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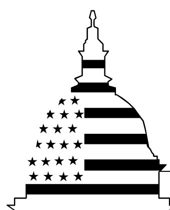
Report to Congressional Committees

January 2006

INTERNET ACCESS TAX MORATORIUM

Revenue Impacts Will Vary by State



GAO-06-273

INTERNET ACCESS TAX MORATORIUM

Revenue Impacts Will Vary by State

GAO Accountability•Integrity•Reliability
Highlights
Highlights of GAO-06-273, a report to congressional committees

Why GAO Did This Study

According to one report, at the end of 2004, some 70 million U.S. adults logged on to access the Internet during a typical day. As public use of the Internet grew from the mid-1990s onward, Internet access became a potential target for state and local taxation.

In 1998, Congress imposed a moratorium temporarily preventing state and local governments from imposing new taxes on Internet access. Existing state and local taxes were grandfathered. In amending the moratorium in 2004, Congress required GAO to study its impact on state and local government revenues. This report's objectives are to determine the scope of the moratorium and its impact, if any, on state and local revenues.

For this report, GAO reviewed the moratorium's language, its legislative history, and associated legal issues; examined studies of revenue impact; interviewed people knowledgeable about access services; and collected information about eight case study states not intended to be representative of other states. GAO chose the states considering such factors as whether they had taxes grandfathered for different forms of access services and covered different urban and rural parts of the country.

What GAO Recommends

GAO is not making any recommendations in this report.

www.gao.gov/cgi-bin/getrpt?GAO-06-273.

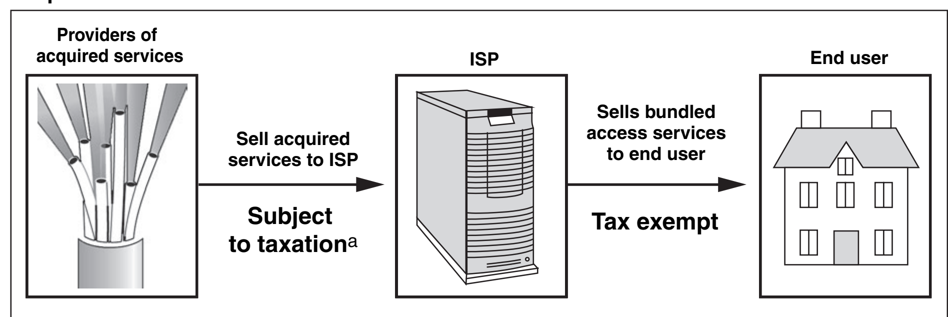
To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

What GAO Found

The Internet tax moratorium bars taxes on Internet access services provided to end users. GAO's interpretation of the law is that the bar on taxes includes whatever an access provider reasonably bundles to consumers, including e-mail and digital subscriber line (DSL) services. The moratorium does not bar taxes on acquired services, such as high-speed communications capacity over fiber, acquired by Internet service providers (ISP) and used to deliver Internet access. However, some states and providers have construed the moratorium as barring taxation of acquired services. Some officials told us their states would stop collecting such taxes as early as November 1, 2005, the date they assumed that taxes on acquired services would lose their grandfathered protection. According to GAO's reading of the law, these taxes are not barred since a tax on acquired services is not a tax on Internet access. In comments, telecommunications industry officials continued to view acquired services as subject to the moratorium and exempt from taxation. As noted above, GAO disagrees. In addition, Federation of Tax Administrators officials expressed concern that some might have a broader view of what could be included in Internet access bundles. However, GAO's view is that what is included must be reasonably related to providing Internet access.

The revenue impact of eliminating grandfathering in states studied by the Congressional Budget Office (CBO) would be small, but the moratorium's total revenue impact has been unclear and any future impact would vary by state. In 2003, when CBO reported how much states and localities would lose annually by 2007 if certain grandfathered taxes were eliminated, its estimate for states with grandfathered taxes in 1998 was about 0.1 percent of those states' 2004 tax revenues. Because it is hard to know what states would have done to tax access services if no moratorium had existed, the total revenue implications of the moratorium are unclear. In general, any future moratorium-related impact will differ by state. Tax law details and tax rates varied among states. For instance, North Dakota taxed access service delivered to retail consumers, and Kansas taxed communications services acquired by ISPs to support their customers.

Simplified Model of Tax Status of Services Related to Internet Access



Source: GAO and PhotoDisc (images).

[a]Depends on state law.

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Abbreviations

AOL	America Online
CBO	Congressional Budget Office
DSL	digital subscriber line
FTA	Federation of Tax Administrators
ISP	Internet service provider
POP	point of presence
POTS	plain old telephone service
VoIP	Voice over Internet Protocol

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United States Government Accountability Office
Washington, D.C. 20548

January 23, 2006

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Co-Chairman
Committee on Commerce, Science and Transportation
United States Senate

The Honorable Joe Barton
Chairman
The Honorable John D. Dingell
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

According to one study, at the end of 2004 some 70 million U.S. adults logged on to the Internet during 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

[1]Pew Research Center, *Trends 2005* (Washington, D.C.: Jan. 25, 2005).

[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).

provided by cable modem service or by a telephone technology known as digital subscriber line (DSL).[4]

This report focuses on the moratorium's impact on state and local government revenues. Its objectives are 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 explores 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. This report does not focus on taxing the sale of items over the Internet. A future report will discuss the impact that various factors, including taxes, have on broadband deployment and adoption.

To prepare this report, we reviewed the language of the moratorium, its legislative history, and associated legal issues; examined studies of revenue impact done 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 report contains a complete discussion of our objectives, scope, and methodology.

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

Results in Brief

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 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.

We are not making any recommendations in this report.

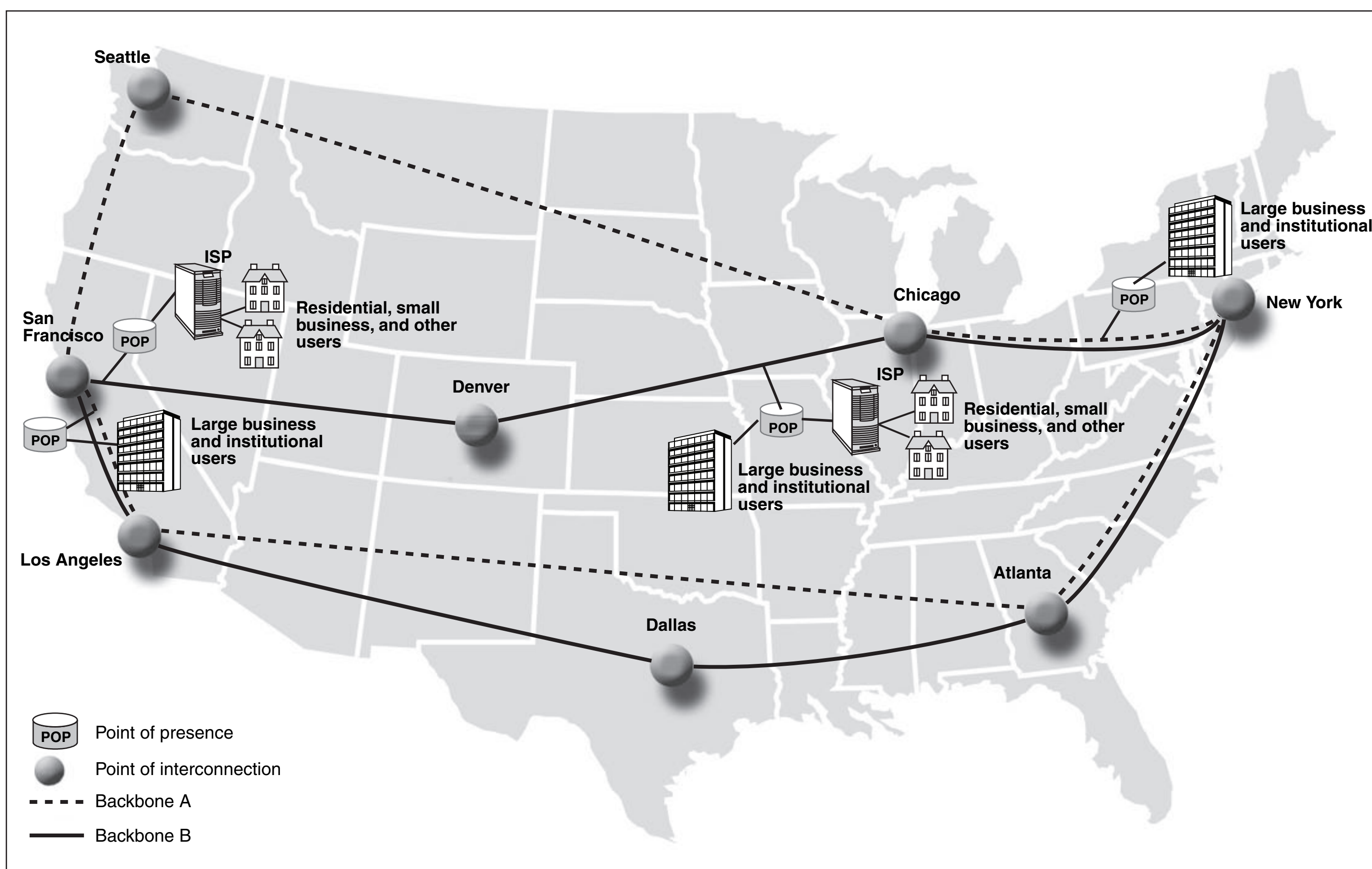
In oral comments on a draft of this report, CBO staff members said we fairly characterized CBO information and suggested clarifications that we have made as appropriate. Federation of Tax Administrators (FTA) officials said that our legal conclusion was clearly stated and, if adopted, would be helpful 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 appendix I, we believe that what is bundled must be reasonably related to accessing and using the Internet. In written comments, which are reprinted in appendix IV, company representatives commented 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.

