

Excise Tax Advisory

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Retail Sales Taxes Imposed on Telecommunications Used to Provide Internet Access

The Internet Tax Freedom Act (“ITFA”), 47 U.S.C. § 151 note¹ prohibits the taxation of Internet access within the United States by states and their political subdivisions. This excise tax advisory (ETA) primarily addresses Washington’s taxation of telecommunications used to provide Internet access under the ITFA.

This ETA is divided into two parts. Part I discusses recent amendments to the ITFA required by Public Law No. 110-108 (2007), otherwise referred to here as the Internet Tax Freedom Act Amendments Act of 2007 or “ITFAA.” Part II discusses the two grandfather clauses contained in the ITFA and the applicability of these grandfather clauses to Washington’s retail sales taxes imposed on telecommunications purchased, sold, or used to provide Internet access through June 30, 2008. Part II is in substance unchanged from the original ETA 2029 issued on February 24, 2006.

This ETA does not address the effects of the ITFAA or the ITFA on any of Washington’s local business and occupation taxes, local public utility taxes, or other similar local taxes. No inferences regarding the effect of the ITFAA or the ITFA should be drawn from this ETA with respect to these taxes.

Part I

Question 1: The ITFA prohibited the taxation of Internet access. This moratorium on taxation was set to expire on November 1, 2007. Has this tax moratorium been extended by the ITFAA?

Answer: Yes. The ITFAA amended the ITFA, extending this tax moratorium from November 1, 2007 through November 1, 2014. As amended, the ITFA continues to prohibit the imposition of retail sales taxes on Internet access services, unless such tax is protected under either of the ITFA’s two relevant grandfather clauses. See Part II of this ETA for more information regarding these grandfather clauses. Washington’s business and occupation tax is not subject to the ITFA’s tax moratorium. Washington is permitted to continue imposing tax on Internet Services under RCW 82.04.297 and RCW 82.04.290.

¹ Internet Tax Freedom Act, Pub. L. No. 105-277, 112 Stat. 2681 (1998), amended by Pub. L. No. 107-75, (2001), 115 Stat. 703 (2001), Pub. L. No. 108-435, 118 Stat. 2615 (2004), Pub. L. No. 110-108, 121 Stat. 1024 (2007) (current version at 47 U.S.C. § 151 note).

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Question 2: What is an Internet access service under the ITFA?

Answer:

An Internet access service is a service that:

- Enables users to connect to the Internet;
- In order to access content, information, electronic mail, or other services;
- Which is offered over the Internet.

Internet access services include telecommunications:

- To the extent these telecommunications are purchased, used or sold;
- To provide an Internet access service; or
- To otherwise enable users to access content, information, or other services offered over the Internet.

For more information concerning the definition of Internet access services, please see the ITFA, §§ 1101(d)(3)(D) and 1105(5), 47 U.S.C § 151 note.

Telecommunications purchased, sold, or used to provide Internet access include transmission capacity over a dial-up connection, coaxial cable, fiber optic cable, T-1 line, frame relay service, digital subscriber line (DSL), wireless technology, or by other means, but only to the extent that these services are purchased, used or sold to provide Internet access.

Question 3: Is retail sales tax due on the sale of telecommunications purchased, used, or sold to provide Internet access in Washington?

Throughout the remainder of Part I of this ETA, the phrase “telecommunications used to provide Internet access” will be used to signify telecommunications purchased, used, or sold to provide Internet access.

Answer:

For sales before June 30, 2008:

Yes. Retail sales tax is due on the sale of telecommunications used to provide Internet access for periods before June 30, 2008.

Through June 30, 2008, Washington will continue imposing retail sales taxes on telecommunications used to provide Internet access pursuant to the ITFA’s first grandfather clause. See Part II of this ETA for a detailed explanation of the application of this grandfather clause to Washington’s taxation of telecommunications used to provide Internet access.

For sales on or after June 30, 2008:

No. Generally, retail sales tax is not due on the sale of telecommunications used to provide Internet access on or after June 30, 2008.

In 2007, the ITFAA amended the definition of Internet access for the purpose of applying the first grandfather clause of the ITFA. The ITFAA provides that for purposes of applying the first grandfather clause Internet access does not include telecommunications services. ITFA, § 1104(c)(1), 47 U.S.C. §151 note. This change in definition will not apply in Washington until June 30, 2008. ITFA at § (1104)(c)(2). However, effective June 30, 2008, the first grandfather clause will cease to apply to retail sales taxes imposed on the sale of telecommunications used to provide Internet access in Washington and Washington will not impose retail sales tax on these sales.

If a business aggregates charges for Internet access with charges for telecommunication services that are subject to taxation as part of a bundled package, the tax moratorium in ITFA will not apply to the bundled package. However, if the business separately states its charges for Internet access or can reasonably identify the charges for Internet access from its books and records kept in the regular course of business, then the ITFA will apply to the charges for Internet access and those charges will be exempt from tax under ITFA. *ITFA, § 1106, 47 U.S.C. 151 note.*

Part II

On December 3, 2004, President Bush signed the Internet Tax Nondiscrimination Act of 2004, Public Law No. 108-435. This legislation reinstated and extended the moratorium on taxes on Internet access by amending the ITFA. The legislation expanded the definition of tax-exempt Internet access services by including telecommunications that are purchased, used, or sold by an Internet service provider (ISP) to provide Internet access to its customers. This expanded definition of Internet access services is thought by some taxpayers to include the type of services provided by network telephone service businesses to ISPs and their customers. This includes services used to connect an ISP to the Internet backbone or to ISP customer locations, such as the provision of transmission capacity over dial-up connections, coaxial cables, fiber optic cables, T-1 lines, frame relay service, digital subscriber lines (DSL), wireless technologies, or other means.

