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Taxing the Internet: An Update on State Policies

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The explosion in Internet activity in the last decade has led to new regulatory questions for government. Internet commerce, in particular, is a growing area of interest. One of the issues with which state governments must now contend is Internet-related taxation. This paper addresses current state tax policy trends in two areas: Internet access and sales of goods over the Internet.

The Internet as a Commercial Marketplace

The Internet is unique in its structure as an industry.[1] It is the creation of many people, using many different computer networks, connecting through a common protocol established by telephone and software links. The Internet is not run by a single agency or group, but by the voluntary cooperation of many. As a "network of networks," it has the advantage of allowing simultaneous interaction among multiple users at remote locations. With current software and telecommunications technology, Internet users can join discussion groups, conduct research, plan vacations, and purchase goods and services online.

The nature of the Internet is such that its commerce cannot be confined by state or even national boundaries. Participants in electronic commerce may complete transactions from opposite sides of the globe, possibly without the knowledge of each other's physical location. This global marketplace presents new tax questions for state governments, which must determine jurisdiction over an amorphous body of revenue. This paper will address two of these critical new tax issues: taxing Internet access services and taxing goods sold over the Internet. Most of the paper will focus on the first topic, as states have applied a broader range of tax options to it.

Why are These Tax Issues Important?

While the actual number of Internet users is unknown, the current estimate of users in the United States alone is 50 million.[2] In order to be connected to the Internet, each user must have an Internet access or service provider (ISP). As the number of users increases, so does the potential profitability of such services. Studies have estimated revenues from Internet access and online services to have ranged from $1.6 to $2.2 billion in 1995, with projected growth to between $7 and $14 billion by the year 2000.[3] This has caught the attention of a number of state tax departments.

Sales of goods over the Internet is another growing commercial interest. While Internet commerce is a very small part of a state's economy, it is nevertheless an industry with significant growth potential. Many experts anticipate sales of goods over the Internet to rise from approximately $500 million in 1996 to $6.6 billion by 2000.[4] This figure holds great significance for the majority of states, in which sales tax accounts for more than 30% of the general fund revenue.[5]

Tax Issue #1: Internet Service Provision

What are ISPs? Internet service or access providers (ISPs) provide commercial access to the Internet. In addition, some ISPs make e-mail, software, or newsletters available to their subscribers.[6] ISPs operate by becoming part of the Internet. They accomplish this by purchasing the computer hardware and software as well as the telecommunications services necessary to link their network to others. They then charge a subscription fee to consumers for access to the Internet.

How can ISPs be Taxed? Internet access, as a new form of service, could potentially be categorized in several ways. Some of the more common service classifications are telecommunications, information, and computer. Any sales, use, gross receipts, or excise tax which a state or locality traditionally applies to these services could be imposed on ISPs.

Some of the issues that states have confronted in deciding whether or not to tax Internet access are the difficulties in determining jurisdiction over out-of-state servers and the possibility of losing in-state companies to states that don't tax Internet access. The question of how and when to tax ISPs is complicated by the fact that a user can purchase Internet access from an ISP in any geographical location. For example, a person in New York could use an ISP which is based in Tennessee. In exchange for Internet access, the New Yorker would pay a monthly fee to the provider in Tennessee. To whom should the sales tax on this service go? To New York, the buyer's state? Or to Tennessee, the seller's location? Is either state entitled to collect the tax? In addition to addressing this tax policy concern, states must consider the fiscal ramifications of imposing a sales tax. There is a concern that a state that does not tax ISPs will become a haven for them, at the expense of other states. A tax exemption, however, means a loss of potential revenue. If the buyer's state requires the tax, a different problem arises. How does the Tennessee provider collect the tax and submit it to New York? How does the provider determine the buyer's location? Could New York compel a Canadian ISP to collect the tax?

Many states, particularly those with a large number of Internet-related businesses, wish to nurture this relatively new industry. To help the industry grow and establish itself, these states may accord Internet services tax-exempt status. Some states have also refrained from taxing Internet access simply because they have not yet decided how to categorize it.