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.[5]

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[6] and again in 2004, retroactively, to remain in force until November 1, 2007.[7] 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.

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[5]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 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 does not focus on taxing the sale of items over the Internet.

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

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

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.

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

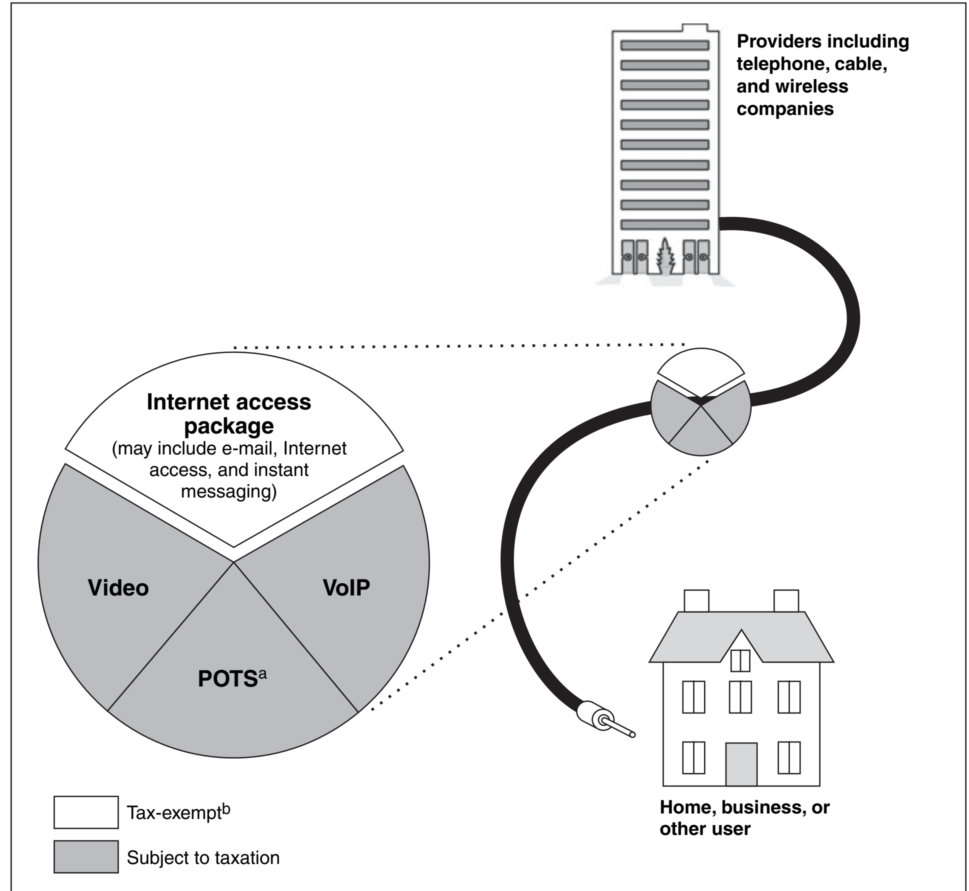
Since its 1998 origin, the moratorium has always prohibited taxing the service of providing Internet access, including component services that an access provider reasonably bundles in its access offering to consumers. However, as amended in 2004, the definition of Internet access contains additional 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*."[8] (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.

[8] 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.

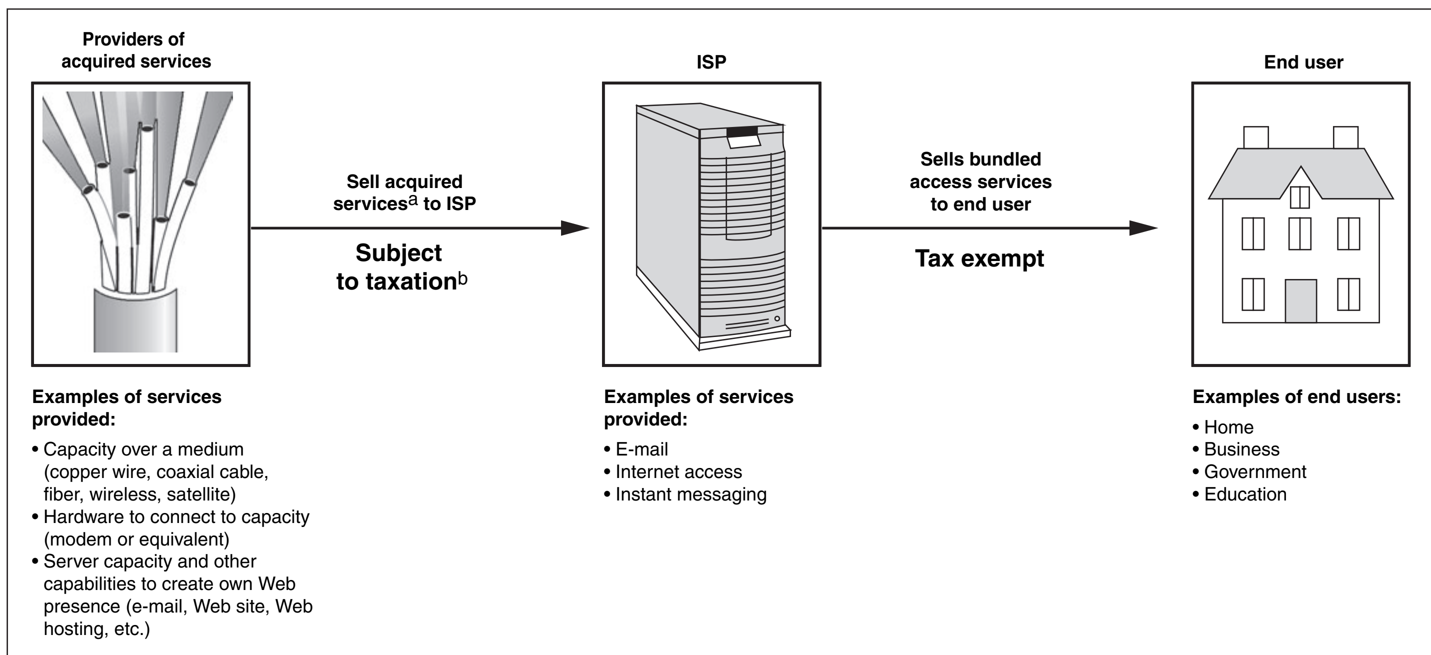
Our reading of the 1998 law and the relevant legislative history indicates that Congress had intended to bar taxes on services bundled with access. However, there were different interpretations about whether DSL service could be taxed under existing law, and some states taxed DSL. The 2004 amendment was aimed at making sure that DSL service bundled with access could not be taxed. See appendix I 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."[9] 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.

[9]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.

[b]Depends on state law.

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 appendix I. 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

(Continued From Previous Page)

State	Collected taxes paid on acquired services	2004 revenue from taxes paid on acquired services (dollars in millions)
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.[10]

CBO's estimates resulted from systematic, detailed analyses of information from state and national sources and involved assumptions to deal with uncertainties. In arriving at these estimates, CBO asked each state with grandfathered taxes for information on how much it collected in taxes related to access services. In addition, it estimated each state's access service-related taxes by using such data as the number of Internet users in the state, the average fees that users paid to providers, applicable state tax rates, expected amounts of dial-up versus broadband usage, and estimates of possible noncompliance with tax assessments. See appendix II for further information on the CBO methodology and associated limitations. Rather than again doing what CBO had done and gathering information on all 50 states, we tried to supplement what we learned from CBO by exploring more in-depth information in case studies of eight states.

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

[10]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.

