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Internet Tax Freedom Act: H.R. 4105 as Passed by the House

Nonna A. Noto
Specialist in Public Finance
Economics Division

Summary

The House of Representatives passed its version of the Internet Tax Freedom Act, H.R. 4105, on June 23, 1998. This report describes the main components of the bill. The bill would impose a 3-year moratorium on the ability of state and local governments to levy certain taxes on the Internet. It would prohibit taxes on Internet access and online service, bit taxes, and multiple or discriminatory taxes on electronic commerce. Products or services delivered uniquely over the Internet could not be taxed. Sales arranged over the Internet but delivered separately in tangible form would be treated like mail order or telephone sales. This means that sales and use taxes would not be collected on most interstate transactions arranged over the Internet, but states could require Internet vendors to collect sales taxes on within-state sales. The bill would establish a temporary Advisory Commission on Electronic Commerce responsible for proposing legislation to Congress addressing sales and use taxation of "remote" or interstate commerce, whether arranged over the Internet or by other means. H.R. 4105 would prohibit the Federal Communications Commission from regulating Internet access fees or imposing regulatory fees on Internet access. The bill expresses Congress's opposition to regulatory, tariff, and tax barriers to international electronic commerce, and asks the President to pursue international agreements. The Senate version of the bill is expected to differ in many detailed respects. The Clinton Administration has indicated its general support for the Internet tax freedom bills. This report will not be updated.

Overview

The Internet Tax Freedom Act, H.R. 4105, was approved by the House of Representatives on June 23, 1998. The bill would impose a three-year moratorium on certain state and local taxes that single out the Internet, or electronic commerce (transactions conducted over the Internet or through Internet access), for special, multiple, or discriminatory treatment. The bill would establish a temporary Advisory Commission on Electronic Commerce to study state and local sales and use taxation of remote commerce (sales made across state lines) whether arranged over the Internet, or by mail order or telephone. The commission would have two years to propose legislation to Congress; the committees of jurisdiction are then asked to act on the legislation within 90 days. The 31 commission members would include specified representatives of the federal government, state and local government organizations, and Internet-related businesses.

In addition, the bill would permanently protect the Internet from the types of regulations and fees imposed by the Federal Communications Commission on telecommunications services. In the bill the Congress requests the President to pursue international agreements that protect international electronic commerce from regulatory, tariff, and tax barriers. The bill calls for a report and recommendations to Congress in these two areas. A report on any federal regulatory fees imposed on Internet providers, along with recommendations to Congress regarding whether such fees should be modified or eliminated, is to be prepared by the National Telecommunications and Information Administration within 1 year of enactment. A report on foreign commerce is to be prepared by the Secretary of Commerce and presented to the President within 18 months of enactment; the President is to review the report and make any recommendations to Congress within 2 years and 45 days of enactment. None of the studies is instructed to specifically address federal taxation of the Internet.

The Senate version of the Internet tax freedom bill is expected to agree with the House-passed bill in general intent, but differ in many detailed respects.[1] The Clinton Administration has indicated its general support for the Internet tax freedom bills, but that it might have suggestions to the conference for improving H.R. 4105.[2] The main components of the House-passed bill will now be explained in more detail. (This report is not an exhaustive description of H.R. 4105.)

Tax Moratorium

H.R. 4105 imposes a 3-year moratorium on the ability of state and local governments to levy certain types of taxes on the Internet and related activities. Specifically, the House-approved bill prohibits taxes on Internet access, bit taxes, and multiple or discriminatory taxes on electronic commerce. The moratorium would apply to all new taxes of these types and to existing taxes other than those specifically exempted.

The ban on taxing *Internet access* is defined to include online services. Thus, the bill would prevent state or local governments from taxing the monthly fee that consumers pay for "pipeline" Internet access services such as Erol's as well as "value-added" online services like America Online or Compuserve. For the moratorium to apply to Internet services that are bundled together for sale as part of a package with other services (such as telecommunications or cable services), the service provider must separately state the portion of the user's bill that applies to the other services.

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[1] For an account of the evolution of H.R. 4105 and its counterpart in the Senate, and a summary of the issues underlying the bills, see CRS Report 98-509, *Internet Tax Bills in the 105th Congress*, by Nonna A. Noto.

[2] Letter from Deputy Treasury Secretary Lawrence H. Summers to House Minority Leader Richard Gephardt, June 23, 1998. Reported in: Holmes, Jeremy. House Approves Internet Tax Moratorium; Focus Shifts to Companion Bill in Senate. Bureau of National Affairs (BNA), *Daily Tax Report*, No. 121, June 24, 1998. p. G-6.

