



**CONGRESSIONAL BUDGET OFFICE
INTERGOVERNMENTAL MANDATES STATEMENT**

March 25, 1998

H.R. 1054

Internet Tax Freedom Act

As approved by the Subcommittee on Telecommunications, Trade, and Consumer Protection of the House Committee on Commerce on October 9, 1997

SUMMARY

By prohibiting the collection of certain state and local taxes, H.R. 1054 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act of 1995 (UMRA). CBO estimates that the direct costs of this mandate would exceed the statutory threshold established in UMRA.

INTERGOVERNMENTAL MANDATES CONTAINED IN BILL

H.R. 1054 would place a moratorium on certain state and local taxes on Internet access service, online services, and communications or transactions using the Internet or online services. The moratorium would remain in effect for six years or until four years after the President submits recommendations to the Congress, whichever is longer.

ESTIMATED DIRECT COSTS OF MANDATES TO STATE, LOCAL, AND TRIBAL GOVERNMENTS

Is the Statutory Threshold Exceeded?

CBO estimates that the direct costs of the mandate in the bill would exceed the threshold for intergovernmental mandates (\$50 million in 1996, indexed annually for inflation) at some point during the first five years of the moratorium. CBO is uncertain exactly which of the taxes that states and localities currently levy on Internet-related communications, transactions, and services would be covered by the moratorium imposed by H.R. 1054. However, because at least one significant state revenue source—taxes on internet access

service and online services—would clearly be affected and several others might be affected, CBO estimates that the moratorium would cause revenue losses that would exceed the statutory threshold.

Total Direct Costs of Mandates

UMRA includes in its definition of the direct costs of a federal intergovernmental mandate the amounts that state, local, and tribal governments would be prohibited from raising in revenues in order to comply with the mandate. The direct costs of the mandate in H.R. 1054 would be the tax revenues that state and local governments would be precluded from collecting because of the moratorium.

H.R. 1054 would temporarily prohibit state and local governments from taxing: access to, or use of, the Internet or online services; the transmission or communication of data by or through the Internet or online services; the use or consumption of data acquired through or accessed via the Internet or online services; and transactions that occur through the Internet or online services.

State and local governments could continue to tax these activities if the tax fell into one of the following categories of taxes:

- taxes imposed on or measured by net income, gross volume of business, or capital stock,
- fairly apportioned business license taxes imposed on businesses having a physical presence in the taxing jurisdiction,
- property taxes,
- taxes imposed on a provider or Internet or online services as a consumer of goods or services,
- taxes imposed on common carriers or other telecommunications carriers,
- franchise fees imposed on cable television companies, and
- sales, use, or other transaction taxes that are also imposed and collected "in the case of similar sales or transactions not effected by use of the Internet or online services."

Many current state and local taxes would fall within one of the categories preserved by the bill. Other taxes would clearly be subject to the moratorium, such as taxes on the monthly charges for Internet access or online services. Still other taxes do not fit neatly in any of the categories. These taxes include business activity taxes on Internet-related revenues and

transaction taxes on information and data processing services. As described below, CBO cannot predict whether this last group of taxes would be suspended under the bill's moratorium.

It is possible that, in the absence of this legislation, some state and local governments would impose new taxes or decide to apply existing taxes to Internet-related services and transactions during the next five years. (UMRA requires CBO to estimate the direct costs of a mandate for the first five years that it is effective.) It is also possible that some governments would repeal existing taxes or preclude their application to these services and transactions. Such changes would affect the ultimate cost of the mandate but are extremely difficult to predict. Therefore, for the purposes of preparing this estimate, CBO considered only those taxes that are currently in place.

BASIS OF ESTIMATE

The moratorium in H.R. 1054 would affect some taxes currently collected by state and local governments. For the purposes of preparing an estimate of those potential losses, CBO gathered information from 25 states and from interest groups representing both state governments and the industries that would be affected by the bill.

Taxes That Would Be Subject to the Moratorium

Taxes on Internet Access Service and Online Services. H.R. 1054 would prohibit states from imposing sales, use, or other transaction taxes on the fees charged by providers of Internet access service or online services. These taxes do not fall within a category of taxes specifically preserved by the bill. CBO has identified 12 states nationwide that currently impose such taxes. (Some localities in those states also tax these services.) Half of these states tax these services as information or data-processing services; the other half tax them as telecommunications services.

