



# **Internet Access Taxes And Broadband Deployment In America**

*10 Reasons Why The Congress Should  
Support Broadband Deployment  
By Extending The Ban On  
Taxation Of Internet Access*

September 25, 2007  
US Internet Industry Association

**Author:** David P. McClure  
**Publication Date:** September 25, 2007  
**Published by:** US Internet Industry Association  
1800 Diagonal Road  
Suite 600  
Alexandria, VA 22314  
(703) 647-7440 Voice  
(703) 647-6009 Fax  
(703) 851-4784 Mobile  
Info.3@usiia.org  
<http://www.usiia.org>

**Executive Summary:** Shortly after the first gavel fell in the 110th U.S. Senate last January, Senator Ron Wyden (D-OR), along with John McCain (R-AZ) and John Sununu (R-NH) introduced legislation to make permanent the current access tax moratorium on Internet connections, which expires on November 1, 2007. The Permanent Internet Tax Freedom Act would also prohibit double taxation of a product or service bought over the Internet and other discriminatory taxes that would treat Internet purchases differently from other types of sales. This paper addresses the arguments of pro-tax advocates, and offers 10 reasons why the current moratorium on taxation of Internet access, as well as the ban on multiple and discriminatory taxes, should be extended.

**Formed in 1994**, the US Internet Industry Association is the primary trade association for companies engaged in Internet commerce, content and connectivity. USIIA serves its members through legislative advocacy and professional services. The association is headquartered in Washington, DC.

**David P. McClure** is President and Chief Executive Officer of the US Internet Industry Association. A technologist by education and experience, McClure has held positions in the Internet, computing, aerospace and environmental services industries. He is widely published on technical and business topics, and is the author of more than 25 white papers related to Internet and Broadband policy, governance and economics.

© *Copyright 2007, US Internet Industry Association. All rights reserved.*

## Table of Contents

<b>Introduction.....</b>	<b>4</b>
<b>A History of the Tax Moratorium .....</b>	<b>5</b>
<b>Efforts to Circumvent The Law.....</b>	<b>7</b>
<b>Arguments of Pro-Tax Advocates .....</b>	<b>8</b>
<b>10 Reasons To Extend The Moratorium.....</b>	<b>11</b>

## **INTRODUCTION**

Shortly after the first gavel fell in the 110th U.S. Senate last January, Senator Ron Wyden (D-OR), along with John McCain (R-AZ) and John Sununu (R-NH) introduced legislation to make permanent the current access tax moratorium on Internet connections, which expires on November 1, 2007.

The Permanent Internet Tax Freedom Act would also prohibit double taxation of a product or service bought over the Internet and other discriminatory taxes that would treat Internet purchases differently from other types of sales.

"Without this ban, consumers would face upwards of a 17 percent increase in their costs for access to the Internet and businesses would face a barrage of discriminatory taxes," Wyden said in a joint statement with McCain and Sununu.

The Senators were correct. On November 2, America's 75 million students will return to class with a new and stark reality: that the Congress of the United States has enabled massive new taxes on their ability to do learn, do homework and complete their studies over the Internet.

Nor will they be the only victims of this unnecessary and predatory taxation:

- Senior citizens will find that health care, increasingly based on eHealth initiatives conducted over the Internet, will cost more.
- Black Americans and Hispanic Americans, who have just in the past few years bridged the digital divide and begun to enjoy the benefits of connectivity and communication, will be again relegated to the backwaters of society as Internet access is priced beyond their means by new taxes.
- Lower income families – who constitute the largest group of consumers who do not have the means to afford Internet access – will find that access substantially more difficult to achieve.
- Small businesses will find their cost of doing business substantially increased.

- Rural telecommunications companies, already struggling to raise the \$1 trillion<sup>i</sup> needed to bring broadband to America's rural communities, will find the goal to be that much more impossible to achieve.

In all, 100 million American households and one million American businesses will find that their access to broadband – for work, medical care, financial services and communication – will cost up to 30 percent more<sup>ii</sup> as municipalities and states rush to impose new and draconian taxes on the Internet.

This will happen if Congress reverses a decade of sound and effective policy and allows the current federal tax ban to expire through inaction.

This paper examines the foundation on which the ban on taxation of Internet access – the “Internet Tax Freedom Act of 1998” – came into being. It will examine the evidence to date regarding the impact of new and substantial taxes on consumers. And it will propose 10 reasons why a permanent extension of the ban on multiple, discriminatory and Internet access taxes are in the best interests of the nation.

