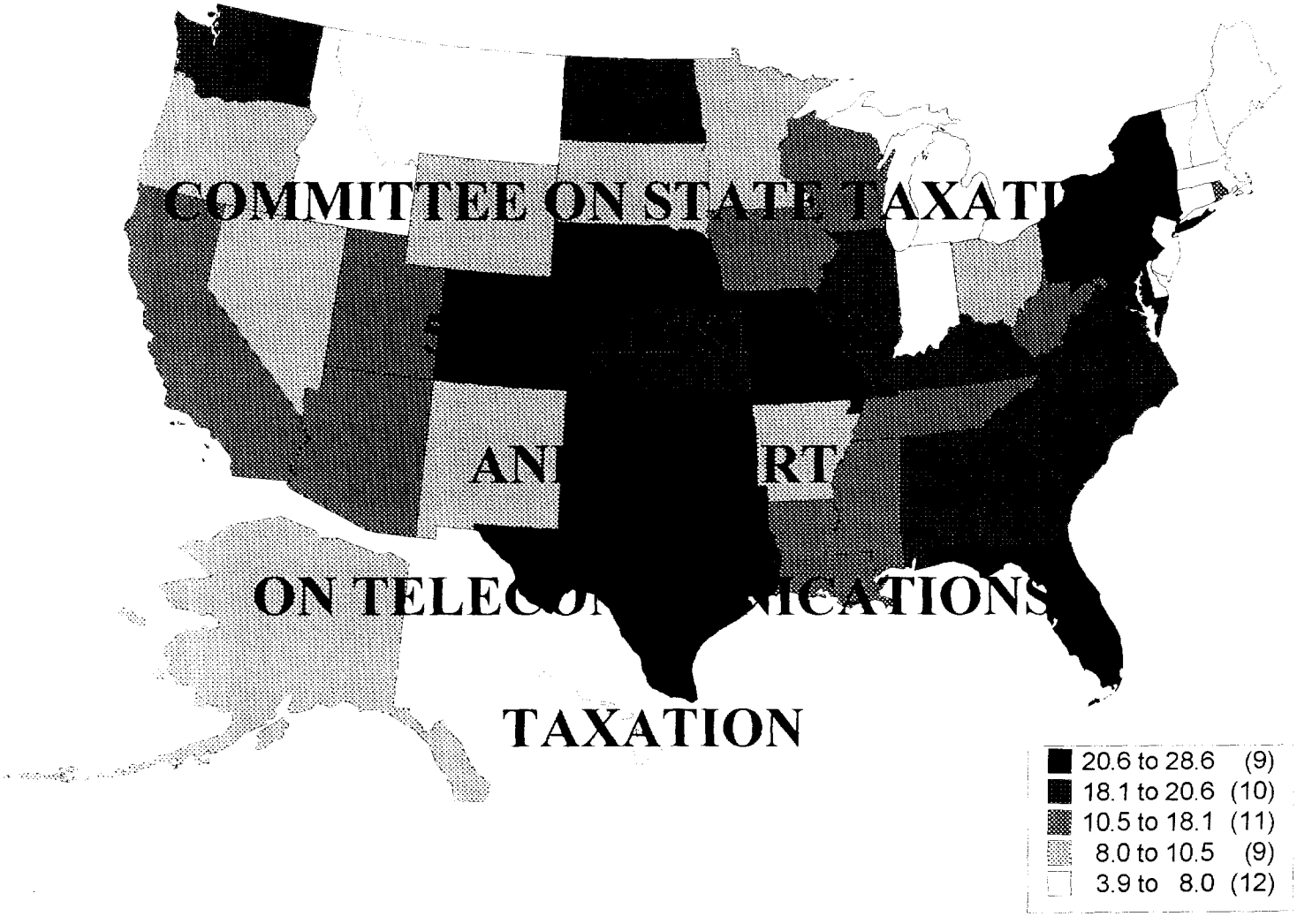
Committee On State Taxation

COST

Total State and Local Tax Rate on Sales of Telecommunication Services



Committee On State Taxation, 122 C Street, NW, Suite 330, Washington, D.C. 20001 September 7, 1999

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EXECUTIVE SUMMARY

COMMITTEE ON STATE TAXATION

50-STATE STUDY AND REPORT ON TELECOMMUNICATIONS TAXATION

The Telecommunications Tax Task Force of the Committee On State Taxation ("COST") has completed a 50-state Study documenting the complex taxation of telecommunications providers and services under state and local transactional and property taxes, including applicable fees, which is discussed in detail in the accompanying Report. COST is a non-profit association based in Washington, D.C., which has an independent membership of more than 500 major multi-state corporations from all sectors of industry engaged in interstate and international business. The Task Force is uniquely situated to present information regarding the multiple rates of taxation and burdensome compliance obligations imposed on telecommunications services because of the broad range of telecommunications services provided by the companies involved in this Study in virtually every jurisdiction throughout the United States. [1]

