November 5, 2003

Honorable Lamar Alexander
United States Senate
Washington, DC 20510

Dear Senator:

This letter responds to the three questions you posed in your letter of November 4, 2003, regarding S. 150, the Internet Tax Nondiscrimination Act.

1. How much revenue is being collected by state and local governments from taxes on DSL?

CBO estimates that state and local governments currently collect at least $40 million per year in taxes on DSL service (Digital Subscriber Line—a high-speed data transmission over regular telephone wires). They are likely to collect revenues totaling more than $80 million per year by 2008 due to growth in the use of high-speed Internet access. These collections are primarily sales and use taxes on DSL service.

2. What would be the revenue loss to state and local governments under the managers' amendment to S. 150?

Based on the version of the proposed amendment CBO received late this afternoon (S150MGR.6), CBO has determined that the bill would create intergovernmental mandates as defined in the Unfunded Mandates Reform Act. We estimate that those mandates would impose costs on state and local governments in at least one of the next five years that would exceed the threshold established in that act ($60 million in 2004, increasing to $66 million in 2008). We have identified three major impacts, each of which would, by itself, exceed the threshold:

- Revenue losses of $80 million to $120 million per year, starting in 2007, to state and local governments that are already taxing Internet access and were covered by the "grandfather clause" contained in the Internet Tax Freedom Act. Some of these are taxes on DSL services. We have no information to suggest that other states will impose taxes on Internet access in the near term.

- Other states are currently imposing taxes on charges for the portions of DSL services they do not consider Internet access. Those states would lose at least $40 million in sales and use taxes on DSL services in 2004, and at least $75 million by 2008. The preemption of DSL taxes would stem from section 2(c) of the amendment, which defines "Internet access."

- Substantial revenue losses that could result from:

    (a) The inability of state and local governments to collect transactions taxes (including sales and use taxes and gross receipts taxes) on certain types of telecommunications services. For example, if technological change shifts traditional telecommunications services to the Internet, those services—for example local and long distance phone calls—could be included, for free, when a customer purchases Internet access;

    (b) The free inclusion of content (movies, music, and written works) with Internet access in response to the tax exemption provided by this bill. Such content is subject to sales and use taxes under current law but might increasingly be available at no charge as part of an Internet access package.

CBO does not have sufficient information to estimate these revenue losses, but we believe they could grow to be large. There is some question, however, as to what types of transactions could not be taxed under the bill; under some interpretations, these revenue losses could remain quite small. The issue might ultimately have to be resolved in the courts.

3. How much tax revenues do state and local governments collect on telecommunication services?

Based on information from industry representatives, state and local governments, and federal statistical sources, CBO estimates that state and local governments currently collect more than $20 billion annually from taxes on telecommunications services. Such taxes generally fall into two categories: transactions taxes and business taxes. Transactions taxes (for example, gross receipts taxes, sales taxes on consumers, and taxes on 911 service) account for about two-thirds of the total.

In arriving at this estimate, CBO took into account the fact that some companies are challenging the applicability of taxes to their services, and thus may not be collecting such taxes, even though states and local governments feel they are obligated to do so. Such potential liabilities are not included in the estimate.

If you would like further details on the information provided in this letter, we would be pleased to provide it. The staff contacts for this legislation are Sarah Puro and Theresa Gullo.

Sincerely,

Douglas Holtz-Eakin
Director

cc: Honorable John McCain
Chairman
Committee on Commerce,
Science, and Transportation

Honorable Ernest F. Hollings
Ranking Member

Honorable Susan M. Collins
Chairman
Committee on Governmental Affairs

Honorable Joseph I. Lieberman
Ranking Member

Honorable Don Nickles
Chairman
Committee on the Budget

Honorable Kent Conrad
Ranking Member

Honorable George Allen

Honorable Ron Wyden