

**The Internet Tax Debate:
Promoting the Democratic Potential of the Internet
in an Environment of Convergence and Broadband Access**

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In 1998, in order to promote expansion of Internet access, Congress prohibited state and local governments from imposing new taxes on Internet access. Without controversy, Congress extended the moratorium in 2001 for 2 years. In 2003, controversy erupted when Congress began consideration of the Internet Tax Nondiscrimination Act, legislation that would make the ban on Internet access taxes permanent. After speedy and bi-partisan House approval, Senate passage was blocked, the moratorium expired, and consumers face the prospect of new taxes being added to their Internet access bills.

Since 1998, there have been major changes in the way users access the Internet, and major changes in the Internet itself. The tax prohibition was first enacted when the Internet was accessed mainly through dial up modems of limited capacity. Now cable modem and digital subscriber line (DSL) technologies offer paths to the broadband Internet. Also, in the past there was a fairly clear distinction between telecommunications services and telecommunications carriers, on the one hand, and Internet access and Internet service providers on the other. Now, many telecommunications carriers also offer Internet access, as do most cable companies. And Internet service can now be used for voice communications.

Confronting these changes, Congress has been seeking in the current tax debate an approach that is technology neutral, one that would apply to DSL and other new broadband access technologies just as it did to narrowband Internet access. At the same time, Congress is sensitive to the needs of the states, many of which face budget crises and have used taxes on telecommunications services as a major source of revenue, especially in recent years.

The Center for Democracy and Technology is dedicated to the promotion of the Internet as a medium uniquely suited to democratic participation, human interaction, innovation and creativity. The Internet uniquely supports diversity of viewpoints. It is a global medium, without gatekeepers, where anyone can be a publisher and where communities of interest can readily form and make their voices heard. CDT has long argued that the democratic potential of the Internet will only be realized with broad and affordable access. It has been our position that

government policies can extend the Internet to a broader cross-section of the population by encouraging the development of new and affordable access options. In the late 1990s, CDT supported policies that would keep Internet access affordable. We have consistently opposed imposing barriers to Internet use that would stifle innovation and the growth of the medium. In 1997 comments filed at the FCC, we stated “Internet users need more choices . . . in the market for the basic telecommunications components of Internet access in order to maintain affordable, higher-bandwidth methods of access to the network.” We noted at the time that affordability was one of the key objectives of Internet policy.

During the period that the Internet access tax moratorium was in place, Internet access expanded significantly. As the Senate Commerce Committee report notes, in 1998, when the tax moratorium was first enacted, 26.2 percent of US households had Internet access. By 2001, prior to the renewal of the ban for two years, 50.5 percent of households had access, and by 2002, that number was 64 percent, more than double the rate at the time the moratorium was first enacted.

While the moratorium has helped spur the growth of the Internet, the Internet still lags behind other technologies, including telephone and cable TV. Moreover, the Internet is transitioning to broadband, which offers much wider range of content and much more dramatic potential for a range of activity, but at higher prices. There is a concern that a digital divide will emerge not only between those with Internet access and those without it, but also between those who can take advantage of the much greater potential of the broadband Internet and those who are left behind with only narrowband. Thus, considerations similar to those that were at stake in 1998 apply today. There is a public interest in supporting the deployment of broadband Internet access with its wider range of applications. To let the moratorium expire now would impose new costs on Internet users, just at the time they are looking to take advantage of the Internet’s expanded potential. To continue with short-term extensions would deprive investors and innovators of the certainty they deserve in making business plans.

The Legislation

The permanent extension of the Internet access tax moratorium quickly passed the House last year on a voice vote, but has been stalled in the Senate, where there are now two competing measures. There is widespread agreement that there should be a prohibition on state and local taxes on Internet access. The central disputes are over the scope of the prohibition and its duration.

The original tax moratorium applied to Internet access service, defined as follows:

“The term ‘Internet access service’ means a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to consumers. ***Such term does not include telecommunications services.***”

On the current round, the House bill and its Senate companion, S. 150 as reported by committee, amended the last sentence in that definition to read as follows:

Such term does not include telecommunications services, except to the extent such services are used to provide Internet access.”

