Executive Memorandum

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# WHY CONGRESS MUST SAVE THE INTERNET FROM STATE AND LOCAL TAXATION

Most Americans view the unprecedented and explosive growth of the Internet and on-line computer services as a major benefit to themselves and to society as a whole. When many state and local government officials look at this developing industry, however, they see something else entirely: a new tax base. With approximately 30,000 separate taxing jurisdictions in the United States eyeing the Internet as a new source of support for their spending habits, Members of Congress should pay attention. Subjecting this wonderful new technology to the collective taxing power of these jurisdictions could destroy it—and quickly. At a minimum, multiple and overlapping taxes on Internet transmissions will hinder the further development of this medium by limiting usage and discouraging increased electronic commerce.

Because Internet and on-line electronic activity are forms of interstate and international commerce, they fall under Congress's jurisdiction and authority. It is imperative, therefore, that Congress act now to ensure that the growth and development of this medium are not hindered by the taxing grasp of state and local lawmakers.

H.R. 1054 and S. 442, introduced by Representative Christopher Cox (R–CA) and Senator Ron Wyden (D–OR), respectively, would prohibit state and local taxation of the Internet or any interactive computer service until further review can be conducted by several federal agencies and by Congress. The House bill also would prohibit any effort by the Federal Communications Commission (FCC) to regulate the price of interactive computer services. Those who understand the nature of the Internet believe such restraint is the only sensible and realistic way to ensure the continued development of this vibrant global medium.

**Constitutional authority over the Internet.** The imposition of state and local taxes, fees, or other levies on an emerging industry is never desirable economically, but it cannot be prohibited by the federal government. The states, counties, municipalities, and other taxing jurisdictions of the United States are free to make such decisions on their own. Yet the taxing authority of these public entities ends at the geographical boundaries of their jurisdictions.

Whenever goods or services enter the stream of interstate commerce, Article I, Section 8, Clause 3 of the U.S. Constitution (the Commerce Clause) clearly gives Congress the authority to prohibit state actions that interfere with the free flow of interstate commerce. Article VI (the Supremacy Clause) makes it clear that, when state laws conflict with each other or with national laws, federal law prevails.

Finally, in Article I, Section 9 and 10, the Founders set forth sound principles of non-discrimination in trade and taxation by noting that "No tax or duty shall be laid on articles exported from any state. No preference shall be given by any regulation of commerce or revenue to the ports of one state over those of another" and "No state shall, without the consent of Congress, lay any imposts or duties on imports or exports...."

Even though the Founders could not have envisioned the development of such modern, technologically advanced sectors of the economy as the interactive computer services industry, the constitutional framework they outlined for the commercial activities and industries of their time is still sound. This framework makes clear their intention that, although most economic activities would be regulated at the state or local level, interstate activities would require congressional oversight to ensure that state-by-state legislative or regulatory action did not infringe unduly on the rights of individuals engaged in interstate commerce.

**The plausibility of taxing electronic commerce.** In the past, it has not always been easy to delineate federal and state jurisdictional boundaries for an industry. But understanding the lack of boundaries for the transmission of electronic information requires only a cursory knowledge of the Internet and on-line electronic commerce.

Electronically transferred information travels across the Internet far too quickly for regulators to monitor and, more important, does so in a way that respects no geographic boundaries. It is virtually impossible to know the points at which the billions of daily Internet transactions begin and end. Consequently, state and local attempts to tax such intangible electronic commerce would result in a confusing and overlapping set of tax laws. Double taxation as well as multiple reporting and compliance problems would be inevitable.

In addition, the proliferation of satellite-based technologies and the wireless transmission of information will serve only to add to this confusion. As an increasing amount of Internet traffic is transmitted wirelessly across the United States and around the world, the jurisdictional claims of states and localities certainly lose credibility. Therefore, even though states and localities may assess routine business income taxes on firms that provide Internet services within their jurisdictions, it is constitutionally questionable (and may well be technologically impossible) to attempt the taxation of intangible electronic transmissions carried on the Internet.

**Critics have no standing.** Although some special interests will wave the ideological banners of states' rights or local autonomy, Members of Congress should not be deterred from acting to protect the Internet from attempts to tax this global medium. State and local regulation of the Internet and electronic commerce is, *prima facie*, unconstitutional.

State and local governments have no legal right to tax commercial activity that falls outside their jurisdictions. Congress should take prompt action to ensure that states and localities are not given a chance to impose taxes that will serve only to retard the growth and development of this crucially important communications medium.

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