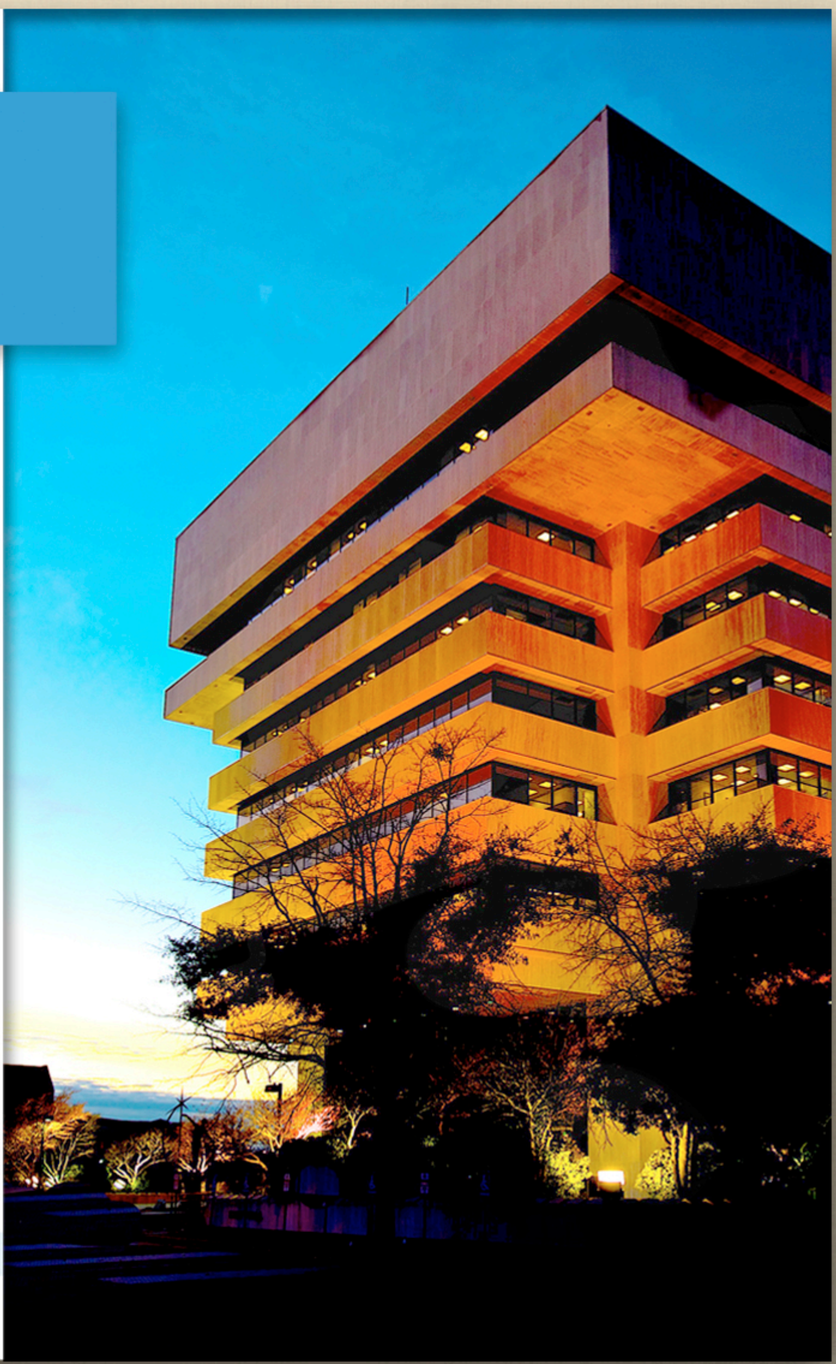
HAMPTON VA

INTERNET TAX FREEDOM ACT

Patricia Melochick, CPA, JD
Sr. Deputy City Attorney
patricia.melochick@hampton.gov
(757) 727-6119

