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INTERNET ACCESS TAX MORATORIUM

Revenue Impacts Will Vary by State

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Highlights of GAO-07-896T, a testimony before the Committee on Commerce, Science and Transportation, U.S. Senate

May 23, 2007

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Revenue Impacts Will Vary by State

Why GAO Did This Study

According to one report, at the end of 2006, about 92 million U.S. adults used the Internet on 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. The objectives of the resulting 2006 report were to determine the scope of the moratorium and its impact, if any, on state and local revenues. This testimony is based on that report (GAO-06-273).

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

What GAO Recommends

GAO makes no recommendations in this testimony.

www.gao.gov/cgi-bin/getrpt?GAO-07-896T.

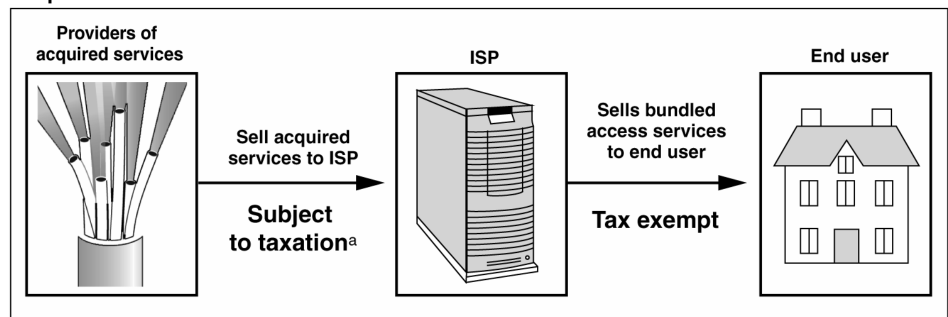
To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

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 GAO when it was preparing its report that 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.

Chairman Inouye, Vice Chairman Stevens, and Members of the Committee:

I appreciate this opportunity to discuss the moratorium on taxing access to the Internet. According to one study, at the end of 2006 about 92 million U.S. adults used the Internet on 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 provided by cable modem service or by a telephone technology known as digital subscriber line (DSL).[4] This year, bills have been introduced in both houses of Congress to make the moratorium permanent.

My remarks today are based on the first of two reports we issued responding to the mandate that we study the impact of the moratorium. Issued in January 2006, that report focused on the moratorium's impact on state and local government revenues.[5] Its objectives were to determine (1) the scope of the moratorium and (2) the impact of the moratorium, if

[1]Pew Internet & American Life Project, *Daily Internet Activities* (Washington, D.C.: Jan. 11, 2007).

[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).

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

[5]GAO, *Internet Access Tax Moratorium: Revenue Impacts Will Vary by State*, GAO-06-273 (Washington, D.C.: Jan. 23, 2006). See the report for more details than this testimony provides about revenue impacts and for more appendixes, including one showing comments from telecommunications industry officials.

any, on state and local revenues. In determining any impact on revenues, the report explored 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. The report did not focus on taxing the sale of items over the Internet. A second report discussed the impact that various factors, including taxes, have on broadband deployment and adoption.[6]

To prepare the first 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 testimony contains a complete discussion of our objectives, scope, and methodology.

Let me begin by summarizing the major points of the report:

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,

[6]GAO, *Telecommunications: Broadband Deployment Is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas*, GAO-06-426 (Washington, D.C.: May 5, 2006).

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 when we were preparing our report that 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.

In oral comments on a draft of our January 2006 report, CBO staff members said we fairly characterized CBO information and suggested clarifications that we 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 the appendix, we believe that what is bundled must be reasonably related to accessing and using the Internet. In written comments, company representatives disagreed with GAO by commenting 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.

