Subj: Real World Examples Impact: Perspectives of PSINet Inc.
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To: Internet Caucus Advisory Committee

Internet Access Taxes Should Be Banned – Telecom Taxes of All Types Should Be Reformed and Simplified

PSINet believes that a permanent ban on Internet access taxes is a substantial, but only preliminary, step toward the type of radical simplification and reform of traditional tax systems that must take place if those systems are to continue to function in the coming decades without suppressing the technological dynamism that powers the American economy.

When we refer to Internet access, generally we think of consumer-oriented, modem-based, "narrowband" dial-up access from a home PC, for prices ranging from $9.95 to $29.95 per month, sometimes at a flat rate and sometimes with an additional premium for hours of usage above a certain level.

The type of Internet access that PSINet has always focused on, however, is the provision of more complex, dedicated, high-bandwidth access to businesses, often accompanied by additional value-added services. The issues we confront when dealing with the tax systems of states and localities in that context are similar to that of other backbone providers and business-oriented ISPs. It is very difficult to separate taxes on Internet access from the plethora of other taxes to which we are subject, particularly as we utilize our IP-optimized network to take on some of the functions of traditional telecommunications companies.

Take as an example one of PSINet's core service offerings to business customers – our "virtual private network" (VPN) solutions, known as PSINet IntraNet®. In the past, businesses seeking to tie together the private data networks of geographically dispersed offices have had to rely on traditional wide-area networking, requiring them to lease expensive, dedicated telephone circuits running between each remote office location. Building on our extensive backbone network, PSINet can offer secure and reliable data connections between remote offices at a fraction of the cost of traditional dedicated networks. Customers need only purchase circuit connections between each office and the nearest PSINet POP (instead of circuits spanning thousands of miles between the offices themselves). We carry the customer's data traffic between remote offices over our own backbone network, but we isolate it from traffic on the public Internet by means of frame relay technology.

Typically, a customer seeking a VPN solution is also concerned about network security, since the data traffic between headquarters and satellite offices may include highly sensitive confidential and proprietary business information. If the customer's objective is to extend its exchange of data with its business suppliers or customers over a VPN (known as an "extranet"), the security concerns may be even greater. PSINet offers additional services – beyond the basic "connectivity" solution – to address these issues, by means of firewalls, packet filtering, remote authentication using encryption technologies, and other value-added security services. Many of these solutions include

hardware, software, on-site and remote service and maintenance components, in addition to connectivity.

Let's examine the tax implications of this fairly straightforward package of services. Since the original Internet Tax Moratorium was enacted, nine states continued to tax Internet access (Connecticut, Hawaii, Ohio for commercial customers, New Mexico, North Dakota, South Dakota, Tennessee, Texas, and Wisconsin). The District of Columbia, Iowa, and South Carolina have – wisely, in our view – repealed their Internet access taxes after the moratorium went into effect. Which of the services offered in this VPN package fall under the definition of "Internet access" in the Internet Tax Freedom Act? Perhaps because the answer is unclear, several states now impose tax on some or all "enhanced" Internet services, including not only network security but also Web hosting, Website design, application service provider ("ASP") offerings, and others.

The industry is also finding that there can be dramatic state and local tax implications depending on how basic ISP access services are "bundled" together with other value-added services. Specifically, a service may be exempt if invoiced to the customer on a stand-alone basis but taxable if bundled with other services. Many business customers are moving away from simple dial-up access to higher-bandwidth connections using dedicated circuits, digital subscriber lines ("DSL"), cable modems, and other means – and ISPs, naturally, are providing those connections as part of a package. Where there is a separate charge for connectivity, most states are likely to tax it (since "telecommunications" are expressly excluded from the definition of "Internet access" under the Internet Tax Freedom Act). Where connectivity is bundled with Internet access into a single charge, states may attempt to tax the *entire* charge, including the otherwise exempt access fees.

Not only are connectivity charges subject to telecommunications taxes, but installation charges, disconnect fees, and associated charges face varying tax treatment among the states and localities. These traditional telecom categories introduce extraordinary levels of complexity and expense, with over 300 types of taxes and fees potentially applicable, at combined rates that reach and (in some cases) exceed 20%.

