

SUBJECT: Sales tax exemptions for Internet access and certain information services

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 10 ayes — Oliveira, McCall, Bonnen, Craddick, Y. Davis, Heflin, Keffer, T. King, Ramsay, Sadler

0 nays

1 absent — Hilbert

SENATE VOTE: On final passage, April 8 — voice vote

WITNESSES: None

BACKGROUND: Under current law, sales taxes are assessed on the purchase of access to the Internet, data processing services, and information services.

“Data processing service” is defined, generally, as computerized data storage and manipulation. It includes word processing, data entry, data search and retrieval, payroll and business accounting data production, and the use of a computer or purchase of time on a computer for data processing.

“Information service” is defined as furnishing general or specialized news or other current information, including financial information, unless furnished to a newspaper or a federally licensed radio or television station. It also includes electronic data retrieval and research.

DIGEST: CSSB 441 would exempt the first \$25 of monthly Internet access service and would phase in an exemption for all information and data processing services from the sales tax.

“Internet access service” would be defined as a service enabling people to access content, including proprietary content, information, electronic mail, or other services offered over the Internet. It would not include telecommunications services or any other form of data processing or information service unless it was provided in conjunction with and merely incidental to accessing the Internet.

CSSB 441 would add Internet access service to the list of taxable services provided by sec. 151.0101(a), Tax Code, and add a new sec. 151.325 to exempt from sales taxes an amount not to exceed the first \$25 of a monthly charge for Internet access service. This exemption would apply without regard to whether the service was bundled with another taxable service or the billing period used by the service provider.

The bill would delete information services and data processing services from that list of taxable services. It would create a temporary sec. 151.01011, Tax Code, to stipulate that the term taxable services would include information and data processing services. That temporary section would expire on October 1, 2003.

CSSB 441 would phase in the exemption for information and data processing services over four years:

- ! 20 percent of the value of the services would be exempt from January 1, 2000, to September 30, 2000;
- ! 40 percent would be exempt from October 1, 2000, to September 30, 2001;
- ! 60 percent would be exempt from October 1, 2001, to September 30, 2002;
- ! 80 percent would be exempt from October 1, 2002, to September 30, 2003; and
- ! 100 percent would be exempt on or after October 1, 2003.

On October 1, 2003, the sections of the Tax Code defining data processing services and information services would be repealed.

CSSB 441 would take effect on October 1, 1999.

**SUPPORTERS
SAY:**

Universal access to the Internet should be a goal of public policy. Consistent with that goal, CSSB 441 would remove Texas from the shortening list of states that still tax Internet access. Most Internet service providers (ISPs) currently charge around \$20 per month, either in installments or an annual lump-sum, to provide unlimited access to the Internet.

Only ISPs in Texas assess the sales tax. Texas customers of the largest ISP, America Online, do not pay sales taxes because the company is based in

Virginia. Its monthly unlimited use plan is less costly to Texans than one offered by a Texas-based ISP, because the Texas-based company must assess sales taxes. Because of the technology involved, an ISP can locate itself anywhere and still provide service to anyone in any other geographic area. Start-up ISPs are less likely to locate in Texas or any of the other few remaining states that tax Internet access.

The bill would limit the exemption to monthly access charges of \$25 or less, meaning that commercial users still would pay sales taxes on amounts above \$25 to maintain their online sites and conduct commercial transactions.

Over a period of five years, the bill would phase in sales tax exemptions for all data processing and information services. As technology rapidly advances, the line between Internet access and the manipulation and presentation of data will become increasingly blurred. Texas-based data processing and information services will rapidly locate out of Texas if the state continues to impose a tax on them while other states do not.

As businesses outsource some of their support services, such as payroll processing, the relative price advantage of untaxed, out-of-state firms will eventually force Texas firms to relocate or shut down. Obviously, if these firms leave the state or cease operating here, then there will be no sales tax revenue associated with data processing and information services.