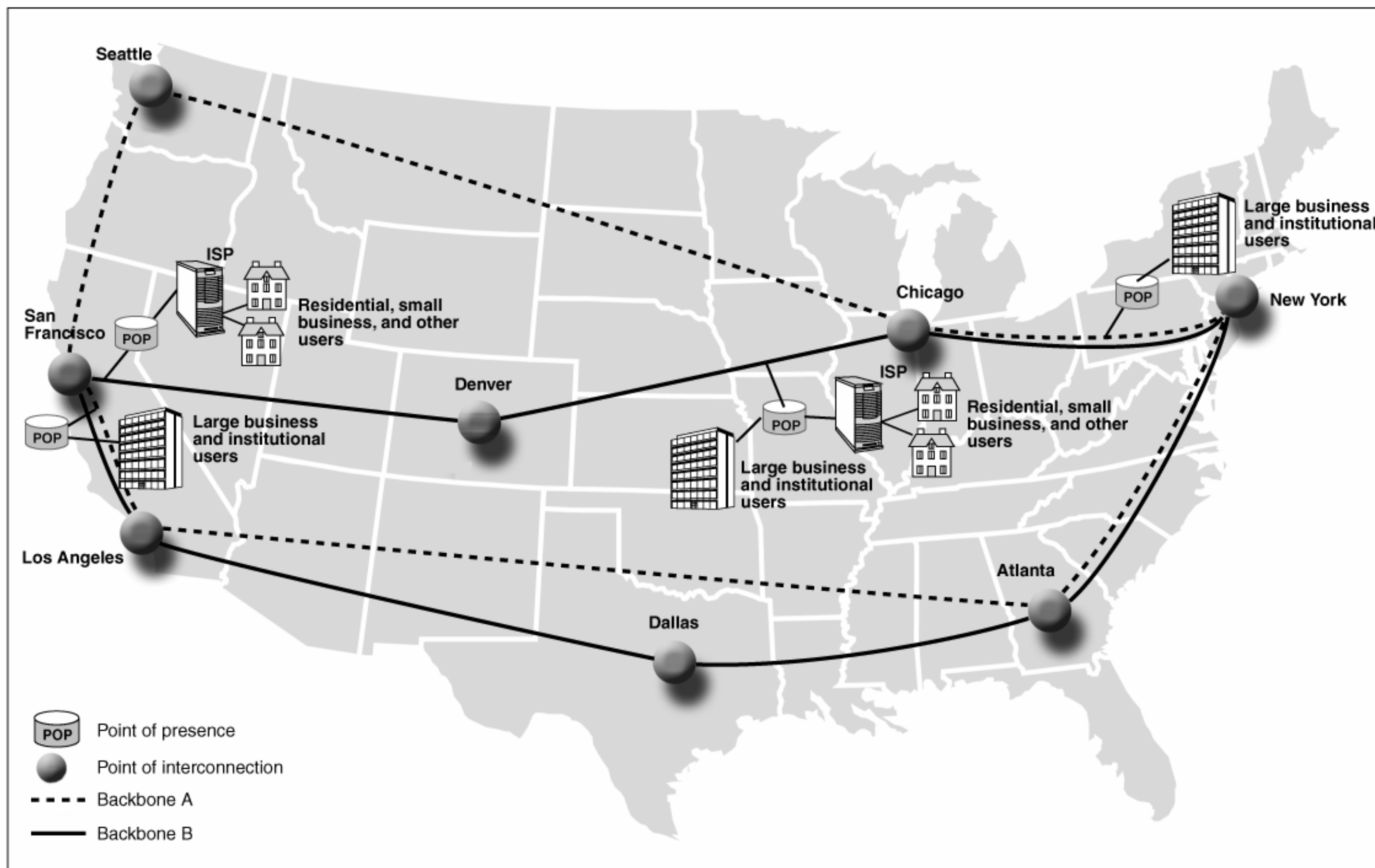
We made no recommendations in the report, and we are not making any recommendations in this testimony.

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.[7]

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[8] and again in 2004, retroactively, to remain in force until November 1, 2007.[9] 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. Recognizing state and local concerns about their ability to tax voice services provided over the Internet, it also contained language allowing

[7]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 have 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 did not focus on taxing the sale of items over the Internet.

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

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

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

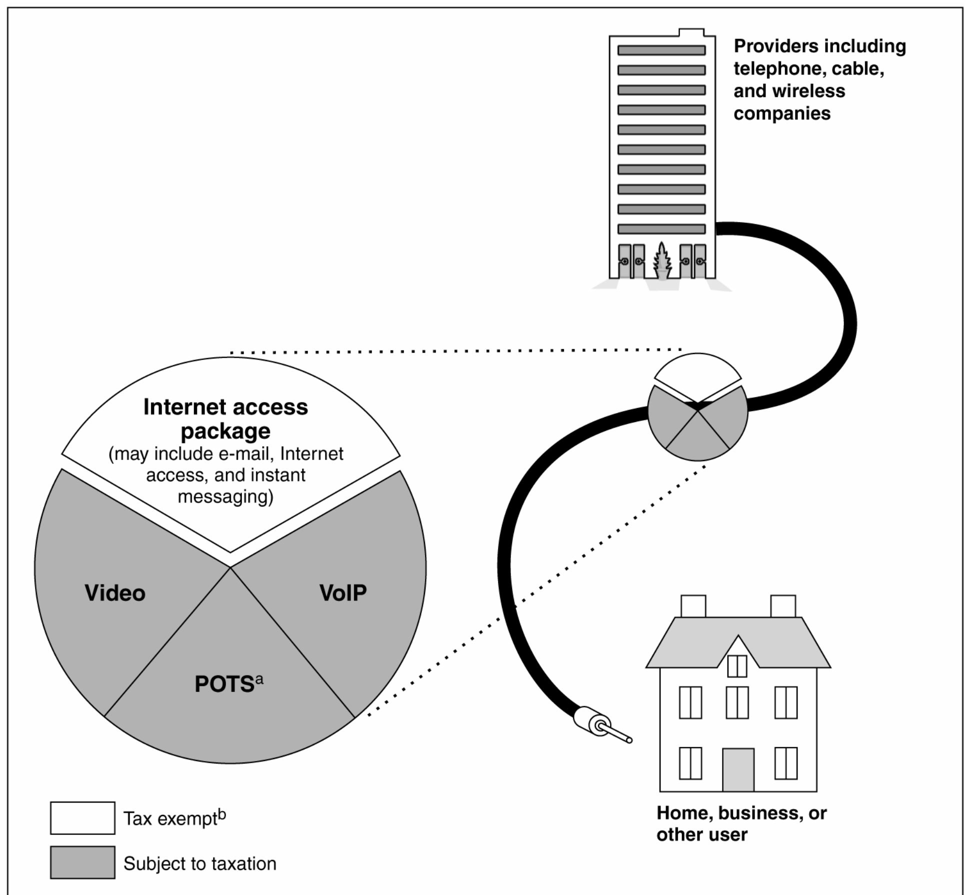
Since its 1998 origin, the moratorium has always prohibited taxing the service of providing Internet access, including component services that an access provider reasonably bundles in its access offering to consumers. However, as amended in 2004, the definition of Internet access contains additional 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*."[10] (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.