Virginia Association of
Local Tax Auditors
August 19, 2016



DISCLAIMER

WORK IN PROGRESS

ALL INFORMATION PRESENTED IS BASED ON RESEARCH TO DATE – SUBJECT TO CHANGE AS RESEARCH CONTINUES

The "Internet"

- Evolved v. Invented
- Today: Regular use by more than 1/3 of World population (about 6.8 billion)
- First use: US Government Cold War Weapon – used by scientists and researchers to communicate and share data
- 1960's: Fear of Destruction of Long Distance Communication
  - MIT and Government scientists propose "galactic network" of computers to "talk" to one another
  - Development of "packet switching" – breaking data into blocks – enabling each to take its own route to its destination
- 1970's:
  - "Node to Node" communication (from one computer to another) – but difficult to establish one "internet"
  - Enhanced by "Transmission Control Protocol" – worldwide communication between mini-networks
  - "IP" added to TCP – Internet Protocol (still used today)
- 1991: Tim Berners-Lee (Switzerland) introduced the World Wide Web – the Internet as we know it today: an Internet that is not simply a way to send files from one place to another but is itself a "web" of information that anyone on the Internet can retrieve
- 1992: 1st sophisticated browser developed ("Mosaic" later known as "Netscape")

Source: http://www.history.com/topics/inventions/invention-of-the-internet (2010)

Internet Tax Freedom Act

- 1998 – 105th U.S. Congress enacts the “Internet Tax Freedom Act”

- Public Law 105-277
  - Titles XI and XII of the Omnibus Consolidated and Emergency Appropriations Act (1999)

- Classified as a “Note” under 47 USCA § 151
  - Title 47 – Telecommunications
  - Chapter 5 – Wire or Radio Communication
  - Subchapter I – General Provisions
  - Section 151 – Purposes of the Chapter; Federal Communications Commission created

- Amended 5 Times
  - Public Law 107-75 (2001; “Internet Tax Nondiscrimination Act”)
  - Public Law 108-435 (2004)
  - Public Law 110-108 (2007)
  - Public Law 113-235 (2014)
  - Public Law 114-125 (2016)

Public Law 105-277

- Multiple Bills Considered by Both the House (5 Different Bills) and Senate (3 versions of 1 + 1 more)
- Common Theme: Temporary Moratorium on State & Local Government Ability to Impose Certain Taxes on the Internet & Related Activities
  - State & Local Tax Base v. Compliance Burden (National & International)
  - Inconsistencies & Jurisdiction
- Four Key Interest Groups:
  - Internet Business Community
    - States will "design discriminatory taxes tailored to the Internet"
    - Interstate Commerce – overlapping taxation ("haphazard"; "nonuniform")
    - High administrative costs = less Internet growth
  - Clinton Administration
    - Promoting Electronic Commerce, US Economy, & International Trade
    - Fear of stifling growth of fledgling internet businesses
    - Set an example for the World by preempting state and local taxation on the homefront
    - Little threat to federal revenues (no dependence on value added, sales, or other transaction taxes)
  - State & Local Revenue Officials
    - Retain authority to determine tax policy & adapt to changing economy
    - Beginning of further erosion of sales tax base resulting from interstate mail orders
    - Concern regarding inter- and intra-state sales
  - Competing Sectors of the Economy Subject to Tax
    - Competitive Disadvantage for "Bricks and Mortar" Retailers
    - Tangible Products v. Electronic Products
    - Taxes, Franchise Fees, FCC Fees imposed on Telephone & Cable Businesses

Source: "Internet Tax Bills in the 105th Congress" CRS Report for Congress by Nonna Noto (12/31/1998)

