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The Internet Tax Freedom Act: In Brief

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Summary

The Internet Tax Freedom Act (ITFA; P.L. 105-277), enacted in 1998, implemented a three-year moratorium preventing state and local governments from taxing Internet access, or imposing multiple or discriminatory taxes on electronic commerce. Under the moratorium, state and local governments cannot impose their sales tax on the monthly payments that consumers make to their Internet service provider in exchange for access to the Internet. In addition to the moratorium, a grandfather clause was included in ITFA that allowed states which had already imposed and collected a tax on Internet access before October 1, 1998, to continue implementing those taxes.

Previously under ITFA, the moratorium on Internet access taxes and the grandfather clause were temporary provisions. With the passage of the Trade Facilitation and Trade Enforcement Act of 2015 (P.L. 114-125), the moratorium on taxing Internet access was extended permanently, while the grandfather clause was extended temporarily through June 30, 2020.

The original three-year moratorium had been extended eight times before being converted to a permanent statute. As the original moratorium was extended, changes were made to the definition of Internet access to include and exclude different services and technology. Notable changes include the inclusion of digital subscriber lines under the moratorium and the exclusion of Voice over Internet Protocol services from the moratorium.

Over time the grandfather clause has protected a decreasing number of states' abilities to tax Internet access. While 13 states previously taxed Internet access and were protected under the grandfather clause, 7 states now tax Internet access. In addition, changes made to ITFA in 2007 rendered the grandfather provision inapplicable for states that repealed or nullified their taxes on Internet access before the enactment of these changes.

As a public policy, the moratorium on taxing Internet access has economic and fairness implications. The policy likely improves lower income individuals' ability to purchase Internet access, which has economic benefits, but the blanket nature of the moratorium likely results in some economic waste. Additionally, the moratorium results in unequal application of state and local taxes to the provision of services depending upon how the services are delivered.

Under the moratorium, state and local governments are prevented from taxing Internet access. This may have implications for state and local government revenues and provision of services.

The Internet Tax Freedom Act and its subsequent extensions are often conflated with issues related to the taxation of electronic commerce across state borders. ITFA is largely unrelated to these issues. For a discussion of interstate electronic commerce and taxation issues, refer to CRS Report R41853, *State Taxation of Internet Transactions*, by Steven Maguire, and CRS Report R42629, *"Amazon Laws" and Taxation of Internet Sales: Constitutional Analysis*, by Erika K. Lunder and Carol A. Pettit.

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The moratorium on Internet access taxes prohibits states, or their political subdivisions, from imposing new taxes on Internet access services. The moratorium was recently converted to a permanent provision as part of Trade Facilitation and Trade Enforcement Act of 2015 (P.L. 114-125), after being previously extended eight times as a temporary provision. Under the Internet Tax Freedom Act (ITFA), states who taxed Internet access before 1998 can continue taxing Internet access through June 30, 2020.

Legislative Status and Background

The Internet Tax Freedom Act of 1998 (ITFA; P.L. 105-277) imposed on state and local governments a three-year moratorium, from October 1, 1998, to October 1, 2001, on (1) new taxes on Internet access, and (2) multiple or discriminatory taxes on electronic commerce. It also established the Advisory Commission on Electronic Commerce. The moratorium includes a grandfather clause allowing states that already had "imposed and enforced" a tax on Internet access to continue enforcing those taxes. The evolution of the Internet, its interaction with telecommunication services, and disputes over state autonomy have led to a number of changes in the law with its successive extensions.

The Internet Tax Nondiscrimination Act (P.L. 107-75), enacted in 2001, was the first extension of ITFA. It extended the Internet tax moratorium and the grandfather clause protections through November 1, 2003, but made no additional changes to the law.

