Testimony of the National Governors Association
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Chairman Inouye, Vice Chairman Stevens, and members of the Subcommittee: thank you for inviting the National Governors Association (NGA) to testify today.

My name is David Quam, and I am the Director of Federal Relations for NGA. I am pleased to be here on behalf of the nation's governors to discuss the organization's perspective on communications and taxation.

Today most of my testimony will focus on the *Internet Tax Freedom Act (the "ITFA"),* although I will also discuss the Streamlined Sales and Use Tax Agreement (SSUTA). The bottom line regarding the ITFA is this: although governors generally oppose federal interference with state authority to develop and manage their revenue systems, NGA supports a temporary extension of the Internet Tax Freedom Act that clarifies the definition of Internet access and does not further limit state authority or revenues.

Background

Although the U.S. Constitution grants Congress broad authority to regulate interstate commerce, the federal government, historically, has been reluctant to interfere with states' ability to raise and regulate their own revenues. State tax sovereignty is a basic tenet of our federalist system and is fundamental to the inherent political independence and viability of states. For this reason governors generally oppose any federal legislation that would interfere with states' sovereign ability to craft and manage their own revenue systems.

The 1998 Internet Tax Freedom Act, which imposed a moratorium on state or local taxation of Internet access, is one exception to longstanding congressional forbearance when it comes to state tax issues. Designed to help stimulate this new technology by making access to the Internet tax free, the moratorium included three important restrictions to protect states:

1. The moratorium applied only to new taxes–existing taxes on Internet access were grandfathered;
2. The definition of "Internet access," while broad, excluded telecommunications services; and
3. The moratorium expired after two years to allow Congress, states and industry the opportunity to make adjustments for rapidly developing technologies and markets.

In 2000 the original moratorium expired, but was extended through November 1, 2003, with its protections for states still in place. In 2003, and 2004, Congress debated bills that targeted state protections by proposing to eliminate the grandfather provision, modify the telecommunications exclusion to address tax disparities between telecommunications broadband services and those of the cable industry, and make the moratorium permanent. Fortunately, the final bill retained several of the original state protections including the grandfather clause, an exception for taxes on voice-over-internet-protocol (VOIP) services, and an expiration date of November 1, 2007.

As Congress begins to consider changes to the ITFA, governors recommend that members examine the scope of the moratorium in light of technological advancements; update the ITFA's definitions to ensure they reflect congressional intent and do not unnecessarily interfere with state taxing authority; extend the moratorium on a temporary basis to respect state sovereignty and the ever-changing nature of the Internet; and retain the original grandfather clause to preserve existing state and local tax revenues.

Congress Should Clarify the Definition of "Internet Access"

A core concern for states is the potential breadth of the ITFA's definition of "Internet access." The current definition of Internet access states:

> "Internet access means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, ***and may also include access to proprietary content, information, and other services as part of a package of services offered to users***. Such term does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access." *(Emphasis added)*

The first sentence of the definition has not changed since 1998 and allows a provider of Internet access to bundle "proprietary content, information, and other services" together with access to make the entire offering tax free. NGA believes that the unlimited ability of providers to bundle together content and "other services" into a single, tax-free offering represents a loophole that could have the unintended effect of exempting content, information or services from otherwise applicable taxes merely because they are delivered over the Internet.

The risk of states losing significant revenues from this provision has grown significantly as broadband connections have become more common and companies have altered business plans to deliver more services over the Internet. Since 2001, the number of high speed lines in the United States has risen from more than 9 million to nearly 65 million with high-speed connections in the United States growing by 52 percent in 2006 alone.[1] Governors support the deployment of broadband services because they increase the ability of citizens to utilize the vast array of services and information available online and are critical to our nation's economic growth and competitiveness.

As more consumers move online, Internet protocol technology is also making more services available over the Internet. For example, a key issue of the 2004 ITFA debate centered on whether VOIP would

[1] Response of Kevin J. Martin, Chairman, Federal Communications Commission, to pre-hearing questions asked by the House Committee on Energy and Commerce, February 7, 2007.

become a viable alternative to traditional phone service. Unlike traditional telecommunications services, VOIP uses the Internet to transmit voice communications between computers, phones and other communications devices. Today, analysts project that VOIP subscriptions will top 18 million in 2009, a dramatic rise from VOIP's 150,000 customers in 2003.[2] The concern in 2004 was what would happen to the $23 billion state and local tax base for telecommunications services if VOIP replaces telecommunications services and were allowed to be bundled with Internet access into a tax-free offering. Congress' solution during the last ITFA extension was to specifically exempt VOIP from the moratorium. This solution, however, did not solve the problem of the underlying definition.

