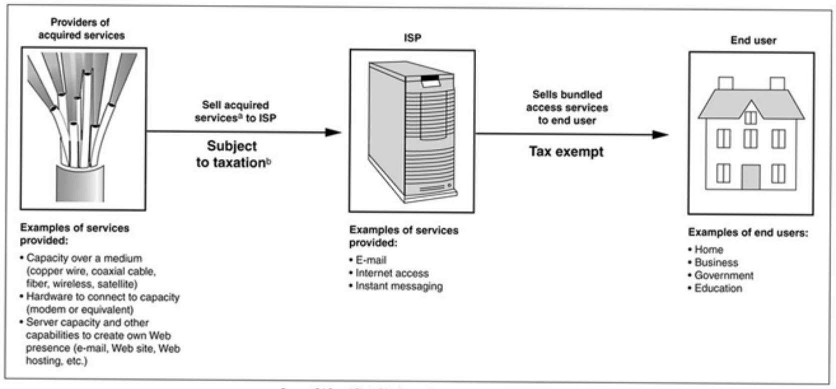
Our reading of the 1998 law and the relevant legislative history indicates that Congress had intended to bar taxes on services bundled with access. However, there were different interpretations about whether DSL service could be taxed under existing law, and some states taxed DSL. The 2004 amendment was aimed at making sure that DSL service bundled with access could not be taxed. See the Appendix for further explanation.

Acquired Services May Be Taxed

Figure 3 shows how the nature and tax status of the Internet access services just described differ from the nature and tax status of services that an ISP acquires and uses to deliver access to its customers. An ISP in the middle of figure 3 acquires communications and other services and incidental supplies (shown on the left side of the figure) in order to deliver access services to customers (shown on the right side of the figure). We refer to the acquisitions on the left side as purchases of "acquired services." [11] For example, acquired services include ISP leases of high-speed communications capacity over wire, cable, or fiber to carry traffic from customers to the Internet backbone.

[11] Some have also used the term wholesale to describe acquired services. For example, the New Millennium Research Council in *Taxing High-Speed Services* (Washington, D.C.: Apr. 26, 2004) said that "wholesale services that telecommunications firms provide ISPs can include local connections to the customer's premise, high-capacity transport between network points and backbone services." We avoid using the term, however, because it suggests a particular sales relationship (between wholesaler and retailer) that may be limiting and misleading.

Figure 3: Simplified Model of Tax Status of Services Related to Internet Access



Source: GAO and PhotoDisc (images).

[a]"Sell acquired services" refers to selling services, either to a separate firm or to a vertically integrated affiliate.

Purchases of acquired services are subject to taxation, depending on state law, because the moratorium does not apply to acquired services. As noted above, the moratorium applies only to taxes imposed on "Internet access," which is defined in the law as "a service that enables users to access content, information, electronic mail, or other services offered over the Internet. . . ." In other words, it is the service of providing Internet access to the end-user—not the acquisition of capacity to do so—that constitutes "Internet access" subject to the moratorium.

Some providers and state officials have construed the moratorium as barring taxation of acquired services, reading the 2004 amendments as making acquired services tax exempt. However, as indicated by the language of the statute, the 2004 amendments did not expand the definition of "Internet access," but rather amended the exception from the definition to allow certain "telecommunication services" to qualify for the moratorium if they are part of the service of providing Internet access. A tax on acquired services is not a tax directly imposed on the service of providing Internet access.

Our view that acquired services are not subject to the moratorium on taxing Internet access is based on the language and structure of the statute, as described further in the Appendix. We acknowledge that others have different views about the scope of the moratorium. Congress could, of course, deal with this issue by amending the statute to explicitly address the tax status of acquired services.

Some States Have Applied the Moratorium to Acquired Services

As noted above, some providers and state officials have construed the moratorium as barring taxation of acquired services. Some provider representatives said that acquired services were not taxable at the time we contacted them and had never been taxable. Others said that acquired services were taxable when we contacted them but would become tax exempt in November 2005 under the 2004 amendments, the date they assumed that taxes on acquired services would no longer be grandfathered.

As shown in table 1, officials from four out of the eight states we studied—Kansas, Mississippi, Ohio, and Rhode Island—also said their states would stop collecting taxes on acquired services, as of November 1, 2005, in the case of Kansas and Ohio whose collections have actually stopped, and later for the others. These states roughly estimated the cost of this change to them to be a little more than $40 million in revenues that were collected in 2004. An Ohio official indicated that two components comprised most of the dollar amounts of taxes collected from these services in 2004: $20.5 million from taxes on telecommunications services and property provided to ISPs and Internet backbone providers, and $9.1 million from taxes for private line services (such as high-capacity T–1 and T–3 lines) and 800/wide-area telecommunications services that the official said would be exempt due to the moratorium. The rough estimates in table 1 are subject to the same limitations described in the next section for the state estimates of all taxes collected related to Internet access.

Table 1: Summary of Case Study State Rough Estimates of 2004 Tax Revenue from Acquired Services

State	Collected taxes paid on acquired services	2004 revenue from taxes paid on acquired services (dollars in millions)
California		$0
Kansas	x	9–10
Mississippi	x	At most, 1
North Dakota		0
Ohio	x	32.3
Rhode Island	x	Insignificant compared to total telecommunications tax revenues
Texas		0
Virginia		0

Source: State officials.
Note: The next section contains a discussion of general limitations of the state estimates of revenue from taxes.

While the Revenue Impact of Eliminating Grandfathering Would Be Small, the Moratorium's Total Revenue Impact Has Been Unclear and Any Future Impact Would Vary by State

According to CBO data, grandfathered taxes in the states CBO studied were a small percentage of those states' tax revenues. However, because it is difficult to know which states, if any, might have chosen to tax Internet access services and what taxes they might have chosen to use if no moratorium had ever existed, the total revenue implications of the moratorium are unclear. In general, any future impact related to the moratorium will differ from state to state.

According to Information in CBO Reports, States Would Lose a Small Fraction of Their Tax Revenues if Grandfathered Taxes on Dial-up and DSL Services Were Eliminated

In 2003, CBO reported how much state and local governments that had grandfathered taxes on dial-up and DSL services would lose in revenues if the grandfathering were eliminated. The fact that these estimates represented a small fraction of state tax revenues is consistent with other information we obtained. In addition, the enacted legislation was narrower than what CBO reviewed, meaning that CBO's stated concerns about VoIP and taxing providers' income and assets would have dissipated.

CBO provided two estimates in 2003 that, when totaled, showed that no longer allowing grandfathered dial-up and DSL service taxes would cause state and local governments to lose from more than $160 million to more than $200 million annually by 2008. According to a CBO staff member, this estimate included some amounts for what we are calling acquired services that, as discussed in the previous section, would not have to be lost. CBO provided no estimates of revenues involved for governments not already assessing the taxes and said it could not estimate the size of any additional impacts on state and local revenues of the change in the definition of Internet access. Further, according to a CBO staff member, CBO's estimates did not include any lost revenues from taxes on cable modem services. In October 2003, around the time of CBO's estimates, the number of cable home Internet connections was 12.6 million, compared to 9.3 million home DSL connections and 38.6 million home dial-up connections.

CBO first estimated that as many as 10 states and several local governments would lose $80 million to $120 million annually, beginning in 2007, if the 1998 grandfather clause were repealed. Its second estimate showed that, by 2008, state and local governments would likely lose more than $80 million per year from taxes on DSL service.[12]

The CBO numbers are a small fraction of total state tax revenue amounts. For example, the $80 million to $120 million estimate for the states with originally

[12] The more than $80 million per year is the amount of revenue that CBO expected state and local governments to collect on DSL service and some acquired services by 2008. If the jurisdictions had recognized that the reason for the 2004 amendments was largely moot, and if they had not been collecting taxes on DSL service in the first place, they would not have had part of the $80 million to lose.

grandfathered taxes for 2007 was about 0.1 percent of tax revenues in those states for 2004—3 years earlier.

The fact that CBO estimates are a small part of state tax revenues is consistent with information we obtained from our state case studies and interviews with providers. For instance, after telling us whether various access-related services, including cable modem service, were subject to taxation in their jurisdictions, the states collecting taxes gave us rough estimates of how much access-service related tax revenues they collected for 2004 for themselves and their localities, if applicable. (See table 2). All except two collected $10 million or less.

Table 2: Case Study State Officials' Rough Estimates of Taxes Collected for 2004 Related to Internet Access

State	Estimated taxes collected (dollars in millions)
California	N/A
Kansas	$9–10
Mississippi	At most, 1 [a]
North Dakota	2.4
Ohio	52.1
Rhode Island	Less than 4.5 [b]
Texas	50 [c]
Virginia	N/A

Source: State officials.

Note: The accompanying text contains a discussion of general limitations of the state estimates of revenue from taxes.

[a] According to a Mississippi official, although estimating a dollar amount would be extremely hard, the state believes the amount collected was at most $1 million.

[b] Rhode Island officials told us that taxes collected on access were taxes paid on services to retail consumers, and Rhode Island did not have an estimate for taxes collected on acquired services.

[c] Texas officials did not provide us with an estimate of taxes collected for Texas localities.

The states made their estimates by assuming, for instance, that access service-related tax revenues were a certain percentage of state telecommunications sales tax revenues, by reviewing providers' returns, or by making various calculations starting with census data. Most estimates provided us were more ballpark approximations than precise computations, and CBO staff expressed a healthy skepticism toward some state estimates they received. They said that the supplemental state-by-state information they developed sometimes produced lower estimates than the states provided. According to others knowledgeable in the area, estimates provided us were imprecise because when companies filed sales or gross receipts tax returns with states, they did not have to specifically identify the amount of taxes they received from providing Internet access-related services to retail consumers or to other providers. As discussed earlier, sales to other providers remain subject to taxation, depending on state law. Some providers told us they did not keep records in such a way as to be able to readily provide that kind of information. Also, although states reviewed tax compliance by auditing taxpayers, they could not audit all providers.

The dollar amounts in table 2 include amounts, where provided, for local governments within the states. For instance, Kansas's total includes about $2 million for localities. In this state as well as in others we studied, local jurisdictions were piggybacking on the state taxes, although the local tax rates could differ from each other.

State tax officials from our case study states who commented to us on the impacts of the revenue amounts did not consider them significant. Similarly, state officials voiced concerns but did not cite nondollar specifics when describing any possible impact on their state finances arising from no longer taxing Internet access services. However, one noted that taking away Internet access as a source of revenue was another step in the erosion of the state's tax base.[13] Other state and local officials observed that if taxation of Internet access were eliminated, the state or locality would have to act somehow to continue meeting its requirement for a balanced budget. At the local level, officials told us that a revenue decrease would reduce the amount of road maintenance that could be done or could adversely affect the number of employees available for providing government services.

[13] In the debate leading to the 2004 amendments' passage, critics had expressed concern that the Federal Government was interfering with state and local revenue-raising ability.

Timing of Moratorium Might Have Precluded Many States From Taxing Access Services, with Unclear Revenue Implications

Because it is difficult to predict what states would have done to tax Internet access services had Congress not intervened when it did, it is hard to estimate the amount of revenue that was not raised because of the moratorium. For instance, at the time the first moratorium was being considered in 1998, the Department of Commerce reported Internet connections for less than a fifth of U.S. households, much less than the half of U.S. households reported 6 years later. Access was typically dial-up. As states and localities saw the level of Internet connections rising and other technologies becoming available, they might have taxed access services if no moratorium had been in place. Taxes could have taken different forms. For example, jurisdictions might have even adopted bit taxes based on the volume of digital information transmitted.

The number of states collecting taxes on access services when the first moratorium was being considered in early 1998 was relatively small, with 13 states and the District of Columbia collecting these taxes, according to the Congressional Research Service. Five of those jurisdictions later eliminated or chose not to enforce their tax. In addition, not all 37 other states would have taxed access services related to the Internet even if they could have. For example, California had already passed its own Internet tax moratorium in August 1998.

Given that some states never taxed access services while relatively few Internet connections existed, that some stopped taxing access services, and that others taxed DSL service, it is unclear what jurisdictions would have done if no moratorium had existed. However, the relatively early initiation of a moratorium reduced the opportunity for states inclined to tax access services to do so before Internet connections became more widespread.

Any Future Impact of the Moratorium Will Vary by State

Although as previously noted the impact of eliminating grandfathering would be small in states studied by CBO or by us, any future impact related to the moratorium will vary on a state-by-state basis for many reasons. State tax laws differed significantly from each other, and states and providers disagreed on how state laws applied to the providers.

As shown in table 3, states taxed Internet access using different tax vehicles imposed on diverse tax bases at various rates. The tax used might be generally applicable to a variety of goods and services, as in Kansas, which did not impose a separate tax on communications services. There, the state's general sales tax applied to the purchase of communications services by access providers at an average rate of 6.6 percent, combining state and average local tax rates. As another example, North Dakota imposed a sales tax on retail consumers' communications services, including Internet access services, at an average state and local combined rate of 6 percent.

Table 3: Characteristics Showing Variations among Case Study States

State	Type of tax [a]	Taxing retail consumer Internet access services	Taxing acquired services	State tax rate (percentage)	Local tax rate (percentage)	Exemptions of customer types or payment amounts
California	N/A			N/A	N/A	
Kansas	Sales		x	5.3	1.3 on average	
Mississippi	Gross income		x	7.0	N/A	
North Dakota	Sales	x		5.0	1.0–2.0	
Ohio	Sales	x	x	5.5	1.0 on average	Residential consumers
Rhode Island	Gross receipts and sales	x [b]	x	5.0, 6.0	N/A	
Texas	Sales	x		6.25	2.0 limit	First $25 of services
Virginia	N/A			N/A	N/A	

Source: State officials and laws.

[a] For purposes of this testimony, a reference to a sales tax includes any ancillary use tax. Also for our purposes, the difference between a sales and a gross receipts tax is largely a distinction without a difference since the moratorium does not differentiate between them.

[b] Rhode Island retail consumers did not pay this tax directly, but rather through the gross receipts tax paid by their providers.

Our case study states showed little consistency in the base they taxed in taxing services related to Internet access. States imposed taxes on different transactions and populations. North Dakota and Texas taxed only services delivered to retail consumers. In a type of transaction which, as discussed earlier, we do not view as subject to the moratorium, Kansas and Mississippi taxed acquired communications services purchased by access providers. Ohio and Rhode Island taxed both the provision of access services and acquired services, and California and Virginia officials told us their states taxed neither. States also provided various exemptions from their taxes. Ohio exempted residential consumers, but not businesses, from its tax on access services, and Texas exempted the first $25 of monthly Internet access service charges from taxation.

Some state and local officials and company representatives held different opinions about whether certain taxes were grandfathered and about whether the moratorium applied in various circumstances. For example, some providers' officials questioned whether taxes in North Dakota, Wisconsin, and certain cities in Colorado were grandfathered, and whether those jurisdictions were permitted to continue taxing. Providers disagreed among themselves about how to comply with the tax law of states whose taxes may or may not have been grandfathered. Some providers told us they collected and remitted taxes to the states even when they were uncertain whether these actions were necessary; however, they told us of others that did not make payments to the taxing states in similarly uncertain situations. In its 2003 work, CBO had said that some companies challenged the applicability of Internet access taxes to the service they provided and thus might not have been collecting or remitting them even though the states believed they should.

Because of all these state-by-state differences and uncertainties, the impact of future changes related to the moratorium would vary by state. Whether the moratorium were lifted or made permanent and whether grandfathering were continued or eliminated, states would be affected differently from each other.

External Comments

We showed staff members of CBO, officials of FTA, and representatives of telecommunications companies assembled by the United States Telecom Association a draft of our January 2006 report and asked for oral comments. On January 5, 2006, CBO staff members, including the Chief of the State and Local Government Unit, Cost Estimates Unit, said we fairly characterized CBO information and suggested clarifications that we made as appropriate. In one case, we noted more clearly that CBO supplemented its dollar estimates of revenue impact with a statement that other potential revenue losses could potentially grow by an unquantified amount.

On January 6, 2006, FTA officials, including the Executive Director, said that our legal conclusion was clearly stated and, if adopted, would be helpful in clarifying which Internet access-related services are taxable and which are not. However, they expressed concern that the statute could be interpreted differently regarding what might be reasonably bundled in providing Internet access to consumers. A broader view of what could be included in Internet access bundles would result in potential revenue losses much greater than we indicated. However, as explained in the appendix, we believe that what is bundled must be reasonably related to accessing and using the Internet. FTA officials were also concerned that our reading of the 1998 law regarding the taxation of DSL services is debatable and suggests that states overreached by taxing them. We recognize that Congress acted in 2004 to address different interpretations of the statute, and we made some changes to clarify our presentation. We acknowledge there were different views on this matter, and we are not attributing any improper intent to the states' actions.

When meeting with us, representatives of telecommunications companies said they would like to submit comments in writing. Their comments argue that the 2004 amendments make acquired services subject to the moratorium and therefore not taxable, and that the language of the statute and the legislative history support this position. In response, we made some changes to simplify the appendix. That appendix, along with the section of the testimony on bundled access services and acquired services, contains an explanation of our view that the language and structure of the statute support our interpretation.

Mr. Chairman, Mr. Vice Chairman, and Members of the Committee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

APPENDIX I: BUNDLED ACCESS SERVICES MAY NOT BE TAXED, BUT ACQUIRED SERVICES ARE TAXABLE

The moratorium bars taxes on the service of providing access, which includes whatever an access provider reasonably bundles in its access offering to consumers.[1] On the other hand, the moratorium does not bar taxes on acquired services.

Bundled Services, Including Broadband Services, May Not Be Taxed

As noted earlier, the 2004 amendments followed a period of significant growth and technological development related to the Internet. By 2004, broadband communications technologies were becoming more widely available. They could provide greatly enhanced access compared to the dial-up access technologies widely used in 1998. These broadband technologies, which include cable modem service built upon digital cable television infrastructure as well as digital subscriber line (DSL) service, provide continuous, high-speed Internet access without tying up wireline telephone service. Indeed, cable and DSL facilities could support multiple services—television, Internet access, and telephone services—over common coaxial cable, fiber, and copper wire media.

The Internet Tax Freedom Act bars "taxes on Internet access" and defines "Internet access" as a *service* that enables "users to access content, information, electronic mail, or other services offered over the Internet." The term Internet access as used in this context includes "access to proprietary content, information, and other services as part of a package of services offered to users." The original Act expressly excluded "telecommunications services" from the definition.[2] As will be seen, the act barred jurisdictions from taxing services such as e-mail and instant messaging bundled by providers as part of their Internet access package; however, it permitted dial-up telephone service, which was usually provided separately, to be taxed.

The original definition of Internet access, exempting "telecommunications services," was changed by the 2004 amendment. Parties seeking to carve out exceptions that could be taxed had sought to break out and treat DSL services as telecommunications services, claiming the services were exempt from the moratorium even though they were bundled as part of an Internet access package. State and local tax authorities began taxing DSL service, creating a distinction between DSL and services offered using other technologies, such as cable modem service, a competing method of providing Internet access that was not to be taxed. The 2004 amendment was aimed at making sure that DSL service bundled with access could not be taxed. The amendment excluded from the telecommunications services exemption telecommunications services that were "purchased, used, or sold by a provider of Internet access to provide Internet access."

The fact that the original 1998 Act exempted telecommunications services shows that other reasonably bundled services remained a part of Internet access service and, therefore, subject to the moratorium. Thus, communications services such as cable modem services that are not classified as telecommunications services are included under the moratorium.

Acquired Services May Be Taxed

As emphasized by numerous judicial decisions, we begin the task of construing a statute with the language of the statute itself, applying the canon of statutory construction known as the plain meaning rule. *E.g., Hartford Underwriter Insurance Co.* v. *Union Planers Bank, N.A.,* 530 U.S. 1 (2000); *Robinson* v. *Shell Oil Co.,* 519 U.S. 337 (1997). Singer, 2A, Sutherland Statutory Construction, §§ 46:1, 48A:11, 15–16. Thus, under the plain meaning rule, the primary means for Congress to express its intent is the words it enacts into law and interpretations of the statute should rely upon and flow from the language of the statute.

As noted above, the moratorium applies to the "taxation of Internet access." According to the statute, "Internet access" means a service that enables users to access content, information, or other services over the Internet. The definition excludes "telecommunications services" and, as amended in 2004, limits that exclusion by ex-

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[1] Notwithstanding fears expressed by some during consideration of the 2004 amendments, this does not mean that anything may be bundled and thus become tax exempt. Clearly, what is bundled must be reasonably related to accessing and using the Internet, including electronic services that are customarily furnished by providers. In this regard, it is fundamental that a construction of a statute cannot be sustained that would otherwise result in unreasonable or absurd consequences. Singer, 2A, Sutherland Statutory Construction, § 45:12 (6th ed., 2005).

[2] The 1998 Act defined Internet access as "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 [Internet access] does not include telecommunications services."

empting services “purchased, used, or sold” by a provider of Internet access. As amended in 2004, the statute now reads as follows:

> “The term ‘Internet access’ means a service that enables users to access content, information, electronic mail, or other services offered over the Internet. . . . 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.” Section 1105(5).”

The language added in 2004—exempting from “telecommunications services” those services that are “purchased, used, or sold” by a provider in offering Internet access—has been read by some as expanding the “Internet access” to which the tax moratorium applies, by barring taxes on “acquired services.” Those who would read the moratorium expansively take the view that everything acquired by Internet service providers (ISP) (everything on the left side of figure 3) as well as everything furnished by them (everything in the middle of figure 3) is exempt from tax.

In our view, the language and structure of the statute do not permit the expansive reading noted above. “Internet access” was originally defined and continues to be defined for purposes of the moratorium as the *service* of providing Internet access to a user. Section 1105(5). It is this transaction, between the Internet provider and the end-user, which is nontaxable under the terms of the moratorium. [3] The portion of the definition that was amended in 2004 was the exception: that is, telecommunication services are excluded from nontaxable “Internet access,” except to the extent such services are “purchased, used, or sold by a provider of Internet access to provide Internet access.” Thus, we conclude that the fact that services are “purchased, used, or sold” by an Internet provider has meaning only in determining whether these services can still qualify for the moratorium notwithstanding that they are “telecommunications services;” it does not mean that such services are independently nontaxable irrespective of whether they are part of the service an Internet provider offers to an end-user. Rather, a service that is “purchased, used, or sold” to provide Internet access is not taxable only if it is part of providing the service of Internet access to the end-user. Such services can be part of the provision of Internet access by a provider who, for example, “purchases” a service for the purpose of bundling it as part of an Internet access offering; “uses” a service it owns or has acquired for that purpose; or simply “sells” owned or acquired services as part of its Internet access bundle.

In addition, we read the amended exception as applying only to services that are classified as telecommunications services under the 1998 Act as amended. In fact, the moratorium defines the term “telecommunications services” with reference to its definition in the Communications Act of 1934,[4] under which DSL and cable modem service are no longer classified as telecommunications services.[5] Moreover, under the Communications Act, the term telecommunications services applies to the delivery of services to the end-user who determines the content to be communicated; it does not apply to communications services delivered to access service providers by others in the chain of facilities through which Internet traffic may pass. Thus, since broadband services are not telecommunications services, the exception in the 1998 Act does not apply to them, and they are not affected by the exception.[6]

The best evidence of statutory intent is the text of the statute itself. While legislative history can be useful in shedding light on the intent of the statute or to resolve ambiguities, it is not to be used to inject ambiguity into the statutory language or to rewrite the statute. *E.g., Shannon* v. *United States* 512 U.S. 573, 583 (1994). In

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[3] As noted previously, the moratorium applies to “taxes on Internet access.” Related provisions defining a “tax on Internet access” for purposes of the moratorium focus on the transaction of providing the service of Internet access: such a tax is covered “regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access.” Section 1105(10).

[4] 47 U.S.C. § 153(46).

[5] DSL and cable modem services are now referred to as “information services with a telecommunications component,” under the Communications Act of 1934. See *In the Matter of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities,* FCC 05–150, (2005), and related documents, including *In the Matter of Communications Assistance for Law Enforcement Act and Broadband Access and Services,* FCC 05–153, 2995 WL 2347773 (F.C.C.) (2005). Although FCC announced its intention as early as February 15, 2002, to revisit its initial classification of DSL service as a telecommunications service under the Communications Act (*In the Matter of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities,* FCC 02–42, 17 F.C.C.R. 3019, 17 FCC Rcd. 3019), it was not until after the Supreme Court’s decision in *National Cable & Telecommunications Ass’n* v. *Brand X Internet Services,* 125 S.Ct. 2688 (2005), that it actually did so.

[6] There was some awareness during the debate that the then pending *Brand X* litigation (“Ninth Circuit Court opinion affecting DSL and cable”) could affect the law in this area. See comments by Senator Feinstein, 150 *Cong. Rec.* S4666.

our view, the definition of Internet access is unambiguous, and, therefore, it is unnecessary to look beyond the statute to discern its meaning from legislative history. We note, however, that consistent with our interpretation of the statute, the overarching thrust of changes made by the 2004 amendments to the definition of Internet access was to take remedial correction to assure that broadband services such as DSL were not taxable when bundled with an ISP's offering. While there are some references in the legislative history to "wholesale" services, backbone, and broadband, many of these pertained to earlier versions of the bill containing language different from that which was ultimately enacted.[7] The language that was enacted, using the phrase "purchased, used, or sold by a provider of Internet access" was added through the adoption of a substitute offered by Senator McCain, 150 *Cong. Rec.* S4402, which was adopted following cloture and agreement to several amendments designed to narrow differences between proponents and opponents of the bill. Changes to legislative language during the consideration of a bill may support an inference that in enacting the final language, Congress intended to reject or work a compromise with respect to earlier versions of the bill. Statements made about earlier versions carry little weight. *Landgraf* v. *USI Film Products,* 511 U.S. 244, 255–56 (1994). Singer, 2A, Sutherland Statutory Construction, §48:4. In any event, the plain language of the statute remains controlling where, as we have concluded, the language and the structure of the statute are clear on their face.

The CHAIRMAN. I thank you very much, Dr. White.
May I recognize Mr. Quam?

STATEMENT OF DAVID C. QUAM, DIRECTOR, FEDERAL RELATIONS, NATIONAL GOVERNORS ASSOCIATION

Mr. QUAM. Thank you, Mr. Chairman, Vice Chairman Stevens, members of the Subcommittee.

My name is David Quam, and I'm the Director of Federal Relations for the National Governors Association. I'm pleased to be here on behalf of the Nation's Governors to talk about two very important issues: the Internet Tax Freedom Act and the Streamlined Sales and Use Tax Agreement.

The bottom line regarding the Internet access moratorium is this: Although Governors generally oppose Federal interference with State authority to develop and manage their revenue systems—they see that as a core element of our federalist system—NGA supports a temporary extension of Internet Tax Freedom Act that clarifies the definition of "Internet access" and does not further limit State authority or revenues.