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. Even the largest state tax amount reportedly collected in 2004 for Internet access revenues, excluding collections for localities—$50 million in Texas—was only about one-sixth of 1 percent of the state's tax revenues for that year; the largest percentage for any of our case study states was about 0.2 percent.

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 and North Dakota's about $400,000 for localities. In these states 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. For example, according to a state official, in Kansas the state tax was 5.3 percent, and the state collected an average of another 1.3 percent for local jurisdictions. While we did encounter localities outside our case study states that taxed access services under their own authority, almost all the collections for local jurisdictions that we came across were amounts collected by the states that were sent back to the localities.

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.[11] 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.

[11]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.

Because of the provisions in the enacted 2004 law, some unquantified revenue losses noted by CBO in its 2003 study that could have grown to be large no longer seem to pose the threat that some feared. For example, CBO mentioned the possibility of state and local governments being unable to tax customers' telephone calls over the Internet. However, as enacted, the 2004 amendments differed from the version reviewed by CBO and contained language excluding Internet-based telephone service, known as VoIP, from the moratorium.[12]

In addition, CBO expressed concern that providers could bundle products containing content, such as books and movies, call the product Internet access, and have the whole bundle be exempt from taxes. Although some people we interviewed still feared bundled content and information might become tax free, they and others indicated they were aware of no court cases in which this argument has been asserted.[13]

The 2004 amendments also included a provision specifically allowing states to tax Internet providers' net income, capital stock, net worth, or property value, addressing another concern raised by some parties.

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

[12]In our case studies, we found that even though the 2004 amendments did not affect the taxation of VoIP, some state and local officials were still very concerned about VoIP's taxability. When questioned about the impact of the moratorium on his state's financial situation, one official noted that the state was more concerned about what will happen with VoIP than about the current provisions of the 2004 amendments. Some local officials we interviewed were concerned that legislation like the 2004 amendments is a step toward eroding their ability to tax utilities such as telephone services. City officials were apprehensive that additional legislation will "piggyback" on the 2004 amendments, exclude services from state taxation, and eventually define VoIP as Internet access, having a severe, detrimental effect on revenues.

[13]Also see the first footnote in appendix I.

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.

Still, after the moratorium began, other states showed an interest in taxing Internet access services. Although the 1998 act precluded those jurisdictions from taxing Internet access, it included language stating that access services did not include telecommunications services. States seeking to take advantage of this provision taxed parts of DSL service they considered a telecommunications service and not an Internet access service. If taxing DSL service shows a desire to tax access services in general, many states not taxing dial-up or cable modem service[14] might have done so but for the moratorium.

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

[14]Care must be taken not to confuse cable television service and cable modem service, which is used to deliver Internet access. Cable television service providers may also provide cable modem service. Only cable modem service is subject to the moratorium.

providers disagreed on how state laws applied to the providers. Appendix III summarizes information we gathered about our case study states.

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. Rhode Island charged a 5 percent tax on companies' telecommunications gross receipts.

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 report, 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 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 have made as appropriate. In one case, we have 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.

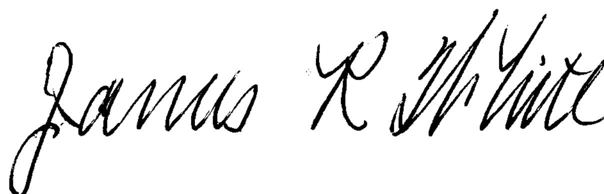
On January 6, 2006, FTA officials, including the Executive Director, said that our legal conclusion was clearly stated and, if adopted, would be helpful in clarifying which Internet access-related services are taxable and which are not. However, they expressed concern that the statute could be interpreted 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 appendix I, 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. Appearing in appendix IV, 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 appendix I. That appendix, along with the section of the report on bundled access services and acquired services, contains an explanation of our view that the language and structure of the statute support our interpretation.

We are sending copies of this report to interested congressional committees and other interested parties. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page

of this report. GAO staff who made major contributions to this report are listed in appendix V.



James R. White
Director, Tax Issues
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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 wire-line 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.

[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."

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 exempting 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.

[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).

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 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,

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[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.

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.

[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.

CBO's Methodology for Estimating Costs Relating to Taxing Internet Access Services

According to Congressional Budget Office (CBO) staff, CBO estimated revenue losses to states and localities from changing how Internet access was taxed by using two independent methodologies and comparing their results. First, it collected information directly from the states. Using data from the Federation of Tax Administrators and the Multistate Tax Commission to identify states taxing access and their related tax collections, CBO discussed with state officials what the dollar amounts included and what they did not. It then reduced the state loss estimates by various percentages to get a sense of the ranges possible by assuming, for instance, that providers were not always paying the taxes states thought they should pay.

To estimate from a second direction, CBO compiled its own state-by-state information. It multiplied the number of Internet users by state times an average access fee for each user times the state's applicable tax rate. It then discounted each state total based on assumptions about noncompliance with tax assessments.

To arrive at the number of users, according to CBO staff, CBO consulted the Department of Commerce, the Federal Communications Commission, and studies of Internet usage. From these sources, it obtained historical numbers of users and trends that it could project showing the number of users growing over time, and how usage was changing between dial-up and high-speed.

Finally, according to the staff members, CBO gathered the other information for its state-by-state estimate from other sources. It obtained state tax rates from Council on State Taxation information and computed a weighted average access fee after calling access providers about their current rates. It assumed that any change in revenues brought on by changes in technology and markets would offset each other. It estimated noncompliance to cover both tax avoidance and nexus[1] issues by using indications it had of certain Internet service providers not paying an access tax, considering their market share, and assuming various percentages of tax not being paid.

CBO considered information from both the approaches it was using to get a range for each state. It used these estimates to produce the part of its

[1]A state may only require an Internet seller to collect taxes if the seller has nexus, that is, a physical presence in the state.

analysis that it could quantify--the nationwide range of $80 million to $120 million beginning in 2007 for states with originally grandfathered taxes and more than $80 million per year by 2008 for the states taxing DSL. CBO did not give point estimates or ranges for specific states, an appropriate choice given the uncertainties in the methodologies used. Although the nationwide estimates should be used with caution, they provide reasonable bases for comparisons with the size of other revenue sources, such as that for overall receipts from state taxes, and for informing policy makers about the relative size of revenue losses related to the moratorium.

Case Study States' Taxation of Services Related to Internet Access

Table 4 and the following summaries show how our case study states significantly differed from each other in how they taxed services related to Internet access. State tax officials gave us much of the following information in conversations and written communications, and it represents their opinions of the application of the Internet Tax Freedom Act and the 2004 amendments to their own unique state laws. That said, the officials' comments are not necessarily binding and reflect their interpretation of state law.

Table 4: Characteristics of Case Study States

State	Taxed retail consumer dial-up Internet access services	Taxed retail consumer cable-modem Internet access services	Taxed retail consumer DSL Internet access services	Taxed acquired services	Type of tax[a]	State tax rate (percentage)	Local tax rate (percentage)	Roughly estimated 2004 state and local tax collections for all these services (dollars in millions)[b]
California					N/A	N/A	N/A	N/A
Kansas				x	Sales	5.3	1.3 on average	$9-10
Mississippi				x	Gross income	7.0	N/A	At most, 1.0
North Dakota	x	x	x		Sales	5.0	1.0-2.0	2.4
Ohio	x	x	x	x	Sales	5.5	1.0 on average	52.1
Rhode Island	x[c]		x[c]	x	Gross receipts and sales	5.0, 6.0	N/A	Less than 4.5[d]
Texas	x	x	x		Sales	6.25	2.0 limit	50[e]
Virginia					N/A	N/A	N/A	N/A

Source: State officials and laws.

[a]For purposes of this report, 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]See earlier text for a discussion of the limitations of the state estimates of revenue from taxes.

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

[d]According to Rhode Island officials, Rhode Island did not have an estimate for taxes collected on acquired services.

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

California

According to a state official, California had no grandfathered taxes on Internet access under any provision of the 2004 amendments. In addition, she said that California had enacted its own Internet Tax Freedom Act that generally prohibited imposing taxes on access starting January 1, 1999. Under this act, local governments were prohibited, with specified exceptions, from imposing any taxes on buying or using Internet access or other online computer services. Expiring January 1, 2004, the law did, however, expressly permit imposing sales and use taxes, utility user taxes, and other taxes of general application on goods and services that included access services. At the time of our contact in mid-2005, California officials were not aware of any state law either authorizing or preventing the taxation of access.