### **THE HISTORY OF THE TAX MORATORIUM**

As the Internet began to grow – and become more critical to the economy of the United States – during the 1990s, so did the efforts of state and local governments to tax Internet access.

Almost as fast as Internet access could be deployed, states rushed in to create new taxes. In Connecticut, it was a Sales and Use Tax; in Hawaii, a General Excise Tax; in New Mexico, a Gross Receipts Tax; in North Dakota a Sales Tax; in Ohio an Electronic Information Services Tax; and so on.

An egregious example of predatory taxation took place in Tennessee, in the case of an online service called The Nashville Connection. While building its service to consumers in the state and rising to become one of the top 20 services of the 8,000 nationwide, the company had requested each year a ruling that they were not required to collect or remit taxes on access.

For seven years, it received a written confirmation that taxes were not to be collected or remitted. But in 1997 the state retroactively changed its policy and demanded seven years of back taxes. When the online service was unable to pay, the state drove it out of business and then announced its intention to target the rest of the state's online services as well.

In 1998, recognizing the importance of universal access to broadband to the future of America and the damage being wreaked on that future by states and localities, the Congress elected to protect Internet access from predatory, multiple and discriminatory taxation by state and local governments through passage of the Internet Tax Freedom Act, now codified as Title XI of Public Law 105-277. This act was a bi-partisan effort based on the Commerce Clause of the U.S. Constitution, which reserves for the federal government alone the right to regulate interstate and international commerce. Twice since, the Congress has re-affirmed its commitment to this goal of universal access to broadband by extending the tax ban.

When ITFA legislation was being considered in the spring of 1998, 10 states and the District of Columbia were applying their sales and use taxes to Internet access. These states asked for and received a stay of execution. This "grandfathering" was not because their taxes were legal or justified, but rather because the states requested time to dismantle their Internet tax laws and replace any revenue they might lose. Today, seven states still impose a sales and use tax on Internet access: New Mexico, North Dakota, Ohio (on businesses only, not consumers), South Dakota, Tennessee, Texas (on monthly charges over \$25), and Wisconsin.<sup>5</sup> In addition, Hawaii levies its general excise tax, New Hampshire its communications services tax (imposed on all two-way communications equipment), and Washington state its business and occupation tax (a gross receipts tax levied on business) on Internet access.<sup>iii</sup>

Nor was the federal government alone. State legislators and governors enacted similar tax bans in many states in the years following the Internet Tax Freedom Act, including two that had been grandfathered in the original legislation. But proponents of taxation have with great regularity and with a variety of strategies attempted to circumvent, overturn, obfuscate and neutralize the American policy of rapid deployment of affordable Internet services through multiple and discriminatory taxes as well as new taxes on basic Internet access and services.

### **EFFORTS TO CIRCUMVENT THE LAW**

Once the Federal and state laws banning Internet access taxes took effect, the nation's 7,500 taxing authorities wasted little time trying to circumvent, redefine or ignore them. Some of the efforts involved lobbying the Congress to overturn the law. But others have been more inventive and far less legal.

By 2003, the Washington Post reported that at least 18 states were collecting taxes on Internet access in violation of the law. Most were doing so by reclassifying DSL broadband service as a telecommunications service subject to telephone taxes rather than the Internet access it is. But others were requiring Internet service providers to pay significant new taxes on the access and bandwidth they needed to serve consumers.

Still other taxing authorities simply pretended the law didn't exist. The most infamous of these cases occurred in Boulder, Colorado. The Colorado Internet Cooperative, a non-profit group that had pioneered Internet deployment in rural areas of Colorado, was presented in 2003 with a bill from the city of Boulder for taxes on their Internet access services. The bill, for nearly \$171,000, was for nine years of back taxes on access.

The city claimed that the Coop must pay taxes not only on the fiber and copper that connects them to the Internet (which the Coop was already paying) but also on the "taxable service" provided in the form of bandwidth and circuit capacity. The city intended this to be a test case

that could be applied to other Internet service providers and businesses. Fortunately, what Boulder attempted to do was deemed illegal under both state and federal law.<sup>iv</sup> The city, however, attempted to circumvent the state and federal laws, offering to drop the tax demand if the Coop agreed to voluntarily submit to such taxes in the future

Nor is the city of Boulder alone. At least one state, Montana, already has a law on the books implementing taxation should the federal law expire or be overturned.