As this Committee and Congress looks to extend the Internet Tax Freedom Act, Governors recommend that they follow three principles. First, be clear; definitions matter. Second, be flexible; a temporary solution is better than permanent confusion. And, third, do no harm; continue grandfather protections to preserve existing State authority and revenues.

[7] For example, proponents of giving the statute a broader interpretation cite S. Rep. 108–155, 108th Cong., 1st Sess. (2003), which includes the following statement.

"The Committee intends for the tax exemption for telecommunications services to apply whenever the ultimate use of those telecommunications services is to provide Internet access. Thus, if a telecommunications carrier sells wholesale telecommunications services to an Internet service provider that intends to use those telecommunications services to provide Internet access, then the exemption would apply."

At the time the 2003 report was drafted, the sentence of concern in the draft legislation read, "Such term [referring to Internet access] does not include telecommunications services, except to the extent such services are used to provide Internet access." As adopted, the wording became, "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." The amended language thus focuses on the package of services offered by the access provider, not on the act of providing access alone.

I'm going to focus my testimony on the ITFA on the first principle, that is of being clear.

The core concern for states is the definition of "Internet access." It reads, "'Internet access' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet"—it then goes on, "and may also include access to proprietary content, information, and other services as part of a package of services offered to users." This sentence has not changed since 1998, but the Internet certainly has.

NGA believes that the unlimited ability of providers to bundle together other services with access to form a single tax-free offering represents a loophole that could exempt otherwise taxable goods and services merely because they are delivered over the Internet. The threat that this loophole represents to State and local government is exacerbated by the Internet's success—more broadband, more services, more people using the Internet.

During 2004, this debate became crystal clear when we considered Voice over Internet Protocol, the threat that telephone service could move over the Internet and be bundled to be tax-free. Congress solved that issue, at that time, by exempting VoIP from the moratorium. That was a single instance taking care of VoIP, but there are more VoIPs out there. The next one is likely to be IPTV, Internet Protocol Television, probably the fastest-growing service worldwide, that's going to move a traditional service onto the Internet. Rather than exempt yet another service, Congress should close the loophole by specifying that the definition of "Internet access" applies only to those services really necessary to connect a user to the Internet.

I'd like to add that the bill introduced today by Senators Carper and Alexander reflects many of the principles that the Governors have put out there: temporary, extend the grandfather clause, and fix the definition of "Internet access."

I'd also like to take a minute to talk about the Streamlined Sales and Use Tax Agreement. The *Quill* decision, which everybody talks about, did two things. First, it created a nearly $20 billion State and local tax gap from uncollected taxes. Second, it provided a roadmap for states to solve the problem by simplifying the collection process for these taxes. The Court also said that Congress has the power to grant equitable collection authority to the states for sales and use taxes on remote sales.

The Streamline Agreement is an agreement between states to meet the challenge of *Quill*. It simplifies the sales and use tax systems to provide greater uniformity and certainty for businesses and consumers. Triggered on October 1, 2005, currently 15 states are full members, six states are associate members, and 19 states and the District of Columbia serve as advisor states to the Agreement. And contrary to what the Congresswoman said, this is a remarkable achievement. Getting that many states to come together on a voluntary basis to streamline sales taxes together is states operating in their capacity to solve a national problem using State sovereign authority. More than 1,000 businesses have taken advantage of these simplifications offered by the Agreement by volunteering to comply and collect sales taxes on their remote sales.

Now it is Congress's turn. Congress should partner with states by prioritizing consideration of Federal legislation to recognize the efforts of states and the business community to simplify State sales and use tax systems and close the tax gap.

In conclusion, Governors remain steadfast in their insistence that decisions regarding State and local taxation should remain with State and local officials. The independent and sovereign authority of states to develop their own revenue systems is a basic tenet of self-government in our Federal system. State efforts under the Streamline process exemplify how states, the business community, and Congress can work together to solve national issues with State and local consequences.

As to the moratorium, NGA, again, urges Congress to work with State and local government by addressing the uncertainties inherent in the overly broad definition of Internet access and preserving the original grandfather clause as part of a temporary extension.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Quam follows:]

PREPARED STATEMENT OF DAVID C. QUAM, DIRECTOR, FEDERAL RELATIONS, NATIONAL GOVERNORS ASSOCIATION

Chairman Inouye, Vice Chairman Stevens, and members of the Subcommittee: thank you for inviting the National Governors Association (NGA) to testify today.

My name is David Quam, and I am the Director of Federal Relations for NGA. I am pleased to be here on behalf of the Nation's Governors to discuss the organization's perspective on communications and taxation.

Today most of my testimony will focus on the Internet Tax Freedom Act (the "ITFA"), although I will also discuss the Streamlined Sales and Use Tax Agreement (SSUTA). The bottom line regarding the ITFA is this: although Governors generally oppose Federal interference with state authority to develop and manage their revenue systems, NGA supports a temporary extension of the Internet Tax Freedom Act that clarifies the definition of Internet access and does not further limit state authority or revenues.

Background

Although the U.S. Constitution grants Congress broad authority to regulate interstate commerce, the Federal Government, historically, has been reluctant to interfere with states' ability to raise and regulate their own revenues. State tax sovereignty is a basic tenet of our federalist system and is fundamental to the inherent political independence and viability of states. For this reason Governors generally oppose any Federal legislation that would interfere with states' sovereign ability to craft and manage their own revenue systems.

The 1998 Internet Tax Freedom Act, which imposed a moratorium on state or local taxation of Internet access, is one exception to longstanding Congressional forbearance when it comes to state tax issues. Designed to help stimulate this new technology by making access to the Internet tax free, the moratorium included three important restrictions to protect states:

1. The moratorium applied only to new taxes—existing taxes on Internet access were grandfathered;
2. The definition of "Internet access," while broad, excluded telecommunications services; and
3. The moratorium expired after 2 years to allow Congress, states and industry the opportunity to make adjustments for rapidly developing technologies and markets.

In 2000 the original moratorium expired, but was extended through November 1, 2003, with its protections for states still in place. In 2003, and 2004, Congress debated bills that targeted state protections by proposing to eliminate the grandfather provision, modify the telecommunications exclusion to address tax disparities between telecommunications broadband services and those of the cable industry, and make the moratorium permanent. Fortunately, the final bill retained several of the original state protections including the grandfather clause, an exception for taxes on Voice-over Internet Protocol (VoIP) services, and an expiration date of November 1, 2007.

As Congress begins to consider changes to the ITFA, Governors recommend that members examine the scope of the moratorium in light of technological advancements; update the ITFA's definitions to ensure they reflect Congressional intent and do not unnecessarily interfere with state taxing authority; extend the moratorium on a temporary basis to respect state sovereignty and the ever-changing nature of the Internet; and retain the original grandfather clause to preserve existing state and local tax revenues.

Congress Should Clarify the Definition of "Internet Access"

A core concern for states is the potential breadth of the ITFA's definition of "Internet access." The current definition of Internet access states:

> "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 purchased, used, or sold by a provider of Internet access to provide Internet access." (Emphasis added)

The first sentence of the definition has not changed since 1998 and allows a provider of Internet access to bundle "proprietary content, information, and other services" together with access to make the entire offering tax free. NGA believes that the unlimited ability of providers to bundle together content and "other services" into a single, tax-free offering represents a loophole that could have the unintended effect of exempting content, information or services from otherwise applicable taxes merely because they are delivered over the Internet.

The risk of states losing significant revenues from this provision has grown significantly as broadband connections have become more common and companies have altered business plans to deliver more services over the Internet. Since 2001, the number of high-speed lines in the United States has risen from more than 9 million to nearly 65 million with high-speed connections in the United States growing by 52 percent in 2006 alone.[1] Governors support the deployment of broadband services because they increase the ability of citizens to utilize the vast array of services and information available online and are critical to our Nation's economic growth and competitiveness.

As more consumers move online, Internet protocol technology is also making more services available over the Internet. For example, a key issue of the 2004 ITFA debate centered on whether VoIP would become a viable alternative to traditional phone service. Unlike traditional telecommunications services, VoIP uses the Internet to transmit voice communications between computers, phones and other communications devices. Today, analysts project that VoIP subscriptions will top 18 million in 2009, a dramatic rise from VoIP's 150,000 customers in 2003.[2] The concern in 2004 was what would happen to the $23 billion state and local tax base for telecommunications services if VoIP replaces telecommunications services and were allowed to be bundled with Internet access into a tax-free offering. Congress' solution during the last ITFA extension was to specifically exempt VoIP from the moratorium. This solution, however, did not solve the problem of the underlying definition.

The next major service moving to the Internet is video programming. Known as Internet Protocol Television (IPTV), this service represents another technological leap for industry and challenge for the ITFA. Worldwide, the annual growth rate of IPTV is projected to exceed 92 percent, rising from 3.9 million subscribers in 2006 to 103 million in 2011. The service brings together voice, Internet and entertainment services in a bundle marketed by some as a triple-play.[3] Much like VoIP in 2004, if a service like IPTV is packaged with Internet access and exempted from applicable taxes, it would create tax disparities for competitors offering similar services and undermine existing state and local revenues.

The emergence of services such as VoIP and IPTV underscore the need to clarify the definition of what constitutes "Internet access" so that the taxability of a good or service is not determined by whether it can be bundled with Internet access and delivered over the Internet. Although NGA supports having the moratorium apply

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[1] Response of Kevin J. Martin, Chairman, Federal Communications Commission, to pre-hearing questions asked by the House Committee on Energy and Commerce, February 7, 2007.

[2] Telecommunications Industry Association's 2006 Telecommunications Market Review and Forecast, February 27, 2006.

[3] Harris, Jan, "IPTV subscription to grow 92 percent year on year," *Platinax Small Business News,* April 10, 2007.

to services related to providing access to the Internet such as email, Congress should close the bundling loophole by specifying that the definition of "Internet access" applies only to those services necessary to connect a user to the Internet.

Any Extension Should be Temporary

When the ITFA became law in 1998, it was passed as a temporary measure to assist and nurture the Internet in its commercial infancy. The Internet of 2007 is far different. It is a mainstream medium that has spawned innovation, created new industries and improved services. What started as primarily a dial-up service available through a handful of providers, today is available through thousands of Internet service providers using technologies ranging from high-speed broadband cable or Digital Subscriber Line services, to wireless, satellite and even broadband Internet access over power lines.

Commercial transactions over the Internet have also exploded. A recent study by the National Retail Federation concluded that Internet sales grew from $176 billion in 2005 to $220 billion in 2006, a 25 percent jump that outpaced projections.[4] The survey projects online sales for 2007 will jump 18 percent to $259 billion. According to one of the survey's senior analysts, "[t]his strong growth is an indicator that online retail is years away from reaching a point of saturation."[5]

The rapid pace of innovation in the Internet and telecommunications industries makes it difficult to define accurately these complex and ever-changing services. Congress made the original moratorium temporary in part for this reason: to provide Congress, industry and state and local governments with the ability to revisit the issue and make adjustments where necessary to accommodate new technologies and market realities. With continued questions as to the scope of the moratorium, the ongoing evolution of the Internet and its developing role in commerce, a temporary extension of the moratorium remains the best way for Congress to avoid any unintended consequences that may arise from a permanent moratorium.

Another reason to support a temporary extension is that making the moratorium permanent would establish a troubling precedent that distorts the state-Federal relationship. As mentioned previously, Governors generally oppose Federal efforts to interfere with state revenue systems because such interference undermines a states sovereign authority to provide government services. A more immediate consequence of a permanent ban on state taxes is the increased pressure Congress would receive from other industries seeking similar preemptions of state laws. Legislation to impose a moratorium on state and local cell phone taxes and efforts to dictate state nexus standards for business activity taxes are recent examples of the types of preemptions strongly opposed by state and local governments that would be bolstered by passage of a permanent moratorium.

Congress Should Maintain the Moratorium's "Grandfather" Clause

NGA recommends that any extension of the moratorium preserve existing state and local revenues by continuing the so-called grandfather clause for taxes imposed prior to 1998. The grandfather clause serves two purposes; first, as a protection for existing state and local tax revenue; and second, as a means to preserve other state and local taxes not specifically mentioned by the ITFA.

Today only nine states have direct taxes on Internet access that qualify for the protection of the 1998 grandfather clause. Those states include Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin. According to Congressional Budget Office estimates from the 2004 ITFA extension, eliminating the grandfather clause will cost those states between $80 million and $120 million annually. While these amounts may seem insignificant in terms of Federal dollars, balanced budget requirements at the state level require that any unanticipated loss of revenues must be made up by either cutting services or raising revenues. These losses also are high enough to make the elimination of the grandfather clause an unfunded Federal mandate under the Unfunded Mandate Reform Act. Any extension of the moratorium should therefore preserve the grandfather clause so as not to reduce existing state and local tax revenues.

The grandfather clause also serves as an important protection for all state and local taxes that indirectly affect providers of Internet access. Under the ITFA, a "tax on Internet access" means:

> [A] tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access and regardless of the terminology used to describe the tax.

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[4] *The State of Retailing Online 2007,* Shop.com/Forrester Research Study, May 14, 2007.

[5] *Online Clothing Sales Surpass Computers, According to Shop.org/Forrester Research Study,* viewed at *www.nrf.com* (May 17, 2007).

Because a tax on Internet access includes both taxes on users and Internet access service providers, some experts interpret the moratorium as applying to both direct taxes on Internet access and indirect taxes such as business taxes on a provider of Internet access. In fact, the pre-1998 versions of the moratorium expressly excluded certain indirect taxes such as income and property taxes from the moratorium. That language was later dropped because the grandfather clause applies to all taxes on Internet access in force before October 1, 1998.[6] Although the 2004 extension does preserve the ability of states to impose a tax "levied upon or measured by net income, capitol stock, net worth, or property value," this list is not exhaustive. Preservation of the grandfather clause is important because it allows Congress to avoid having to define those direct taxes subject to the moratorium and any other taxes that lie outside the scope of the moratorium.

Congress Should Support the Streamlined Sales and Use Tax Agreement

The National Governors Association has long supported state's efforts to pursue Federal legislation provisions that would require remote, out-of-state vendors to collect sales and use taxes from their customers. Such action is necessary to restore fairness between local retail store purchases and remote sellers and to provide a means for the states to collect taxes that are owed under existing law. The rapid growth of the Internet and electronic commerce underscores the importance of maintaining equitable treatment among all sellers.

In the *Quill* decision, the U.S. Supreme Court stated that, to secure a level playing field in the collection of sales and use taxes, states needed to eliminate undue administrative burdens on interstate commerce by simplifying the collection process for these taxes. The Court also clarified that Congress has the power to grant equitable collection authority to the states for sales and use taxes on remote sales. Governors support the development of a 21st century sales tax system that simplifies compliance requirements and streamlines sales taxes to ensure that states are prepared for the global electronic marketplace.

Several states are working to eliminate undue administrative burdens on interstate commerce associated with sales and use taxes by participating in the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA is designed as an agreement between states to simplify their sales and use tax systems to provide greater uniformity and certainty for businesses and consumers. Simplification would be accomplished through several key features, including uniform definitions within tax laws, rate simplification, state level tax administration of all state and local sales and use taxes, uniform sourcing rules, simplified exemption administration, uniform audit procedures, and state funding of the system.

SSUTA was triggered on October 1, 2005, when 13 states representing more than 20 percent of the population were certified as having met the requirements of the Agreement. Currently, 15 states are full members; 6 states are associate members; and 19 states and the District of Columbia serve as advisor states to the Agreement. Since the agreement was triggered, more than 1,000 businesses have taken advantage of the simplifications offered by the agreement by volunteering to comply and collect sales taxes from their remote sales.

As Congress examines issues related to the Internet and state and local taxes, it should partner with states by prioritizing consideration of Federal legislation to recognize the efforts of states and the business community to simplify state sales and use tax systems.

Conclusion

Governors remain steadfast in their insistence that decisions regarding state and local taxation should remain with state and local officials. The independent and sovereign authority of states to develop their own revenue systems is a basic tenet of self government and our Federal system. State efforts under the SSUTA exemplify how states, the business community and Congress can work together to solve national issues with state and local consequences. As to the ITFA, NGA urges Congress to work with state and local governments by addressing the uncertainties inherent in the overly broad definition of Internet access and preserving the original grandfather clause as part of a temporary extension.

The CHAIRMAN. I thank you very much, Mr. Quam.

And now may I recognize Mr. Duncan.

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[6] Mazerov, Michael, "Making the Internet Tax Freedom Act permanent in the form currently proposed would lead to a substantial revenue loss for states and localities," Center on Budget and Policy Priorities, October 20, 2003.

STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. DUNCAN. Thank you very much, Mr. Chairman, members of the Committee.

My name is Harley Duncan. I'm Executive Director of the Federation of Tax Administrators, which is an association of the principal revenue-collecting and tax-administration agencies in the 50 states, D.C., New York City, and Puerto Rico. As with the Governors Association, we appreciate the opportunity to be here and address the issues of the Internet tax moratorium and the streamlined sales tax legislation.

Our organization generally has a position opposing Federal intervention in State taxation where the Constitution would otherwise allow us to impose taxes unless there are compelling administrative and policy reasons to do so. In addition, when Congress does choose to intervene, we make efforts to ensure that any intervention is targeted to the problem at hand, and doesn't have a series of unintended consequences.

With respect to the Internet tax moratorium, we would encourage you to address three particular issues in this regard. The first is the breadth of the moratorium, or the definition of "Internet access." As you've heard, the definition of "Internet access" is "a service that allows a user to access the content, information, and services available over the Internet," as well as proprietary content, information, and services. I think we would all agree that this is the universe of what is available over the Internet.

The problem from the State tax administrators' standpoint is that the term "access" itself has two definitions. One is to connect to, and put yourself in a position to use; the second is the right to use those services, content, and information. In other words, if the second definition of "access" is adopted, we believe that a package of access that enabled one to use all of the services, content, and information that's available on the Internet, bundled into a single package at a single price, would be precluded from State taxation because of the broad definition of the "content, information, and services" and the definition of "access."

It's this potential bundling of services and claiming exemption that causes us concern about the definition of "access." We wish we could get to the "reasonably bundled" portion of the definition that Dr. White referenced. But, in the plain language, as we read it, "reasonably bundled" is not there. Changes are necessary so that we don't have a package of Internet access that includes what we all understand to be access, as well as five digital books and ten movies per month all claimed to be exempt. We've worked with your staff and others, and we will continue to work, to craft a definition that includes connection, the basic services, the navigation, the mail, the messaging, and the like—that is the general package of what we consider to be access today—and prevents the bundling. And we hope that we can gather your attention on that issue.

The second is, we believe that the—any extension of the moratorium should be temporary. The technology continues to evolve, the manner in which it is used by consumers and business continues to evolve.

Beyond this, Congress, when it takes the step of extending the Internet Tax Freedom Act, has inserted itself into State tax law in a way that it hasn't, commonly, in the past. It is dealing with specific transactions and types of services that will not be subject to the State sales tax. We believe that, in inserting yourself in that fashion, in a way you haven't done in other areas, it is only prudent and reasonable to expect that you would preserve the opportunity to come back and review that law on a periodic basis, much the same as you do with other laws that you pass.

Third, we would argue, in the Internet Tax Freedom Act, that you should preserve the grandfather clause that preserves those taxes on charges for access that were in place in 1998. That was a part of the original deal involving the Internet Tax Freedom Act. The agreement was not to disrupt the revenue systems of those states, and we believe that should be preserved. In addition, repealing the grandfathers could reach a broader range of taxes than we commonly consider. Because of the definition of "tax on Internet access" that's in the bill, it could also involve a series of general-purpose business taxes that are levied on Internet service providers—the Washington State business and occupation tax, local doing business taxes, unemployment taxes, and the like.

Finally, 1 minute on remote sales and the streamlined legislation. We would support enactment of this, and encourage you to consider it carefully for all the reasons that the Governors Association has outlined. I think as you go through this you're going to hear a lot of concerns about, Is it simple enough? Should this be added? Should this be added? Do we need to make some changes here?

I think it's important to remember two basic things. The first is, remote sales continue to grow at 25 percent a year, and the revenue impact on the states, and the unfairness and competitiveness disadvantage to retailers that collect, continues to grow at that same rate. And the second is that, through the Streamlined Sales and Use Tax Agreement, the states, working with the business community, we have achieved a system that significantly simplifies State sales tax administration, provides for much greater uniformity, and provides significant protections to people that make good-faith efforts to collect sales tax. It deserves your support, in terms of authorizing states that are part of that agreement to require remote sellers to collect.

While there are a lot of things that a lot of people would like to have in the Streamlined Sales and Use Tax Agreement, we need to remember that it is a major piece of simplification that few would have expected a few years ago.

Thank you.

[The prepared statement of Mr. Duncan follows:]

PREPARED STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

My name is Harley Duncan. I am the Executive Director of the Federation of Tax Administrators. 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. I am please to testify on the current restrictions on states taxing Internet access and the efforts of the states to streamline their sales taxes in anticipation of a mandatory collection system that would require out-of-state sellers to collect state sales taxes. First I will address the possible extension.

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.

Internet Taxation Moratorium

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 Government 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.[1] 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, given 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."

[1] 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.

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 states that have levied a tax on Internet access, all else being equal."[2]

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 highlighted several examples of state and local programs aimed a 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.
- ConnectKentucky's 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"[3] 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, databases, information services and the like.[4]

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 9 years ago.

If the current moratorium with the current definition of Internet access is made permanent it would lead to 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 their competitive advantage over "brick 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 also 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

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[2] 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.

[3] Section 1105(5) of the original Internet Tax Freedom Act, at 47 U.S.C. § 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."

[4] 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."

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 impacted 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 review of the Act and its consequences; and
- The original commitment to those states imposing taxes on Internet access should be continued.

State Sales Tax Simplification

FTA supports the enactment of Federal legislation to authorize states to require remote sellers to collect sales and use taxes on goods and services sold into the state. FTA believes that advancing this legislation should be the top state tax priority issue of the Commerce Committee. The change to a service based from a manufacturing based economy along with the saturation of our sales system with Internet transactions make modernization of the sales tax collection system an essential step that states must take.

The first major achievement of the system has already occurred. Late last year a voluntary system for remote seller collection of sales taxes began. We have 1,200 companies participating and more that 30 percent of the U.S. population covered in the new system. We expect a rapid expansion of the system once it becomes mandatory.

Streamlining of state sales taxes has a long history. The U.S. Supreme Court held (*Quill Corp.* v. *North Dakota*) that a state may not require a seller that does not have a physical presence in the state to collect tax on sales into the state. The decision was based in part on the complexity of the sales tax system for remote sellers *i.e.,* nonresident sellers without a physical presence in the state of purchase. The Court also said clearly that Congress could authorize states to require remote sellers to collect tax.

States have worked for 5 years with the business community to simplify administration of sales and use taxes for fixed-base retailers as well as for remote sellers, to reduce the compliance burden. Action began with the Streamlined Sales Tax Project (SSTP) and led to the creation of the Streamlined Sales and Use Tax Agreement. The Agreement substantially simplified sales tax collection. Congress should authorize member states to require remote sellers to collect sales taxes.

Senate legislation from the 109th Congress would have provided the basis for states to require the collection of sales taxes by remote sellers. S. 2152 and S. 2153 were similar bills, differing only in the rules for exempting small businesses from the collection requirement. A single bill resolving the differences is expected to be introduced by Senators Dorgan (D–ND) and Enzi (R–WY) before Memorial Day.

- Key simplifications of SSTP include state-level administration of all local sales taxes, greater uniformity in tax bases, greater use of technology, due diligence safe harbors for sellers, and uniform definitions.
- Erosion of state and local government tax bases will intensify without required collection. It is estimated annual revenue loss to the state and local governments is now approximately $15 billion.
- The absence of required remote seller tax collection places hometown sellers that are required to collect tax at an unfair competitive disadvantage.
- The Streamlined Sales and Use Tax Agreement took effect on October 1, 2005, with 19 states, representing almost 30 percent of the population, participating. Collection of sales and use taxes by remote sellers under the Agreement is voluntary. Federal legislation could require participation of remote vendors under the Agreement.

FTA urges the Committee to take up streamlining as a separate and distinct issue. It should be advanced to conclusion this year.

The CHAIRMAN. I thank you very much.

And now may I recognize Ms. Canning.

STATEMENT OF ANNABELLE CANNING, ESQ., VICE PRESIDENT, STATE TAX POLICY, VERIZON COMMUNICATIONS

Ms. CANNING. Chairman Inouye, Senator Stevens, and members of the Committee, thank you for this opportunity to testify on an issue of real importance to millions of consumers and businesses across the United States.

My name is Annabelle Canning and I am Vice President for State Tax Policy at Verizon Communications. I appear today on behalf of a broad coalition of Internet service providers, Internet backbone providers, and Internet application and content providers to support a permanent extension of the Internet tax moratorium. Thank you for the opportunity to speak today.

It appears that the states and industry are in agreement that the moratorium should be extended. Accordingly, I would like to focus my comments on three important points.

First, at a time when State and local economic development experts are touting broadband as critical to economic competitiveness, the moratorium should be made permanent because new taxes on Internet access could have a chilling effect on broadband investment.

The moratorium has benefited the entire United States economy by improving the productivity of American businesses and lowering prices for consumers through competition. Recent studies support the premise that broadband investments that increase the speed and reach of communications networks improve the productivity of businesses. Unfortunately, in many states, economic development policy and tax policy are not aligned.

Congressional approval of a permanent moratorium would send a clear signal to the markets that long-term investment decisions will not be undermined by the imposition of new taxes on Internet access or discriminatory taxes on electronic commerce. A strong pro-investment signal from Congress would help ensure that these investments, which have had such an important role in the U.S. economic growth and productivity over the last decade, will continue to be encouraged and rewarded. It will send a signal to the capital markets to invest here in the U.S., and not abroad.

Second, now that competition between different types of Internet access providers is lowering prices for consumers and making high-speed Internet access more accessible and affordable to lower-income households, regressive new taxes on Internet access would create a new obstacle in efforts to close the digital divide.

The convergence that many in the industry have discussed for years is finally here. In more and more areas of the country, consumers have choices: high-speed DSL, high-speed cable modem access, or wireless "3G" service. Other technologies on the horizon may provide even more competitive choices.

With the benefits of competition now coming to low- and moderate-income households, the imposition of new taxes on Internet access would increase prices and make broadband access less affordable to such households as well as small businesses that need broadband access to compete in the global economy. Taxes matter in many households with limited amounts of discretionary income.

Finally, Congress should make it clear that the transport underlying the provision of Internet access is covered by the moratorium.

The current Internet tax moratorium on State and local taxes covers the transport purchased, used, and sold by Internet access service providers to provide Internet access. Nonetheless, some states and localities have persisted in imposing taxes on Internet transport. From an economic standpoint, taxation of the transport component of Internet access is indistinguishable from taxation of Internet access itself.

Congress expressed its clear legislative intent that Internet access taxes be banned at both the retail and the wholesale level. Congress must ensure that consumers are not subject to hidden taxes, and that all providers of Internet access are subject to the same level of taxation with respect to purchases of wholesale transport services.