Kansas

According to a state Department of Revenue official, Kansas taxes on acquired services were grandfathered under the 2004 amendments. The state imposed a general sales tax of 5.3 percent (with, according to the official, local governments adding an average of another 1.3 percent) that applied to telecommunications services bought by an ISP and used to provide Internet access. ISPs paid sales tax on these acquired services to other providers that then remitted the funds to the state. According to the official, the state annually collected an estimated $9 million to $10 million in revenue from this tax, including about $2 million of local tax revenues. The $9 million to $10 million was an unverified estimate based on conversations between the Department of Revenue and telecommunications providers about the providers' volume of sales to ISPs. It was derived by taking 10 percent of the $98 million total telecommunications sales tax receipts that the state collected in 2004. The approximately $8 million of state revenue was about 0.15 percent of Kansas's total tax receipts of about $5.3 billion in 2004. According to the official, he expected Kansas to lose this yearly revenue starting on November 1, 2005.

Mississippi

According to Mississippi State Tax Commission officials, although the state did not tax access that was purchased by retail consumers, its tax on sales of telecommunications services to ISPs--services we are categorizing as acquired services--was grandfathered under the 2004 amendments. Since before the 1998 Internet Tax Freedom Act, the state collected a gross income tax on public utilities, including telecommunications providers, which operated much as a sales tax would. No sale-for-resale exemption

applied to these services, according to the officials, because under Mississippi law the ISP was not a reseller of the same service; the ISP changed the service before selling it to the retail consumer. The tax rate was 7 percent and, although officials told us the amount of resulting revenue collections was extremely difficult to calculate due to a lack of data, they believed the total amount to be less than $1 million per year. This was about 0.02 percent of Mississippi's 2004 tax revenues of about $5.1 billion. According to the officials, telecommunications companies remitted sales tax collected from ISPs to the state on a monthly basis. As there were no local option sales taxes in Mississippi, the state was the only Mississippi entity that taxed the telecommunications services.

North Dakota

North Dakota Office of State Tax Commissioner officials maintained that their state was grandfathered under the 2004 amendments, and as such continued to tax retail consumer Internet access. The state imposed a sales tax on communications services, which it applied to Internet access. The tax rate was 5 percent and, according to the officials, led to state revenue collections of about $2 million per year, which was about 0.16 percent of North Dakota's approximately $1.2 billion in 2004 tax revenues. In addition, local rates of generally 1 percent provided about another $400,000 in yearly collections for local jurisdictions. Retail consumers were taxed on intrastate Internet access transactions, whether through dial-up, cable modem, DSL, or wireless technologies. ISPs collected the taxes and then transferred them to the state. To determine the amount of tax revenue collected, state officials said they reviewed each registered ISP and approximated how much income resulted from providing Internet access. According to the officials, the state's determinations were confirmed by subsequent state audits.

Ohio

According to Ohio Department of Taxation officials, Ohio was grandfathered to continue taxing business (but not residential) purchases of Internet access and provider purchases of other services to provide access. Ohio imposed a 5.5 percent sales tax on business users of telecommunications and electronic information services, supplemented, according to the officials, by an average 1 percent tax for local jurisdictions. The same taxes also applied to acquired services. Ohio also provided a 25 percent sales tax credit for electronic information service providers, which meant that ISPs could get a tax credit for the equipment that they purchased and used primarily to provide Internet access.

Because Ohio taxed Internet access as part of electronic information services for business users, it was difficult for state officials to determine exactly how much tax was paid on Internet access. Officials estimated that in 2004, the state collected $17 million in taxes paid on Internet access services (including some research services) sold to end users, and an additional $2.8 million from local taxes on those same services. They derived these numbers using economic census data and vendors' tax returns.

In addition, an Ohio official estimated collecting another $27.3 million in state taxes and $5 million in local taxes in 2004 from other Internet access-related services that state officials said Ohio could no longer tax starting in November 2005. The combined $32.3 million state and local revenues for services not taxable in November 2005 included several components. The largest was $20.5 million on telecommunications services and property provided to ISPs and Internet backbone providers, for example, high-speed lines leased by an ISP from a telecommunications provider. In arriving at this estimate, state officials assumed that 10 percent of telephone and wireless services would become tax exempt. The next largest component was $9.1 million for private line services, such as T-1 and T-3 lines, and 800/wide-area telecommunications-type services that an official said would be exempt due to the moratorium. The state derived this number by assuming that 10 percent of the relevant services were attributable to Internet customers. These services had become taxable as of July 1, 2003, when Ohio repealed exemptions for them, but, according to state officials, these services were becoming tax exempt again at November 1, 2005, under the changed definition of Internet access.

The amount of Internet access-related state taxes that an Ohio official said the state collected in 2004 was $44.3 million. This was the sum of the $17 million from retail services and $27.3 million from acquired services. This total amounts to about 0.2 percent of Ohio's approximately $22.5 billion in tax collections for 2004. It does not reflect a problem that Ohio officials expected from taxpayers bundling services as Internet access services in order to avoid sales tax. Although the officials said the size of the problem was unknown, they assigned a $24 million sales tax loss to it for 2007, assuming it to be similar in size to other annual tax losses that would start in November 2005.

Rhode Island

State officials told us that Rhode Island was grandfathered under the 2004 amendments to tax Internet access through both a gross receipts tax on

ISPs and a sales tax on telecommunications services acquired by ISPs. The gross receipts tax, in existence since 1942, was imposed on any company charging a telecommunications access fee, with provisions to prevent the same charges from being taxed twice. This tax was assessed at a rate of 5 percent, and companies submitted an annual return to the state and made estimated payments throughout the year. According to state officials, Rhode Island did not tax companies providing Internet access services via cable modem but did tax those providing access services through dial-up, DSL, or wireless technologies. Not knowing what part of reporting companies' gross receipts came from providing Internet access, the officials could not determine precisely how much revenue the state collected from Internet access under the gross receipts tax. They did say that since Internet access charges probably totaled less than 10 percent of annual telecommunications gross receipts of $40 million to $45 million, the amount of state revenue collected from taxing Internet access would be less than $4.5 million. This would be about 0.19 percent of 2004 state tax revenues that totaled about $2.4 billion.

The officials also said that Rhode Island would be affected by the new definition of Internet access under the 2004 amendments as it applies to the state sales tax, and thus to the taxation of acquired services. The sales tax was imposed at a 6 percent rate on the purchase of telecommunications services bought by ISPs to provide Internet access. The sale/resale exemption did not apply because ISPs are considered to be the "end users" of the services, as their own products differ from the ones purchased. The officials did not think revenues from taxing acquired services were significant compared to overall state telecommunications tax revenues.

Texas

An official with the Texas Comptroller of Public Accounts maintained that his state had been permitted to tax retail consumer Internet access for years, making Texas another one of the relatively few states that continued to be grandfathered under the 2004 amendments. Because Texas had no state income tax, a sales tax was its primary source of revenue. In 1985, telecommunications were added to the services covered by the sales tax, and in 1988, information services were added as well. According to the official, the 6.25 percent sales tax rate led to state revenue collections of about $50 million for 2004, which was about 0.16 percent of Texas's approximately $30.8 billion in tax revenues for 2004. Local jurisdictions typically imposed an extra one-quarter to 1 percent additional sales tax on Internet access, but the combined total of state and local taxes could not exceed 8.25 percent. Texas exempted from taxation the first $25 of

Internet access charges incurred by a customer when buying Internet access from an ISP. However, according to the official, a corporate customer qualified for one $25 exemption regardless of how many accounts it maintained. The sale-for-resale exemption applied in Texas to services sold by a provider to an ISP for resale purposes, so those acquired services were not taxable. Retail consumers were taxed on intrastate Internet access transactions, whether through dial-up, cable modem, DSL, wireless, or satellite technologies. ISPs collected the taxes and then transferred them to the state.

Virginia

According to Virginia Department of Taxation officials, Virginia had no taxes on Internet access grandfathered under the 2004 amendments. In Virginia, ISPs were subject to taxes of general application, like corporate income and gross receipts taxes imposed by the state or local jurisdictions, but Internet access transactions were not taxable transactions. According to the officials, Virginia's sales tax statutes exempted ISPs from collecting sales tax, codifying then current state practices. Virginia had exempted Internet access services from its sales and use tax in April 1998. Acquired services were similarly not taxable in Virginia.

Comments from Telecommunications Industry Officials

January 17, 2006

James R. White
Director, Tax Policy and Administration
U.S. Governmental Accountability Office
441 G. Street, N.W.
Washington, DC 20548

Re: Draft GAO Report on the Impact of the Internet Tax Nondiscrimination Act on State Tax Revenues

Dear Mr. White:

Thank you for the opportunity to provide input on the Draft GAO Report ("Report") discussing the impact of the Internet Tax Nondiscrimination Act ("ITNA") on state tax revenues. We appreciate the time and effort put forth by GAO during the preparation of the Report and the willingness of GAO staff to discuss pertinent issues with us.