The Bills

- Agreement
  - Moratorium on Ability of State & Local Governments to Impose Certain Taxes on Internet & Related Activities
  - Preemption for Certain Taxes (Variation in Bills)
  - Study Group – Identify Issues, Make Recommendations
  - Protected: Internet Access (i.e. AOL monthly access charges)
  - Sale of goods arranged via internet treated same as mail order/phone sales (sellers can't be required to collect taxes from customers – sales v. use tax)
- Key Differences
  - Length of Moratorium (2, 3 or 5 years – or Indefinite)
  - Internet Aspects to be Protected
    - Bundled Services (bundled or separate billing)
    - Bit Taxes (volume of digital information transmitted)
    - Multiple or discriminatory taxes (i.e. taxation of electronic good/service delivered uniquely over Internet)
    - Bandwith Taxes (capacity to transmit)
    - Use or consumption of data
  - Grandfathering
    - Existing Taxes
    - New Taxes
    - Implemented by statute v. rulings or other decisions
    - Generally imposed or actually enforced before a certain date
    - Express statutory affirmation
    - Specific identification by state, tax type
- Final Act is Essentially Identical to Senate Bill 442 passed October 8, 1998

Source: "Internet Tax Bills in the 105th Congress" CRS Report for Congress by Nonna Noto (12/31/1998)

Senate Bill 442 (105th Congress)

- **March 13, 1997 Introduced**
- **November 4, 1997 Commerce Substitute Approved (Reported 5/5/98)**
- July 21, 1998 Referred to Finance until 7/30/98
- **July 30, 1998 Finance Substitute Approved/Reported**
- October 2, 1998 – October 8, 1998 Multiple Amendments Considered & Acted On
- **October 8, 1998 Passed by Senate**

Source: https://www.congress.gov/bill/105th-congress/senate-bill/442/all-actions?pageSort=asc
Source: "Internet Tax Bills in the 105th Congress" CRS Report for Congress by Nonna Noto (12/31/1998)

Senate Bill 442 - Introduced

- Brief - 8 pages – Large Font
- Key Findings:
  - Massive Global Network Spanning International Borders
  - Internet Does Not Respect State Lines
  - Packet Switching Makes it Impossible to Determine Routes or Endpoints
  - Inconsistent/Inadministrable State and Local Taxes Threaten All Levels of Commerce
  - Old Tax law – New Technology
- Key Terms:
  - Moratorium on Direct/Indirect Taxation of (1) Internet or Interactive Computer Services and (2) Use of Internet or Interactive Computer Services
  - Preservation of State and Local Taxing Authority - Moratorium Not Applicable to:
    - Taxes imposed on/measured by net income;
    - **Fairly apportioned business license taxes applied to businesses having a business location in the taxing jurisdiction;**
    - Sales & use tax if (1) same as tax imposed on mail order, telephone, other remote means and (2) obligation imposed on same person as for taxes set out in (1)
  - Tax defined to include "any tax, license, or fee that is imposed by any governmental entity, and includes the imposition on the seller of an obligation to collect and remit tax imposed on a buyer."
- Itemized list of taxes to counter broad interpretation of prohibition

Source: SB 442 (3/13/97)
Source: "Internet Tax Bills in the 105th Congress" CRS Report for Congress by Nonna Noto (12/31/1998)

Senate Bill 442 - Commerce

- Grows to 9 pages

- Additional Key Findings
  - Electronic Marketplace especially beneficial to senior citizens, the physically challenged, citizens in rural areas, and small businesses
  - Need for uniform, simple, fair tax to avoid overburdening evolving form of interstate and foreign commerce

- Key Terms:
  - Prior to January 1, 2004, no state or political subdivision may impose, assess, or attempt to collect tax on (1) communications or transactions using the internet; and (2) online services or Internet access service
  - Preservation of State and Local Taxing Authority – Moratorium Not Applicable to
    - Authority to impose sales, use, other transaction tax if:
      - Tax is the same as imposed in the case of similar transactions not using the Internet
      - Obligation to collect or pay on same person as in similar sales
    - Taxes imposed on or measured by gross or net income derived from online services, Internet access service, or communications or transactions using the Internet, or on value added, net worth or capital stock
    - **Fairly apportioned business license taxes**
    - Taxes paid by a provider or user of online/Internet services as consumer of goods not otherwise excluded
    - Property taxes imposed or assessed on property owned or leased by a provider or user of online/Internet services
    - Taxes imposed on or collected by certain common carriers
    - Taxes imposed on or collected by State or local franchising authority for the provision of cable services

