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INTERNET TAX FREEDOM ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

ON

H.R. 1054

INTERNET TAX FREEDOM ACT

July 17, 1997

Serial No. 25

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taxed, and when Governor Weld came in he repealed that tax, except for certain taxes that related to telecommunication transactions.

Since then there has been an interpretation by our Department of Revenue that extends the language for telecommunication tax-related matters into Internet online service, Web posting—those different services. So right now we're passing a bill to clarify that it doesn't.

Mr. GEKAS. We thank the gentleman, and we'll turn to Professor Hellerstein, and we'll elucidate, I think, on some of your propositions during the question and answer period.

Professor Hellerstein.

STATEMENT OF PROF. WALTER HELLERSTEIN, UNIVERSITY OF GEORGIA, SCHOOL OF LAW

Mr. HELLERSTEIN. I appreciate the subcommittee's invitation to testify today on H.R. 1054. I do not appear here on behalf of any client, public or private, and the views I'm expressing here today reflect my best independent professional judgment.

I wish to make it clear at the outset that I'm not here to support or to oppose H.R. 1054. The subcommittee has already heard ample testimony, both in support and opposition to H.R. 1054, and I have nothing to add to the general debate over the merits of congressional legislation limiting State taxation of the Internet.

Instead I would like to focus on three issues the bill raised, issues to which I believe the subcommittee should give serious thought in determining whether to approve H.R. 1054 in its present form.

First and foremost, I would urge the subcommittee to pay close attention to the precise language of H.R. 1054, in light of what may be unintended consequences of the legislation. Second, I would urge the subcommittee to consider carefully whether it intends, through H.R. 1054, to enact, I quote, "a moratorium" on State taxation of the Internet as that term is commonly understood and, if so, whether H.R. 1054, if enacted into law, constitutes such a moratorium.

Third, I would encourage the subcommittee to enlist those with expertise and experience in the field of State and local taxation in establishing the consultative group charged with developing policy recommendations for congressional legislation in this domain. I would like to elaborate briefly on each of these points.

Incidentally, it is my understanding that changes to be proposed in the markup of H.R. 1054, as well as changes to which Senator Wyden alluded in his testimony earlier today, reflect some of the suggestions I have made in my testimony, which is directed to H.R. 1054 as it was provided to me. If, and to the extent that, this is so, I would obviously support those proposed changes. But such changes have not been made available to me, and my testimony is not directed to them.

Let me start with the point about unintended consequences. In contrast to areas in which Congress has considerable legislative experience and expertise—for example, the Federal income tax—Congress has rarely legislated in the State tax field. Congress' relative unfamiliarity with State and local taxing regimes creates the risk

that when Congress does legislate in this area, it may bring about consequences that it did not intend—and I give an example of that in my written testimony that I won't burden you with here.

Although I enumerate several examples of what may be the unintended consequences of H.R. 1054 in my written testimony, let me focus on just one for the moment. Does the subcommittee truly intend to extend the prohibition of H.R. 1054 to, quote, "any tax or fee directly or indirectly on interactive computer services or the use of interactive computer services?"

To be sure, the subcommittee has borrowed the definition of, quote, "interactive computer services" from recent amendments to the Federal Communications Act. These definitions embrace an enormous range of computer-related activity, so long as it, quote, "provides or enables computer access by multiple users to a computer server." '

In preparing my testimony, for example, I used a, quote, "system" that, quote, "provides or enables access by multiple users to a computer server," namely, the University of Georgia network server. Well no one, so far as I know, was attempting to tax the system. Yet there is nothing particularly unusual or Internet-related about what I was doing.

I'm not suggesting that the subcommittee should or should not extend the bar of H.R. 1054 to such services. I am suggesting only that the subcommittee be aware of precisely how far this legislation extends, and to clarify its intent to reach all of the transactions that it appears, in my judgment, to include.

