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INTERNET TAX FREEDOM ACT

MAY 5, 1998.—Ordered to be printed

Mr. MCCAIN, from the Committee on Commerce, Science, and Transportation, submitted the following

REPORT

together with

MINORITY VIEWS

[To accompany S. 442]

The Committee on Commerce, Science, and Transportation, to which was referred the bill to establish a national policy against State and local government interference with interstate commerce on the Internet or interactive computer services, and to exercise congressional jurisdiction over interstate commerce by establishing a moratorium on the imposition of exactions that would interfere with the flow of commerce via the Internet, and for other purposes, reports favorably thereon with an amendment in the nature of a substitute and recommends that the bill, as amended, do pass.

PURPOSE OF THE BILL

The purpose of the bill is to foster the growth of electronic commerce and the Internet by facilitating the development of a fair and consistent Internet tax policy.

BACKGROUND AND NEEDS

Commerce conducted through use of the Internet is experiencing tremendous growth. According to Forrester Research Inc., a Massachusetts consulting firm, the value of goods and services traded over the Internet could grow to over $300 billion in 2002, a substantial increase from the $8 billion that electronic commerce is estimated to have generated in 1997. This immense growth is ex-

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pected to boost our nation's economy by creating new jobs and new business opportunities.

The Internet also offers advantages such as providing small- and medium-sized companies the opportunity to compete with multinational conglomerates because they can now gain access to consumers globally without having to invest in costly marketing and distribution channels. Moreover, through the Internet, individuals in rural areas will have the same access to goods and services as those located in urban areas, and disabled and elderly persons will be able to purchase products without having to leave their homes.

The benefits to be gained by the surge in electronic commerce could be stifled, however, by the haphazard imposition of multiple and confusing State and local taxes that apply only to Internet-related transactions and services. If these taxes are not levied in a consistent and equitable manner, electronic commerce will not continue to develop at its expected pace.

In general, there are three types of Internet taxation. Some States tax Internet access charges, which are fees Internet service providers (ISPs) impose on Internet users for access to the Internet and other services like electronic mail. About 12 States subject Internet access charges to a sales, use or other transaction tax while others view Internet access as a tax-exempt service.

Another type of Internet-related tax is one that involves sales of goods over the Internet. When a consumer orders a product online, it is often delivered through traditional channels, like the U.S. mail. Such transactions are sometimes compared to mail order catalogue sales. In the latter situation, taxability of a transaction turns on the issue of nexus. Under the United States Supreme Court's Quill decision, a seller cannot be subject to a State's tax jurisdiction unless it has a "substantial nexus" with that jurisdiction. Substantial nexus can exist if a seller has a physical presence in the taxing jurisdiction, such as a store, office, or warehouse, or if the seller's agent, such as a sales representative or contractor, is conducting business in a location.

These traditional notions of nexus are difficult to apply to the Internet because of the way that Internet transactions occur. For example, a company can be based in State A, have a server located in State B, and receive an order from a consumer in State C who purchases a product from the company and has the product delivered to State D. Under these circumstances, it is unclear which State would have the ability to tax the event. One problem is that State and local taxing authorities may disagree on whether or not maintenance of a server in their location is sufficient to establish nexus. A State or locality also could decide that an ISP which hosts a World Wide Web site on its servers for another company is an agent of that company. In either situation, the same transaction could be subjected to multiple taxes.

A third type of Internet tax concerns purchases of software or information through the downloading of the software or information off of the Internet. Most States only tax tangible goods, tangible goods traditionally being those that you can physically see and touch. Many States take different positions on whether downloading software is a transfer of a tangible or intangible good. Currently, approximately 25 States tax the downloading of soft-

ware or information from the Internet while such transactions are tax exempt in as many as 17 States.

Confusing and inconsistent interpretations of these important issues could lead to redundant taxation and uncertainty regarding the tax collection and remittance obligations of Internet-based companies. Such confusion and uncertainty can be enough to discourage companies from doing business on the Internet. In particular, small- and medium-sized companies will be adversely affected. The Internet is a low cost way for these companies to market their products to customers worldwide. While a substantial portion of the country's 30,000 taxing jurisdictions have not adopted Internet taxes, the potential costs of complying with the tax demands of these authorities could make use of the Internet uneconomical for such companies.

Most State and local commercial tax codes were enacted prior to the development of the Internet and electronic commerce. Efforts to impose these codes without any adjustment to Internet communications, transactions or services or to impose discriminatory Internet-related taxes will lead to State and local taxes that are imposed in unpredictable and overly burdensome ways. Before States and localities are allowed to take such actions and thereby stunt the growth of electronic commerce, a temporary moratorium on Internet-specific taxes is necessary to facilitate the development of a fair and uniform taxing scheme. Congress has the authority under Article I, section 8, clause 3 of the United States Constitution to establish such a moratorium because communications or transactions using the Internet, online services, and Internet access service are all services or activities that are inherently interstate in nature.

Because policymakers must be given an opportunity to develop an equitable, technology-neutral tax policy, this moratorium is intended to prohibit taxes that discriminate against Internet communications or transactions and Internet access and online services.

LEGISLATIVE HISTORY

INTRODUCTION

S. 442 was introduced on March 13, 1997, by Senator Wyden.

MAY 22, 1997 HEARING

The full committee held a hearing on S. 442, the Internet Tax Freedom Act, on May 22, 1997.

WITNESSES

Panel I

Hon. Christopher Cox (R–CA)
Hon. Rick White (R–WA)
Hon. Lawrence H. Summers, Deputy Secretary, Department of Treasury

Panel II

Timothy Kaine, Richmond City Councilman, National League of Cities, Richmond, Virginia
Wade Anderson, Director of Tax Policy, Office of the State Comptroller, State of Texas
Kendall Houghton, General Counsel, Committee on State Taxation
Linda Rankin, General Counsel, Bear Creek Corporation
James Walton, Association of Online Professionals

PANEL I

Congressman Cox testified that it is Congress' responsibility to examine what is necessary to promote the continued development of the Internet. He stated that there are over 30,000 taxing jurisdictions that could tax Internet communications, transactions or services. He asserted that if these jurisdictions do tax the Internet in pursuit of their own interests, the Internet will not continue to grow at its phenomenal rate. Congressman Cox also stated that the moratorium would apply only to taxes that target the Internet and that are applied in a discriminatory way. He also said that it is possible for Congress to work with the States and the special taxing jurisdictions on this issue. He noted that the California State Board of Equalization, the California Franchise Tax Board, and the Governor of the State of California have voted unanimously to endorse S. 442.

Congressman White argued that the moratorium in S. 442 applies only to special taxes on the Internet. It does not include nondiscriminatory taxes such as a property tax on a building that houses an Internet server. He also asserted that it is Congress' duty, pursuant to the Commerce Clause of the United States Constitution, to protect the Internet as a national market phenomenon. According to Congressman White, States and localities should not be allowed to harm the Internet by imposing unfair taxes.

Lawrence Summers testified that the Treasury wholeheartedly supports the goals and objectives of S. 442. In November of 1996, the Treasury issued a white paper on taxes relating to electronic commerce, and its central principle was that there should be no taxes directed at limiting or scaling back the growth of the Internet. He agreed with the approach of temporarily prohibiting discriminatory taxes while preserving technology-neutral taxes. Summers noted the potential chilling effect of possible future taxes on business activity and stated that it will be much easier to deal with the tax issue at an early stage. He said that S. 442 furthers important public policy objectives because it will help business, make the United States more competitive, and empower American citizens by promoting the growth of Internet technology.

PANEL II

Timothy Kaine testified that an indefinite moratorium on State and local Internet taxes is unnecessary because so few States and localities actually tax the Internet. He stated that the moratorium would harm localities by denying them revenue they now rely on and would promote discriminatory treatment of local businesses. Kaine also said that S. 442 is inconsistent with the Unfunded Mandates Reform Act of 1995. He asserted that State and local governments and business interests can work together to establish a fair tax policy. He also suggested that the bill should be amended to preserve other existing, neutral taxes, such as local property taxes. He expressed concern about the burden of local taxation falling harder on Main Street retailers than on companies who conduct business over the Internet.

Wade Anderson expressed concern about the preservation language in S. 442. He said that sales taxes are the primary revenue source in Texas. Anderson also mentioned that Texas does tax Internet access charges because they view it as a local transaction. He stated that electronic commerce and Internet access are 2 distinct areas that can be addressed separately. Anderson also asserted that there is no end date for the moratorium in the bill.

Kendall Houghton testified that the moratorium in S. 442 will do three positive things. First, it will send a message to States and localities that electronic commerce is not to be taxed in inconsistent and burdensome ways that will hamper the growth of the Internet. Second, it will facilitate constructive dialogue among the different interests involved. Third, it will help American companies compete on a global basis. Houghton said that Congress can act in this area pursuant to its Commerce Clause authority. She also stated that taxpayers are clearly willing to pay their fair share of taxes on electronic commerce.

Linda Rankin stated that the potential of the Internet could be severely impaired if this national and international business medium is subjected to a host of provincial taxes without coordination and consideration of the national interest. She said that while the United States Supreme Court has ruled a number of times that to force national marketers with no presence in a State to collect and remit sales and use taxes would be an undue burden on interstate commerce, States have repeatedly tried to impose these duties on out-of-State marketers. Rankin asserted that under pressure to raise needed revenue, State and local governments will act without regard to national policies or the economy as a whole.

James Walton testified that he received opinion letters from the Tennessee Department of Revenue in 1994 and 1996 stating that as an ISP, he did not provide a taxable service, and therefore, he did not have to collect sales tax. In 1996, after his business was audited by the Tennessee Department of Revenue, Walton was told that he should have been collecting sales tax on Internet access charges since January of 1993. This decision caused Walton's business to fail, and Walton ultimately was forced to file for bankruptcy protection. Walton asserted that ISPs already pay taxes on every phone line they use, on every dollar they make, and on the salaries they pay. He said that the Internet industry has become a target

for State and local taxing authorities seeking to increase their revenues.

NOVEMBER 4, 1997 EXECUTIVE SESSION

In open executive session on November 4, 1997, the Committee ordered reported S. 442, the "Internet Tax Freedom Act," by a vote of 14 to 5, with an amendment in the nature of a substitute.

ESTIMATED COSTS

In accordance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate and section 403 of the Congressional Budget Act of 1974, the Committee provides the following cost estimate, prepared by the Congressional Budget Office:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC., January 21, 1998.

Hon. JOHN MCCAIN,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate and mandates statement for S. 442, the Internet Tax Freedom Act. The bill contains an intergovernmental mandate as defined in the Unfunded Mandates Reform Act of 1995.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Rachel Forward (for federal costs), and Pepper Santalucia, (for the state and local impacts).

Sincerely,

JUNE E. O'NEILL, *Director.*

Enclosure.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

S. 442—Internet Tax Freedom Act

CBO estimates that enacting S. 442 would result in new discretionary spending of less than $1 million over the 1998–2003 period, assuming appropriation of the necessary amounts. Because the bill would not affect direct spending, pay-as-you-go procedures would not apply. S. 442 contains no private-sector mandates as defined in the Unfunded Mandates Reform Act of 1995 (UMRA), but it does contain an intergovernmental mandate on state and local governments (see the attachment mandates statement).

S. 442 would impose a moratorium on certain state and local taxation of online services, Internet access service, and communications or transactions using the Internet until January 1, 2004. In addition, S. 442 would require the Secretaries of Treasury, Commerce, and State to examine domestic and international taxation of these Internet services and to recommend policies regarding the taxation of such services to the President. Based on information provided by the affected agencies, CBO estimates that the agencies would spend a total of less than $1 million between 1998 and 2000

to complete the studies required by the bill, assuming appropriation of the necessary amounts.

The CBO staff contact for this estimate is Rachel Forward. This estimate was approved by Robert A. Sunshine, Deputy Assistant Director for Budget Analysis.

CONGRESSIONAL BUDGET OFFICE MANDATES STATEMENT

S. 442—Internet Tax Freedom Act

Summary: S. 442 contains no private-sector mandates, but by prohibiting the collection of certain types of state an local taxes, the bill would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act of 1995 (UMRA). CBO cannot estimate whether the direct costs of this mandate would exceed the statutory threshold established in UMRA ($50 million in 1996, indexed annually for inflation).

Intergovernmental mandates contained in bill: S. 442 would place a moratorium until January 1, 2004, on certain state and local taxes on online services, Internet access service, or communications or transactions using the Internet. The moratorium would not affect state and local taxes on these services and transactions as long as the taxes meet certain criteria in the bill. Because existing taxes are not specifically grandfathered by the bill, any current taxes that fail to meet these criteria would be preempted until the year 2004.

Estimated direct costs of mandates to State, local, and tribal Governments

Is the statutory threshold exceeded?

Because it is unclear how the criteria in the bill would apply to the state and local taxes that are currently levied on Internet-related transactions or services, CBO is unable to determine whether the threshold for intergovernmental mandates ($50 million in 1996, indexed annually for inflation) would be exceeded in any of the first five years of the moratorium. The applicability of many of the criteria and definitions allowing for the collection of certain taxes would likely be litigated, and we cannot predict the outcome of such litigation at this time. If the criteria allowing for the collection of taxes are interpreted narrowly and if, as a result, most or all existing taxes that could be affected by this bill are suspended, the loss of revenues would probably exceed the threshold.

Total direct costs of mandates

UMRA includes in its definition of the direct costs of a federal intergovernmental mandate the estimated 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 S. 442 would be the tax revenues that state and local governments would be precluded from collecting because of the moratorium.

Because the taxation of Internet-related services and transactions is changing rapidly, 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 in this area over 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 during this time some state and local governments would repeal existing taxes or administratively limit their application to Internet-related services and transactions. These changes would affect the ultimate cost of the mandate but are extremely difficult to predict. Therefore, for the purposes of preparing this estimate, CBO limited its analysis to those taxes currently collected by state and local governments.

S. 442 would temporarily prohibit state and local governments from taxing Internet access service, online services, or communications or transactions using the Internet, unless the tax fell into one of the categories of taxes specifically preserved by the bill. These categories include:

taxes imposed on or measured by net or gross income derived from such services;

taxes imposed on or measures by value added, net worth, or capital stock;

fairly apportioned business license taxes;

property taxes;

taxes imposed on or collected by common carriers or other providers of telecommunications service;

franchise fees imposed on cable services; and

sales, use, or other transaction taxes that are also imposed and collected "in the case of similar sales, uses, or transactions not using the Internet, online services, or Internet access service."

While many existing taxes would clearly fall within one of these categories and thus would be preserved, some current state and local taxes do not fit neatly in one of the categories. These taxes are sales, use, or other transaction taxes on internet access and online services and on information and data processing services. As described below, however, CBO cannot predict whether these taxes would be temporarily suspended by the bill's moratorium.

Basis of estimate: The moratorium in S. 442 could affect some taxes currently collected by state and local governments. For the purpose 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 on Internet Access Service and Online Services. CBO has identified 12 states nationwide that currently impose a sales, use, or other transaction-based tax on the fees charged by providers of Internet access or online services. Some of those states also allow local taxes on these same services. Half of these states tax Internet access as an information or data-processing service. The other half tax Internet access as a telecommunications service. In general, states could not provide definitive estimates of their tax revenues, because many providers of these services also provide other taxable services and typically remit their tax collections to the states as one sum. In addition, the industry is growing so quickly that revenue figures from previous years are not very useful for estimating present collections. Based on the information that states could provide and on national market data, CBO estimates that 1997 reve-

nues for the 12 states and various localities that currently collect these taxes were close to $50 million. Given the rapid growth in use of the Internet, these revenues are likely to grow in coming years as more households and businesses decide to purchase Internet access.

It is not clear whether S. 442 would allow states and localities to continue collecting all of these revenues. The question is whether the taxes are also imposed and collected in the case of "similar sales, uses, or transactions not using the Internet, online services, or Internet access service." This question is likely to be the subject of litigation.

In the case of a sales/use tax on information and data processing services, a state wishing to preserve its tax could argue that it imposes the tax both on Internet access and on similar services not using the Internet, such as Westlaw or Lexis/Nexis. However, a provider could argue that Internet access is significantly different from access to a single data base, and that sales of Internet access should not be considered "similar sales" for taxation purposes. The same arguments could be made concerning taxes imposed on Internet access and online services as telecommunications services. It is not clear whether courts would find these services "similar" to other telecommunication services, such as telephone, fax, paging, and voice mail.

Taxes on Information and Data Processing Services. CBO also cannot predict exactly how S. 442 would affect sales, use, or other transaction-based taxes on information services or data processing services provided via the Internet or online services. For decades, companies have provided these services by allowing customers to directly connect to the companies' computers via 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-based tax on some kinds of 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 jurisdictions alone were between $35 million and $45 million annually. As with Internet access, 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 S. 442 were enacted, states and localities 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 using the Internet or online services. CBO expects that litigation would be required to determine which state and local taxes pass this test. 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 it also applies to computer-based information services that do not utilize the Internet. However, the information provider could

argue that its product is more similar to newspapers and magazines, which may not be subject to sales and use tax in the state.

REGULATORY IMPACT STATEMENT

In accordance with paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee provides the following evaluation of the regulatory impact of the legislation, as reported:

NUMBER OF PERSONS COVERED

This legislation will impose a moratorium on the imposition, assessment, or collection of State and local taxes that discriminate against communications or transactions using the Internet, and against online services or Internet access service. It will have no effect on the number of individuals regulated.

ECONOMIC IMPACT

This legislation establishes a moratorium until January 1, 2004, on State and local taxes that discriminate against the Internet. It would preserve State and local taxing authorities' ability to impose traditional sales and use taxes, excise taxes, and other taxes that are technology-neutral. These taxes make up the vast majority of State and local tax revenues. Therefore, any adverse economic impact that the moratorium would have is minimized. In addition, this measure will allow for growth in electronic commerce and the Internet industry and will thereby create benefits for the economy.

PRIVACY

This legislation will not have any adverse impact on the personal privacy of the individuals affected.

PAPERWORK

This bill will require State and local taxing authorities temporarily to stop imposing, assessing or collecting discriminatory Internet taxes. Therefore, the paperwork requirements associated with this measure should be minimal.

SECTION-BY-SECTION ANALYSIS

Section 1. Short title

Section 1 provides that the bill may be cited as the "Internet Tax Freedom Act."

Section 2. Findings

Section 2 includes the findings of Congress. Among the findings are: that as a massive global network spanning not only State but international borders, the Internet and the related provision of online services and Internet access service are inherently a matter of interstate and foreign commerce within the jurisdiction of the United States Congress under Article I, section 8, clause 3 of the United States Constitution; that consumers, businesses and others engaging in interstate and foreign commerce through online services and Internet access service could become subject to more than 30,000 separate taxing jurisdictions in the United States alone; and

that because the tax laws and regulations of so many jurisdictions were established long before the advent of the Internet, online services, and Internet access service, their application to this new medium and services in unintended and unpredictable ways could prove to be an unacceptable burden on interstate and foreign commerce of the Nation.

Section 3. Moratorium on the imposition of taxes on the Internet, online services, or Internet access service

Section 3 of the reported bill establishes a moratorium, which expires on January 1, 2004, on State and local taxes that discriminate against communications and transactions using the Internet, and online services and Internet access service. The purpose of the "time out" on discriminatory taxes is to allow for a process to examine current policies and practices and to develop policy recommendations with respect to taxation of communications and transactions using the Internet, online services, and Internet access service. Ideally, this process will produce policies on taxation that eliminate any disproportionate burden on interstate commerce conducted electronically and establish a level playing field between electronic commerce using the new media of the Internet and traditional means of commerce, such as in-store sales, mail order and telephone sales. It is expected that participants in electronic commerce will pay their "fair share" of State and local taxes.

The original verion of the bill provided for an indefinite moratorium on taxes that discriminate against the Internet. The committee substitute establishes an end date for the moratorium. The inclusion of an end date for the moratorium strikes a balance between the interests of State and local authorities in imposing taxes on the Internet, and businesses that believe State and local tax authorities would simply "wait out" the moratorium and then tax electronic commerce in whatever manner they desired. The duration of the moratorium is designed to allow the Consultative Group established in Section 4 of the Act sufficient time to develop policy recommendations for the President, for the President to prepare policy recommendations for Congress, and for Congress or the State and local authorities to act upon any legislative policy recommendations made by the President pursuant to the work of the Consultative Group.

Section 3(a) provides that except as otherwise provided in this Act, prior to January 1, 2004, no State or political subdivision thereof may impose, assess, or attempt to collect any tax on communications or transactions using the Internet, online services or Internet access service. The moratorium would not affect any State or local tax on communications or transactions using the Internet, online services or Internet access service as long as they are imposed or assessed in a technologically neutral and nondiscriminatory way. The moratorium applies to both existing and new taxes and administrative interpretations that are inconsistent with the provisions of this Act. For example, the moratorium would apply to a tax that a State or local authority imposes and assesses on a subscription to a newspaper accessed online if that State does not also tax a newspaper subscription ordered over the telephone or through the mail. The moratorium would also apply to "double

taxation" of products or services, such as a tax imposed or assessed on telecommunications services provided by a local phone company to an Internet service provider (ISP) where the ISP has already paid a tax on the telecommunications services.

The moratorium applies to online services, Internet access service, or communications or transactions conducted through the Internet, regardless of the technology being used to deliver these services—e.g., the public switched network, cable systems, and wireless networks. However, it applies only to the portion of the medium being used to provide such services. For example, the moratorium would apply to discriminatory taxes imposed on online services via a cable network, but only to the portion of the cable network provider's communications or transactions that employ the Transmission Control Protocol, Internet Protocol, or any predecessor or successor protocols. The moratorium does not allow a cable network, public switched network or wireless network to claim or to seek immunity from taxes—discriminatory or otherwise—for the provision of other products or services, such as cable programming or telephone calls, that do not employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols.