In 2004, the Internet Tax Nondiscrimination Act (ITNA; P.L. 108-435) extended the Internet tax moratorium through November 1, 2007. Before the passage of ITNA, some states had implemented taxes on digital subscriber line (DSL) Internet connections, claiming they were a telecommunication service and therefore exempt from the ITFA tax moratorium. ITNA changed the definition of Internet access to include DSL connections under the moratorium. Taxes on DSL service were given grandfather protection through November 1, 2005, and grandfather protection for other Internet access taxes in place before October 1, 1998, was extended through November 1, 2007. Changes in ITNA also excluded Voice over Internet Protocol (VoIP) services from the moratorium, allowing state and local governments to tax this service. Lastly, ITNA directed the Government Accountability Office (GAO) to investigate the impact of the Internet tax moratorium on state and local government revenues and the adoption of broadband technologies.[1]

The Internet Tax Freedom Act Amendments Act of 2007 (P.L. 110-108) extended the Internet tax moratorium and the original grandfather clause through November 1, 2014. Additionally, the law revoked grandfather protections if states had voluntarily repealed their Internet access taxes since the passage of ITFA in 1998.

In the 113th Congress, ITFA was extended twice but no further changes were made to its provisions. As part of a continuing appropriations resolution (P.L. 113-164) enacted in 2014, ITFA was extended through December 11, 2014. Later in the 113th Congress, ITFA was extended through October 1, 2015, as part of the Consolidated and Further Continuing Appropriations Act (P.L. 113-235), but no additional changes were made.

In the 114th Congress, ITFA was extended three times before the moratorium on taxing Internet access was made permanent by P.L. 114-125. ITFA was first extended through December 11,

[1] The results of the GAO investigation were published in two reports in 2006. U.S. Government Accountability Office, *Internet Access Tax Moratorium: Revenue Impacts Will Vary by State*, GAO-06-273, January 2006, http://www.gao.gov/new.items/d06273.pdf, and U.S. 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, May 2006, at http://www.gao.gov/new.items/d06426.pdf.

2015, as part of the 2016 Continuing Appropriations Act (P.L. 114-53). An 11-day extension of ITFA was then passed as part of P.L. 114-100 through December 22, 2015. Shortly thereafter, ITFA was extended through October 1, 2016, as part of the 2016 Consolidated Appropriations Act (P.L. 114-113). Lastly, P.L. 114-125 extended the moratorium on taxing Internet access permanently, and temporarily extended the grandfather clause provision through June 30, 2020.

Moratorium on Taxing Internet Access

The moratorium on Internet access taxes established by ITFA and its subsequent extensions prohibits states or their political subdivisions from imposing any new taxes on Internet access services. Internet access service is defined 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 consumers."[2] The sale and purchase of Internet access services is exempt from taxation under ITFA; however, costs related to acquired services, such as an Internet service provider (ISP) leasing capacity over fiber, are not covered by the moratorium and thus potentially subject to taxation.[3] Internet access is often bundled with other services such as voice or video service. In these situations, if the ISP can reasonably separate the charges related to Internet access from the other service charges, the Internet access charges remain exempt from taxation; otherwise the Internet access charges can be taxed.[4]

The moratorium on taxing Internet access affects consumers of the Internet, ISPs, and state and local governments. One of the most significant effects of ITFA is that state and local governments cannot impose their sales taxes on the monthly payments that consumers make to their ISP, such as Comcast or AT&T, in exchange for access to the Internet. The moratorium prohibits taxes on Internet access services regardless of whether the tax is imposed on the consumer or the provider.

The moratorium affects state and local governments by limiting the activities that can be taxed, reducing their potential tax base, which may reduce state and local revenues. One estimate suggests that the moratorium on Internet access taxes could reduce potential state and local revenues by as much as $6.5 billion each year.[5] It should be noted that this estimate assumes that all states and local governments would impose their sales tax on Internet access services. This revenue estimate is further discussed below in the "State Revenues and Autonomy" section.

The Grandfather Clause

ITFA contained a grandfather clause to allow state and local governments to continue taxing Internet access if they already had a tax on Internet access that was generally imposed and actually enforced before October 1, 1998. Initially 13 states were included under the grandfather clause, but a number of states have voluntarily eliminated their Internet access taxes since the

[2] 47 U.S.C. §151, note.

[3] U.S. Government Accountability Office, *Internet Access Tax Moratorium: Revenue Impacts Will Vary by State*, GAO-06-273, January 2006, pp. 10-11.

[4] 47 U.S.C. §151, note.

