

**DESCRIPTION OF S. 442,  
THE "INTERNET TAX FREEDOM ACT,"  
AND A PROPOSED CHAIRMAN'S AMENDMENT  
IN THE NATURE OF A SUBSTITUTE**

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## INTRODUCTION

S. 442, the "Internet Tax Freedom Act," was reported by the Senate Committee on Commerce, Science, and Transportation on May 5, 1998 (S. Rept. 105-184). S. 442 would impose a moratorium on the ability of States and local governments to impose taxes with respect to Internet activity, both access to and transactions conducted on the Internet. S. 442 further would direct the Secretaries of State, Treasury, and Commerce, in consultation with private business and appropriate Congressional committees, to undertake a study of the appropriate taxation of Internet activity, and would provide that it is the sense of the Congress that Internet activity be a tariff-free zone. Consistent with the jurisdiction of the Committee on Finance (the "Finance Committee") over issues related to interstate taxation by States and local governments and international taxation and trade, S. 442 has been sequentially referred to the Finance Committee through July 30, 1998.

Similar legislation, H.R. 4105, was passed by the House of Representatives on June 23, 1998.

The Finance Committee has scheduled a markup on July 28, 1998, to consider an amendment in the nature of a substitute to S. 442. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides an overview description of S. 442 and H.R. 4105 (Part I), an overview of present law (Part II), and a description of a proposed amendment in the nature of a substitute to be offered by Chairman Roth (Part III).

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of S. 442, the "Internet Tax Freedom Act," and a Proposed Chairman's Amendment in the Nature of a Substitute to S. 442* (JCX-58-98), July 24, 1998.

## I. OVERVIEW OF S. 442 AND H.R. 4105

### S. 442

S. 442 (the "Internet Tax Freedom Act") would prohibit States and local governments from imposing any tax, license, or fee directly or indirectly on the Internet or interactive computer services between the date of the bill's enactment and January 1, 2004. This moratorium would not apply to taxes on net income derived from the Internet (including interactive computer services), to fairly apportioned business taxes applied to businesses having a business location within the taxing jurisdiction, or to the authority of States or local governments to impose any sales or use tax on transactions effected through the Internet if the taxes (1) are generally applicable taxes and (2) are imposed in the same manner as is permitted on sales or transactions effected by mail order, telephone, or other remote means.

S. 442 would direct the Secretaries of State, Treasury, and Commerce to consult with appropriate Congressional committees and the private sector to develop policy recommendations on the appropriate taxation (domestic and international) of Internet activity. These recommendations would be required to be provided to the President within 18 months after the bill's enactment, and the President would be directed to transmit legislative recommendations to the Congress within two years after enactment.

Further, S. 442 would declare that it is the sense of the Congress that international agreements be negotiated providing that international use of the Internet is free from tariffs and taxation.

### H.R. 4105

H.R. 4105 would prohibit States and local governments from imposing any taxes on Internet access, any "bit" taxes, or any multiple or discriminatory taxes on electronic commerce during the three-year period beginning on the date of the bill's enactment. The bill would exempt from this moratorium certain taxes currently imposed by the States of Connecticut, Wisconsin, Iowa, North Dakota, New Mexico, Tennessee, and Ohio, if those taxes are expressly re-enacted during the one-year period beginning on the date of the bill's enactment. A bit tax is defined as any tax on electronic commerce expressly imposed on or measured by the volume of digital information transmitted or the volume of such information per unit of time transmitted electronically.<sup>2</sup> A discriminatory tax is defined as any tax on electronic commerce that is not generally imposed on transactions accomplished by other means or is not imposed at the same rate as other such transactions.

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<sup>2</sup> Taxes on telecommunication services (e.g., telephone access) would be specifically excluded from the moratorium.

H.R. 4105 would establish an Advisory Commission on Electronic Commerce, composed of 31 members representing the Federal Government, States and local governments, and the private sector to develop legislative recommendations (to be submitted to the Congress within two years after the bill's enactment) on the appropriate taxation of Internet activity and other remote area transactions (e.g., mail order or catalog sales). The recommendations, once submitted to the Congress, would be considered under special, expedited legislative procedures. The bill includes specific provisions identifying associations and industry groups to be represented on the commission, and detailed rules governing actions of the commission.