Section 3(b), Preservation of State and Local Taxing Authority, specifically preserves the authority of State and local entities to tax in a nondiscriminatory manner online services, Internet access service, and communications or transactions using the Internet. Existing taxes are specifically grandfathered by the bill provided they are imposed and assessed in a nondiscriminatory and technologically-neutral manner. This subsection specifically preserves sales, use, or other transaction taxes; taxes imposed or measured by gross or net income derived from online services, Internet access service, or communications or transactions using the Internet, or on value added, net worth or capital stock; fairly apportioned business license taxes; taxes paid by a provider or user of online services or Internet access service as a consumer of goods and services; property taxes imposed or assessed on property owned or leased by a provider or user of online services or Internet access service; taxes imposed on or collected by a common carrier acting as a common carrier; taxes imposed on or collected by a provider of telecommunications service (as defined in the Communications Act of 1934 (47 U.S.C. 153)); and franchise fees for the provision of cable services.

The bill as reported preserves general forms of State and local taxation, which account for the vast majority of State and local level tax revenues on an annual basis; they will be unaffected by the bill. These taxes include net income taxes, gross income (e.g., business license) taxes, property taxes and sales and use taxes. The bill as introduced preserved three types of taxes; the committee substitute significantly expands the coverage to preserve the eight most common types of taxes.

Subsection (b)(1) would ensure that transactions effected through the Internet or online services which are functionally equivalent to transactions effected through traditional forms of commerce (e.g., mail order or phone sales) remain subject to sales and use tax. Other transaction taxes include taxes on the sale of alcohol, to-

bacco, and fuel. For example, if a taxable event occurs when a customer orders a computer from a mail order company, using its 1-800 telephone line to place the order, then the transaction should likewise be taxable if that customer goes online to order the computer from the mail order company's Web site.

Another example involves software vendors that deliver their product electronically and who have had to analyze the sales tax implications of the mode of delivery of their products. Traditionally, determining whether a software vendor has a sales or use tax obligation involves a 2-step analysis. First, it must be determined whether the electronic delivery of the software is considered tangible personal property subject to tax or whether it should instead be treated as exempt intangible property. As an illustration, Virginia has ruled that software which would otherwise be taxable as the sale of tangible personal property is not subject to tax when delivered electronically because the electronically-delivered software is considered intangible property. Second, if the software is taxable, the seller must have the requisite nexus with the jurisdiction in order to have a sales and use tax collection obligation. Thus, if the seller does not have any physical presence in the jurisdiction, either through employees or property, the seller may not have a tax obligation regardless of the tax classification of the software. States must treat sales of other electronically-delivered items, such as movies and music, in a like manner.

Pursuant to the bill as reported, 2 conditions must exist in order to preserve the ability to impose a sales or use tax on an electronic commerce transaction: (1) the tax (including the rate at which it is imposed) is the same as it would have been had the transaction been conducted via telephone (e.g., as a catalogue sale); and (2) the obligation to collect the tax is imposed on the same person or entity as in the case of non-electronic commerce transactions (e.g., the vendor has the duty to collect and remit the tax, in both cases). In other words, as long as the State or local sales tax is imposed on Internet transactions at the same rate and in the same manner as mail order transactions, then the tax is not affected by the bill.

As a related matter, the committee substitute directly addresses concerns about the labeling of taxes raised by the State of Hawaii (e.g., that its General Excise Tax will be suspended during the period of the moratorium) and the State of Illinois (e.g., that its Retail Occupation Tax will be suspended during the period of the moratorium). These taxes may have different names or labels, but the purpose they serve is that of a sales tax, and experts widely regard and call them such. The use of the term "sales or use tax" in the committee substitute is intended to apply to the many varieties of sales and use taxes, regardless of their label.

Subsection (b)(2) would ensure that participants in electronic commerce pay their fair share of State and local income taxes. Because income taxes are typically imposed in a neutral fashion (e.g., without regard to the manner in which the income is earned or derived) and do not create inordinate compliance burdens, income taxes are specifically excluded from the moratorium. The committee substitute removes the word "net" so as to preserve both net income taxes and gross income taxes. States' business taxes are typically imposed on or measured by net income, but not every

State takes this approach: one example of an alternative business tax is the Washington State Business and Occupation Tax, which is imposed on gross rather than net income. The committee substitute, by eliminating the word "net," broadens the income tax preservation to include net and gross income taxes and clarifies that Washington's State-level income tax is preserved. Similarly, California imposes a "franchise tax" that is measured by the net income of corporations subject to the tax; although the tax is not labeled as an "income tax," it clearly operates in the prescribed fashion and is specifically preserved by the committee substitute.

Subsection (b)(3) preserves fairly apportioned business license taxes, which are typically imposed on the gross receipts of businesses that have a location within the taxing jurisdiction. Such taxes are a significant source of revenue for localities. The committee substitute provision is consistent with United States Supreme Court precedent by requiring business license taxes to be fairly apportioned. By including the words "fairly apportioned," the committee does not intend to imply that other preserved taxes do not have to be fairly apportioned.

Subsection (b)(4) preserves taxes paid by a provider of Internet or online services as a consumer of goods and services not otherwise excluded from taxation pursuant to this legislation. This subsection was added to the original version of the bill to ensure that Internet service providers and other entities providing Internet and online services pay State and local taxes when acting as consumers (e.g., purchasing goods and services) as opposed to providing electronic commerce services. The bill as reported does not excuse Internet sellers and online service providers from paying sales and use taxes on their purchases. Where an Internet or online service provider purchases a good or service that is already subject to a resale exemption, such exemption should continue to apply.

Subsection (b)(5) preserves property taxes imposed or assessed on property owned or leased by an Internet or online service provider. Property taxes include real property, personal property, and intangible property taxes assessed on property that is owned or leased. This subsection was added to the original version of the bill to reflect the committee's intent that the moratorium would not apply to property taxes assessed or collected at the State or local level.

Subsection (b)(6) preserves taxes imposed on a common carrier acting as a common carrier, and subsection (b)(7) preserves taxes imposed on a provider of telecommunications services to ensure that State and local telecommunications taxes, fees, and regulations are unaffected by the bill. The preservation of this taxing authority, added to the original version of the bill, is intended to apply to entities when they act as telecommunications service providers and not as Internet access or online service providers. For example, a company that provides both telecommunications and Internet access service and uses its lines to provide Internet access does not cause such lines to be exempt from telecommunications taxes.

Subsection (b)(8) preserves franchise fees imposed by a State or local franchising authority for the provision of cable services. The preservation of this authority, which parallels the provisions of subsections (b)(6) and (7), ensures that cable providers remain lia-

ble for local franchise fees in connection with the provision of cable services, pursuant to section 622 or 653 of the Communications Act of 1934.

The broad preservation of State and local taxing authority set forth in section 3(b) is not intended to be an inclusive or exhaustive list of preserved taxes; rather, it is illustrative of the general categories of taxes that State and local authorities impose or assess on businesses and consumers. State and local authorities may continue to impose and assess sales, use, and other transaction taxes on communications and transactions using the Internet, online services or Internet access services provided the tax is the same tax imposed on traditional means of commerce, and the obligation to collect or pay the tax is imposed on the same person as in the case of traditional means of commerce. Sales, use, and other transaction taxes that create a substantively greater burden on electronic commerce or participants in electronic commerce than other means of commerce are not preserved. For example, the preservation authority in this subsection means that if a State generally imposes and collects a sales or use tax on mail order sales, then it may impose and collect a sales or use tax on sales made using the Internet, online services or Internet access service. This subsection does not provide special protection from taxes for communications or transactions using the Internet, online services or Internet access service that are also generally applied to communications or transactions using other means, such as mail order or in-store retail; rather, it seeks to ensure that taxes are imposed and assessed in a technologically neutral way and in a manner that does not discriminate against communications or transactions using the Internet, online services or Internet access service.

Section 4. Administration policy recommendations to Congress

Section 4 establishes a process by which the Administration, State and local governments, and business and consumer groups will examine current policies and practices, and develop and recommend to Congress policies on taxation of communications and transactions using the Internet, online services, and Internet access service.

Section 4(a) directs the Secretaries of the Treasury, Commerce and State, in consultation with appropriate committees of Congress, State and local authorities, and consumer and business groups, to examine United States domestic and international taxation of communications and transactions using the Internet, online services, and Internet access service, and the telecommunications infrastructure used by them, and to jointly transmit within 18 months of the date of enactment of S. 442 any recommendations to the President. It is expected that the Consultative Group first will determine whether taxes should be imposed and assessed on communications and transactions using the Internet, online services and Internet access service. Second, if taxation is recommended, it is expected the Consultative Group will examine and recommend policies to ensure such taxation is uniform, fair, and administrable. It is expected the Consultative Group will evaluate current domestic and foreign policies and practices on taxation of communications and transactions using the Internet, online serv-

ices, and Internet access service, and will develop policy recommendations for the President on taxation of the Internet, online services, and Internet access service. The Consultative Group shall consider any specific proposals from the National Tax Association's Joint Communications and Electronic Commerce Tax Project and the National Conference of Commissioners of Uniform State Laws.

The confusion caused by the variety of ways in which different States tax communications and transactions using the Internet, online services, and Internet access service is underscored by the Congressional Budget Office (CBO) in its January 21, 1998 estimate, on S. 442. The CBO states it "has identified 12 States nationwide that currently impose a sales, use or other transaction-based tax on the fees charged by providers of Internet access or online services. Some of those States also allow local taxes on these same services. Half of these States tax Internet access as an information or data-processing service. The other half tax Internet access as a telecommunications service. In general, States could not provide definitive estimates of their tax revenues because many providers of these services also provide other taxable services and typically remit their tax collections to the States as one sum." If communications and transactions using the Internet, online services or Internet access service are to be taxed, then the tax policy should be simple, uniform, and administrable.

Section 4(b) directs the President not later than 2 years after the date of enactment of S. 442 to transmit to the appropriate committees of Congress policy recommendations on taxation of online services, Internet access service, and communications and transactions using the Internet.

Section 5. Declaration that the Internet should be free of foreign tariffs, trade barriers, and other restrictions

Section 5 expresses the sense of the Congress that the President should seek bilateral and multilateral agreements through appropriate international organizations and fora to establish that commercial transactions using the Internet are free from tariff and taxation. This section supports the policy of the Administration to work to create a worldwide "duty free zone" on the Internet.

Section 6. Definitions

Section 6 sets forth the definitions of the "Internet," "online services," "Internet access service," and "tax" for purposes of S. 442. The definitions of the "Internet," "online services," and "Internet access service" apply only to the terms as used in the reported bill, and are not intended to affect in any way existing law, regulation, or policy.

ROLLCALL VOTES IN COMMITTEE

In accordance with paragraph 7(c) of rule XXVI of the Standing Rules of the Senate, the Committee provides the following description of the record votes during its consideration of S. 442:

Senator McCain (for himself, Mr. Wyden, Mr. Burns, and Mr. Kerry) offered an amendment in the nature of a substitute to S. 442. By rollcall vote of 14 yeas and 5 nays as follows, the amendment was agreed to:

YEAS—14 —

Mr. McCain–
Mr. Stevens [1]
Mr. Burns– –
Ms. Snowe—
Mr. Ashcroft [1]–
Mr. Frist [1]
Mr. Abraham
Mr. Brownback
Mr. Hollings
Mr. Inouye
Mr. Rockefeller
Mr. Kerry [1]
Mr. Breaux
Mr. Wyden

[1] By proxy

NAYS—5

Mr. Gorton
Mrs. Hutchison
Mr. Ford [1]
Mr. Bryan [1]
Mr. Dorgan

CHANGES IN EXISTING LAW

In compliance with paragraph 12 of rule XXVI of the Standing Rules of the Senate, the Committee states that the bill as reported would make no change to existing law.

MINORITY VIEWS OF SENATOR DORGAN

I oppose S. 442, the Internet Tax Freedom Act on several grounds, not the least of which is the fact that this legislation constitutes one of the more significant federal assaults on state and local sovereignty in recent memory. In my judgment, this legislation is unwarranted and if enacted, it would significantly erode state and local tax bases and hurt main street businesses. The claims of the bill's sponsors that S. 442 is needed to fend off aggressive tax discrimination by states and to prevent a crippling burden on Internet commerce, as well as the erroneous assertion that Internet traffic constitutes a unique form of interstate commerce, are without foundation and cannot justify this broad reaching assault on state and local sovereignty. I object to the notion that the Congress ought to step in and write state and local tax laws. Until specific tax problems or abuses are identified and supported with evidence, federal legislation of this nature should not be entertained.

This legislation violates the Unfunded Mandates Reform Act of 1995 (P.L. 104–4) and I intend to raise a point of order on this legislation should it be considered by the full Senate. Because the bill contains ambiguous language and new definitions which have not been adequately reviewed by the Commerce Committee, the bill's exact impact on state and local revenues is hard to determine at this point. However, it is clear that the impact will be large, the question is how large (in terms of hundreds of millions of dollars).

In addition to the unfairness of Congress dictating state and local tax policy, this legislation would create an unfair competitive situation with respect to telecommunications providers and local business by carving out a specific technology from broad based state and local taxation; placing some telecommunications providers and local businesses at an unfair disadvantage because they would remain subject to state and local taxation. This bill creates more than just a tax break—it creates a technology preference policy and a new unregulated, untaxable medium for commerce. What is the justification for singling out Internet commerce for special tax treatment? Why should buying a sweater through an Internet service be exempted from the same tax that is imposed when the identical sweater is purchased at a store on main street or purchased through a mail order catalog? The tax effect of this bill is that Internet commerce will be given favored tax treatment, and that is not fair to other lines of commerce. This should raise concerns with not just state and local governments but the businesses and individuals that are left subject to regulations and taxes. It is my belief that taxes—whether federal, state, or local—ought to be imposed in a fair and equitable manner and I object to the approach embodied under S. 442 which creates a special tax status for a particular technology and category of users who have not

made a public policy case why government should single them out for special tax treatment.

The effect of this legislation, if enacted in its present form, would be to create the "Cayman Islands" of sales taxes by establishing a tax free haven that will hurt main street businesses and dictate to state and local governments an inequitable application of sales, use, and other taxes that have historically been under state and local jurisdiction. This legislation attempts to create a "tax free access road" along the information superhighway that will unfairly hurt local businesses and create an unfair competitive situation with respect to the use of telecommunications services; creating a "nexus free" medium for commerce that will circumvent state and local tax laws that all other businesses are obligated to follow. Given the fact that the Internet is a new medium and business activity is just beginning to grow in this area, it is not surprising that there would be issues that need to be resolved. However, these issues should be resolved appropriately—through cooperative discussions between industry and state and local governments. Congress should not dictate a moratorium on state and local governments. In fact, I contend that the moratorium imposed under S. 442 will actually be counter productive to the efforts of those who are attempting to develop uniform taxation of electronic commerce.

Further, the ambiguities in terms of what is included in the legislation's moratorium and the vague definition of the so-called exceptions to that moratorium indicate that the bill is certain to create extensive litigation as telecommunications providers and businesses that use electronic commerce vie for the tax breaks provided by this legislation.

LEGISLATION IS UNWARRANTED

S. 442 is a solution in search of a problem. The proponents of this legislation have simply failed to make the case that it is necessary to pass federal legislation preempting state and local taxation on electronic commerce. It seems to me that if Congress is to consider taking such drastic action as to tell state and local governments how they can and cannot tax, then those seeking the tax breaks must make a compelling case that such action is necessary. That case has certainly not been made with respect to S. 442.

Advocates have claimed that electronic commerce is being subjected to unfair and discriminatory taxation by state and local governments. The fact is that there is no discriminatory taxation occurring that warrants a federal moratorium. Proponents have failed to identify a single enacted state or local law that singles out Internet services or on-line services for punitive or discriminatory taxation. The bill's advocates fail to identify any specific tax in any specific state or local jurisdiction which would justify a federal preemption. The justification cited by the advocates seeking the tax preemption is that state and local governments are discriminating against Internet providers and on-line services in their taxation policies is simply not grounded in fact. Different tax treatment of a newspaper, for example, may be due to the fact that products that are exempt from a sales tax in tangible form may be subject to a sales tax in electronic form because it is available through an online service—which, in general, is subject to a broad based use

tax. The reason why it may be taxed in the latter situation is because it is part of a broad based use, sales, or other taxes on "information services" regardless of the method of delivery—not because of an Internet-specific tax. Even if there were discriminatory taxation occurring at the state or local levels, there is no need for a federal law to correct that situation for such taxation has long ago been declared unconstitutional. If a state or local government were to impose a discriminatory tax, then those who are subject to such discriminatory taxation have constitutional protection. Each state must, and does, provide ready avenues to aggrieved taxpayers to protest potentially discriminatory taxes through the court system. The U.S. Supreme Court has determined that fairly apportioned state and local taxation that does not discriminate against interstate commerce are constitutional so long as the tax is applied on an activity with a substantial nexus with the taxing state.[1] Court precedent has made it clear that discriminatory taxation is not constitutional.[2]

I am opposed to discriminatory taxation and I will not defend attempts by state or local governments to single out electronic commerce for punitive or discriminatory taxation. However, no evidence of such discriminatory taxation has been presented to the Congress that would substantiate the claims of the bill's proponents.

I believe that there is no policy justification for the moratorium on state and local taxation in this legislation. There is not a signal state or local enacted law, currently in effect, that imposes a specific tax on Internet or on-line services or the use of those services. There are instances where these services are taxed, but where they are taxed, they are subject to broad based taxes that apply generally to sales of goods and services or to telecommunications services or similar business activities.

The bill advocates have also claimed that the legislation is necessary to address fears that states and localities will impose taxes on the transmission of Internet traffic. The bill's findings suggest that the future viability of the Internet is threatened because of excessive taxation and that state and local taxes are restricting the growth of this medium. Internet commerce hardly shows any sign of being impeded. The sponsors claim that without federal protection, Internet commerce would be strangled as state and local governments seek to impose taxes on the transmission of Internet traffic, regardless of any nexus determination. Such claims have no foundation. The Supreme Court has ruled that there must be a sufficient connection between the state and the activity seeking to be taxed, and the mere transmission of communications through a

[1] Quill v. North Dakota, 504 U.S. 298 (1992).

[2] A variety of types of discrimination in state taxation have been struck down by the state and federal courts. For example, the Pennsylvania courts determined that a statutory exemption from the sales and use tax and corporate taxes that was allowed for broadcasters but not for cable television operators violated the Equal Protection Clause of the U.S. Constitution, in Suburban Cable TV Co. V. Commonwealth, 570 A.2nd 601 (Pa. Cmwlth. 1990), aff'd, 527 Pa. 364, 591 A.2d 1054 (1991), Taxes that discriminated among speakers that were based on content [Arkansas Writers] Project, Inc. v. Ragland, 481 U.S. 221 (1987), City of Cincinnati v. Discovery Network, Inc., 507 U.S. 410 (1993)], or that singled out the press or targeted a small group of speakers [Grosjean v. American Press Co., 460 U.S. 575 (1983)], have been struck down as violations of the First Amendment. And, tax classifications that discriminated against interstate commerce have been determined to be violations of the Commerce Clause, Boston Stock Exchange v. State Tax Commission, 429 U.S. 318 (1977), Armco Inc. v. Hardesty, 467 U.S. 638 (1984).

state is insufficient to meet this test. No new Federal law is necessary to address this fear.[3]

It is important to note that Internet commerce is thriving without the special federal protection that the bill sponsors' claim is urgently needed. In 1997 alone, web-generated revenues exceeded $24 billion, which was an 800 percent increase from the previous year. Web-generated revenues are forecasted to exceed $300 billion by 1999 and over $1 trillion by the year 2001, constituting increases from 1996 of 1130 percent and 3875 percent respectively. The total value of goods traded in 1997 on the Internet was an estimated $8 billion and is expected to reach $327 billion by the year 2002[4]—absent any special tax protection imposed by the Congress. Compared to other industries, Internet commerce is far from a struggling infant. According to figures from Standard and Poor's, in 1997, the wireless telecommunications industry grew 20%; biotechnology revenues grew 15%; radio advertising 8.2%; national network television advertising 3.1%; and air transportation revenues 0.2% from the previous year. The growth of Internet commerce—which is growing at an annual rate exceeding 800%—is staggering compared to these other major growth industries.

Finally, there is nothing unique about the "interstate" nature of on-line commerce, which is the foundational premise of this legislation, according to the sponsors. The issues surrounding the debate over how to tax Internet commerce are fundamentally no different than the debates over the past 30 years over mail order sales and other matters of interstate commerce. This legislation uses the "interstate nature" of Internet commerce as justification to further exacerbate the current inequities for local businesses with respect to their mail order competitors who are often not collecting the same local sales taxes for example. The only unique quality in the debate over Internet commerce taxation viz a viz other forms of commerce is the technological means—not its interstate nature. There is no policy justification to enact a federal tax break that will cost state and local governments millions of dollars simply because a new technology has emerged into commerce.