  - Tax defined to include "any charge imposed by legislative authority to raise revenue for the needs of the public, as well as any license or fee that is imposed by any governmental entity. Such term also includes the imposition on the seller of an obligation to collect and remit to a governmental entity any charge, license, or fee imposed on the buyer by a governmental agency.

Source: SB 442 (Reported 5/5/98)

Senate Bill 442 - Finance

- Grows to 19 pages
- Additional Key Findings;
  - Consumers, business, others using online services could be subject to more than 30,000 separate US taxing jurisdictions
- Key Terms
  - During the period beginning July 29, 1998 and ending 2 years after the date of the enactment of this Act, no state or political subdivision shall impose any of the following taxes on (1) taxes on Internet access; (2) Bit Taxes; (3) Multiple or discriminatory taxes on electronic commerce.
  - Moratorium shall not apply with respect to provision of Internet access that is offered for sale as part of a package of services that includes services other than Internet access, unless the service separately states that portion of the billing that applies to such services on the user's bill.
  - Defined "Tax" as "any levy, fee, or charge imposed under governmental authority by any governmental entity; or the imposition of or obligation to collect and remit to a governmental entity any such levy, fee, or charge imposed by a governmental entity" EXCEPT any franchise fee or similar fees imposed by state or local franchising authority.
  - Also Defined Bit Tax, Discriminatory Tax, Multiple Tax, Sales or Use Tax

Source: SB 442 (Reported 7/30/98)

Senate Bill 442 - Approved

- Grows to 75 pages (combined with other initiatives)
- Key Terms:
  - During the period beginning October 1, 1998 and ending 3 years after the date of the enactment of this Act, no state or political subdivision shall impose any of the following taxes on (1) **taxes on Internet access, unless such tax was imposed and generally enforced prior to October 1, 1998**; and (2) multiple or discriminatory taxes on electronic commerce.
  - Preservation of State & Local Taxing Authority – Except at otherwise provided:
    - Nothing in this Act shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of any State or local tax pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal Law and in effect on the date of enactment of this Act.
  - Definition of Generally Imposed and Actually Enforced:
    - **If before October 1, 1998, the tax was authorized by statute and either**:
      - A provider of internet access services had a reasonable opportunity to know by virtue of a rule or other public proclamation made by the appropriate administrative agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; **OR**
      - **A state or political subdivision thereof generally collected such tax on charges for Internet access**
  - Defines "Tax on Internet Access" to include enforcement or application of any new or preexisting tax on the sale or use of Internet services unless such tax was generally imposed and actually enforced prior to October 1, 1998.
  - Definition of "Internet Access" excludes telecommunications services
  - **This encompasses state and local taxes and does not require states to enact any legislation affirming such a tax.**

Source: SB 442 (10/21/98)

Source: "Internet Tax Bills in the 105th Congress" CRS Report for Congress by Nonna Noto (12/31/1998)

Public Law 107-75 (2001)

Extended the Moratorium from “3 years after the enactment of the Act” to November 1, 2003.

Public Law 108-435 (2004)

- For the period from November 1, 2003 – November 1, 2007, no state or political subdivision shall impose any of the following taxes on (1) **taxes on Internet access**; or (2) multiple or discriminatory taxes on electronic commerce.

- Retained Section Titled "Preservation of State and Local Tax Authority"

- "Tax on Internet Access" redefined as "any tax on Internet access, regardless of whether such tax is imposed on a provider or Internet access or a buyer of Internet access and regardless of terminology used to describe the tax" but does NOT include "tax levied upon or measured by net income, capital stock, net worth or property value."
- "Internet access" qualifies exclusion of telecommunication services - except to the extent such services are purchased used or sold by a provider of Internet access to provide Internet access."