Second, H.R. 1054 purports to impose a moratorium on the imposition of taxes on Internet or interactive computer services while a consultative group examines the problem and develops recommendations for a consistent and coherent national policy regarding taxation of Internet activity. While we can quibble over the precise definition of a moratorium, there is little question that in its usual usage, it connotes a temporary delay or suspension, rather than a permanent one.

The language of H.R. 1054, however, imposes no temporal limits on its restraint on State taxing authority. Perhaps that is precisely what the subcommittee intends, and if so, the language of H.R. 1054 accomplishes its intended purpose.

If, on the other hand, the subcommittee intends that its moratorium on State taxes should, in fact, be temporary, it should say so explicitly in H.R. 1054. Otherwise the moratorium may well become a permanent fixture in the framework of Federal legislation limiting State taxing authority.

Third, while in general I have refrained from either supporting or opposing H.R. 1054 on the merits, I wholeheartedly endorse section 4 of the bill that establishes a consultative group to examine the complex problems raised by taxation of the Internet and interactive computer services, and to submit appropriate policy recommendations to solve these problems.

In the subcommittee's consideration of the participants in this consultative group, however, I would strongly urge—and I see the red light; if this were the Supreme Court, I would say, "Thank you, Mr. Chief Justice."

Mr. GEKAS. No, you may proceed.

Mr. HELLERSTEIN. In the subcommittee's consideration, I would strongly urge it to enlist the participation of those with expertise and experience with regard to State taxation.

Specifically, I would urge the subcommittee to work with the National Tax Association-sponsored Committee on Taxation of Telecommunications and Electronic Commerce, which includes a broad spectrum of interested and knowledgeable private and public sector parties who are currently engaged in fashioning a solution for the complex problems to which H.R. 1054 is addressed.

Let me close with a parting word that I always give to my teenage kids as they rush out the door into their cars: "Please be careful." I would urge you, whatever you do, to please be careful. You are dealing with extremely complex issues, and many conflicting and legitimate concerns lie in the balance. Legislation that does not take careful account of all of these concerns may do more harm than good.

Thank you very much.

[The prepared statement of Mr. Hellerstein follows:]

PREPARED STATEMENT OF PROF. WALTER HELLERSTEIN, UNIVERSITY OF GEORGIA, SCHOOL OF LAW

I am Walter Hellerstein, Professor of Law at the University of Georgia and a partner in the law firm of Sutherland, Asbill & Brennan. I have devoted most of my professional life to the study and practice of state and local taxation, and, in recent years, I have devoted particular attention to state and local taxation of telecommunications and electronic commerce. Pursuant to House Rule XI, clause 2(g)(4), I have attached to this statement a curriculum vitae. I have also attached to this statement two recent articles I have written addressed specifically to issues raised by state and local taxation of Internet-related activities. In accord with House Rule XI, clause 2(g)(4), I hereby declare that neither I nor any entity I represent at the hearings[1] have received any federal grant, contract, or subcontract in the current or preceding two fiscal years.

I am honored by Chairman Hyde's invitation to appear before the Subcommittee and to testify on H.R. 1054, "the Internet Tax Freedom Act." I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my best, independent professional judgment.

I wish to make it clear at the outset that I am not here to support or to oppose H.R. 1054. The Subcommittee will have heard ample testimony both in support and in opposition to H.R. 1054, and I have nothing to add to the general debate over the merits of congressional legislation limiting state taxation of the Internet. Instead, I would like to focus on three issues that the bill raises—issues to which I believe the Subcommittee should give serious thought in determining whether to approve H.R. 1054 in its present form.

First, and foremost, I would urge the Subcommittee to pay close attention to the precise language of H.R. 1054 in light of what may be unintended consequences of the legislation. Second, I would urge the Subcommittee to consider carefully whether it intends through H.R. 1054 to enact a "moratorium" on state taxation of the Internet, as that term is commonly understood, and, if so, whether H.R. 1054, if enacted into law, would constitute such a moratorium. Third, I would encourage the Subcommittee to enlist those with expertise and experience in the field of state and local taxation in establishing the consultative group charged with developing policy recommendations for congressional legislation in this domain. I elaborate on each of these three points below.

