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The New Internet Tax Freedom Act

May 2008

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President George W. Bush signed into law on October 31, 2007 legislation (House Bill 3678,^[1] the Internet Tax Freedom Act Amendments Act of 2007) that extends for another seven years, until November 1, 2014, the moratorium precluding state and local taxes on Internet access and multiple and discriminatory taxes on electronic commerce.^[2] The new Internet Tax Freedom Act (hereinafter the “2007 ITFA”) also amends the previous law in several significant ways. Among the most important changes are that the 2007 ITFA: (1) amends the definition of “Internet access” to help clarify the nature and scope of services protected from state taxation under the moratorium; (2) extends for seven years but clarifies, both retroactively back to November 1, 2003 and going forward, the provisions grandfathering certain states that have historically taxed Internet access; and (3) excepts certain general business gross receipts taxes from the scope of prohibited taxes on Internet access.

The Definition of “Internet Access”

The definition of “Internet access” has evolved since the original Internet Tax Freedom Act was enacted in 1998 (the “1998 ITFA”). The 1998 ITFA generally defined “Internet access” as a service that enables users to access content, information, electronic mail, or other services offered over the Internet, except for telecommunications services.^[3]

The definition of “Internet access” was first amended in 2004, pursuant to the Internet Tax Nondiscrimination Act (“2004 ITNA”), to extend to telecommunications services purchased, used, or sold by an Internet Service Provider (“ISP”) to provide Internet access.^[4] The 2004 amendment was made for two reasons. First, Congress sought to prevent states from taxing Internet access differently depending on how an ISP assembled and delivered the service to consumers (for example, some states previously taxed digital subscriber line (“DSL”) transmission services sold with Internet access but did not tax cable broadband transmission services sold with Internet access). Second, Congress sought to prevent states from taxing the “wholesale” purchase of “backbone” telecommunications services used to provide Internet access (i.e., the underlying telecommunications services purchased and used by ISPs to provide end users with Internet access).

The 2007 ITFA further amends the definition of “Internet access” to address numerous concerns raised by taxpayers and tax administrators regarding their understanding of the previous definition. The new definition provides that Internet access refers to the service that connects users to the Internet, and also includes closely related Internet communications services, such as electronic mail, home pages and instant messaging, whether provided as incidental to or separate from the core Internet access service.^[5] Services and products sold by vendors over the Internet are not included within the definition of “Internet access.”^[6]

The new definition also more affirmatively clarifies Congress’s intent to include “backbone” telecommunications services purchased and used by ISPs to provide Internet access services to consumers.^[7] This clarification was made in response to a study issued by the Government Accounting Office (“GAO”) in 2006 in which the GAO took the position that the telecommunications services included within the definition of “Internet access” only included telecommunications services purchased and resold by the ISP to end users as part of the Internet access bundle, and that Internet access did not include other “backbone” telecommunications services purchased by the

ISP.^[8]

Finally, even though the 2004 ITNA provided that “nothing in this Act shall be construed to affect the imposition of tax on a charge for voice or similar service using Internet protocol,”^[9] the new definition expressly removes from the scope of protected services voice, audio or video programming that utilizes Internet or successor protocols for which there is a charge, making it clear that states and localities will be free to tax Voice over Internet Protocol (“VoIP”) and similar services.^[10]

Grandfather Provisions

Since its inception in 1998, the moratorium has grandfathered states that previously taxed Internet access. The 2007 ITFA extends these provisions but also clarifies them to address and correct conflicting interpretations that arose when the grandfather provisions were amended in 2004.

The 2004 ITNA included two grandfathering provisions allowing states that had taxed “Internet access” prior to certain dates to continue doing so for set periods of time.^[11] The first grandfather provision applied to taxes on Internet access imposed and enforced prior to October 1, 1998 (the original date of the 1998 ITFA) and excluded such taxes from the moratorium until the 2004 ITNA’s expiration on November 1, 2007 (the “2007 Grandfather”). The second grandfather provision applied to taxes on Internet access imposed and enforced as of November 1, 2003 (the effective date of the 2004 ITNA’s amendments) and excluded such taxes from the moratorium until November 1, 2005 (the “2005 Grandfather”).

The legislative history and purpose of the 2004 ITNA’s amendments indicate that the 2007 Grandfather was intended to apply to “Internet access” as that term was defined by the 1998 ITFA, and that the 2005 Grandfather was intended to apply to “Internet access” as that term was redefined and expanded in 2004. However, because both the 2007 Grandfather and the 2005 Grandfather used the same term, “Internet access,” some states adopted a “plain-language” reading of the 2005 and 2007 Grandfathers and took the position that “Internet access” referred to “Internet access” as that term was redefined in 2004 with respect to both of these provisions. This plain-language reading of the 2005 and 2007 Grandfathers appeared to undermine Congress’s entire purpose for expanding the definition of “Internet access” to include and protect telecommunications services purchased, used, or sold by an ISP, because the vast majority of taxes imposed upon such telecommunications services would be allowed until the 2004 ITNA expired.^[12]

The 2007 ITFA expressly clarifies the definition of “Internet access” for each of these grandfather provisions in a manner consistent with the legislative intent of the 2004 ITNA. Specifically, the 2007 ITFA provides that, effective November 1, 2003, the term “Internet access” used in the 2007 Grandfather shall mean “Internet access” as defined in the 1998 ITFA^[13] and that the term “Internet access” used in the 2005 Grandfather shall mean “Internet access” as that term was redefined by the 2004 ITNA.^[14]