- Added Section "Grandfathering of States that Tax the Internet"
  - **Pre-October 1, 1998 Taxes**
    - **Incorporates as general rule the (former) definition of "Generally Imposed and Actually Enforced**"
  - Pre-November 1, 2003 Taxes (applicable until November 1, 2005)
    - If before November 1, 2003, the tax was authorized by statute and:
      - A provider of internet access services had a reasonable opportunity to know by virtue of a rule or other public proclamation made by the appropriate administrative agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; AND
      - A state or political subdivision thereof generally collected such tax on charges for Internet access
- Expressly exempted USF and E911 fees and charges

Public Law 108-435 (2004)

- Grandfathering – Differing Opinions
  - Distinction suggested by Legislative History – Type of Access (Telecommunications)
    - Pre October 1998 taxes – original definition of "Internet Access"
      - Excluding telecommunications (in total)
    - Pre November 2003 taxes – amended definition of "Internet Access"
      - Qualified telecommunications exclusion
      - Applicable only to those states taxing telecommunications services purchased, used, or sold by an Internet access provider to provide Internet access (i.e. DSL)
  - Plain-Language Interpretation
    - Pre October 1998 definition of Internet Access applies for all years
    - Pre November 2003 applicable to states that taxed telecommunications before November 1, 2003, but after October 1, 1998

Source: "Too Many Grandfathers Spoil the Broth: The Failure of the Internet Tax Nondiscrimination Act?" by James P. Kratochvill and Pilar M. Sansone; State Tax Notes (October 1, 2007)

Source: "Internet Taxation: Issues and Legislation" CRS Report for Congress by Steven McGuire and Nonna Noto (July 7, 2008)

Public Law 110-108 (2007)

- Generally extends moratorium to November 1, 2014

- Grandfathering - Clarifies applicability of definitions of "Internet Access"
  - Pre October 1998 – definition as enacted PL 105-277
  - Pre November 2003 – definition as amended by PL 108-435
  - Creates certain exceptions (defers applicability until June 30, 2008)
    - Applies to telecommunications services
    - Requires public proclamation prior to July 1, 2007

- Expanded "Internet Access" definition
  - Includes incidental services
  - Excludes voice, audio, video programming and other programming using Internet protocol
  - Includes homepage, electronic email, instant messaging

- "Tax on Internet Access"
  - Effective November 1, 2007, does not include a State tax expressly levied on commercial activity, modified gross receipts, taxable margin, or gross income of the business, by a State law specifically using one of those terms and subject to certain conditions
    - Replaced in whole or in part modified VAT or tax levied upon or measured by net income, capital stock, or net worth

Public Law 113-235 (2014)

Extended the Moratorium from November 1, 2014 to October 1, 2015.

Public Law 114-125 (2016)

Extended the Moratorium from October 1, 2015 to June 30, 2020.

BPOL – Not a Tax on “Internet Access”