The next major service moving to the Internet is video programming. Known as Internet-protocol television (IPTV), this service represents another technological leap for industry and challenge for the ITFA. Worldwide, the annual growth rate of IPTV is projected to exceed 92 percent, rising from 3.9 million subscribers in 2006 to 103 million in 2011. The service brings together voice, Internet and entertainment services in a bundle marketed by some as a triple-play.[3] Much like VOIP in 2004, if a service like IPTV is packaged with Internet access and exempted from applicable taxes, it would create tax disparities for competitors offering similar services and undermine existing state and local revenues.

The emergence of services such as VOIP and IPTV underscore the need to clarify the definition of what constitutes "Internet access" so that the taxability of a good or service is not determined by whether it can be bundled with Internet access and delivered over the Internet. Although NGA supports having the moratorium apply to services related to providing access to the Internet such as email, Congress should close the bundling loophole by specifying that the definition of "Internet access" applies only to those services necessary to connect a user to the Internet.

Any Extension Should be Temporary

When the ITFA became law in 1998, it was passed as a temporary measure to assist and nurture the Internet in its commercial infancy. The Internet of 2007 is far different. It is a mainstream medium that has spawned innovation, created new industries and improved services. What started as primarily a dial-up service available through a handful of providers, today is available through thousands of internet service providers using technologies ranging from high-speed broadband cable or Digital Subscriber Line services, to wireless, satellite and even broadband Internet access over power lines.

Commercial transactions over the Internet have also exploded. A recent study by the National Retail Federation concluded that Internet sales grew from $176 billion in 2005 to $220 billion in 2006, a 25

[2] Telecommunications Industry Association's 2006 Telecommunications Market Review and Forecast, February 27, 2006.
[3] Harris, Jan, "IPTV subscription to grow 92% year on year," Platinax Small Business News, April 10, 2007.

percent jump that outpaced projections.[4] The survey projects online sales for 2007 will jump 18 percent to $259 billion. According to one of the survey's senior analysts, "[t]his strong growth is an indicator that online retail is years away from reaching a point of saturation."[5]

The rapid pace of innovation in the Internet and telecommunications industries makes it difficult to define accurately these complex and ever-changing services. Congress made the original moratorium temporary in part for this reason: to provide Congress, industry and state and local governments with the ability to revisit the issue and make adjustments where necessary to accommodate new technologies and market realities. With continued questions as to the scope of the moratorium, the ongoing evolution of the Internet and its developing role in commerce, a temporary extension of the moratorium remains the best way for Congress to avoid any unintended consequences that may arise from a permanent moratorium.

Another reason to support a temporary extension is that making the moratorium permanent would establish a troubling precedent that distorts the state-federal relationship. As mentioned previously, governors generally oppose federal efforts to interfere with state revenue systems because such interference undermines a states sovereign authority to provide government services. A more immediate consequence of a permanent ban on state taxes is the increased pressure Congress would receive from other industries seeking similar preemptions of state laws. Legislation to impose a moratorium on state and local cell phone taxes and efforts to dictate state nexus standards for business activity taxes are recent examples of the types of preemptions strongly opposed by state and local governments that would be bolstered by passage of a permanent moratorium.

Congress Should Maintain the Moratorium's "Grandfather" Clause

NGA recommends that any extension of the moratorium preserve existing state and local revenues by continuing the so-called grandfather clause for taxes imposed prior to 1998. The grandfather clause serves two purposes; first, as a protection for existing state and local tax revenue; and second, as a means to preserve other state and local taxes not specifically mentioned by the ITFA.