This was intended to put telephone companies’ DSL offerings on the same footing as dial-up Internet access and high speed access by cable and other means. (Cable Internet access had never been subject to taxation.) Telephone companies logically argued that they were now competing with ISPs and cable companies to offer Internet service and that their Internet access services should compete on a level field, with the same tax status as the offerings of ISPs and cable companies. State and local governments argued that the exception clause in the House bill would preclude any taxation of traditional telecommunications services, since even plain old telephone service is “used to provide Internet access.”

Senate supporters of S. 150, the companion to the House bill, have compiled a “Managers’ Amendment” to clarify that nothing in the bill is intended to preclude traditional telecommunications taxes and to respond in other ways to the concerns expressed by state and local governments. The Managers’ Amendment is now the relevant text of S. 150. The Managers’ Amendment would clarify the exception clauses of the definition of Internet access service to read as follows:

“The term ‘Internet access service’ 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 Managers’ Amendment goes a step further and adds an accounting rule that makes it clear that Internet access can be taxed if it is commingled or bundled with telecommunications services in a way that precludes separating out the telecommunications services:

“If charges for Internet access are aggregated with and not separately stated from charges for telecommunications services or other charges that are subject to taxation, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business.”

This also makes it clear that, if the Internet access and telecommunications elements of a service fee can be separated out, then the state can tax the telecommunications portion.

The opposing Senate proposal is S. 2084, which would extend the existing moratorium on Internet access taxes for two years and grandfather existing dial-up and DSL taxes. The sponsors of S. 2084 state that they also want to expand coverage of the moratorium to include consumer DSL. Their bill would amend the second sentence of the definition of Internet access service to read as follows:

“The term ‘Internet access’ does not include telecommunications services, except

to the extent such services are purchased, used, or sold by an Internet access provider to connect a purchaser of Internet access to the Internet access provider.”

S. 2084 would deny the tax exemption to business-to-business backbone transactions, an issue that has been contested under the original moratorium.

Side-by-side comparison of the two proposals	
Managers' Amendment to S. 150	Alexander-Carper, S. 2084
Makes permanent the moratorium on taxation of Internet access	Extends the moratorium on taxation of Internet access for two years, subject to the grandfather clause that leaves taxes in effect in about 10 states on dial-up access
Provides a definition of Internet tax that would include consumer “end user” taxes on IPSs and DSL as well as other broadband services	Expands the coverage of the current Internet access tax moratorium to consumer DSL, but subject to the grandfather clause that leaves taxes in place on DSL in a significant number of states
Precludes taxes on business-to-business transactions involving access to the Internet “backbone”	Permits taxes on business-to-business transactions related to access to the Internet backbone, including “sale for resale” transactions
Prohibits multiple or discriminatory taxes on electronic commerce	
Provides a three-year sunset for jurisdictions that were allowed to impose taxes on Internet access under a “grandfather” clause in the prior law	Allows those jurisdictions that taxed DSL prior to November 2003 to continue to do so; allows jurisdictions that taxed dial-up Internet access prior to October 1, 1998 to continue to do so
Clarifies that the term “tax on Internet access” does not include taxes based on net income, capital stock, net worth or property value	Same
Makes explicit that the Act has no effect on universal service, taxes related to E-911, or federal or state regulatory proceedings unrelated to taxation	Same

CDT Analysis

At the outset, it should be emphasized that the Internet tax debate is arising in part because of the success of communications policies put in place over the course of the past decade – policies that have resulted in a diversity of service providers, technical innovation, increased

competition, innovation and falling access prices for consumers. The communications landscape is a lot more complicated than it was ten years ago – and that is a very good thing. The fact that the Internet tax debate, having been relatively non-controversial for years, is now so contentious is because both incumbent telephone carriers and state tax authorities are having to cope with radically changed landscapes. On the whole, however, that landscape is much richer and more fulfilling for consumers, and policymakers should be very hesitant to abandon policies that helped promote those changes.