The 2007 ITFA makes two exceptions to this definitional clarification (the “excepted taxes”). First, excepted taxes include taxes on telecommunications services purchased, used or sold by ISPs if the state (or political subdivision) issued a public ruling prior to July 1, 2007 applying the tax to such services in a manner inconsistent with the definitional clarification.^[15] Second, excepted taxes include taxes that were the subject of litigation instituted in a judicial court prior to July 1, 2007 where the state (or political subdivision) was seeking to enforce such taxes in a manner inconsistent with the definitional clarification.^[16] Finally, with respect to such “excepted taxes,” the 2007 ITFA states that “[n]o inference of legislative construction shall be drawn from this subsection or the [definitional clarification] for any period prior to June 30, 2008.”^[17]

It may appear at first under the 2007 ITFA exceptions that those states imposing excepted taxes will not have to defend their administrative positions to impose the excepted taxes after November 1, 2005. Although the legislative history of the 2007 ITFA suggests that Congress intended to hold those states harmless until November 1, 2007,^[18] upon close reading, the new language does not appear to foreclose future taxpayer challenges to the “plain-language” interpretation by those states or court decisions rejecting such interpretation. Rather, the definitional clarification simply cannot be used to interpret the 2005 and 2007 Grandfathers prior to November 1, 2007. Thus, states imposing excepted taxes after November 1, 2005 may still have to sustain their plain-language interpretation based upon the language contained in the 2005 and 2007 Grandfather provisions, and taxpayers in those states are still entitled to argue that the 2005 and 2007 Grandfathers as enacted should be interpreted in a manner consistent with the legislative history and purpose of the 2004 ITNA.

Exception for Certain General Business Taxes

The other major change enacted by the 2007 ITFA is a specific exception to the scope of prohibited taxes on Internet access. The 2007 ITFA specifies that, effective November 1, 2007, prohibited taxes on Internet access shall not include recently enacted general business taxes in states meeting certain narrow criteria.^[19] The legislative history explains that this provision was enacted in response to a small group of states that recently enacted gross receipts taxes that apply to almost all large businesses in the state, with the intention that such taxes apply to ISPs as well as other businesses.^[20]

The new gross receipts taxes in these states, including Michigan, Texas, and Ohio, as well as the venerable Washington B&O tax enacted more than seventy years ago, either substitute for or supplement the corporate income tax currently in place in those states, whereas in most other states, the corporate income tax alone serves as the general business tax. The problem identified by Congress regarding those four states is that both the 1998 ITFA and the 2004 ITNA contained an explicit exception for corporate income taxes imposed on Internet access providers, but contained no exception for gross receipts taxes. Thus, it was thought that these states could suffer a disproportionate loss under the moratorium because their approach to general business taxation is not protected, while the more prevalent approach, a tax on corporate profits, was protected and could be used to tax profits earned from providing Internet access services.

The amendment addresses this problem by creating an exception for states that have enacted gross receipts taxes as a substitute for state corporate income taxes and not as taxes directed to Internet access. To be exempt, the state law must meet certain criteria. First, the law must have been enacted between June 20, 2005 and November 1, 2007, or, in the case of a state business and occupation tax (i.e., the Washington B&O tax), enacted after January 1, 1932 and before January 1, 1936.^[21] Second, the law must replace, in whole or in part, a modified value-added tax or a tax levied upon or measured by net income, capital stock, or net worth.^[22] Finally, the law must be imposed on a broad range of business activity and must not be discriminatory in its application to providers of communication services, Internet access, or telecommunications.^[23]

Footnotes:

[1] H.R. 3678, 110th Cong. (1st Sess. 2007).

[2] 47 U.S.C.S. ? 151 note at ? 1100 *et seq.* (2000 & Supp. 4 2005).

[3] *Id.* at ? 1104(5).

[4] 47 U.S.C.S. ? 151 note at ? 1105(5) (2000 & Supp. 4 2005).

[5] 47 U.S.C.S. ? 151 note at ? 1105(5)(C), (E) (2007).

[6] 47 U.S.C.S. ? 151 note at ? 1105(5)(A) (2007).

[7] 47 U.S.C.S. ? 151 note at ? 1105(5)(B)(i) (2007).

[8] United States Government Accountability Office, Report to Congressional Committees GAO-06-273, *Internet Access Tax Moratorium: Revenues Impacts Will Vary by State* (Jan. 2006).

[9] 47 U.S.C.S. ? 151 note at ? 1108 (2000 & Supp. 4 2005).

[10] 47 U.S.C.S. ? 151 note at ? 1105(5)(D) (2007).

[11] 47 U.S.C.S. ? 151 note at ? 1104(a)(1), (b)(1) (2000 & Supp. 4 2005).

[12] For a detailed analysis of this issue, see J. Kratochvill and P. Sansone, *Too Many Grandfathers*

Spoil the Broth: The Failure of the Internet Tax Nondiscrimination Act?, 46 State Tax Notes 1 (Oct. 1, 2007).

[13] 47 U.S.C.S. ? 151 note at ? 1104(c)(1)(A) (2007).

[14] 47 U.S.C.S. ? 151 note at ? 1104(c)(1)(B) (2007).

[15] 47 U.S.C.S. ? 151 note at ? 1104(c)(2)(A) (2007).

[16] 47 U.S.C.S. ? 151 note at ? 1104(c)(2)(B) (2007).

[17] 47 U.S.C.S. ? 151 note at ? 1104(c)(3).

[18] H.R. Rep. No. 110-372 (2007).

[19] 47 U.S.C.S. ? 151 note at ? 1105(10)(C) (2007).

[20] H.R. Rep. No. 110-372 (2007).

[21] 47 U.S.C.S. ? 151 note at ? 1105(10)(C)(i)(I) (2007).

[22] 47 U.S.C.S. ? 151 note at ? 1105(10)(C)(i)(II) (2007).

[23] 47 U.S.C.S. ? 151 note at ? 1105(10)(C)(i)(III), (IV) (2007).