Background

The 2004 amendments to the Internet Tax Freedom Act ("ITFA") included several significant changes to the federal statute. Notable among them was a key clarification of the definition of "Internet access" to exempt telecommunications services "purchased, used, or sold by a provider of Internet access to provide Internet Access" from state taxation.[1] As a result of this legislative change, state and local governments are prohibited from imposing taxes upon the telecommunications services "purchased, used, or sold by a provider of Internet access to provide Internet Access."

Congress intended to advance two related and equally compelling purposes by clarifying the definition of Internet Access. The first purpose was to prevent states from taxing Internet access differently depending on how a provider assembles its service and delivers the service to consumers. The second and related purpose was to prevent states from taxing the wholesale purchase of "backbone" (*i.e.*, the underlying telecommunications services) by Internet access providers used to provide Internet access. Both purposes were targeted at eliminating discriminatory tax treatment of Internet access services provided by various providers and

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[1] 47 U.S.C. § 151, note § 1105(5).

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technologies. The dual purposes that underlie the change in definition of "Internet access" are supported in both legislative history and the plain language of the statute.

Legislative History

In 2004, Congress included language in ITNA that specifically prevents states from taxing telecommunications services that are "purchased, used, or sold by a provider of Internet access to provide Internet access." Language in the introduced versions of the House and Senate ITNA bills varied slightly from the enacted version. Early versions of the bills prevented states from taxing telecommunications services that were merely "used to provide Internet access."[2] The words "purchased" and "sold" were added as the bills progressed through the legislative process in Congress. Although the language used by Congress may have evolved during the deliberative process, the legislative intent of the language was clear and never changed. As the legislative history detailed below demonstrates, it was the intent of Congress throughout the process to protect *both* the providers and consumers of Internet access from state and local tax burdens.

1. Committee Reports

The House and the Senate Committee reports discussing the early version of the language support the contention that the exemption for telecommunications services provided in section 1105(5) of ITNA was intended to exempt wholesale purchases of telecommunications services that become a component part of Internet access service. The Senate Commerce Committee report on the introduced version of S. 150 indicates that it was the sponsors' clear intent from the outset to protect wholesale purchases of backbone services from state taxes:

> [T]he Committee believes that the current definition of Internet access under the Act requires clarification to ensure that States and localities do not attempt to circumvent the moratorium on Internet access taxes by taxing individual components of access such as telecommunications services used to provide Internet access
>
> . . .
>
> 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

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[2] S. 150, 108th Cong. (2004); H.R. 49 108th Cong. (2004).

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> intends to use those telecommunications services to provide Internet access, then the exemption would apply.[3]

The House Committee on the Judiciary Report on H. 49 (which also contained slightly different language at the time of the report than was included in ITNA) also indicates a clear legislative intent to protect the wholesale purchases from state taxes. The report noted that the ITNA wholesale language:

> clarified the exception to the definition: while telecommunications services are not generally within the definition of Internet access, to the extent they are used to provide Internet access, they are subject to the moratorium. Transmission services used to provide Internet access, whether at the wholesale or retail level, constitute "Internet access."[4]

Thus, Committees of both legislative bodies early on acknowledged the overall goals of ITNA could not be achieved without protecting wholesale purchases from state taxation. Both Committees concluded that a tax on a provider's wholesale purchase of telecommunications services used to assemble Internet access service would be passed on to the end consumer and therefore should be prohibited.

2. Floor Debate

The floor debate on ITNA also exemplifies the strong desire on the part of its sponsors to prevent states from taxing wholesale purchases of telecommunications services that are used to provide Internet access services. Senator Allen's floor statement particularly illustrates this point: "We wanted to stop those who found a loophole in the original moratorium and started taxing the backbone of the Internet. They are taxing that and, of course, ultimately the consumer has to pay for those taxes. We wanted to stop that immediately."[5] Some states were taxing the backbone transmission services, or wholesale services, as telecommunications services—such states justified taxation of such backbone services by classifying such services as telecommunications services. Moreover, responding to Senator Dorgan on the meaning of the proposed words "purchased, used, or sold by a provider of Internet access to provide Internet access," Senator Allen stated: "The simple answer is we do not want the bandwidth being taxed . . . . The point is, though, that for the bandwidth, that actual transport, that should not be taxed."[6]

Further information from the floor debate shows that state officials similarly interpreted the new ITNA language to be an exemption for the wholesale purchase of telecommunications

[3] S. Rep. No. 108-155, at 3 (2003).
[4] H. Rep. No. 108-234, at 10 (2003).
[5] 150 Cong. Rec. S4401 (April 27, 2004) (Statement of Sen. Allen).
[6] 150 Cong. Rec. S4461 (April 27, 2004) (Statement of Sen. Allen).

services that are used in the provision of Internet access. Senator Alexander introduced two letters from state officials during the floor debate on ITNA that interpret the ultimate language of ITNA as protecting wholesale purchases from state taxes. The Tennessee Tax Commissioner noted:

> [The ITNA wholesale language] has the effect of exempting telecommunication services that make up the Internet backbone, the 'middle mile" telecommunications used by Internet Service Providers to provide Internet access and the "last mile" telecommunications services used to connect an end user to the Internet.[7]

The National Governors Association also noted in a letter to Senator Alexander that:

> Not only would the [ITNA wholesale language] prohibit states and localities from collecting taxes on DSL, it would also exempt all telecommunications services used anywhere along the Internet—from the end-user all the way to and including the "backbone."[8]

3. Congressional Research Service Report on the Internet Tax Bills

In late 2003, the Congressional Research Service issued a report on all of the Internet tax bills that were pending in the 108th Congress. The report detailed each bill and summarized some of the key issues related to the bill. When discussing ITNA and the debate surrounding the key issues, the report clearly acknowledged that the ITNA language protects the wholesale purchase from state taxes by stating: "[The ITNA wholesale language] could also exempt from tax not only the telecommunications or other services that connect the consumer to the Internet but all of the telecommunications and other services that make up the Internet backbone."[9]

4. Enacted Text of ITNA Contrasted with Alexander-Carper Bill

The progression of the bill and state opposition to an exemption for wholesale purchases indicate that the clear legislative intent was to include wholesale purchases in the exemption from taxes under ITNA. While ITNA was being debated, state opposition led to the introduction of the competing Carper/Alexander Bill that did *not* protect wholesale purchase from taxes. Important language differences between the Carper/Alexander Bill and ITNA as enacted support a conclusion that the enacted ITNA provision protects wholesale purchases from state taxes.

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[7] 150 Cong. Rec. S4639 (April 29, 2004) (Statement of Senator Alexander submitting a letter from Lauren Chumley, Commissioner of Revenue, State of Tennessee).
[8] 150 Cong. Rec. S4640 (April 29, 2004) (Statement of Senator Alexander submitting a letter from the National Governor's Association).
[9] Congressional Research Service, *Internet Tax Bills in the 108th Congress* CRS-5 (November 10, 2003).

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The relevant text of the enacted version of ITNA reads: "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." [Emphasis added.] However, the relevant text of the Alexander-Carper Bill illustrates a failed attempt to exclude a wholesale exemption from ITNA by changing key words of the bill: "The term 'Internet access service' 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."[10] [Emphasis added.] Furthermore, the presentations used to explain to Members of Congress the differences between the Carper/Alexander bill and ITNA support a conclusion that wholesale purchases of backbone services are protected from state taxation by the enacted language of ITNA.[11]

The significance of these differences in language was not lost on those state tax policy commentators who discussed the issue. For example, the Center on Budget and Policy Priorities issued a detailed report comparing the Alexander-Carper language to the ITNA language. The report noted: "The proposed S. 150 would prohibit all state and local taxation of both 'last mile' telecommunications services and the 'upstream' telecommunications services that constitute the underlying infrastructure and 'backbone' of the Internet."[12] Additionally, "Whip Talking Points" used by the state and local government representatives during the debate demonstrate that the states interpreted the language as including wholesale purchases.[13]

5. Importance of the Wholesale Exemption to the Industry

A great deal of public testimony and comments on ITNA indicate that concern over the taxation of the wholesale purchase of telecommunications services was an important reason for the language change. All segments of the communications and Internet access industries were strong proponents for the inclusion of the wholesale exemption in ITNA, as this exemption provides both clarity and equity for all service providers, regardless of the ownership of the backbone. Testimony by Mark Beshears, Assistant Vice President of State and Local Tax, Sprint Corporation, stated that the taxation of wholesale purchases is a "real world" problem associated with the older ITFA language.[14] In a prepared Statement, Steven K. Berry, Senior Vice President for Government Affairs, Cellular Telecommunications & Internet Association noted that "[i]t is unfortunate that legislation designed to prevent multiple and discriminatory taxation