What are States Doing? Currently, because of these difficulties, there is a trend among states to exempt Internet access and service providers from taxation. Thirty-five states do not tax access to the Internet. Of the states that do tax Internet access, most do so by placing it within existing tax structures, rather than developing a new taxable category (see Table 1). States have accomplished this primarily by classifying Internet access as a telecommunications service. (It should be noted, however, that ISPs must purchase telecommunications services in order to provide Internet access; the industry has objected that a telecommunications tax means ISPs must pay twice. Some states have acknowledged this, and tax only the end transaction.) The type of tax which states choose to apply to these services varies. While some states use a gross receipts or excise tax, the predominant type of tax imposed on Internet access is a state sales tax, with possible local tax additions.

Table 1: State Taxes on ISPs[7]

Category	State	Type of tax	Tax rate	Estimated Annual Revenue
Telecommunications Services	Alabama[8]	Gross utility receipts	4%, but the Alabama Dept. of Revenue does not tax ISPs	Not applicable
	Illinois[9]	Telecommunications excise tax, and Telecommunications municipal infrastructure maintenance fee	(Only if hourly rate; no tax on flat monthly fee) Excise tax: 5% in 1997, 7% in 1998 Maintenance fee: 0.5%	State has no estimate
	Iowa[10]	Sales tax (both ends of the transmission must be in-state)	flat rate fee subject to 5% sales tax, additional 1% local tax may apply	$4 million
	North Dakota[11]	Sales and Gross receipts	5% sales tax rate; 2% gross receipts tax rate, beginning in 1998	State has no estimate; not applicable
	South Carolina[12]	Sales tax	5% state rate, possible 1% local tax addition	$1.5 million
	Tennessee[13]	Sales tax	6% state rate, generally 2.5% local tax addition	$1.7 million state, $0.7 million local
	Wisconsin[14]	Sales or use tax (service must originate *or* terminate in-state, and service address must be in-state)	5% state rate, up to 5.6% with local	$80,000 collected (not all companies complied)
Information Services	District of Columbia[15]	Sales tax	5.75%	No response
	Ohio[16]	Sales tax Commercial access only	5% state rate, counties may add up to 2%	$3 million state, $600,000 county
	Texas[17]	Sales tax	6.25% state rate, locals may add up to 2%, varies by both buyer's and seller's locations.	State has no estimate
Computer Services	Connecticut[18]	Sales or use tax (if the end terminal is in-state)	5% from 7/1/97 to 6/30/98, decreasing thereafter by 1% each year until services become exempt on 7/1/02	No response
	South Dakota[19]	Sales tax	4% state rate, plus up to 2% local	State has no estimate
Services or Interstate telecommunications services	New Mexico[20]	Gross receipts	5% state rate, plus up to 2% local (for in-state services) or 4.25% on interstate telecommunications services	No response
(General) Services	Hawaii[21]	General excise tax	4%	No response

California's Position. California places a number of surcharges on intrastate telecommunications services, but does not include Internet access in the telecommunications category. California does not tax Internet access, and several bills now before the Legislature would act to strengthen ISP tax exemption. AB 1614 (Lempert), titled the "California Internet Tax Freedom Act" would prevent the state and local governments from imposing any Internet access-related taxes. SCA 18 (Mountjoy) would prohibit the state from levying any tax on Internet communications or users, and AJR 20 (Lempert), would state California's support of the federal bill, the "Internet Tax Freedom Act," which will be addressed later in this paper.

States That Tax ISPs

South Carolina taxes Internet access under telecommunications laws. The same is true of Iowa, North Dakota, Tennessee, and Wisconsin, with the provision that both ends of the service transmission are in-state. In Iowa, however, Representative Van Fossen's subcommittee introduced House Study Bill 238, a bill that would exempt access charges to the Internet and other online computer services from sales and use taxes. The bill was not carried over, but a new version may be introduced in the coming session. Iowa Governor Terry Branstad has indicated that his 1998 legislative package will include a repeal of the tax on Internet access.[22] Illinois taxes ISP charges as a telecommunications service, but only if the ISP has a "time-related" (ie. hourly) fee; a flat monthly fee is not taxable.[23] Georgia also classifies Internet access as a communications service, but does not tax such services.