UNFUNDED MANDATE

The preemption imposed under this legislation constitutes an unfunded mandate on state and local governments that could cost them billions of dollars in revenue that is needed for education, welfare services, transportation infrastructure and other state and local needs. I take seriously the new era of federal-state relations that was set when the Congress passed the Unfunded Mandates Reform Act of 1995 (PL 104-–4) and I believe that the Congress ought to resist granting special interest tax breaks at the expense of state and local governments. In the past few years, numerous special interests have come running to Congress seeking special tax breaks at the state and local level. In the last Congress, I saw satellite companies, airlines, busing companies, cellular companies,

[3] Cf: Goldberg v. Sweet, 488 U.S. 252 (1989) establishing that a state may tax interstate telephone services only if the origin or destination of the call was within the state AND the billing address for the call was in the state. Moreover, the Court required that there be a mechanism to avoid multiple taxation by two or more states to pass constitutional muster.

[4] The Forrester Report, Volume One, Number One (July, 1997).

and even the National Weather Service, claiming that they needed a special tax break at the expense of state and local governments. The scenario in each case is similar where special interests claim that state and local governments are unfair and are signaling them out for special taxation. Each special interest makes the same assertion that they are victims of discrimination by unreasonable local and state governments that Congress must take up their cause. But the facts reveal that the necessity of federal preemption are rarely, if ever, warranted.

S. 442 places an unfunded mandate on states and local governments and would be subject to a point of order under the Unfunded Mandates Act enacted in the last Congress. Since the bill affects both future and present methods of state and local taxation, the financial impact on state and local governments is likely to be very significant. The basic premise of S. 442 flies in the face of the principle that the Congress ought to return power to the states and I reject the notion that "Washington knows best." It would be unfortunate if the Congress would undermine the important principle of deferring to state and local governments in areas that are traditionally in their jurisdiction such as taxation.

According to the CBO analysis required under the Unfunded Mandates Reform Act, (January 21, 1998) the version of S. 442 that was reported by the Senate Commerce Committee "contains an intergovernment mandate as defined in the Unfunded Mandates Reform Act of 1995" and that the bill would preempt "existing taxes." Because of the ambiguity of the language in the bill with respect to the preemptions on state and local taxes, the CBO stated that it could not estimate whether or not the bill in its present form would exceed the statutory threshold established in the unfunded mandates law ($50 million annually). CBO predicts that litigation that will likely occur over the ambiguous language in this legislation and, depending on the interpretation provided to the terms in the bill after court battles, the loss of revenues to state and local governments could probably exceed the $50 million threshold test under the Unfunded Mandates Reform Act.

The CBO's determination that the scope of the bill's impact on state and local revenues cannot be accurately determined triggers Section 424(a)(3) of the Unfunded Mandates Reform Act which states that:

> [I]f the Director determines that it is not feasible to make a reasonable estimate that would be required under paragraphs (1) and (2), the Director shall not make an estimate, but shall report in the statement the reasons for that determination in the statement. If such determination is made by the Director, a point of order under this part shall lie only under section 425(a)(1) and as if the requirement of section 425(a)(1) had not been met.

Section 425(a)(1) states that:

> [I]t shall not be in order in the Senate or the House of Representatives to consider any bill or joint resolution that is reported by a committee unless the committee has published a statement of the Director on the direct costs of

> Federal mandates in accordance with section 423(f) before such consideration * * *

Thus, S. 442 is subject to a point of order in the Senate should S. 442 be considered by the full Senate, the first vote on this legislation will be on the point of order raised under the Unfunded Mandates Reform Act.

IMPACT OF S. 442

S. 442, would, among other things, preempt state and local taxes by imposing a moratorium on state and local taxation on Internet or on-line services until 2004. S. 442 would prohibit state and local taxation on "communications or transactions using the Internet and online services or Internet access service." In addition to the certain litigation that will occur over the scope and meaning of this broad and ambiguous language if this legislation is enacted, there are serious consequences that could be financially devastating for local businesses and the budgets of state and local governments. While the bill sponsors contend that Sec. 3(b) preserves certain state and local taxes from the preemption, I am not convinced. Such a claim cannot be held with much confidence since it is not possible to determine—without extensive litigation—whether or not the specific state and local taxes identified under this subsection will be upheld or preempted. The structure of the bill, which establishes a blanket prohibition followed by several exceptions creates uncertainty and the risk of litigation for states and localities, which will have to prove for every challenge that their taxes fall completely and squarely within one of the exceptions.

This legislation takes the approach of establishing a broad preemption of taxation of electronic commerce and then attempts the absurd by authorizing state and local governments to impose only certain types of taxes. If an existing state or local tax does not meet the exact description provided under this legislation, then such tax would be preempted. This approach is fatally flawed and instead of identifying and addressing any particular problem of state or local tax application on Internet commerce, it will launch a new era of litigation that will cost state and local governments and corporations millions in unnecessary court battles.

Communications using the Internet would be excluded from state and local taxation under this legislation, which establishes a very broad application of Internet commerce and excludes all communications using the Internet and online services from state and local taxation. Thus, the preemption in the bill would affect any tax applied to e-mail services, web page hosting, advertising, and Internet telephony. This would create a circumstance where communications through other telecommunications mediums would be subject to tax but the same service provided through the Internet would be exempted from that same tax.

This legislation is not prospective. Instead, it exempts a certain category of users—i.e., electronic commerce—from existing taxes. The Commerce Committee heard testimony from the Texas Comptroller of Public Accounts who said that the state of Texas alone would lose hundreds of millions of dollars in revenues from existing

broad-based taxes that would be preempted under this legislation.[5] In addition, a survey of some states conducted by the Federation of Tax Administrators calculated that several states would lose between $1 million and $1.5 billion each.[6]

The bill creates more questions about taxation than it resolves. The findings suggest that Internet services are solely a matter of interstate commerce, thereby implying that state and local jurisdictions have no authority to impose a regulation or tax on any aspect of Internet services. What is it that makes Internet services different from other forms of interstate telecommunications services that justifies this privilege status? Long distance phone calls that cross state boundaries are interstate commerce. However, like Internet services, telephone calls have a local origin and a local destination. As a result, telephone services are not shielded from state or local jurisdiction. Internet and on-line communications ought to be treated in similar fashion.

Does the assertion that Internet services are solely a matter of interstate commerce mean that no state or local government could impose a state or local regulation of any kind? How does this affect the growing controversy over direct alcohol sales and the attempt of state and local governments to regulate access to Internet pornography, the growing commerce of Internet pornography, and the burgeoning field of Internet gambling? What impact does this policy have on state and local attempts to address problems associated with the Internet being used to lure minors into sexual encounters or the distribution of pornographic material that would otherwise be banned or prohibited if it were distributed to minors through other mediums? If Internet commerce is solely a matter of interstate commerce, then does that mean state and local laws that require minimum drinking ages would not apply to the distribution of alcohol via Internet commerce? Is this legislation the beginning of a slippery slope agenda designed to make the Internet a tax-free, regulation-free medium that will not only disrupt the fair and nondiscriminatory application of state and local taxes but also undermine the ability of local communities to control otherwise illegal activity such as the distribution of alcohol to minors? Under the bill, can electronic commerce be used to conduct tax-free, regulation-free Internet gambling and games of chance?

The revised version of S. 442 provides new federal definitions on a broad range of state and local taxes such as sales and use taxes, property taxes, income taxes, franchise taxes, and business license taxes. In analyzing the bill, the question is: what kinds of sales and use taxes, for example, fall within the definition in the bill and what kinds of sales or use taxes fall outside of the definition and therefore would be preempted? Below is a discussion of just a few examples of the problems created by this legislation by the vague language and broad preemption.

Income Taxes. The bill attempts to preserve corporate income taxes. However, the bill does not take into account the different ways in which states impose corporate income taxes and how they apportion revenues and assets to determine those taxes. The bill

[5] Attachment A.
[6] Attachment B.

raises questions as to how states are going to have to differentiate between revenues derived from Internet services as opposed to other services. With respect to states that impose corporate income taxes, how will this bill affect the manner in which these states apportion income related to Internet services as opposed to other telecommunications services? Will states have to restructure their income taxes differently for determining income derived from Internet services as a result of this legislation? To my knowledge, the Committee has not obtained an analysis on how this legislation will affect the imposition of income taxes on those states that provide Internet services; neither has the Committee reviewed the corporate income statutes in all the states to determine whether or not there are any states that currently apply income taxes measured by something other than gross or net revenue or on net worth or capital stock. The Committee never conducted an analysis on the various means that States use to determine income taxes to determine which income taxes are not included in this clause so as to provide a means to avoid the determination of income in that particular instance.

The beneficiaries of the tax break provided under this legislation will include some very significant telecommunications and computer companies who not only provide Internet services but other telecommunications services as well. I fear that this legislation will create a significant tax loophole for major corporations.

In addition, there is the question as to how this legislation affects payroll taxes such as unemployment insurance and workers compensation taxes. Would these taxes—which are paid by corporations that provide Internet services and online services—be preempted? These are not income taxes and there is no mention in the exceptions of this legislation to ensure that the corporations receiving the tax breaks provided under this legislation would have to pay payroll taxes, unemployment taxes, or workers compensation taxes.

Fairly apportioned business license taxes. What is the meaning of fairly apportioned business license taxes in this legislation? There is already a constitutional requirement that taxes on interstate commerce be fairly apportioned.[7] Does the inclusion of this phrase in this legislation suggest a different meaning? The Committee did not determine what state and local governments currently impose business taxes nor did it determine whether or not this phrase refers to all kinds of business license taxes or only certain specific types of business license taxes.

Because of the way in which the preemption under this legislation is structured (i.e., imposes a broad preemption than identifies exceptions to that broad preemption), a tax that operates like a business tax but is named something else and may not be directly related to the privilege of doing business will be preempted.

According to a letter addressed to Senator McCain dated October 3, 1997,[8] the State of Texas claimed that this legislation would cost the State of Texas about $1.5 billion. My understanding is that the business license taxes supposedly permitted under Sec. 3(b) do not

[7] Cf: Complete Auto Transit v. Brady.
[8] Cf: Attachment B.

include the Texas franchise tax which is imposed on all telecommunications carriers, including Internet service providers and commerce over that medium. How does this provision relate to the franchise tax on telecommunications services imposed in a state like Texas and why would Texas come to the conclusion that this legislation would cost them $1.5 billion?

According to a letter from the Comptroller of the State of Texas, Wade Anderson,[9] said that the franchise tax imposed by Texas is not a business tax and therefore would be preempted under this legislation. The Committee never conducted an assessment on how the franchise taxes in States like New York and Ohio would be impacted under this provision. What is a business license tax? How is it defined in the bill? What happens if a tax is called a "privilege tax?" Who decides whether it will be treated like a "business license" tax? Here again, the structure of the bill creates a problem in that if a tax does not fall squarely within the 4-corners of one of the exceptions, it could be prohibited.

Sales Taxes. Section 3(b)(6)(A) of the bill states that sales taxes would be exempted from the moratorium if they are imposed on "similar sales or transactions." But, "similar" is highly ambiguous. Does this refer to an item-by-item comparison (e.g., electronic newspaper vs. tangible newspaper) or is it a comparison of classifications of taxation (e.g., use taxes on like tangible products or use taxes on electronic services or products?) In addition, the ambiguity creates a whole host of issues and potential litigation as to what constitutes a "similar sale." It is my understanding that in the case of newspapers, some jurisdictions have exempted the tangible versions from sales taxes (based on statutes decades old) but the electronic version is captured under a broader sales or use tax on "computer services" or "information services." Would this legislation mean that in those jurisdictions where this situation exists, the broader computer services tax or information services tax would be preempted? If that is the interpretation, would that not then create an incentive for those jurisdictions to remove their sales tax exemptions on tangible versions to avoid a major revenue loss because this new law would strike down their broad based computer services tax or their broad based information services tax?

Our understanding is that some states impose sales taxes on computer information services—which is unique to Internet or online commerce in terms of its delivery and distribution in some cases. Computer and information service taxes are unique by their very nature, but the imposition of them may not suggest discrimination. If, in a state or local jurisdiction, sales taxes were imposed on all information services, then does that mean the sales tax on computer and information services is preempted or would it be permissible under this legislation?

What is the impact of the bill on sales and use taxes applied to Internet access charges to end consumers? If the sales tax is applied generally to telecommunications, does it meet the "similar sales" requirement of Section 3(b)? What if the tax exempts residential service, or applies only to intra- and interstate long-distance calls? Does it still meet the "similar sales" requirement? Who

[9] Cf: Attachment A.

will decide? The latest version seems to allow sales taxes on access charges if they meet the requirement of also being applied to "similar" sales not involving the Internet. The problem is it just becomes another area for litigation.

What is the impact of the bill on sales taxes on electronic information services? In some services, a person can receive news already sorted by specified topics delivered to one's computer daily. A data base of historical news of particular stocks with regular updates and performance for example can be delivered as well. Is this a "similar sale" to a newspaper or a library or the services of a stockbroker? Will the bill allow a state or locality to impose a tax on that service since it all takes place using the Internet? Some research and services are available only on-line. In this case, what will determine whether or not there is a similar sale? The point here is the difficulty created by the sales tax preservation language. The "similar sale" language will create a great deal of litigation and constrain the ability of states and localities to make reasonable decisions and classifications on what they want to tax and what they do not want to tax.

Most importantly, the bill attempts to establish that electronic commerce sales should be compared to mail order or direct marketing sales in determining whether the seller should be required to collect use taxes on the transaction. As we all know, the Supreme Court has held that states may not require a direct marketer without physical presence in the state to collect such taxes.[10] The bill attempts by fiat to treat all electronic commerce marketers as mail order marketers and to prevent states from requiring them to collect use taxes whether or not they have the requisite presence in the state. The effect is to blow a gaping hole in the revenue base of state and local governments and to further place main street businesses at a competitive disadvantage.

About half of all revenues to state governments are derived from sales taxes. Any preemption of that revenue base could have a dramatic impact on States. According to a recent Federation of Tax Administrators report, 14 states impose sales taxes on computer and information services and 11 states impose sales taxes on computer and data processing services. It is not clear how the sales taxes in these states be impacted under this bill and whether or not the states that impose such sales taxes will satisfy the "similar" test under Sec. 3(b)(6)(A). Unfortunately, the Committee has not done a sufficient analysis on what State and local sales taxes would be preempted and which ones would be permissible under this legislation and nobody, including the bill sponsors nor CBO, can explain with confidence the full scope of the impact this legislation will have on State and local sales taxes.

Finally, section 3(b)(4) of the bill would exempt "taxes paid by a provider or user of online service or Internet access service as a consumer of goods and services not otherwise excluded from taxation pursuant to this Act." What kinds of taxes are referenced in this subsection? The clause "not otherwise excluded from taxation pursuant to this Act" seems to create a negative, canceling out what tax is being referred to in the first part of the sentence.

[10] Cf: Quill v. North Dakota, 504 U.S. 298 (1992).

The revised version says that the tax preemption does not apply to common carriers acting in their capacity as common carriers. Does this mean that transnational taxes and access charges would not be preempted when common carriers—such as phone companies—provide Internet service but the same service would be preempted from taxes if it were provided by someone other than a common carrier? Is this an equitable application of a tax?

Despite the failed attempts of the legislation to preserve certain types of taxes from the broad preemption imposed, there are a range of taxes on the books in many States and local governments that are clearly not mentioned in Sec. 3(b) and therefore would be preempted under this legislation. Those taxes include:

Franchise Taxes. There are at least 3 states that impose franchise taxes: Texas, New York, and Ohio and these taxes would be preempted under S. 442 with respect to Internet services and online services, but would still apply to other telecommunications services. The bill does not specifically mention that franchise taxes are preserved and therefore I can only conclude that these would be preempted with respect to the application of these kinds of taxes on Internet commerce.

Information Services Taxes. There are 11 states that have information services taxes which would be preempted. Those states are: South Dakota; Texas; New Mexico; South Carolina; Iowa; Connecticut; Ohio; Pennsylvania; Colorado; New York; and District of Columbia. It appears that under this legislation, Internet services and online services would be exempted from the information services taxed in these States.

Internet Access Taxes. The legislation specifically preempts Internet access taxes. I understand that 16 States have laws taxing Internet access: Tennessee; South Dakota; Texas; New Mexico; Utah; South Carolina; Iowa; Connecticut; Ohio; Illinois; North Dakota; Wisconsin; West Virginia; Colorado; Alabama; and the District of Columbia.

Tobacco and Alcohol Taxes. Tobacco sales over the Internet are growing fast. Under this legislation, it appears that tobacco sold through Internet commerce or through an online service would be exempted from taxes whereas tobacco purchased at a store remain subject to tax. The same situation exists for alcohol sales—which I understand is a growing problem, not only with respect to taxes but also with respect to minors accessing alcohol through Internet commerce, circumventing state and local laws designed to limit access to alcohol and tobacco. Will this bill allow special excise taxes to be applied to the purchase of cigarettes, cigars, wine and the like over the Internet? In some states, it is possible to purchase certain quantities of these products via mail order or by phone orders and a requirement that state tobacco taxes or liquor taxes be paid. If they are purchased over the Internet under this bill, the sale would seem to be tax exempt because there is no exception for the taxes.

Gaming Taxes. Where gaming taxes exist, they would be preempted under this legislation with respect to gaming activity over the Internet.

Telecommunications Excise Taxes. The effect of the bill on existing special telecommunication excise taxes on Internet access charges to the end consumer and the purchase of telecommuni-

cations services to create the networks that make up the Internet is unclear at best. Only a couple of states impose a special telecommunications excise tax (special in that it applies only to telecommunications and not just Internet access), but a number of others apply such a tax to the purchase of telecommunications services that make up the backbone of the Internet and the corporate intranet. There is no exception for such taxes and therefore these taxes would be preempted.

Definitions. The bill introduces new definitions, creating uncertainty about the bill's impact. This legislation would preempt taxation on "online services" and on "Internet access service," and it is not clear on how "on line services," as defined in this bill, relates to how these services are defined in the Communications Act.

The term "online services" is defined as the "offering or provision of information, information processing, and products or services to a user as part of a package of services that are combined with Internet access service and offered to the user for a single price." It appears this includes preempting taxes on the use of Lexis/Nexus, stock quotations, real estate listings, and other on-line data bases that are currently subject to taxation.

Our understanding is that several states have statutes taxing "information services," "computer services," and "data processing" services and these are interpreted as online services. It appears that these taxes would all be preempted. For the most part, the consumer paying these kinds of taxes are law firms, corporations, and significantly-sized businesses. It is the determination of the bill sponsors that law firms and major companies need a break from these taxes? And have the sponsors determined how much revenue is at stake here and would be shifted to other revenue sources that may have a large impact on individuals? In other words, it appears that the preemption of taxation on online services is largely going to benefit law firms; shifting State and local tax burdens on individuals.

Finally, this definition may capture private communications networks set up between the various locations of a single business enterprise. These "intranet" networks are becoming increasingly popular and are proliferating. Thus, telecommunications taxes applied to the telecommunications services used for such networks would be preempted.

"Internet access services" are defined as the "offering or provision of the storage, computer processing, and transmission of information that enables the user to make use of resources found via the Internet" i.e., the Internet connection. The definition says that these services include the use of telecommunications services and cable services defined under 602 of the Communications Act.

Does this mean that under the legislation, taxes on cable services would be preempted from taxation? Or would a portion of cable services, i.e., Internet services, be immune from taxation while other cable services would remain subject to taxation? I understand that the legislation says that franchise fees for the provision of cable services are specifically excluded from the preemption. However, the definition of Internet access services suggests that any tax imposed on a cable company outside of franchise fees would be preempted. Is that the intent of the legislation: to provide a tax

break for cable companies who provide Internet access? Also, what is to keep cable companies (and other telecommunications carriers for that matter) from exploiting this special tax treatment by classifying their other telecommunications services as Internet access services? If Internet access qualifies for tax breaks, what aspects of telecommunications networks would be excluded from this special tax treatment and what would be included?

Does this definition mean that sales taxes imposed on cable services would be preempted? Following the logic of the legislation's claim that taxes on "similar sales or transactions" would not be preempted, would that mean all sales taxes on cable services would be preempted because of Section 602 of the Telecommunications Act which preempts state and local taxation on direct-to-home satellite services, thereby ensuring that there are no other similar taxes?

There is also the concern about this definition undermining universal service. According to the May, 1997 universal service order issued by the Federal Communications Commission (FCC)[11] Internet service providers are specifically excluded from the requirement to contribute to universal service. Under S. 442, cable services are classified as Internet services, thereby creating a loophole for some providers to avoid the requirement to contribute to universal service. Although Section 7 of this legislation states that nothing in this Act shall affect the implementation of the Telecommunications Act, if this Act defines cable services as Internet services—which the FCC specifically exempted from the Telecommunications Act's requirements to contribute to universal service—this legislation then establishes a new category of telecommunications carriers excluded from the requirement to contribute to universal service. Although this legislation does not change the Telecommunications Act statute—it does expand the exclusion created by the FCC's interpretation of the Telecommunications Act in terms of allowing a new class of telecommunications carriers to avoid contributing into universal service.

SUMMARY

This legislation creates an unfair special interest tax break for a particular category of telecommunications providers based on technological means of commerce, provided on the backs of state and local governments. Why should Congress decide that one specific technology deserves a special tax break over other means of commerce? The moratorium imposed in S. 442 would create an unfair competitive situation by providing on-line providers with a tax break that others not utilizing electronic commerce would not receive. This is a tax break provided solely on the basis of a particular technology, not on the service; creating a technologically-specific preference policy. It is a tax break that is not technologically neutral and therefore, it runs counter to one of the fundamental principles of the Telecommunications Act of 1996 that was designed to create a regulatory environment to promote competition on a technologically neutral basis.

[11] FCC Report and Order (FCC 97–157), May 7, 1997.