As with S. 442, H.R. 4105 would declare that it is the sense of the Congress that international agreements be negotiated providing that international use of the Internet is free from tariffs and taxation.

H.R. 4105 also contains provisions, not within the jurisdiction of the Finance Committee, regarding Federal regulation of the Internet and imposition of user fees.<sup>3</sup>

H.R. 4105 was passed by the House of Representatives on June 23, 1998.

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<sup>3</sup> Authorizing committees of the Congress may impose, or authorize executive agencies to impose non-tax, or true, user fees that agencies may charge for specific services they provide. In general, a true user fee is a charge levied on a class that directly avails itself of a governmental program, and is used solely to finance that program rather than to finance the costs of Government generally. The amount of the fee charged to any payor may not exceed the direct costs of providing the services with respect to which the fee is charged. There must be a reasonable connection between the payors of the fee and the agency or function receiving the fee. Those paying a fee must have the choice of not utilizing the governmental service or avoiding the regulated activity and thereby avoiding the charge. In other words, the fee can be viewed as payment for a special privilege, as opposed to a mandatory charge (e.g., tax) imposed on the public at large for general or specified governmental purposes.

## **II. OVERVIEW OF PRESENT FEDERAL INCOME TAX, EXCISE TAX, AND TARIFF PROVISIONS RELATING TO THE INTERNET AND STATE AND LOCAL GOVERNMENT TAXATION OF INTERNET AND SIMILAR INTERSTATE SALES ACTIVITIES**

### **Federal tax provisions**

#### **Income taxation of the Internet**

There are no special Federal income taxes on Internet services. The Federal income tax applies to Internet services in the same manner that it applies to any other provision of services. Accordingly, the income received by an Internet service provider is includible in that provider's income for Federal income tax purposes. Similarly, a business that pays amounts to an Internet service provider generally may deduct or amortize (as appropriate) those amounts as an ordinary and necessary business expense (assuming the other prerequisites for a deduction or amortization are satisfied).

#### **Federal excise taxation of the Internet**

Present law imposes no special excise taxes on Internet services. Access to and transactions conducted on the Internet are subject to generally applicable Federal excise taxes in the same manner as other taxable activities. For example, present law imposes a three-percent excise tax on certain communications services (i.e., local and long distance telephone service). Thus, amounts paid for telephone service connecting users to the Internet are subject to this excise tax in the same manner as other payments for telephone service. Charges for actual Internet service are not subject to this tax, as long as the service provided does not otherwise fall within the statutory provisions governing the communications excise tax (e.g., voice quality local or toll service).

### **International trade provisions**

Present law provides no direction to the President regarding Congress' interest in or intent with respect to the conduct of international negotiations regarding barriers to electronic commerce. Nothing in the law directs the President to include barriers to electronic commerce among the barriers cataloged annually in the National Trade Estimates report prepared by the United States Trade Representative. The National Trade Estimates report serves as a compendium of foreign barriers to U.S. commerce and a presumptive target for future negotiations with our trading partners.

### **State and local government taxation of interstate transactions**

Under the Constitution, a State or local government may impose taxes on sales that occur within its jurisdiction or on the use of property within its jurisdiction. Approximately 6,600

State and local jurisdictions impose sales and use taxes.<sup>4</sup> A limited number of States have applied their sales or other excise taxes to Internet activity. The allowable sales tax authority of a State or local government extends to mail order sales by out-of-State vendors to residents of the State if the sale is deemed to take place within the taxing jurisdiction.<sup>5</sup> There are, however, limitations on the methods State and local jurisdictions may employ to collect sales and use taxes.

State and local sales and use taxes are levied on the final purchaser, but are collected primarily through the vendor. In the case of a sale by an out-of-State vendor, the U.S. Supreme Court has held that a State or local government cannot constitutionally require the vendor to collect and remit use taxes unless the vendor has a sufficient business nexus with the State.<sup>6</sup> In the *National Bellas Hess* case, the Court found that the required nexus was not present if the vendor's only connection with customers in the State was by common carriers or the United States mail.<sup>7</sup> The Court based this conclusion on due process considerations and on the Commerce Clause of the United States Constitution, which reserves to Congress the power to regulate and control interstate commerce.<sup>8</sup> The required nexus has been held to exist when the vendor arranges sales through local agents or maintains retail stores in the taxing State.