The state's economy is increasingly reliant on high-tech companies and the computer industry. The Legislature should take steps to ensure that the uses of this technology will remain and continue to locate in Texas.

**OPPONENTS
SAY:**

CSSB 441 would go way beyond tax relief for ordinary Texans who utilize the Internet for electronic mail, news and information, and commerce by wholly exempting data processing and information services. This bill would cost nearly \$500 million per biennium once its exemptions have been fully phased in beginning in late 2003. The Legislature should not commit itself to a large tax exemption for a whole class of services until it fully studies the economics involved.

The growth of Internet commerce may cost states considerably more in lost sales taxes as people purchase more goods and services over the Internet in the coming years. The comptroller should be required to report on the

potential loss to the state in sales taxes from Internet commerce. The report should examine other states' actions with respect to Internet commerce and should make recommendations to the Legislature with respect to taxation of Internet commerce. Until such a report is received, the Legislature should not enact sweeping exemptions of information and data services

Internet access still is predominantly an upper-income phenomenon and should still be thought of as a luxury item. Families earning \$45,000 or more per year would see 60 percent of the tax breaks in CSSB 441 by fiscal 2001, according to the bill's tax equity note.

The Legislature could enact specific sales tax exemptions that would prove far more beneficial to lower-income Texans. Legislation that already has passed the House to exempt over-the-counter medications and diapers from the sales tax could be jeopardized by approval of a large set of corporate tax breaks.

OTHER
OPPONENTS
SAY:

As appropriations are justified and reviewed biennially, so tax exemptions — which, like appropriations, involve the directing of state funds — should be reviewed periodically as well. The Legislature should require the comptroller to prepare a report on the effectiveness and economic benefit of tax incentives. Such a report would provide the Legislature with sufficient quantitative evidence to determine whether these incentives should be extended, modified, or eliminated.

Taxes should not be reduced until schools, health care, and human service programs are fully funded. Teacher salaries are well below the national average. Texas ranks 35th nationally in per-capita elementary and secondary education spending.

If the Legislature determined that a tax cut was desirable, broad-based tax-rate reductions would produce more benefits for the state economy in terms of job creation and capital formation in relation to the revenue the state would lose. Narrow exceptions to taxation may help some Texans, but they produce little in terms of overall economic benefit. All Texans have contributed to the state through higher taxes, and all Texans should share fairly in a tax cut. Texas families would be served better by a reduction in the sales tax rate than by a series of specific exemptions aimed at limited numbers of families.

A more broad-based approach to tax reduction also would minimize the impacts on local governments. Once an item is exempted from the state sales tax, it also is exempted from all local sales taxes. Not all cities, counties, transportation authorities, and other taxing districts have large surpluses allowing them to afford to exempt items from the sales tax.

Enacting CSSB 441 would set a poor precedent for tax legislation, as the bill is designed to put off its full cost to years that are beyond the fiscal note's reach. If the Legislature intends to exempt data and information services from the sales tax, it should do so all at once.

NOTES:

The committee substitute deleted every provision of the Senate-passed bill and added the provisions relating to the sales tax exemptions for internet access and information and data processing services. The Senate version would exempt from the sales tax over-the-counter drugs specifically formulated and labeled for children and diapers and create a "sales tax holiday" for certain clothing and footwear during a two-week period in August.

HB 2372 by Gutierrez, which would exempt over-the-counter medications and blood glucose monitoring test strips from the sales tax, passed the House by 143-0 on May 7 and was reported favorably as amended by the Senate Finance Committee on May 14. The Finance Committee amendment deleted the section allowing local governments to repeal the exemption of local sales taxes on those items.

HB 2371 by Gutierrez, which would exempt diapers from the sales tax, passed the House by 143-0 on May 7 and was reported favorably without amendment by the Senate Finance Committee on May 14.

HB 2280 by Dutton, which would provide a sales tax holiday for certain clothing and footwear, was recommitted to the House Ways and Means Committee on May 6 on a record vote.