S. 442 is the opposite of fairness and equitable tax treatment. The fundamental approach of this legislation is not to level the playing field but to tilt the field in favor of a special class of commerce, namely electronic commerce. This legislation is seriously flawed and ill-conceived and it ought not be considered by the Senate until the Commerce Committee and other appropriate Committees that have jurisdiction over issues of taxation can explore the issues related to taxation of electronic commerce.

This legislation would seriously hurt main street businesses, creating a tax-protected avenue for commerce that discriminates against main street businesses and other areas of commerce. Under this bill, transactions and the use of a particular area of commerce—namely, Internet use and online activity—receive special federal tax protection. There are a whole host of business activities which would be exempted from state and local taxation as long as those activities are occurring over the Internet and not from main street or mail order distribution. Non-electronic commerce activity would remain subject to State and local taxation.

This legislation will impose unfair taxation circumstances on main street businesses and create a "tax free" pricing advantage for those doing business via on-line services. Main street businesses will be disadvantaged because they will have to continue paying taxes that their competitors who use the Internet as their commercial medium will receive special tax treatment.

A dozen major state and local government organizations have informed the Committee of their opposition of this legislation:

- The National Governors Association;
- The International City/County Management Association;
- The National Association of Counties;
- The National Council of State Legislatures;
- The National League of Cities;
- The Council of State Governments;
- The U.S. Conference of Mayors;
- The National Association of County Treasurers and Finance Officers;
- The National Association of State Auditors, Comptrollers, and Treasurers;
- The National Association of Telecommunication Officers and Advisors;
- The National Association of State Treasurers; and
- The Government Finance Officers Association.[12]

My objective is to advance policies that neither favor nor discriminate against particular types of commerce, electronic or otherwise. In my judgement, electronic commerce ought not to be subject to discriminatory taxation, nor should it receive special tax treatment unless a legitimate public policy reason requires unique tax status. So far, such a case has not been made.

This legislation is harmful and counter productive to the discussions currently taking place between industry and state and local government officials that are attempting to develop model legislation for the taxation of Internet services. Discussions have been ongoing between the industry and state and local government officials

[12] Attachment C.

under the sponsorship of the National Tax Association. NTA, working with industry and state and local officials, is studying methods to address issues related to the appropriate taxation of businesses using the Internet and other issues related to on-line commerce. Although the bill sponsors altered the original bill to limit the moratorium to 6 years, I doubt that once the Internet industry is provided with the special tax status afforded under this legislation, they will never give up their special tax privilege and will have no incentive to participate in those discussions. S. 442 in its present form creates a circumstance in which the industry will have no incentive to negotiate with state and local governments to develop uniform taxation. By installing a permanent tax preemption, the industry will have the incentive to fight any new method of taxation. In contrast to S. 442, we ought to create a level playing field where all sides will have the appropriate pressure and incentive to work cooperatively to develop a uniform method of taxation. The Congress should encourage the industry to work in good faith with state and local governments to address legitimate issues of taxation of on-line services as opposed to granting a special interest tax break. Granting a moratorium will not be productive. Rather, it will be counter productive and will not encourage either side to work for a consensus solution.

The Congress needs to be reminded about the serious commitment that state and local governments are making to work cooperatively with the industry to address legitimate concerns. Imposing moratoriums on state and local rights do not move the process forward. Rather, moratoriums will have a chilling affect on these important discussions.

The National Governors Association also endorses this approach instead of the legislation. According to a resolution approved by the NGA at their winter meeting,[13] the Governors will continue to oppose federal action to preempt the sovereign right of the states to determine their own tax policies. The Governors therefore endorse the process undertaken by the National Tax Association with the support of the Federation of Tax Administrators and the Multistate Tax Commission to review existing problems in the taxation of telecommunications and to propose coordinated policies that will help states promote fair competition while ensuring that the telecommunications industry bears it fair share of taxation.

It seems to me that the objective we should seek to accomplish is to establish a uniform method of taxation of not only Internet services but other telecommunications services and lines of commerce as well. Section 4 of S. 442 is productive in that it calls for a discussion between all levels of government to study taxation issues and develop proposals for a uniform taxation system. However, the process is already taking place and the moratorium imposed under Sec. 3(a) defeats the purpose of ensuring a good faith dialog. Our efforts ought to focus on how to ensure that the existing process succeeds, rather than creating an erosion of state and local tax bases.

The fundamental difficulty with S. 442 in its present form is that it preempts existing broad based taxes and creates an un-uniform

[13] Attachment D.

method of imposing a whole host of state and local taxes on commerce by exempting a specific technology from existing broad-based taxes. I believe that taxes that target a specific technology—such as the Internet—should not be imposed. Broad-based taxes that are fair and reasonable because they apply to all categories of services and on all categories of telecommunications providers should not be carved up through a special interest Federal preemption. Under S. 442, state and local governments could lose hundreds of millions of dollars because their existing broad-based taxes would have certain persons and businesses carved out in an anti-competitive fashion.

COMPTROLLER OF PUBLIC ACCOUNTS
STATE OF TEXAS
AUSTIN, 78774

June 4, 1997

Ms. Barrie Tobin
National League of Cities
1301 Pennsylvania Avenue, NW
Washington, DC 20004

Dear Ms. Tobin:

After I returned to Austin, I asked our chief revenue estimator to cost out S. 442. Enclosed is a copy of our estimates of lost Texas revenues relating to the Cox/Wyden bill should it pass as introduced.

You will notice that the estimate did not include a cost for lost franchise taxes because the estimators interpreted as "apportioned business license taxes" in Sec. 3 (b) (2) of the bill to include our franchise privilege tax which is based on apportioned capital. Neither I nor our franchise tax section have ever considered our franchise tax a business license tax. Because time is of the essence and the amount of money surrounding this issue is not large, I am forwarding the figures without any further reference to our franchise tax. However, if the bill is redrafted to grandfather existing taxes, I believe further effort should be made regarding capital based franchise taxes because I have reservations as to whether the existing language protects them.

I realize that some of the items listed are arguable. But, my experience with taxes is that if an item can be argued as exempt, it will be. Therefore, we have included possible losses of sales taxes in items 1, 3, and 6.

If you have any questions, please call me at 1-800-531-5441, extension 3-4004, or write me at 111 East 17th Street, Austin, Texas 78774.

Sincerely,

Wade Anderson
Director, Tax Policy

Enclosure

cc: Billy Hamilton, Deputy Comptroller, Texas Comptroller of Public Accounts
Harley Duncan, Executive Director, Federation of Tax Administrators
The Honorable Byron Dorgan, United States Senator

DATE: May 30, 1997

TO: Wade Anderson

FROM: Mike Reissig and John Heleman

SUBJECT: Revenue Estimates Related to the Cox/Wyden Internet Bill

The Telecommunications Infrastructure Fee

The maximum potential revenue loss from the TIF is shown in the following table:

Fiscal Year	Loss ($mil.)
1998	$139.2
1999	$149.4
2000	$160.7
2001	$173.1
2002	$187.7

Franchise Tax

It appears that the franchise tax capital portion would be largely unaffected, since the federal legislation would permit "apportioned business license taxes applied to businesses having a business location in the taxing jurisdiction." This appears to include the capital portion of the franchise tax.

Second, businesses that base themselves on internet activity or computers are usually low in capital assets and high in labor content. These businesses usually have negligible capital tax liabilities and usually are earned surplus taxpayers. The capital tax paid by SIC 737x industries totaled only $1.5 million for fiscal 1996. This industry group includes computer programming, data processing and other computer related services.

Finally, the capital tax paid by all firms in 1996 was about $300 million. We are unable to determine what portion of this amount is due to use of computer equipment to generate sales.

Sales Tax

As discussed, the following figures do not relate to any fiscal gain or loss from S442, but reflect the estimated amount of state sales tax currently collected on a variety of items—items which might be affected by the provisions of S442.

1. State sales tax on all taxable telecommunications services. This includes both local access and long-distance services; both voice and data communications.
Est. FY97: $649.2 million

2 Internet access charges. Est. FY97: $10.0 million

3. Retail sales (for both personal and business purposes)—all computers, software, printers, related hardware and equipment, etc.
Est. FY97: $110.1 million

4. Information services (Reuters, etc.) Est. FY97: $10.0 million

5. State sales tax on other items, such as web site art work, charges to set-up a web site, storage of information at a web site, etc.
Est. FY97: $5.0 million

6. Sales "effected" by the use of interactive computer systems / Internet. As we discussed, Wade, this reflects a rough, "ballpark" estimate of retail sales purchased using credit cards (versus cash or check)—cards processed using some sort of telecommunications network.
Est. FY97: $1.5 Billion

Property Tax

The numbers below do not address any state requirement to increase school districts' state payments because of additional property tax exemptions.

1. In tax year 1996, the total taxable value of telephone companies in the state was approximately $10 billion. If you assume that this is exempt from property taxes, the property tax loss to the local jurisdictions would be approximately $251.5 million (1996 weighted tax rates).

Losses by type of jurisdiction
Schools: $147 million
Cities: $40.9 million
Counties: $37.6 million
Special districts $26 million

2. Very rough estimates show that slightly less than 1 percent of the total value of business personal property is in computers, modems, and software. This includes oil companies and big retailers and all other businesses that render personal property values to appraisal districts.

If you assume that all business computers, modems, and software are exempt from property taxes, the property tax loss to local jurisdictions would be approximately $13.6 million (1996 weighted tax rates).

Losses by type of jurisdiction
Schools: $8 million
Cities: $2.2 million
Counties: $2 million
Special districts: $1.4 million

3. Local jurisdictions could tax the household goods and personal effects of private individuals, but none do so. Some jurisdictions tax private autos, boats, airplanes and motorcycles. Consequently, the personal computers, modems, and software of private individuals currently generate no property taxes.

Presentation to the United States Senate Committee on
Commerce, Science, and Transportation
Wade Anderson
Director, Tax Policy
Comptroller of Public Accounts
State of Texas

The "Internet Tax Freedom Act" is correctly labeled - more so than its sponsors probably ever believed possible. It is represented as a moratorium on new taxes on the Internet. At a minimum, it actually grants telephone companies, software companies and computer on-line service companies major, permanent exemptions from a wide range of taxes which they are presently paying. These include property taxes, telecommunications sales and excise taxes, use taxes on equipment, unemployment and workers compensation taxes on its employees, motor fuels taxes, vehicle registration fees, and local government right of way fees. It grants all businesses and professions a permanent exemption from property taxes on the vast majority of their computers. It grants a sales tax exemption to modem-equipped computers, telephone equipment with computer connections, all computer software and all computer information services sold in America. Those are simply the exemptions from existing taxes that are quite clear. The loss of existing revenue would be significant in most states. In Texas, the loss would be dramatic as it would forbid our collecting taxes on a wide range of services and sales which have been subject to our taxes for many years including sales tax on information services and telecommunications services.

The possible exemptions do not end there. The bill, because of its ambiguous language, will certainly generate litigation to test the full extent of the tax relief it provides from existing taxes. Because of the definitions used in the bill, motor fuel taxes on any sale of fuel made by credit cards or processed through computer networks may be exempt. It may even exempt from state and local sales taxes any sales made by credit cards or processed through computer networks even if made through local retail stores.

This potential impact of S.442 as introduced would be devastating for state and local government services and for the holders of state and local government bonds. The bill should not tempt this fate for state and local governments to whom Congress has so recently delegated increased responsibility for meeting the human service needs of this nation. The bill, we trust, will be given a full analysis by the Congressional Budget Office

under the unfunded federal mandates legislation enacted with great fanfare in the last Congress. I believe that if this is done, the costs to the states associated with passing the bill will far exceed the unfunded mandates limit.

The protections given to state and local governments regarding the imposition and collection of sales tax may be empty protections or worse. The language may actually endanger the continued viability of sales taxes as the major source of State revenue. In Texas, the sales tax is our primary state revenue source. It allows state and local governments to collect sales taxes on sales "affected by ... interactive computer services" only if the sales tax is the same tax as is 'generally ... collected on interstate sales ... effected by mail order, telephone, or other remote means ..." Because states are prohibited by current Supreme Court rulings from generally requiring mail order companies from collecting taxes on interstate sales made by these means, the bill may provide virtually no protection to state and local taxing authority.

In addition, while the bill provides for the preservation of certain state and local taxing authority, it leaves out more than it provides. While it provides for income taxes, it does not provide for franchise taxes measured by capital. When subsection (b)(2) of Section 3, addresses licenses, it does not address other taxes businesses pay, such as Texas' Telecommunication Infrastructure Fee which is not a business license tax. Other taxes, such as those previously listed, are not addressed.

The bill grants tax exemptions to a wide range of companies. These include companies that the sponsors would have anticipated as being exempted such as telephone companies and computer on-line service companies. However, the sponsors might be surprised to discover other companies, such as software companies, businesses not involved in rendering telecommunications services, professions, retail stores, and oil companies, also claiming exemption.

How does the language of the bill grant telephone companies, software companies, and computer on-line service companies major, permanent exemptions from a wide range of taxes including property taxes, telecommunications sales and excise taxes, use taxes on equipment, unemployment and workers compensation taxes on its employees, motor fuels taxes and vehicle registration fees, and local government right of way fees? It grants these companies these major exemptions because of the broad definition of an interactive computer service under the bill. With the possible exception of pay phones without

computer connections, the bill includes in the tax relief it grants virtually the entire U.S. phone system in the scope of the bill because it is a "system that ... enables computer access by multiple users to a computer server." The bill includes in the tax relief all software companies because they are "access software providers" which are a sub category within "interactive computer services." The bill includes all on-line service companies because they operate an "information service ... that enables computer access by multiple users to a computer server."

How does the language of S.442 grant all businesses and professions a permanent exemption from property taxes on the vast majority of their computers? Very simply, the vast majority of computers used by businesses and professional firms are linked in networks or have modems and software that enable connections to computer information services, other computers or to the Internet. By definition all these computers are "interactive computer services" under the bill. Property taxes directly tax those computers and would be preempted by the bill. Included in the scope of exempt equipment are specialized computer networks such as ATM machines, credit card approval networks and computers used by companies for electronic data interchange.

How does the language of S.442 grant a sales tax exemption to modem-equipped or net workable computers, telephone equipment with computer connections, all computer software and all computer information services sold in America? Again, the definition of "interactive computer services" includes all such items and grants them tax relief. Moreover, the supposed protection for State and local sales and use taxes -- which has other problems as previously stated -- offers no protection for sales and use taxes on the sale of goods and services that qualify as "interactive computer services." It is written to protect only sales "effected by" the Internet or interactive computer services -- not the sale of the computers, software, telecommunications equipment or information services that comprise "interactive computer services."

How does the language of S.442 create the potential for litigation to expand the scope of its tax preemptions to motor fuels taxes on fuel paid for by credit cards or otherwise processed through a network of company computers? The bill prohibits taxes that "indirectly" tax the use of an interactive computer service. Credit card approval networks or company computer networks used to process motor fuel sales qualify as interactive computer service. Any motor fuels tax on a sale made using such systems can be argued to be indirectly taxing such systems.

How does the language of S.442 create the potential for exemption from sales and use taxes the sale of any item or service paid for by credit card or otherwise processed through a network of company computers? First, the reason is the same as for the motor fuels tax case. A tax on a sale made through the use of a credit card approval network or a network of retail store computers may be interpreted as taxing indirectly the use of interactive computer services.

There are a number of "hows" in the preceding paragraphs. The "why" arises essentially from four sources which are as follows:

1. The bill borrows definitions from the "Decency "Act" provisions of the Telecommunications Act of 1996 for "interactive computer services" that basically sweeps every type of computerized equipment, all software, every software company, and all telephone companies into the scope of tax relief granted by the bill. The Decency Act definitions were drafted broadly to protect the children and other citizens from "obscene, harassing and wrongful utilization of telecommunications facilities." Transferring broad definitions intended to protect children from pornography to the realm of taxation has a broad and devastating effect on state and local government.

2. The bill prohibits any taxes or fees that "directly or indirectly" affect interactive computer services or the use of interactive computer services (which includes the U.S. phone system, nearly all computers, all software and all software companies). The prohibition on taxes that "indirectly" affect interactive computer services or the use of such services creates vast litigation opportunities for any companies wishing to prove that they incurred an indirect economic burden as a result of virtually any state or local tax.

3. The bill defines taxes in a sweeping manner to include all state and local government taxes and fees, including not only general property, sales and income taxes, but also several other important taxes such as motor fuels taxes, vehicle fees, unemployment and workers compensation taxes, and right-of-way fees. Moreover, the sweeping definition includes even the obligation to collect a tax, which especially implicates sales and use taxes and motor fuels taxes.

4. The supposed protection provided to sales and use taxes under the bill is so obscurely and ambiguously drafted that it, in fact, may not only not protect sales and use

taxes at all, but actually create a serious threat to the continued viability of our largest single source of state government revenue.

The bill is represented as creating a moratorium on state and local taxes. There is no end to the moratorium in the bill. Therefore, regardless of the use of the term "moratorium", the bill creates a permanent exemption not only for taxes that might be applied to future services involving the Internet but from taxes that have been applied directly or indirectly to persons for decades.

Ostensibly, the sponsors of the bill would like to see a national solution to the problem of taxation of economic commerce over the Internet and services connected with the Internet. At present, state organizations and business associations have formed the Communications and Electronic Commerce Tax Project whose primary goal is to develop model legislation for the application of state and local taxes and fees to economic activities that include operating through the Internet, electronic on-line services and comparable electronic means. Some of the organizations represented are the Federation of Tax Administrators, the National Tax Association, the Multistate Tax Compact, the National Conference of State Legislators, the National Governors Association, the Committee on State Taxation, the National Cable Television Association, the United States Communications Association, the Financial Institutions State Tax Coalition, the Information Technology Association of American, and representatives from companies, such as Microsoft, IBM, U.S. West, Bell South Corporation, and AT&T. If S.442 is passed granting a permanent exemption to most if not all of the business participants in this project, it is unlikely that the project can succeed. Therefore, the bill will be counter productive to the sponsors' aims.

In conclusion, the bill, if passed will result in years of litigation, substantial erosion of current tax bases in the states, a loss of future revenues involving sales of goods and services over the Internet, and a natural reluctance by industry to solve the tax problems surrounding the Internet.

FEDERATION OF TAX ADMINISTRATORS

444 North Capitol St., NW, Washington, D.C. 20001 • (202) 624-5890

October 3, 1997

The Honorable John McCain
United States Senator
241 Senate Russell Office Building
Washington, D.C. 20510-0303

Dear Senator McCain:

I write on behalf of the Federation of Tax Administrators, a non-profit organization whose members consist of the principal revenue agencies of the 50 states, the District of Columbia, and New York City. Many of our members are concerned about the potential fiscal impact of S. 442, the Internet Tax Freedom Act, on current state revenue collections. These members believe that the potential magnitude of state revenue losses has not been adequately expressed to the Committee.

While it is true that some states are not seriously affected by the bill (and some may not experience any reductions in revenues at all), other states have indicated that they will suffer substantial losses. The FTA conducted a survey of the states, asking them to give a rough estimate of their revenue losses from the bill. Although not all states have responded as of yet, below is a list of responses to date. Please note that all totals are approximates per year:

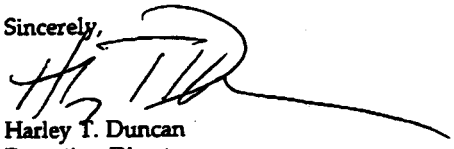
Hawaii:	$10 million
Massachusetts:	Less than $10 million
Ohio:	$9.5-$12 million
South Carolina:	$1.25 million
Tennessee:	$2 million
Texas:	$1.5 billion
Washington:	$28-280 million
Wisconsin:	$1.2-$3.8 million

As you can see, the potential revenue loss from just these few states is quite substantial. Differences in the magnitude of potential losses stem from the fact that some of these states impose taxes that are not protected from preemption by the bill. For example, we would point out that because the bill does not protect VAT-type taxes from preemption, the State of Michigan stands to lose all of its Single Business Tax revenues that would have

otherwise been paid by Internet businesses. Although Michigan is one of the states that has not yet responded to our survey, it is certain that their revenue losses would be material.

We hope this information is useful to you and the Committee. The Federation stands ready to work with you and others in developing legislation that respects the complexities of state and local taxation.

Sincerely,



Harley T. Duncan
Executive Director

cc: Members of the Senate Commerce Committee

National Governors' Association
National Association of Counties
National League of Cities
United States Conference of Mayors
International City/County Management Association

November 4, 1997

Honorable John McCain
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D.C. 20510

Honorable Ernest F. Hollings
Ranking Member
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D.C. 20510

Dear Chairman McCain and Senator Hollings:

On behalf of the nation's elected state and local government officials we write to express our continued strong opposition to the latest version of the Internet Tax Freedom Act, S. 442. Although many changes have been made in the bill, we still oppose it because of its flawed structure, which places a broad range of existing state and local taxes at risk of preemption – intended or not. By establishing a clear and broad federal preemption and then attempting to protect certain existing taxes through a generic list, this proposal ensures that both states and local governments will be forced to defend an unknown number of specific taxes in court throughout any moratorium. The language of any list of exemptions following such a broad preemption cannot be perfected because of the necessary complexity of state and local tax law.

The bill proposed an even graver threat by establishing federal policy that sales over the Internet must be treated as mail order catalogue sales. While this is in fact current law, forcing the federal government to take this stand will likely interfere with our attempts through the National Tax Association (NTA) to establish a truly technologically-neutral sales tax. The explosive growth of the Internet guarantees that transactions over the Internet will far exceed mail order sales in only a few years, and, over time, to rival retail stores. This proposed legislation will lead to Main Street stores and small businesses in small and medium-sized towns across America being forced to close due to the discriminatory impact of a sales tax levied only on retail stores, not their Internet competitors. That is not a policy we can support.

