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Internet Taxation

Internet taxation generally refers to taxes applied to Internet access fees or to sales and use taxes on sales made over the Internet (e-commerce). This information brief describes current taxes on Internet access and e-commerce in this state and other states. It also discusses other taxes that might be considered Internet taxes and describes their status. This is one of a series of information briefs prepared by House Research on the Internet and related tax issues.

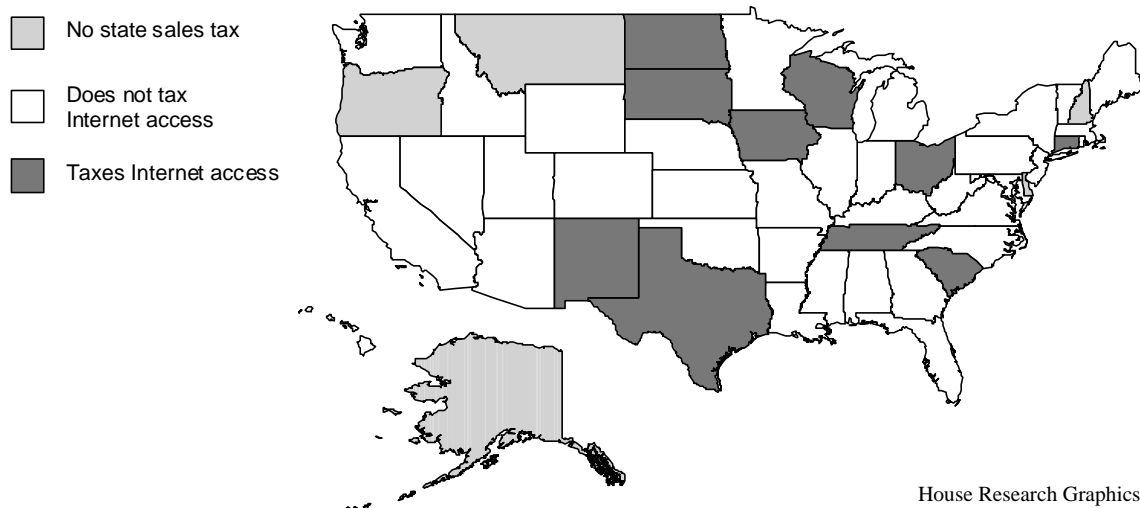
Taxes on Internet Access

Do any states or local governments currently impose a sales tax on Internet access?

Some states and local governments impose their general sales and use tax on Internet access. As illustrated in Figure 1, ten states and the District of Columbia impose sales taxes¹ on Internet access fees. None of these states or cities specifically enacted a law to impose the tax on Internet access. Internet access is taxable in these jurisdictions because the tax is already imposed on either information and data processing services or telecommunications services and the definition of that service is sufficiently broad that it includes Internet access. In Iowa and North Dakota, the Internet connection must originate and terminate in the state to be subject to the tax. Ohio only taxes Internet access fees paid by businesses.

¹ A few states such as New Mexico impose a gross receipts tax which is the equivalent of a sales tax. To provide a comprehensive picture, these taxes are included as sales taxes for this discussion.

Figure 1
States That Impose Sales Tax on Internet Access



Does Minnesota currently impose a sales tax or other tax on Internet access?

No, Minnesota does not impose its sales tax on Internet access charges. Minnesota does not tax services unless they are specifically listed in the definition of a taxable sale. Telephone services are defined as a taxable sale, but the definition of telephone service does not include Internet access. Information and data processing are not included in Minnesota's sales tax base.

Are more states likely to impose taxes on Internet access in the future?

No, the federal government just passed the Internet Tax Freedom Act² as part of the 1998 budget bill. Part of this bill provides for a three-year moratorium on states and local governments imposing new taxes on Internet access. Therefore no state may impose a new tax on Internet access charges until October 21, 2001.

Even before the passage of the federal Internet Tax Freedom Act, the trend among the states was actually to reduce taxes on Internet access. California passed its own state Internet Tax Freedom Act that included a moratorium on taxes on Internet access. Colorado, Florida, and New York enacted legislation to permanently exempt Internet access charges from the sales tax base. Massachusetts enacted a bill to retroactively exempt Internet access charges, web site hosting, and other on-line services from its sales tax base for the period from September 1, 1990, to July 1, 1999. Finally, Connecticut is phasing out its sales tax on Internet access charges over a six-year period.