State and local governments have failed, over the past decade to reduce excessive and discriminatory taxes on telecommunications services—Virginia remains the only State that has successfully eliminated its discriminatory taxes and reduced the level of taxation imposed on communications services to the same level imposed on other competitive goods and services.

What level of taxation would likely be imposed on Internet access and electronic commerce if the moratorium is expired? Consumers in Prince George's County, Maryland, could pay an additional 11 percent in local taxes on purchases of Internet access, while consumers in Jacksonville, Florida, could pay as much as 30 percent in combined State and local taxes on purchases of high-speed broadband access.

There is widespread agreement that, given the critical importance of education in the global economy, broadband access is not a luxury but a necessity for American families. It is time to treat all consumers in the U.S. the same and to protect all consumers from excessive and regressive taxation by eliminating the grandfathering of the nine remaining states.

Taxes do matter. The risk of excessive taxation of Internet access is as real in 2007 as it was in 1998.

Mr. Chairman and members of the Committee, thank you, again, for the opportunity to testify on this important subject, and I respectfully urge you to pass a permanent extension of the Internet tax moratorium without extending the grandfather provisions.

I look forward to answering any questions you may have.

[The prepared statement of Ms. Canning follows:]

PREPARED STATEMENT OF ANNABELLE CANNING, ESQ., VICE PRESIDENT, STATE TAX POLICY, VERIZON COMMUNICATIONS

Chairman Inouye, Senator Stevens, and members of the Committee, thank you for this opportunity to testify on an issue of real importance to millions of consumers and businesses across the United States.

My name is Annabelle Canning and I am Vice President, State Tax Policy at Verizon Communications. I am responsible for pursuing state legislative tax reform initiatives that ensure fair and nondiscriminatory taxation of our consumers and encourage increased broadband investment by communications providers in innovative, new technologies. I appear today on behalf of a broader coalition of Internet service providers, Internet "backbone" providers, and Internet application and content providers—the "Don't Tax Our Web" Coalition—to support a permanent extension of the Internet tax moratorium.

Unless Congress acts, the Internet Tax Freedom Act will expire on November 1, 2007. I will focus on three important reasons why Congress should make the Internet tax moratorium permanent:

- First, at a time when state and local economic development experts are touting broadband as critical to economic competitiveness, new taxes on Internet access could have a chilling effect on broadband investment.
- Second, now that competition between different types of Internet access providers is lowering prices for consumers and making high-speed Internet access more accessible and affordable to lower income households, regressive new taxes on Internet access would create a new obstacle in efforts to close the "digital divide."

- Finally, a number of states and localities are ignoring the will of Congress; therefore, Congress needs to make it clear once and for all that the transport underlying the provision of Internet access and high-speed Internet access is covered by the moratorium on taxes on Internet access service. Otherwise, the record is clear that states and localities will seek to avoid the moratorium on Internet access taxes by imposing taxes on the underlying transport and high-speed Internet access. Recent studies of the taxation of telecommunications services suggest that such taxes could be excessive and discriminatory.

1. Taxes on Internet Access Could Have a Chilling Effect on Investment in Broadband Networks

The Internet Tax Freedom Act was adopted by the Congress and signed into law by President Clinton in 1998 to promote the availability of Internet access services by preventing excessive and inconsistent taxation of these services. Congress was rightly concerned that high taxes would impose undue burdens on consumers, and the administrative burdens of filing in thousands of taxing jurisdictions would impose a barrier to new competitors and innovation.

The moratorium, by preventing the imposition of excessive telecommunications and other taxes on Internet access, has been instrumental in promoting the rapid development of high-speed broadband networks and the web-based applications that use these networks. Congress' foresight in adopting the moratorium has benefited the entire U.S. economy by improving the productivity of American businesses and lowering prices for consumers through competition.

Economists strongly discourage policymakers from imposing taxes on investment. However, in the case of investments in the communications networks that make up the backbone of the Internet, tax policies that discourage investment are especially problematic because of the network benefits of advanced investments in the telecommunications infrastructure. Network benefits are the economic benefits provided by infrastructure investments—benefits that extend beyond the direct impact on the affected industry and enhance growth throughout the entire economy.

Numerous studies support the premise that investments that increase the speed and reach of communications networks improve the productivity of the businesses that use these networks to conduct business every day. For example, a recent study by the international technology consulting firm Ovum and Indepen found that as much as 80 percent of the productivity growth in the entire economy in 2003 and 2004 was due to just two sectors: communications and information technology.[1] For this reason, tax policies that have the effect of reducing investment in telecommunications networks have negative consequences that extend far beyond the firms directly hit with the new taxes.

The productivity benefits to the U.S. economy that flow from ensuring continued growth of the communications sector and increased investment in these networks highlight the importance of making the Internet tax moratorium permanent. Failure to make the moratorium permanent will likely result in the excessive and discriminatory taxes currently imposed on other communications services being extended to Internet access, resulting in decreased productivity in the economy generally.

New taxes on Internet access, or discriminatory taxes on electronic commerce, would impose significant new costs on purchasers of Internet access and purchasers of goods and services that are delivered over the Internet. Higher prices for such services would reduce sales, reduce company revenues, and thus lower the rate of return on investments in communications networks and the applications provided over them. In addition, new taxes would increase the cost of doing business for U.S. firms that increasingly rely on Internet-based applications and services as part of their operations.

Much has been written in the last few years about the investments that our economic competitors in China, India, and other nations are making in their communications networks. They recognize that broadband networks are crucial components of a successful strategy to compete in a global economy. Here at home, the Congress, our Governors, state legislators, and local officials also recognize the importance of broadband networks in an overall economic development strategy.

Unfortunately, in many states, state economic development policy and tax policy are not aligned. On the one hand, states subsidize broadband deployment while on the other hand they impose excessive property and sales taxes on the equipment necessary to provide broadband service. A review of current state tax policy suggests that, notwithstanding the good intentions of state and local governments, economic development policy priorities alone have not been sufficient to prevent state and

[1] Lewin, David and Roger Entner. "Impact of the U.S. Wireless Telecom Industry on the U.S. Economy ," Ovum and Indepen, Boston, MA, September 2005.

local governments from pursuing tax policies that are counterproductive to economic growth.

Congressional approval of a permanent moratorium would send a clear signal to the markets that long-term investment decisions will not be undermined by the imposition of new taxes on Internet access or discriminatory taxes on electronic commerce. Such a strong, pro-investment signal from the Congress would help ensure that these investments—which have had such an important role in U.S. economic growth and productivity over the last decade—will continue to be encouraged and rewarded. It will send a signal to the markets to invest here, not abroad.

2. Regressive New Taxes on Internet Access Would Hurt Efforts To Close the "Digital Divide"

The "convergence" that many in the industry have been touting for years is finally here. In more and more areas of the country, consumers have choices. They can get high-speed Internet access from a cable provider, DSL from a telecommunications company, and/or WiFi or "3G" service from a wireless provider. Other technologies on the horizon may provide even more competitive choices. The key to this consumer choice is the availability of competing networks that reach the consumer.

As a result of competition, the price of broadband Internet access service has fallen in many markets. In those areas that still lack competition, the key to bringing down prices for consumers is to get competing networks built and operating.

At the very time that the benefits of competition are coming to low- and moderate-income households, the imposition of new taxes on Internet access would increase prices and make broadband access less affordable to such households as well as small businesses that need broadband access to enhance their ability to compete. New taxes on Internet access would be especially problematic if excessive state and local telecommunications taxes were simply extended to such services by tax authorities.

3. Congress Should Act To Ensure That the Moratorium Is Not Undermined by State and Local Taxation

The Internet Tax Freedom Act's moratorium on state and local taxes covers the transport purchased, used, and sold by Internet access service providers to provide Internet access and high-speed Internet access. Nonetheless, some states and localities have persisted in imposing taxes on Internet transport and high-speed Internet access. If left unchecked, such activities will undermine the moratorium. From an economic standpoint, taxes on the transport component of Internet access are indistinguishable from taxes on Internet access services. Both put the same upward pressure on end-user cost of service, deterring the growth of Internet access subscribership.

A report released by GAO in 2006, on the Impact of the Internet Tax Nondiscrimination Act on State Tax Revenues,[2] concluded that the Internet tax moratorium did not apply to Internet backbone services (described as "acquired services"). However, the plain language of the statute, as well as the relevant legislative history, reflect a clear legislative intent to ban Internet access taxes at both the retail and wholesale level. One of Congress's primary purposes underlying the reenactment of ITNA was to address potential and existing inequities with respect to the states' taxation of the various providers of Internet access. Congress was concerned that those providers who are required to primarily purchase the transport backbone services from another entity would be placed at a competitive disadvantage compared to those who own backbone networks.

Congress sought to correct this potential inequity to ensure that all providers of Internet access would be subject to the same level of taxation with respect to their purchase of wholesale transport services and consumers would not be subject to additional costs through the imposition of "hidden taxes" on the transport.

The willingness of states and localities to tax communications services at excessive and discriminatory rates highlights the risk to consumers of indiscriminate new taxes if the moratorium is not extended and its applicability to Internet transport is not clarified once and for all. These excessive rates impact not only consumers but also the growth of the Nation's economy generally.

In 1999, the Committee on State Taxation released a comprehensive study of the state and local tax burden on telecommunications services.[3] The study found that consumers of telecommunications services paid effective state/local tax rates that

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[2] Government Accountability Office, "Internet Access Tax Moratorium Revenue Impacts Will Vary by State." Washington, D.C., January 2006, GAO–06–273.

[3] Committee on State Taxation, "50-State Study and Report on Telecommunications Taxation." Washington, D.C., 1999.

were more than twice those imposed on taxable goods sold by general business (13.74 percent *vs.* 6 percent). Including Federal taxes, the tax burden was nearly three times higher than general business. In addition, due to the sheer number of different state and local taxes imposed in many jurisdictions, the typical communications service provider was required to file seven to eight times as many tax returns compared to those filed by typical businesses (63,879 *vs.* 8,951 annually).

Unfortunately, with the exception of Virginia, states with excessive and discriminatory taxes on telecommunications service have not reformed their taxes to reduce the level of taxation imposed on these services to the same level imposed on other competitive goods and services. The Heartland Institute released a new report this month that found that consumers of cable TV, wireless and wireline phone service paid an average of 13.5 percent in taxes, more than two times the 6.6 percent average sales tax rate. The study found that the average household would pay $125 less in taxes per year if excessive taxes on cable TV and telecommunications were lowered to the sales tax rate.

The failure of most State and local governments over the past decade to reduce excessive and discriminatory taxes on telecommunications services and the efforts by some states and localities to circumvent the moratorium by taxing telecommunications transport in blatant disregard of the moratorium heightens the risk that, absent the moratorium, these excessive and discriminatory taxes could be extended to Internet access. The moratorium was enacted to prevent this from happening, and this threat is as real in 2007 as it was in 1998. It is time to make the moratorium permanent and to end the state grandfather clauses.

There is widespread agreement that, given the critical importance of education in the global economy, broadband access is not a luxury but a necessity for American families. Making the moratorium permanent and clarifying the scope of its applicability would ensure that regressive state and local taxes do not impose another obstacle on the ability of low-income families to prepare for and participate in the global economy, particularly since only 16 states specifically exempt Internet access from their sales or communications taxes.[4]

To summarize, making the Internet tax moratorium permanent will provide important social and economic benefits for American consumers and businesses. A permanent moratorium will send a strong, pro-investment signal to those entrepreneurs that are looking to improve communications and commerce over the Internet. It will prevent the imposition of expensive new taxes and administrative burdens on businesses that conduct interstate commerce over the Internet. It will ensure that regressive new tax burdens are not imposed on lower-income American families seeking to ensure that their kids are prepared for the global economy.

Mr. Chairman and members of the Committee, thank you again for the opportunity to testify on this important subject, and I respectfully urge you to pass a permanent extension of the Internet tax moratorium.

The CHAIRMAN. I thank you very much, Ms. Canning.

Now may I recognize Mr. Dircksen.

STATEMENT OF JEFF DIRCKSEN, DIRECTOR, CONGRESSIONAL ANALYSIS, NATIONAL TAXPAYER UNION FOUNDATION

Mr. DIRCKSEN. Thank you, Mr. Chairman.

Mr. Chairman, Mr. Vice Chairman, members of the Committee, my name is Jeff Dircksen, and I am the Director of Congressional Analysis for the National Taxpayers Union Foundation, the research and education arm of the National Taxpayers Union. NTU is America's oldest and largest grassroots taxpayer organization, with over 362,000 members in all 50 states. You can learn more about NTU and NTUF online, at *NTU.org*.

I appreciate the opportunity to testify on the topic of communications, taxation, and federalism here today. I also had the privilege, in 2001, of addressing the Committee. And so, in the sense of Senator Carper's déjà vu, here I am again, as well.

But these hearings continue to address some of the most important technological and economic issues facing America. I am here

[4] AL, AZ, CO, CT, DC, FL, IA, MD, MA, MI, MO, NY, NC, PA, UT, VA.

on behalf of NTU's members, and taxpayers in general, to urge you to extend the Internet tax moratorium and to ensure that the Internet and online transactions remain free from predatory taxation.

My prepared statement touches on three taxpayer concerns. The first is that taxpayers already face sizable taxes, fees, and other charges for telecommunications services. Research shows that, over time, the users of telecom services have consistently shouldered higher tax burdens on those products, when compared to the tax on other goods and services.

Also, studies have shown that there is a significant economic deadweight loss, due to taxes and fees on cable and wireless services, that run in the billions annually. I would also commend to you a 2006 study by Chicago Professor Goolsbee, who found that the deadweight loss, in looking back to 1998, on broadband services in some markets would have forced some providers to exclude those markets or not enter those markets at all. It's seeing them as marginal.

Second, additional taxes on telecommunication services would be counterproductive for consumers and service providers. Representative Eshoo noted earlier that we rank 15th in broadband penetration among OECD countries.

Third, we believe that the 1992 Supreme Court *Quill* ruling has protected taxpayers by ensuring tax competition among states and local governments. We believe tax harmonization will only result in a race to the top, as State legislators are unwilling to forego local add-on taxes and, instead, build from that base up.

And, finally, fourth, we talk about pro-taxpayer, pro-market solutions and suggestions that can encourage economic growth and innovation on the telecom sector. Just a couple of recommendations would be: a permanent ban on Internet access taxes, a permanent ban on levying new discriminatory taxes on wireless services, and the repeal of the remainder of the phone excise taxes that apply to local phone calls.

As Senator Carper mentioned, I'd like to retell or follow up on a story I told when I testified in 2001.

Prior to my testimony, I received an e-mail from my sister, who lived in Gann Valley, South Dakota. She said that my brother-in-law was going to give up farming and go to work for the local telecom, and do telecommunications Internet services. I mentioned that in the hearing. My mother, who lives in South Dakota, was listening to the hearing online, and was surprised to hear that fact. My sister hadn't told her yet. Now, that little touchy moment for my family was probably unimportant to the millions of people who access the Internet. But that little family moment, for us, was made possible because the Internet does not have high tax and regulatory burdens that either faced my sister in Gann Valley or in Woonsocket or Parker or Tea or Harrisburg, South Dakota, or for my mother, in Sioux Falls. It's important, then, to make sure that those individuals, whether in metro areas or across rural areas, have access to Internet broadband technology.

In a recent conversation with someone, talking about these issues, the individual said, "Well, this ground has been well plowed." And I said, "Yes." It seems as if the Internet and these

Internet issues—tax policy issues—have been around forever. We believe that it is time that members of the Committee agree that Internet access should not be taxed. Back in 2001, a member of the Committee came out and said so. Senator Carper has said so. It's time to send a clear signal to consumers and service providers that making the Internet tax moratorium permanent is the way to go, that other legislation should be adopted, then, that is both low-tax and pro-free-market. Those are the best means to clear the way for more innovation and more growth in the 21st century. NTU's government affairs folks are willing to work with you, your staff, and the Committee to help advance a pro-taxpayer, low-tax, pro-growth agenda.

I thank you, again, for the opportunity to testify. It is my hope that in the future, if I have the privilege to return again, we will be talking about the successes of these pro-growth policies, and not wishing that we could extend them for a few more years.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Dircksen follows:]

PREPARED STATEMENT OF JEFF DIRCKSEN, DIRECTOR, CONGRESSIONAL ANALYSIS, NATIONAL TAXPAYERS UNION FOUNDATION

Chairman Inouye, Vice Chairman Stevens, and Members of the Committee, my name is Jeff Dircksen, and I am the Director of Congressional Analysis for National Taxpayers Union Foundation, the education and research arm of the National Taxpayers Union (NTU). NTU is America's oldest and largest grassroots taxpayer organization with over 362,000 members in all 50 states. You can learn more about NTU and NTUF online at *www.ntu.org*.

I appreciate the opportunity to testify on the topic of communications, taxation, and federalism. This hearing addresses some of the most important technological and economic issues facing America. *I am here on behalf of NTU and its membership to urge you to extend the Internet tax moratorium and to ensure that the Internet and online transactions remain free from predatory taxes.*

Today, I want to share three taxpayer concerns regarding taxing Internet usage and the application of additional taxes or fees to Internet access or transactions. In addition, I will suggest policy alternatives that would be both pro-free market and pro-taxpayer in their orientation. First, state and local governments already place sizable taxes, fees, and other charges on taxpayers who subscribe to various telecommunications services, whether wired, wireless, or online. Second, allowing governmental entities to increase this burden would be counterproductive for consumers and telecommunications providers. Third, the Supreme Court's 1992 *Quill* ruling has protected taxpayers by ensuring tax competition among state and local governments who might otherwise engage in round after round of tax hikes in a "race to the top."

Finally, on behalf of our members, I would urge you to consider how taxpayers would be better served by low-tax, pro-free market policies that encourage economic growth and innovation in the telecommunications sector (in contrast to higher taxes, fees, and additional regulation).

1. Taxpayers Already Face Sizable Taxes, Fees, and Other Charges for Telecommunications Services

In 2000, the National Conference of State Legislatures estimated that there were nearly 11,000 state and local governmental entities that could levy taxes or fees on telecommunication activities, including franchise taxes, utility taxes, line access and right-of-way charges, 9–1–1 fees, relay charges, and maintenance surcharges.[1] Research shows that over time, the users of telecommunication services have consistently shouldered higher tax burdens on telecommunications products when compared to taxes on other goods and services. A Council on State Taxation (COST) report released in 1999 found that consumers faced an effective state and local tax rate of 13.74 percent, which was more than double the 6 percent rate that imposed

[1] Scott Mackey, "Telecommunications and the Tangle of Taxes," *State Legislatures,* February 2000, *www.ncsl.org*.

on other taxable goods.[2] A 2005 update to that report found that the effective rate confronting taxpayers had risen to 14.17 percent, while general business taxes had increased to 6.12 percent from 6 percent.

While a recent report produced by the Heartland Institute and the Beacon Hill Institute at Suffolk University found a slightly lower tax rate than the COST study, it did estimate that the average tax rate for telecommunications services was either 13.52 percent or 11.04 percent, depending upon whether Internet access taxes were included or not. Table 1 below summarizes the average monthly bill, tax paid, and tax rate that consumers face. That rate is still double the average general sales tax, which was 6.61 percent in the study. Please bear in mind also that Heartland/Beacon Hill's findings reflect adjustments to the methodology for which COST's study was criticized by self-interested local officials. Using the average annual taxes and fees paid on cable TV and telephone services (both wired and wireless), the authors estimate that the total annual tax bill paid by consumers is $37 billion. The estimate does not include "losses due to reduced investment, productivity, and consumption." [3]

Table 1.—The Average Monthly Bill, Tax Paid, and Tax Rate for Communication Services

Service	Average monthly bill	Average tax paid	Average tax rate
Cable TV	$52.36	$6.12	11.69%
Wireline Phone	49.33	8.50	17.23
Wireless Phone	49.98	5.89	11.78
Subtotal	151.67	20.51	13.52
Internet Access	36.50	0.26	0.71
Total	188.17	20.77	11.04

Source: Heartland Institute Policy Study #113, May 2007.

Lowering the taxes on telecommunications to even the average sales tax rate would put some money in the pockets of consumers. The authors of the Heartland and Beacon Hill Institute study observe, "The average household would save $125.76 a year if taxes and fees on cable television and phone calls were the same as the average general sales tax on clothing, sporting goods, and household products." [4] The savings may not appear to be significant to those of us living in the Washington metro area, but for consumers in other areas of the country the amount might not be a paltry matter. (Of course, the savings could be even more substantial if the tax rates were reduced to zero for the communications services.) I make this point because when I had the opportunity to testify on these issues in 2001, I mentioned that I had just learned that my brother-in-law was planning to stop farming near Gann Valley, South Dakota, and start working for a local Internet service provider. For some potential Internet or telecommunications customers in Gann Valley, Woonsocket, or Viborg, South Dakota, those savings might make the difference between connecting to a world outside of the Great Plains or not.

2. Additional Taxes on Telecommunications Services Would Be Counterproductive for Consumers and Service Providers

Additional taxes on Internet access or other telecommunications services may further slow the adoption of broadband technologies in the U.S. According to data from the Organisation for Economic Co-operation and Development (OECD), as of December 2006, the U.S. ranks 15th out of 30 OECD countries for broadband subscribers per 100 inhabitants.[5] Table 2 below shows that the U.S. trails countries such as Denmark and Canada, but also Luxembourg.

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[2] Scott R. Mackey, Testimony before the House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, Oversight Hearing on State Taxation of Internet Telecommunications Services, June 13, 2006.

[3] David Tuerck *et al.,* "Taxes and Fees on Communication Services," The Heartland Institute, Policy Study #113, May 2007, *http://www.heartland.org,* p. 22.

[4] David Tuerck *et al.*

[5] Organisation for Economic Co-operation and Development, "OECD Broadband Statistics to December 2006," *http://www.oecd.org/sti/ict/broadband.*

Table 2.—Broadband Subscribers per 100 Inhabitants

Country	Rank
Denmark	1
Netherlands	2
Iceland	3
Korea	4
Switzerland*	5
Norway	6
Finland	7
Sweden*	8
Canada	9
Belgium	10
United Kingdom	11
Luxembourg	12
France	13
Japan	14
United States	15

Notes: *Data for Sweden and Switzerland are preliminary estimates based on September 2006 data.
Source: OECD.

Broadband technologies are highly price-elastic, meaning that consumers are sensitive to changes in price, including the imposition of additional taxes and fees. Steve Titch, a policy analyst with the Reason Foundation, points out that a 1 percent hike in the price of wireless service leads to a 1.29 percent drop in demand. The demand for cable TV falls 3 percent in response to a 1 percent rise in the price of the service. Titch concludes, "This elasticity also is why legislators should avoid the temptation to 'simplify' telecom taxes by raising them all to match the service taxed at the highest rate. In addition to being simplified, telecom taxes must be lowered." [6]

Such taxes can cause consumers to alter their decisionmaking processes and to select services based on taxes rather than on the true cost or quality of what is being offered. Producers may decide to forego an investment that they might have made in the absence of the tax structure. These economically inefficient decisions lead to a loss of both consumer and producer surpluses, resulting in what economists would call a "deadweight loss." The annual deadweight loss due from taxes and fees on cable has been estimated to be as high as $2.6 billion annually.[7] The economic loss to the country from wireless taxes and fees is even larger—$8.8 billion a year.[8] A 2006 analysis by economist Austan Goolsbee found that if taxes had been levied on broadband technologies in 1998 that the resulting deadweight loss would have slowed the entry of broadband suppliers into some marginal markets.[9] According to Goolsbee, "[T]he deadweight loss adjustment associated with the impact of taxes on diffusion, $70 million, exceeds the conventional deadweight loss by a factor of 2 (raising the total [deadweight loss] from around 180 percent of revenue to 434 percent of revenue.)" [10]

Rather than aggravating these economic losses with new or higher taxes, Congress should adopt a policy that bans new taxes and repeals those already in place (or at least lowers them). NTU has supported the temporary extensions of the Internet tax moratorium, while urging a permanent ban on access taxes and other telecommunications fees. Such a ban would remove the economic inefficiencies and uncertainties associated with temporary moratoriums, thereby sending a strong and clear signal to taxpayers and service providers: namely, that broadband and wireless are technologies that will be allowed to grow and innovate without the specter of the "tax man" lurking in the shadows.

3. The *Quill* Ruling has Protected Taxpayers by Ensuring Tax Competition Among State and Local Governments

Any scheme that intends to simplify, streamline, or make sales taxes "fairer" online is just one step away from trampling the Supreme Court's 1992 *Quill* ruling.

[6] Steve Titch, "The $37 Billion Telecom Tax Burden," *http://www.reason.org,* May 1, 2007.
[7] Jerry Ellig and James Nicholas Taylor, "The Consumer Costs of Wireless Taxes and Surcharges," *Working Paper in Regulatory Studies,* Mercatus Center, March 2006, cited in David Tuerck *et al.*
[8] *Ibid*.
[9] Austan Goolsbee, "The Value of Broadband and the Deadweight Loss of Taxing New Technology," *Contributions to Economic Analysis & Policy,* Vol. 5, Issue 1, 2006.
[10] Austan Goolsbee, pp. 19–20.

Consumers should be wary of this backdoor attempt to run roughshod over the Court's restrictions on taxing phone and catalog sales. If such a system of extraterritorial collection is allowed, Congress will have opened the door to any number of potential tax cartels that will eventually harm rather than help taxpayers.

Forty-five states and the District of Columbia impose some type of a broad-based retail sales and use tax.[11] The Federation of Tax Administrators calculates the median state sales tax rate to be 5.5 percent.[12] The sales taxes levied on consumers is likely higher, however, since local governments in 34 states are also allowed to levy a sales tax. Consequently, there are an estimated 7,458 governmental entities that can impose a sales or use tax.

In almost every case, the taxes imposed by local governments are "add-ons," or taxes that are in addition to the state's base sales tax rate. One must ask whether it is reasonable to believe that local elected officials would be willing to eliminate these "add-ons" in the name of simplification. Instead, taxpayers are likely to see an escalation of rates—a "race to the top"—especially when politicians can hide behind the cloak of "simplification" and "harmonization." In reality, such actions would essentially kill tax competition among states. Elected officials would have little incentive to keep tax rates—or government expenditures—in check. The current sales tax structure authorizes states and localities to determine taxing priorities, allowing tax bases and rates to vary as legislative bodies see fit. NTU frequently receives letters and e-mail messages from individuals who are considering relocating their families and businesses and want to find information on state and local tax burdens. These individuals see tax competition among states as extremely beneficial.

4. Pro-Taxpayer, Pro-Market Policy Suggestions That Encourage Economic Growth and Innovation in the Telecommunications Sector

The following is a list of recommendations that would benefit taxpayers through lower taxes and economic expansion, as well as through innovation in the quality and delivery of telecommunication services.