[10] S. 2084, 108th Cong. (2004).
[11] *See,* Attachment 1.
[12] Center on Budget and Policy Priorities, *The Alexander-Carper Internet Access Tax Moratorium Bill, S. 2084: A True Compromise That Substantially Broadens The Original Moratorium* 4 (March 15, 2004).
[13] *See,* Attachment 2.
[14] *Internet Tax Moratorium: Hearings on S. 150 before Senate Comm. on Commerce, Science, & Transportation,* 108th Cong. (July 16, 2003) (statement of Mark Beshears, Assistant Vice President of State and Local Tax, Sprint Corporation).

of Internet and Electronic Commerce specifically excludes the one service that is absolutely vital to the functioning of the Internet—the telecommunications backbone—and the one service that is subject to one of the highest discriminatory state and local tax burdens in the country."[15]

6. Indications of Legislative Intent Contained in the GAO's Draft Report

The draft Report contains several observations that also support a conclusion that ITNA prevents states from imposing tax on wholesale purchases. For example, many states were very involved in the debate over the wholesale purchase exclusion—either directly or through the Multistate Tax Commission and Federation of Tax Administrators. The draft Report recognizes that four of the eight study states have acknowledged that they will discontinue taxing wholesale purchases on November 1, 2005; two of the study states do not tax Internet access at all, and it is unclear from the report whether any of the eight study states will tax wholesale purchases. A number of states, including Massachusetts, North Carolina, Louisiana, Kentucky and Mississippi, have already interpreted the language as protecting the wholesale purchase on November 1, 2005.

The draft Report also indicates that the CBO interpreted ITNA as preventing a tax on wholesale purchases. Thus, the CBO—contemporaneously with the debate on the scope of the bill—interpreted the provision to exempt to wholesale purchases from state taxes.

Statutory Construction

Application of statutory construction principles in interpretation of the ITNA provision also yields a conclusion that the language prevents the taxation of any telecommunications services that are purchased, used, or sold to provide Internet access.

1. Plain Reading

A plain reading of the provision indicates that ITNA prevents a state from taxing the wholesale purchase of telecommunications services used to provide Internet access. The operative provision of ITNA provides that "[n]o State or political subdivision thereof shall impose any of the following taxes during the period beginning November 1, 2003, and ending November 1, 2007: (1) Taxes on Internet access . . .."[16] ITNA defines Internet access to mean

> 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

[15] *Internet Tax Moratorium: Hearings on S. 150 before Senate Comm. on Commerce, Science, & Transportation*, 108th Cong. (July 16, 2003) (statement of Steven K. Berry, Senior Vice President for Government Affairs, Cellular Telecommunications & Internet Association).
[16] 47 U.S.C. § 151, note § 1101.

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> 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.*[17]

Read together, these two provisions provide a clear exemption for any telecommunications service that is purchased, used or sold by a provider of Internet access to provide Internet access. Simply stated, wholesale purchases of telecommunications services used by an Internet service provider to provide Internet access is protected from state taxation under ITNA. No other provision of ITNA alters this plain interpretation. Neither the accounting rule in section 1106 that addresses aggregated charges nor the specific mention of voice services in section 1108 should change this interpretation.

2. The Words "Purchased" and "Used" Must be Given Meaning

The words "purchased, used, or sold" must be interpreted more broadly than simply as a means to level the playing field between different technologies and providers with respect to end-users (*e.g.*, to tax end-user DSL and cable broadband consistently). If the new language is interpreted to only level the playing field with respect to the ultimate consumer purchase, most of the new language would be rendered moot. If the drafters had intended only to level the playing field, they would not have included such a broad provision concerning "purchased, used or sold by a provider of Internet access to provide Internet access." Consistent tax treatment on the sale to the end-user could have been accomplished by merely using the word "sold." The Senate debate that focused on the Alexander-Carper alternative, which is discussed above, supports this conclusion. The addition of the words "purchased" and "used" can only be read to protect the wholesale purchase from state taxes.

3. The Language Should be Interpreted Consistently with State Transaction Tax Concepts

ITNA preempts the state and local taxation of certain services; consequently, much of the language in ITNA was crafted to be consistent with phrases and concepts that are well grounded in state and local tax.[18] The words "purchased," "used," and "sold" are all terms of art in state and local tax that should be accorded similar significance in the context of ITNA. States presently use this same language to exempt the wholesale purchase of all types of goods and services, and it is logical to use the same language when describing an exemption from taxation for the purchase of wholesale services used to provide Internet access.

[17] 47 U.S.C. § 151, note § 1105(5) (emphasis added).
[18] *See, e.g.,* Ala. Admin. Code § 810-6-5-.26.01; Cal. SBE Reg. § 1823; Fla. Stat. § 212.06(2)(k); Conn. Agencies Regs. § 12-410(5)-1; D.C. Code § 47-2201; Ill. Admin. Code § 160.101; NY Tax Law § 1115; Ohio Rev. Code § 5741.01(C) & (D); 61 Pa Code § 31.13; S.D. Laws § 10-45-6.1; Tenn. Code § 67-6-507; 34 Tex. Admin. Code § 3.287

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The use of the phrase "purchased, used, or sold" parallels exemption language used in existing state transactional tax provisions that strive to prevent the pyramiding of taxes, which is an important tax policy issue that Congress also addressed when considering ITNA. In theory, the retail sales tax is designed to tax final consumption of goods and services. In other words, the tax should be imposed only on the purchase of taxable sales by households while exempting business purchases. A report prepared for the Council on State Taxation supports the theory that a pyramiding of the sales tax leads to unfavorable results for consumers and other negative economic results.[19] The imposition of " . . . state and local sales taxes . . . on a significant portion of business-to-business sales . . . results in problems, including distortions in how firms operate, arbitrary and hidden differences in effective sales tax rates on different goods and services that distort consumer choices, violations of horizontal and vertical equity principles, and detrimental effects on a state's business competitiveness. Those problems are partially a result of the pyramiding of the retail sales tax." Pyramiding causes the taxes paid by businesses to be built into the price charged to the consumer; this practice violates principles of equity and neutrality because some forms of consumption are taxed more than others, depending on the extent to which business inputs were subject to tax. "In some cases, legislators have chosen to tax inputs purchased by firms, such as healthcare providers [or Internet access providers], as an indirect way to tax services that are intentionally exempted from direct sales taxation for public policy ('equity') reasons."[20]

These pyramiding principles are equally applicable when discussing the ITNA wholesale language. Congress intended to limit the ability of states to tax the ultimate purchase of Internet access by consumers. The imposition of taxes at the wholesale level on telecommunications services utilized to provide Internet access to consumers would unquestionably result in a pyramiding of taxes borne by the ultimate consumer.

4. The Language Should be Interpreted Consistently with the Recognized Legislative Intent of Treating Like/Similar Services Equally

One of Congress's primary purposes underlying the reenactment of ITNA was to address the potential and existing inequities between the states' taxation of dial-up Internet access and high-speed Internet access (*i.e.*, DSL and cable modem service). A critical inequity that Congress identified in this regard could occur between facilities-based telecommunications providers that could use their own network to primarily provide Internet access services and non-facilities-based providers that primarily procure their telecommunications services necessary to provide Internet access to consumers. Congress was concerned that providers that are able to primarily utilize their own networks (*i.e.*, the backbone) could have a competitive advantage to

[19] Robert Cline, John L. Mikesell, Thomas S. Neubig, Andrew Phillips, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, 2005 State Tax Today 29-1 (Jan. 28, 2005).
[20] *Id.*