The other major category under which states have placed Internet service provision is that of information or computer services. As seen in Table 1, Connecticut, the District of Columbia, Ohio (for commercial use only), South Dakota, and Texas tax Internet access under this classification. Connecticut, however, is currently phasing out ISP taxes (see appendix for details). Virginia also classifies Internet access as electronic transmission of information, but does not tax this service.

New Mexico imposes either a services gross receipts tax (for in-state charges) or an interstate telecommunications gross receipts tax on Internet access. Hawaii differentiates between Internet service provision and telecommunications services, and imposes a general excise tax on ISPs.

The majority of these states apply a sales tax to ISP charges, regardless of the category under which they place Internet access. Three states impose a gross receipts tax: Alabama (see recent changes, below), New Mexico, and North Dakota. North Dakota's gross receipts tax is effective beginning in 1998, and is levied in addition to the sales tax.[24] Hawaii and Illinois are the only states to apply an excise tax to ISPs.

The tax rates applied to ISP charges range from 4% to 8.5%. The most common state tax rate is 5%, and many states allow a 1% or 2% local tax as well. Many ISPs charge a monthly rate of approximately $10.00. This means that the average consumer, in a state that taxes ISP charges, pays about $6.00 a year in taxes. Internet access charges are not generally considered to be a major source of revenue. Some states, in fact, do not currently have the means to determine the amount generated by these taxes. Of the states that responded to our telephone survey, the estimated annual state revenues range from $80,000[25] to $4 million.[26]

Recent or Pending Policy Changes in Other States (See Appendix A for Details). Massachusetts, Florida, and Washington enacted legislation this year prohibiting the taxation of Internet services as telecommunications or network telephone services. Connecticut legislation requires a gradual six-year phase-out of Internet service taxation. A Minnesota bill (Ch. 231, 1997) requires a legislative committee in the 1997-98 session to study the issue of taxing Internet access.

New York and Alabama have addressed the issue through their state departments that handle taxation. New York's Department of Taxation and Finance decided this year to exempt Internet service providers from sales tax. Senate Bill 5016-A (Volker) was then proposed to codify the decision in law, but was vetoed because of technical deficiencies (see Appendix A). The Department anticipates that a modified bill will be signed in the next legislative session. As of October 1997, amendments to Alabama's Department of Revenue (DOR) utility tax regulations include Internet access charges under the state's utility gross receipts tax as "telephone services." Although the amendments were scheduled to go into effect on December 1, 1997, the DOR has not adopted them, and does not intend to do so.[27] The Governor is unwilling to tax ISPs, and has indicated that he will propose legislation to exempt them if necessary.[28]

Tax Issue #2: Sale of Goods or Services

Sales of goods over the Internet can be accomplished in one of two ways. The buyers can either order the item online, usually by providing a credit card number, or they can download an order form and complete the transaction by mail or telephone.

States almost universally treat goods sold over the Internet as tangible personal property, subject to the rules of *nexus* and the state's sales or use tax laws.[29] Nexus is defined as a physical presence in the buyer's state. The determination of what constitutes nexus was addressed by the Supreme Court in 1904, in *Quill Corporation v. North Dakota* (112 S. Ct. 1904 [1992]), a case involving mail-order catalog sales. The Court determined that an actual physical presence was necessary in order for the buyer's state to impose sales tax. Thus, for example, a company based in Maine could sell its products by mail to a buyer in California, without having to collect sales tax for the California State government. If, however, that company were to open a branch office in California, it would then have a physical presence in California, and items shipped there would be subject to sales tax. Recently, however, several major direct marketing firms have entered an agreement with state governments to voluntarily collect sales tax on goods purchased from out of state.[30] This may impact the Internet sales tax policy, as states have generally applied the *Quill* nexus standard to these as well. Several states already use a slightly different definition of nexus for Internet vendors.

Michigan, New Mexico, and Texas have additional tax rules.[31] Michigan imposes a use tax when goods purchased over the Internet are shipped to a Michigan address. New Mexico imposes a sales or use tax if the seller has nexus or if the Internet service provider is acting as an agent for the seller. Texas treats sales of goods as most other states do, but has interpreted nexus to include servers that reside within the state. As the volume and variety of sales over the Internet increase, states may attempt to revise their tax policies in this area.