- *A permanent ban on Internet access taxes.* As NTU's Senior Government Affairs Manager Kristina Rasmussen noted in a January 5, 2007 letter to Senators Wyden, McCain, and Sununu, "Since its enactment in December 2004, the Internet Tax Nondiscrimination Act has stopped any new taxes targeted at Internet access services. This bill and its predecessors have helped to create a dynamic environment where the Internet is thriving and bringing advanced communication capabilities to millions. Keeping the burden of new government-mandated access charges off Internet service has made entry to the information superhighway more affordable for Americans from all walks of life." Making the moratorium permanent would continue to keep that information superhighway affordable, today and in the future.
- *A permanent ban on levying new discriminatory taxes on wireless services.* Local and state governments believe wireless taxes, fees, and surcharges are a "cash cow" for the 21st century. Yet, they fail to consider that the total wireless tax and fee burden can exceed 20 percent in some areas—a higher effective tax rate than the typical middle-class consumer pays on a 1040 Federal income tax return. Again, higher wireless taxes will cause consumer demand to fall and limit the ability of service providers to enhance current offerings or develop new ones.

  The fact is, all too many officials in states and localities have been oblivious, and often contemptuous, toward this miserable situation. The City of Corvallis, Oregon provides but one example of where elected leaders resorted to a noxious tax scheme to make wireless services far less affordable. Voters demolished this proposal when it was referred to them last fall, but this laudable outcome entailed extraordinary efforts on the part of local residents (including our own members) to beat back the tax hike. Until citizen activists can establish comprehensive tax limitation and reduction measures in their communities, it is perfectly reasonable for Congress to set some sensible boundaries under Federal law (just as it did with the Internet Tax Freedom Act).
- *Repeal the remainder of the phone excise tax.* While the Treasury's decision to forgo collection of the phone excise tax on long distance telephone calls was a

[11] Harley T. Duncan, "State and Local Retail Sales Taxes, Submitted to the President's Advisory Panel on Federal Tax Reform," Federation of Tax Administrators, April 2005.

[12] Federation of Tax Administrators, "State Sales Tax Rates and Vendor Discounts," January 1, 2006, *http://www.taxadmin.org/fta/rate/vendor.pdf.*

step in the right direction, action should be taken to repeal the tax that is still being levied on local calls.

- *Adopt business activity tax simplification legislation.* The integration of the Internet and telecommunications technologies has allowed businesses to expand across state lines, and interstate business activities are now commonplace. However, these developments have created confusion about when states are permitted to collect income taxes from out-of-state companies conducting certain activities within their jurisdiction. Unfortunately, governments are increasingly defining "substantial nexus" differently, leading to a complex matrix of tax rules. Congress should adopt legislation that contains specific standards that define when firms should be obliged to pay business activity taxes.
- *Provide clarification on whether "acquired transactions" are taxable or not.* In its January 2006 report to this Committee entitled "Internet Access Tax Moratorium: Revenue Impacts Will Vary by State," the Government Accountability Office (GAO) argued that the current Internet tax moratorium does not exempt certain "acquired services" from taxation. These services include "high-speed communications capacity over fiber, acquired by Internet service providers (ISP) and used to deliver Internet access."[13] However, GAO's view is not accepted by all state tax officials or representatives of the telecommunications industry. We would recommend exempting such transactions to prevent state or local governments from making an end-run around the moratorium.
- *Maintain the integrity of the spectrum auctioning process.* Competitive bidding for taxpayer-owned airwaves has been successful all around, by providing a fair price for a valuable commodity, yielding billions of dollars in potential deficit reduction, and fostering the expansion of telecommunications services. Yet, Congress and the FCC continue to experience pressure from certain businesses seeking exceptions or favorable treatment during the auctioning process. Furthermore, disgruntled rivals in the same or even other industries seek regulatory action to enjoin common business decisions such as mergers. The proper response to such pleas is not additional intervention in the market, but rather providing the spectrum (through competitive auctioning) that will allow all comers to follow through with their business plans and offer consumers more choices.
- *Reexamine unproductive subsidies.* To give just one example, the Universal Service Fund's "High Cost" program, which subsidizes phone service in certain areas (often rural), was created as a way to further the goal set out by the 1934 Communications Act to provide reasonably priced communications across the Nation. According to the Office of Management and Budget's Program Assessment Rating Tool, High Cost is rated "Results Not Demonstrated" because it "does not measure the impact of funds on telephone subscribership in rural areas or other potential measures of program success, nor does it base funding decisions on measurable benefits." A program whose purpose has been firmly implanted for decades should have established benchmarks for success by now, but apparently not in this case.

Conclusion

Given the potentially destructive impact that expanding or raising Internet and telecommunications taxes could have on this important economic sector, the remedy could not be clearer: Congress and the states should declare this tax territory permanently "off limits." Again, I appreciate the opportunity to testify here today, Mr. Chairman. Our membership is grateful that the voices of taxpayers are being heard as well as recognized. I look forward to your questions.

The CHAIRMAN. I thank you very much, Mr. Dircksen.

May I now recognize our Vice Chairman, Senator Stevens.

STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Senator STEVENS. Thank you very much, Mr. Chairman.

Would you put my statement—opening statement in the record here——

The CHAIRMAN. It is so ordered.

[13] U.S. Government Accountability Office, "Internet Access Tax Moratorium: Revenue Impacts Will Vary by State," January 2006, Highlights.

Senator STEVENS.—please?

[The prepared statement of Senator Stevens follows:]

PREPARED STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Thanks to the Internet, more goods and services are sold in Alaska every day, and Alaskans are able to market their goods to customers in the Lower 48. This is beneficial for small businesses. Access to the Internet has provided Alaskans with a means to get lower rates for hotel and air travel when they are planning trips outside the state. Additionally, broadband access has eliminated distance barriers for education and medicine.

To ensure those benefits continue to reach as many Americans as possible, Congress should reduce any obstacles to Internet access. One way to do that is to prevent Federal, state and local taxes that drive up costs for Internet access. During the period of the imposition of the moratorium in 1998 and now, there has been tremendous investment, growth and innovation in broadband deployment and I hope this continues.

I am pleased to see that this issue has bipartisan support in both the House and the Senate and look forward to the testimony today and working with my colleagues to extend the moratorium which expires in November of this year.

Senator STEVENS. I apologize for being late.

And I do not wish to offend my good friend, but I'm compelled to ask this question. Under what procedure do you think we could approach the nine remaining states that do tax, and have a phase-out that's fair to all concerned? Any suggestions?

Ms. Canning?

Ms. CANNING. Yes. I think most states are either in session once a year or every 2 years. So typically when we've done solutions in the states, as far as tax-reform types of solutions, it's typically been a 2-year period. I think it theoretically could be a 4-year period. But I think the idea is, to give the State sufficient time. We're not talking about a substantial amount of money, as compared to other sources of revenue in the states, and, I would think, over some period of time that allowed for the states to analyze their budget considerations during the 1 year, 2 year, maybe a 4 year period——

Senator STEVENS. Well, I'm informed——

Ms. CANNING.—it could be addressed.

Senator STEVENS. I'm informed that Hawaii's is somewhere around $5 million a year. It is just a State tax, and it's not county or local taxes, right?

Ms. CANNING. It can vary. There may be a few local jurisdictions in Colorado. It's sort of uncertain. But, otherwise, it's only state-level, yes.

Senator STEVENS. Well, if we could do that, we could then have a permanent, rather than a moratorium, right?

Ms. CANNING. That is correct.

Senator STEVENS. Any of you have any opposition to that concept?

Mr. Quam?

Mr. QUAM. Yes, sir. The Governors have called for a temporary extension and a continuation of the grandfathers. And the reason for that, they serve some very important purposes. They are safeguards. It's pretty clear, from even the testimony today in some differences in what the definition means, both between GAO, NGA, and industry, that we haven't gotten this right yet. The temporary extension of the moratorium and the grandfathers were part of the original deal, really out of respect for federalism and the fact that these are State and local taxes that we're dealing with. By having those safeguards in place in a temporary moratorium, you can deal with issues of the definition. Congress can come back and recheck where the things stand, because the Internet is changing so much.

And then, on the grandfather clause, it's not just nine states with taxes I think you're right, in Colorado there are some local jurisdictions—but that protection also protected a lot of other taxes in all states, because it grandfathered in all taxes that may apply to this industry as it came online.

You'd have to go back and, with the grandfather protection, make sure that the moratorium would not inadvertently apply, especially at the local level, to taxes that were not anticipated or people aren't thinking of. It's not just the direct tax on Internet access, there is a protection there for indirect taxes that, unless you get the definitions right, could fall under the moratorium. So, it's an important safeguard, and we'd argue that it needs to stay in place.

Senator STEVENS. Well, if I understand this correctly, the use of the Internet has expanded that—the economy of the country—that all states benefit from that expansion. Now, the difficulty is, is there were some states that already had taxes in place. You sort of implied that you think that there are taxing jurisdictions be— smaller than the states themselves, that are still imposing taxes. That surprises me. I didn't think that was the case.

But I would like to see us get to the point where it's a level playing field. It does seem to me that the states that don't have taxes are being penalized by the moratorium more than those that have—get the moratorium, obviously. And I'd like to see us eliminate this moratorium, the necessity to extend the moratorium every—it's 2 years, isn't it, Mr. Chairman?

The CHAIRMAN. It expires in November.

Senator STEVENS. November, yes.

We could put into this extension a process for elimination of the existing taxes, if we desire to do so. And I seem to remember a discussion like this the last time we extended this. Now, were any of you involved in those discussions?

Mr. QUAM. Yes, sir.

Ms. CANNING. Yes. And, actually, I do want to point out that, in fact—last time around, we did have—similar concerns raised about the clarity of what is meant by a tax on Internet access. When we talk about a tax on Internet access, we're talking about the purchase of service by the consumer. These are consumer taxes. And additional language was put into the compromise version last time that did clarify the fact that it did not apply to taxes on infrastructure, on the companies, that sort of thing.

Senator STEVENS. Well, I think as long as the moratorium exists, it raises the question of how to get around it in those states that want to continue to tax. And I think we ought to have a flat, absolute barrier to taxes on the Internet. Now, I don't know how we get there, but I would encourage you all to give us some suggestions. I don't know how the Chairman and other members of the Committee feel about that. But it does seem to me that this is such an essential element now, particularly going into broadband, its ubiquitous utility now has got to be realized by everybody, and it's not going to be if some places are going to try to go around what we've done and impose the tax and leave it up to some court to decide whether that's valid or not. I would like to see an impregnable ban on tax on the Internet.

Now, does that—do any of you think that's not possible?

Dr. White, do you think that's possible?

Dr. WHITE. It's possible, Senator. Our issue is about the clarity of the language in the law. We interpreted the plain language of the statute. In terms of the clarity issues, we recognize that there are others that have a different opinion on what it means, and we would be happy to work with your staff to clarify the language, if that's the issue. In terms of extending it to the nine states, we haven't done work on that specific issue, the best way to do that.

Senator STEVENS. Yes.

Mr. DUNCAN. Mr. Chairman?

Senator STEVENS. Well, I would invite your assistance to the staff to make suggestions. And I don't know yet how my colleagues feel about this, but I know that ours is a State that deals with the Internet exclusively now, in terms of commerce, and most people don't realize how Alaska has utilized the Internet to the extent of just almost total utilization in very remote areas. And, through the use of the mails and the express delivery, we now have the concepts of access to markets we've never had before. Now, if our people, in using that new system—(new to us)—are going to face taxes from another State, that bothers me. I think we should be assured that's not going to happen. I hope that we can find some way to just put down a blanket prohibition against anyone charging taxes of fees or anything else on utilization of the Internet for commerce. And I hope that we can achieve that goal someday, and I'd like to start that process this year, if it's at all possible.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Duncan?

Mr. DUNCAN. If I might, two comments on the grandfather. First, with respect to taxpayers in Alaska facing some additional cost because of a grandfathered tax, I——

Senator STEVENS. No, there are people that are utilizing it. They're not paying any taxes in Alaska.

Mr. DUNCAN. No, and I understand. The grandfathered taxes are, indeed, consumer taxes, so if it's levied by the State of Wisconsin, it is paid only by a Wisconsin resident, and does not have an effect on Alaska. The amendments adopted last time that prevented or prevent states from taxing the—what I will call a wholesale purchase of telecommunications by an Internet service provider when they're used to provide Internet access, are, indeed, intended to reduce the costs to Alaskan residents and across the country. And that piece—while the grandfathered taxes from 1998 are consumer taxes, we estimate them at something on the order of $100 to $120 million across the country, the piece that was expanded last time to the telecommunications purchases by Internet service providers affected many more states, and, we think, is several hundred million dollars in foregone revenue. So, that there are significant steps that have already been taken to eliminate taxes that were imposed on Internet access, and then—consumer taxes from 1998 are there because they were levied by those states in 1998, and there is no getting around the moratorium there.

Senator STEVENS. Well, if we eliminated the moratorium, and prohibited it, they could not collect those any longer, right?

Mr. DUNCAN. That would be correct. But what we're saying is that they were in place in 1998. They're taxes on the consumers in those states as part of their sales tax that tries to get at the broad taxation of consumer purchases by people living in the State. And the arrangement in 1998 was that they would remain in place.

The other thing is that they are paid by consumers in those states, and work by the Government Accountability Office as well as by economists at the University of Tennessee, would show you that the degree to which consumers adopt Internet access and adopt broadband, and the degree to which companies provide broadband services, is not statistically related to whether the State taxes it or not. In other words, whether a State taxes Internet access doesn't have any statistically significant effect on whether the consumers in that State adopt it or whether the companies provide it. Other things are much more important, particularly income levels of the families and education levels.

Senator STEVENS. Do you have any——

Mr. DUNCAN. Those are the primary determinants.

Senator STEVENS. Do you have any statistics on the total amount of taxes collected by those moratorium states?

Mr. DUNCAN. When you dealt with it previously, were $80 to $120 million. We're in the process of gathering them. We think that that's still an accurate range.

The CHAIRMAN. Thank you very much.

Senator Carper?

Senator CARPER. Thanks. Thanks, Mr. Chairman.

And let me just say welcome to all of you. Thank you for your testimony today.

I want to go back and ask a couple of you to repeat what you said, please. And, Mr. Quam, would you go back, I think you said there are three principles that we should adhere to.

And I would invite Senator Stevens—Senator Stevens? Excuse me, Senator Stevens, I don't know if you were here when Mr. Quam mentioned these three principles, right at the top of his testimony. I'm just going to ask him to repeat them for all of us, please.

Mr. QUAM. Thank you, Senator Carper.

The three principles we would ask Congress to look at is, when they're looking at the moratorium: first, be clear; definitions matter. Again, we're talking about State and local taxes. Be very clear as to what is going to be affected. Number two, be flexible; a temporary solution is better than permanent confusion. Therefore, a temporary extension of the moratorium makes more sense. And, number three, do no harm; continue the grandfather protections to preserve existing State authority and revenues.

Senator CARPER. Thank you.

Mr. Duncan, I don't know if you had three principles that you shared with us, but—I'll call them three principles—would you just go back and repeat those, as well, please?

Mr. DUNCAN. Yes, Senator. The three key points on the access and moratorium that I made were that the definition of Internet access needs to be modified as we go forward, and it needs clarification so that it deals with issues of connecting to the Internet, the tools to navigate, the e-mail, the instant messaging, but avoids the bundling of other services.

The second is that we believe the moratorium should be extended only temporarily, and that Congress should preserve its prerogatives to come back and review that periodically.

And, third, that the grandfather clause that protects those taxes in place prior to 1998 should remain.

Senator CARPER. OK. All right. I think both of you talk about making the extension of the moratorium temporary, and I just want us to dwell on that for just a moment.

A dozen or so years ago, when the Internet was maybe not in its infancy, but was certainly just a pup, just sort of growing up, and we wanted to make sure it had a chance to really reach its potential, I could see a need to try to protect it and to nurture it. And we sought to do that with the legislation that the Congress passed in 1998. In 1998, we didn't think of things like VoIP or IPTV. In fact, in 2001, it was my first year here—when we extended the moratorium for, oh, 2 or 3 years, we just hadn't thought of it. At least I don't recall ever hearing, in debate, any discussion of VoIP or IPTV. In fact, 3 years ago, in 2004, when we passed the last extension of this moratorium, I didn't hear we were talking about VoIP. I joked, at the time, I had barely learned how to spell VoIP, and now I have to learn how to spell IPTV; and the technology just continues to change. And I think that that's one of the factors that argues for not making this permanent, at least until this all kind of settles out and we, sort of, know what we're facing. And so, your recommendation for the temporary nature of the extension is, I think, well founded.

I would just say to my colleagues, in—anybody want to comment on what I just said?

[No response.]

Senator CARPER. No? OK.

Ms. Canning, go ahead.

Ms. CANNING. Yes, just to address the permanency issue, the communications providers that are making investment decisions, they're making them over 5 to 10 year periods, as far as investment in these networks that I think everybody has agreed is incredibly critical to the country's future, as far as the productivity of our businesses and competing in the new economy. Having a permanent moratorium is critical to enable those companies to make the right investment decisions to get as much capital in the form of infrastructure in this country.

The other issue I'd just like to mention——

Senator CARPER. Well, before you do that—I only have so much time, so—thank you for responding to my point.

As an old Governor, as a recovering Governor, I'm mindful of the need for the business community to have certainty. And, you know, they're making these big decisions, big investments. And I—obviously, they'd want certainty. I would want certainty, too. But the question is, how do we balance that desire, that need—in our desire to extend broadband throughout the country—how do we balance that with the need for some certainty from State and local governments that are trying to provide education for kids, early childhood education, run their schools, K–12, to provide some hospital care for people who, maybe, don't have the access to the sort of hospital care or healthcare that the rest of us do—how do we balance that against the needs for, you know, State and local governments to have some certainty, too, with respect to their revenue streams? And as I said earlier, we don't have a sales tax in my State, so this idea of remote collection of sales tax—it's actually not a parochial issue for me, so I think I can be, maybe, a little more objective than some in looking at this.

But if—how is it appropriate for those of us in the Congress to say to a State or a local government, "You can't collect telephone taxes, even if you've collected them for years. But as telephone services move over to the Internet, you can't collect those." Well, we said, 3 years ago, "You can collect those. You can continue to collect them." I think—I might be wrong, but I think under the legislation that our colleague Senator Wyden and others are going to do—I think we actually may go back and change that.

Can somebody clarify that for me? Mr. Quam, do you know how we continue to protect VoIP for the states?

Mr. QUAM. I believe the bills that are out there, including Senator Wyden's bill, would just be a straight extension of current law. That should carry the VoIP——

Senator CARPER. OK.

Mr. QUAM.—extension forward. The problem is, it does not change the underlying loophole. So, it's the next VoIP—IPTV, whatever the next major service is—that causes the problem. We never addressed the underlying issue of the definition, the last go-round.

Senator CARPER. Hopefully, as we go through that—this process, this year, we can find a way to address that. But, put on my old hat, or a State or local government person, I just don't know that it's appropriate for us to take away their ability to continue to raise revenues from ways they've traditionally done that. If you happen to be a city with cable franchise taxes, and your video migrates to the Internet, or your telephone I don't know that it's appropriate for us to step in and say, "Well, you've always collected these taxes, and we're not going to let you do that." You know, they need some certainty, as well, and what we have to do is find the right balance that's respectful of the need for the business community to have some certainty as they make their investment decisions. We also have a need to respect the obligation of State and local governments to serve the folks that need to be served, and particularly at a time when their ability to collect sales tax is being undermined.

Anyone want to comment on that?

Dr. White, do you have any thoughts?

Dr. WHITE. Well, again, I think if the issue is uncertainty, based on the language of the statute, we have an interpretation of what the statute means. We would be happy to work with the Committee's staff to further clarify that, because we do recognize there are differences of opinion about both what's in an Internet access bundle and whether or not the moratorium applies to acquired services.

Senator CARPER. All right.

Mr. Quam?

Mr. QUAM. Senator Carper, you strike a very important tone, and it was one that was here in 1998. And it's that of balance, that if Congress is going to take a step, that it needs to balance that with the sovereign authority of states to really define what their revenue systems are and meet the needs of their citizens. That was a core reason why it was temporary, why grandfather clauses were made part of the original moratorium. As we look at the debate that's before us today, if you look at a moratorium that prohibits states from taxing a certain service, it should be done very surgically, and should be done very rarely. It's not a business, I think, Congress really should get into, because it starts to cross the line and interfere with that State-Federal relationship.

On the other side—and I know Delaware doesn't collect State sales taxes—however, the Streamlined Agreement is states actually coming together to address a problem that everybody said was a problem, and that's the complexity of State sales tax systems. Well, Governors and legislators and others, using their sovereign authority, came together to say, "We'll solve it together." We have a national issue. The states came together, working with the business community, to come up with a voluntary agreement, incredible odds against it, and yet you have 15 full member states, and most states actually participating at some level, and over 1,000 companies agreeing to voluntarily collect those taxes. That's a success story that we should be talking about. That's the type of balance and respect for federalism that I think's really important here. Congress can help by coming in and authorizing those states who have done that work.

On the moratorium, we need to keep a balance, and I think that's going to be very important.

Senator CARPER. Mr. Chairman, thanks. Thanks very much.

If I could just say one last quick sentence, you know, to my colleagues, Mr. Chairman, on the one hand, I think we all want to see broadband deployed broadly in this country. And we know that's going to be part of our glide path, if you will, to success in the 21st century as an economy. By the same token, another part of our success is going to be determined by the kind of skills that kids graduate with from high school and college—the kind of skills that they bring to the workforce, and the ability of states to be able to ensure that those kids get the education they need at very young ages, and throughout their years in public school.

So, our challenge is to find that balance. I think we can have both. And the challenge for us is to find a way to do both.

The CHAIRMAN. Thank you very much.

Senator Smith?

STATEMENT OF HON. GORDON H. SMITH, U.S. SENATOR FROM OREGON

Senator SMITH. Thank you, Mr. Chairman.

Mr. Quam and Ms. Canning, Senator Carper has touched on a question I'm interested in, and it's related just to the whole issue of bundling. Are there any businesses that are under the current definition of "Internet access," take the position that anything they sell as part of the package with Internet access is exempt, because it is part of a package?

Mr. QUAM. I have no specific examples of that. However, the temporary aspect of the moratorium also helps protect against that. What you have is a very broad definition that was meant to be temporary in 1998. A straight reading of that would say that it is possible to read it that way, that you can bundle these together and make the whole package tax-free. We're only asking for a clarification to say that was not Congress's intent. If that's the practice today, then no one's doing it. It should not be a problem, then, to define this to make sure it's absolutely clear that it can't be done, because that is the risk into the future.

Senator SMITH. OK.

Ms. CANNING. This issue actually came up last time, when the bill was up for extension, as well. And, at that time, in addition to the VoIP provision that was included to clarify that Voice over Internet Protocol would be subject to tax, there was also an accounting rule included in that bill and that accounting rule is very similar to the same bundling rule that is included in the Streamlined Sales and Use Tax Agreement and process. And the entire purpose of that provision is to address the concern of bundling, which means, if a company is selling video/music-type services included in the bundle, they will be charging for those services, and that the accounting rule requires the company to separate the—out the taxable charges for either telecommunications or other services from the nontaxable Internet access. Failure to unbundle will result in the entire package being taxable, and, obviously, substantial revenues to State and local governments.

Senator SMITH. Are there any businesses that you know of that are currently taking that aggressive——

Ms. CANNING. I'm not aware of any businesses that are taking an aggressive position.

Senator SMITH. Mr. Quam?

Mr. QUAM. I would add, and Ms. Canning is absolutely right, the bundling or the accounting provision was very important. However, it only works if there is something actually to unbundle. If you have to unbundle with Internet access, but "Internet access" can mean everything, the accounting rule really has no effect.

Really, by clarifying the definition, you can make the accounting rule, which everybody agreed to, work. Therefore, we can get to the point I think you're trying to make, which is, no one's doing it now, let's make sure that Congressional intent was never that, "just because it goes over the Internet means it's not subject to state and local taxes;" rather, Congressional intent was, access to the Internet, we want tax-free. That's one of the reasons we're supporting an extension of the moratorium——

Senator SMITH. And a clarification.

Mr. QUAM. Absolutely.

Senator SMITH. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Dorgan?

STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you very much.

You know, I think these issues can be resolved. All of us know they are difficult and complicated. The Internet has changed a lot in our lives. It's happened very quickly. It's one of the innovations in our lives that is unusual, and perhaps one of the great innovations in many, many decades.

I was thinking, sitting here, you know, in the morning, at home, I go on the computer and check the news in North Dakota. So, that's my home computer. I go to the Internet. Driving in, I'll use my cell phone. I'll probably also use my cell phone to go to the Internet, check *Headline News, CNN News* or something. I get to the Capitol, I've got a BlackBerry, so I'm walking to the Russell Building, I, perhaps, will use the Internet on my BlackBerry. And then, maybe I'll stop someplace to make a phone call, and they have VoIP service for telephone. So, that's four different activities, all of which use the Internet. But the Internet came in different forms to all of those activities. And I think it describes why it is so important that, whatever we do, we do understanding the consequences of the actions. The definitions are critical here.

You know, the issue of the moratorium has been controversial, not because there are a lot of people that want to say to the states or local governments, "Go ahead and just impose some new taxes. It's a new area of activity, just layer on some taxes, if you like." That's not been the attitude, I think, of any Member of the Congress that I'm aware of.

We have, however, tried to link, if we could, the opportunity to give the states some help in collecting taxes that are already owed with respect to Internet—the commerce on the Internet; that is, the purchasing and so on, the shopping that goes on. When that happens, a tax is owed for the access to a product on the Internet, but is never paid, because it needs to be paid in the form of a use tax, because it's not collected in the form of a sales tax. But the use tax on hundreds of billions of transactions is never paid by an individual consumer. So, the question is, can the State and local governments be able to collect that tax on the remote sale?

I'm somebody who believes we should try to find a way to help make that happen, but I don't want anyone—a business that is affected, to have to subject themselves to 7,000 jurisdictions and different rates, different bases, and the complexity of all that. So, the question is, how does one streamline that, or how does one simplify it? These two issues have generally been linked. That's why we have had a temporary, rather than permanent, moratorium; not because somebody believes that there should be new layers of taxes on the Internet.

I think somehow we can work through this and solve it. Mr. Dircksen, you probably disagree. But I know some of the organizations in town that feel as you do, feel that we should not be collecting sales tax or use taxes on transactions from the Internet. Would you agree that if you bought that necktie that you're wearing on the Internet——

Mr. DIRCKSEN. This was a gift from my girlfriend, Senator.

[Laughter.]

Senator DORGAN. Well, that's——

Mr. DIRCKSEN. That's why I'm wearing it this morning.

Senator DORGAN. Well, I happen to know that your girlfriend bought that on the Internet.

[Laughter.]

Senator DORGAN. And——

Mr. DIRCKSEN. Really?

[Laughter.]

Senator DORGAN. And when she did, my guess is——

Mr. DIRCKSEN.—the instant messenger when I——

Senator DORGAN. Yes.

Mr. DIRCKSEN.—the room now——

Senator DORGAN. When she——

Mr. DIRCKSEN.—I know why.

