



Revenue and Transportation Interim Committee

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58th Montana Legislature

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TO: Revenue and Transportation Committee
FROM: Leanne Kurtz
DATE: February 10, 2004
RE: Taxation of Internet Access

At the Committee's December meeting, Senator Story brought to the members' attention Congressional activity on the Internet access tax moratorium. Specifically, he said that legislation to make the moratorium permanent may reach beyond the original moratorium's intent and impact states' collection of all types of taxes from the telecommunications industry. The following is background information on the Internet access tax moratorium, a discussion of the federal legislation and its potential ramifications, and an update on where the federal legislation currently stands.

Background

Internet access charges are the fees paid by a user of an Internet service provider, such as America Online or Yahoo. It may be a flat monthly fee or a charge based on the amount of time per month a user is online.

In 1998, Congress passed the Internet Tax Freedom Act (ITFA), which provided, in part:

(a) Moratorium.--No State or political subdivision thereof shall impose any of the following taxes during the period beginning on October 1, 1998, and ending 3 years after the date of the enactment of this Act--

(1) taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and

(2) multiple or discriminatory taxes on electronic commerce.

At the time of the moratorium's enactment, 10 states and the District of Columbia imposed sales taxes on Internet access (language in the bill allowed those entities to continue to collect the tax). To give some idea of the numbers involved in the imposition of an Internet access tax, the states, the rates they imposed in 1998, and how much tax a user would pay on a \$20 monthly access charge are listed in the table on the next page.

State	Percent Tax	Amount of Tax on a \$20 per month Internet access fee
Connecticut	6%	\$1.20/mo.
District of Columbia	5.75%	\$1.15/mo.
Iowa	5%	\$1.00/mo.
New Mexico	5%	\$1.00/mo.
North Dakota	5%	\$1.00/mo.
Ohio	5%	\$1.00/mo.
South Carolina	5%	\$1.00/mo.
South Dakota	4%	\$.80/mo.
Tennessee	6%	\$1.20/mo.
Texas	6.25%	\$1.25/mo.
Wisconsin	5%	\$1.00/mo.

Source: "Which States Tax Internet Access?", National Conference of State Legislatures, March 25, 1998.

Some of the states also allowed local governments to impose an additional tax which ranged from a maximum of 1% to a maximum of 2.75%.

In anticipation of the November 1, 2003, expiration of the moratorium, on September 17, 2003, the U.S. House passed H.R. 49, which would make the moratorium permanent. Meanwhile, the Senate was set to debate its version of the permanent moratorium, S. 150. "The identical bills, which contained an amended definition of Internet access, also started a fight that shows no signs of subsiding," reported Doug Sheppard for the January 5, 2004, edition of *State Tax Notes*.

The Legislation

H.R. 49 and S. 150 in their current form do three major things: remove the language in the ITFA that ends the moratorium, amend the definition of Internet access, and repeal the "grandfather" language that allowed the states listed in the table above to continue collecting the taxes imposed before October 1, 1998, while the moratorium was in place.

The fight that Sheppard refers to centers around Section 2(c) of H.R. 49, characterized in the bill as a "clarification". The definition of "Internet access" in the ITFA, found in section 1104(5), is 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, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. Such term does not include telecommunications services.

The clarification in H.R. 49 amends the definition so that the last sentence reads:

Such term does not include telecommunications services, **except to the extent such services are used to provide Internet access** [emphasis added].

Point-Counterpoint

The interpretation of the amended language and its consequences (cost to states) depends on who is doing the interpreting, and the amendments have pitted sectors of the telecommunications and information technology industry, the Bush Administration, and key legislators against the National Governor's Association (NGA), the National Association of Counties, the National Conference of State Legislatures (NCSL), the Council of State Governments (CSG), and the Multistate Tax Commission (MTC). In his article for *State Tax Notes*, Sheppard explains:

Proponents of this new definition say it would maintain neutrality by including digital subscriber line (DSL) service. Opponents of the amended access definition, however, said it would do much more by covertly expanding the moratorium to cover a significant portion of telecommunications taxes; they also argued that this definition is worded so broadly that any goods or services bundled with access and sold over the Internet would become tax-free.

In a paper entitled "Revenue Impact in State and Local Governments of Permanent Extension of the Internet Tax Freedom Act",¹ MTC asserts that H.R. 49 "will eventually exempt all or nearly all of the telecommunications industry from major state and local taxes: sales, excise, income, property and other taxes" and estimates that the reduction in revenue from taxes levied by the 50 states, the District of Columbia, and local governments will be between \$4 billion and \$8.75 billion annually by 2006. MTC substantiates its claim by explaining that the movement of video and voice traffic to the Internet backbone will result in the qualification of all telecommunications services as services offered over the Internet and falling under the amended definition of "Internet access".

MTC also estimates that if H.R. 49 were amended to conform to the original intent of the ITFA, "preempting only sales taxes on solely Internet access to customers, including broadband, and extending the preemption to 'grandfathered' sales taxes of certain states," the cost to states and local

¹ Dan Bucks, Elliot Dubin and Ken Beier, Staff of the Multistate Tax Commission, September 24, 2003.

governments would be about \$500 million.

The National Governors Association released a statement in early November 2003 calling on Congress not to expand the Internet access tax moratorium. CSG has called for a 2-year extension to give the industry and state and local governments time to work out their differences. NCSL, which had supported the bill with the amended language, reversed its position because of uncertainty over the consequences and in the name of state sovereignty.

Those who supported the amended definition of Internet access have countered that MTC's estimate is overblown and contend that it was never their intent to exempt the entire telecommunications industry from taxation. Sheppard quotes Scott Mackey, an economist with a government relations consulting firm and Mark Beshears with Sprint Corp. as maintaining that "only telecommunications services that are used to provide Internet access would be covered under the moratorium."

Robert Cline, Ernst & Young National Director of State and Local Tax Policy Economics, critiques MTC's paper in the October 27, 2003, edition of *State Tax Notes*, claiming that MTC's estimates are "based on erroneous assumptions that the law changes will exempt all telecommunications services from all state and local taxes." Cline also maintains that MTC's conclusions are fundamentally flawed "because [MTC] ignores the simple meaning of the terms used in the ITFA and the proposed new law, and the clear legislative intent of the current and proposed law."

Joining others in endorsing a permanent moratorium--including the Bush Administration, according to a November 6, 2003 Statement of Administration Policy--the Software and Information Industry Association released a statement deriding MTC's claims. The Association believes that the amendment to the definition of Internet access is critical to making the law consistent with modern technology. "It is a shame that a critical definition change to create technical neutrality has been the focus of unwarranted attack by the Multistate Tax Commission and other state officials for preventing the taxation of telecommunications," reads a November news release by the Association.

A New Bill

The dogfight over the definition of Internet access has stalled S. 150 in the Senate. However, on January 28, a staff working draft version of a bill to be sponsored by Senators Lamar Alexander and Thomas Carper was released.

This bill, entitled the "Internet Access Tax Ban Extension and Improvement Act" conforms with what CSG, MTC, and others had endorsed--reviving and extending the moratorium for 2 more years and preserving the ability of states that have been collecting the tax to continue to do so. Significantly, the bill also strikes the second sentence of the original definition of Internet access and adds:

The term "Internet access" does not include telecommunications services, except to the extent such services are purchased, used, or sold by an Internet access provider to

connect a purchaser of Internet access to the Internet access provider.

According to staff at the Montana Public Service Commission, the new bill is supported by NGA, the National Association of Counties, and the National League of Cities, among others.

Staff will continue to monitor the federal legislation and will report any significant developments to the Committee.