² Another information brief in this series describes the Federal Internet Tax Freedom Act in more detail.

Sales Taxes on Electronic Commerce

Do most states tax goods purchased over the Internet?

States with a sales and use tax³ impose the tax on goods sold over the Internet if the item sold is in the state's sales tax base. However, a good portion of the tax that is imposed is not collected because the Internet seller often legally cannot be required to collect the tax. Under the Due Process and Commerce Clauses of the Federal Constitution, a state cannot require a seller to collect its sales tax unless the seller has a physical presence or "nexus" in the state.⁴

Although the seller may not collect the sales tax on the purchase of goods over the Internet, compensating use tax is still due from the purchaser. Most states make an effort to collect the use tax from businesses; however, states make only limited attempts to collect the use tax from consumers.

Do most states tax information and other services purchased over the Internet?

The sales and use tax in most states is primarily imposed on tangible goods. However, some states impose the tax on a limited number of services as well. Figure 2 shows the states that impose their sales tax on information purchased and downloaded from the Internet. In all cases, the tax is imposed because the sale meets an existing definition of taxable information or data services. It should be noted that actual collection of the sales tax on information and other services sold via the Internet is subject to the same problems as goods purchased over the Internet.⁵

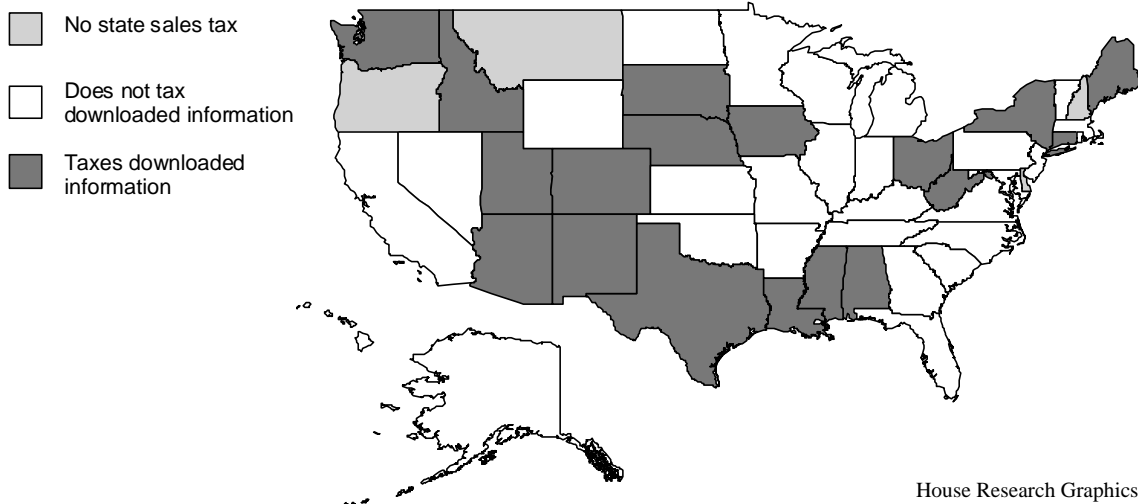
A special kind of item that can be purchased over the Internet is what is known as "functional equivalents." Functional equivalents are intangible items that exist electronically, which serve the same function as a tangible product. Most functional equivalents, such as electronic books and downloaded music and videos, are not subject to sales tax because most states do not tax intangibles. One major exception is computer software, as noted in the box on the next page.

³ Forty-five states and Washington, D.C., impose a general sales and use tax or its equivalent.

⁴ The related House Research information brief titled "Sales Tax Nexus and Siting in the Age of Electronic Commerce" provides a more complete explanation of the nexus issue and how it relates to the state's ability to collect taxes on electronic commerce.

⁵ Collecting sales tax on the purchase of information and other non-tangible items is actually more difficult because it may be extremely hard to "site" a sale (i.e., to determine the physical location where the site was made). With the sale of tangible goods there is at least a shipping address, but it may be impossible to identify the location of a computer (or computers) which receives downloaded information.

Figure 2
**States That Impose Sales Tax on Information
 Downloaded from the Internet**



House Research Graphics

Special note on downloaded computer software and other functional equivalents

Some states consider downloaded computer software to be taxable data and information services, while other states define computer software as a tangible product regardless of the means of transmission or delivery. Computer software that is downloaded via the Internet is taxable in the following states:

Alabama*	Iowa	Nebraska	Tennessee
Arizona	Kansas	New Mexico	Texas
Colorado	Louisiana	New York	Utah
Connecticut	Maine	North Dakota	Washington*
Idaho	Michigan*	Ohio (business purchases only)	West Virginia
Illinois*	Minnesota*	Pennsylvania	Wisconsin*
Indiana*	Mississippi	South Dakota	

* Only sales of canned (non-custom) computer software is taxable.