Washington has traditionally taxed the sale of these network telephone services to a consumer under the retailing classification of the business and occupation (B&O) tax and required the seller to collect retail sales tax. In 1997, RCW 82.04.065 was amended to explicitly include "the provision of transmission to and from the site of an internet provider via a local telephone network, toll line or channel, cable, microwave, or similar communication or transmission system" as taxable network telephone service. To the extent that these services are included within the federal definition of "Internet access" (see below), ITFA appears to preempt the State's authority to apply retail sales taxes to the purchase of network telephone service used to provide Internet access, as well as the ISP's provision of traditional Internet access itself.

Public Law No. 108-435 included two relevant grandfather clauses that were codified in the ITFA. The first clause (subsection (a)(1)) grandfathers a state's right to continue assessing taxes on Internet access that were imposed and actually enforced as of October 1, 1998 if the tax was authorized by statute and the State had issued a public proclamation that such taxes were being imposed **or** the state generally collected tax on Internet access. This-right continues through November 1, 2014. The second grandfather clause (subsection (b)) applies to taxes imposed and enforced as of November 1, 2003. It grandfathers a state's right to continue imposing such taxes if the state had issued a public proclamation that taxes on Internet access were being imposed **and** the state generally collected such taxes. The right to continue imposing taxes under the second grandfather clause expired November 1, 2005. The language in the two grandfather clauses is substantively identical except for the different time periods (the first applies to pre-October 1998 taxes and the second applies to pre-November 2003 taxes) and the fact that the two provisos are written in the disjunctive for the first clause and in the conjunctive in the second clause.

Some taxpayers believe that the second grandfather clause applies – to the exclusion of the first grandfather clause – to all taxes imposed on network telephone service used to provide Internet access services. These taxpayers point to statements made in the Congressional record that suggest that members of Congress thought that all state taxation of DSL services used to provide Internet access would cease as of November 1, 2005. Therefore, these taxpayers believe that they no longer need to collect and remit retail sales tax on sales of network telephone service used for Internet access after November 1, 2005.

The actual statutory language does not, however, support this interpretation of the law. The first grandfather clause applies to any "tax on Internet access that was generally imposed and actually enforced prior to October 1, 1998." The term "Internet access service" is defined to include "telecommunications services . . . purchased, used, or sold by a provider of Internet access to provide Internet access." To the extent this modified definition includes purchased telecommunications used to provide Internet access, the first grandfather clause clearly applies to allow Washington State's taxation of telecommunications used to provide Internet access, because these taxes were imposed and enforced before October 1998. There is no indication in the statutory language that Congress intended the separate clauses to apply to different types of services, as opposed to covering taxes imposed in different time periods – the language describing the applicable service is identical in both clauses. The applicable rule of statutory interpretation is that if the statutory language is unambiguous, a court will not consider the legislative history of the statute to reach a contrary conclusion. *Whitfield v. U.S.*, 543 U.S. 209, 215 (2005). Even if a court were to look to the legislative history of the act, however, the record is far from definitive and contains statements that could be seen to support either reading of the statute.

Finally, Washington meets the technical requirements of the first grandfather clause. In Washington, B&O and retail sales taxes on the sale of network telephone service used to provide Internet access were generally imposed and actually enforced prior to October 1, 1998. Taxpayers also had a reasonable opportunity to know of this practice due to the fact that RCW 82.04.065 explicitly stated that "the provision of transmission to and from the site of an internet provider via a local telephone network . . . or similar communication or transmission system" was taxable as network telephone service. Finally, the State generally collected B&O and retail sales taxes on the purchase of such network telephone service.

In 2007, the ITFAA amended the definition of Internet access for the purpose of applying the first grandfather clause of the ITFA. The ITFAA provides that for purposes of applying the first grandfather clause Internet access does not include telecommunications services. ITFA, § 1104(c)(1), 47 U.S.C. §151 note. This change in definition will not apply in Washington until June 30, 2008. ITFA at § (1104)(c)(2). However, effective June 30, 2008, the first grandfather clause will cease to apply to retail sales taxes imposed on the sale of telecommunications used to provide Internet access in Washington and Washington will not impose retail sales tax on these sales.

For these reasons, Washington's taxation of network telephone service used to provide Internet access qualifies under the first grandfather clause and will continue to be subject to retail sales tax until June 30, 2008.

This conclusion makes it unnecessary for the department to adopt a position with respect to the interpretation of the term "Internet access" advanced in the January 2006 Government Accountability Office report "Internet Access Tax Moratorium: Revenue Impacts Will Vary by State." The department may, before the expiration of the grandfather period, consider whether the amended definition allows the continued taxation of telecommunications services used to provide Internet access services, but does not do so at this time.