Today only nine states have direct taxes on Internet access that qualify for the protection of the 1998 grandfather clause. Those states include Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin. According to Congressional Budget Office estimates from the 2004 ITFA extension, eliminating the grandfather clause will cost those states between $80 million and $120 million annually. While these amounts may seem insignificant in terms of federal dollars, balanced budget requirements at the state level require that any unanticipated loss of revenues must be

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[4] *The State of Retailing Online 2007*, Shop.com/Forrester Research Study, May 14, 2007.
[5] *Online Clothing Sales Surpass Computers, According to Shop.org/Forrester Research Study, viewed at* www.nrf.com (May 17, 2007).

made up by either cutting services or raising revenues. These losses also are high enough to make the elimination of the grandfather clause an unfunded federal mandate under the Unfunded Mandate Reform Act. Any extension of the moratorium should therefore preserve the grandfather clause so as not to reduce existing state and local tax revenues.

The grandfather clause also serves as an important protection for all state and local taxes that indirectly affect providers of Internet access. Under the ITFA, a "tax on Internet access" means:

> [A] tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access and regardless of the terminology used to describe the tax."

Because a tax on Internet access includes both taxes on users and Internet access service providers, some experts interpret the moratorium as applying to both direct taxes on Internet access and indirect taxes such as business taxes on a provider of Internet access. In fact, the pre-1998 versions of the moratorium expressly excluded certain indirect taxes such as income and property taxes from the moratorium. That language was later dropped because the grandfather clause applies to all taxes on Internet access in force before October 1, 1998.[6] Although the 2004 extension does preserve the ability of states to impose a tax "levied upon or measured by net income, capitol stock, net worth, or property value," this list is not exhaustive. Preservation of the grandfather clause is important because it allows Congress to avoid having to define those direct taxes subject to the moratorium and any other taxes that lie outside the scope of the moratorium.

Congress Should Support the Streamlined Sales and Use Tax Agreement

The National Governors Association has long supported state's efforts to pursue federal legislation, provisions that would require remote, out-of-state vendors to collect sales and use taxes from their customers. Such action is necessary to restore fairness between local retail store purchases and remote sellers and to provide a means for the states to collect taxes that are owed under existing law. The rapid growth of the Internet and electronic commerce underscores the importance of maintaining equitable treatment among all sellers.

In the *Quill* decision, the U.S. Supreme Court stated that, to secure a level playing field in the collection of sales and use taxes, states needed to eliminate undue administrative burdens on interstate commerce by simplifying the collection process for these taxes. The Court also clarified that Congress has the power to grant equitable collection authority to the states for sales and use taxes on remote sales. Governors

[6] Mazerov, Michael, "Making the Internet Tax Freedom Act permanent in the form currently proposed would lead to a substantial revenue loss for states and localities," Center on Budget and Policy Priorities, October, 20, 2003.

support the development of a 21st century sales tax system that simplifies compliance requirements and streamlines sales taxes to ensure that states are prepared for the global electronic marketplace.

Several states are working to eliminate undue administrative burdens on interstate commerce associated with sales and use taxes by participating in the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA is designed as an agreement between states to simplify their sales and use tax systems to provide greater uniformity and certainty for businesses and consumers. Simplification would be accomplished through several key features, including uniform definitions within tax laws, rate simplification, state level tax administration of all state and local sales and use taxes, uniform sourcing rules, simplified exemption administration, uniform audit procedures, and state funding of the system.

SSUTA was triggered on October 1, 2005, when 13 states representing more than 20 percent of the population were certified as having met the requirements of the agreement. Currently, 15 states are full members; 6 states are associate members; and 19 states and the District of Columbia serve as advisor states to the agreement. Since the agreement was triggered, more than 1,000 businesses have taken advantage of the simplifications offered by the agreement by volunteering to comply and collect sales taxes from their remote sales.

As Congress examines issues related to the Internet and state and local taxes, it should partner with states by prioritizing consideration of federal legislation to recognize the efforts of states and the business community to simplify state sales and use tax systems.

Conclusion

Governors remain steadfast in their insistence that decisions regarding state and local taxation should remain with state and local officials. The independent and sovereign authority of states to develop their own revenue systems is a basic tenet of self government and our federal system. State efforts under the SSUTA exemplify how states, the business community and Congress can work together to solve national issues with state and local consequences. As to the ITFA, NGA urges Congress to work with state and local governments by addressing the uncertainties inherent in the overly broad definition of Internet access and preserving the original grandfather clause as part of a temporary extension.