Towards a Uniform Tax Policy?

The numerous state and local authorities capable of imposing taxes on Internet commerce have prompted some to fear the balkanization of electronic commerce in the United States. Because of this, various groups have proposed the development of a uniform tax policy. At the federal level, the "Internet Tax Freedom Act," H.R. 1054 (Cox-Wyden), now before Congress, would place a moratorium on new state and local taxes on Internet services and sales while Congress studies the issue. Several revenue or finance departments in other states[32] have been active in policy research in this area.

In addition to government research, various groups have formed committees or held conferences to discuss the issue. While much of the focus has been on methods for taxing goods sold over the Internet, the issue of taxing Internet access could be addressed in a similar fashion.

Selected Options for Taxing Electronic Commerce. This paper takes no position on whether electronic commerce should be taxable at the state level. However, should such transactions prove to be taxable, the following options are worth examining.

The National Tax Association (NTA) has addressed this topic in their Communications and Electronic Commerce Tax Project. In their first report, released in November of 1997,[33] the Drafting Committee proposed several options for applying the retail sales tax to electronic commerce. These suggestions are based on the assumption that the purpose of a sales tax is to tax consumption, and thus the tax should be levied in the consumer's state.

The Committee suggests the use of the consumer's billing address in order to determine the state in which consumption occurs. If the vendor is unable to determine a billing address, they recommend that the vendor collect and remit sales tax in one of the following ways:

1) Collect for the state of their principal place of business[34] or

2) Collect the average state sales tax, and distribute it to all U.S. states based on the proportion of business that is billed to each state.

Several other groups also advocate the use of the consumer's billing address for tax purposes. The drawback to this scheme, however, is that it may be difficult to determine a consumer's billing address in the majority of cases. This is true, for instance, in the increasingly popular encrypted credit card transactions, in which the Internet vendor is not privy to the purchaser's credit card number or billing information. Also, purchasers might establish separate "billing addresses" in states without sales tax. The use of a purchaser's shipping address is another option, but consumers could still use shipping addresses in states without the tax, and have the goods forwarded. A shipping address would also be inapplicable to a broader range of sales such as downloadable information and software and services such as Internet access.

A second option suggested by the Committee is that Congress establish a state tax information clearinghouse. Vendors without physical presence in the purchaser's state would be required to report the sale, including both the billing and shipping addresses, to the clearinghouse. Each state would then be able to access the clearinghouse and use the information to collect sales taxes. Vendors who participate in this system would have no further obligation to collect sales tax on out-of-state purchases.

Nathan Newman, of the Center for Community Economic Research at the University of California, Berkeley, has also addressed this topic.[35] He points out that, while the Supreme Court has ruled that states cannot collect sales tax on out-of-state sales, the U.S. Congress may collect the revenue and remit it to the states. This, like the NTA's recommended state tax clearinghouse, would simplify the issue for vendors by centralizing the collection process.

These possibilities would require federal legislation, and thus will likely arise in an administrative study if Congress passes the "Internet Tax Freedom Act." Other proposals, as well as current state policies, could also be valuable resources as federal and state officials continue to grapple with this issue.

Appendix A

Recent state legislation in this area has generally acted to clarify and exempt Internet service providers from telecommunications laws. The following is a brief summary of recent state activities.[36]

Alabama
The Department of Revenue's (DOR's) Rule 810-6-5-.26, as of 1996, requires that a utility gross receipts or utility service use tax be applied to ISP charges. On October 6, 1997 a hearing was held to update utility tax regulations to include Internet access. The resulting proposal, an amendment to include Internet access charges under the definition of "computer exchange services," has not been adopted by the DOR. The Governor does not want to tax Internet access, and 1998 legislation on the subject is anticipated.[37]

California
AB 1614 (Lempert), now before the Senate enacts the "California Internet Tax Freedom Act" to prohibit taxing the Internet or interactive computer services or their use. SCA 18 (Mountjoy), introduced in September, prohibits the state from levying any tax on Internet communications or users, and AJR 20 (Lempert), before the Assembly Rules Committee, supports the federal HR 1054.