### **ARGUMENTS OF PRO-TAX ADVOCATES**

Since 1998, advocates favoring multiple and discriminatory taxes on the Internet, as well as taxes on Internet access, have put forth a number of arguments in support of their position. These may be broadly classified into five claims:

1. States need the money to maintain essential services.
2. States must have the money to replace revenues lost in other areas.
3. The current Federal tax ban allows some Internet access providers to avoid paying legitimate taxes on other, “bundled” services.
4. Taxing Internet services would have no detrimental impact on the deployment of Internet access in America.
5. The Commerce Clause of the Constitution does not apply because Internet access is provided at the local level.
6. The federal law is an intrusion on State rights.

None of these arguments has withstood even cursory examination.

Because of recessionary pressures in the early 1990s, some states did experience budget shortfalls. But the Congress has provided an increasing level of funding for the states each year to help offset these pressures. Small Business & Entrepreneurship Council Chief Economist

Raymond Keating finds that there has been no revenue shortage flowing to state and local governments as Internet usage has been rapidly expanding. He cites U.S. Census Bureau data showing that state and local government revenues increased from \$1.4 trillion in 1995 to \$2.5 trillion in 2005 – a 78 percent increase, compared to inflation registering 22 percent over the same period.<sup>v</sup>

When states refer to revenues lost, they are generally referring to the taxes that have been collected on telephone services. Beginning in the days when telephone services were localized by community, such taxes may have had validity. And in fact, states have come to rely on these taxes, which have reached as high as 30 percent of the total local telephone bills for some consumers.

But time and telephone technologies are the problem here, not Internet access. As telephone technologies evolved, local exchanges and operators – and even locally-based area codes – have become an anachronism. Today's telecommunications services are not longer local, but rather are based on packetized technologies that supersede regional or national control. Even a simple phone call across a city or county may today be routed through Missouri, Moscow or Mozambique, depending on the most efficient pathway available. It may even be argued that telephone services in the 21<sup>st</sup> Century no longer qualify for state and local taxation, though this is beyond the scope of this paper.

In any event, there is no legal precedent that makes it incumbent upon the Internet to replace taxes lost in other venues.

Nor is the Internet enabling anyone to escape paying legitimate taxes for other services. The language of the original Internet Tax Freedom Act and its two extensions have set only three prohibitions – on multiple taxes, on discriminatory taxes, and on services or products used to access the Internet. To the extent that access is bundled with other services, every effort is made to separate the costs of service where taxes may be due and to remit taxes on non-Internet services.

The claim that taxing the Internet – effectively adding up to 30 percent to the cost of Internet access – is not detrimental is hard to fathom. Like any other commodity, Internet access is price elastic. That is, the willingness of consumers to purchase the product decreases as the cost goes up, particularly among working-class Americans with limited disposable income.

Virtually all studies done to date show that broadband service is highly price-elastic, including the research by the Pew Internet and American Life Project and the seminal 2005 University of Michigan study.<sup>vi</sup> The studies clearly show that income levels are the second leading determinant of broadband access utilization in the US population. Any increase in cost due to taxation would therefore significantly affect broadband utilization. Likewise, small service providers that do not have large internal tax compliance departments would have to bear this as an additional cost, further driving up the cost of their services or driving these competitors out of business.

A 1999 study by the Washington State Department of Revenue is any indication of things to come, small businesses would be hit hardest with respect to the costs of compliance with multi-jurisdiction tax rates. More specifically, a 1999 study by one of the Big 5 accounting firms, Ernst and Young, has estimated the costs of compliance of small businesses to be close to 87 percent of the sales tax they collect--a far greater percentage than the 14 percent of the tax collected that it would cost large businesses to comply. While these costs might be eased by employing various software packages, such software can cost well over \$ 20,000.<sup>vii</sup>

When the Government Accountability Office studied the impact of Internet Taxation in 2006, The US Internet Industry Association noted that GAO's study had failed to consider this substantial additional cost of compliance.<sup>viii</sup> As for considering the impact on the "grandfathered" states, USIIA noted that the sample size was too small to be statistically significant and that the GAO study did not consider the variations between states.