To solve this issue, our members have already begun negotiations with industry and expect to have a proposal developed next year. During this study and the federal government's review of its conclusions, states and local governments are precluded from imposing taxes on Internet sales except within the home state of the business. There is a need to study this issue and develop consistent and fair policy; there is no need for a moratorium.

Honorable John McCain and Honorable Ernest F. Hollings
November 4, 1997
Page 2

We urge you to keep this legislation in committee and ask the industry to negotiate with state and local government to develop a proposal that we both can support.

Sincerely,

Raymond C. Scheppach
Executive Director
National Governors' Association

Larry E. Naake
Executive Director
National Association of Counties

Donald J. Borut
Executive Director
National League of Cities

J. Thomas Cochran
Executive Director
U.S. Conference of Mayors

William H. Hansell, Jr.
Executive Director
International City/County Management Association

c. Senate Commerce Committee Members

PLEASE DELIVER TO: Byron Dorgan 1 OF 2 NOV 3 97

THE UNITED STATES CONFERENCE OF MAYORS

1620 EYE STREET, NORTHWEST
WASHINGTON, D.C. 20006
TELEPHONE (202) 293-7330
FAX (202) 293-2352
TDD (202) 293-9445
URL: www.usmayors.org/uscm

President
PAUL HELMKE
Mayor of Fort Wayne
Vice President
DEEDEE CORRADINI
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Mayor of Abilene
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Mayor of Spokane
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Mayor of Boston
DAVID W. MOORE
Mayor of Montgomery
ARLENE J. MULDER
Mayor of Arlington Heights
DOUGLAS PALMER
Mayor of Trenton
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Mayor of Akron
EDWARD RENDELL
Mayor of Philadelphia
M. SUSAN SAVAGE
Mayor of Tulsa
KURT L. SCHMOKE
Mayor of Baltimore
MARTHA A. WOOD
Mayor of Winston-Salem
Executive Director
J. THOMAS COCKRAN

November 3, 1997

RECEIVED NOV 04 1997

Dear Senator:

We are writing once again to express our strong opposition to the Internet Tax Freedom Act (S. 422) and to urge that action on the proposal be delayed. Before any action is taken, state and local groups must be given the opportunity to develop, with representatives from the telecommunications industry, recommendations on the state and local taxation of electronic commerce. As we informed the committee before, our national associations are currently participating in a voluntary effort, under the auspices of the National Tax Association to address the issues of consistency, uniformity and clarity in the state and local taxation of electronic commerce. We are still convinced that this approach offers us the best opportunity for developing a fair and equitable solution to these issues.

Although S. 422 has been modified several times, we remain concerned about the five-year moratorium imposed on new state and local taxes, as well as the other issues mentioned in a June 25 letter to you from state and local government groups. We pointed out in that letter our strong opposition to the preemption of sales taxes and telecommunication excise taxes on charges for access fees to and use of the Internet and online services. We also expressed concerns about the absence of language in the bill that would grandfather existing tax laws. Because of this, state and local governments stand to lose existing revenue sources in mid-year which could be disruptive to many critical public services.

Much of the debate over this bill has focused on what states and localities might do to tax the growing Internet industry, rather than on what has actually happened. Preempting existing state and local tax bases on such speculation would be unfair and unwarranted. Again, we urge you to delay action on S. 422 until we have had the opportunity to develo and submit recommendations in this are

Sincerely,

Mayor Paul Helmke
City of Fort Wayne
President
U.S. Conference of Mayors

Mayor Deedee Corradini
City of Salt Lake City
Vice President
U.S. Conference of Mayors

Mayor Wellington Webb
City of Denver
Chair of the Advisory Board
U.S. Conference of Mayors

Wilmington, Del.

New Orleans, La

Chicago, IL

Akron, Ohio

Knoxville, TN

Rockford, Illinois

Eugene, Indiana

Cedar Rapids, IA.

Long Beach, Calif

Detroit, Mich.

San Leandro, CA

Palatine, IL

Richmond, Ca

Reno, Nevada

Arlington Heights, Il.

Stamford CT

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Charlotte, NC

Beaumont, Texas

NATIC OCT 31 '97 02:34PM NAT. P.6/12

NATIONAL GOVERNORS' ASSOCIATION

George V. Voinovich
Governor of Ohio
Chairman

Thomas R. Carper
Governor of Delaware
Vice Chairman

Raymond C. Scheppach
Executive Director

Hall of the States
444 North Capitol Street
Washington, D.C. 20001-1512
Telephone (202) 624-5300

October 29, 1997

The President
The White House
Washington, D.C.

Dear Mr. President:

On behalf of the nation's Governors, we are writing to express our strong opposition to the Internet Tax Freedom Act. As Governors, we look to the growth of the Internet to increase economic development and improve the delivery of public services. We share your belief in the importance of the Internet for the nation's economic future in an expanding global economy. However, we ask your help to ensure that any action on this legislation be postponed until 1998 so that a number of critical state and local economic issues can be addressed.

The nation's Governors view potential action to preempt state taxing authority on the Internet as the most significant challenge to state sovereignty that Congress has considered in many years. First, this proposed legislation would have the immediate impact of preempting existing state taxes. Second and much more importantly, it will impose major inequities in state tax systems over the next ten years. Currently, about 49 percent of total state tax revenues are generated by sales taxes. In the future, most Americans will be purchasing goods over the Internet circumventing state sales taxes. A recent report by an Internet marketing research firm projects that World Wide Web sales will be $1.5 trillion by 2002. This will lead to unequal and discriminatory tax treatment in states. Individuals who buy goods on Main Street will pay taxes; those who purchase over the Internet will not. This could also lead to the virtual collapse of state sales taxes over the next ten years. Such far-reaching implications require a more thorough investigation and debate.

The National Governors' Association endorses an effort being undertaken by the National Tax Association to bring industry and government representatives together to develop consensus proposals for the taxation of electronic commerce. We believe that this is the best approach to the threat that inconsistent and uncoordinated federal, state, and local taxes may become a hindrance to development of the Internet. Adoption of the proposed legislation will only create a privileged class of taxpayers. Rather than addressing the problem, it will exacerbate it. The best hope for consistent, administrable, and equitable taxation is for industry to work with states, localities, and your administration to develop simplified and consistent approaches to taxation.

Finally, we are seriously concerned that the structure of the proposed legislation is unworkable. The bills completely preempt all state and local taxing authority over the Internet and then establish a list of categories of permissible taxes. It will take the courts years of litigation to determine how to apply the categories of permissible state and local taxes to our necessarily complex tax codes. In the meantime, states will face serious problems in estimating revenues, which will make balancing state budgets and ensuring needed public services much more difficult. The cost of litigation alone could more than outweigh the perceived harm that state and local taxes might have on the development of the Internet.

The Internet Tax Freedom Act is not consistent with the policy expressed in your administration's white paper, "A Framework for Global Economic Commerce," which states there should be no new or discriminatory taxes on the Internet. As drafted, this bill represents the single most serious challenge to state sovereignty that Congress has considered in many years. For that reason, we request that you send a letter to the relevant congressional committees indicating that you will not sign a bill that preempts state authority.

Sincerely,

Governor George V. Voinovich
Chairman

Governor Thomas R. Carper
Vice Chairman

National Governors' Association
National Conference of State Legislatures
National Association of Counties
National League of Cities
The United States Conference of Mayors
International City/County Management Association

October 23, 1997

The President
The White House
Washington, D.C.

Dear Mr. President:

We are writing to seek your assistance in a matter of great importance to state and local governments. It is our understanding that before recessing for the year, both the House and the Senate may try to complete action on the Internet Tax Freedom Act as sponsored by Senator Ron Wyden of Oregon and Representative Chris Cox of California. State and local elected officials are concerned the pending bills, S. 442 and H.R. 1054, despite changes that have been made so far, will preempt or limit existing state and local revenues and create a privileged class of taxpayers, namely those whose businesses involve the Internet. Both these impacts go beyond the policy expressed in your administration's white paper issued this past July, *A Framework for Global Electronic Commerce*, which states, "no new or discriminatory taxes on the Internet."

State and local governments recognize the vital importance of the Internet and advanced communications systems for our states and our nation and realize that there is a need for a coordinated and simplified tax structure that will not be an impediment to the growth of these services. We should note for the record that not one state has ever passed an Internet-specific tax, and this year alone, a number of states have passed legislation specifically exempting the Internet from various state and local taxes. We and our colleagues across the country are as concerned as you are about the unintended consequences of obsolete or discriminatory taxes on this vital new technology. At the same time, there are critical, if unintended, consequences of this broadly drafted and ill-defined federal legislation that could seriously undermine existing state revenues and place unfair burdens on small Main Street businesses.

Although we remain opposed to any federal effort that would preempt the sovereign rights of states and localities to determine their own tax and franchise policies, we also realize that constantly changing technological advances present unique challenges to current state and local tax policies. For this reason, all of the national state and local organizations have endorsed participation in the National Tax Association's Communications and Electronic Commerce Tax Project. This project, which is referenced in the Internet Tax Freedom Act, is identifying the issues involved in applying state and local taxes and fees to electronic commerce and developing recommendations, including model tax legislation, regarding the applications of such taxes. At the first meeting of the project, we voted to ensure that the U.S. Treasury Department has a role in the discussions. We believe the process is working and that Congress should not act in haste in passing these ill-defined prohibitions that will only result in numerous and costly lawsuits against state and local governments.

The President
October 23, 1997
Page 2

We believe your administration's position on Internet taxation is more consistent with the position of state and local governments. We urge you to communicate to Congress your clear determination not to sign any Internet taxation legislation unless it is limited to affecting new and discriminatory taxes.

Sincerely,

Governor George V. Voinovich, Ohio
Chairman
National Governors' Association

Senator Richard Finan, Ohio
Senate President
President, National Conference of State Legislatures

Commissioner Randy Johnson
Hennepin County, Minnesota
President, National Association of Counties

Council Member Mark S. Schwartz
Oklahoma City
President, National League of Cities

Mayor Paul Helmke
City of Fort Wayne
President, The U.S. Conference of Mayors

Mr. Gary Glyn, City Manager, Grand Prairie, Texas
President
International City/County Management Association

NATIONAL GOVERNORS' ASSOCIATION

News Release

Hall of the States
444 North Capitol Street
Washington, D.C. 20001-1512
Telephone (202) 624-5330

FOR IMMEDIATE RELEASE
October 28, 1997 (145-97)
Contact: Becky Fleischauer 202/624-5364

Governors Step Up Efforts to Urge More Responsible, Fair Internet Tax Legislation

Washington, D.C.—The nation's governors are stepping up efforts to urge Congress to adopt more responsible, fair Internet tax legislation. Several governors, mayors and county executives will meet with key members of Congress this week to voice their strong opposition to proposed Internet tax legislation that would preempt existing state and local taxes.

"Some in Congress are pushing protections for one segment of industry at the expense of Main Street business and other taxpayers," said NGA Chairman Ohio Gov. George V. Voinovich and Vice Chairman Delaware Gov. Thomas R. Carper. "State and local governments are in no way poised to levy new taxes on the Internet. In fact, this year alone seven states have even passed laws that *remove* taxes from the Internet. We are meeting with members of Congress this week to drive home the point that any legislation preempting existing state and local taxes is premature, unnecessary, and creates a protected class of taxpayers at the expense of Main Street business and other taxpayers. The tax inequity created by these proposals would spark a virtual collapse in state and local sales tax bases."

Governors are committed to ensuring that state tax policies are not a barrier to growth in the communications industry. Increased access to reliable, high-speed communication services is key to job creation and delivery of more cost-effective public services. Governors in many states are working to develop ways to use the Internet to deliver a broad range of citizen services, but they believe the consequences of proposed legislation should be a wake-up call for more thought, deliberation, and debate.

Currently, about 50 percent of total state and local tax revenues are generated by a sales tax. In the very near future, most Americans will be purchasing goods over the Internet, circumventing state sales taxes at the expense of Main Street businesses and other taxpayers. A recent report by an Internet marketing research firm projects that World Wide Web sales will be $1.5 trillion by 2002. This kind of sales explosion has the potential to seriously erode state and local tax bases and devastate rural America.

Governors believe the goal of any legislation should be tax fairness. Federal legislation should not create a protected class of taxpayers at the expense of businesses and other taxpayers. Choosing to give the nation's premier growth companies a tax break is not the solution most taxpayers would suggest to address unsubstantiated concerns about state and local taxes on the Internet.

As our nation moves from a manufacturing-based economy to a service- and information-based economy, governors believe care should be taken to ensure that our tax system keeps pace. "The formulation of Internet tax legislation warrants a thoughtful, deliberate approach like the National Tax Association effort," said Govs. Voinovich and Carper. "The National Tax Association, a professional association of tax practitioners from industry, government, and academia, is making important progress in developing a more consistent state tax treatment of electronic commerce. Using this neutral forum, NTA expects to complete a consensus paper that could be used as model legislation by fall 1998. This is not a time for federal legislation—it is a time for discussion and consensus building between industry and government. Congress should step back and allow states and industry to complete this important work together."

—END—

Note: NGA news releases are available on the World Wide Web at http://www.nga.org.

National Governors' Association
National Conference of State Legislatures
National Association of Counties
National League of Cities
The United States Conference of Mayors
International City/County Management Association

October 23, 1997

The President
The White House
Washington, D.C.

Dear Mr. President:

We are writing to seek your assistance in a matter of great importance to state and local governments. It is our understanding that before recessing for the year, both the House and the Senate may try to complete action on the Internet Tax Freedom Act as sponsored by Senator Ron Wyden of Oregon and Representative Chris Cox of California. State and local elected officials are concerned the pending bills, S. 442 and H.R. 1054, despite changes that have been made so far, will preempt or limit existing state and local revenues and create a privileged class of taxpayers, namely those whose businesses involve the Internet. Both these impacts go beyond the policy expressed in your administration's white paper issued this past July, *A Framework for Global Electronic Commerce*, which states, "no new or discriminatory taxes on the Internet."

State and local governments recognize the vital importance of the Internet and advanced communications systems for our states and our nation and realize that there is a need for a coordinated and simplified tax structure that will not be an impediment to the growth of these services. We should note for the record that not one state has ever passed an Internet-specific tax, and this year alone, a number of states have passed legislation specifically exempting the Internet from various state and local taxes. We and our colleagues across the country are as concerned as you are about the unintended consequences of obsolete or discriminatory taxes on this vital new technology. At the same time, there are critical, if unintended, consequences of this broadly drafted and ill-defined federal legislation that could seriously undermine existing state revenues and place unfair burdens on small Main Street businesses.

Although we remain opposed to any federal effort that would preempt the sovereign rights of states and localities to determine their own tax and franchise policies, we also realize that constantly changing technological advances present unique challenges to current state and local tax policies. For this reason, all of the national state and local organizations have endorsed participation in the National Tax Association's Communications and Electronic Commerce Tax Project. This project, which is referenced in the Internet Tax Freedom Act, is identifying the issues involved in applying state and local taxes and fees to electronic commerce and developing recommendations, including model tax legislation, regarding the applications of such taxes. At the first meeting of the project, we voted to ensure that the U.S. Treasury Department has a role in the discussions. We believe the process is working and that Congress should not act in haste in passing these ill-defined prohibitions that will only result in numerous and costly lawsuits against state and local governments.

The President
October 23, 1997
Page 2

We believe your administration's position on Internet taxation is more consistent with the position of state and local governments. We urge you to communicate to Congress your clear determination not to sign any Internet taxation legislation unless it is limited to affecting new and discriminatory taxes.

Sincerely,

Governor George V. Voinovich, Ohio
Chairman
National Governors' Association

Senator Richard Finan, Ohio
Senate President
President, National Conference of State Legislatures

Commissioner Randy Johnson
Hennepin County, Minnesota
President, National Association of Counties

Council Member Mark S. Schwartz
Oklahoma City
President, National League of Cities

Mayor Paul Helmke
City of Fort Wayne
President, The U.S. Conference of Mayors

Mr. Gary Gwyn, City Manager, Grand Prairie, Texas
President
International City/County Management Association

National Governors' Association
National Association of Counties
National League of Cities
United States Conference of Mayors

October 8, 1997

Honorable John McCain
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D.C. 20510

Honorable Ernest F. Hollings
Ranking Member
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D.C. 20510

Dear Chairman McCain and Senator Hollings:

We are writing to express our continuing strong opposition to the Internet Tax Freedom Act, S. 442. We urge you to postpone action on this legislation to permit the voluntary industry-government effort to move forward under the auspices of the National Tax Association (NTA). The best hope for consistent, administrable, and equitable taxation is through this cooperative effort. The board of the NTA Electronic Commerce Project held a meeting September 4 and has set meetings for November 12 and early December.

Once again, we have received a new draft of the bill only days before a scheduled mark-up. We have not been invited to express our concerns with any new language. We agree that the continued growth of the Internet is an important component of the nation's future economic health and vitality. As elected officials in state and local government, we expect to rely on the Internet and telecommunications for the improved delivery of services. We are genuinely supportive of its development. However, the viability of state and local revenue systems, which support essential safety, health, educational, and environmental services – as well as business assistance programs – are equally essential to a healthy national economy. This legislation addresses one concern, the Internet, at the expense of another, state and local government tax bases. Preemption of state and local government taxing authority is a serious step to be taken only after all other means of communication and cooperation have failed. In this circumstance, these efforts have barely begun. Preemption is not a reasonable or acceptable federal action at this time.

Again, we urge you to postpone action on the Internet Tax Freedom Act and to allow the National Tax Association's voluntary industry-government effort to proceed with its work.

Sincerely,

George V. Voinovich

Governor George V. Voinovich, Ohio
Chairman
National Governors' Association

Randy Johnson

Commissioner Randy Johnson
Hennepin County, Minnesota
President, National Association of Counties

Mayor Paul Helmke
City of Fort Wayne
President, The U.S. Conference of Mayors

Councilmember Mark S. Schwartz
Oklahoma City
President, National League of Cities

Copy: Members of the Senate Committee on Commerce, Science, and Transportation
Copy: Senate Majority Leader Trent Lott and Senate Minority Leader Thomas A. Daschle

NATIONAL GOVERNORS' ASSOCIATION

Governor of Ohio
Chairman

Thomas R. Carper
Governor of Delaware
Vice Chairman

October 6, 1997

Honorable John McCain
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D.C. 20510

Honorable Ernest F. Hollings
Ranking Member
Committee on Commerce, Science,
and Transportation
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman and Senator Hollings:

On behalf of the nation's Governors, we are writing to express our strong opposition to the Internet Tax Freedom Act. As Governors, we look to the growth of the Internet to increase economic development and improve the delivery of public services. We share your belief in the importance of the Internet for the nation's economic future. However, we ask that you postpone any action on this legislation until a number of critical federalism issues are addressed.

The nation's Governors view this issue of federal action to preempt state tax authority regarding the Internet as the most significant challenge to state sovereignty that Congress has considered in the last ten years. First, this proposed legislation will have the immediate impact of preempting existing state taxes. Second, and much more important, it will impose major inequities in state tax systems over the next ten years. Currently, about 49 percent of total state tax revenues are generated by sales taxes. In the very near future, most Americans will be purchasing goods over the Internet, which will circumvent state sales taxes. A recent report by an Internet marketing research firm projects that World Wide Web sales will be $1.5 trillion by 2002. This will lead to unequal and discriminatory tax treatment in states. Individuals who buy goods on Main Street will pay taxes; those who purchase over the Internet will not. This could also lead to the virtual collapse of state sales taxes over the next ten years. Such a far-reaching impact requires a much more thorough investigation and debate.

The National Governors' Association has endorsed an effort being undertaken by the National Tax Association to bring industry and government representatives together to develop consensus proposals for the taxation of electronic commerce. We believe that this is the best approach to the threat that inconsistent and uncoordinated state and local taxes may become a hindrance to development of the Internet. Adoption of the proposed legislation will only create a privileged class of taxpayers. Rather than addressing the problem, it will exacerbate it. The best hope for consistent, administrable, and equitable taxation is for industry to work with states and localities to develop simplified and consistent approaches to taxation.

Finally, we are seriously concerned that the structure of the proposed legislation is unworkable. The bills completely preempt all state and local taxing authority over the Internet and then establish a list of categories of permissible taxes. It will take the courts years of litigation to determine how to apply the

categories of permissible state and local taxes to our necessarily complex tax codes. In the meantime, states will face serious problems in estimating revenues, which will make balancing state budgets and ensuring needed public services much more difficult. The cost of litigation alone could more than outweigh the perceived harm that state and local taxes might have on the development of the Internet.

For all the above reasons, we ask you to delay action on HR. 1054, the Internet Tax Freedom Act, until a better approach to these national and intergovernmental issues can be jointly developed. Again, this bill represents the single most serious challenge to state sovereignty that Congress has considered in the last ten years. Before you undertake such a fundamental restructuring of our federal system, it is important that all potential impacts be analyzed and known.