The ban on *discriminatory taxes* on electronic commerce would prevent state and local governments from taxing products or services that are delivered uniquely over the Internet — in electronic form only, with no off-line equivalent. Transactions arranged over the Internet but delivered separately in tangible form would be treated like mail order or telephone sales. Under the current interpretation of "nexus" rules (explained below), this means that for most interstate sales arranged over the Internet, sellers could not be required to collect sales and use taxes from the customer. H.R. 4105 specifies that the use of a computer server in a state does not qualify as substantial nexus.

The ban on *multiple taxes* on electronic commerce means that more than one state, or more than one local jurisdiction, could not tax the same activity or transaction. (A locality and its state could both levy a tax, however.) It also means that a jurisdiction could not levy a telecommunications tax so that the consumer pays the tax twice, once on the underlying phone service used to connect to the Internet and again on the Internet service itself. To avoid the ban, a credit against the Internet access tax must be offered for the tax paid on the underlying phone service.

Bit taxes refer to taxes imposed on or measured by the volume of digital information transmitted electronically, or the volume of digital information per unit of time transmitted electronically. No state or local government currently imposes a bit tax.

Grandfathered Exemptions. The House-passed bill would exempt from the moratorium the taxes on Internet access now in effect for eight states named in the bill,[3] on the condition that within one year of H.R. 4105's enactment those states enact a law affirming such a tax. Currently, the taxes are applied as the result of administrative decisions, not statutory actions. No grandfathering would be provided for Internet access taxes currently applied by a few local governments and the District of Columbia.

Advisory Commission on Electronic Commerce

The states have long sought help from Congress in collecting sales and use taxes due on "remote" or out-of-state sales arranged by mail order or telephone. That concern now extends to sales arranged over the Internet. As Internet commerce grows, state and local governments are concerned about further loss of sales tax revenues. "Main Street" retailers, obliged to collect sales taxes from local customers, are concerned about losing business to out-of-state Internet merchants who do not need to charge the customer the sales tax. Under the compromise reached between the congressional sponsors of the bill and state and local interest groups, H.R. 4105 would create the temporary Advisory Commission on Electronic Commerce to study the issue of sales and use taxation of remote or interstate commerce, and draft proposed federal legislation.

Background on nexus rules. Under the current legal interpretation of "nexus" rules, a seller is required to collect and remit sales taxes only on behalf of the jurisdiction in

[3] The eight grandfathered states are Connecticut, Wisconsin, Iowa, North Dakota, South Dakota, New Mexico, Tennessee, and Ohio. The Governors of South Carolina and Texas voluntarily withdrew their states from the exemption.

which it has a "physical presence."[4] If a sale is made and delivered to a purchaser in another state, the seller is not obligated to collect a sales tax on the transaction. States would like Congress to change the nexus rules regarding interstate sales so that the states could require remote sellers (large sellers in particular) to collect the use tax from the customer and then remit the revenues to the customer's home state.

Duties of the Commission. H.R. 4105 describes 13 topics that the Commission may examine. They focus on state and local taxation of remote sales, and of transactions using the Internet and Internet access. They include investigating simplified methods for administering and collecting sales and use taxes on remote (interstate) commerce, such as special provisions for small sellers, a third-party collection system, single or uniform tax registration and tax returns, and a single sales tax rate per state.

The Commission is not encouraged to evaluate the basic question of whether Internet access should be taxed. Instead, the bill suggests, but does not require, that the Commission recommend that the temporary moratorium on certain taxes imposed by H.R. 4105 be made permanent.

Legislative recommendations. The Advisory Commission is to draft proposed federal legislation addressing the taxation of remote commerce in general — whether the sales are arranged over the Internet or by other means such as mail-order, telephone, or fax. The commission is given 2 years from the date of enactment to transmit the proposed legislation to the President and the Congress. The committees of jurisdiction within the House and Senate are to consider the proposed legislation within 90 days as defined under H.R. 4105's expedited procedure provisions. H.R. 4105 suggests contents for the proposed legislation, including:

- defining the "nexus" standards (the level of contacts) considered sufficient for a state to require an out-of-state seller to collect sales and use taxes from the customer;
- providing that sellers could be required to collect if, and only if, the state had adopted a single, combined state and local sales and use tax rate for remote commerce, a method of distributing to its local governments their proportionate share of such taxes, and other simplified procedures for the administration of its sales and use tax (sellers would not be held responsible for administering the sales taxes of individual local jurisdictions);
- providing uniform definitions of the categories included in the sales and use tax base and those categories considered exempt (to be used by all jurisdictions);
- making permanent the temporary tax moratorium imposed by H.R. 4105; and
- providing a dispute resolution mechanism between states regarding matters of multiple taxation.