[5] Michael Mazerov, *Congress Should End - Not Extend - the Ban on State and Local Taxation of Internet Access Subscriptions*, Center on Budget and Policy Priorities, Washington, DC, July 10, 2014, Table 2, at http://www.cbpp.org/cms/?fa=view&id=4161.

passage of ITFA.[6] Currently seven states claim to collect tax revenue from Internet access: Hawaii, New Mexico, North Dakota,[7] Ohio, South Dakota, Texas, and Wisconsin.[8] According to a recent survey, these seven states collect a combined $563 million per year from their taxes on Internet access.[9] The grandfather clause protecting taxes on Internet access implemented before October 1, 1998, is set to expire on June 30, 2020

In addition to the original grandfather clause established in ITFA, an additional grandfather clause was established as part of the Internet Tax Nondiscrimination Act (ITNA) for certain taxes on Internet access imposed and enforced before November 1, 2003. The grandfather clause established under ITNA expired on November 1, 2005, which largely applied to state and local taxes on DSL Internet access services.

Moratorium on Multiple or Discriminatory Taxes

ITFA also prohibits state and local governments from imposing multiple or discriminatory taxes on electronic commerce. The ban on multiple taxes prohibits more than one state, or more than one local jurisdiction at the same level of government (i.e., more than one county or city), from imposing a tax on the same transaction, unless a credit is offered for taxes paid to the other jurisdiction. However, the state, county, and city in which an electronic commerce transaction takes place could all levy their own sales (or use) taxes on the transaction.

The ban on discriminatory taxes prohibits additional taxes or an alternative tax rate on a good, service, or information delivered electronically that would differ from the tax or rate applied to the same, or similar, good, service, or information if it were purchased through traditional commerce (e.g., brick and mortar stores, catalog sales). In other words, under the moratorium the same tax rate must be applied to similar items regardless of how they were purchased. For example, purchasing a book through a local book store's website cannot be taxed at a higher rate than purchasing it at the local book store's physical location.

ITFA also lists conditions under which a remote seller's use of a computer server, an Internet access service, or online services does not establish a minimal connection to a state for taxation purposes. These circumstances include the sole ability to access a site on a remote seller's out-of-state computer server; the display of a remote seller's information or content on the out-of-state computer server of a provider of Internet access service or online services; and processing of orders through the out-of-state computer server of a provider of Internet access service or online services. Some businesses have taken advantage of these nexus limits in ITFA's definition of discriminatory tax to establish what are referred to as Internet kiosks or dot-com subsidiaries. The businesses claim that these Internet-based operations are free from sales and use tax collection requirements. Critics object that these methods of business organization are an abuse of the definition of discriminatory tax.[10]

[6] Ibid., p. 18.

[7] North Dakota voted to eliminate their tax on Internet access in 2015, as part of North Dakota Senate Bill 2096. The repeal of their Internet access tax is effective as of June 30, 2017.

[8] Henry Reske, "Ending Internet Law's Grandfather Clause Could Cost States $500 Million," *Tax Analysts*, 2014-15565, June 24, 2014.

[9] Ibid.

[10] See CRS Report RL33261, Internet Taxation: Issues and Legislation, by Steven Maguire and Nonna A. Noto.

Use Taxes and Interstate E-Commerce

The collection of use taxes has become a larger issue in public debates recently; however, this issue is largely unrelated to ITFA and its moratorium on Internet taxes. ITFA deals specifically with taxes on Internet access, and multiple or discriminatory taxes on electronic commerce, while the issues related to taxing interstate electronic commerce center largely on the Supreme Court's decision in *Quill Corp. v. North Dakota* and the Commerce and Due Process Clauses of the Constitution.[11] Both clauses require that an entity have some type of connection, or nexus, with a state before the state can impose a tax on it. *Quill* established that, under the Commerce Clause, a retailer must have a "physical presence" in the state before the state can require the retailer to collect use taxes, while due process imposes a lesser standard.[12] A great deal of electronic commerce involves firms that have a physical presence in a single state where they house their servers or warehouse their goods but sell goods to individuals in the other 49 states. Due to the definition of nexus established in *Quill,* firms cannot be compelled to collect use taxes from individuals at the point of sale when engaged in transactions in states where they have no physical presence. Instead, individuals making the purchase are supposed to remit a use tax to their own state governments; compliance with this requirement is low.[13]

For further discussion of interstate electronic commerce issues see CRS Report R41853, *State Taxation of Internet Transactions*, by Steven Maguire, and CRS Report R42629, *"Amazon Laws" and Taxation of Internet Sales: Constitutional Analysis*, by Erika K. Lunder and Carol A. Pettit.