The other oft-quoted study of this matter came from the Center for Business and Research at the University of Tennessee. Proponents claim that this study documents not only the need for access taxes but the lack of detrimental effects on Internet deployment. Unfortunately, this study does neither. In fact, it addresses taxation of goods and services sold over the Internet – a different and unrelated tax matter that should properly be addressed in a different proceeding. It offers little relevant information on the issues of Internet access or the impact of multiple and discriminatory taxes.

More recently the Center for Budget and Policy Priorities has made the claim that the intent of the original Internet Tax Freedom Act was not to prohibit access taxes, but only to give the state and local governments an opportunity to study how best to apply those taxes.<sup>ix</sup> However, there is neither legislative language nor other data to support this assertion.

As to the other claims relating to states rights or the applicability of the Commerce Clause of the Constitution, one need only review the considerable body of case law at levels from the federal district courts to the US Supreme Court, which have consistently held that the power to tax interstate commerce rests with the Congress.

## **10 REASONS TO EXTEND THE MORATORIUM**

In 2007, Congress has a choice. It can renew the Internet Tax Freedom Act and its two successor bills or allow it to expire. But the new taxes that could be imposed by multitudes of jurisdictions in the event of expiration, would drive up the cost of Internet access and undermine the national goal of universal broadband adoption. There are 10 reasons why this must not be allowed to happen:

1. **Taxation of Internet access would clearly harm deployment of broadband Internet in the United States.** The majority of research, including studies by Ernst & Young and the University of Massachusetts, show that takeup of Internet access services is price-elastic.

As the cost goes up, families are increasingly unable to afford Internet access. And taxation of the Internet would clearly make the costs go up substantially.<sup>x</sup>

2. **Taxation of Internet access would critically wound small businesses.** Adding up to 30 percent to the cost of Internet access (based on similar taxes on other telecommunication services) would not only directly affect the ability of small companies online, it would subject them to substantial costs of compliance for more than 7,500 individual taxing authorities. The burden would be even greater should some state or local tax authorities impose retroactive taxes. The burden of retroactive taxes potentially going back a decade or more would drive many small businesses out of business. Other small companies would be forced to curtail their Internet access, limiting their ability to participate in the emerging global economy.
3. **Taxation of Internet Access would harm school children, seniors, minorities and working families.** Studies by the Pew Internet and American Life Project clearly document the gains made by these groups since the initial tax moratorium was passed in 1998. Allowing the moratorium to expire would reverse these gains. Particularly among minorities and working families, taxing Internet access would make it increasingly difficult for them to join in the benefits of the 21<sup>st</sup> Century American economy.
4. **Sales taxes are currently collected on electronic commerce and would not be affected by extension of the moratorium.** Those who want the federal moratorium lifted engage in two deceptions: claiming that the moratorium prohibits taxation of sales over the Internet, and claiming that tens of billions of dollars will be lost to the states as a result. The moratorium covers only multiple, discriminatory taxes and those on Internet access. Sales taxes on e-Commerce are not affected by this legislation, and even efforts to document hypothetical losses are subject to widespread debate – while estimates of revenues lost because states do not collect taxes on electronic commerce are estimated to be as much as \$35 billion in 2008,<sup>xi</sup> the Direct marketing Association says these figures are overblown and that real losses will amount to only \$4.5 billion by 2011.<sup>xii</sup>

5. **By reducing online commerce, an end to the moratorium would cut state sales tax revenues.** A cut in broadband adoption or even a slowdown in the rate of growth because of new Internet taxes would reduce sales taxes on online commerce. Thus any state revenue gains from new Internet taxes would be partly offset by a loss in state sales taxes. Opponents of the moratorium ignore this likely effect in their analyses.
6. **Taxing Internet Access Will Diminish Economic Benefits of Broadband.** The growth of broadband Internet access is delivering enormous economic benefits to every state and jurisdiction. A June 2007 study by the Brookings Institution estimates that each percentage point increase in broadband adoption adds more than 290,000 jobs to the U.S. economy. This job growth also boosts economic growth generally and generates additional tax revenue that would be lost if new taxes on Internet access by slowing or reversing the spread of broadband in the United States.
7. **This legislation merely extends existing policy that has helped fuel rapid growth in broadband.** The bill targets specific kinds of taxes – those for multiple taxes on the same service, those for taxes that discriminate against Internet services over bricks-and-mortar services, and those that seek to tax Internet access. It maintains the status quo. It does not seek new rights, it does not extend the ban to services other than Internet access, and it does not alter key definitions to the detriment of the states.
8. **There is no need for more study of the issue.** That’s already been done, under the original Internet Tax Freedom Act. The Advisory Commission on Electronic Commerce was convened under the Act and headed by Virginia Governor James Gilmore. That panel gave a majority opinion that the moratorium was justified and should be extended, with Chairman Gilmore noting that, “In the end, my fundamental belief in the Internet to empower citizens as consumers and entrepreneurs and the failure of pro-tax advocates to demonstrate a real need for additional tax revenues led me to conclude that the Internet should remain tax free.”<sup>xiii</sup> The commission’s work on taxation of Internet access has been confirmed by every major academic study conducted since.