Senator DORGAN. When she bought that beautiful necktie on the Internet, she, like most Americans, will not pay a use tax. She won't pay a sales tax, because the Internet seller, in most cases, isn't required to collect it, so will not. She, perhaps, is required to pay a use tax, but will not file a use tax form to pay a use tax on the necktie. So, do you, first of all, do you agree that a tax is owed on that transaction?

Mr. DIRCKSEN. There is a use tax transaction, yes. And, as the NTU has stated previously, and as I talked about, testifying in 2001, we believe that states unfortunately, have rarely made an effort, or only are then starting to make efforts, to inform consumers of their use tax obligations. We feel it's, kind of, the lazy tax collector way to say, "You know what? We can't really do anything. We're not going to make any effort to tell you about use tax. So, we're just going to try to come together through the harmonization process," which we, again, have a concern will result in higher tax rates—simplified is fine, but higher for consumers.

Senator DORGAN. But, you know what? That's a curious choice for you to make. It seems to me you're saying, "Let's send the local taxing authorities after, individually, hundreds of millions of people. Let's just sic them on those people individually"—that's a curious thing to do. It seems to me you would want to simplify it for those that owe the taxes.

Mr. DIRCKSEN. We believe in, again, a simplified process. But there could be education efforts made by states to let consumers know of their obligation. Again, as I stated in 2001, I formerly worked for the Pennsylvania Department of Revenue. The Commonwealth of Pennsylvania, in their statistics of revenue collections, has the category of "Unknown Use Tax Collections." They don't know where it comes from. People just send them checks. They cash the checks. They're very happy to take the checks. And they don't do anything else. And then, when they did their online analysis, said, "Oh, but we don't know where this comes from, but we really don't think it comes from the Internet. So, we're losing a lot of money."

Senator DORGAN. But, as a practical matter, hundreds of millions of transactions are not going to result in the filing of individual use tax. That's just common sense. And so, there is a substantial amount of difficulty with State governments being able to collect.

And the question is, how do we try to find a way to help them do that, collect a tax that is already owed?

Now, on the question of the issue of Internet access, I personally am not very interested in having somebody go to the Internet and say, "You know what? We've got a new area of activity here, let's slap a tax on it." I'm very interested in much deeper penetration of Internet use in this country, of broadband use especially. And I don't think that's very tax sensitive, But, by the same token, I have no difficulty in saying, "Let's not have people take a look at this as a plum with which we can impose a new tax." But as we begin thinking about these areas, the definitions are absolutely crucial, because I think there is no question, once you write this, if you give an opportunity for interests to bundle up a lot of activities and decide these are activities that are out of the reach—activities that, in previous cases, have always had to bear a tax—after all, you know, we have to build roads, and we have to have law enforcement and inspect food. We have to do things as a government, and we have to pay for that, so we have a tax system. So, I mean, ultimately, we've got to find ways here to wind our way through this without creating massive problems. And I think at least early on in this discussion, some of the proposals would have caused very serious problems, had we enacted them. I recall one in front of this Committee, Mr. Chairman, dealing with VoIP, when it was going to be a broad preemption from VoIP, broad preemption of issues. And when I said, "Well, what are you preempting?" and the author had no idea, couldn't give me a list—just wanted to preempt, but didn't know what he wanted to preempt.

So, it seems to me that we ought to at least have some basic understanding, or minimum understanding, of what we're doing and what the consequences of that would be.

I'll make one additional comment. Mr. Duncan and Mr. Quam make a point, and it's not an irrelevant point. It has not customarily been the province of the U.S. Congress to take a look at a State and say, "We've defined the role here," in federalism, "of what you can and cannot do." And so, we need to tread very carefully in those areas. Their admonition about that is, I think, well taken.

Having said all of that, I think the testimony here has been good testimony, and we need to think our way through this carefully. I know there are people who just say, "Well, permanent moratorium," and then leave the room. That's just a slogan, you know, "permanent moratorium."

We need to balance all of the issues here of fostering Internet growth, fostering broadband penetration, all those issues, with all the other related issues, including the one that I was asking Mr. Dircksen about. And I didn't mean to engage your girlfriend's——

[Laughter.]

Senator DORGAN.—identity here.

Mr. DIRCKSEN. You and I will talk later.

[Laughter.]

Senator DORGAN. And it is a nice necktie.

[Laughter.]

Mr. DIRCKSEN. As is yours, Senator.

Senator DORGAN. Mr. Chairman, I'm going to send a series of questions to these witnesses, because I think there are a lot of things we should put on the record as our Committee begins to think through how we deal with these issues that Senator Enzi and Senator Wyden raised, as well as Representative Eshoo, and the issues raised by these five witnesses.

So, thank you very much for holding the hearing.

The CHAIRMAN. Thank you.

When this Committee participated in the enactment of the Telecommunications Act of 1996, I believe the word "Internet" appeared three times in the final measure that became law. Since then, the Internet and Internet services have grown phenomenally. And there is a song that says, "We've only just begun." It would be most applicable.

Obviously, listening to the testimony—and I purposely permitted this freewheeling discussion—there is much confusion as to interpretation, and it will take some clarification to determine what Congressional intent was, or should be, and whether the moratorium is permanent or temporary. Listening to the testimony, I would opt out for a temporary extension, if at all, because I have no idea, at this moment, what we enacted, listening to all of the experts here. I don't know whether services, such as music, things like that, should fall into Internet. So, I will join my colleague in submitting questions, if I may, to all of you, so that our record will show your thoughts.

The CHAIRMAN. And, with that, I can tell my staff here, "Your work is cut out for you"——

[Laughter.]

The CHAIRMAN.—because if we are coming up with any measure we must do so before November the 1st, because that's when the moratorium expires.

I can assure the witnesses that we will do our very best to come up with something that is fair and equitable, because we are treading into an area, as my colleague stated very clearly—our role should not be an absolute one, but one that's very fair, equitable.

So, with that, I'd like to thank all of you for your testimony. It's been very helpful, but confusing.

[Laughter.]

The CHAIRMAN. And the hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF HON. JOHN THUNE, U.S. SENATOR FROM SOUTH DAKOTA

Chairman Inouye, Vice Chairman Stevens—Thank you for holding this hearing today. I was serving in the House of Representatives when the original Internet Tax Freedom Act was passed in 1998 and when it was extended in 2001. I supported the measure both times with the inclusion of the grandfather clause for states that had already levied taxes on Internet access. As most of you know South Dakota is one of those grandfathered states.

Some of the arguments we heard during those first debates focused on the Internet being a nascent technology. We were told that we shouldn't be putting a heavy tax burden on this new sector of our economy. Today's hearing is extremely important because the Internet is no longer a nascent technology, but there are still significant reasons why we should extend the Internet tax moratorium, either temporarily or permanently. The Internet has been essential to recent economic growth. Multiple or discriminatory taxes could easily slow the growth we have seen in this sector.

Additionally, as a strong supporter of expanding broadband deployment out to those furthest reaches, many of which are in my home State of South Dakota, I have to seriously consider the impact new and discriminatory taxes might have on these efforts. It doesn't make any sense to support broadband deployment on the one hand and then support taxing broadband and making it out of reach for some of those who do not yet have an Internet connection in extremely rural or urban areas.

As policymakers we will have to weigh these benefits against the arguments we will hear from those who believe a moratorium handcuffs states and their ability to collect revenue. This is an important debate and I look forward to having it.

PREPARED STATEMENT OF HON. BOB GOODLATTE,
U.S. REPRESENTATIVE FROM VIRGINIA

Thank you for inviting me to speak with you about the need to permanently extend the moratorium on Internet access taxes.

The Internet has facilitated faster, more efficient and less expensive communication among businesses, between businesses and consumers, and among consumers. It has helped usher in a new era of reduced costs, increased efficiency, and increased access to those who would not otherwise be able to travel to obtain goods and services.

One of the best ways to ensure that businesses, consumers, and our economy will continue to reap these benefits from the Internet is to keep it free from burdensome taxes and regulations. As you know, the Internet Tax Freedom Act of 1998 created a moratorium on Internet access taxes and multiple and discriminatory taxes on e-commerce. As a result of this moratorium, the Internet has remained relatively free from the burdens of new taxation. The moratorium has been extended on numerous occasions. Most recently, it was extended until November of this year.

However, without further action by Congress, the moratorium will sunset in November of this year, subjecting the Internet to possible taxation from more than 7,500 taxing jurisdictions. We have seen the tremendous growth in both the rollout and adoption of broadband Internet connections over the past decade. The moratorium on Internet access taxes has undoubtedly contributed to this growth, and now is not the time to hamstring the Internet. On the contrary, now is the time to permanently make the tax moratorium permanent.

Excessive taxation and regulation will hamper the Internet's tremendous growth and stifle investment in small businesses that utilize this tremendous medium. The last thing that consumers need is for the puzzling array of taxes on their phone bills to be repeated on their Internet service bills. In addition, the last thing that innovative Internet service providers need is to have to factor into their business plans the costs of complying with a multitude of additional tax burdens. Let's permanently free these businesses to focus their resources on rolling out broadband to more rural areas and enhancing the cutting edge services they already offer.

In addition, it is estimated that only 11 percent of U.S. households with incomes of less than $30,000 have high-speed Internet service, as opposed to 61 percent of households with incomes over $100,000. Taxes on Internet access will increase the costs of households going on-line, as the prices for providing Internet access service increase. What this means is that the digital divide between those who can afford to go online and those who cannot will become much larger, further complicating our efforts to bridge this divide.

During the 107th Congress, I introduced legislation that sought to permanently ban Internet access taxes and discriminatory taxes on electronic commerce. In addition, I worked to help pass legislation out of the House in the 108th Congress, which also enacted a permanent ban. This Congress, I was pleased to join with my colleague, Representative Anna Eshoo, to introduce the bipartisan Permanent Internet Tax Freedom Act, H.R. 743. This legislation, which has already garnered over 65 additional bipartisan cosponsors, will encourage continued investment in and utilization of the Internet by permanently banning Internet access taxes. This legislation is forward-looking, will help make Internet access more affordable for all citizens, and will provide the long-term certainty that businesses need to make calculated decisions regarding the ways in which they will utilize and invest in Internet technologies.

Senator Wyden has introduced identical, bipartisan legislation in the Senate, along with Senators McCain and Sununu. I look forward to continuing to work with all Members from both chambers on this and other solutions to ensure that the Internet remains a tremendous boon to our economy, as well as a medium that continues to enhance the quality of life of our citizens.

Thank you again for inviting me to speak to you today on this important matter.

PREPARED STATEMENT OF JOAN WAGNON, CHAIR, MULTISTATE TAX COMMISSION

Mr. Chairman, Vice Chairman Stevens, and members of the Committee on Commerce, Science, and Transportation:

My name is Joan Wagnon and I am the Chair of the Multistate Tax Commission. I am also the Secretary of the Kansas Department of Revenue. The Multistate Tax Commission (MTC) is an intergovernmental State tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged with:

- Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration; and
- Avoiding duplicative taxation.

Established in 1967, forty-six states and the District of Columbia participate in the work of the MTC.

Thank you for the opportunity to present our views. In considering whether to enact a Federal law that gives preferential treatment to one economic sector under State and local tax law, Congress must first consider its Constitutional responsibility to allow state and local governments to manage their own fiscal affairs. It is axiomatic that states cannot provide governmental services to its citizenry without the power to raise revenues. Federal preemption of state taxing authority not only undercuts the states' ability to provide those services, it also undercuts the very lifeblood of state power and distorts the Constitution's intentional balance of power between the Federal Government and the states that created it. Congress should, therefore, consider exercising its authority under the Commerce Clause of the United States Constitution to preempt State and local tax laws only when there is a compelling reason to do so.

Thus, it is appropriate to consider the reasons presented by the industry representative to see if they are of the magnitude to warrant Federal preemption of State and local tax laws. The first argument is that "new taxes on Internet access could have a chilling effect on broadband investment." First, even if this were true, it provides no basis for Congressional regulation under the Commerce Clause. Second, it may not even be true. The best way of testing the validity of this statement is to examine the evidence in the nine states that currently impose taxes on Internet access and compare that evidence to that of the other forty-one states. In fact, this very analysis was performed by economists at the University of Tennessee who conducted a regression study to discern whether there was any impact of existing Internet access taxes on Internet access. The result: "Internet access taxation has no statistically discernible effect." (*State Tax Notes,* May 17, 2004, p 519). The industry representative did not provide any evidence to the contrary.

The second argument advanced in support of federally-imposed preferential tax treatment is that "new taxes on Internet access would create a new obstacle in efforts to close the 'digital divide.'" In other words, a monthly tax of 4½ percent to 7½ percent of a $30 access fee ($1.35–$2.25 per month) would discourage those of limited means from accessing the Internet. Once again, no evidence was presented to back up this assertion. A larger obstacle preventing Internet access would be the cost of the computer itself. Moreover, American consumers pay ten times or more for Internet access than do their fellow consumers across the globe. (Testimony of Ben Scott, Consumer Federation of America before the U.S. Senate Committee on Commerce, Science, and Transportation, "Communications, Broadband and Competitiveness: How Does the U.S. Measure Up?," April 24, 2007) Therein lies the "digital divide."

Finally, the proponents of imposing permanent preferential tax treatment of one industry upon state and local governments argue that Internet access taxes are discriminatory, imposing a higher taxation burden on Internet users than on non-Internet users. Once again, no evidence is presented from the nine existing states that already tax Internet access. There is only a comparison to the telecommunications industry, which is still adjusting from decades of monopoly status to its current competitive situation. Ironically, however, it is the current Internet access tax moratorium that causes discriminatory taxation. Under the present moratorium, non-grandfathered states may not tax e-mails or instant messaging. Yet, text messaging does not fall within the moratorium and is taxed under existing State and local telecommunication tax laws. The current moratorium, therefore, causes discriminatory tax treatment of functionally equivalent digital communications methods. Indeed, the moratorium results in disparate tax treatment if electronic messages accessed on precisely the same digital device; e-mails and instant messaging accessed on a cell phone come within the moratorium while text messages accessed on the same cell phone do not.

The proponents of a permanent Internet access tax preemption have not provided any substantive justification for Congressional exercise of interstate commerce authority for this one sector of the national economy. Congress has traditionally seen fit to intervene in State and local tax policy choices only where there has been a perception that states may seek to "export" their tax burdens or where taxation would impose a disproportionate burden on interstate business. Thus, when Congress passed the Railroad Regulatory Reform and Revitalization Act of 1977, it chose to prohibit State taxation only to the extent such taxes discriminated or imposed higher burdens on railroads than competing modes of transportation. Pub. L. 94–210, 45 U.S.C. Sec. 801; Tax Reform Act of 1976, Pub. L. 94–455, 15 U.S.C. Sec. 391 (Prohibiting discriminatory taxes on electrical generation and transmission; *See also,* Buck Act, 4 U.S.C. Sec. 111(a) (prohibiting states from imposing discriminatory income taxes on Federal employees on Federal reservation); Pub. L. 96–113, 49 U.S.C. Sec. 2101 (limiting taxation of airline employees to state of residence or state where 50 percent of flight time occurs); Pub. L. 104–95; 4 U.S.C. Sec. 114 (limiting state taxation of pension income to residents). The common thread in each of these Acts has been to trust local legislatures to respond to political pressure brought by its constituents. Where a tax is passed on to local residents, as is the case with Internet access charges, the political process ensures that those taxes will remain at an appropriate level.

Moreover, it is worth reconsidering the original purpose for the 1998 Federal preemption and whether that legislative purpose is still valid in 2007. When President Clinton signed the original law 9 years ago, Internet access was considered a "fledgling" industry. In 2007, it is "fledgling" no more. In the last 6 years, e-commerce has ballooned from $25.8 billion to $107.8 billion, and high-speed lines have expanded from 9 million locations to nearly 65 million. Looking into the future, Internet Protocol Television is expected to expand by 92 percent per year. Any justification that existed 9 years ago to aid this sector of the economy by bestowing upon it Federal preferential treatment under State and local tax laws, therefore, no longer exists today.

Thank you again for the opportunity to present these views.

PREPARED STATEMENT OF ROGER J. COCHETTI, GROUP DIRECTOR—U.S. PUBLIC POLICY, THE COMPUTING TECHNOLOGY INDUSTRY ASSOCIATION (COMPTIA)

On behalf of CompTIA's more than 20,000 members, I am pleased to submit this testimony strongly supporting passage of S. 156, the Permanent Internet Tax Freedom Act of 2007. Our members, particularly our roughly 15,000 small business members, thank the Committee for discussing a topic so vital to the welfare of American small businesses and consumers. Small businesses are the backbone of the American economy. Some 23 million small businesses employ over half of the private sector workforce. Small businesses are a vital source of the entrepreneurship, creativity, and innovation that keeps our economy globally competitive. As a Nation, we are dependent upon the health of the small business sector, and this is why we are so adamantly in support of making permanent the moratorium on Internet access taxes and the prohibition on multiple or discriminatory Internet sales and use taxes.

The U.S. Congress championed small businesses and consumers and promoted growth in the American economy by enacting a moratorium on Internet access taxes and new, discriminatory taxes on e-commerce in 1998, and by further extending that moratorium most recently in 2004. The Congress's wise policy decision in 1998 served as a catalyst to revolutionize the way small businesses and consumers interact and needs to be made permanent to ensure small businesses and consumers can continue to drive our e-commerce economy. Nearly all economists today agree that the unprecedented growth in American productivity with almost no inflation that we experienced from the mid-1990s onward was driven in large part by the benefits of the use of the Internet by business and consumer alike. These statistics do not begin to capture the enormous contribution that the Internet has made to education, culture, entertainment, and international cooperation, however.

The U.S. policy of not permitting anti-Internet taxes—including taxes on Internet access or taxes that discriminate against Internet transactions—has led the world in this direction and done as much as any other single policy to promote the benefits of Internet usage. The time has long passed when this policy should be made permanent.

CompTIA Overview

CompTIA is the largest computer industry trade association in the United States. We include among our members virtually every brand name and large company in the industry as well, as noted above, roughly 15,000 small information technology (IT) companies that are commonly called Value-Added Resellers or VARs. A typical small business in the United States, almost regardless of its business, will not have an IT department of its own. Instead, America's small businesses rely on the services of one or more of thousands of VARs that are located in every city, town, country and district in the United States. VARs are small businesses who are themselves system integrators and operators. VARs design, install and maintain computer systems and networks for other small businesses. An estimated 32,000 VARs, most of which are small businesses themselves, sell approximately $43 billion worth of computer hardware, software, and services annually. This means that over one-third of the computer hardware sold in the U.S. today is sold by VARs.

While we in CompTIA represent all segments of the IT industry, including large hardware, software, services and training companies, we also uniquely represent America's VARs. For 25 years, CompTIA has provided research, networking, and partnering opportunities to its 20,000 mostly American member companies. And while we represent nearly every major computer hardware manufacturer and software publisher, nearly 75 percent of our membership is comprised of American VARs—the small business component of the tech industry.

In addition to representing the interests of VARs, CompTIA also works to provide global policy leadership for the IT industry through our headquarters in Chicago and our public policy offices in Washington, Brussels, Hong Kong, and São Paulo. For most people in the computer industry, however, CompTIA is well known for the non-policy-related services that it provides to advance industry growth: standards, professional certifications, industry education, and business solutions.

The Online Economy, Small Business and Consumers

The clients of CompTIA's 15,000 VARs are traditionally not large corporations; our VAR members serve as the IT departments for America's small businesses, which are themselves the backbone of the American economy. As such, our members are highly sensitive to the needs of both small businesses and consumers of small business products and services. At the time of the initial passage of the Internet Tax Freedom Act, many small businesses considered it a relatively expensive novelty to maintain some presence on the Internet. Now, the times have drastically changed.

On May 21st, the new head of the Small Business Administration (SBA), Steve Preston, told a conference of small businesses that embracing high-tech solutions "can mean the difference between maintaining a competitive organization and potentially not being in business anymore." He also explained, as we all know, that something as simple as having a high-quality website can "make a small business look like a big business." Small businesses are as much, if not more, a beneficiary of the benefits of the Internet as are large businesses and consumers.

Naturally, in today's U.S. markets, small businesses justifiably consider marketing and selling on the web essential to the success of their businesses and are pushing the envelope of innovation and creativity online. In a recent survey of small business owners conducted by *allbusiness.com,* 83 percent reported that the Internet had improved communication about their company, and 61 percent said that the Internet had helped open new markets for their businesses. The same survey found that small businesses are using the Internet to improve operational efficiency; 87 percent use the Internet for business communications and 89 percent of those surveyed use the Internet regularly for research. Moreover, 44 percent of small businesses surveyed already had a website up and running and 38 percent had plans to launch a website within 6 months. The Internet is the great leveling field in American business today, permitting a small business to compete with one that is much larger. In that respect, the Internet promotes competition, innovation and productivity.

We should not discourage the use of this medium by taxing it or allowing anyone to impose discriminatory taxes that will discourage its use. In fact, we should be doing everything that we can to encourage greater access to the Internet and investments in, and use of, it.

Small Business Success Online Depends on Access, Affordability, and Parity

These successes for small businesses and consumers would not have been possible without the Internet tax moratorium. There are two driving factors behind the growth of e-commerce for small business: Access to affordable high-speed Internet connections for businesses and consumers and tax parity between online and offline sales. This hearing addresses a key component in Internet access and usage by small businesses and consumers: the taxes that may be imposed on it. Onerous and unjust Internet tax schemes would add significantly to the cost of both providing and obtaining Internet services and thereby discourage Internet usage and broadband adoption. Should this occur, small businesses and consumers would experience more limited availability of Internet infrastructure, frustrating the Internet's rich promise. For these reasons, CompTIA supports broadband deployment, broadband competition, and the further closing of the digital divide, in addition to supporting the permanent ban on Internet access taxes.

But access must be more than available—it must also be affordable and predictably affordable. For small businesses operating on slim margins and consumers working to make ends meet, even small increases in cost can push either group offline and the unpredictability of what new taxes may be imposed on Internet services at any time will scare away consumers, investors and entrepreneurs alike. Layering an unpredictable array of changing Internet access taxes on top of what is an essential but moderately priced component of people's businesses and lives can easily prevent those with the most to gain from the empowerment of the Internet from being able to use it. This is especially true for rural small businesses. According to an SBA study in December of 2005, rural small businesses pay nearly 10 percent more for broadband services than their urban counterparts. Given that broadband services are price elastic, disparities created by access taxes will unjustly harm small businesses, particularly those in rural areas.

The driving force that the Internet has become for the United States' economy and culture should not ever be subject to an access tax. Such a regressive tax would place a significant hurdle to clear for small businesses and low to moderate income consumers to access to what has become the defining economic, political and cultural necessity of this century. Permitting unpredictable and multiple taxes on Internet access was not a sound social or economic policy in 1998, and it will not be in 2008, 2018, or 2028. Congress should provide cost conscious small businesses and consumers the piece of mind that their increasing investments in, and reliance upon, the Internet will not be wasted because arbitrary state or local taxes levied against them in the future will make the Internet unaffordable.

Moreover, the continued success of e-commerce, specifically among small businesses, depends upon Congress' protection of consumers and businesses from unpredictable and multiple or discriminatory taxes. The mere legal possibility that a consumer could be taxed by multiple states on a single purchase would have a chilling effect on small businesses in the United States. Given the impressive contributions that e-commerce has made to our economy, education, culture and prosperity since 1998, and the trends indicating that online marketing and sales by small businesses will only increase, it would be an economic disaster to ever let the our current pro-Internet policy expire.

Recommendations and Conclusion

To continue Congressional support of small business and individual taxpayers, CompTIA specifically supports the following related to the Internet tax moratorium:

- The Internet tax moratorium should be made permanent for both access taxes and for new, multiple, unpredictable discriminatory sales and use taxes.
- The Internet tax moratorium legislation before the Senate should be amended to clarify the definition of Internet access to cover all the services intended by Congress in enacting the original moratorium and in subsequent amendments. This is necessary to prevent taxing bodies from finding creative ways to try to tax Internet access services.
- The State Streamlined Sales Tax Project is an important but quite separate issue and its progress should not be merged with, muddied by, or otherwise confused with the importance of a pro-Internet tax policy. A prohibition of discriminatory taxes against Internet usage does not impact any state's ability to tax online sales in a nondiscriminatory manner, or otherwise collect business and telecommunications taxes. The bill simply continues the existing prohibition on taxation of Internet access and precludes any taxation that would single out Internet users for unfair tax treatment. As such, the merits and progress of the Streamlined Sales Tax Project need to be considered independently.

Given the growth of the Internet's economic and social importance—from saving time buying back to school clothes, to finding and evaluating a doctor or searching for employment—access to the Internet, free of unjust taxes, is one of the most critical issues before America's consumers and small business entrepreneurs. As such, CompTIA strongly encourages this Committee and this Congress to continue its vigorous defense of small businesses and American consumers by passing S. 156.

PREPARED STATEMENT OF THE COALITION FOR RATIONAL AND FAIR TAXATION [1]

The Coalition for Rational and Fair Taxation ("CRAFT") is a diverse coalition of some of America's largest corporations involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and multistate entertainment and service businesses. The businesses maintain locations throughout the United States and employ several hundred thousand employees in our country.

This statement focuses on why a bright-line, quantifiable physical presence nexus standard is the appropriate standard for state and local taxation of out-of-state businesses and why modernization of Public Law 86–272 is essential to the U.S. economy. CRAFT strongly supports Business Activity Tax Simplification Act of 2006("BATSA") legislation, which was introduced as S. 2721 in the 109th Congress. Such legislation would bring clarity and uniformity to the currently diverging state business activity tax jurisdictional standards. We believe that it is essential for Congress to act to provide clear guidance to the states in the area of state taxing jurisdiction, removing the drag that the current climate of uncertainty places on American businesses, and thereby protecting American jobs and enhancing the U.S. economy.

The absence of a clear business activity tax jurisdictional standard has negatively affected interstate commerce. Businesses are not certain what activities they can and cannot do in states before becoming subject to taxation. A few states now assert that they can impose a business activity tax on a business that has no property or employees in the state, but that merely has an out-of-state telephone number that is registered in a local telephone book.[2] The intent is clearly to punish out-of-state businesses that reach into a state and try to open lines of communication with potential in-state customers. Broadcasters are subject to similar treatment. Broadcasting a signal into a state is being asserted as grounds for business activity tax-

[1] By Arthur R. Rosen, Counsel CRAFT, McDermott Will & Emery LLP, 340 Madison Avenue, New York, NY 10173.
[2] *See* 2007 BNA Survey of State Tax Departments, p. S–14.

ation in some states. An outrageous tactic of some state revenue departments is to impose a business activity tax on corporations that merely have trucks passing through the state for as little as six times in an entire year, even where the trucks do not stop in the state and do not deliver goods in the state.[3] This is not only bad policy. It also is a difficult standard as a practical matter—after all, it requires that a corporate tax department keep track of the routes truckers take and what the taxability standards are for each state the trucks pass through. Tax jurisdiction should not be based on such trivialities.