Sincerely,

Governor Georges V. Voinovich
Chairman
State of Ohio

Governor Thomas R. Carper
Vice Chairman
State of Delaware

Governor Roy Romer
State of Colorado

Governor Lawton Chiles
State of Florida

Governor Bob Miller
State of Nevada

Governor David M. Beasley
State of South Carolina

Governor Michael O. Leavitt
State of Utah

Governor Howard Dean, M.D.
State of Vermont

Governor Tommy G. Thompson
State of Wisconsin

Copy: Senate Commerce, Science and Transportation Committee Members
Copy: Senate Majority Leader Trent Lott and Senate Minority Leader Thomas A. Daschle

MAYOR ELZIE ODOM

October 3, 1997

FACSIMILE TRANSMITTAL (202) 224-1193

The Honorable Byron L. Dorgan
United States Senate
Washington, D.C. 20510

RE: Internet taxation (S 442)

Dear Senator Dorgan:

During the process that this legislation is being considered, we request that you do not ignore local government.

The "Internet Tax Freedom Act" (S 442), as written, should be opposed. This bill:

- prohibits state and local governments from collecting revenues on electronic transactions on the Internet or other on-line services -- both existing and future taxes;
- discriminates against local merchants and reduces state and local revenues; and
- preempts state and municipal authority to collect sales and other taxes comparable to those collected from local merchants providing the same goods and services to your citizens and businesses.

The Congressional Budget Office has concluded that earlier versions of this bill would cost states and local governments $50 million in lost tax revenues, exceeding the limit in the Unfunded Federal Mandate Reform Act.

This type of legislation somehow gets caught up in a process that eliminates or disregards "grass roots" local government. Please do not forget your local constituents.

Sincerely,

Elzie Odom
Mayor

Mail Stop 01-0310
101 West Abram Street • P.O. Box 231 • Arlington Texas 76004-0231 • Office 817-459-6121 • Home 817-274-8049

LOS ANGELES CITY COUNCIL
OFFICE OF THE CHIEF LEGISLATIVE ANALYST

RONALD F. DEATON
CHIEF LEGISLATIVE ANALYST

JAMES F. SEELEY
CHIEF LEGISLATIVE REPRESENTATIVE

1301 PENNSYLVANIA AVE., N.W. • SUITE 400
WASHINGTON, D.C. 20004
(202) 347-0915
FAX (202) 347-0919

September 18, 1997

Honorable Byron L. Dorgan
Member of the Senate
SH-713 Hart Senate Office Building
Washington, D.C. 20515

Dear Senator Dorgan,

S. 442, the Internet Tax Freedom Act, may soon come before the Senate Commerce, Science, and Transportation Committee. The City of Los Angeles is opposed to S. 442 unless amended to clarify that local franchise fees can be imposed on internet access services provided by cable television companies.

In many areas of the country, including Los Angeles, cable television companies are now beginning to sell Internet access to the public. As part of their franchise agreement with the City of Los Angeles, cable companies pay a 5% franchise fee on gross revenues from all services provided over the cable system, including Internet access. The percentage fee -- a standard provision in franchise agreements between local governments and cable companies -- is paid by companies for the privilege of using publicly-owned rights of way.

We are deeply concerned that the overly-broad language contained within S. 442 would prohibit cities from collecting franchise fees on Internet access services provided by cable companies. Therefore, we will be pursuing an amendment to S. 442 that exempts from the moratorium franchise fees in connection with the sale of Internet access by cable television companies.

The intent of the legislation is to halt the imposition of new taxes on Internet transactions, not to preempt local franchise fees on corporate revenues generated by the provision of Internet access services. Selling Internet access is entirely different from actual transactions taking place over the Internet, thereby placing the issue of franchise fees beyond the purview of the bill. For these reasons, the City believes that the proposed exemption is justified and consistent with the purposes of S. 442.

ROOM 255 • CITY HALL • LOS ANGELES, CA 90012
(213) 485-6622
FAX (213) 485-8963

1400 K STREET, ROOM 308 • SACRAMENTO, CA 95814
(916) 441-2533
FAX (916) 448-7162

We would welcome the opportunity to work with you to address this section of the bill prior to committee markup. If you have any questions, please contact me or David Kim at (202) 347-0915.

Sincerely,

James F. Seeley

NATIONAL GOVERNORS' ASSOCIATION

George V. Voinovich
Governor of Ohio
Chairman

Thomas R. Carper
Governor of Delaware
Vice Chairman

Raymond C. Scheppach
Executive Director

Hall of the States
444 North Capitol Street
Washington, D.C. 20001-1512
Telephone 202/624-5300

cc: Greg Abbott

September 3, 1997

RECEIVED SEP 1 1 1997

The Honorable John McCain
Chair
Commerce, Science and Transportation Committee
United States Senate
Washington, D.C. 20510

The Honorable Ernest F. Hollings
Ranking Member
Commerce, Science and Transportation Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Chair and Senator Hollings:

During the National Governors' Association's (NGA) annual meeting this summer, Governors adopted the attached policy on telecommunications and Internet taxation.

The Governors continue to oppose federal preemption of state tax authority in regard to the Internet and continue to endorse the public-private effort being undertaken through the National Tax Assocation to develop proposals for more consistent, streamlined, and fair taxation of businesses involved with the Internet. The Governors intend to monitor this process and consider any proposals that are developed. Recognizing that there are differences across state and local jurisdictions regarding the taxation of electronic commerce and the Internet, the Governors believe the joint public-private effort is the best approach to finding tax policy solutions that are consistent, nondiscriminatory, and easy to administer.

This policy does not imply that Governors support raising taxes on the Internet. Rather it supports the authority of states to set their own tax policy.

If you have any questions regarding this policy, please have your staff contact Tim Masanz at NGA, at 202/624-5311. We thank you for your consideration in this matter, and we look forward to working with you.

Sincerely,

Edward T. Schafer

Governor Edward T. Schafer
Chair, Committee on Economic Development and Commerce

Paul E. Patton

Governor Paul E. Patton
Vice Chair, Committee on Economic Development and Commerce

Copy: Senate Commerce, Science and Transportation Committee

Attachment

NATIONAL GOVERNORS' ASSOCIATION

NGA Policy

EDC-21. TELECOMMUNICATIONS AND INTERNET TAXATION

The passage of the Telecommunications Act of 1996 was an important step toward strengthening competition in the telecommunications industry. Its passage has promoted wide-ranging changes both in the industry itself and in the application of technological advances to existing services. As a result, state tax systems, developed primarily in an age of manufacturing industries and in a period of local or regional, regulated, monopolistic telecommunications utilities, are often ill-equipped to respond to these changes.

For the past several years, the Governors have supported policy favoring increased competition in telecommunications and the removal of barriers to entry in order to bring more companies into local markets. The Governors also have supported regulatory symmetry, ensuring that similar services and service providers are treated in a similar manner. The Telecommunications Act of 1996 calls on states and localities to treat competing companies in a nondiscriminatory manner.

Congress has recognized the sovereignty of states to determine their tax policy with respect to telecommunications. The Governors support state review of existing state tax policies to determine their effect on telecommunications and the future growth of the industry, and to ensure that outdated and inconsistent tax treatment does not hinder the growth of competition. Several states have undertaken telecommunications taxation studies during the last year and many more are contemplating doing so.

On November 11 and 12, 1996, a conference was held in Boston, Massachusetts, on taxation of the telecommunications industry. The conference, sponsored by several national tax organizations, provided a forum for both states and industry to talk about this critical issue and to seek solutions. At the conclusion of the conference, a suggestion was made to form a smaller group to draft model legislation. The offer was taken up by one of the sponsoring organizations, the National Tax Association, a professional association of tax practitioners from industry, government, and academia. The National Tax Association offered to serve as a neutral convener on the issues. Plans are currently underway to create a process to seek more uniform state tax treatment of telecommunications companies.

The Governors continue to oppose federal action to preempt the sovereign right of the states to determine their own tax policies in all areas, including telecommunications and the Internet. The Governors acknowledge there are differences across state and local jurisdictions in regard to taxation of electronic commerce and the Internet. The Governors seek to work with industry to develop tax policy that is consistent, nondiscriminatory, and easy to administer. The Governors therefore endorse the process undertaken by the National Tax Association with the support of the Federation of Tax Administrators and the Multistate Tax Commission to review existing problems in the taxation of telecommunications and to propose coordinated policies that will help states promote fair competition while ensuring that the telecommunications industry bears its fair share of taxation. The Governors intend to monitor the process and consider any proposals that are developed. This policy does not imply that the Governors support raising taxes on the Internet. Rather it supports the authority of states to set their own tax policy.

Time limited (effective Annual Meeting 1997–Annual Meeting 1999).
Adopted Winter Meeting 1997; revised Annual Meeting 1997.

National Governors' Association
National Conference of State Legislatures
National Association of Counties
National League of Cities
United States Conference of Mayors

June 25, 1997

Honorable John McCain
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Room 508
Senate Dirksen Office Building
Washington, D.C. 20510

Honorable Ernest F. Hollings
Ranking Member
Committee on Commerce, Science,
and Transportation
United States Senate
Room 558
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Chairman McCain and Senator Hollings:

We understand you have scheduled a mark-up of the Internet Tax Freedom Act, S. 442, for tomorrow morning. We have reviewed a draft of proposed amendments dated June 23rd, the McCain substitute, and still have serious concerns that must be addressed. We have not seen the language that will be offered tomorrow, nor have we seen any analysis by the Congressional Budget Office regarding the impact of any proposed new language on state and local finances. Once again, we urge you to delay action until we have been given a chance to understand the impact of the legislation.

The indefinite moratorium is the first provision that we oppose. The imposition of an indefinite moratorium on state and local government taxing authority is equivalent to preemption. The moratorium proposed in the bill would require an action by a future Congress before this taxing authority would be reinstated. Second, we are seriously concerned about the preemption of broad-based sales taxes and telecommunications excise taxes on charges for access to the Internet. Neither of these types of tax is targeted on the industry. By creating an exemption from taxation for Internet access services, the Congress would create a privileged class of businesses, shifting the burden of taxation to other businesses. That should not be the goal of this legislation, and we oppose the blanket preemption of Internet access fees.

Third, we are concerned about the impact of the bill on sales taxes because of language which will likely lead to litigation over whether or not the transaction being taxed is "similar" to a sale conducted through another means. The sales tax is the single largest source of state revenues, and federal action affecting this tax must be done in close cooperation with states and localities relying on its revenues.

Currently seven states have no income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) and two states (New Hampshire and Tennessee) have no income tax on earned income. Our opposition to the provisions affecting non-income-based taxes is intensified by the disproportionate impact the bill will have on these states. It is important that they have the opportunity to review the provisions of the bill before action is taken.

Our opposition to the preemption of specific taxes by the bill is also much stronger because there is no language in the bill grandfathering existing tax laws. Both states and localities operate under balanced budgets, and the loss of an existing revenue source in mid-year will require costly and inefficient corrections in the form of program reductions and increases in costs to other taxpayers. The issue of tax fairness is also a concern since our tax laws are adopted through negotiations with all affected parties. Federal mandates, which shift the tax burden of state and local taxes, should be a last resort and reserved for instances of demonstrated obstruction of interstate commerce. Much of the debate over this bill has focused on what states and localities might do to tax the growing Internet industry, rather than on what has actually happened. Preempting existing tax bases on such speculation is unfair and unwarranted.

Fourth, the requirement that states ignore all Internet-based activities in making nexus determinations is problematic. The language of the June 23 draft suggests that if a company has a Web server or other property in the state from which they conduct Internet sales and marketing, the presence of that property does not confer nexus on the company. This is a serious constraint on current nexus standards and interpretations. The inclusion of the nexus language could lead to serious erosion of sales tax revenues in every jurisdiction. A firm could easily set up a separate, out-of-state Internet sales entity, allow inspection of goods at a store, allow customers to place orders through an Internet kiosk in the store, and arrange for delivery to the customer via common carrier.

Under this provision, none of the firm's sales would be subject to sales tax, because states would be prohibited from considering the above activities in making a determination of sales tax nexus for the out-of-state Internet sales entity. Current constitutional standards, however, would support a finding of nexus for sales tax purposes in these circumstances. The provision should be limited to provide that the ability to access a Web page is not a factor in determining nexus, leaving intact the principle that the ownership or leasing of property in a state is determinant of constitutional nexus. Changing the definition of nexus for any reason is an action that can have major consequences for state and local tax revenues.

As we stated previously, our national associations are currently participating in a voluntary effort under the auspices of the National Tax Association to address the issues of consistency, uniformity and clarity in the state and local taxation of electronic commerce. In testimony before the Senate Commerce Committee, Wade Anderson, Director of Tax Policy in the Office of the Texas Comptroller of Public Accounts, listed the industry associations represented at this effort: the Committee on State Taxation, the National Cable Television Association, the United States Communications Association, the Financial Institutions State Tax Coalition, the Information Technology Association of America, and representatives from companies such as Microsoft, IBM, U.S. West, Bell South Corporation, and AT&T. We continue to believe that this avenue offers the best hope for an effective and timely solution. We urge you to support this effort and encourage business to be full partners in the project, which is intended to avoid both costly litigation and unadministrable tax laws. A broad preemption of state authority as created by this bill leaves states and localities with little standing to negotiate effectively.

Honorable John McCain and Honorable Ernest F. Hollings
State and Local Coalition
June 25, 1997
Page 3

Thank you for your consideration of these matters.

Sincerely,

Governor Paul E. Patton, Kentucky
Chair, Committee on Economic Development and Commerce
National Governors' Association

Representative Myra Jones, Arkansas
Acting Chair, Committee on Commerce and Communications
National Conference of State Legislatures

Commissioner Michael Lightower
Fulton County Georgia
President, National Association of Counties

Councilmember Mark S. Schwartz
Oklahoma City
President, National League of Cities

Mayor Paul Helmke
City of Fort Wayne, Indiana
President, The U.S. Conference of Mayors

c. Senate Commerce Committee Members
c. Senate Majority Leader Trent Lott and Senate Minority Leader Thomas A. Daschle

RECEIVED

Government Finance Officers Association (GFOA)
National League of Cities (NLC)
National Association of State Treasurers (NAST)
National Association of Telecommunications Officers and Advisors (NATOA)
National Association of Counties (NACo)
National Association of County Treasurers and Finance Officers (NACTFO)
National Association of State Auditors, Comptrollers and Treasurers (NASACT)

June 25, 1997

The Honorable Byron L. Dorgan
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

RE: S. 442, the Internet Tax Freedom Act

Dear Senator Dorgan:

On behalf of the nation's state and local government officials, the groups listed above write in opposition to S. 442, the Internet Tax Freedom Act, now scheduled to be marked up in the Commerce Committee on June 26. We appreciate the efforts of the Committee and its staff to make the current version of this legislation (dated June 25, 1997) more acceptable to state and local governments than the bill that was originally introduced. However, we have reviewed the proposed amendment to S. 442 and have concluded that this legislation, which is based on a preemption of state and local government taxing authority, remains flawed because it would significantly infringe on state and local sovereignty and have severe budgetary implications for state and local governments.

Imposition of a Moratorium is a Drastic Step. State and local governments, no less than the federal government, appreciate the concern that taxation by any jurisdiction may have on the fiscal health of emerging industries. However, the imposition of a moratorium on the collection of legitimate state and local taxes, including those on Internet services, violates long-standing principles of federalism. Preemption of the ability of state and local governments to impose and collect equitable taxes and fees would prevent state and local officials from obtaining sufficient revenues to carry out their responsibilities to meet the needs of their constituents. Rather than imposing a moratorium prior to studying how to deal with the issue, as S. 442 would do, the wiser course would be to examine the issue first and then decide how best to proceed, in partnership with state and local governments.

A Moratorium on Existing Taxes Will Severely Impact Both State and Local Governments and Small Businesses. Because neither the original bill nor the proposed amendments include a grandfather provision for existing taxes, the prohibition against the collection of taxes currently on the books will result in several consequences for both governments and the small businesses in their jurisdictions.

- State and local governments will be in automatic violation of the legal requirement that their budgets be balanced on an annual basis. Unlike the federal government, which is permitted to carry over deficits, state and local governments are required by law to balance their budgets annually. The sudden reduction in revenues, which occurs not as a result of a reasoned consensus among state officials and citizens but as a result of arbitrary action by the federal government, will place these jurisdictions in violation of their state statutes. This is perhaps an unintended consequence of this legislation, but one which presents a very real threat to state and local governments.

- The Unfunded Mandates Relief Act of 1995 will be triggered by this legislation. Although the scoring of this latest version of S.442 has not been completed by the Congressional Budget Office, it seems clear from CBO's earlier estimates of the original bill that the costs to state and local government -- that is, the amounts they would be prohibited from raising in revenues in order to comply -- will exceed the $50 million threshold established in the UMRA. This is also further evidence of how severe the revenue implications will be for state and local governments.

- Small businesses will suffer as a result of the grant of a tax advantage to Internet service providers. By offering protection to Internet-related businesses, Main Street businesses would be placed at a competitive disadvantage under S. 442. While local merchants collect and pay their fair share of taxes which support vital state and local services, companies selling over the Internet would enjoy the advantages of these same services without providing any support. In addition, small businesses and other segments of the community would have a greater share of the tax burden shifted to them in order to make up for the state and local revenue that would be lost from computer-related companies.

Key Terms and Definitions in the Bill are Unclear. If one of the purposes of the bill is to bring certainty to the state and local taxing arena, this bill does not accomplish that purpose. Some key terms used in the bill are unclear and confusing. For example, the bill excepts "business license taxes" from the prohibition; however, there are many taxes which operate as a business license tax but which are named something else. These may or may not be prohibited under this legislation. In addition, the latest definition provided for "online service" may well include those services used internally by businesses with their own intranet activities. These are but two examples of the lack of clarity provided by this legislation.

Legislation is Unnecessary to Bring the Parties Together. If the real purpose of this preemption legislation is to bring industry, business and governments together to study the issue of taxation, this legislation is unnecessary. These groups are already participating in an ongoing project under the auspices of the National Tax Association to find a solution to the challenges of taxation raised by the growth of the Internet. We fear that these efforts could be undercut by enactment of S. 442 at this time by actually providing a disincentive for cooperation -- that is, the moratorium on state and local taxation -- and resulting instead in delay and inaction.

We urge you to oppose S. 442 when it comes before the Committee, and instead work with your partners in governing, the state and local governments, to find mutually beneficial means of encouraging new technologies and industries without penalizing state and local governments and their citizens.

Contacts:

Betsy Dotson, GFOA	202/429-2750
Frank Shafroth, NLC	202/626-3000
Chris Allen, NAST	202/624-8595
Eileen Huggard, NATOA	703/506-3275
Ralph Tabor, NACo	202/942-4254
Marilyn Green, NACTFO	303/660-7415
Steve Kenneally, NASACT	202/624-5451

THE UNITED STATES CONFERENCE OF MAYORS

1620 EYE STREET, NORTHWEST
WASHINGTON, D.C. 20006
TELEPH. (202) 293-7330
FAX (202) 293-2352
TDD (202) 293-9445
URL: www.usmayors.org/uscm

President
Vice Presidents
Past Presidents
Trustees
Advisory Board
Executive Director
J. Thomas Cochran

June 24, 1997

Dear Senator:

We are writing to express strong opposition to S. 442, the Internet Tax Freedom Act, which may be voted on as early as this week in the Senate Commerce, Science and Transportation Committee. While this legislation has been rewritten three times in recent weeks, we remain concerned that it would preempt the authority of state and local governments to tax internet and other electronic commerce. It would also impose a huge unfunded mandate on state and local governments that far exceeds the $50 million threshold and as such will be subject to a point of order under the Unfunded Mandates Reform Act. Further, it represents a significant infringement on state and local sovereignty and has the potential for creating enormous budgetary problems. For these reasons, we urge you to vote against this proposal and insist that the sponsors of the bill work with representatives of state and local governments to develop a process for addressing our mutual concerns.

Computer and telecommunications services are among the fastest growing sectors of the economy. By the turn of the century, they are projected to constitute one-sixth of our national economy. As our economy evolves, it is essential that state and local governments have the ability to seek revenues from growing sectors of the economy that benefit significantly from government resources and services.

By shielding certain industries from paying their fair share of revenues, Congress will effectively impose higher taxes on average citizens and the businesses not covered by the preemption. There is no reason to exempt legitimate commerce from paying its fair share of government cost just because such commerce is conducted over the internet. Congress must be careful not create loopholes in our tax system that will aid one industry at the expense of another.

Again, we urge you to vote against S. 442. Please feel free to contact our Executive Director J. Thomas Cochran or Larry Jones at 202/293-7330 if you have any questions.

Sincerely,

Richard M. Daley
President
Mayor of Chicago

Paul Helmke
Vice President
Mayor of Fort Wayne

Deedee Corradini
Chair, Advisory Board
Mayor of Salt Lake City

cc. The Honorable Trent Lott
The Honorable Newt Gingrich

Knoxville, Tn.
Kevin Kelly - Elgin, Il
Douglas B England - Indiana
Bellingham, Wa
Mark Armundson, Bellingham, Wa
Angelo Hamilton, Chapelle, CO
Rosemary M Carlson, Richmond, Ca
Stanley Williams, Dunseith, ND
JACK GERAGHTY - SPOKANE, WA
Rochester NY
St. Louis, MO
Jerry A Shiffle, Gen, NY
Michael Cazenda
Fayetteville, Arkansas
James C Stalie Nagano Filling
Sol Grocer, Cedar Rapids, Ia.
Carroll Bradley, Sweet Water, TX
Kenneth Hoyt, Hagerstown, IN.
Allen Hindman, Columbia, MD.
Sam H Kamm Jr, Laredo, TX.
Kenosha, WI
Manson, WI
Carrizo, CA
Rock Springs, Wyo.
Estelle, Ky.
Muskogee, OK.
San Leandro, CA
Hayward, Ca.

Knoxville, Tn.

Mark Clark

David M. Clough Westfield

City of Belmont

Loyalty J. Reid - Mansfield, O.