Subsequently, in 1992, the U.S. Supreme Court ruled that an out-of-state mail-order house with neither outlets nor sales representatives in the State is not required to collect and pay use tax on goods purchased for use in the State.<sup>9</sup> The Court ruled that the due process clause did not bar enforcement of the State's use tax, but held that enforcing the State's use tax would be inconsistent with the Court's commerce clause jurisprudence. The Court concluded by observing that "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."<sup>10</sup>

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<sup>4</sup> Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Vol. 1* (1995), table 27.

<sup>5</sup> See, e.g., *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944).

<sup>6</sup> *National Bellas Hess, Inc., v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967) (henceforth referred to as *National Bellas Hess*).

<sup>7</sup> *Id.* at 754.

<sup>8</sup> *Id.* at 760.

<sup>9</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>10</sup> *Id.* at 318.

### III. DESCRIPTION OF CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE

The Chairman's amendment would substitute the provisions described below for the provisions of S. 442, as reported by the Committee on Commerce, Science, and Transportation.

#### **State and local tax moratorium**

In lieu of the approximately six-year moratorium provided in S. 442, the Chairman's amendment would prohibit imposition of State and local taxes on the Internet for a period of three years, beginning on the date of the bill's enactment.<sup>11</sup> Taxes to which the moratorium would apply include any taxes on Internet access, any bit taxes, or any multiple or discriminatory taxes on electronic commerce.

The Chairman's amendment further would provide that this moratorium applies only to taxes imposed after July 28, 1998 (the date of Finance Committee action). Thus, the amendment would not affect the ability of States or local governments to collect tax with respect to transactions occurring before July 29, 1998, or the rights of parties in any dispute concerning State and local taxation of Internet activity during periods before July 29, 1998. Unlike H.R. 4105, the Chairman's amendment would not grandfather any existing State or local taxes on Internet activity during the period of the moratorium.

#### **Sense of the Congress resolution on new Federal Internet taxes**

The Chairman's amendment would provide that it is the sense of the Congress that no new Federal taxes like the State and local government taxes to which the three-year moratorium would apply should be enacted on Internet activity during the moratorium.

#### **International trade provisions**

Like S. 442 and H.R. 4105, the Chairman's amendment would express the sense of Congress that the President should continue efforts to ensure that electronic commerce remains free of tariffs, discriminatory taxation, and any form of discriminatory regulation.

Unlike S. 442 and H.R. 4105, the Chairman's amendment would amend existing law to direct the United States Trade Representative, under existing statutory authority, to include barriers to electronic commerce, among the barriers designated annually in the National Trade Estimates report.

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<sup>11</sup> The moratorium does not affect taxes, fees, and other charges imposed pursuant to Federal law.



### **Establish national advisory commission**

Similar to the provisions of H.R. 4105, the Chairman's amendment would establish a national advisory commission to study and recommend appropriate rules for international, Federal, State, and local government income and excise taxation of the Internet and other comparable interstate or international sales activities, as well as appropriate tariff treatment of such activities.

The commission would be comprised of 13 members, as follows:

Federal Government representatives.—The Secretaries of State, Treasury, and Commerce, the Attorney General, and the United States Trade Representative, or the designee of each such cabinet member would represent the Federal Government.

State and local government representatives.—A total four representatives of State and local governments would be appointed, one member each by the Speaker of the House of Representatives, the Minority Leader of the House, the Majority Leader of the Senate, and the Minority Leader of the Senate.

Electronic industry and consumer representatives.—A total of four representatives of the electronic industry and of consumer groups would be appointed, one member each by the Speaker of the House of Representatives, the Minority Leader of the House, the Majority Leader of the Senate, and the Minority Leader of the Senate.

Legislative history accompanying the bill would suggest that the Congressional leadership coordinate their appointments to the commission to assure the broadest possible State and local government and private sector representation.

The commission would be directed to submit its findings, with legislative recommendations, to the Congress within two years of the date of the bill's enactment. Unlike H.R. 4105, the Chairman's amendment would not provide any expedited procedures for consideration of the commission's recommendations.

The Chairman's amendment further would direct the President to continue negotiations currently under way in a variety of fora regarding the regulation of the electronic commerce. The amendment would establish a set of concrete trade negotiating objectives designed to guide the President in future negotiations. Those negotiating objectives would include the removal of barriers to trade in goods and services that are essential to the delivery of electronic commerce as well as barriers to electronic commerce itself.