CRAFT submits this statement to apprise this committee about BATSA-type legislation, to explain why it is necessary and to advocate for its passage. We believe that this Committee will find BATSA-type legislation to be particularly interesting, because it is actuated by concern about recent trends in the state taxation of interstate commerce, telecommunications, interstate trucking and transportation and many other matters within this Committee's purview.

Overview

The principal motivation for the adoption of the United States Constitution as a replacement to the Articles of Confederation was a desire to establish and ensure the maintenance of a single, integrated, robust American economy. This is reflected in the Commerce Clause, which provides Congress with the authority to safeguard the free flow of interstate commerce. As an additional consideration, the Supreme Court has determined, in the context of the Due Process Clause, that, in the area of state taxation, "the simple but controlling question is whether the state has given anything for which it can ask return."[4]

Unfortunately, some state revenue departments have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on businesses located in other states that have little or no connection to their state. Some state revenue departments have even asserted that they can tax a business that merely has customers in the state based on the recently-minted notion of "economic nexus." Such behavior is entirely logical on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state's society. But this country has long stood against such taxation without representation. And worse, the "economic nexus" concept flies in the face of the current state of business activity taxation, which is largely based on the notion that a business should only be subject to tax by a state from which the business receives benefits and protections. And worse still, it creates significant uncertainty that has a chilling effect on interstate economic activity, dampening business expansion and job growth. Practicing tax attorneys and accountants regularly advise businesses that ultimately decide not to engage in a particular transaction in another state out of concern that those businesses might become subject to tax liability in that state. It is entirely appropriate for Congress to intervene to prevent individual states from erecting such barriers to trade, and to protect and promote the free flow of commerce between the states for the benefit of the U.S. economy.[5]

Confronted with aggressive—and often Constitutionally questionable (as is discussed below)—efforts of state revenue departments to tax their income when they have little or no presence in the jurisdiction, American businesses are faced with a difficult choice. They can oppose the tax—but then must bear substantial litigation costs to do so. Or, they can knuckle under to the state revenue departments and pay the asserted tax—but then they risk being subject to multiple taxation. Unfortunately, the latter choice is sometimes made, especially since some state revenue departments are making increasing use of "hardball" tactics, a topic on which the American business community would truly relish elaborating at another time or in another forum. Moreover, the compliance burdens of state business activity taxation can be immense. Think of an interstate business with customers in all 50 states. If economic nexus were the standard, that business would be faced with having to file an income or franchise tax return with every state and pay license or similar taxes to thousands upon thousands of localities.

As businesses adapt to the "new order" of conducting business in the new economy, efforts by state revenue departments to expand their taxing jurisdiction to cover activities conducted in other jurisdictions constitute a significant burden on the business community's ability to carry on business. Left unchecked, this at-

[3] *Id.* At S–40–S–41 (five states reported that they would impose a business activity tax on these facts; several other states reported that they may or may not impose the tax depending on the taxpayer's business and/or the total number of miles logged in the state by the trucks).

[4] *Wisconsin* v. *J.C. Penney Co.,* 311 U.S. 435 (1940).

[5] *See e.g.,* Diann L. Smith, *Supreme Court Would Uphold Pub. L. 86–272* (letter to the editors), 25 State Tax Notes 135 (July 8, 2002) (discussing the authority of Congress to regulate interstate commerce).

tempted expansion of the states' taxing power will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation, and uncertainty escalate. Clearly, the time is ripe for Congress to consider when state and local governments should and should not be permitted to require out-of-state businesses to pay business activity taxes. It appears eminently fair and reasonable for Congress to provide relief from unfair and unreasonable impositions of income and franchise taxes on out-of-state businesses that have little or no physical connection with the state or locality.

Consistent with principles enumerated by the majority of the Federal Advisory Commission on Electronic Commerce ("ACEC"),[6] and earlier by the Congressional Willis Commission in 1965, the Business Activity Tax Simplification Act is designed to address the issue of when a state should have authority to impose a direct tax on a business that has no or merely a minimal connection with the state. This issue has become increasingly pressing as the U.S. and global economies have become less goods-focused and more service-oriented and as the use of modern technology has proliferated throughout the country and the world. BATSA-type legislation would apply to state and local business activity taxes, which are direct taxes such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes that are imposed on businesses engaged in interstate commerce. BATSA-type legislation does not apply to other taxes, like sales and use taxes, personal income taxes,[7] gross premium taxes imposed on insurance companies, or transaction taxes measured by gross receipts, such as the New Mexico Gross Receipts and Compensating Tax Act.[8]

The underlying principle of BATSA-type legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, BATSA-type legislation would ensure that state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state. Such legislation would do so in a manner that would ensure that the business community continues to pay its fair share of tax but would put a stop to new and unfair tax impositions. Perhaps most important, a physical presence nexus standard is entirely consistent with the jurisdictional standard that the Federal Government uses in tax treaties with its trading partners. In fact, creating consistency with the international standards of business taxation is vital to eliminating uncertainty and promoting the growth of the U.S. economy.

Background

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state has been asked for decades.[9] In 1959, the Supreme Court ruled that a corporation with several sales people assigned to an office located in the State of Minnesota could be subjected to that state's direct tax scheme.[10] Prior to that time, there had been a "well-settled rule," stated in *Norton Co.* v. *Illinois Dept. of Revenue,* 340 U.S. 534 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place."[11] The Supreme Court's 1959 decision in *Northwestern States Portland Cement,* coupled with the Court's refusal to hear two other cases[12] (where the taxpayers, which did not maintain offices in the state, conducted activities in the state that were limited to mere solicitation of orders by visiting salespeople), cast some doubt on that "well-settled rule" and fueled significant concern within the business community that the states could tax out-of-state businesses with unfettered authority, thereby imposing

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[6] *See* Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965); and Advisory Commission on Electronic Commerce, "Report to Congress," pp. 17–20 (April 2000), respectively.

[7] In addition, nothing in BATSA-type legislation affects the responsibilities of an employer to withhold personal income taxes paid to resident and nonresident employees earning income in a state or to pay employment or unemployment taxes.

[8] N.M. Stat. § 7–9–1 *et seq.*

[9] *See, e.g.,* Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication,* 41 Tax Law. 37 (1987).

[10] *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450 (1959).

[11] *Wisconsin Dep't of Revenue* v. *William Wrigley Jr. Co.,* 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).

[12] *Brown Forman Distillers Corp.* v. *Collector of Revenue,* 101 So.2d 70 (La. 1958), *appeal dismissed* and *cert. denied,* 359 U.S. 28 (1959); *International Shoe Co.* v. *Fontenot,* 107 So.2d 640 (La. 1958), *cert. denied,* 359 U.S. 984 (1959).

significant costs on businesses and harm to the U.S. economy in general. As a result, Congress responded rapidly, enacting Public Law 86–272 a mere 6 months later. Public Law 86–272 prohibits states and localities from imposing income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state.[13] Subsequently, the Congressional Willis Commission studied this and other interstate tax issues and concluded that, among other things, a business should not be subject to a direct tax imposition by a state in which it merely had customers.[14]

In recent years, certain states and organizations of state tax collectors have been advocating the position that a state has the right to impose tax on a business that merely has customers there, even if the business has no physical presence in the state whatsoever.[15] The business community, in contrast, believes that a state can impose direct taxes only on businesses that have a physical presence in the state.[16] While the taxpayers' position has repeatedly been upheld, the state courts and tribunals have rendered non-uniform decisions on this issue.[17] Unfortunately, the Supreme Court has not granted writs of *certiorari* in relevant cases.[18]

The bottom line is that businesses should pay tax where they *earn* income. It may be true, as certain state tax collectors assert, that without sales there can be no income. While this may make for a nice sound bite, it simply is not relevant. Income is earned where an individual or business entity employs its labor and capital, *i.e.,* where he, she, or it actually performs work.[19] In fact, as early as 2019, the Attorney General of the State of New York pointed out that "the work done, *rather than the person paying for it,* should be regarded as the 'source' of income."[20]

Proponents of the so-called "economic nexus" standard argue that the states provide benefits for the welfare of society as a whole and, therefore, the states should be able to collect business activity taxes from all U.S. businesses, wherever located. Such an argument is not only ludicrous, but it ignores the fact that businesses (and individuals) are members of the American society and pay Federal taxes for such general benefits and protections. Nevertheless, some argue that states have spent significant amounts of revenue to maintain an infrastructure for interstate commerce and court systems that the Nation can utilize, not to mention spending tril-

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[13] Pub. L. No. 86–272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).

[14] Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965), Vol. 1, Part VI., ch. 39, 42. *See also* W. Val Oveson, *Lessons in State Tax Simplification,* 2002 State Tax Today 18–39 (Jan. 20, 2002).

[15] A survey conducted by BNA Tax Analysts demonstrates the extent to which the states are asserting the right to impose tax on out-of-state businesses based on so-called "economic nexus" grounds. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S–9–S–43, at S–36, S–37 (April 23, 2004). *See also Ensuring the Equity, Integrity and Viability of Multistate Tax Systems,* Multistate Tax Commission Policy Statement 01–2 (October 17, 2002). *Accord* Letter from Elizabeth Harchenko, Director, Oregon Department of Revenue, to Senator Ron Wyden (July 16, 2001). *See also* Doug Sheppard, *The Certainty of Disagreement on Business Activity Tax Nexus,* 25 State Tax Notes 420 (Aug. 5, 2002).

[16] *See Jurisdiction to Tax—Constitutional,* Council of State Taxation Policy Statement of 2001–2002; *The Internet Tax Fairness Act of 2001: Hearing on H.R. 2526 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary,* 107th Cong. (2001) (statements of Arthur Rosen on Behalf of the Coalition for Rational and Fair Taxation; Stanley Sokul, Member, Advisory Commission On Electronic Commerce, on Behalf of the Direct Marketing Association and the Internet Tax Fairness Coalition). *See also* Scott D. Smith and Sharlene E. Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction,* 25 State Tax Notes 787 (Sept. 9, 2002).

[17] *See Lanco Inc.* v. *Director, Div. of Tax'n,* 008 A.2d 176 (N.J. 2006); *A&F Trademark, Inc.* v. *Tolson,* 605 S.E.2d 187 (N.C. Ct. App. 2004); *Acme Royalty Co.* v. *Missouri Dir. of Revenue,* 96 S.W.3d 72 (Mo. 2002); *Rylander* v. *Bandag Licensing Corp.,* Tex. App. Ct., No. 03–99–004217–CV (May 11, 2000); *J.C. Penney National Bank* v. *Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999); *Cerro Copper Prods., Inc.,* No. F–94–444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995); *Geoffrey, Inc.* v. *South Carolina Tax Comm'n,* 437 S.E.2d 13 (S.C. 1993); and *Wisconsin* v. *J.C. Penney Co.,* 311 U.S. 435 (1940).

[18] *Comptroller of the Treasury* v. *SYL, Inc.; Crown Cork & Seal Co. (Del.), Inc.,* 825 A.2d 399 (MD 2003), *cert. denied* 2003 U.S. LEXIS 8044 (2003) and 2003 U.S. LEXIS 9221 (2003); *J.C. Penney National Bank* v. *Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied,* 531 U.S. 927 (2000); *Geoffrey, Inc.* v. *South Carolina Tax Comm'n,* 437 S.E.2d 13, *cert. denied,* 510 U.S. 992 (1993).

[19] As noted by one state tax expert, "'[i]ncome,' we were told long ago, 'may be defined as the gain derived from capital, from labor, or from both combined.'" W. Hellerstein, *On the Proposed Single-Factor Formula in Michigan,* State Tax Notes, Oct. 2, 1995, at 1,000 (quoting *Eisner* v. *Macomber,* 252 U.S. 189, 207 (2020)).

[20] Op. N.Y. Att'y Gen. 301 (May 29, 2019) (emphasis added).

lions of dollars over the years to provide education to their populations. This argument continues with the incredible example of the student who benefits from his or her state's education funding who may someday work for an out-of-state company; apparently, the out-of-state company would then receive benefits that had been provided by that employee's former state and should therefore bear some of the burden by paying tax to the state that provided that education. The absurdity of this position should be clear. Should U.S. companies that have hired people educated in England have to pay taxes to the Queen? Should every business automatically be obligated to pay taxes to all 50 states, in anticipation of the possibility, however remote, that they may at some undefined future point hire a person who was educated in the taxing state? No one can argue that the states do not play an important role in interstate commerce, that an educated public is not an element of a fruitful society and marketplace, or even that a court system does not help to promote order. But this simply cannot be a basis for states to impose tax on all businesses in the Nation. Imposing business activity taxes on every out-of-state business is truly "taxation without representation."

The business activity tax concepts that were incorporated in the 109th Congress's S. 2721 were similar to the recommendations of the majority report issued by the Advisory Commission on Electronic Commerce. Specifically, the ACEC majority report concluded that a company should have some level of physical presence before a state could impose business activity tax reporting and payment obligations on it and that certain activities would not be considered physical presence for this purpose and specifically carved them out from nexus consideration.[21] Consistent with this conclusion, S. 2721 provided for a bright-line physical presence standard that recognized that certain instances of "presence" are qualitatively *de minimis.*[22] As a result, S. 2721 was more conservative and actually provided states with more opportunity to tax interstate commerce than was available under the ACEC majority report recommendation.

BATSA-type legislation would provide simple and identifiable standards that would significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government. Although it is unlikely that such legislation would end all business activity tax jurisdictional controversies, any statute that adds nationwide clarification would obviously reduce the amount of controversy and litigation by narrowing the areas of dispute. For example, in the 47 years since its enactment in 1959, Public Law 86–272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense. Recent litigation has focused on what the appropriate nexus standard for business activity taxes actually is; there is no indication that this issue will be settled absent Congressional action.

The Provisions of the 109th Congress's S. 2721

Codification of the Physical Presence Standard. S. 2721 provided that, pursuant to Congress' Commerce Clause authority, a state or locality could not impose business activity taxes on businesses that did not have a "physical presence" within the jurisdiction. The requisite degree of physical presence (employees, property, or the use of third parties to perform certain activities) was set at greater than 21 days during a taxable year, with certain specified incidences of presence being disregarded as qualitatively *de minimis.*

The 21-day quantitative *de minimis* threshold was measured by each day that a business assigned one or more employees in the state, used the services of certain third parties in the state, or had certain property in the state. For example, a business that sent only four employees into a state together for 10 days would not have physical presence. On the other hand, a business that sent one employee into a state on twenty-two different days during a taxable year would have physical presence in that state. The standard proposed in S. 2721 thus would have made taxpayer compliance and state revenue department administration simple and straightforward.

S. 2721 included two exceptions to the 21 day rule that applied to those who really do earn their income during shorter visits to the state. The first exception en-

[21] *See* Advisory Commission on Electronic Commerce, *Report to Congress,* pp. 21–22 (April 2000).

[22] H.R. 2526 and S. 664 from the previous Congress were drafted "negatively," defining "substantial physical presence" by what it was not, *i.e.,* the activities protected by the safe harbors recommended by the ACEC majority. In response to state revenue departments' criticisms of this "negative" definition, S. 2721 was drafted to positively define what is a "physical presence" for purposes of allowing states to impose business activity taxes on out-of-state businesses (among other refinements).

sured that businesses engaged in actual selling of tangible personal property through the use of traveling employees, *e.g.,* businesses that hold "tent sales" or "off the truck sales," or in performing certain services to real property in the state through the use of traveling employees, *e.g.,* migrant painters or roofers, were subject to state and local business activity taxes. The second exception was targeted at athletes, musicians, and other entertainers. Such persons were not eligible for the *de minimis* exceptions (and, thus, were subject to tax by the jurisdictions in which they perform). Both of these exceptions were consistent with the underlying intent of S. 2721 that businesses pay tax where income is actually earned.

For a qualitative *de minimis* standard, S. 2721 provided that certain property or certain activities engaged in by a business' employees within the jurisdiction's boundaries would not be considered in determining whether the business had the requisite physical presence in the jurisdiction. This approach of disregarding certain activities for nexus purposes was recognized in Public Law 86–272, where Congress determined that mere solicitation is qualitatively *de minimis* relative to the benefits that protecting such activities offered to the U.S. economy. The protected activities were limited to situations where the business was *patronizing* the local market (*i.e.,* being a customer), and thereby generating economic activity in the state that produced other tax revenues for the state, rather than *exploiting* that market (many states have issued rulings, albeit inconsistent and *ad hoc* in nature, recognizing this principle), including ancillary property and activities. This encompassed visiting current and prospective suppliers, attending conferences, seminars, or media events, utilizing an in-state manufacturer or processor, or having testing performed in the state.

In the area of attributing one business' physical presence in a state to another, S. 2721 provided that an out-of-state business would have a physical presence in a state if that business used the services of an in-state person, on more than 21 days, to perform services that established or maintained the nonresident business' market in that state, unless the in-state person performed similar functions for more than one business during the year. The ownership relationship between the out-of-state person and the in-state person was irrelevant for purposes of this provision. By limiting attribution of nexus only to situations involving market enhancing activities, S. 2721 not only more accurately reflected the economics of a transaction or business, but was also consistent with the current state of the law. Expanding attribution any further would undermine the principles of fairness and equity in taxation. To the extent that a separate company was conducting business in a state, its own income, including appropriate entrepreneurial profit, was subject to tax in that state. In other words, limiting attribution ensures that a state taxes the economic activity that actually occurred in that state and not the activity that occurred elsewhere.

As an example, suppose a manufacturing company located only in State A used a sales company in State B to market and sell the manufacturer's product in State B. The sales company was conducting a business activity within State B and there is no doubt that it should be subject to tax by the state. That state would receive tax revenues commensurate with the marketing and selling activities that actually occurred in the state; the tax revenues would be based on the compensation, set at fair market value, that the manufacturer paid the sales company for its marketing and selling services (*i.e.,* the in-state activities that add value in the economic stream). As for the manufacturing company, its activities constituted a separate business activity that took place totally outside of State B. Putting this example in a global context, attempts by the state of manufacture to tax the out-of-state manufacturing company would be akin to France attempting to impose tax on the manufacturing income of every American business that contracted with a French marketing company to market and sell products in France. Clearly, merely signing the contract with the in-state company provides too attenuated a connection to enable the state to tax the out-of-state manufacturer on its manufacturing income.

Modernization of Public Law 86–272. As noted earlier, our economy has undergone significant changes in the 47 years since Public Law 86–272 was enacted. In addition to codifying the physical presence nexus standard, BATSA-type legislation extends the longstanding protections of Public Law 86–272 to *all* sales, not just to sales of tangible personal property, in recognition of those changes, specifically, the change in the focus of the American economy from goods to services and the increased importance of intangible property in the marketplace.

BATSA-type legislation also modernizes Public Law 86–272 by addressing the efforts of some aggressive states to avoid the restrictions imposed by Congress in Public Law 86–272 by establishing taxes on business activity that are measured by means other than the net income of the business. Two examples of these new state business activity taxes are the Michigan Single Business Tax, which imposes a tax on a company's business activities in the state, not on net income, and the New Jersey Corporation Business Tax, which was amended effective in 2002 to impose a gross profits/gross receipts tax. What is most distressing about the New Jersey amendments is that, as of July 1, 2006, these "gross" taxes apply *only* to businesses protected by Public Law 86–272. In other words, New Jersey has effectively circumvented the Congressional policy decision underlying the enactment of Public Law 86–272 by imposing a non-income tax only on those businesses that would otherwise be protected by the Public Law. States are increasingly turning to non-income based business activity taxes, in large part to avoid the effect of Federal law. Both Ohio and Texas have recently done just that. BATSA-type legislation addresses this by ensuring that Public Law 86–272 covers *all* business activity taxes, not just net income taxes.

Federalism

As noted above, considerations of federalism support passing BATSA-type legislation. The Founding Fathers, by discarding the Articles of Confederation and establishing a single national economy, intended for Congress to protect the free flow of commerce among the states against efforts by individual states to set up barriers to this trade. Congress itself has recognized this numerous times in the context of state taxation and has exercised its responsibilities repeatedly by enacting laws that limit the states' authority to impose taxes that would unreasonably burden interstate commerce. A few of the many such instances are:[23] Public Law 86–272, the statute that S. 2721 would modernize; the Federal Aviation Act; the Mobile Telecommunications Sourcing Act; the Amtrak Reauthorization Act; Public Law 104–95; the ICC Termination Act; the Miscellaneous Revenue Act of 1981; the Railroad Regulatory Reform and Revitalization Act (the "4R Act"); and the Soldiers and Sailors Civil Relief Act.

The very adoption of the Constitution was itself a backlash against the ability of states to impede commerce among themselves; in adopting the Constitution, which expressly grants Congress the authority to regulate interstate commerce, the states relinquished a portion of their sovereignty.[24] The Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[25]

BATSA-type legislation strikes the correct balance between state autonomy/sovereignty and the regulation of interstate commerce. Such legislation merely codifies current jurisdictional standards for *when* a business may impose a tax and does nothing to determine *how* a state may tax businesses that are properly subject to its taxing jurisdiction. A state remains free to determine what type of tax to impose, be it an income tax, a gross receipts tax, a value added tax, or a capital stock tax; to determine how to apportion the income that is taxed in the state, be it a single- or three-factor formula based on property, payroll and/or sales; to set the rate at which the tax chosen will be imposed; to determine whether or not to follow Federal taxable income, *e.g.,* to choose whether to decouple from Federal bonus depreciation; to provide credits or deductions for certain types of expenses; and so on.

On the other hand, the economic nexus standard (*i.e.,* establishing the requisite nexus based solely on a business having a customer in the taxing jurisdiction) asserts that a business is liable for a business activity tax if that business has derived revenue or income from a customer in a state—even though the business has conducted no activities in the state (*i.e.,* has had no property or employees located in that state). Keeping in mind that every buyer in a transaction in a free market economy benefits from the transaction as much as the seller, the economic nexus standard effectively imposes a toll charge on out-of-state businesses for exchanging cash for property (or for the provision of a service). Such a tax acts as a tariff on interstate commerce and creates exactly the problem that existed under the Articles of Confederation and that led to the adoption of the Constitution. Under the Articles of Confederation, state taxes and duties impeded interstate commerce as states began enacting their own tariffs and taxing interstate commerce, thereby putting up

[23] For a detailed list of instances where Congress has exercised its authority under the Commerce Clause, *see* Frank Shafroth, *The Road Since Philadelphia,* 30 State Tax Notes 155 (October 13, 2003).

[24] *See* Adam D. Thierer, *A Delicate Balance: Federalism, Interstate Commerce, and Economic Freedom in the Technological Age,* The Heritage Foundation (1998) (citing Alexander Hamilton, *Federalist No. 22*).

[25] *Barclay's Bank PLC* v. *Franchise Tax Bd. of Cal.,* 512 U.S. 298 (1994); *Quill Corp.* v. *North Dakota,* 504 U.S. 298 (1992). *See also* Eugene F. Corrigan, *Searching for the Truth,* 26 State Tax Notes 677, (Dec. 9, 2002) ("No amount of state legislation of any kind can extend a state's taxing jurisdiction beyond the limits set by the Supreme Court; and that Court has, for all practical purposes, washed its hands of the matter, deferring it to Congress.")

trade barriers to free trade.[26] This led to some states retaliating by banning products from other states. By effectively imposing such toll charges, the economic nexus standard would clearly have a negative impact on interstate commerce.

Comparison to Current Common Law

The physical presence nexus standard set forth in BATSA-type legislation is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Constitution's Due Process Clause and its Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus" between the taxing state and a putative taxpayer for all state taxes, whereas the Due Process Clause requires only a "minimum" connection. In *Quill,* the Supreme Court determined, in the context of a business collecting sales and use taxes from its customers, that the substantial nexus requirement could be satisfied only by the taxpayer having a physical presence in the state; the Court refrained from articulating the appropriate measure for business activity taxes.[27] This is because under the American legal system, a court only has the authority and responsibility to address the case before it. The Supreme Court has not granted a writ of *certiorari* for a case that would permit it to address the business activity tax nexus issue. So what constitutes substantial nexus for business activity taxes?[28]

Since the Court has not yet ruled on this issue, we must use clear logic and review what state courts and tribunals have recently decided. The answer is clear: if non-*de minimis* physical presence is the test for a mere collection and remission situation such as is the case for sales and use taxes, physical presence must be, at a bare minimum, the appropriate test for the imposition of business activity taxes. Indeed, the standard for business activity taxes should, if anything, be *higher* than the standard for sales taxes for at least two reasons. First, a business activity tax is an actual direct tax (and not a mere obligation to collect tax from someone else) and the consequent greater economic burden should require a greater connection (as the Supreme Court seems to have recognized in *National Geographic Society* v. *Board of Equalization*).[29] Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes. Sales and use taxes typically involve only two jurisdictions (the state of origin and the state of destination). However, corporate business activities often create contacts with many states. Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.

Effect on State Revenues

There simply is no basis for any contention that BATSA-type legislation could lead to any significant loss of state revenues. The most recent study, performed on a state-by-state, industry-by-industry, bill section-by-bill section basis, analyzed the likely effect of S. 2721 and concluded that the total effect would be less than 0.1 percent of state and local taxes currently paid by businesses. It is essential to keep in mind that S. 2721 and BATSA-type legislation is based on the principle that a business engaged in interstate commerce should pay its fair share of tax.[30] BATSA-type legislation does not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the correct jurisdiction.

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[26] *See, e.g., Gibbons* v. *Ogden,* 22 U.S. (9 Wheat.) 1, 11 (1824); *Quill* v. *North Dakota,* 504 U.S. 298, 313 (1992).

[27] *Quill Corp.* v. *North Dakota,* 504 U.S. 298 (1992).

[28] Opponents of a physical presence standard cite *International Harvester,* a 1944 U.S. Supreme Court case, as support for their position that economic nexus is appropriate. *See International Harvester Co.* v. *Wisconsin Dep't of Taxation,* 322 U.S. 435 (1944). Reliance on this case is simply not appropriate because to do so ignores a full 60 years of subsequent jurisprudence (*e.g., Complete Auto Transit Inc.* v. *Brady,* 430 U.S. 274 (1977) and *Quill).* But even more fundamentally, the case involved a Due Process analysis and never considered the requirements of the Commerce Clause. In addition, when read in the proper context, it is clear that *International Harvester* does not endorse an economic presence standard for business activity taxes. In fact, *International Harvester* concerned the ability of Wisconsin to require a corporation with a physical presence in the state to withhold tax on dividends that it paid to its shareholders. Further, the imposition of liability on the corporation can be seen as merely a delayed income tax on the physically present corporation. Clearly, this case is not to be relied upon to determine the appropriate nexus standard for business activity taxes.

[29] *National Geographic Society* v. *Board of Equalization,* 430 U.S. 551 (1977).

[30] A recent study commissioned by the Council on State Taxation found that businesses (not including pass-through entities) paid $378.9 billion in state and local taxes in 2002, an amount that was considered to be at least business' fair share of tax. *See* Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, *A Closer Examination of the Total State and Local Business Tax Burden,* 27 State Tax Notes 295 (Jan. 27, 2003).

