

A PERMANENT INTERNET TAX FREEDOM ACT: HARMFUL AND UNWARRANTED Michael Mazerov, Senior Fellow, mazerov@cbpp.org

The Adverse Impacts on State and Local Governments of a Permanent ITFA

Making ITFA permanent and eliminating the grandfathering of existing taxes on access could make it difficult for states and localities to continue to secure revenues needed to fund health care, education, public safety, and other critical services:

Eliminating the grandfather clause could invalidate a wide array of general, broad-based state and local taxes currently paid by companies providing Internet access. ITFA's definition of "taxes on Internet access" includes taxes imposed on *providers*, not just consumers. These companies could take the position that they are exempt from a wide variety of taxes that other businesses have to pay — such as sales taxes on computer servers or unemployment taxes — because they would constitute *indirect* taxes on Internet access. ITFA's grandfather clause (which S.156/H.R. 743 would eliminate) currently blocks such a claim, because it preserves all taxes on providers that were in effect prior to 1998.

The extremely broad definition of "Internet access" in ITFA could encompass virtually all goods and services delivered over the Internet, and threaten states' and localities' ability to extend conventional sales taxes to online music, movies, games, television programming, and similar products. Many of these services — for example, music-streaming and online file storage — arguably meet ITFA's definition of tax-exempt "Internet access," "a service that enables users to access content. . . over the Internet." ITFA further provides that in addition to the direct Internet connection and the ability to use e-mail, access encompasses "access to proprietary content, information, and other services as part of a package of services offered to consumers." Any company with valuable content that can be transmitted in digital form could achieve tax-exempt status by "bundling it" with "Internet access" as conventionally understood and selling it for a single, combined price. True Internet access providers like Verizon, Comcast, and AT&T are bundling more and more content with their access services. A permanent tax exemption for all content and services delivered over the Internet would seriously impact states' ability to finance critical public services in the long term, as "IPTV" and other Internet services continue to grow.

A Permanent "Moratorium" Is Unnecessary and Unwarranted

Apart from the damage that would be done to state and local government finances, there is no justification for either the elimination of ITFA's grandfather clause or the law's permanent extension:

If a temporary moratorium and the grandfathering of existing taxes were warranted in 1998, they are even more justified now. When ITFA was enacted, e-commerce was still in its infancy and broadband was just beginning to become available to households. Congress was seeking to balance states' and localities' need to finance essential services and its desire to encourage the development of the industry. Even in 1998, Congress decided that striking that balance entailed grandfathering existing taxes and prohibiting new taxes on Internet access only temporarily. Surely that calculus demands the same conclusion today, when almost 70 percent of households have Internet access and e-commerce has boomed.

Taxes do not have a significant impact on broadband deployment. Studies by the GAO and by U. of Tennessee economists find that taxes have not had an adverse impact on household decisions to purchase Internet access services or industry decisions about where to deploy broadband services. Every one of the 14 developed nations that has achieved greater broadband penetration than the U.S. subjects Internet access to normal consumption taxes, often at rates 2-3 times higher than typical combined U.S. state and local sales tax rates. Indeed, the world leader in broadband penetration, Denmark, taxes Internet access at a 25 percent rate.

A permanent moratorium will not help close the "digital divide." The cost of computers is a much more significant barrier for low-income households to get on the Internet than is the cost of an access service. Almost 90 percent of those who own computers subscribe to some type of Internet access service. State and local governments play a critical role in closing the digital divide by encouraging people to go online to use services like drivers' license renewals, offering adult education in using technology, and providing public Internet access in libraries and community centers. The revenue losses that ITFA is likely to cause would impair states and localities' ability to provide these services, and thus is more likely to broaden than to narrow the digital divide. Regressive sales taxes on Internet access services purchased by low-income households can be offset by much better targeted policies than an across-the-board Internet access tax exemption for rich and poor alike.