In general, states could not provide definitive estimates of their tax revenues because many providers of these services also provide other taxable services and remit their tax collections to the states as one sum. In addition, the industry is growing so quickly that previous years' collections are not very useful for estimating present or future collections. Based on the information that states could provide and on national market data, CBO estimates that 1997 revenues for the 12 states and various localities that currently collect these taxes were close to \$50 million. Given the rapid growth in the industry, these revenues are likely to grow in

coming years as more households and businesses decide to purchase access to the Internet and online services.

Taxes That Might Be Subject to the Moratorium

Taxes on Business Activity. A broad reading of the bill would include in the moratorium state and local business activity taxes, such as corporate income taxes or franchise taxes. Section 3 of the bill would preserve these taxes, but only if the tax "is the same as the tax generally imposed and collected in the case of all other business entities in that State or political subdivision thereof..." and is not discriminatorily imposed. Very few, if any, taxes are imposed on or collected by all business entities in a state. For example, many states' corporate income taxes do not apply to business entities such as partnerships or S corporations.

Read literally, section 3 would preserve very few business activity taxes. Assuming that the scope of the moratorium would be broad enough to capture such taxes in the first place, Internet-related businesses and online service providers could be effectively exempt from many states' corporate income taxes, franchise taxes, or gross receipts taxes. States were unable to provide CBO with data sufficient to estimate possible revenue losses from this provision. However, CBO expects that revenue losses could be significant as electronic commerce grows in popularity.

In addition, H.R. 1054 might prohibit the collection of state value-added taxes from Internet-related businesses. Both Michigan and New Hampshire have this kind of business tax. While it could be argued that the moratorium would not apply to this type of tax, the bill explicitly attempts to preserve similar business taxes like corporate income and franchise taxes. A company could argue that if value-added taxes were meant to be preserved, they would have been listed with the other taxes in the bill. CBO cannot predict how courts would respond to such an argument, and therefore cannot estimate whether these two states would lose any revenues. Fiscal year 1997 revenues from these two taxes were about \$2.4 billion, but only a small portion of these revenues would be at stake.

Taxes on Information and Data Processing Services. CBO cannot predict exactly how H.R. 1054 would affect sales, use, or other transaction taxes on information services or data processing services that are provided via the Internet or online services. For decades, companies have provided these services by allowing customers to connect directly to the companies' computers by modem. It is increasingly common, however, for firms to also provide these services over the Internet. In some cases, the companies are completely Internet-based.

A 1996 survey by the Federation of Tax Administrators identified 15 states that levy a sales, use, or other transaction tax on information and data processing services. Some of those states also allow localities to levy an additional sales tax on these same services. Of those states and localities, three states and one major city were able to provide estimates of their revenue from these sources. The 1997 revenues for these four jurisdictions alone totaled between \$35 million and \$45 million. As with Internet access and online services, the market for information and data processing services provided over the Internet is growing quickly, and state tax revenues from this market are likely to follow suit. Some portion of future revenues could be interrupted by the bill's moratorium.

If H.R. 1054 were enacted, states and localities, in order to preserve these revenues, would have to show that they tax the sales or use of information services provided via the Internet the same way that they tax "similar" sales or uses not effected by the Internet or online services. CBO expects that litigation would be required to determine which state and local taxes meet this criterion. For example, a state that levies a sales tax on the subscription that a customer pays to access news or financial information at an Internet site could argue that the tax is preserved because the tax also applies to computer-based information services that are not delivered via the Internet. However, the information provider could argue that its product is more similar to newspapers and magazines, which may not be subject to tax in the state. CBO has no way of predicting the outcome of such disputes.

APPROPRIATION OR OTHER FEDERAL FINANCIAL ASSISTANCE PROVIDED IN BILL TO COVER MANDATE COSTS

None.

OTHER IMPACTS ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

None.

PREVIOUS CBO ESTIMATE

On June 18, 1997, CBO completed an intergovernmental mandates statement for S. 442, as introduced. In that estimate, we determined that the direct costs of the intergovernmental mandate would likely exceed the statutory threshold.

On January 21, 1998, CBO completed a cost estimate for S. 442, as ordered reported by the Senate Committee on Commerce, Science, and Transportation. That version of the bill was narrower in scope, but CBO could not determine whether the direct costs of the intergovernmental mandate would exceed the threshold established in UMRA.

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