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Updated Revenue Threat Alert: Preserve Texas' Ability to Tax Internet Access

Tax Raises $55 Million a Year

Federal law allows certain states, including Texas, to tax Internet access charges. Texas currently collects $55 million a year by applying the state sales tax to all but the first $25 of a monthly Internet access charge. However, the federal provision will expire on November 1, 2007, and might not be extended, reducing the ability of Texas state government to fund critical public services. In addition, Texas' new "margins tax" might not apply to revenue received by companies such as AT&T or Time Warner for providing Internet access. Access providers can be taxed only by specific types of general business taxes, which might not include the "margins tax," which is a new form of taxation.

Texas grandfathered in current law

In 1998 Congress passed the federal Internet Tax Freedom Act (ITFA), which imposed a temporary moratorium on state and local taxation of Internet access charges. This moratorium has been extended twice – in 2001 and 2004 – but is scheduled to expire this November.

The current federal law contains a "grandfather clause" that allows states that taxed Internet access charges prior to October 1, 1998, to continue taxing them. Texas is included in this "grandfather clause" and currently applies the sales tax to all but the first $25 of a monthly Internet access fee (Tax Code, sec. 151.325).

<u>Applying the sales tax to Internet access charges generates $55 million a year to fund services provided by Texas state government</u>.

Congress may repeal grandfather clause

Congress is considering whether to extend the current law and whether to eliminate the grandfather clause. The "Permanent Internet Tax Freedom Act" (S. 156/H.R. 743), sponsored by Senator Ron Wyden (Oregon) and Rep. Anita Eshoo (California) would make the moratorium permanent and eliminate the grandfather provision that allows Texas to tax Internet access. The "Internet Tax Freedom Extension Act" (S. 1453), sponsored by Senators Tom Carper (Delaware) and Lamar Alexander (Tennessee) would extend the moratorium, including the grandfather clause, for another four years.

Repeal of the grandfather clause, eliminating Texas' ability to tax a portion of monthly Internet access fees, would reduce the state's ability to fund important services.

Extending ITFA in its current form could also invite tax evasion through bundling services that are currently taxed, such as telephone and cable TV, with Internet access to create a potentially exempt service. This type of tax dodge could reduce state revenue by over a billion dollars a year.

Renewal of the Act could limit the scope of Texas' new "margins tax"

Although the grandfather clause involves only the sales tax paid by consumers, the ITFA broadly prohibits taxes on both providers and buyers of Internet access. However, most state business taxes are exempted from the prohibition by a specific provision excluding "a tax levied upon or measured by net income, capital stock, net worth, or property value." Texas Internet-access providers therefore were subject to the state's former corporate franchise tax, which was related to net income and net worth.

During the 2006 special session, the Legislature significantly changed the franchise tax, so that it is now based on a firm's gross receipts, minus certain deductions. It is possible that, due to these changes, the revised tax (now popularly known as the "margins tax") might be prohibited by the ITFA and therefore could not be imposed on Internet access providers.

An Internet access provider, such as AT&T or Time Warner, might decide not to pay the "margins tax" on its receipts attributable to providing Internet access service. (Companies would still have to pay the tax on receipts from providing conventional telephone and cable TV services.)

How to fix these problems

The best policy would be to allow ITFA's prohibition on taxing Internet access to expire. When the ITFA was first enacted, Internet commerce was just starting to expand, but there is no longer any need to continue protecting it as an "infant industry."

The next-best policy would be to pass the Carper-Alexander bill, which would extend the existing moratorium for four years and preserve the grandfather clause, allowing Texas to maintain an important source of sales tax revenue. See: http://thomas.loc.gov/cgi-bin/query/z?c110:S.1453:

In addition, Congress should add explicit protection for Texas' new "margins tax" to the section of the ITFA that exempts state business taxes. This change could be made to either of the proposed bills.

Committee action soon

Sen. Kay Bailey Hutchison of Texas is a member of the U.S. Senate Commerce Committee, which is expected to act on the ITFA in September. The U.S. House Judiciary Committee, Subcommittee on Commercial and Administrative Law, which does not have any Texas members, may also act in September.

For more information on ITFA

Renewing the "Internet Tax Freedom Act" could have an especially adverse impact on Kentucky, Michigan, Ohio, and Texas:
http://www.cbpp.org/7-26-07sfp.htm

Making the "Internet Tax Freedom Act" permanent could lead to a substantial revenue loss for states and localities:
http://www.cbpp.org/7-11-07sfp.htm

ITFA does not affect sales taxes on Internet purchases

The ITFA involves taxation of Internet access, but does not affect state and local sales taxes on purchases of goods or services made over the Internet.

A state currently cannot require an out-of-state company to collect a sales tax when a purchase is made over the Internet. The U.S. Supreme Court has ruled that states cannot make sellers who do not have a physical presence ("nexus") in a state collect that state's sales tax. According to an estimate made in 2004, this rule could cost Texas as much as $3 billion in lost sales-tax revenue in 2008 alone (http://www.cbpp.org/5-17-05sfp.pdf, Table 6).

The Supreme Court has indicated that Congress could choose to pass legislation to permit states to tax sales made by sellers not physically present in a state. Opponents of the approach argue that differences among the taxes in different states would make tax collection too difficult for out-of-state sellers. In response, states have attempted to reduce these differences through the Streamlined Sales Tax Project, to encourage Congress to act. Some twenty-two states are currently full or associate members of the project.

Texas was an early participant in the project, passing a bill in 2001 to make the statutory modifications necessary for Texas to join the Streamlined Sales Tax Agreement (HB 1845, 77th Legislature, now Tax Code, sec. 142). However, Texas has not been willing to comply with the Agreement's rule that sales taxes would be paid according to where the item or services was received ("destination sourcing"), rather than where the seller is located ("origin sourcing").

For instance, if a buyer in Dallas purchases a computer from the Dell plant in Round Rock TX, under current law the local sales tax is received by the city of Round Rock. Under destination sourcing, the local tax would be received by Dallas.

Texas cannot sign the Agreement unless the governor, lieutenant governor, speaker, and the comptroller unanimously agree that it "would be in the state's best interest" (Tax Code, sec. 142.005(c)).

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