Source: Vertex Tax Cybrar, at http://www.vertexinc.com/taxcybrary20/CyberTax_Channel/taxtable_72.html (as of 12/30/98).

Does Minnesota impose its sales and use tax on purchases made over the Internet?

To the extent that an Internet seller has nexus with the state, it must collect the Minnesota sales tax on sales of taxable goods and services made to Minnesota consumers. Many Internet sellers will not have a physical presence in Minnesota and therefore cannot be compelled to collect the Minnesota sales tax. Minnesota does not tax data services so, with the exception of canned computer software, the state does not impose a tax on intangibles and services purchased over the Internet.

Minnesota does make an effort to collect use tax from businesses for their taxable Internet purchases⁶ but the Department of Revenue currently makes little effort to collect use tax on Internet purchases by private individuals. In addition, Minnesota Statutes, section 297A.14, subdivision 4 allows a personal use tax exemption for up to \$770 in purchases per year.

Other Internet Taxes

Are there any other taxes that are considered Internet taxes?

There are two other types of taxes that are often included in discussions of Internet taxes. They are “capacity” taxes, telecommunication taxes and fees, and general business taxes imposed on Internet firms.

There are two types of “capacity” tax that have been identified and discussed in the context of Internet taxation: bit taxes and bandwidth taxes. A bit tax is a tax based on the amount of information⁷ sent or received (capacity used) by someone over the Internet. A bandwidth tax is a tax based on the amount of information that can be transmitted simultaneously over the transmission system (available capacity) that links the taxpayer to the rest of the Internet.

Telecommunication taxes and fees include federal and state access charges, franchise fees, and 911 surcharges. General business taxes include sales tax on business inputs, property taxes, and corporate income taxes.

Do any states impose Internet capacity taxes?

No state imposes either a bit tax or a bandwidth tax at this time. Currently the Internet is not configured to allow for the assessment and collection of these kinds of taxes. California’s state Internet Tax Freedom Act explicitly bans bit and bandwidth taxes. Although earlier versions of the Federal Internet Tax Freedom Act bill also banned bit and bandwidth taxes, the final version did not contain this ban.

⁶ Most businesses voluntarily pay use taxes on business purchases and the Department of Revenue specifically audits for use tax owed when auditing businesses for sales tax purposes.

⁷ In computer terminology a “bit” is a binary digit, either a “0” or a “1.” Every printed character is represented on a computer by a “byte” which is a series of eight bits in different configurations such as “0110001.”

Do other states impose telecommunications taxes and general business taxes on Internet firms?

States do require Internet businesses to pay the general taxes that they impose on most business. Whether an Internet firm, particularly an Internet access provider (ISP), must pay telecommunications taxes and fees depend mainly on two things: how telecommunications is defined for various taxes in the state, and how the Internet access is provided (e.g., over regular telephone lines, cable, or a wireless transmission system.)

The Federal Internet Tax Freedom Act specifically excludes from its definition of forbidden taxes “fees imposed for a specific privilege, service or benefit conferred,” or “any franchise fee or similar fee imposed by a state or local franchising authority . . . or any other fee related to obligations or telecommunication carriers under the Communications Act of 1934.” Therefore, this act probably will have little effect on any telecommunication taxes and fees imposed by various states on ISPs.

It is beyond the scope of this information brief to assess the types of telecommunications fees and charges that are imposed on Internet business by the various states. This information is difficult to gather because these fees and charges are sometimes based on the type of delivery system (e.g., line based) and are sometimes based on type of service delivered (e.g., two-way voice vs. data transmission). You need to know both how Internet access is being delivered and also what services are being delivered via the Internet to determine whether various telecommunication taxes and charges apply.

Does Minnesota impose state telecommunication taxes and fees on Internet service providers?

Minnesota applies several charges to local telephony. In addition, a state gross operating revenue assessment funds the Public Utilities Commission (PUC) and Department of Public Safety (DPS) regulation of telephone companies. City franchise fees apply to cable companies. Whether these taxes apply to the Internet depends on the service provided and transmission mode used by the ISP. Another information brief in this series looks at this question in more detail.