Michael DiSimone - Waco Tx

EAST ORANGE, N.J.

Fremont CA

Elizabeth NJ

M. Moore - Beaumont, Tx

Neil Dillard, Carbondale, Ill.

Va. Beach, Va

WILLIAM J.

City of Detroit

Wardell Stanley Flint, Mi

[illegible]	Denton TX
[illegible]	
[illegible]	Arlington Hts. Illinois
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]

National Governors' Association
National Conference of State Legislatures
National Association of Counties
National League of Cities
United States Conference of Mayors

June 17, 1997

Honorable John McCain
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Room 508
Senate Dirksen Office Building
Washington, D.C. 20510

Honorable Ernest F. Hollings
Ranking Member
Committee on Commerce, Science,
and Transportation
United States Senate
Room 558
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Chairman McCain and Senator Hollings:

We are writing to ask that the June 19 markup of S. 442, the Internet Tax Freedom Act, be postponed. We understand that important amendments will be proposed to the bill. We are concerned that the impact of these amendments on states and local governments will not be known without adequate time for review.

Current language in S. 442 would have a serious impact on both existing revenues and tax fairness in states and localities, and we are pleased that amendments are being drafted. Once we have a chance to analyze the new language, we will share this information with you and the committee.

Thank you for your consideration in this matter.

Sincerely,

Governor Paul E. Patton, Kentucky
Chair, Committee on Economic Development
and Commerce
National Governors' Association

Representative Myra Jones, Arkansas
Acting Chair, Committee on Commerce and
Communications
National Conference of State Legislatures

Commissioner Michael Hightower
Fulton County Georgia
President, National Association of Counties

Councilmember Mark S. Schwartz
Oklahoma City
President, National League of Cities

Mayor Richard M. Daley
City of Chicago
President, The U.S. Conference of Mayors

c. Senate Commerce Committee Members
c. Senate Majority Leader Trent Lott and Senate Minority Leader Thomas A. Daschle

National Conference of State Legislatures
Council of State Governments
Government Finance Officers Association
International City/County Management Association
National Association of Counties
National Governors' Association
National League of Cities
United States Conference of Mayors

June 17, 1997

Honorable John McCain
Chairman
Committee on Commerce, Science,
and Transportation
United States Senate
Room 508
Senate Dirksen Office Building
Washington, D.C. 20510

Honorable Ernest F. Hollings
Ranking Member
Committee on Commerce, Science,
and Transportation
United States Senate
Room 558
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Chairman McCain and Senator Hollings:

This letter expresses state and local leaders' strong opposition to the Internet Tax Freedom Act (S. 442). As introduced, this bill has the potential to substantially affect state and local tax systems in ways that we believe have not been given sufficient consideration. S. 442 effectively creates a permanent exemption for on-line computer service companies, telecommunications companies, and software providers from a wide range of taxes they are currently paying. The difficulty of applying existing state and local tax law to electronic commerce is one that has led all of our associations to join in a voluntary government-industry effort to establish consistent, fair, and streamlined rules and regulations. We believe this is a more effective approach than federal legislation.

State and local governments have four primary concerns with the bill. First, public discussions have thus far stressed that the bill is intended to impose a two-year moratorium on state and local enactments of "new taxes" on the Internet and on-line activity. However, the bill contains no language specifying a date on which the moratorium would be lifted. Rather, there is simply a requirement for a national commission to report findings to Congress within two years of the bill's implementation. Any modification of the preemptive moratorium would require further congressional enactment. We also have concerns that a moratorium will interfere with efforts to develop a streamlined and perhaps technology-based solution to the issue of fair taxation of electronic commerce. A moratorium also sets up a potential for further discrimination in tax treatment between main street and on-line businesses.

Second, public explanations of the bill express an intent not to preempt existing taxes but only to limit new levies specifically imposed on the Internet and on-line services. However, there is no language in the bill to "grandfather" or protect existing taxes and thus limit the effect of the bill to new taxes. Thus, we are forced to conclude that existing taxes, which are implicated by the language of the bill, would be preempted.

Third, the bill calls for the President within two years to consult with various parties and to issue recommendations addressing the issues raised by state and local taxation of electronic

commerce. Our associations believe a better forum for the discussion of these issues is a cooperative effort being sponsored by state and local governments and various parts of the interactive service, information technology, and telecommunications industries under the auspices of the National Tax Association. We would urge Congress to place its emphasis on this mechanism of addressing the issues raised by the application of existing state and local taxes to electronic commerce rather than a moratorium and a national commission.

Finally, public discussions of the bill indicate that it is intended to apply only to new or special taxes imposed on the Internet and on-line services. The actual impact of the bill, however, goes far beyond the stated purpose and would preempt a broad range of sales, excise, property, and payroll taxes not only on Internet and on-line service providers, but on telecommunications companies, software developers, and many firms and individuals using computers in their daily business. It could also potentially affect taxation of a broad range of transactions processed over "interactive computer services." The bill as introduced holds the potential to significantly disrupt state and local taxation in a number of states.

There are essentially two reasons why the impact of this bill is so widespread. First, the bill prohibits state and local governments from imposing a tax "directly and indirectly" on the Internet and interactive computer services and on the use of the Internet and interactive computer services. Second, the bill defines "interactive computer service" as "any information service, system, or access software provider that provides or enables computer access by multiple users to computer server...." "Access software provider" is then defined as "...a provider of software (including client or server software), or enabling tools" that perform a number of extremely common software functions such as " transmit, receive, [or] display ... content." Taken together, these definitions create a prohibition on direct or indirect taxation of on-line services and networked computers or the use of those services and networks as well as a prohibition on the taxation of a broad range of software providers.

Based on these broad definitions and preemptions, we believe the bill could impact state and local taxation in a number of ways.

- It would preempt state and local sales and excise taxes on charges for access to the Internet and other proprietary on-line services, as well as on charges for the telecommunications networks used by many companies, associations, and others to establish computer communications networks among various offices.
- It would preempt state and local sales taxes on charges for content provided over the Internet or on-line networks, such as for downloading information or access to databases such as Lexis/Nexus.
- It would preempt sales and use taxes on services offered by Internet providers and other services that enable individuals or businesses to be present on the Internet, such as Web page design or hosting services, e-mail services, and the like.
- It would preempt state and local property taxes or other fees imposed on providers of Internet access, the telecommunications and computer hardware and software that actually comprise the Internet, and the hardware and software used in providing other on-line computer services.
- It would prohibit nearly all non-income taxation of a wide range of software providers, including sales and property taxes as well as the imposition of payroll taxes such as unemployment insurance and workers' compensation levies on such enterprises.
- The breadth of the definition of "interactive computer service" encompasses any entity that maintains or provides access to any type of network of computers without regard to whether

they are used in electronic commerce, including even "run-of-the-mill" local area networks (i.e., those enabling access by multiple users to a computer server). At issue, then, is what taxes or fees applied to such providers are prohibited by the bill, given that the moratorium is on taxes imposed "directly or indirectly." Property taxes and sales and use taxes on the hardware and software in such networks would seem to be subject to the moratorium. Further, property taxes, sales taxes, and fees assessed or imposed on other parts of businesses (or individuals) using such networks would also be included in the moratorium because of the "directly or indirectly" language.

- The bill potentially exempts the imposition of sales, use, excise, and property taxes on major portions of all telecommunications companies in the United States. Telecommunications companies certainly provide a portion of the network services for the Internet itself; they also provide a system or service that "enables access by multiple users to a computer server" and thus qualify as an "interactive computer service." As a result, the ability to impose sales and property taxes and other fees on telecommunications or telecommunication companies is brought into question.

We hope that this letter will spur you to look closely at the potential impact of the Internet Tax Freedom Act on state and local revenue collection and to support the ongoing efforts by state and local governments and industry to resolve the outstanding tax issues in a fair and equitable manner for all parties.

Sincerely,

William T. Pound
Executive Director
National Conference of State Legislatures

Daniel M. Sprague
Executive Director
Council of State Governments

Jeffrey L. Esser
Executive Director
Government Finance Officers Association

William H. Hansell, Jr.
Executive Director
International City/County Management Association

Larry E. Naake
Executive Director
National Association of Counties

Raymond C. Scheppach
Executive Director
National Governors' Association

Donald J. Borut
Executive Director
National League of Cities

J. Thomas Cochran
Executive Director
U.S. Conference of Mayors

c. Senate Commerce Committee Members

Rick Clayburgh
COMMISSIONER

STATE OF NORTH DAKOTA
OFFICE OF STATE TAX COMMISSIONER
STATE CAPITOL, 600 E. BOULEVARD AVE., BISMARCK, NORTH DAKOTA 58505-0599

701-328-2770 FAX 701-328-3700 TDD 701-328-2778 HTTP://WWW.STATE.ND.US/TAXDPT

RECEIVED JUN 16 1997

June 11, 1997

cc Dorgan Record
Doug
Greg
Allen
assign to Jensen

Senator Byron Dorgan
713 Hart Office Bldg.
Washington, DC 20510

Dear Senator Dorgan:

I am writing to express my concerns about the "Internet Tax Freedom Act" (S.442), introduced to the Congress by Senator Wyden (D-Ore.) and Representative Cox (R-Calif.) on March 13, 1997. This bill, as written, has the potential to substantially affect state and local tax systems in ways that I do not believe have been given sufficient consideration. The bill effectively creates a permanent tax exemption for on-line computer service companies, telecommunications companies, and software companies from a wide range of taxes they are currently paying.

First, I am troubled by the bill's indefinite moratorium on state and local taxation of the Internet and on-line activity. Public discussions have stressed a two-year moratorium on the imposition or enactment of "new" state and local taxes, but the bill does not mention a specific date certain when the moratorium will be lifted. Instead, the bill merely requires a commission formed by the President to report its findings to the Congress within two years of the bill's implementation. Any modification of the preemptive moratorium would require further Congressional modification.

Although I have been advised that the intent of the bill is not to preempt existing taxes but only to limit new levies imposed on the Internet and on-line services, I believe that the bill goes far beyond this stated purpose. First, I note that the bill contains no language "grandfathering" existing taxes, or limiting the effect of the bill to new taxes. Without specific, protective language, existing state taxes remain vulnerable to challenge by taxpayers affected by the bill.

I further note that the bill, as introduced, would preempt a broad range of taxes not only on Internet and on-line service providers but on telecommunications companies, many firms and individuals using computers in their "every-day" business. There are essentially two reasons why the impact of this bill is so widespread.

First, the bill prohibits states and local governments from imposing "direct and indirect" taxes not only on the Internet and interactive computer services, but also on the use of the Internet and interactive computer services. Second, the bill defines "interactive computer service" as "any information service, system, or access software provider that provides or enables computer access by multiple users to computer server ..." "Access software provider" is then defined as "... a provider of software (including client or server software), or enabling tools" that perform a number of extremely common software functions such as "transmit, receive, [or] display ... content." Taken together, the bill creates a prohibition on direct or indirect taxation of on-line services and networked computers or the use of those services and networks as well as a prohibition on the taxation of a broad range of software providers.

Other implications of the "direct or indirect" language and the definition of "interactive computer service" are as follows:

- Non-income taxes, such as real and personal property taxes, unemployment insurance and workman's compensation levies are implicated as "indirect" taxes on on-line service providers as well as software providers.

- The breadth of the definition of "interactive computer service" encompasses any entity that maintains or provides access to any type of network of computers without regard to whether they are used in electronic commerce, including even "run of the mill" local area networks. Coupled with the "directly and indirectly" language, property taxes and sales and use taxes on the hardware and software used in such networks are prohibited, as well as property and sales taxes and other fees imposed on other parts of businesses and individuals using such networks.

- The potential exemption from sales, use, excise and property taxes on major portions of all telecommunications companies in the U.S. Telecommunications companies certainly provide a portion of the network services for the Internet itself; they also provide a system or service that "enables access by multiple users to a computer server", and thus qualify as an "interactive computer service."

The difficulty is that the definition of "interactive computer service" is far too broad. This definition was taken from the decency provisions of the Telecommunications Reform Act of 1996, aimed at preventing underage and other illegal access to pornography. Casting a definitional net wide enough to encompass virtually every participant in the electronic commerce and computer hardware and software industry for decency purposes is certainly appropriate. However, such a definition is not appropriate for purposes of bestowing tax exemptions to encourage the development of a nascent industry whose unique configuration does present real tax issues that require resolution.

Finally, the bill calls for the President to consult with various parties and to issue a report with recommendations addressing the issues raised by state and local taxation of electronic commerce within two years after the bill is implemented. As a state tax administrator, I believe that a better forum for the discussion of these issues is the cooperative effort currently underway by state and local governments and various parts of the interactive service, information technology and telecommunications industry under the auspices of the National Tax Association.

I hope that this letter will spur you to look closely at the potential, devastating impact of the "Internet Tax Freedom Act" on state and local revenue collection, and support the ongoing efforts by state and local governments and industry to resolve the outstanding tax issues in a fair and equitable manner for all parties. Should you have questions, or need further information, please contact Harley Duncan, Executive Director, or Roxanne Davis, Attorney, at the Federation of Tax Administrators at (202)624-5890.

Sincerely,

Rick Clayburgh
TAX COMMISSIONER

RC:jm
970611.jms

National Governors' Association ◆ International City/County Management Association ◆National Association of Counties ◆ National Conference of State Legislatures ◆National League of Cities ◆ Council of State Governments ◆ ◆ The U.S. Conference of Mayors ◆

May 20, 1997

The Honorable Ron Wyden
U.S. Senate
Washington, D.C. 20510

Dear Senator Wyden:

On behalf of the nation's state and local government officials, we are writing to make you aware of our strong opposition to your bill, S. 442, the Internet Tax Freedom Act, and to urge you to support the voluntary effort under the sponsorship of the National Tax Association (NTA) to address appropriate taxation of businesses utilizing the Internet. We believe that an indefinite moratorium on state and local taxes on Internet or on-line services, as proposed in S. 442, would be a significant infringement on state and local sovereignty. Moreover, we believe that this legislation could lead to unfair competition in the marketplace and create considerable budgetary problems for state and local governments. Rather than seek to impose a federal solution on state and local governments, we would rather a collaborative effort to address an issue with implications for the federal government, as well as our levels of government. Consequently, we urge you to reconsider pursing S. 442 as part of your agenda in the 105th Congress, and instead encourage you to work with our organizations to find a mutually beneficial way to address your concerns over Internet taxation.

While we appreciate your concern over the possible impact federal, state and local taxation may have on the fiscal health of new and developing industries, we disagree with your attempts to address these concerns by implementing an indefinite moratorium on state and local taxation of Internet services. It is our belief that where Congress or the federal government has a particular policy concern that affects our mutual constituents, they should work in partnership with state and local governments to address the area of concern. Your legislation, however, would first impose an indefinite moratorium on state and local taxation. Once the moratorium is in effect, then a committee to study the issue of Internet taxation would be created. This approach violates long-standing Constitutional principles of federalism and undermines the legitimacy of the partnership among the three levels of government.

Moreover, the traditional main street retailer will suffer if S. 442 becomes law. If S. 442 is enacted, it would provide those companies operating on the Internet with a "tax-free" pricing advantage that could cripple thousands of local businesses. And, while local merchants collect and pay their fair share of taxes which support vital state and local services, and local employees pay state and local taxes, companies selling over the Internet would benefit from these same services without contributing their fair share.

A major aspect of the recent Congressional agenda has been to enact legislation that would turn more authority back to state and local governments, as well as to limit the unfunded burdens that might be imposed. We believe that your legislation would undermine these earlier Congressional successes. S. 442 would intrude on state and local taxing and regulatory authority by imposing an indefinite moratorium on our taxing ability, and could well create an unfunded burden for state and local governments of considerable proportion.

For these reasons, we strongly oppose S.442. We urge you to reconsider pursing this legislation during the 105th Congress, and instead encourage you to support the voluntary effort already underway under the auspices of the National Tax Association to develop appropriate tax treatment of the Internet. Both the Federation of Tax Administrators and the Multistate Tax Commission are taking part in this study along with broad business representation. All of our organizations will be taking part in this effort, which initially will look at transactional taxes, such as the sales tax, charged for goods and services purchased over the Internet, whether tangible or intangible. Your support for this effort will ensure that honest and frank concerns are discussed and resolved.

Sincerely,

Bob Miller, Governor of Nevada
Chairman, National Governors' Association

Michael Hightower, Commissioner
Fulton County, Georgia
President, National Association of Counties

Michael E. Box, Majority Chairman, Alabama
President, National Conference of State Legislatures

Jeff Wells, Majority Leader
Colorado State Senate
Chairman, Council of State Governments

Mark Schwartz, Council Member
Oklahoma City, Oklahoma
President, National League of Cities

Richard M. Daley, Mayor
City of Chicago
President, The U.S. Conference of Mayors

Donald H. Gerrish, Town Manager
Town of Brunswick, Maine
President, International City/County Management Association

cc: Senate Commerce Committee Members

NATIONAL GOVERNORS' ASSOCIATION

Bob Miller
Governor of Nevada
Chairman

George V. Voinovich
Governor of Ohio
Vice Chairman

Raymond C. Scheppach
Executive Director

Hall of the States
444 North Capitol Street
Washington, D.C. 20001-1512
Telephone (202) 624-5300

May 13, 1997

The Honorable Ron Wyden
United States Senate
Room 717, Senate Hart Office Building
Washington, D.C. 20510

The Honorable Christopher Cox
United States House of Representatives
Room 2402, Dirksen House Office Building
Washington, D.C. 20515

Dear Senator Wyden and Representative Cox:

We are writing to express our opposition to legislation you have both introduced to establish a moratorium on state authority to levy taxes on business activity conducted over the Internet. Although the Governors agree that the use of the Internet poses substantial challenges for existing tax systems, we do not conclude that a moratorium is the best approach to finding a just and mutually agreeable solution.

Enclosed is a resolution that the National Governors' Association adopted at our 1997 winter meeting. It expresses our support for an effort being undertaken by the National Tax Association (NTA) with the support of state tax administrators. NTA has asked business and state representatives to begin meeting to seek mutually satisfactory solutions to the challenges associated with taxation and the Internet. The first challenge they are addressing is the issue of transactional taxes. As each issue is resolved, they will move to another topic related to electronic commerce.

Conversations with your staff have revealed that your moratorium would consider state revenue department rulings on the application of existing taxes to any service related at all to the Internet as new taxes. This would amount to a tax exemption for any taxpayer seeking a clarification of existing tax law. This is a dangerous proposal that will cost states significant amounts of revenue without any resulting public policy gain. We urge you instead of moving this legislation to join us in supporting the work of the National Tax Association to ensure that industry is well represented in the joint effort. A letter from your offices to the National Tax Association including your express wish that industry representatives work in good faith with state tax administrators and representatives of Governors, state legislators, and local governments would be extremely helpful. This would better ensure that the issue is examined in a timely fashion, that the affected parties all participate, and that appropriate tax strategies are developed.

Thank you for your consideration in this matter.

Sincerely,

Governor Paul E. Patton
Chair
Committee on Economic Development
and Commerce

Governor Edward T. Schafer
Vice Chair
Committee on Economic Development
and Commerce

c. Senate Commerce, Science and Transportation Committee
House Commerce Committee

NATIONAL GOVERNORS ASSOCIATION

News Release

Hall of the States
444 North Capitol Street
Washington, D.C. 20001-1512
Telephone (202) 624-5330

Internet Taxation: Myths and Realities

MYTH: States and localities are looking to the Internet as a "cash cow" to afford additional public expenditures.

REALITY: States have lowered their tax revenues each year for the past 4 years, and in 1997 alone, Connecticut, Florida, Georgia, Iowa, Massachusetts, and New York have each exempted the Internet from taxation. Neither states nor localities are moving to enact new taxes on the Internet. All levels of government are attempting to do more with less.

MYTH: To ensure that states and local sales taxes are nondiscriminatory, such taxes should not be imposed on Internet transactions because these sales are like mail order catalogue sales.

REALITY: The goal of a nondiscriminatory sales tax would require that all sales are treated the same, including "Main Street" retail sales, mail order catalogue sales, and Internet sales. Today, $4 billion of nearly $150 billion in state sales tax collections are lost through mail order catalogue sales. The expected explosive growth of the Internet will doom the sales tax unless a genuinely nondiscriminatory, easy-to-administer sales tax can be developed with industry.

MYTH: 30,000 taxing jurisdictions will suffocate the Internet's development.

REALITY: Transactions over the Internet are nearly always taxable on the basis of the purchaser's jurisdiction, and transactions take place one at a time. Thus, if any tax is due on a transaction, it can be easily traced to a single jurisdiction.

MYTH: Small businesses hoping to use the Internet to sell their goods or services have no reliable way of knowing what sales tax is due on a particular sale.

REALITY: Small business are not liable to collect sales taxes on sales made anywhere but in their home state where they are likely to know the applicable law. Only companies with operations in more than one state must collect more taxes, and then only in states where they operate. Only one state, Texas, requires out-of-state businesses that use a server located within Texas to collect the Texas sales tax.

MYTH: States and localities can kill the Internet by seeking to tax every transaction that moves through their jurisdiction. And since the Internet moves products by packet switching, one never knows what route the material has taken from seller to buyer.

REALITY: A bit tax, taxing the flow of bits through the wires of the telecommunications companies located a jurisdiction, has been discussed by academics in Europe, but the concept has not been adopted either in the U.S. or abroad. The U.S. Constitution would prohibit such a tax if a state or locality ever imposed it since it effectively operates as a border tax, an unfair burden on interstate commerce.

MYTH: Congressional action is necessary to keep states and localities from imposing new taxes on the Internet.