One of the more important issues in the debate is the treatment of DSL. Supporters of both the Managers' Amendment and the competing S. 2084 agree that DSL charges should be exempt from tax, but the grandfather clause in S. 2084 protects taxes imposed on DSL in a significant number of states.

The Managers' Amendment seems to respond to the states' concern that the House bill is too broad by making it clear that telecommunications services bundled with Internet services are not exempt from tax. Indeed, if the company's bill does not distinguish between a telecommunications service and Internet access, then the whole service is taxable. Thus, states can continue to tax the telecommunications component of a DSL line. If the Internet access and telecommunications elements of a service fee can be separated out, then the state can tax the telecommunications portion. Telephone companies interested in providing their customers with the lowest cost service presumably would find it beneficial to separate the charges, so only the telecommunications portion would be taxed. But in no case does the telecommunications portion of a DSL service escape taxation.

The Managers' Amendment makes explicit that the permanent moratorium does not cover taxes based on the income of service providers or their capital stock net worth, nor does it affect property taxes. It does not impact universal service contributions, taxes related to E-911 or federal or state regulatory proceedings unrelated to taxation.

Another important issue in the debate is "grandfathering." The Managers' Amendment would phase out all state taxes. S. 2084 would protect many state taxes, including the taxes of a number of states that have imposed taxes on DSL. (As noted, the Managers' Amendment would allow taxes on any segregated (or segregable) portion of a DSL charge that represents the line itself.)

There are very difficult policy issues to be decided outside the Internet access tax debate. The 1996 distinction between telecommunications services and information services may need to be revisited by Congress. There is an ongoing process to develop a simplified sales tax that will resolve tax issues associated with both telephone and online mail order sales of goods and products across state lines. But those issues should be separated from the question of taxation of Internet access services, and nothing in the Managers' Amendment would prejudge any of them. S. 150 also does not prejudge questions about whether VoIP is a "telecommunications service" for purposes of the Telecommunications Act or even for purposes of the tax moratorium. Even as S.150 is being implemented, issues surrounding the status of emerging VoIP services will need to be sorted out in the states, in state and federal courts, at the FCC and possibly in

Congress. It is impossible to achieve a one-size-fits-all regulatory categorization of VoIP, and the Internet access tax debate should not be held up for that.

Conclusion

A permanent tax moratorium is important to continued health and growth of the medium as a forum for commerce, education, research and political discourse. (Nothing, of course, is ever permanent legislatively. While S. 150 seeks to make the moratorium permanent, Congress is not precluded from revisiting the issue of taxation should the need present itself.) In the meantime, the Internet access tax moratorium has expired, leaving Internet users exposed to new taxes, at the very time they are eager to take advantage of new broadband services. Those taxes could make the difference, putting Internet access out of the reach of many and slowing the deployment of new broadband technologies.

While the Center for Democracy and Technology has not been actively engaged in the current public policy debate on Internet access taxes, CDT strongly supported the original Internet access tax moratorium and continues to believe that a ban on Internet access taxes is vital to the continued economic growth and social value of the medium. CDT is concerned that the Internet access tax moratorium has expired and believes that the Internet Nondiscrimination Act should be enacted immediately.

The Managers' Amendment to S.150 responds to the central concerns that have been expressed about the moratorium. It provides a clear accounting rule to distinguish between Internet access and telecommunications services when such services are aggregated (thereby protecting the government's revenue when a customer takes up DSL on her only line); and it clarifies that the Act has no effect on universal service contributions, taxes related to E-911 or federal or state regulatory proceedings unrelated to taxation. It continues the current grandfather clause contained in the 1998 moratorium for three more years for jurisdictions that taxed tax Internet access prior to 1998.

CDT acknowledges that opponents of S.150 have tried to move the debate forward with the introduction of a bill that will extend a moratorium for two years. But S. 2084 does not adequately protect the interests of Internet consumers. Putting off the resolution of this debate for two more years will create uncertainty over the future of the Internet access tax ban and could thus discourage investment and innovation in the sector.

For more information: James X. Dempsey, jdempsey@cdt.org, or Paula Bruening, pbruening@cdt.org (202) 637-9800