1. ANY CONGRESSIONAL LEGISLATION LIMITING STATE TAXATION OF THE INTERNET SHOULD BE CAREFULLY CRAFTED TO AVOID UNINTENDED CONSEQUENCES

In contrast to areas in which Congress has considerable legislative experience and expertise (*e.g.*, the federal income tax), Congress has rarely legislated in state tax field.[2] Congress' relative unfamiliarity with state and local taxing regimes creates the risk that when Congress does legislate in this area, it may bring about consequences that it did not intend.

To illustrate the problem, consider one recent piece of federal legislation designed to limit state tax power. In *Oklahoma Tax Commission* v. *Jefferson Lines, Inc.*,[3] the U.S. Supreme Court upheld an Oklahoma sales tax on the full sales price of bus tickets for interstate trips. Eight months after the Court's decision, Congress enacted the following legislation in an apparent effort to overrule *Jefferson Lines:*

> A State or political subdivision thereof may not collect or levy a tax, fee, head charge, or other charge on (1) a passenger traveling in interstate commerce by motor carrier; (2) the transportation of a passenger traveling in interstate commerce by motor carrier; (3) the sale of passenger transportation in interstate commerce by motor carrier; or (4) the gross receipts derived from such transportation.[4]

While Congress thus overturned the particular result in *Jefferson Lines*, it arguably did much more. *Jefferson Lines* involved taxes on consumer purchases of bus tickets. Read literally, the legislation preempts not only retail sales taxes on interstate passenger transportation but also "a tax . . . on . . . the gross receipts derived from such transportation." Under this language, an apportioned gross receipts tax imposed on a company providing inter state transportation—a type of levy that has long been regarded as constitutionally acceptable[5] and whose propriety none of the parties in *Jefferson Lines* questioned—apparently is barred.[6] I doubt Congress intended these consequences.

In my judgment, H.R. 1054 raises similar issues of unintended consequences. Turning to the specific terms of H.R. 1054, I would like to raise the question whether the Subcommittee really intends to bring about certain consequences that arguably flow from the bill's language.

Does the Subcommittee intend to preempt property taxes on those who use the Internet or provide interactive computer services? H.R. 1054 preserves the states' authority to impose income taxes and certain business license and sales or use taxes, but says nothing about preserving their authority to impose property taxes. A broad—perhaps an overbroad—reading of the preemptive language barring "any tax or fee . . . indirectly" imposed on the Internet or interactive services (or the use thereof) arguably could extend to taxes on property employed in connection with the use or provision of Internet-related services. For example, a creative lawyer might contend that a property tax on a computer server employed by an Internet service provider (ISP) is a tax "indirectly" imposed on the use of the Internet, especially if those taxes are passed on to the ISP's customers in the form of higher Internet access charges. If the Subcommittee does not intend to preempt such taxes, it should say so in H.R. 1054.

Does the Subcommittee intend to preempt gross receipts taxes in lieu of property taxes on those who use the Internet or provide interactive computer services? Several states impose gross receipts taxes on telecommunications companies in lieu of the property taxes that would ordinarily be imposed on the property of such companies.[7] If such taxes are not deemed to be "business license taxes"[8] (and there is

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[1] As noted in the next paragraph, I represent no such entity.

[2] See *Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation* 305 (6th ed. 1997) (describing the relatively few statutes in which Congress has exercised its power under the Commerce Clause to restrain state tax power).

[3] 115 S.Ct. 1331 (1995).

[4] Pub. Law 104–88, 109 St. 803, Dec. 29, 1995, 49 U.S.C. § 14505.

[5] See *Central Greyhound Lines, Inc.* v. *Mealey*, 334 U.S. 653 (1948).