The interaction of multiple taxes adds insult to injury. Frequently taxes build on one another, where the base for calculation of one tax may include other taxes applied to that service – thereby assessing a "tax on tax." Federal and state excise taxes, for example, could be built into the base for computation of a state sales tax.

Similarly, there are too frequent instances of pyramiding of tax – payment of tax at *both* the wholesale and retail levels – which increase bottom-line service costs to the customer. For instance, while 13 states allow telecommunications companies a sales tax exemption on equipment used to deliver their services, only New York and, to a very limited extent, Virginia do so for Internet Service Providers. ISPs generally cannot avail themselves of resale exemptions with respect to the telecom connectivity services provided as a necessary part of the offer of Internet access. One concrete example is Connecticut, where regulations flatly deny a resale exemption even where a dedicated circuit is resold directly to the customer. As such, an ISP may pay tax on the lease of a circuit from the customer to its POP, then be forced to bill its customer for the tax *again* when it passes through the circuit cost.

Finally, which jurisdictions are entitled to impose their specific array of taxes on which portions of the entire package of services (the VPN and security services, in our example)? By definition, a virtual private network spans several locations, usually with the headquarters or "hub" in one state and the satellite or remote offices in others. Tangible products (such as routers) may be shipped to specified locations and taxed there, but the services (such as connectivity, remote monitoring, and network design) may span a variety of jurisdictions – each with its own tax rates, its own definitions and rules for determining the amount of the overall transaction applicable to its jurisdiction, and its own exemption requirements – many of which may be contradictory or inconsistent with those of other jurisdictions.

The Committee on State Taxation's Fifty State Study and Report on Telecommunications Taxation noted that a full service telecommunications provider operating nationwide would be required to file 55,748 tax returns a year, with total effective tax rates exceeding 20% in ten states (with Texas topping the list at 28.56%).

It is difficult to overstate the burden these complexities place on ISPs as the tax collection agents for these overlapping tax systems – not to mention their customers, as they attempt to sort out the taxes included in their bills. As another tax expert observed in a recent authoritative study:

> [C]ompared to other advanced industrialized nations, the sales tax in the United States is complicated by the large number of state, county, and local jurisdictions that impose sales and use taxes. Currently, 45 states and the District of Columbia impose sales or use taxes at the state level. … In addition to the states, approximately 7,500 counties, cities, towns, transportation districts, and other special local jurisdictions impose sales or use taxes on transactions occurring within their borders.
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> …By contrast, in the European Union, there are only 15 countries and generally only 15 different national value-added tax rates. There are no local or county value-added tax rules or rates to be complied with.

Karl Freiden, *Cybertaxation: The Taxation of E-Commerce* (Chicago: Arthur Andersen LLP, 2000), p. 82.

A fair assessment of the value of Internet access taxes should therefore take into consideration the negative effects that saddling U.S. companies with these administrative costs may inflict on their competitiveness in the global economy.

Besides going a short distance to reduce the burdens and costs of collection on ISPs, a permanent moratorium on Internet access taxes would have an immediate positive impact by reducing the costs of Internet access for both consumers and businesses. Reducing access costs is a quick and obvious way to boost American competitiveness and to lower the "Digital Divide" that threatens to exclude from the information economy those citizens with fewer resources to spend on computers and Internet connectivity.

Making the moratorium permanent and applying it to Internet access taxes previously excluded by the grandfather clause would not threaten state and local revenues in any significant way. States could radically simplify and decrease the telecom taxes that are now imposed on the channels by which Internet access is delivered to their citizens –

telephone lines, wireless transmissions, and cable television and satellite communications – and still maintain substantial revenue from these sources. Income taxes, both corporate and individual, from income generated by the growth of electronic commerce would be unaffected. Sales and use taxes on most in-state purchases would continue to be collected. Revenue losses from abolishing Internet access taxes and decreasing other telecom taxes would therefore be minimal.

Adapted from testimony presented by PSINet Inc. to the Oversight Subcommittee of the House Ways and Means Committee on May 16, 2000.