BATSA-type legislation does not depart to any significant degree from what is now being done in the states. The operational reason for this has been confirmed by the former Executive Director of the Multistate Tax Commission.[31] Outside the context of passive investment companies,[32] state revenue departments simply have not been successful in their attempts to assert economic nexus to impose tax on businesses that do not have a physical presence in the state.

S. 2721 would not have had an effect on taxes derived from businesses that maintained a facility in the jurisdiction for more than 21 days during the taxable year. Clearly, state and local governments derive most—if not virtually all—of their business activity tax revenue from such businesses. The amount of revenue received by taxing jurisdictions from those businesses that maintain no office, store, warehouse, or other facility—or even inventory—in the jurisdiction at all must truly be minimal.

Consider first states that impose a net income tax to which Public Law 86–272 applies. It is difficult for tax practitioners, corporate tax managers, and several government officials that were queried to believe that these states are actually collecting any material amount of revenue from businesses that have no office in the state and have non-solicitation employees in the state for zero to 21 days during the year. There simply cannot be many businesses paying such taxes and, thus, any revenue loss would be negligible.

Consider next those states, such as Michigan, New Jersey, Texas, and Washington, that impose business activity taxes that are not solely based on net income and, thus, are not covered by Public Law 86–272. These states are currently able to collect revenue from out-of-state businesses that do not themselves maintain an office or other facility in the state but that employ individuals in the state who perform solicitation in that state. Modernizing Public Law 86–272 to cover non-income taxes clearly means that such states will no longer be able to collect this revenue. The amount of tax paid by such businesses, however, again must be minimal because it is unlikely that businesses are paying business activity tax to states in which they only have a fleeting presence.

It simply cannot be the case that BATSA-type legislation would have more than a negligible revenue impact to the states. Charges by critics that the bill would have a significant fiscal effect are simply masking what is really going on, *i.e.,* that state revenue departments and their representatives do not want any legislative constraints on or oversight of their taxing authority—even when the legislative constraints are squarely within Congress' authority to regulate interstate commerce.[33]

[31] "It seems to me that the states need to face the reality that most of them are generally incapable of enforcing the 'doing business' standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general—and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway." Eugene Corrigan, *States Should Consider Trade-Off on Remote-Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

[32] It is interesting to note that the states have now moved on to using other, more effective attacks against passive investment companies, such as the economic substance and *alter ego* arguments, combined reporting, and the denial of the relevant deductions. *See* Mitchell J. Tropin, *States Moving Away From 'Geoffrey,' Using Sham Arguments, 'Attribution' Nexus,* Daily Tax Report, No. 27 (Feb. 10, 2003).

[33] It is interesting that critics of proposals that address multistate taxation always counter with claims that the proposal will cause significant revenue loss to the states. *See, e.g., Corporate Tax Sheltering and The Impact On State Corporate Income Tax Revenue Collections,* Multistate Tax Commission (July 25, 2003); Dan Bucks, Elliott Dubin and Ken Beier, *Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act,* Multistate Tax Commission (Sept. 24, 2003); Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities,* Center on Budget and Policy Priorities (October 20, 2003). Yet there is no reliable empirical evidence that states have actually lost revenue when measures affecting state taxation have been enacted. This certainly goes to the credibility (or lack thereof) of such claims. As an example of the unreliability of such claims, the National Conference of State Legislatures has expressed its concern over projections by some national organizations that the inclusion of telecommunications services in the Internet tax moratorium would cost the states $22 billion each year (an estimate representing the total revenue from all state and local telecommunication taxes in the 50 states from 1992); in a letter to Senator Alexander dated November 5, 2003, the Congressional Budget Office estimated that the actual revenue cost would be between $80 million and $120 million per year starting in 2007—an estimate that is approximately 220 times smaller. *Accord* Congressional Budget Office Cost Estimate, H.R. 49, Internet Tax Nondiscrimination Act, as requested by the House Comm. on the Judiciary (July 21, 2003). In a November 4, 2003 action alert regarding S. 150, "The Internet Tax Non-Discrimination Act," the NCSL stated that "[t]he $20 billion estimation runs counter to expressed Congressional

Moreover, the statements of revenue impact made by certain state revenue departments and their representatives have been shown to be highly unreliable because the "estimates" focus on *potential* effects from *hypothetical* restructurings by businesses, are based on *hypothetical* changes in state law, or cite to *potential* impacts on apportionment rules (which is an issue of how much to tax, not whether to tax). Such considerations do not make for a reliable or accurate revenue estimate; proper revenue estimates are based on revenues currently collected. In reality, there simply will be no material effect on the amount of revenue received by the states because BATSA-type legislation seeks to maintain the *status quo*.

Effect on International Taxation and American Competitiveness

Our country's own history and the Federal Government's position in the context of international taxation provide sufficient reason to establish a physical presence nexus standard. The United States and its tax treaty partners have, for decades, adopted and implemented a "permanent establishment" rule. The "permanent establishment" concept is a long-standing principle and has been extremely important to U.S. businesses and, thus, to the U.S. economy.

The "permanent establishment" rule provides that neither country that is a party to the treaty will impose an income tax on a business from the other country unless that business maintains a substantial physical presence in the taxing country. Using the U.S. Model Treaty provisions as an example, a foreign business must have a "fixed place of business [in the United States] through which the business of an enterprise is wholly or partly carried on" before the United States may impose a tax on that business.[34] Under this standard, neither a "rep office" staffed by a few people, nor a facility used for storage, nor the maintenance of goods or merchandise for processing by another business would rise to the level of being a "permanent establishment" in the United States sufficient for the imposition of Federal income tax on that business.

A physical presence standard places an appropriate limit on states gaining taxation powers over out-of-state firms and conforms to common sense notions of fair play. It is significant that the OECD has recently studied the issue and preliminarily concluded that the "permanent establishment" rule should remain the proper standard for international tax treaties even with the proliferation of electronic commerce.[35] The policy reasons underlying such a conclusion are clear. Imagine for a moment that a foreign country tried to tax the profits of U.S. companies simply because the U.S. firms exported goods into that country. There is no doubt that the U.S. Government and business community would be outraged. However, the economic nexus standard that the states would like to implement would have a similar effect on interstate commerce.

Unfortunately, it has been said that some smaller countries, citing the efforts of U.S. state revenue departments to impose direct taxes on any business that has customers within the state's borders, are now saying that they want to renegotiate their treaties with the United States so they can begin taxing every U.S. business that has a customer in their country. This would be a disaster for the U.S. economy. Enactment of BATSA-type legislation, which includes a nexus standard that is analogous to those found in U.S. tax treaties, is essential for ensuring that the current international system of taxation remains intact.

Interplay With State Tax Incentives

In recent years, states have been increasingly active (and competitive) in offering tax incentive packages to businesses to locate and/or expand their operations in that state. Such incentives are offered not only to entice businesses into a state but also to ensure that businesses already located in the state do not relocate to, or expand in, other jurisdictions. The in-state company receives the benefits and protections provided by the state and, absent the incentives, would therefore be properly subject to full taxation.

A less obvious tax incentive occurs when states adopt apportionment formulas that weight the sales factor more heavily than the property and payroll factors. If a state has a double-weighted sales factor or a single-factor apportionment formula based only on sales (which is increasingly popular among the states), in-state busi-

intent and the provisions of the Manager's amendment and as a result threatens to seriously harm the credibility of state governments before Congress and the Administration."

[34] United States Model Income Tax Convention of September 20, 1996, Art. 5.

[35] *See Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?,* Organisation for Economic Co-operation and Development, Technical Advisory Group on Monitoring the Application of Existing Treaty Norms For Taxing Business Profits, Public Discussion Draft (Nov. 26, 2003).

nesses enjoy a significant benefit over businesses that have little or no property or payroll in the state but that do have sales that are apportionable to the taxing state.

When combined with the economic nexus standard, states would actually be subsidizing such incentives for in-state businesses at the expense of out-of-state businesses that do not receive the benefits and protections provided by the state. Not only does this offend the basic principle of nondiscrimination that is required by the Commerce Clause of the U.S. Constitution,[36] but, in addition, it surely is misguided tax policy to make one party that is not really "in" the jurisdiction bear the tax burden of those persons who actually receive the benefits and protections of the government services that the taxes are funding.

Effect on American Job Retention and Growth

The U.S. economy has been making gains in the overall level of growth, with low inflation, home ownership at record levels, and household consumption expanding. These economic gains have been due in large part to the ongoing expansion in the productivity of U.S. workers and businesses. While productivity gains are unquestionably a good thing for the U.S. economy, the flip side is that U.S. businesses have proven capable of increasing output without expanding employment at the same rate as seen in most past recoveries. Therefore, responsible Federal policymakers need to identify and rectify potential barriers to new job creation in America to ensure that our economic expansion creates the largest number of high-quality jobs.

The current level of uncertainty and ambiguity in the application of state-level taxes on U.S.-based businesses impedes new job creation. Businesses operating in the U.S. must deal with the ambiguity in the current nexus rules that govern when states have the right to impose direct taxes on businesses. Rather than a clear set of Federal rules regarding when a business is subject to state taxes, the current environment is governed largely by the level of aggressiveness of state tax administrators and ongoing litigation. As noted earlier, state tax officials have increasingly pushed the envelope in an effort to raise revenues from out-of-state enterprises. The uncertainty will only increase as states continue to assert jurisdiction over out-of-state businesses based on "economic nexus" principles.

It is noteworthy that this uncertainty is borne chiefly by businesses based in the United States. Investing in the creation of new plants, equipment, and jobs in other countries is actually encouraged by the ambiguity in nexus standards and the aggressiveness of state tax officials. When combined with the effect of bilateral tax treaties and the difficulty of collecting state-level taxes from foreign enterprises, the uncertainty and ambiguity of state taxation has become another incentive that unnecessarily promotes new investment and job creation abroad.

Foreign business enterprises are often shocked to learn that while treaties may insulate them from Federal taxation, state taxation may potentially still be imposed. This factor, when combined with the ambiguity of current state tax nexus law and the aggressiveness of state tax administrators, has put a real damper on foreign investment. Even when a foreign business initially considers opening an active business in the United States and paying Federal tax and state tax where it locates its property and employees, the specter of having to pay tax to every jurisdiction where it merely has customers is daunting. Addressing the problems of state tax uncertainty and the risk of litigation costs clearly has the potential to encourage additional foreign investment in the U.S., thus creating new jobs throughout the country.

By providing a bright line, quantifiable physical presence standard, BATSA-type legislation addresses the current level of uncertainty in the nexus rules that apply to direct business taxes by lowering litigation expenses for companies that operate facilities in the United States and by reducing the likelihood that they will be targeted by out-of-state tax authorities bent on raising revenues from businesses that do not have a presence in their state. BATSA-type legislation, while certainly not an answer to all the questions related to encouraging new job creation in America, will encourage businesses, whether based in America or overseas, to put new investment and create new jobs here in America rather than in another country.

Conclusion

The physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy[37] and that is consistent with Pub-

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[36] *See, e.g., Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450 (1959) and *Armco, Inc.* v. *Hardesty,* 467 U.S. 638 (1984).

[37] Richard Pomp, who testified as a tax policy expert on behalf of the taxpayer in *Lanco Inc.* v. *Director, Div. of Tax'n,* N.J. Tax Ct., No. 005329–97 (Oct. 23, 2003), articulated "six principles of tax policy . . . as representing the values inherent in the commerce clause: desirability of a clear or 'bright-line' test, consistency with settled expectations, reduction of litigation and pro-

lic Law 86–272, a time-tested and valid Congressional policy. Physical presence is an accepted standard for determining nexus.[38] And a physical presence test for nexus is consistent with the established principle that a tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer.

What the entire nexus issue boils down to is fairness. The BATSA-type legislation's bright-line physical presence nexus standard provides the most fair and equitable standard. This is true primarily for two reasons. One, businesses have a reasonable expectation of taxation only when they are the recipients of the benefits and protections provided by the taxing jurisdiction. Two, a physical presence standard protects in-state businesses from "foreign tax" imposed by jurisdictions solely because of the business having customers located in the taxing jurisdiction. By providing clarity, the physical presence standard removes an impediment to investment in the United States. For these reasons, the bill would benefit both U.S. businesses and consumers and, thus, the U.S. economy as a whole.

These comments only scratch the surface of why a physical presence nexus standard for business activity taxes and modernization of Public Law 86–272 is the right answer and why BATSA-type legislation should therefore be enacted. But it is clear that BATSA-type legislation warrants the full and enthusiastic support of the Committee. Its enactment will ensure that the U.S. business community, and thus the U.S. economy, are not unduly burdened by unfair attempts at taxation without representation. BATSA-type legislation will not cause any dislocations in any state's revenue sources. CRAFT would be pleased to expand on any of the matters set forth above.

COMBINED RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE, HON. BYRON L. DORGAN, AND HON. FRANK R. LAUTENBERG TO DR. JAMES R. WHITE

Question 1 from Senator Inouye and Senator Dorgan. Definition of Internet Access. Under Section 1105(5) of Internet Tax Freedom Act (ITFA), 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 purchased, used, or sold by a provider of Internet access to provide Internet access." (Emphasis added)

Under current law, what is the dividing line that determines what services fall within the definition of Internet access and what services fall outside the definition of Internet access? What should or should not be included in the definition of Internet access?

Answer. As shown in the simplified illustration in figure 1, the items reasonably bundled in a tax-exempt Internet access package may include e-mail, instant messaging, and Internet access itself. Internet access, in turn, includes broadband services, such as cable modem and digital subscriber line (DSL) services, which provide continuous, high-speed access without tying up wireline telephone service. As figure 1 also illustrates, a tax-exempt bundle does not include video, traditional wireline telephone service referred to as "plain old telephone service" (POTS), or Voice over Internet Protocol (VoIP). These services are subject to tax. For simplicity, figure 1 shows a number of services transmitted over one communications line. In reality, a line to a consumer may support just one service at a time, as is typically the case for POTS, or it may simultaneously support a variety of services, such as television, Internet access, and VoIP.

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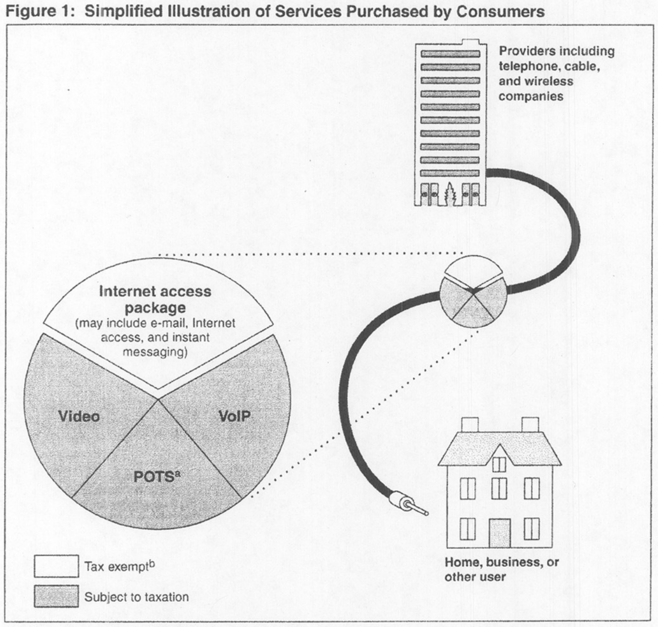
motion of interstate investment, non-discriminatory treatment of the service sector, avoidance of multiple taxation, and efficiency of administration." *Lanco Inc.* v. *Director, Div. of Tax'n,* N.J. Tax Ct., No. 005329–97 at 15–16 (Oct. 23, 2003). Professor Pomp concluded that a physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.* at 16.

[38] *See, e.g., Quill Corp.* v. *North Dakota,* 504 U.S. 298 (1992) and *National Bellas Hess, Inc.* v. *Department of Revenue,* 386 U.S. 753 (1967).

Figure 1: Simplified Illustration of Services Purchased by Consumers



Source: GAO and PhotoDisc (images).

[a]Traditional wireline telephone service, commonly referred to in the communications industry as "plain old telephone service" (POTS).

[b]May become taxable if not capable of being broken out from other services on a bill.

Question 2 from Senator Inouye and Question from Senator Lautenberg. Should the moratorium cover services provided over the Internet like music and movie downloads or even Internet Protocol television if they are bundled with the provision of Internet access? The GAO found that, to be tax-exempt, services "must be reasonably related to accessing and using the Internet, including electronic services that are customarily furnished by providers." Under this interpretation, would services such as movie and music downloads be taxable even if they were bundled with Internet access?

Answer. Our interpretation is that there must be a reasonable nexus between what the moratorium protects and the service of providing Internet access. Under our interpretation, any relationship between, *e.g.,* Internet sales by on-line music, movie, and television providers and the service of providing Internet access, is simply too remote to exempt such sales from taxation. The providers are selling music, movies, and television—even if the music, movies, and television are on-line music, movies, and television that can be downloaded. It is the music, movies, or television, not access, which is the subject matter of the business transaction.

Question 3 from Senator Inouye. Would it be possible to craft a more transparent rule that relies more on an objective test and less on the discretion of how a provider bundles its services?

Answer. We believe that concerns regarding the scope of the statute could be addressed legislatively if it were amended to clearly define access in terms of connectivity to the Internet and if Congress then spelled out what, if any, services it wishes to allow to be treated as tax exempt when bundled with access. The concerns raised stem from the phrase "package of services offered to users" which was included in the current statutory language but which suggests to some that the statute is completely open-ended.

Question 4 from Senator Inouye and Question 2 from Senator Dorgan. Is there any hard evidence, perhaps from states that were grandfathered from the initial 1998 Act, linking the effect of the moratorium on broadband penetration? For example, since adoption of the initial moratorium in 1998, Hawaii, among other states, has been allowed to apply its sales tax to Internet access services. But despite that fact, reports on broadband penetration show that Hawaii ranks either first or second among the states in residential broadband penetration. Is there any correlation between the moratorium and higher broadband penetration? Is Internet access really tax sensitive?

Answer. In a May 2006 report, we used two econometric models to assess the factors—including taxation—influencing the deployment and adoption of broadband service.[1] In the case of deployment, we did not find that taxation of Internet access by state governments influenced the deployment of broadband service. We also did not find that taxation of Internet access influenced the adoption of broadband service, although this finding was less clear-cut than in the case of broadband deployment.[2]

Question 3 from Senator Dorgan. Two of our witnesses provided us with principles by which we can approach this issue of taxation. They suggested that we be flexible and that we do no harm. Bearing this in mind please respond to the following questions. What is the need to make this moratorium permanent? With technology changing so rapidly, would it not be better to maintain a flexible, temporary solution that allows for periodic review?

Answer. Whether the moratorium should be permanent or temporary is a policy judgment to be made after considering concerns about affecting the Internet's growth and electronic commerce and about the need for state and local revenue.

Question 4 from Senator Dorgan. How would our states be harmed were we to get rid of the Grandfather Clause that protects those taxes in place prior to 1998? How would our states be harmed if we keep this clause in place?

Answer. The revenue impact of eliminating grandfathering in states studied by the Congressional Budget Office and by us would be small. Because of state-by-state differences and uncertainties, the impact of future changes related to the moratorium would vary by state. Whether the moratorium were lifted or made permanent and whether grandfathering were continued or eliminated, states would be affected differently from each other.

Question 5 from Senator Dorgan. Does a temporary solution really affect investment?

Answer. It is hard to know how, if at all, broadband deployment would have been affected if there had been no moratorium, if the moratorium had been made permanent, or if grandfathering had been eliminated. We drew this kind of conclusion in our May 23, 2007, testimony when we commented on what might have happened in the absence of a moratorium.[3] Given that some states never taxed access services while relatively few Internet connections existed, that some stopped taxing access services, and that others taxed DSL service, it was unclear to us what jurisdictions would have done if no moratorium had existed.

Questions 6 and 7 from Senator Dorgan. Should state and local governments be able to require large remote sellers to collect the sales tax on a remote sale after state and local sales tax systems are dramatically simplified? Have state and local sales tax collection systems been simplified today such that state governments should be permitted to require large remote sellers to collect sales taxes?

Answer. Whether state and local governments should be able to require large remote sellers to collect sales tax on remote sales is a policy judgment.

As we reported in June 2000, states require that out-of-state remote sellers collect a use tax on the sale of goods and services if the sellers have a substantial presence, or nexus, with the state.[4] The use tax, which complements the sales tax, is imposed on the purchaser for the privilege of use, ownership, or possession of taxable goods and services. If the out-of-state remote seller does not collect the use tax, the purchaser is required to remit the tax.

While reliable national estimates of sales tax compliance did not exist, we reported that state officials and other observers believed that compliance was highest for in-store sales, next highest for remote sales with nexus, and lowest for remote sales without nexus. To the extent that continued growth in the volume of Internet

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[1] GAO, *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 (Washington, D.C.: May 5, 2006).

[2] We did not find that taxation of Internet access influenced adoption of broadband service at the 5-percent level of significance. If we assume a 10-percent level of significance, we did find that Internet access influenced adoption of broadband service. However, given the nature of our model, it is unclear whether this finding is related to the tax or other characteristics of the states in which households resided.

[3] GAO, *Internet Access Tax Moratorium: Revenue Impacts Will Vary by State,* GAO–07–896T (Washington, D.C.: May 23, 2007).

[4] GAO, *Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain,* GAO/GGD/OCE–00–165 (Washington, D.C.: June 30, 2000).

sales occurred, it increased remote sales where compliance was already most problematic.

We concluded that with better data about the determinants of the tax loss associated with Internet sales, policymakers would be better positioned to confront the challenges confronted by e-commerce to sales and use tax administration. Such data could provide more of a basis for evaluating alternative policy choices. We also pointed out, however, that understanding the limits of data in an environment as dynamic as the Internet is important. Even with improved data, policymaking regarding Internet sales will be done in an environment of significant uncertainty.

RESPONSE TO WRITTEN QUESTION SUBMITTED BY HON. AMY KLOBUCHAR TO DR. JAMES R. WHITE

Question. As you mention in your testimony, the GAO recently published a report that examined issues relating to the deployment of broadband services, with a particular emphasis on the deployment of broadband in rural areas. This is an issue that is very important to Minnesota. Can you provide more information about GAO's findings in this report? What did you find were the factors affecting deployment of broadband in rural areas? Did you find the moratorium affected deployment?

Answer. A variety of market and technical factors, government efforts, and access to resources at the local level have influenced the deployment of broadband infrastructure. Areas with low population density and rugged terrain, as well as areas removed from cities, are generally more costly to serve than are densely populated areas and areas with flat terrain. As such, deployment tends to be less developed in more rural parts of the country. Technical factors can also affect deployment. For example, DSL can generally extend only 3 miles from the central office with a telephone company's copper plant, which precludes many households from obtaining DSL service. GAO also found that a variety of Federal and state efforts, and access to resources at the local level, have influenced the deployment of broadband infrastructure. As mentioned earlier, the imposition of taxes was not a statistically significant factor influencing the deployment of broadband.[5]

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE TO HARLEY T. DUNCAN

Question 1. Definition of Internet Access. Under Section 1105(5) of Internet Tax Freedom Act (ITFA), 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 purchased, used, or sold by a provider of Internet access to provide Internet access. *(Emphasis added)*

Under current law, what is the dividing line that determines what services fall within the definition of Internet access and what services fall outside the definition of Internet access?

Answer. Under current law, the dividing line between what constitutes access and what does not is extremely murky. All that can be said with certainty is that certain telecommunications services that are not included in access are excluded. Otherwise, the language is sufficiently broad, in our estimation, to allow any "content, information [or] service" that is delivered over the Internet to be considered as part of a package of Internet access.

Question 2. Should the moratorium cover services provided over the Internet like music and movie downloads or even Internet Protocol television if they are bundled with the provision of Internet access?

Answer. The moratorium should not cover services or products that are delivered over the Internet. To do so would significantly erode state revenue bases, discriminate against sellers of similar or equivalent products and services that were tangible, and set Internet content providers in a preferred position outside state and local tax codes. We believe the moratorium should be limited to those services necessary to traverse and navigate the Internet (as well as services incidental thereto), but not include content received through the Internet.

Question 3. Would it be possible to craft a more transparent rule that relies more on an objective test and less on the discretion of how a provider bundles its services?

[5] GAO–06–426.

Answer. We believe it is. As I noted in my testimony, we have been and will continue to work with representatives of the Internet access provider community to develop such a definition. We would plan to share it with the Committee when we complete that process.

Question 4. Is there any hard evidence, perhaps from states that were grandfathered from the initial 1998 Act, linking the effect of the moratorium on broadband penetration? For example, since adoption of the initial moratorium in 1998, Hawaii, among other states, has been allowed to apply its sales tax to Internet access services. But despite that fact, reports on broadband penetration show that Hawaii ranks either first or second among the states in residential broadband penetration. Is there any correlation between the moratorium and higher broadband penetration?

Answer. I am aware of no evidence that suggests that taxation of Internet access reduces the adoption of broadband by consumers or provision of broadband by suppliers. In my testimony, I cited two studies [1] that came to this conclusion. Much the same as Hawaii, New Hampshire taxes Internet access (at a 7 percent rate), and it also has among the highest level of broadband adoption in the country. Finally, a recent study by the Center on Budget and Policy Priorities [2] finds that Internet access is subject to taxation in each of the 15 countries worldwide in which the level of broadband adoption exceeds that of the U.S. I think the evidence is rather convincing that taxation of Internet access (under the range of taxes imposed by the states) does not impede broadband adoption.

Question 5. Could you describe the current disparity that exists between the tax treatment of goods sold at "brick and mortar" stores and the tax treatment of goods sold online?

Answer. The U.S. Supreme Court has held that a state may not require a seller that does not have a physical presence (facilities, employees, representatives) in the state to collect sales tax on goods and services sold into the state. Therefore, if an online seller has no physical presence in a state, any goods or services sold into the state have no tax applied to them. The brick and mortar seller, on the other hand, must apply tax which automatically creates a price disadvantage (other things being equal) for the brick and mortar seller.

Question 5a. How would online companies deal with the administrative burden of different tax rules in different states?

Answer. There is no doubt that collection of taxes on a multistate basis can be difficult. That is why the states have worked with the retail community through the Streamlined Sales Tax Project to simplify the tax collection responsibilities. Generally, the project has used several strategies to reduce the burden of collecting tax: (a) simplifying many provisions of law (*e.g.,* adopting a uniform tax return); (b) significantly greater uniformity in provisions across states (*e.g.,* uniform definitions of certain items like food or telecommunications); (c) having the state assume greater responsibilities to assist sellers (*e.g.,* requiring states to maintain databases that provide the right tax rate for any address and holding the seller harmless from any action of their use of the data provided by the state; and (d) promoting greater use of technology in administering sales taxes (*e.g.,* certifying certain compliance software providers and saying if you use these providers, you (the seller) will be held harmless on audit. Finally, we believe there should be a *de minimus* provision that excludes sellers with less than some moderate level of sales from collecting in those states in which they do not have a physical presence. The combination of these types of simplifications, we believe, reduces significantly the burden of tax collection.