[10] 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).

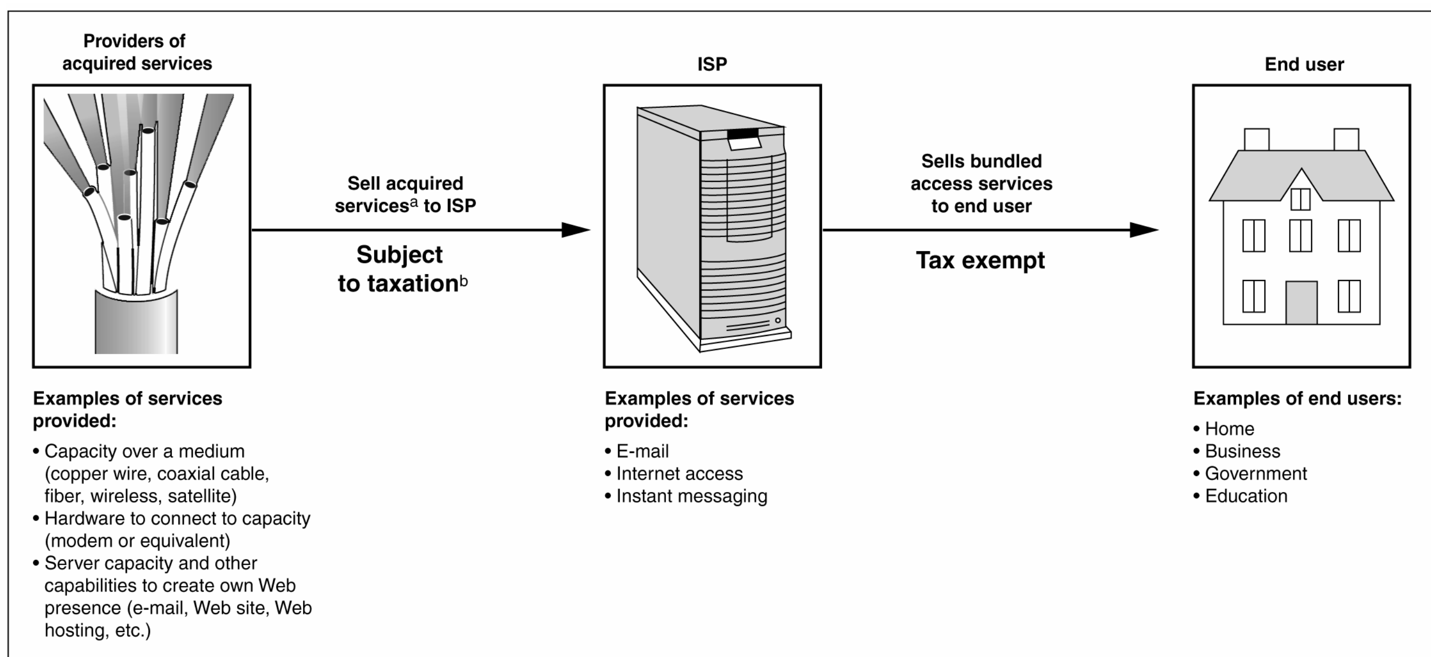
[b]May become taxable if not capable of being broken out from other services on a bill.

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 the appendix 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."[11] 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.

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.

[11]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.

[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 the appendix. 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
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.[12]

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.

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

[12]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.

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.

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. In this state 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.

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.[13] 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.

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 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.

[13] 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.

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.

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 providers disagreed on how state laws applied to the providers.

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.

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 testimony, 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 January 2006 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 made as appropriate. In one case, we 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 the appendix, 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. 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 the appendix. That appendix, along with the section of the testimony on bundled access services and acquired services, contains an explanation of our view that the language and structure of the statute support our interpretation.

Mr. Chairman, Mr. Vice Chairman, and Members of the Committee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contacts and Acknowledgments

For further information, please contact James R. White on (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 testimony. Individuals who made key contributions to this testimony include Michael Springer, Assistant Director; Edda Emmanuelli-Perez; Lynn H. Gibson; Bert Japikse; Shirley A. Jones; Lawrence M. Korb; Donna L. Miller; Walter K. Vance; and Bethany C. Widick.

Appendix I: 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.

The original definition of Internet access, exempting "telecommunications services," was changed by the 2004 amendment. Parties seeking to carve

[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."

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.

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

[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).

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, 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

[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.

[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.

"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.

"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.

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