Connecticut
Connecticut currently taxes ISP charges as computer and data processing services. Effective July 1, 1997, the taxes are to be phased out over a six year period. The tax rate will be 5% from July 1, 1997 to June 30, 1998, decreasing thereafter by 1% each year until services become exempt on July 1, 2002.

Florida
SB 404 (Chapter 97-283), exempting Internet access charges from sales and other taxes, recently became law without the Governor's signature.

Georgia
HR 366 (Resolution Act 66, 1997), signed by the Governor in April, confirms that Internet access services shall remain exempt from taxation.[38]

Maryland
SB 746 (Chapter 629, 1997), signed by the Governor in May, exempts Internet access from the gross receipts tax.[39]

Massachusetts
The Department of Revenue placed a temporary moratorium on the collection of sales or use taxes on Internet access and other electronic services, effective until December 31, 1998 or until legislation exempts the services.[40] HB 4608, the Joint Committee on Taxation's redraft of HB 2398 (Bosley) is currently before the House.

Minnesota
Introduced in the Legislature in March 1997, SF 1795 would have added Internet access and online services performed within or mostly within Minnesota to the list of taxable telecommunications services. It would also have created an advisory council to examine and make recommendations on the issue of telecommunications service taxation.[41] The bill was partially incorporated into the Omnibus Tax Bill, HF 2163 (Chapter 231, Article 5, Section 18). The bill requires that the issue of Internet access be studied in the coming session, but does not provide for currently taxing ISPs.

New Jersey
AB 3031 (DeCroce), introduced in June 1997, would clarify that the state may not apply sales tax to Internet access service.

New York
The State Department of Taxation and Finance, after study of other state policies, announced its policy to exempt Internet access charges from sales tax beginning in February of 1997.[42] SB 5016-A (Volker), passed by the Legislature, would have codified the exemption, but was vetoed by the Governor for technical reasons. Stating that the bill did not exempt Internet services from the telecommunications tax or include some of the other provisions, the Governor directed the Department to work with Legislative staff to produce a new bill.[43] The Governor expects to sign the new bill in the coming session.

North Carolina
HB 970 (Reynolds), introduced in May, declares a moratorium on Internet service taxation for at least two years.

Washington
SB 5763 (Chapter 304, 1997), prohibits taxing ISPs as network telephone services.