The experience of the telecommunications industry, documented in this Study, indicates that the tax system imposed on this industry is no longer manageable, and therefore, no longer serviceable. The Report demonstrates that the existing telecommunications tax system is even more burdensome and unmanageable than the complicated transactional tax system applicable to general businesses[2]. The Study indicates that a higher nationwide average effective rate of

[1] The following companies participated in the Study: AirTouch Communications, ALLTEL Corporation, Ameritech Corporation, AT&T Corporation, Bell Atlantic Corporation, BellSouth Corporation, Citizens Utilities Company, CommNet Cellular Inc., Frontier Corporation, GTE Corporation, MCI WorldCom, Nextel Communications, Inc., SBC Communications, Inc., Sprint Corporation, U.S. West, VoiceStream Wireless, and Western Wireless Corporation.

[2] The Report includes an appendix which sets forth the methodology used by the Study's participants to determine the state and local transactional and property taxes (and corresponding compliance obligations) applicable to general business (*e.g.*, a seller of tangible personal property with stores in every taxing jurisdiction) compared to telecommunications business (and their customers). A review of the charts and accompanying footnotes reflects the complexity involved in gathering the data for this study and the problems with synthesizing the information because a myriad of taxes are imposed on different types of services by a multitude of jurisdictions.

transactional taxes applies to sales of telecommunications services (18%)[3] than to sales of goods by general business (6%). The Study also concludes that the telecommunications providers have substantially more administrative filing requirements (55,748 returns required to be filed each year across the nation) as compared to sellers of goods (7,237 returns nationwide).

Much of the existing system of taxing telecommunications can be traced back to an era when telephone service was provided by a single provider as a "public service" and providers paid special public utility taxes in exchange for the grant of an exclusive franchise to provide service. Although the industry has been deregulated, the industry-specific taxation of telecommunications services, telecommunications providers' property and telecommunications business inputs remains. The existing telecommunications tax system could negatively impact the growth of the telecommunications infrastructure that is critical to the economic growth of businesses in every state. The Report includes a discussion of options for simplifying the number and types of taxes imposed on telecommunications services and the corresponding compliance burden, including options for simplifying existing state and local telecommunications transactional tax statutes.

Tax policy decisions should include a reasoned calculation of the appropriate amount of revenue that should be raised through transactional and property taxes. The number of taxes and fees imposed on traditional telecommunications services that raise revenues for general revenue fund purposes and specific social service programs is excessive. Any recommendations offered by the Advisory Commission on Electronic Commerce regarding reforms to federal, state and local tax statutes should consider the information contained in the Study and the concerns raised in this Report regarding the taxation of traditional telecommunications services.

[3] This percentage includes federal, state and local taxes applicable to sales of telecommunications services.

INTRODUCTION

The Committee On State Taxation

The Committee On State Taxation ("COST") is a non-profit association based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce, and today has an independent membership of more than 500 major multi-state corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. As an organization that includes in its membership major corporations from all sectors of industry as well as virtually all of the major telecommunications providers, the COST Telecommunications Tax Task Force ("Task Force") believes it is uniquely situated to make this presentation.

The COST Telecommunications Tax Task Force Study

A few years ago, COST established the COST Telecommunications Tax Task Force to focus on issues related to the state and local taxation of members engaged in the telecommunications business. The initial activities of the Task Force involved the prioritization of issues and the coordination of legislative efforts regarding the taxation of telecommunications providers and their customers under state and local taxes. However, the Task Force quickly recognized that the predominant concerns of the industry related to the burdensome and complicated taxation of telecommunications services and the property used in providing such services. The Task Force determined that there was a need to compile a study that would illustrate the taxation of the telecommunications business and the compliance difficulties confronted by companies engaged in the transmission and/or sale of telecommunications services (a copy of the "Study" is included as Appendix A).

Most members of the COST Telecommunications Tax Task Force participated in the compilation of data inventorying the transaction and property taxes applicable to general business (*e.g.*,a seller of tangible personal property with stores in every state and local taxing jurisdiction) versus telecommunications businesses. The participants also compiled information regarding the number of returns a statewide telecommunications provider would remit each year in each of the 50 states and the District of Columbia. The following COST member companies participated in the Study: AirTouch Communications, ALLTEL Corporation, Ameritech Corporation, AT&T Corporation, Bell Atlantic Corporation, BellSouth Corporation, Citizens Utilities Company, CommNet Cellular Inc., Frontier Corporation, GTE Corporation, MCI WorldCom, Nextel Communications, Inc., SBC Communications, Inc., Sprint Corporation, U.S. West, VoiceStream Wireless, and Western Wireless Corporation.