[6] Indeed, the literal language of the statute would bar a state from imposing any "tax, fee, head charge, or other charge on . . . a passenger traveling in interstate commerce by motor carrier." Thus, an state income taxes imposed on those who have travailed as passengers in interstate commerce are arguably prohibited. To confine its scope, one might read the legislation as limiting the states from imposing taxes on passengers "with respect to" their travel in interstate commerce by motor carrier. But so read, the legislation might not reach the tax in *Jefferson Lines* itself, because the tax, as in interpreted by the Court, was imposed not "with respect to" interstate transportation but rather on the freedom to purchase a ticket. See generally, Walter Hellerstein, et al., *Commerce Clause Restraints on State Taxation After Jefferson Lines*, 51 Tax L. Rev. 47 (1995).

[7] For example, in North Dakota, mutual or cooperative telephone companies pay a cross receipts tax in lieu of property tax, in South Dakota, small telephone companies (less than $25 million in receipts) pay a gross receipts tax in lieu of property tax; and in Wisconsin, local exchange carriers pay a gross receipts tax in lieu of property tax, although the law has been repealed effective May 15, 19987. *Office of Tax Policy Analysis, New York State Department of Taxation and Finance, Improving New York State's Telecommunications Taxes: A Background Study and Status Report* 49–53 (1996); [1 Wis.] State Tax Rptr. (CCH) ¶ 80–130 (1997).

[8] I consider definitional issues further below.

clearly room for argument that gross receipts taxes imposed in lieu of property taxes do not constitute "business license taxes"), there is at least a plausible claim that a taxpayer can make along the lines suggested in the preceding paragraph that Congress has preempted such taxes, should it enact H.R. 1054 in its present form. If the Subcommittee does not intend to preempt such taxes, it should say so in H.R. 1054.

Does the Subcommittee intend to preempt taxes on Internet or interactive computer services that are taxable under existing (and, in many instances, long-standing) state taxes on telecommunications services, information services, or data processing services?[9] For example, many states impose taxes on charges imposed for access to the Internet, either as a telecommunications service, computer service, or information service.[10] While Section 3(a) of the bill appears to prohibit such taxes, Section 3(b) suggests such taxes may be still be imposed if they are "the same" as the tax imposed on other transactions "effected by mail order, telephone or other remote means" and if the obligation to collect the tax "is imposed on the same person or entity as in the case of sales or other transactions effected by mail order, telephone or other remote means."

The scope of this "savings" clause, however, is unclear. Suppose the tax is "the same" not as a tax on "sales or interstate transactions" effected by "remote means" but rather as a tax on "sales" effected by "proximate" means, *e.g.* a tax on services provided by a local telecommunications system access provider. Is the tax on Internet access still preempted? Or suppose the state imposes a tax on a transaction effected by "remote means" (*e.g.*, an interstate telephone call) but relies on a local exchange carrier to collect the tax on the call. Is the local exchange carrier "the same person or entity" as the on-line service provider or the Internet service provider? These are important questions to which H.R. 1054 provides no ready answers. The Subcommittee should clarify its intent with regard to these questions in language that explicitly addresses them.

H.R. 1054 also raises thorny definitional questions. The savings clause preserves state "taxes imposed on and measured by net income derived from the Internet or interactive computer services." Does this mean that H.R. 1054 does not preserve such taxes imposed on a corporate franchise and measured by net income?[11] Or was the use of the conjunction "and" rather than "or" merely a loose use of language?

H.R. 1054 does not affect states' power to impose fairly apportioned "business license taxes" on businesses with a business location in the taxing jurisdiction. Does a "business license tax" include a corporate privilege or franchise tax that many states impose? Or is it limited to a tax on a true "license" to do business, such as the business occupation taxes imposed by many states and localities? Without clarification of this definition, this provision could be construed to have a much narrower scope than the Subcommittee may have intended.

And does the Subcommittee truly intend to extend the prohibition of H.R. 1054 to "any tax or fee directly or indirectly on . . . interactive computer services . . . or the use of . . . interactive computer services." To be sure, the Subcommittee has borrowed the definition of "interactive computer services" from 47 U.S.C. § 230(e)(2).[12] These definitions embrace an enormous range of computer-related activity as long as it "provides or enables computer access by multiple users to a computer server."