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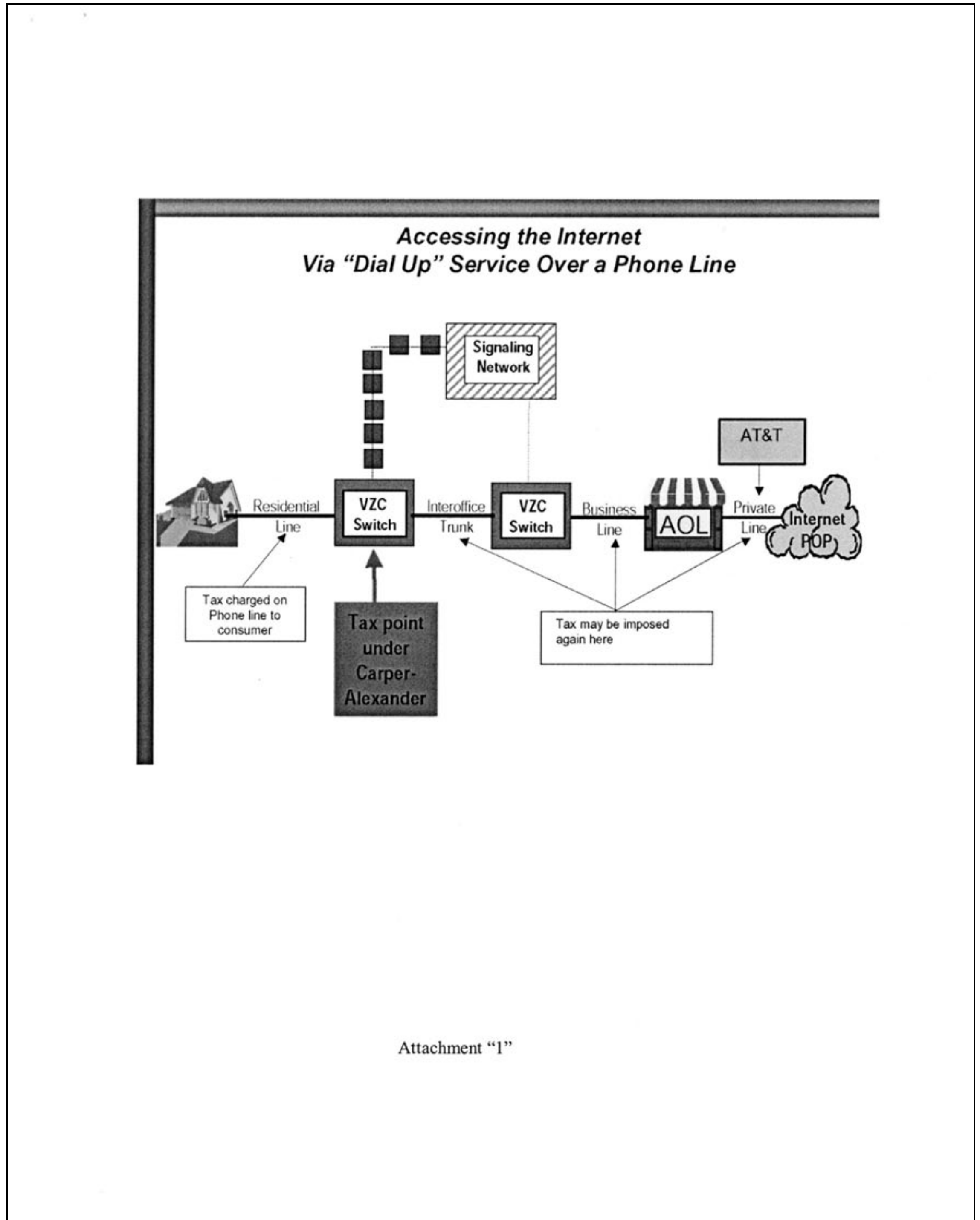
those providers who are required to primarily purchase the telecommunications backbone for Internet service from another entity. Congress sought to correct this potential inequity regarding the treatment of these wholesale service transactions to ensure that all providers of Internet access would be subject to the same level of taxation with respect to their purchase of wholesale services. Thus, Congress' purpose cannot be fulfilled without reading ITNA to address both the retail and wholesale purchase of telecommunications service.

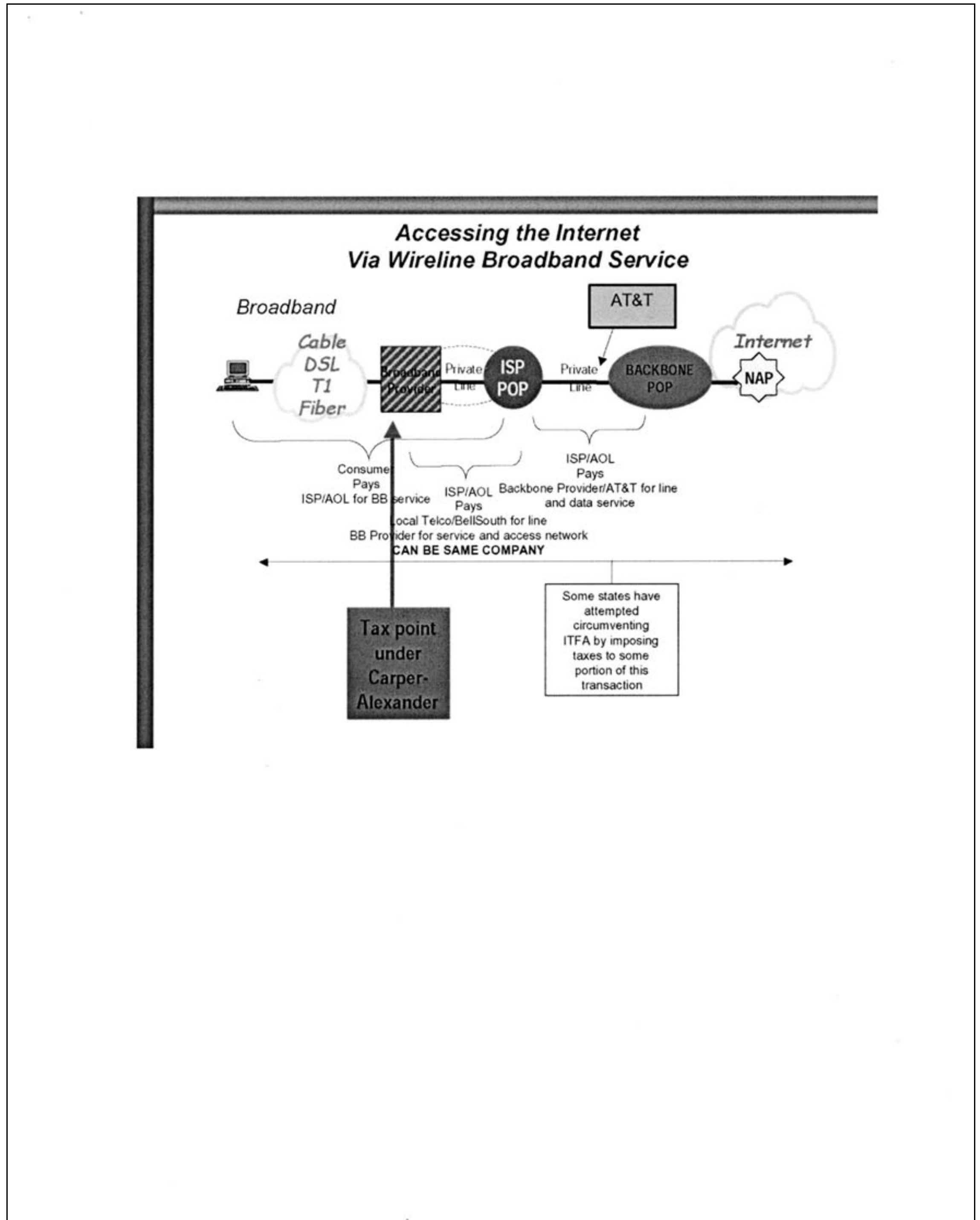
Sincerely,

America Online Inc.
AT&T Corp.
BellSouth Corp.
Comcast Corp.
Level 3 Communications
Sprint Nextel
T-Mobile USA
Verizon
Verizon Wireless
Time Warner Cable
United States Telecom Association

cc: Lawrence M. Korb
Bert Japikse



Attachment "1"


