



CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

September 9, 2003

S. 150

Internet Tax Nondiscrimination Act

*As ordered reported by the Senate Committee on Commerce, Science, and Transportation
on July 31, 2003*

SUMMARY

S. 150 would permanently extend a moratorium on certain state and local taxation of online services and electronic commerce, and after October 1, 2006, would eliminate an exception to that prohibition for certain states. Under current law, the moratorium is set to expire on November 1, 2003. CBO estimates that enacting S. 150 would have no impact on the federal budget, but beginning in 2007, it would impose significant annual costs on some state and local governments.

By extending and expanding the moratorium on certain types of state and local taxes, S. 150 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA). CBO estimates that the mandate would cause state and local governments to lose revenue beginning in October 2006; those losses would exceed the threshold established in UMRA (\$64 million in 2007, adjusted annually for inflation) by 2007. While there is some uncertainty about the number of states affected, CBO estimates that the direct costs to states and local governments would probably total between \$80 million and \$120 million annually, beginning in 2007. The bill contains no new private-sector mandates as defined in UMRA.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

CBO estimates that enacting S. 150 would have no impact on the federal budget.

INTERGOVERNMENTAL MANDATES CONTAINED IN THE BILL

The Internet Tax Freedom Act (ITFA) currently prohibits state and local governments from imposing taxes on Internet access until November 1, 2003. The ITFA, enacted as Public Law 105-277 on October 21, 1998, also contains an exception to this moratorium, sometimes referred to as the “grandfather clause,” which allows certain state and local governments to tax Internet access if such tax was generally imposed and actually enforced prior to October 1, 1998.

S. 150 would make the moratorium permanent and, after October 1, 2006, would eliminate the grandfather clause. The bill also would state that the term “Internet access” or “Internet access services” as defined in ITFA would not include telecommunications services except to the extent that such services are used to provide Internet access (known as “aggregating” or “bundling” of services). These extensions and expansions of the moratorium constitute intergovernmental mandates as defined in UMRA because they would prohibit states from collecting taxes that they otherwise could collect.

ESTIMATED DIRECT COSTS OF MANDATES TO STATE AND LOCAL GOVERNMENTS

CBO estimates that repealing the grandfather clause would result in revenue losses for as many as 10 states and for several local governments totaling between \$80 million and \$120 million annually, beginning in 2007. We also estimate that the change in the definition of Internet access could affect tax revenues for many states and local governments, but we cannot estimate the magnitude or the timing of any such additional impacts at this time.

UMRA includes in its definition of the direct costs of a mandate the amounts that state and local governments would be prohibited from raising in revenues to comply with the mandate. The direct costs of eliminating the grandfather clause would be the tax revenues that state and local governments are currently collecting but would be precluded from collecting under S. 150. States also could lose revenues that they currently collect on certain services, if those services are redefined as Internet access under the bill.

Over the next five years there will likely be changes in the technology and the market for Internet access. Such changes are likely to affect, at minimum, the price for access to the Internet as well as the demand for and the methods of such access. How these technological and market changes will ultimately affect state and local tax revenues is unclear, but for the purposes of this estimate, CBO assumes that over the next five years, these effects will largely offset each other, keeping revenues from taxes on Internet access within the current range.

The Grandfather Clause

The primary budget impact of this bill would be the revenue losses—starting in October 2006—resulting from eliminating the grandfather clause that currently allows some state and local governments to collect taxes on Internet access. While there is some uncertainty about the number of jurisdictions currently collecting such taxes—and the precise amount of those collections—CBO believes that as many as 10 states (Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington, Wisconsin) and several local jurisdictions in Colorado, Ohio, South Dakota, Texas, Washington, and Wisconsin are currently collecting such taxes and that these taxes total between \$80 million and \$120 million annually. This estimate is based on information from the states involved, from industry sources, and from the Department of Commerce. In arriving at this estimate, CBO took into account the fact that some companies are challenging the applicability of the tax to the service they provide and thus may not be collecting or remitting the taxes even though the states feel they are obligated to do so. Such potential liabilities are not included in the estimate.

It is possible that if the moratorium were allowed to expire as scheduled under current law, some state and local governments would enact new taxes or decide to apply existing taxes to Internet access during the next five years. It is also possible that some governments would repeal existing taxes or preclude their application to these services. Because such changes are difficult to predict, for the purposes of estimating the direct costs of the mandate, CBO considered only the revenues from taxes that are currently in place and actually being collected.

Definition of Internet Access

Depending on how the language altering the definition of what telecommunications services are taxable is interpreted, that language also could result in substantial revenue losses for states and local governments. It is possible that states could lose revenue if services that are currently taxed are redefined as Internet “access” under the definition in S. 150. Revenues could also be lost if Internet access providers choose to bundle products and call the product Internet access. Such changes would reduce state and local revenues from telecommunications taxes and possibly revenues from content currently subject to sales and use taxes. However, CBO cannot estimate the magnitude of these losses.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

This bill would impose no new private-sector mandates as defined in UMRA.

PREVIOUS CBO ESTIMATE

On July 21, 2003, CBO transmitted a cost estimate for H.R. 49, the Internet Tax Nondiscrimination Act, as ordered reported by the House Committee on the Judiciary on July 16, 2003. Unlike H.R. 49, which would eliminate the grandfather clause upon passage, S. 150 would allow the grandfather clause to remain in effect until October 2006. Thus, while both bills contain an intergovernmental mandate with costs above the threshold, the enactment of S. 150 would not result in revenue losses to states until October 2006.

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