Question 5b. What steps are needed to equalize the tax treatment of online and offline sales?

Answer. What is required is for Congress to enact legislation that would authorize states to require remote sellers (those without a physical presence in a state) to collect tax and to set forth the conditions under which this grant of authority may be

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[1] 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. 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.

[2] Michael Maerov, "Making the "Internet Tax Freedom Act" Permanent Could Lead To A Substantial Revenue Loss for States and Localities," Center on Budget and Policy Priorities, Washington, D.C., July 11, 2007.

exercised. We believe S. 34 by Senator Enzi provides an appropriate set of conditions.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. BYRON DORGAN TO HARLEY T. DUNCAN

Question 1. Two of our witnesses provided us with principles by which we can approach this issue of taxation. They suggested that we be flexible and that we do no harm. Bearing this in mind please respond to the following questions. What is the need to make this moratorium permanent? With technology changing so rapidly, would it not be better to maintain a flexible, temporary solution that allows for periodic review?

Answer. FTA does not believe the moratorium should be made permanent. As you note, the pace of technological change would seem to make it imperative that Congress put in place a mechanism for periodic review of the impact of the moratorium. In addition, Congress is the only overseer of this legislation; there is no Executive Branch agency with responsibility for rulemaking or oversight. Congress needs to review the impact of the moratorium periodically.

Question 1a. How would our states be harmed were we to get rid of the Grandfather Clause that protects those taxes in place prior to 1998? How would our states be harmed if we keep this clause in place?

Answer. Repealing the 1998 Grandfather Clause would have two impacts: (1) The nine states that currently impose their sales or other receipts-based tax on charges for Internet access would be prohibited from doing so. We estimate the revenue impact of the bill to be in the $150 million per year range. (2) There are also other taxes, most commonly general purpose business taxes (*e.g.,* the Washington State Business and Occupation Tax, unemployment taxes) that are not excluded from the definition of a “tax on Internet access,” but are protected by the 1998 Grandfather that could be challenged as being a prohibited tax on Internet access. The current definition of a “tax on Internet access” says it includes a tax on the service itself as well as a tax on Internet service providers unless it is a net income, net worth, property, or franchise tax.

Question 1b. What should or should not be included in the definition of Internet access?

Answer. We believe that Internet access should be defined to include those services necessary to connect to and to traverse and navigate the Internet (as well as services incidental thereto), but not include content received through the Internet. The moratorium should not cover services or products that are delivered over the Internet. To do so would significantly erode state revenue bases, discriminate against sellers of similar or equivalent products and services that were tangible, and set Internet content providers in a preferred position outside state and local tax codes.

Question 1c. Does a temporary solution really affect investment?

Answer. In my testimony, I cited two studies (see answer elsewhere) showing that taxation of Internet access has no statistically significant impact on whether companies invest in providers of broadband services. It is, therefore, difficult to believe that a temporary moratorium will affect investment. The demand for broadband services is going to be driven by the types of services, products and content available and other communication requirements, and not whether Congress has only a temporary moratorium in place.

Question 1d. Is Internet access really tax sensitive?

Answer. I am aware of no evidence that suggests that taxation of Internet access reduces the adoption of broadband by consumers or provision of broadband by suppliers. In my testimony, I cited two studies [3] that came to this conclusion. Much the same as Hawaii, New Hampshire taxes Internet access (at a 7 percent rate), and it also has among the highest level of broadband adoption in the country. Finally,

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[3] 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. 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.

a recent study by the Center on Budget and Policy Priorities[4] finds that Internet access is subject to taxation in each of the 15 countries worldwide in which the level of broadband adoption exceeds that of the U.S. I think the evidence is rather convincing that taxation of Internet access (under the range of taxes imposed by the states) does not impeded broadband adoption.

Question 1e. Should state and local governments be able to require large remote sellers to collect the sales tax on a remote sale after state and local sales tax systems are dramatically simplified?

Answer. FTA supports the adoption of Federal legislation that would authorize those states that have simplified their sales to require remote sellers to collect tax on goods and services sold into the state. If such legislation is not passed, states sales tax bases will continue to suffer erosion from untaxed remote sales. In addition, those sellers that are required to collect tax will continue to face a unfair competitive disadvantage. It would be appropriate in any such legislation to have a *de minimus* threshold that would provide that sellers with national sales below some level would not be required to collect tax in states in which they have no physical presence.

Question 1f. Have state and local sale tax collection systems been simplified today such that state governments should be permitted to require large remote sellers to collect sales taxes?

Answer. FTA believes the simplifications that are contained in the Streamlined Sales and Use Tax Agreement contain sufficient simplifications such that states should be authorized to require certain remote sellers to collect tax on goods and services sold into a state. The project has used several strategies to reduce the burden of collecting tax: (a) simplifying many provisions of law (*e.g.,* adopting a uniform tax return); (b) significantly greater uniformity in provisions across states (*e.g.,* uniform definitions of certain items like food or telecommunications); (c) having the state assume greater responsibilities to assist sellers (*e.g.,* requiring states to maintain databases that provide the right tax rate for any address and holding the seller harmless from any action of their use of the data provided by the state; and (d) promoting greater use of technology in administering sales taxes (*e.g.,* certifying certain compliance software providers and saying if you use these providers, you (the seller) will be held harmless on audit. Finally, we believe there should be a *de minimus* provision that excludes sellers with less than some moderate level of sales from collecting in those states in which they do not have a physical presence. The combination of these types of simplifications, we believe, reduces significantly the burden of tax collection.

Question 2. How would you assess the impact of the grandfather clause of the current Moratorium? Is it true that all states get some type of protection from the grandfather clause?

Answer. The current grandfather clause serves two purposes: (1) It allows nine states that imposed a tax on charges to consumers for Internet access in 1998 to continue to impose and collect those taxes. (2) It also allows states to continue to impose certain general business taxes that would qualify as a "tax on Internet access" under the definition in the Act. Such taxes would include unemployment insurance taxes, the Washington State Business and Occupation Tax, as well as some local general purpose business taxes that are based on gross receipts.

Question 2a. Please describe the range of taxes that may be protected by the clause? Can you give us a state-by-state revenue impact? If not for all states, which states can you give us a revenue figure for?

Answer. As described above, the taxes covered by the Grandfather Clause include sales taxes on charges for Internet access in eight states—Hawaii, Texas, Wisconsin, Ohio, New Mexico, South Dakota, New Hampshire and North Dakota. It also protects imposition of the Washington Business and Occupation Tax on Internet service providers. We are in the process of gathering information on the revenues protected by the Grandfather Clause.

Question 3. What is the scope of the Streamlining Project? We hear different numbers on state participation in the Project. Can you tell me how many states participate and in what capacity they are active? Please tell us what you expect in the future too.

Answer. The Streamlined Sales Tax Project is a multi-year effort of state and local governments working with the retail industry to simplify administration of the

[4] Michael Maerov, "Making the 'Internet Tax Freedom Act' Permanent Could Lead To A Substantial Revenue Loss for States and Localities," Center on Budget and Policy Priorities, Washington, D.C., July 11, 2007.

sales tax, particularly for multistate sellers. In terms of participation, nearly every state with a sales tax has actively participated in the process of formulating the simplification requirements contained in the Streamlined Agreement. As to membership, there are currently 15 "full Member States" meaning that the state has made changes to its sales tax law, rules and policies so as to incorporate each of the provisions of the Agreement. There are also 7 "Associate Member States," meaning that the state has incorporated all the provisions of the Agreement into its laws and policies but the effective date of one or more provision has been delayed beyond July 1, 2007 or that the state has incorporated most of the provisions of the Agreement into its laws and policies and is expected to incorporate the remaining ones by a particular date. By January 1, 2008, two of the Associate Member States are expected to be accepted as full Member States. By July 1, 2008, two additional Associate Members should become full Member States.

Question 4. Two of the witness testifying before the Committee suggested that states could collect use taxes directly from individual consumers. What steps are being taken now by states to collect use taxes owed by individual consumers? What would be required for states to effectively collect the use tax from individual consumers that owe the tax?

Answer. It is not reasonable to suggest that states can collect the use tax from individual consumers in any cost-effective or even-handed manner. About 20 states have included a line on the state individual income tax return that taxpayers can use to report use tax on purchases made over the course of the year. To effectively collect use tax from individual consumers would require all sellers to report all untaxed sales to the state to which the sale is delivered along with the name and address of the purchaser, the identification of the items being purchased and the sale price of the items. In this manner, each state would have the data necessary to compute the tax due and bill the individual purchaser. Obviously, this approach if more costly than collection of the tax at the time of sale.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO HARLEY T. DUNCAN

Question 1. Do you agree with the GAO's narrow interpretation of how "Internet access" is defined under current law?

Answer. We do not agree with the GAO interpretation of the definition of Internet access. We believe a court would look to the plain meaning of the words in the statute. For that reason, we do not believe a court would reach a determination that only services "reasonably bundled" with Internet access would be considered exempt.

Question 2. Are you aware of any "bundling" of services that is avoiding taxation because of a *broad* interpretation of how "Internet access" is defined under current law?

Answer. We are not aware of instances where there has been unreasonable bundling under the current law. We believe this is in part due to the fact that the moratorium is temporary, and Congress must periodically revisit the issue and the propriety of the definition.

Question 3. Is there any empirical evidence of the effects that a permanent moratorium would have on state revenues?

Answer. If the moratorium is made permanent and there is no Grandfather Clause protection for the pre–1998 taxes, state revenues would be reduced by an estimated $150–$200 million per year in the eight states that currently impose the state sales tax on charges for Internet access and Washington State with its business and occupation tax.

RESPONSE TO WRITTEN QUESTION SUBMITTED BY HON. AMY KLOBUCHAR TO HARLEY T. DUNCAN

Question. With respect to the Streamlined Sales and Use Tax Agreement, it is my understanding that business representatives from 39 states worked with state governments to achieve the Agreement, yet the level of adoption of this agreement varies among states, with 15 states acting as full members. Can you provide more information about the varying level of participation among states? What is the impact on businesses in states that are fully participating *versus* businesses in those states that are not?

Answer. In terms of participation, nearly every state with a sales tax has actively participated in the process of formulating the simplification requirements contained in the Streamlined Agreement. As to membership, there are currently 15 "full Member States" meaning that the state has made changes to its sales tax law, rules and policies so as to incorporate each of the provisions of the Agreement. There are also 7 "Associate Member States," meaning that the state has incorporated all the provisions of the Agreement into its laws and policies but the effective date of one or more provision has been delayed beyond July 1, 2007 or that the state has incorporated most of the provisions of the Agreement into its laws and policies and is expected to incorporate the remaining ones by a particular date. By January 1, 2008, two of the Associate Member States are expected to become full Member States. By July 1, 2008, two additional Associate Members should become full Member States.

In my estimation, the primary reason more states have not become full Members is twofold: (1) Some of the simplifications required for membership have significant impacts on a state's tax policy and structure; and (2) Without Congressional authorization that would allow states to require remote sellers to collect tax on sales into the state, some of these states are unlikely to take the steps necessary to become Member States. In other words, without the additional revenue that would result from requiring remote sellers to collect, there is little motivation for some states to undertake the difficult simplifications.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE TO ANNABELLE CANNING, ESQ.

Question 1. Under current law, what is the dividing line that determines what services fall within the definition of Internet access and what services fall outside the definition of Internet access?

Answer. The dividing line between what is and is not covered by this definition is the concept of access. Internet access is, fundamentally, a special type of access—nothing more and nothing less. As defined by section 1105(5), Internet access service enables users to access content, information, e-mail, or other services offered over the Internet. Even when the content, information, or other service being accessed is proprietary, if that service is being accessed over the Internet, section 1105(5) establishes that the access to such service is Internet access.

However, while *access* to content, information, e-mail and other services—whether proprietary or not—is within the definition of Internet access, what is accessed is not covered. Thus, for example, in the case of a service that permits a user to download music, the service that permits the user to establish a link between the user's computer and the music provider's computer—that is, to *access* the provider's computer—is Internet access. But the music file that the user downloads from the music provider's computer to the user's computer is not "access"; instead, this file is what is *being accessed*.

Some services offered over the Internet consist of nothing more than access, and thus are completely covered by the definition of Internet access. E-mail is the best example of such a service. However, even here, the music-file example described above can be applied to illustrate the distinction between what is and is not covered by the definition of Internet access: If a service permits a user to request that a music file be transmitted by e-mail, then the e-mail service by which the user transmits an e-mail message to the music provider, and by which the music provider replies, is within the definition of Internet access. But if the music provider sends a music file back to the requesting user as an e-mail attachment, then that file itself is not within the definition of Internet access; instead, the file is what is being accessed.

Question 2. Should the moratorium cover services provided over the Internet like music and movie downloads or even Internet Protocol television if they are bundled with the provision of Internet access?

Answer. Expanding the moratorium to treat bundled services, such as music and movie downloads and Internet Protocol television, as Internet access would be a substantial change from current law. As described in my answer to the first question, above, these bundled services are not covered under the current definition of Internet access because they are not access but, instead, are what is being accessed. Indeed, under the "bundling rule" of section 1106 that was added in 2004, if a charge for one of these services is taxable under state or local law, then bundling that charge with a charge for Internet access risks subjecting the entire bundled charge to tax.

The moratorium should not be expanded to prohibit states and local governments from imposing nondiscriminatory taxes on those services. That is, a state that taxes the purchase of a music CD on Main Street should be able to impose the same tax on music delivered on-line, either as a sales tax if the seller has nexus or, otherwise, as a use tax. However, the moratorium currently prohibits—and should continue to prohibit—a state from discriminating against electronic commerce by taxing on-line music purchases and not taxing a purchase of the same music on a CD.

Question 3. Would it be possible to craft a more transparent rule that relies more on an objective test and less on the discretion of how a provider bundles its services?

Answer. While it might be possible to craft such a rule, there is no need to do so. I am unaware of any examples of a provider of Internet access using the Internet access definition to attempt to market and sell otherwise taxable services as part of a bundle that includes Internet access. As stated above, because of the accounting rule provided by section 1106, an Internet access provider that attempted to do so would put the entire "bundle" at risk of being subject to taxation. Furthermore, because a provider would have failed to collect and remit sales tax from its customer on the taxable pieces of the bundle, it would face the prospect of paying the entire tax liability as its own cost without the ability to recoup the tax from its customers. Given the risk of creating additional, unreimbursed transaction tax costs, it is not surprising that I am unaware of any instance of a provider bundling Internet access with other taxable services in order to avoid taxation.

In addition to being unnecessary, any attempt to create a more transparent rule may also create additional problems. Notwithstanding Congress's clear intent that the moratorium cover telecommunications purchased, used, or sold by a provider of Internet access to provide Internet access, some state and local tax authorities have moved aggressively to assert that such telecommunications are not covered. Changes intended to effect transparency could give states additional opportunities to pursue these erroneous assertions. Thus, if a more "objective" test is to be created, it should be carefully crafted to ensure that the level playing field that Congress created between ISPs that own their own Internet backbone and those that must purchase telecommunications service from a backbone provider is explicitly preserved so that states cannot impose hidden taxes that disadvantage certain Internet access providers.

Question 4. Is there any hard evidence, perhaps from states that were grandfathered from the initial 1998 Act, linking the effect of the moratorium on broadband penetration? For example, since adoption of the initial moratorium in 1998, Hawaii, among other states, has been allowed to apply its sales tax to Internet access services. But despite that fact, reports on broadband penetration show that Hawaii ranks either first or second among the states in residential broadband penetration. Is there any correlation between the moratorium and higher broadband penetration?

Answer. Many factors influence the rate of broadband penetration in the states, including household income, a state's geography, and the presence or absence of competing providers. For this reason, it is very difficult to find statistically significant studies that can isolate the impact of the moratorium on broadband penetration.

Having said that, however, there certainly is evidence that the presence or absence of competition among broadband providers influences broadband penetration rates. This is because competition results in lower prices to consumers, which in turn increases broadband penetration as more households decide that they can afford to purchase broadband Internet access.

Given the evidence in elasticity studies that price is a significant factor in broadband purchasing decisions, I have to believe that the moratorium plays a significant role in expanding broadband penetration. Without the moratorium, it is likely that many states would conclude that broadband Internet access falls under the expansive definition of "telecommunications service" contained in most state tax statutes and would commence taxing such services at excessive rates.

Recent studies from the Heartland Institute and the Council On State Taxation have documented that telecommunications services are, on average, taxed at rates nearly twice as high as general sales and use taxes. The Heartland study of 51 large cities found that the average rate is 13.5 percent, while the COST study tagged the rate at 14.2 percent. At current broadband prices, such taxes could add as much as $8.00 to the monthly cost of broadband Internet access. These taxes would have a measurable impact on broadband penetration and would hit low and moderate income households the hardest.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. BYRON L. DORGAN TO ANNABELLE CANNING, ESQ.

Question 1. Two of our witnesses provided us with principles by which we can approach this issue of taxation. They suggested that we be flexible and that we do no harm. Bearing this in mind please respond to the following questions. What is the need to make this moratorium permanent? With technology changing so rapidly, would it not be better to maintain a flexible, temporary solution that allows for periodic review?

Answer. One of the most important benefits of the moratorium is to expand the availability and affordability of broadband Internet access, so that all American households will have access to the educational and economic benefits of the Internet. In addition to keeping the cost of Internet access down for American households, the moratorium is also critical to providing a stable investment climate for businesses that not only provide access to the Internet but also create the applications, products, and services that are accessible through the Internet.

A permanent moratorium will send a very favorable, pro-investment signal to the firms that are driving innovation in our economy that states are not going to impose excessive and discriminatory taxes on Internet access. In terms of "doing no harm," a permanent moratorium will do no harm to consumers by preventing states and localities from imposing taxes at excessive rates that slow the growth of the Internet.

A permanent moratorium would not prevent a future Congress from revisiting this issue should it decide that changes need to be made to definitions or other provisions of the moratorium. Therefore, a permanent moratorium preserves Congress's flexibility to address changing market conditions, and Congressional oversight authority provides for periodic review and study of these issues.

Question 1a. How would our states be harmed were we to get rid of the grandfather cause that protects those taxes in place prior to 1998? How would our states be harmed if we keep this clause in place?

Answer. The states that continue to tax Internet access under the 1998 Grandfather Clause have had almost 10 years to prepare for the elimination of the grandfather clause. States have enjoyed large budget surpluses due to strong economic growth over the last 5 years—much of that economic growth generated by strong productivity gains driven by the communications and information technology sectors. A recent study by Ovum and Indepen found that almost 80 percent of the productivity growth in 2004 was attributable to the communications and information technology industries.

The National Conference of State Legislatures reported in February the following data about surplus revenues held in FY 2007 by the nine states covered by the 1998 Grandfather Clause:

State	Surplus as % of Gen. fund $
Hawaii	13.9
New Hampshire	3.8
New Mexico	8.9
Ohio	11.1
South Dakota	13.5
Texas	17.8
Washington	3.4
Wisconsin	0.1

The GAO reported that the total revenues in question for the grandfathered states are under $120 million, representing a small fraction of each state's total tax collections. Given the surpluses available in these states, elimination of the grandfather clause would not harm the budgets of the grandfathered states.

Question 1b. What should or should not be included in the definition of Internet access?

Answer. Internet access is, fundamentally, a special type of access—nothing more and nothing less. As defined by section 1105(5), Internet access service enables users to access content, information, e-mail, or other services offered over the Internet. Even when the content, information, or other service being accessed is proprietary, if that service is being accessed over the Internet, section 1105(5) establishes that the access to such service is Internet access. However, while *access* to content, information, e-mail and other services—whether proprietary or not—is within the definition of Internet access, what is accessed is not covered.

There is no apparent reason to change the scope of the current definition. However, Congress should ensure that states comply with the intent of the 2004 amendments that telecommunications services purchased, used, or sold by a provider of Internet access to provide Internet access are covered by the moratorium. Notwithstanding the 2004 amendments, some states have aggressively moved to tax telecommunications services that are covered by the definition of Internet access. If Congress does not confirm the original intention of the 2004 amendments, these states will continue their efforts and may be joined by others, resulting in taxes at the wholesale level that would ultimately be borne by consumers through higher access prices.

Question 1c. Does a temporary solution really affect investment?

Answer. As I said earlier, a permanent moratorium is critical to providing a stable investment climate for businesses that not only provide access to the Internet but also create the applications, products, and services that are accessible through the Internet.

A permanent moratorium will send a very favorable, pro-investment signal to the firms that are driving innovation in our economy that states are not going to impose excessive and discriminatory taxes on Internet access. In terms of "doing no harm," a permanent moratorium will prevent states and localities from imposing taxes that slow growth of the Internet.

A permanent moratorium would not prevent a future Congress from revisiting this issue should it decide that changes need to be made to definitions or other provisions of the moratorium. Therefore, a permanent moratorium does preserve Congress's flexibility to address changing market conditions, and Congressional oversight authority provides for periodic review and study of these issues.

Question 1d. Is Internet access really tax sensitive?

Answer. Many factors influence the rate of broadband penetration in the states, including household income, a state's geography, and the presence or absence of competing providers. For this reason, it is very difficult to find statistically significant studies that can isolate the impact of the moratorium on broadband penetration.

Having said that, however, there is evidence that the presence or absence of competition among broadband providers influences broadband penetration rates. This is because competition results in lower prices to consumers, which in turn increases broadband penetration as more households decide that they can afford to purchase broadband Internet access.

Given the evidence in elasticity studies that price is a significant factor in broadband purchasing decisions, I have to believe that the moratorium plays a significant role in expanding broadband penetration. Without the moratorium, it is likely that many states would conclude that broadband Internet access falls under the expansive definition of "telecommunications service" contained in most state tax statutes and would commence taxing such services at excessive rates.

Recent studies from the Heartland Institute and the Council On State Taxation have documented that telecommunications services are, on average, taxed at rates nearly twice as high as general sales and use taxes. The Heartland study of 51 large cities found that the average rate is 13.5 percent, while the COST study tagged the rate at 14.2 percent. At current broadband prices, such taxes could add as much as $8.00 to the monthly cost of broadband Internet access. These taxes would have a measurable impact on broadband penetration and would hit low and moderate income households the hardest.

Question 1e. Should state and local governments be able to require large remote sellers to collect the sales tax on a remote sale after state and local sales tax systems are dramatically simplified?

Answer. The so-called Streamlined Sales Tax issue is really a separate issue from the extension of the Internet access tax moratorium. I do not believe that the issue should be addressed as part of the moratorium debate. With operations and physical presence throughout the country, this is not an issue for my company.

Question 1f. Have state and local sale tax collection systems been simplified today such that state governments should be permitted to require large remote sellers to collect sales taxes?

Answer. States and localities have a lot more work to do when it comes to simplifying state and local taxes on telecommunications services. Since the original study was published in 1999 by the (then) Committee on State Taxation, a handful of states (Florida, Illinois, Utah, Virginia) have drastically reduced the administrative burden of collection of telecommunications taxes by centralizing collection of local taxes at the state level. The industry has sought to work with states to simplify state and local taxes on telecommunications services in a number of other states, unfortunately without much success.

Even with those simplifications, however, a telecommunications carrier selling service nationwide is still required to file some 47,921 tax returns annually—about seven times as many as the 7,501 required for general businesses.

In fact, one of the reasons why it is critical to extend the Internet moratorium is the very real concern that without the moratorium, states would interpret their statutes as imposing many of these telecommunications taxes on Internet access. This would not only impose a huge new burden on Internet providers, but it would also expose consumers to the same types of excessive taxes that currently apply to telecommunications services. Currently, only 17 states have specific statutory exemptions for Internet access in their statutes, which leaves the door open for new telecommunications taxes in two-thirds of the states.

Question 2. I am deeply interested in broader Internet penetration across the country. As I said in the hearing, I believe the Internet is crucial to our lives and if we work at this, we can find a reasonable solution here. I am concerned about what would happen were we to abolish the existing grandfather clause. We must have a clear understanding of the consequences of a permanent moratorium.

Answer. As I noted above, elimination of the Grandfather Clause would mean that the eight states that continue to tax Internet access would no longer be able to do so. These states have had almost 10 years to prepare for the elimination of the Grandfather Clause. My prior answer also describes the budget surpluses that are currently available in each of these states, and the relatively minor impact of losing taxes on Internet access. Given these factors, elimination of the Grandfather Clause would not harm the budgets of the grandfathered states.

Question 3. In your opinion, what taxes are covered by the Grandfather Clause for Pre-1998 taxes? If the Grandfather Clause were eliminated under S. 156, which state and local taxes would be subject to the moratorium and which would be exempt?

Answer. The pre-1998 grandfather permits states that taxed Internet access at the time the law first passed to continue imposing those taxes. This includes the taxation of Internet access under broad gross receipts taxes in Hawaii, New Mexico, and South Dakota; taxation of certain types of Internet access under New Hampshire's communications services tax; sales taxes in Ohio (business only), Texas (first $25 exempt; remainder taxable), and Wisconsin; and under the Business and Occupation Tax in Washington.

If the grandfather clause were eliminated, none of the taxes identified above would continue to apply to Internet access.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO ANNABELLE CANNING, ESQ.

Question 1. Is there any evidence that broadband penetration is higher in those states that exempt Internet access from taxation?

Answer. Many factors influence the rate of broadband penetration in the states, including household income, a state's geography, and the presence or absence of competing providers. For this reason, it is very difficult to find statistically significant studies that can isolate the impact of the moratorium on broadband penetration.

Having said that, however, there certainly is evidence that the presence or absence of competition among broadband providers influences broadband penetration rates. This is because competition results in lower prices to consumers, which in turn increases broadband penetration as more households decide that they can afford to purchase broadband Internet access.

Given the evidence in elasticity studies that price is a significant factor in broadband purchasing decisions, I have to believe that the moratorium plays a significant role in expanding broadband penetration. Without the moratorium, it is likely that many states would conclude that broadband Internet access falls under the expansive definition of "telecommunications service" contained in most state tax statutes and would commence taxing such services at excessive rates.

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Question 2. Do you believe that the current definition of "Internet access" allows movie downloads and music downloads to be bundled with Internet access services tax-free? Are you aware of efforts in the industry to move in that direction?

Answer. No, I do not believe that the current definition of "Internet access" allows movie downloads and music downloads to be bundled with Internet access services tax-free. While the definition of Internet access covers the service that permits a user to access movie and music downloads, it does not cover music or movies that are downloaded.

I am unaware of any provider trying to bundle movie or music downloads into a tax-free Internet access package. This may be attributable to the accounting rule in section 1106, which was added as part of the 2004 changes to the moratorium. Under this rule, if charges for Internet access are "bundled" with other charges that are subject to taxation—such as charges for movie or music downloads—then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records. Therefore, an Internet access provider has a strong incentive to "unbundle" for tax purposes those taxable services in order to ensure that the entire package of services that includes Internet access is not subject to tax. This accounting rule that was modeled on a similar provision in the Mobile Telecommunications Sourcing Act and has since been used as a model for language that was included in the Streamlined Sales Tax Act.

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