Accessing the Internet
Via Wireline Broadband Service
Broadband
AT&T
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T1
Fiber
Broadband Provider
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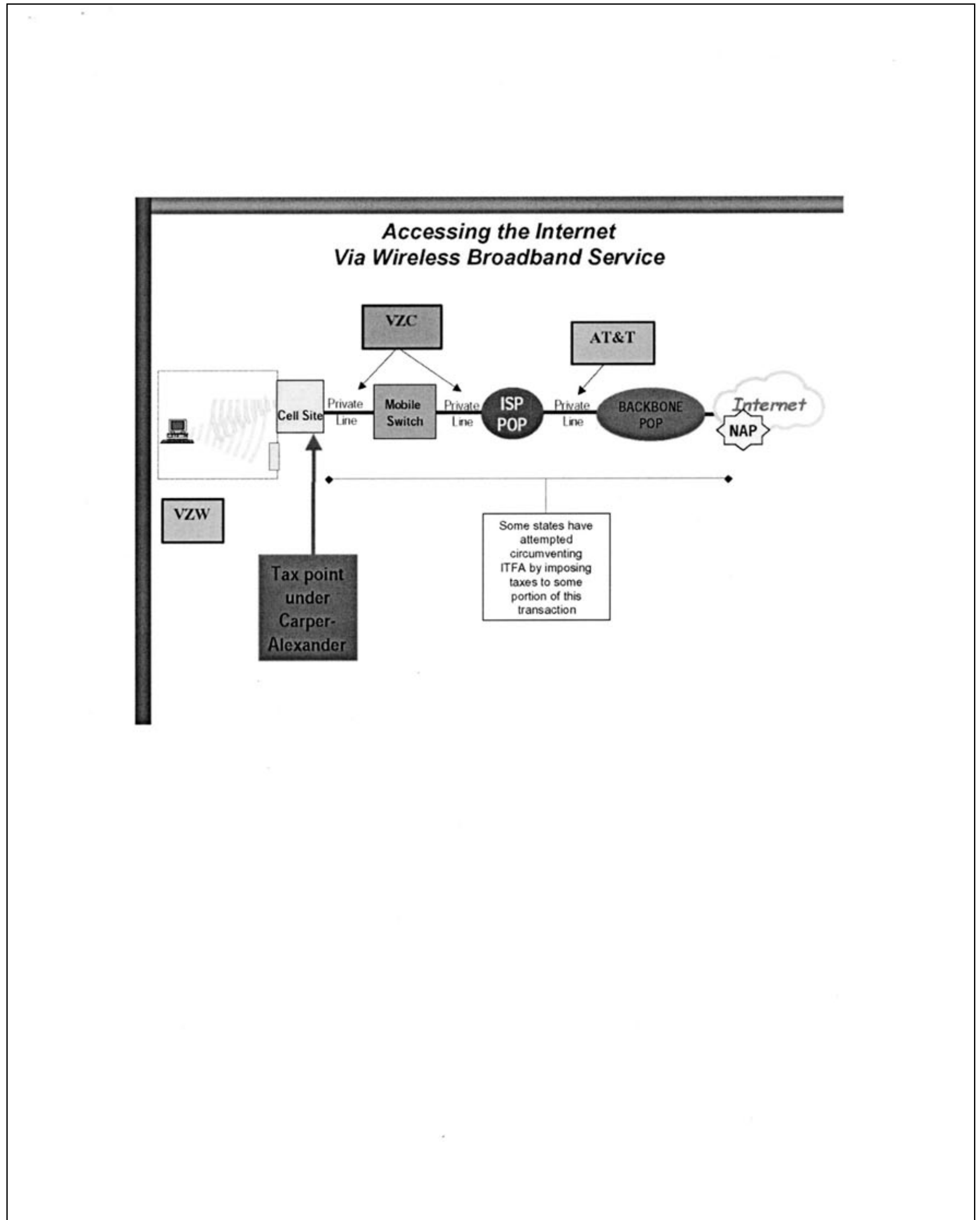
Internet
NAP
Consumer Pays ISP/AOL for BB service
ISP/AOL Pays Local Telco/BellSouth for line BB Provider for service and access network
ISP/AOL Pays Backbone Provider/AT&T for line and data service
CAN BE SAME COMPANY
Tax point under Carper-Alexander
Some states have attempted circumventing ITFA by imposing taxes to some portion of this transaction


Accessing the Internet
Via Wireless Broadband Service
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Cell Site
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Mobile Switch
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ISP POP
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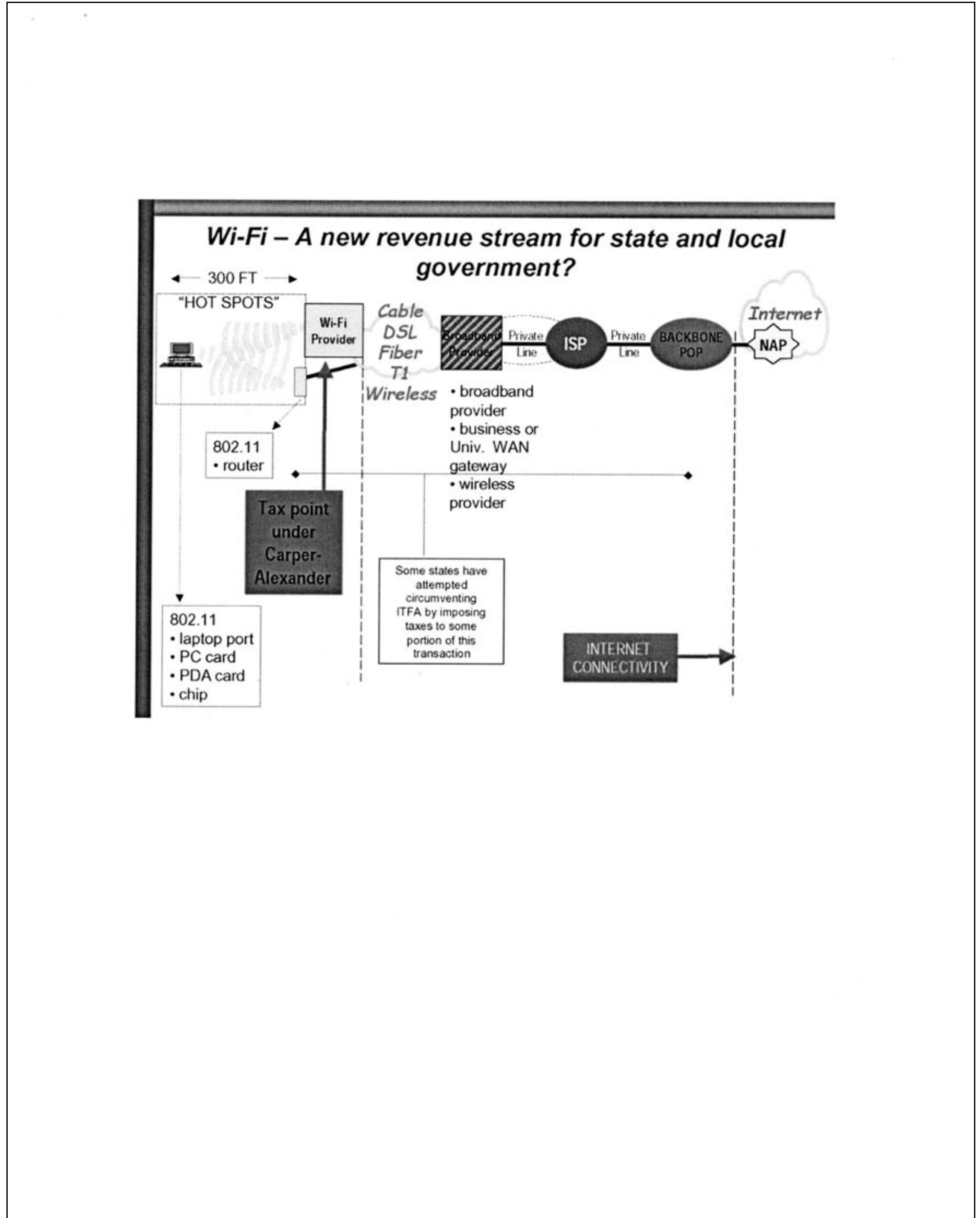
Tax point under Carper-Alexander
Some states have attempted circumventing ITFA by imposing taxes to some portion of this transaction


Wi-Fi – A new revenue stream for state and local government?
300 FT
"HOT SPOTS"
Wi-Fi Provider
Cable
DSL
Fiber
T1
Wireless
Broadband Provider
Private Line
ISP
Private Line
BACKBONE POP
Internet
NAP
• broadband provider
• business or Univ. WAN gateway
• wireless provider
802.11
• router
Tax point under Carper-Alexander
Some states have attempted circumventing ITFA by imposing taxes to some portion of this transaction
INTERNET CONNECTIVITY
802.11
• laptop port
• PC card
• PDA card
• chip

Whip Talking Points:

- State and local governments oppose S. 150 because it unnecessarily expands the existing moratorium on Internet access taxes to include certain telecommunications services. The Multistate Tax Commission estimates that this expansion will cost state and local governments $4 to $8.75 billion annually. **[NOTE: substitute/add state numbers if available.]**

- The sponsors of S. 150 have proposed changes to the bill that they claim address state and local concerns. The proposed changes **do not take care of problems identified by state and local governments and should be opposed**. Our best estimates are that the proposed changes would still cost state and local governments $2 to $4 billion annually. **[NOTE: Substitute/add state numbers if available.]**

- State and local government groups offered compromise language to tighten the definitions in the bill and to make the moratorium permanent. That language would have made telecommunications transmissions from the consumer to the ISP tax free (and cost the state/locals hundreds of millions in revenues). The state/local offer was rejected by the sponsors.

- Because of the cost and uncertainty associated with both S. 150 and the proposed Managers' amendment, NGA and others are pushing for a simple extension of current law until industry, Congress and state and local government groups can produce language that is thoughtful and fiscally fair.

- Given the complexities of this issue and the potential cost to state and local governments, would Senator ________ support an amendment on the Senate floor to change S. 150 to a simple extension of the current moratorium?

Attachment "2"

GAO Contact and Staff Acknowledgments

GAO Contact

James R. White (202) 512-9110

Acknowledgments

In addition to the contact named above, Michael Springer, Assistant Director; Bert Japikse; Shirley A. Jones; Lawrence M. Korb; Walter K. Vance; and Bethany C. Widick made key contributions to this report.

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