Economic Considerations

Tax policy is generally evaluated based on its equity, efficiency, and simplicity. The following sections will evaluate the ITFA, specifically the moratorium on taxing Internet access, with respect to these characteristics and other relevant factors, including its impact on state and local governments.

Equity

The equity, or fairness, of tax policy can be thought of along two different axes. One axis, referred to as horizontal equity, is concerned with how the tax policy will affect similar individuals. All else equal, a tax policy which places a similar tax burden on similarly situated tax payers is considered horizontally equitable. The alternative axis, referred to as vertical equity, is concerned with how tax policy will affect dissimilar individuals. All else equal, a tax policy is viewed as vertically equitable if taxpayers with a greater ability to pay will tend to pay more in taxes, than those with a lesser ability to pay.

Horizontal Equity

The Internet provides numerous services that are similar to services that are provided through more traditional means and are subject to taxation by state and local governments. The moratorium on taxing Internet access therefore provides a relative tax advantage to services offered through the Internet. For example, an individual who would like phone service can obtain

[11] For more information on this case, see CRS Report R42629, *"Amazon Laws" and Taxation of Internet Sales: Constitutional Analysis*, by Erika K. Lunder and Carol A. Pettit.

[12] Quill v. North Dakota, 504 U.S. 298, 308 (1992).

[13] Linda O'Brien, "Tax Trends: States Address Declining Tax Revenues," *The Tax Magazine*, April 1, 2005, p. 9.

similar service either by purchasing plain old telephone service, which is often subject to state and local sales taxes, or they can purchase Internet access and use a free service, like Skype, to make phone calls and avoid paying any sales or use taxes.

The inequitable tax treatment under the moratorium violates the principle of horizontal equity. With the current Internet tax moratorium under ITFA, two firms that provide almost identical services can be subject to different tax rates based on how the service is provided, either over the Internet or by a brick-and-mortar business.

Vertical Equity

The Internet tax moratorium acts as a subsidy, lowering the effective price of purchasing Internet access by eliminating any state or local tax on the service. Higher-income individuals tend to have greater access to the Internet than low-income individuals. In 2013, 24% of adults making less than $30,000 per year did not use the Internet, while 4% of adults making more than $75,000 did not use the Internet. It is possible that this subsidy could help lower-income individuals gain access to Internet. However, only about 6% cited the cost of Internet access as the reason they do not use the Internet. [14]

The structure of the Internet access tax moratorium and resulting subsidy does not satisfy the principle of vertical equity. Upper-income individuals are likely more capable of paying state and local sales taxes on their Internet access charges than lower-income individuals, however both upper- and lower-income individuals have access to the subsidy. Because these dissimilar individuals face similar tax burdens with respect to Internet access, the moratorium does not exhibit the concept of vertical equity.

Efficiency

The ITFA, specifically the moratorium on taxing Internet access, likely improves economic efficiency by expanding access to the Internet among individuals who may not be able to afford the service otherwise. However, the blanket nature of the moratorium, where both low- and high-income individuals receive the benefits of a lower tax burden, likely reduces the economic efficiency gains produced by this policy.