Membership. While the Internet tax legislation was evolving in the House, there was concern about whether the commission would be dominated by business or by state and local government interests. H.R. 4105 proposes an equal number of representatives from each of the two groups. The temporary Advisory Commission on Electronic

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[4] See CRS Report 92-487, *Quill v. North Dakota: The Mail Order Tax Case*, by Thomas B. Ripy.

Commerce would have 31 members, including three representatives from the federal government; 14 representatives from specified state and local government organizations, and 14 representatives from specified areas of the Internet industry. There are no designated representatives of "Main Street" merchants (storefront retailers), the telecommunications industry, or other business sectors that remain subject to tax. Specifically, under H.R. 4105 the commission members would include:

- 3 representatives from the federal government:
  - the Attorney General,
  - the Secretary of Commerce,
  - and the Secretary of the Treasury, or their respective representatives.

- 14 representatives from state, local, and county governments:
  - 2 each from:
    - the National Governors' Association
    - the National Conference of State Legislatures
    - the Council of State Governments
    - the National Association of Counties
    - the National League of Cities
    - the United States Conference of Mayors.
  - 1 each from:
    - the International City/County Managers Association
    - the American Legislative Exchange Council.

- 14 representatives of taxpayers and business:
  - 7 appointed by the majority leaders of the Congress (jointly by the Speaker of the House and the majority leader of the Senate) and
  - 7 appointed jointly by the minority leaders of the House and Senate.
  - Within each group of 7:
    - 3 employed by or affiliated with persons engaged in providing Internet access or communications or transactions that use the Internet;
    - 3 engaged in electronic commerce, including at least 1 engaged in mail order commerce; and
    - 1 engaged in software publishing.

Commission members are to be appointed within 45 days of enactment. The chair would be selected from among the members. Sixteen of the 31 members would constitute a quorum, but 19 members (a supermajority) would be needed to approve any proposed legislation. All commission meetings would be open to the public. The commission is to consult with the National Tax Association Communications and Electronic Commerce Tax Project, and other interested parties. The commission would terminate when the last of the committees of jurisdiction concludes consideration of the proposed legislation, or three years after the date of enactment, whichever occurs first.

No staff or funding. There is no provision for staff, compensation, or reimbursement of expenses for members of the commission, but the commission may accept gifts and grants. The commission is to have reasonable access to resources of the Departments of Justice, Commerce, and Treasury, and to their facilities for meetings.

Federal Communications Commission and Telecommunications Issues

H.R. 4105 defines Internet access as not including telecommunications services. The bill would prohibit the Federal Communications Commission (FCC) or state commissions from regulating the prices paid by subscribers for Internet access or online services. The FCC also would be prohibited from imposing regulatory fees on such services. However, the FCC and state commissions would not be prevented from otherwise implementing the 1996 Telecommunications Act or from regulating telecommunications carriers that offered Internet access or online services bundled with other telecommunications services. The prohibited "bit tax"does not include taxes imposed on the provision of telecommunications services. Telecommunications carriers could not escape their liability for telecommunications taxes by bundling telephone service together with Internet access.

FCC issues and the telecommunications services industry are included in the instructions for all three studies mandated by H.R. 4105. The bill directs the existing National Telecommunications and Information Administration, within one year of enactment, to determine whether any direct or indirect federal regulatory fees are imposed on Internet providers, and make recommendations to Congress regarding whether such fees should be modified or eliminated. One of the topics the new Advisory Commission on Electronic Commerce is to examine is ways to simplify state and local taxes imposed on the provision of telecommunications services. In its instructions for the study to be conducted by the Secretary of Commerce examining barriers in foreign markets, the bill names U.S. providers of telecommunications services, along with U.S. businesses engaged in electronic commerce, as a focus of concern.

International Issues

Report on foreign commerce. The Secretary of Commerce would be required to conduct a study and prepare a report on foreign commerce, and present the report to the President within 18 months of enactment. Within 2 years and 45 days from enactment, the President is to review the report and submit to the appropriate committees of Congress any policy recommendations he deems necessary or expedient.

The purpose of the study and report is to promote electronic commerce worldwide. One element is to examine barriers in foreign markets on U.S. providers of property, goods, services, or information engaged in electronic commerce and on U.S. providers of telecommunications services. A second is to examine how those barriers affect U.S. consumers, the competitiveness of U.S. businesses abroad, and the growth of the Internet. A third is to examine what measures the U.S. government should pursue to promote the development of electronic commerce in the United States and in foreign markets.

Declaration that the Internet be free from international barriers. H.R. 4105 includes a "sense of Congress" declaration encouraging the President to seek bilateral and multilateral agreements to remove barriers to global electronic commerce, through several named international organizations. The agreements should require that Internet access and online services be free from undue and discriminatory regulation by foreign governments, and that electronic commercial transactions between the United States and foreign businesses be free from undue and discriminatory regulation, tariffs, and discriminatory taxation.