9. **Under the Constitution, the right to tax Interstate Commerce belongs solely to the federal government.** Contrary to tax proponents' claims, the issue is not "states rights," but the ability of Congress to promote a vibrant national economy that benefits all Americans. Because the Founding Fathers recognized the harmful impact that patchwork regulation and taxation could impose on goods that moved across state lines, Section 8 of the U.S. Constitution clearly assigns the right to regulate and tax interstate commerce to the Federal Government. The Internet, a global medium that crosses all borders, clearly fits the definition of interstate commerce.
10. **Taxing the Internet is directly contrary to long-standing U.S. policy.** Recognizing the benefits of a strong global economy over the Internet, presidents Clinton and Bush have both supported a ban on Internet taxes and have called on other countries not to impose their own taxes. For more than a decade, we have encouraged our trade partners and other nations to stand firm against such taxes because they unnecessarily act to the detriment of the all nations. This policy extends equally well to the states and protectorates of the United States.

As it has for the past decade – passing by overwhelming majorities in both the House and Senate – this issue enjoys widespread support by both parties. It is also supported by representatives of consumers, industry, many state governors and legislators, regulators, the current administration, and the leadership of Congress. It is legislation that deserves immediate attention and passage.

## **End Notes**

---

<sup>i</sup> “Next Generation Networks,” ABI Research, February, 2007, at [http://www.abiresearch.com/products/research\\_brief/Wireless\\_Infrastructure\\_Research\\_Briefs/106](http://www.abiresearch.com/products/research_brief/Wireless_Infrastructure_Research_Briefs/106)

<sup>ii</sup> Based on compilation of state, county and local taxes currently applied to telephone bills in jurisdictions such as Richmond, VA.

<sup>iii</sup> Cybrary analysis at <http://www.vertexinc.com>

<sup>iv</sup> “Internet Tax Simplification: Is It Really That Simple?,” 2003, at <http://www.netcaucus.org/events/2003/tax/onepaggers/usiia-tax2003.pdf>

<sup>v</sup> “Click and tax? Nov. 1 Deadline Could Open Internet to New Taxes,” at <http://www.foxnews.com/story/0,2933,296601,00.html>

<sup>vi</sup> <http://web.si.umich.edu/tprc/papers/2005/485/Broadband.pdf>

<sup>vii</sup> Comments of Commissioner Orson Swindle, Federal Trade Commission, "Policy Perspectives on the Taxation of Cyberspace Conference on E-Commerce: The Law of E-Business," May, 2000

<sup>viii</sup> USIIA Comments on GAO Study of Internet Deployment, 2006, at <http://www.usiia.org>

<sup>ix</sup> “The Internet Tax Freedom Act and the "digital divide," Center on Budget and Policy Priorities, 2007

<sup>x</sup> Sidak, Crandall and Singer, “The Empirical Case Against Asymmetric Regulation of Broadband Internet Access,” Berkeley Technology Law Journal, Vol. 17, No. 3, pp. 953-987

<sup>xi</sup> “State and Local Tax Revenue Loses From e-Commerce,” Bruce and Fox, University of Tennessee, July, 2004

<sup>xii</sup> “DMA: E-Commerce Overblown, and Shouldn't be Taxed,” at [http://directmag.com/news/marketing\\_dma\\_ecommerce\\_overblown/](http://directmag.com/news/marketing_dma_ecommerce_overblown/)

<sup>xiii</sup> Comments of Governor James Gilmore, “Report to Congress,” Advisory Committee on Electronic Commerce, April 3, 2000