Due to the nature of the Internet, having additional businesses and individuals connecting to the Internet provides benefits both to the new Internet users but also to those who were already using the Internet. Or in economic terms, when an individual purchases Internet access they receive personal benefits, in the form of increased access to goods, services, and information, but they also generate external benefits for other individuals already using the Internet, in that they now have another Internet user to interact with or engage in commercial transactions.[15] When an individual is making a decision about whether to purchase Internet access, they tend to only consider their personal benefits from accessing the Internet and are unlikely to consider the external benefits they will create by purchasing Internet access. This results in fewer individuals accessing the Internet than is socially optimal. The moratorium on taxing Internet access acts as a subsidy to individuals and businesses by lowering the cost of Internet access. Lowering the cost of Internet access should increase the number of individuals using the Internet. And increasing the

[14] Kathryn Zickuhr, *Who's Not Online and Why*, Pew Research Center, Washington, DC, September 25, 2013, p. 6, at http://pewInternet.org/reports/2013/non-Internet-users.aspx.

[15] George R. Zodrow, "Network Externalities and Indirect Tax Preferences for Electronic Commerce," *International Tax and Public Finance*, vol. 10 (2003), pp. 83-84.

number of individuals on the Internet could improve economic efficiency by bringing the number of people on the Internet closer to the socially optimal level.

Some have argued that the subsidy provided by the Internet access tax moratorium is too large in comparison to the external benefits generated by an individual joining the Internet.[16] Additionally, scholars argue that as the Internet has grown the external benefits associated with an additional user have decreased, and at a certain point negative external consequences may arise from congestion.[17]

The subsidy offered to businesses and individuals through the moratorium on taxing Internet access also likely generates a certain amount of waste due to the blanket design of the subsidy. A large number of individuals would likely choose to purchase Internet access even if the price was higher due to state and local governments applying taxes to the service. Offering the subsidy to individuals who would have purchased Internet access regardless of the subsidy is considered wasteful from an economic perspective because the forgone revenue associated with the subsidy could be used elsewhere in a more productive capacity. Better targeting of the subsidy to individuals who struggle to afford Internet access would likely be a more economically efficient use of resources.

State Revenues and Autonomy

As the Internet has grown in size and popularity, states have forgone a source of potential revenues because of the federal moratorium. As mentioned previously, one estimate suggests that states could collect as much as $6.5 billion in revenue each year from taxing Internet access.[18] This estimate assumes that all states and local jurisdictions would impose their sales taxes on Internet access. This is unlikely to occur when considering that multiple grandfathered states eliminated their Internet access taxes voluntarily, and California even implemented a similar state-level moratorium on Internet taxes in 1999. Estimating the lost revenue from the Internet tax moratorium is difficult because it is necessary to speculate how states would have acted in the absence of the moratorium. The seven states that currently collect sales tax on Internet access raise an estimated $563 million per year.[19]

States have historically been allowed the freedom to determine how they want to raise their own revenues. ITFA is one example of a departure from this relationship in that the federal government restricted state and local governments from taxing certain activities. The National Governors Association has voiced concerns about the federal government encroaching on state autonomy, and hopes to revise parts of ITFA to shrink the definition of Internet access to allow taxation of more activities related to the provision of Internet access.[20]

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[16] George R. Zodrow, "Network Externalities and Indirect Tax Preferences for Electronic Commerce," *International Tax and Public Finance*, vol. 10 (2003), pp. 85.

[17] Austan Goolsbee and Jonathan Zittrain, "Evaluating the Costs and Benefits of Taxing Internet Commerce," *National Tax Journal*, vol. 52 (September, 1999), pp. 413-428.

[18] Ibid.

[19] Henry Reske, "Ending Internet Law's Grandfather Clause Could Cost States $500 Million," *Tax Analysts*, 2014-15565, June 24, 2014.

[20] David Quam, *Testimony - Communications, Taxation, and Federalism*, National Governors Association, May 23, 2007, at http://www.nga.org/cms/home/federal-relations/nga-testimony/page_2007/col2-content/main-content-list/may-23-2008-testimony—communic.html.

Simplicity

The moratorium on taxing Internet access likely simplifies complying with the tax code for ISPs. It is estimated that the number of different state and local tax jurisdictions ranges from 7,600 to 14,500.[21] For any ISPs which span multiple tax jurisdictions, the moratorium on taxing Internet access likely reduces the administrative burden of complying with those multiple tax jurisdictions.

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[21] Glen Kessler, "McConnell's Claim that There Are 'Nearly 10,000' Tax Codes Nationwide," *The Washington Post*, April 29, 2013.