- Privilege of doing business, not a tax on internet access
  - Rate structure originally based on study of business operation margins by business type
  - Akin to a VAT
  - Gross receipts are a measure of business size used to determine the amount of license tax
- PDs 13-191 (and PD 13-192)
  - Duty Free Store located in an airport
  - Sells merchandise to customers leaving the US for foreign destinations
  - Taxpayer contends that because federal law preempts a state's right to impose state sales tax and local property tax for merchandise sold to customers leaving the United States, it would also preempt the BPOL tax. The imposition of BPOL would violate the Commerce Clause.
  - County concedes that federal law preempts a state's right to impose excise, sales and property taxes. However, it asserts that the BPOL tax is not preempted by federal law because the BPOL tax is a tax for the privilege to engage in business in a given jurisdiction.
  - Determination: Taxpayer is not exempt from BPOL tax as a result of federal preemption. The application of the BPOL tax to the Taxpayer's gross receipts derived from goods sold for use outside of the United States does not violate the Commerce Clause.
- Dulles Duty Free, LLC v. County of Loudon (Circuit Court; April 26, 2016)
  - 13 pages, well –reasoned opinion
  - Duty Free retail operations at 5 locations in Dulles Airport
  - Agreed domestic sales taxable for BPOL
  - Challenged inclusion of international sales (90% of sales) – claiming Constitutional violation (Import Export Clause preemption on duties on exports)
  - Legislature recognizes business use of County services
  - Gross receipts legitimate means authorized by the General Assembly to measure level of business activity
  - *Town of Ashland v. Board of Supervisors* (202 Va. 49); Theory that assumes every tax that affects property in anyway, directly or indirectly, is a tax on that property is not sound.
  - BPOL accrues on business activity, not at point of sale – and is not identified with the sale of a particular good

Special Thank you to Ray Warren for his contribution to this presentation!

BPOL – Not a Tax on "Internet Access"

- PD 01-43 (see also PD 15-160): Business that provided internet access to customers was properly subject to the BPOL tax, and should be taxed as a business service.
  - Business was not a telephone company or other public service company.

- PD 04-138: Considered applicability of the BPOL tax to a full service competitive local exchange carrier ("CLEC"), subject to the provisions of Code of Virginia §58.1-3731 and §58.1-2600.
  - CLEC sought to exclude gross receipts from services such as anonymous call rejection, call block, call forwarding, call waiting, remote call forwarding, unlimited repeat dialing, unlimited return call, and business data services.
  - Tax Commissioner held all receipts from those services to be taxable, and stated:
    - With the exception of gross receipts attributed to long distance service, Va. Code § 58.1-3731 places no restriction on what constitutes the business of a telephone company. The fact that the taxpayer's local services as a CLEC have expanded with the development of new technologies is of no consequence for the purposes of the local license tax because the original language embraced all services with the exception of long distance services.

  - See also PD 15-160
    - Distinction between §58.1-3731 and §58.1-2600
    - §58.1-3731 – sales taxable only if accrued from sales to ultimate consumer in taxing locality

Other Virginia Taxes

- Alternative Minimum Tax (Code of Virginia §400.1)
  - Telecommunications Companies
  - May be due in lieu of corporate income tax
  - PD 99-240 (affirmed in PD 07-147: Revenue generated from providing Internet service included in (taxable) gross receipts; no provision in Code of Virginia for exclusion
  - PD 08-166 – Overview of ITFA
  - Level 3 Communications v. SCC; 282 Va 41 (2011)
    - SCC does not have authority to deduct a telecommunications company's Internet related revenues when determining gross receipts certified to the Department of Tax

- Communications Sales and Use Tax
  - IFTA bars the application of state tax to Internet access service, but does not prohibit deeming connectivity charges subject to the CSUT
  - Taxable communication services include Internet services
  - PDs 15-217 & 15-218 (12/8/15)
    - Contested charges: broadband recovery fee, services activation fee, early termination fee
  - PD 15-44 (3/8/15)
    - Contested charges: reactivation fees
  - PDs 14-130 & 14-131 (8/7/14)
    - Contested charges: activation fees

Generally Imposed & Actually Enforced

- In place for nearly 200 years
- Authorized by Code of Virginia § 58.1-3700 *et. seq,*
- Enacted locally by ordinance
- Proof - Record Retention Practices

Additional Points to Ponder

- Applicability
  - Sales Tax…. Or …..Sales Tax and Beyond
- Notice
  - "Gross Receipts" - the whole entire, total receipts, without deduction
- Who pays v. Nature of Tax
  - Whether paid by customer or provider
- Intent
  - "Fairly apportioned business license tax"
  - "State or local tax"

QUESTIONS?