Endnotes

[1] For an overview of the Internet, see Ken Umbach, *The Internet: A California Policy Perspective*, California Research Bureau, California State Library, March 1997.
[2] Ken Umbach, personal communication, December 18, 1997.
[3] National Association of State Budget Officers, "Taxing the Internet," *NASBO News,* November/December 1996.
[4]Ibid.
[5] John Berry, "Who Will Tax the Web?" *Internet World,* April 1997.
[6] Some states tax the purchase of software or information downloaded from the Internet. This paper addresses only the taxes applied to the Internet access fee itself.
[7] L.J. Kutten recently published "1997 Sales/Use Tax Chart of Computer Software and Internet Transactions" in *State Tax Notes,* November 17, 1997, pp. 1243-44. The chart covers tax policies for various types of software as well as Internet access. The information presented here on Internet access differs slightly, and is the result of personal communications with government officials in other states.
[8] Mike Emfinger, Alabama Department of Revenue, personal communication, December 17, 1997.
[9] Marlin Jackson, Illinois Department of Revenue, personal communication, January 15, 1998.
[10] Rule 701 IAC 18.20(5), received from Arlene Sweet, Iowa Department of Revenue and Finance, December 11, 1997.
[11] John Quinlan, North Dakota Tax Department, personal communication, December 11, 1997.
[12] South Carolina Sales and Use Tax Code, Sec. 12-36-910, amended by 1995 Act No. 145, Part II, Sec. 105A.
[13] Ray Todd, Manager of Taxpayer Education, Tennessee Revenue Dept., personal communication, December 11, 1997.
[14] Dave Prochaska, Wisconsin Revenue Dept., personal communication, December 11, 1997.
[15] David Meyer, District of Columbia Finance and Revenue Dept., Economic and Tax Policy Division, personal communication, December 12, 1997.
[16] Tim Carpenter, Sales Tax Division, Ohio Taxation Dept., personal communication, December 11, 1997.
[17] David Parnell, Texas State Comptroller, personal communication, December 11, 1997.
Texas State Comptroller Web Site, http://www.window.state.tx.us/taxinfo/taxpubs/tx96_237_971.html. Title 34. Public Finance, Part I, Ch. 3, Subchapter O, S. 3.342.
[18] Vertex, Inc. Taxation Table, http://www.vertex.com/taxcybrary20/taxchannel70/taxtable_72.html.
[19] Julie Lorensen, South Dakota Revenue Department, personal communication, December 11, 1997.
[20] Jeanne Flannery, New Mexico Taxation and Revenue Dept., personal communication, January 21, 1998.
[21] Denise Inoye, Hawaii Taxation Department, personal communication, January 5, 1998.
[22] John Simmons, "Battle over Internet Taxes Heats Up as Congress Considers a Plan for Moratorium on New Levies," *The Wall Street Journal*, October 23, 1997, A20.
[23] Marlin Jackson, Illinois Department of Revenue, personal communication, January 15, 1998.
[24] Interstate telecommunications services are exempt from the service gross receipts tax. Jeanne Flannery, New Mexico Taxation and Revenue Department, personal communication, January 21, 1998.
[25] This is a low estimate, as it does not include the potential revenue from several large ISPs that did not collect and remit the tax. Craig Kammhoz, Wisconsin Revenue Department, personal communication, January 13, 1997.
[26] Wayne Cooper, Iowa Department of Revenue & Finance, personal communication, January 13, 1998.
[27] Mike Emfinger, Alabama Department of Revenue, personal communication, December 17, 1997.
[28] "Weekly Review," *State Tax Notes*, October 24, 1997.
[29] For a discussion of this issue, see Ken Umbach, *The Internet: A California Policy Perspective*, California Research Bureau, California State Library, March 1997.
[30] Frederick Thys, "Early Morning Edition," National Public Radio, November 6, 1997.
[31] Vertex, Inc. Taxation Table, http://www.vertex.com/taxcybrary20/taxchannel70/taxtable_72.html.
[32] For example, the New York Department of Taxation and Finance and the Massachusetts Department of Revenue have both researched the issue.
[33] James Eads et al, "National Tax Association Communications and Electronic Commerce Tax Project Report No. 1 of the Drafting Committee," *State Tax Notes*, November 17, 1997, pp. 1255-70.
[34] A vendor's principle place of business may be defined as either: (1) the state(s) in which the vendor is located or (2) the state in which the most goods or services are consumed.

[35] Nathan Newman, *Prop 13 Meets the Internet: How State and Local Governments Are Becoming Road Kill on the Information Superhighway*, Center for Community Economic Research, University of California, Berkeley, August 1995.
[36] This information was obtained from a variety of sources. Unless otherwise noted, it may be found on the Vertex, Inc. World Wide Web site, http://www.vertexinc.com/taxcybrary20/taxchannel70/taxtable_72.html.
[37] National Conference of State Legislatures, "1997 Bill Introductions Relating to Internet Taxation as of October 29, 1997," unpublished list.
[38] Ibid.
[39] Ibid.
[40] Mitchell Adams, "Temporary Sales Tax Moratorium on Internet Access and Related Telecommunications Services," Massachusetts Department of Revenue, TIR-97 available online at http://www.magnet.state.ma.us/dor./rul_reg/tir/97/tir97_10.html.
[41] Minnesota State Legislature Web Site, http://www.revisor.leg.state.mn.us.
[42] Brian Kopp, "New York State Announces New Internet Tax Policy," *New York Tax News*™, Nixon, Hargrave, Devans and Doyle LLP publication, http://www.nhdd.com/nytax.
[43] The Associated Press, "Pataki Vetoes Internet Tax Bill," *The New York Times*, September 12, 1997.