[9] Almost all states with sales and use taxes impose such levies on telecommunications services, and many states tax information, data processing, and mainframe access services. *Federation of Tax Administrators, Sales Taxation of Services: 1996 Update 9–10 (1997); Office of Tax Policy Analysis, New York State Department of Taxation and Finance, Improving New York State's Telecommunications Taxes: A background Study and Status Report 49–53 (1996).*

[10] David Cowling and Andrew M. Ferris, *Internet Taxation Reviewed, State Tax Notes* July 7, 1997, pp. 41, 45–46.

[11] Students of state taxation will recognize the distinction between so-called "direct" net income taxes imposed "on" the income and "indirect" taxes imposed on some other subject (*e.g.*, a corporate franchise) and merely measured by net income. The distinction, though discarded as anachronistic and formalistic in some areas of state tax law, continues to be important in other areas. *See, e.g.* 31 U.S.C. § 3124 (barring "direct" state taxes on federal obligations or the income there from but permitting "a nondiscriminatory franchise tax" measured by such obligations or income).

[12] That section defines "interactive computer services" as "any information service, system, or access software provider that provides or enables computer access by multiple users to a computer server, including specifically a service or system that provides access to the Internet and such systems operated or services offered by libraries or educational institutions."

47 U.S.C. § 230(e)(3) in turn defines an "access software provider" as "a provider of software (including client or server software), or enabling tools that do one or more of the following: (A) Filter, screen, allow, or disallow content, (B) Pick, choose, analyze, or digest content, and (C) Transmit, receive, display, forward, cache, search, subset, organize, reorganize, or translate content.

Right now, for example, in preparing this testimony, I am using a "system" that "provides or enables access by multiple users to a computer server," namely, the University of Georgia network server. While no one (so far as I know) is attempting to tax this system, there is nothing particularly unusual or Internet-related about what I am doing. Again, I am not suggesting that the Subcommittee should (or should not) extend the bar of H.R. 1054 to such services. I am suggesting only that the Subcommittee be aware of precisely how far this legislation extends and to clarify its intent to reach all of the transactions that it appears, in my judgment, to include.

2. IF THE SUBCOMMITTEE INTENDS TO IMPOSE A "MORATORIUMS" IN THE SENSE OF A TEMPORARY SUSPENSION—AS DISTINGUISHED FROM A PERMANENT PROHIBITION OF—STATE TAXES ON THE INTERNET AND INTERACTIVE COMPUTER SERVICES, IT SHOULD MAKE ITS INTENTION CLEAR IN H.R. 1054

H.R. 1054 purports to impose a "moratorium" on the imposition of taxes on Internet or interactive computer services while a consultative group examines the problem and develops recommendations for a "consistent and coherent national policy regarding taxation of Internet activity." While we can quibble over the precise definition of a "moratorium,"[13] there is little question that in its usual usage it connotes a temporary delay or suspension rather than a permanent one. And, in light of H.R. 1054s explicit establishment of a consultative group to develop broader recommendations for a coherent solution raised by state taxation of the Internet and interactive computer services, one can surmise that the drafters of H.R. 1054 had in mind a temporary rather than a permanent limitation on the states' power to tax such services.

The language of H.R. 1054, however, imposes no temporal limits on its restraint of state taxing authority. Perhaps that is precisely what the Subcommittee intends and, if so, the language of H.R. 1054 accomplishes its intended purpose. If, on the other hand, the Subcommittee intends that its "moratorium" on state taxes should in fact be temporary, it should say so explicitly in H.R. 1054. Otherwise the "moratorium" may well be become a permanent fixture in the framework of federal legislation limiting state taxing authority.