REALITY: Since states aren't enacting new taxes, no moratorium is needed. States instead have joined a voluntary industry-government effort, led by the National Tax Association and including local government representatives, to develop mutually acceptable tax policy to ensure that consistent and administrable tax policy for the Internet.

MYTH: As soon as a company's website appears on a computer in another city or state, that company may be liable for taxes.

REALITY: U.S. courts have already determined that access to a website in a jurisdiction does not permit any long arm jurisdiction over the company. The standard for sales tax jurisdiction is even higher. Based on such precedents, no company has any rational basis to fear that a state could assert sales tax jurisdiction merely because its website was accessible there.

NATIONAL GOVERNORS' ASSOCIATION

Backgrounder

Economic Development and Commerce Group
Contact: Tim Masanz, 202/624-5311
October 17, 1997

Preparing for Our Economic Future with Fair, Sensible Internet Tax Policy

Introduction

The nation's governors strongly support the development and growth of the Internet. Increased access to reliable, high-speed communication services is key to job creation and the delivery of more cost-effective public services. In the near future, Governors expect to use the Internet to deliver a broad range of services, including administering motor vehicle registrations; enhancing distance learning; improving health services through telemedicine; enabling one-stop shopping for construction permits, fees, and environmental permits; and simplifying registration and eligibility for social services and children's services.

Few areas of public services will not be affected by further developments in telecommunications technology and the Internet. For that reason, the governors, at the 1997 winter meeting of the National Governors' Association (NGA), stated their support for a review of "existing tax policies to determine their effect on telecommunications and the future growth of the industry and to ensure that outdated and inconsistent tax treatment does not hinder the growth of competition." The Governors adopted policy, stating "The Governors seek to work with industry to develop tax policy that is consistent, nondiscriminatory, and easy to administer." To accomplish this goal, the Governors endorsed the National Tax Association (NTA) Electronic Commerce Tax project "to review problems in the taxation of telecommunications and to propose coordinated policies that will help states promote fair competition while ensuring that the telecommunications industry bears its fair share of taxation." This joint industry-government effort is the most effective means of finding mutually acceptable solutions. (EDC-21, NGA policy adopted, July 30, 1997)

The Internet has already had a tremendous impact on business, and all evidence indicates that this will only continue to increase.

- Advertising on the World Wide Web is expected to reach $446 million in 1997; advertising during the first half of 1997 experienced a 250 percent increase over the same six months in 1996.
- Internet analysts estimate that in December 2001, 39 percent of users will buy goods and services on the Web, compared with 25 percent in December 1996.
- Amazon.com, the largest seller of books over the Internet, posted an increase in sales of 74 percent in the second quarter of 1997 over the same period in 1996.
- The largest shopping mall on the Web, the America's Choice Mall, now boasts 1,100 retailers, larger than the multi-acre Mall of America in Bloomington, Minnesota – the nation's largest shopping mall.

- IBM has launched a major marketing effort on "e-business," with the understanding that nearly every business will have some use for the Internet and online communications in the near future.

States Are Not Targeting the Internet for Increased Taxation

States are in no way poised to levy any new taxes on the Internet, and have in fact demonstrated the opposite posture. In the past year, Connecticut, Florida, Georgia, Massachusetts, and Washington have each passed laws removing taxes from the Internet. The California legislature is currently considering a bill to roll back taxes on the Internet. A Florida statute removes Internet access fees from the definition of taxable telecommunication services. In Massachusetts, a statute eliminates all taxes on Internet access, online information, and sales over the Internet over the next five years. A Connecticut law also eliminates taxes over five years, although this law only applies to Internet access charges and online information charges. The same Connecticut law also exempts the costs of developing, establishing and maintaining websites. New York Governor George Pataki lifted New York State taxes on the Internet by executive order, including taxes on transactions taking place over the Internet. In Iowa, Governor Terry E. Branstad announced that at the start of the next Iowa legislative session, he will offer legislation to exempt Internet access providers from the state sales tax.

Overall, state budgets this past year reflect Governors' efforts to hold the line on spending, satisfy the public's desire for a smaller public sector, and prepare for uncertain future federal funding. As highlighted in the April 1997 edition of *The Fiscal Survey of States*, states are exercising caution, proposing moderate spending increases, modest tax cuts, and increased budget reserves. Twenty-five states recommended tax reductions, and, for the fourth consecutive year, state revenues have declined. Even with strong, continuing growth in the nation's economy, a commitment to doing more with less has been a common theme for Governors' budget proposals. The states are not targeting the Internet for increased taxation.

Federal Legislation is Premature and Unnecessary

Congressional committees are considering legislation to address the "problem" of state and local taxes potentially threatening the future growth and development of the Internet. Although taxes are inconsistent from state to state, Governors have not heard evidence of double taxation from overlapping jurisdictions. The fear that 30,000 taxing jurisdictions could bring down the Internet is an unfounded one. Individual transactions take place between two parties, a buyer and a seller. Occasionally multiple parties are involved, but it is nearly always a small and manageable number. The only taxes that could be involved in such a transaction are the taxes of the states and cities in which those parties are located. In fact, in most cases, the purchaser's location determines the tax consequences. The concern that multiple jurisdictions will be taxing single transactions has yet to be validated. Before federal legislation is adopted, there must be clear evidence of a problem.

As drafted, congressional initiatives would create a protected class of taxpayers whose business is conducted in an Internet tax haven. This is a far cry from the goal of prohibiting discriminatory taxes, which the authors of these proposals frequently express. Individuals with the resources to purchase a high-speed personal computer enabling them to use the Internet to make purchases that most Americans make in local stores are not a class of taxpayers needing an exemption from state sales taxes. Companies that have converted portions of their business into online communications, data processing, information exchange, and transactions do not need a tax break more than companies

operating on Main Street America. Equity in state taxes is an important principle that must be preserved and a decision that should be left to states. A number of states are already moving to make changes in how the use of the Internet and online services are being taxed. Federal action at this time is unwarranted.

Congressional Proposals Will Severely Erode the State and Local Sales Tax Base

Congressional efforts currently under consideration would have a serious impact on state and local tax systems and could cripple the sales tax. Growth in Internet use and transactions is expected to explode in the next five to ten years. Estimates by Internet marketing research firms project that World Wide Web sales will be $1.5 trillion by 2002. This growth will lead to unequal and discriminatory tax treatment in states. Individuals who buy goods and services on Main Street will pay sales and excise taxes; those who purchase over the Internet will not. This discrimination and lost revenue could lead to the virtual collapse of state sales taxes over the next ten years, as rate increases needed to ensure stable sales tax revenues exacerbate the difference between the price of goods in stores versus the price when sold over the Internet. The sales tax yields 49 percent of total state tax revenues. For all states, but especially for those nine states without a personal income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming; New Hampshire and Tennessee have no income tax on earned income), the sales tax is a critical revenue instrument that must be preserved. States need to work with the federal government and industry to develop an effective means to adapt the sales tax to an Internet world, and efforts by Congress to equate Internet sales with mail order catalogue sales would likely doom this effort.

Proposed Legislation Would Unjustly Preempt State and Local Taxing Authority

Current congressional initiatives are structured as broad preemptions of state and local taxing authority, opening the door to years of costly litigation. State tax codes run into the thousands of pages. Congress is proposing to protect the majority of state and local taxes from preemption with a page or two of listed "exemptions" to the moratorium. This is not only naïve, it will guarantee years of litigation as businesses and government struggle to determine which taxes remain in place and which are preempted. If any legislation is needed, it ought to be written to specify the discriminatory taxes the authors of proposed measures in Congress intend to preempt. Vaguely promising to later make a fix by exempting most taxing authority from the broad so-called moratorium is rash and threatens the entire state and local tax base.

The period of time for the congressionally proposed "moratorium," a minimum of 5 to 10 years, is far in excess of the time needed to develop a consensus industry-government agreement. As explained below, a National Tax Association effort is already underway to develop consensus between industry and government. That effort needs to move forward without federal action to strip states and localities of tax authority during the negotiations. Under preemption, industry would be better served to negotiate with Congress than states and localities. If federal legislation is needed, the moratorium period on new discriminatory taxes should be a brief one to two years.

It is also important to note that none of the initiatives being discussed includes a grandfathering of existing taxes. If enacted, they would result in an immediate loss of revenues to state and local governments. These revenues would need to be replaced by levies on other classes of taxpayers. This would immediately distort the equity of state tax systems and should be avoided unless evidence of

serious discrimination against interstate commerce can be demonstrated. Again, the equity of state tax systems should be the responsibility of state elected officials; if federal legislation is needed, all efforts should be made to grandfather existing taxes.

Few State and Local Taxes Affect the Internet

Sales Taxes: Only five states—Alaska, Delaware, Montana, New Hampshire, and Oregon—have no sales tax. The sales tax (including taxes such as gross receipts taxes, which have the same incidence as a sales tax) makes up 49 percent of state tax revenues. Industry has expressed concern that the goods and services covered by this tax vary from state to state and that the rates levied vary even from city to city within some states. However, most entrepreneurs and companies that hope to sell goods and services over the Internet have no liability to collect the sales tax except for sales in their home state. If companies own property and have employees in more than one state, they are liable to collect sales tax on sales in those states as well.

There are certain problems with state sales taxes that the National Tax Association project needs to address. One of these is determining where a purchaser is located when a sale is transacted over the Internet. In the majority of cases, the answer is readily available. When goods are sold and shipped, an address is clearly available. However, if a service or intangible product is sold, such as software being downloaded over the Internet, it is more difficult to identify the location of the purchaser. Because most Internet transactions are legitimate business transactions and are recorded as business costs, locating a purchaser should only be a problem for taxpayers seeking tax avoidance. Another is the difference in what is taxed from jurisdiction to jurisdiction. A third would be to ensure that when services are sold over the Internet clear definitions are developed to permit an effective exemption for those services purchased and later resold. This is needed to avoid double taxation.

Tax Policy Should Keep Pace with Changing Technologies

Bit Tax: Fears have been expressed by industry representatives that as the digital delivery of a piece of software is made over the Internet, states or local jurisdictions may tax the flow of bits through the wires of the telecommunications companies located within their jurisdictions. A bit tax has been discussed by academics in Europe, but the concept has not been adopted either in the United States or abroad. The U.S. Constitution prohibits such a tax, as it effectively operates as a border tax, an unfair burden on interstate commerce.

Income Taxes: Corporate income taxes account for 4.5 percent of state and local revenues, and the Internet can pose a problem in determining where income is generated. By facilitating rapid and accurate international communications, the Internet will aid companies in spreading their operations around the country and around the world. As products are built and assembled in other countries, and when portions of services, such as text proofing or accounting, are done outside the United States, it becomes increasingly difficult to allocate company profits to geographical locations. The U.S. Treasury Department is beginning to look into these issues. It is likely that the NTA project will eventually consider this problem for domestic operations. Another issue is that in lieu of a corporate income tax, Michigan and New Hampshire both operate value added taxes. The impact of the Internet on these taxes is harder to predict, although proposed federal legislation would preempt them as well.

Telecommunications Excise Taxes and Internet Access Fees: Another category of taxes is telecommunications excise taxes that vary among jurisdictions but are intended to ensure that each industry pays its fair tax burden. Because the telecommunications industry as well as the Internet is rapidly changing and developing, the application of this tax is continually being re-examined. In general, telecommunications taxes may, depending on state law, be imposed on Internet access charges to the end consumer or to Internet service providers and others providing the Internet backbone or corporate intranets. Congressional proposals would specifically preempt this tax. The issue of double taxation can arise in situations where there is a lack of a sale for resale exemption. Rather than requiring federal preemption, this tax should instead be examined by the joint industry-government NTA project. Only when industry works with government to develop clear and accurate descriptions of new technologies and services is tax policy effective.

Business License Taxes: One initiative in the Senate would reform business license taxes that are generally charged by local governments, although Washington state has a business and occupational license tax in lieu of a corporate income tax. These taxes are based on the concept of doing business within a jurisdiction. As mentioned above, access to a company's website from a city or state other than the originating location cannot be considered as a basis to require payment of a business license or any other tax. The federal proposal would require that a business have a "physical business location" within a jurisdiction to be required to pay this tax. This is a new legal concept for business licenses that will have to be described in a committee report and again be subject to litigation. It is not clear what problem this proposal is addressing, and until it is litigated, it is not clear what impact it will have on either the Internet or state and local tax revenues.

States Have a More Thoughtful, Sensible Strategy to Address Internet Taxation

There is no evidence of a major problem of discriminatory taxes hindering the development of the Internet. The basis for federal action has not been proven. In fact, the evidence is that states are moving to lift taxes from the Internet, precisely in accord with the sentiments of the authors of Congressional proposals. States continually compete with one another for economic and business development. In this context, it is likely that more and more states will seek to establish tax preferences to attract more Internet business.

There is also evidence that this is a period of rapid growth in using the Internet especially for business and personal transactions. Microsoft stated that the speed of technological change on the Internet is so rapid that three months is considered an "Internet year." With such rapid change, it is difficult to predict the impact of federal legislation, especially legislation as broadly written as the current proposals. Unintended and unforeseen consequences are likely when the subject is so volatile. Governors believe a more thoughtful approach is required, one in which industry and government work side by side to gauge both the seriousness of the problems and the effectiveness of solutions. Only by working together can we hope to develop solutions that are open-ended enough to cope with the changes already on the horizon.

In November 1996, the National Tax Association convened its members—academics, industry representatives, and government representatives, all working in the field of taxation—to discuss the taxation of electronic commerce. At the close of the meeting, the association decided to pursue a joint effort to create consistent and fair treatment of electronic commerce. At the 1997 winter meeting of the

National Governors' Association, Utah Governor Michael O. Leavitt introduced a resolution to endorse this NTA effort, and it was adopted unanimously.

A number of meetings of the NTA Electronic Commerce Tax project have been held in 1997: a January meeting in Chicago, a March meeting in Tampa, Florida, and a May meeting in Washington, D.C. Finally, on September 4, a meeting of the board of eighteen industry representatives and eighteen government representatives was held in Washington, where attendees agreed to the preliminary project description. The next meeting is set for November 12 in Chicago; and meetings are planned in San Jose, California, in December and Washington, D.C., in January. The first issue the NTA project will address is the taxation of transactions that take place on the Internet. A drafting committee has been appointed, and its members intend to raise preliminary questions for discussion at a November 12 meeting. They intend to release a draft proposal in January containing elements of a solution for discussion in the spring, and hope to have a general consensus paper completed by fall 1998. National experts in state and local taxation and in telecommunications and the Internet are involved. A list of industry organizations participating in the effort is attached. The following organizations of state and local elected officials are also taking part:

National Governors' Association

National Conference of State Legislatures

National Association of Counties

National League of Cities

The U.S. Conference of Mayors

STEERING COMMITTEE BUSINESS REPRESENTATIVES: NTA ELECTRONIC COMMERCE TAX PROJECT

American Electronics Association (AEA)
Mary Jane Egr (Coopers & Lybrand)
Jeffrey McMillen (AEA)

Association Of Online Professionals
David McClure
COMMERCENET
Kaye Caldwell

Committee On State Taxation (COST)
Jim Eads (AT&T)
Jeffrey Friedman
Kendall Houghton

Direct Marketing Association
Robert Levering

Financial Institutions State Tax Coalition (FIST)
Fred Ferguson

Information Technology Association Of America (ITAA)
Carol Cayo
Pat Hunnicutt (IBM)

Institute For Professionals In Taxation (IPT)
Robert S. Goldman (Vickers, Madson & Goldman)

Interactive Services Association
Bruce Reid (Microsoft)

Media Tax Group
Jim Schroeder (The Thomson Corporation)
Chris Baldwin (Gannett Co., Inc.)
Ken Silverberg (Nixon, Hargrave, Devans & Doyle LLP)

National Cable Television Association (NCTA)
Teresa A. Pitts
Lisa Schoenthaler

Software Publishers Association
Mark Nebergall

Tax Executives Institute (TEI)
Timothy McCormally

United States Communications Association (USCA)
Scott Brian Clark
Price Waterhouse
Andy Ottinger (US West)

Wall Street Tax Group
Art Rosen (McDermott Will & Emery)

Wireless Tax Group
Keith Collard (Commnet Cellular)
Robert Landau (Bellsouth Corporation)

NATIONAL GOVERNORS' ASSOCIATION

News Release

Hall of the States
444 North Capitol Street
Washington, D.C. 20001-1512
Telephone (202) 624-5330

FOR IMMEDIATE RELEASE
October 28, 1997 (145-97)
Contact: Becky Fleischauer 202/624-5364

Governors Step Up Efforts to Urge More Responsible, Fair Internet Tax Legislation

Washington, D.C.—The nation's governors are stepping up efforts to urge Congress to adopt more responsible, fair Internet tax legislation. Several governors, mayors and county executives will meet with key members of Congress this week to voice their strong opposition to proposed Internet tax legislation that would preempt existing state and local taxes.

"Some in Congress are pushing protections for one segment of industry at the expense of Main Street business and other taxpayers," said NGA Chairman Ohio Gov. George V. Voinovich and Vice Chairman Delaware Gov. Thomas R. Carper. "State and local governments are in no way poised to levy new taxes on the Internet. In fact, this year alone seven states have even passed laws that *remove* taxes from the Internet. We are meeting with members of Congress this week to drive home the point that any legislation preempting existing state and local taxes is premature, unnecessary, and creates a protected class of taxpayers at the expense of Main Street business and other taxpayers. The tax inequity created by these proposals would spark a virtual collapse in state and local sales tax bases."

Governors are committed to ensuring that state tax policies are not a barrier to growth in the communications industry. Increased access to reliable, high-speed communication services is key to job creation and delivery of more cost-effective public services. Governors in many states are working to develop ways to use the Internet to deliver a broad range of citizen services, but they believe the consequences of proposed legislation should be a wake-up call for more thought, deliberation, and debate.

Currently, about 50 percent of total state and local tax revenues are generated by a sales tax. In the very near future, most Americans will be purchasing goods over the Internet, circumventing state sales taxes at the expense of Main Street businesses and other taxpayers. A recent report by an Internet marketing research firm projects that World Wide Web sales will be $1.5 trillion by 2002. This kind of sales explosion has the potential to seriously erode state and local tax bases and devastate rural America.

Governors believe the goal of any legislation should be tax fairness. Federal legislation should not create a protected class of taxpayers at the expense of businesses and other taxpayers. Choosing to give the nation's premier growth companies a tax break is not the solution most taxpayers would suggest to address unsubstantiated concerns about state and local taxes on the Internet.

As our nation moves from a manufacturing-based economy to a service- and information-based economy, governors believe care should be taken to ensure that our tax system keeps pace. "The formulation of Internet tax legislation warrants a thoughtful, deliberate approach like the National Tax Association effort," said Govs. Voinovich and Carper. "The National Tax Association, a professional association of tax practitioners from industry, government, and academia, is making important progress in developing a more consistent state tax treatment of electronic commerce. Using this neutral forum, NTA expects to complete a consensus paper that could be used as model legislation by fall 1998. This is not a time for federal legislation—it is a time for discussion and consensus building between industry and government. Congress should step back and allow states and industry to complete this important work together."

—END—

Note: NGA news releases are available on the World Wide Web at http://www.nga.org.

NATIONAL GOVERNORS' ASSOCIATION

NGA Policy

TELECOMMUNICATIONS TAXATION (Resolution*)

The passage of the Telecommunications Act of 1996 was an important step toward strengthening competition in the telecommunications industry. Its passage has promoted wide-ranging changes both in the industry itself and in the application of technological advances to existing services. As a result, state tax systems, developed primarily in an age of manufacturing industries and in a period of local or regional, regulated, monopolistic telecommunications utilities, are often ill-equipped to respond to these changes.

For the past several years, the Governors have supported policy favoring increased competition in telecommunications and the removal of barriers to entry in order to bring more companies into local markets. The Governors also have supported regulatory symmetry, ensuring that similar services and service providers are treated in a similar manner. The Telecommunications Act of 1996 calls on states and localities to treat competing companies in a nondiscriminatory manner.

Congress has recognized the sovereignty of states to determine their tax policy with respect to telecommunications. The Governors support state review of existing state tax policies to determine their effect on telecommunications and the future growth of the industry, and to ensure that outdated and inconsistent tax treatment does not hinder the growth of competition. Several states have undertaken telecommunications taxation studies during the last year and many more are contemplating doing so.

On November 11 and 12, 1996, a conference was held in Boston, Massachusetts, on taxation of the telecommunications industry. The conference, sponsored by several national tax organizations, provided a forum for both states and industry to talk about this critical issue and to seek solutions. At the conclusion of the conference, a suggestion was made to form a smaller group to draft model legislation. The offer was taken up by one of the sponsoring organizations, the National Tax Association, a professional association of tax practitioners from industry, government, and academia. The National Tax Association offered to serve as a neutral convener on the issues. Plans are currently underway to create a process to seek more uniform state tax treatment of telecommunications companies.

The Governors continue to oppose federal action to preempt the sovereign right of the states to determine their own tax policies. The Governors therefore endorse the process undertaken by the National Tax Association with the support of the Federation of Tax Administrators and the Multistate Tax Commission to review existing problems in the taxation of telecommunications and to propose coordinated policies that will help states promote fair competition while ensuring that the telecommunications industry bears its fair share of taxation. The Governors intend to monitor the process and consider any proposals that are developed.

* Based upon Policy EDC-8, State Priorities in Telecommunications.

Time limited (effective Winter Meeting 1997–Winter Meeting 1998).
Adopted Winter Meeting 1997.