I would again turn to our experience with other federal legislation limiting state power as evidence that the issue I am raising should be taken seriously. In 1959, the U.S. Supreme Court held in *Northwestern States Portland Cement Co. v. Minnesota*[14] that a state could constitutionally impose a nondiscriminatory, fairly apportioned net income tax on a foreign corporation engaged exclusively in interstate commerce in the taxing state. In response to this decision, Congress enacted a "stopgap measured"[15] designed to limit state taxing authority in limited circumstances analogous to those at issue in Northwestern.[16] At the same time Congress, established a special subcommittee to consider broadly the problems of state taxation of interstate commerce and to propose remedial legislation.[17] After five years of labor, the congressional subcommittee produced the most extensive study of virtually all major aspects of state taxation in our history.[18] Yet no legislation ever emerged from Congress as a result of this study. Meanwhile, the "stopgap measure," popularly known as Public Law 86–272,[19] enacted nearly 40 years ago, remains a permanent feature of the state tax landscape.

[13] Webster's Third New International Dictionary (1967) defines it as "a legally authorized period of delay in the performance of a legal obligation or the payment of a debt's (*e.g.*, "asked the legislature for a moratorium of one year on farm mortgage payments"), "a waiting period set by some authority" (*e.g.*, "usually there was at least one day's moratorium on news coming out of such background briefings"); "a suspension of activity: a temporary ban on the use or production of something' (*e.g.*, "so thorough was the moratorium on brains that nobody in power dared do any primary thinking").

[14] 358 U.S. 450 (1959).

[15] Comment, *State Taxation of Interstate Commerce*, 36 U. Chi. L. Rev. 186, 189 (1968).

[16] Act of Sept. 14, 1959, Pub. L. 86–272, 73 Stat. 55, codified at 15 U.S.C. § 381–85. *See generally* Walter Hellerstein, *State Taxation of Interstate Business and the Supreme Court, 1974 Term Standard Pressed Steel and Colonial Pipeline*, 62 VA. L. Rev. 149, 151–54 (1976).

[17] *Id.*

[18] *Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, State Taxation of Interstate Commerce*, H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964) H.R. Rep. Nos. 565 and 952, 89th Cong., 1st Sess. (1965) (popularly known as the "Willis Committee Report").

[19] *See supra* note 16.

My point, in the end, is a simple one. If the Subcommittee wishes to make the legislation it is contemplating in H.R. 1054 temporary, it should so provide explicitly. Otherwise the law of inertia may operate to make it permanent. Moreover, the real possibility that the legislation that Congress enacts will be on the books for some time reinforces my first point: that the Subcommittee should take considerable care with the precise implications of the legislation it is contemplating because the legislation may well outlive its current life expectancy.

3. THE SUBCOMMITTEE SHOULD ENLIST THOSE WITH EXPERTISE AND EXPERIENCE IN THE FIELD OF STATE AND LOCAL TAXATION IN ESTABLISHING THE CONSULTATIVE GROUP CHARGED WITH DEVELOPING POLICY RECOMMENDATIONS FOR CONGRESSIONAL LEGISLATION REGARDING STATE TAXATION OF THE INTERNET AND INTERACTIVE COMPUTER SERVICES

My third point is brief. While in general I have refrained from either supporting or opposing H.R. 1054 on the merits, I wholeheartedly endorse Section 4 of the bill that establishes a consultative group to examine the complex problems raised by taxation of the Internet and interactive computer services and to submit appropriate policy recommendations to solve these problems. In the Subcommittee's consideration of the participants in this consultative group, however, I would strongly urge it to enlist the participation of those with expertise and experience with regard to state taxation.

As I mentioned at the outset of my testimony, Congress lacks the depth of expertise in this area that it has in many of the other areas in which it traditionally legislates. Therefore it is particularly important for Congress to include those with the requisite expertise and experience in the deliberative process. In particular, the Subcommittee may wish to work with the National Tax Association sponsored Committee on Taxation of Telecommunications and Electronic Commerce, which includes a broad spectrum of interested and knowledgeable private and public sector parties who are currently engaged in fashioning a solution to the complex problems to which H.R. 1054 is addressed.

CONCLUSION

Let me close with the parting words I always leave with my teenage children as they rush out the door into their cars: please be careful. I would urge you—whatever you do—please to be careful. You are dealing with extremely complex issues, and many conflicting and legitimate concerns lie in the balance. Legislation that does not take careful account of all of these concerns may do more harm than good.