Summary of Findings

Overall, the Study illustrates that too many jurisdictions are imposing their "own" tax on both general business and telecommunications businesses. Although general business is subject to a confusing array of state and local taxes, the tax system confronted by a telecommunications provider is a substantially more cumbersome. The existing telecommunications tax system would hypothetically require any provider that intends to sell the full array of telecommunications services throughout the United States to maintain different tax matrices for each of the 310 separate state and local taxes that are applied to 687 different tax bases. Many state statutes permit local jurisdictions to specify a tax base that differs from both the state as well as other local jurisdictions. For example, a provider in Colorado must maintain information regarding eight separate taxes applied to 179 different tax bases.

A full-service telecommunications provider, operating nationwide, must file 55,748 tax returns each year. Whether the tax return filing burden is experienced by general business as well as

telecommunications businesses or only by telecommunications businesses varies from state to state. For example, in Tennessee a general business is required to file 3,745 returns while telecommunications businesses must file 4,878 returns. In Illinois, however, a general business is only required to file 12 returns, while telecommunications businesses must file 9,629 returns.

BACKGROUND

Historic Taxation and Regulation of the Telecommunications Industry

Prior to 1984, the Bell System was the principal provider of long distance service and provided local service to a large segment of the United States population, with smaller independent telephone companies operating in exclusive territories. During this period, telephone service was a highly regulated service provided by a few companies generally subject to tax under statutes applicable to "public utilities." The statutes typically imposed special gross receipts, franchise and property taxes on companies that were engaged in the "telephone or telegraph" business. Although the statutes may not have determined applicability of a tax based on whether a telephone company was regulated in a particular way, the companies subject to these "public utility" taxes were typically regulated at the state level with respect to intra-state long distance and local calls. These taxes were typically passed on to consumers as part of the "rates," pursuant to lengthy and complicated rate of return regulatory proceedings (*e.g.*, with respect to a $.20 per call rate calculation, approximately $.01 would be identified as attributable to the state 5% gross receipts tax).

In 1984, AT&T signed an antitrust consent decree that broke up the existing national telephone company into "Baby Bells" -- six smaller companies responsible for providing local telephone service over specific service areas. The Baby Bells were restricted to local service, but were also assigned FCC licenses attributable to the cellular telephone business, then in its infancy, as part of

the consent decree. Other companies that also provided local service over specific service areas included GTE and United Telephone. AT&T retained the long-distance business and the equipment business. Sprint and MCI had already commenced offering competing long-distance service. After 1984, intrastate long distance and local service remained subject to the state and local transactional taxes and property taxes applicable to telephone companies. However, until 1989, it was generally believed that state and local transactional taxes could not be imposed on interstate long distance service. The long-distance providers were still subject to the special property taxes in many but not all jurisdictions.

In 1989, the U.S. Supreme Court decided *Goldberg v. Sweet*,[4] in which the Court held that interstate telecommunications service could be taxed by certain states under a "two-out-of-three test." The Court held that long distance telecommunications service could be taxed in a particular state if the telecommunications service originated or terminated in the state and was charged to a service address in the state (regardless of where the amounts were billed or paid). As is discussed in more detail later, those states that commenced taxing interstate and international telecommunications services typically did so under the state's sales and use tax statutes in accordance with the test approved in *Goldberg v. Sweet*. Because the state "public utility" taxes had historically been tied to state regulation of intrastate service, such taxes typically remain applicable only to intrastate service.

In 1996, Congress enacted sweeping changes to the telecommunications industry by eliminating "barriers" between local and long-distance service (subject to certain regulatory requirements) and barriers between telephone and other forms of telecommunications. The full extent and impact of these changes is beyond the scope of this report. However, the deregulation of the industry was not accompanied by any corresponding elimination of the taxes that had historically been tied to the regulatory status of the telecommunications companies. The telecommunications

companies remained burdened with the special gross receipts, franchise and property taxes that had always been paid in exchange for the special monopoly status granted such companies due to their historical classification as "utilities." With intense competition in the long-distance and wireless telecommunications markets and increasing competition in the local telecommunications market, the historic justification for these taxes has disappeared.

Evolution of Communications Technologies

Although wireless telecommunications companies affiliated with the local telephone companies (following the divestiture of AT&T) were not authorized to sell long-distance service prior to 1996, wireless telecommunications providers have always been regulated at the federal level because cellular and PCS providers are authorized to operate pursuant to federal licenses granted or auctioned by the FCC.[5] Accordingly, state and local governments generally had no regulatory basis for the imposition of traditional telephone utility taxes. However, because some public utility tax statutes do not specifically require telecommunications providers to be regulated, many taxing jurisdictions commenced aggressive initiatives to extend the same public utility taxes that had historically applied to the local telephone companies to wireless telecommunications services and their providers[6]. The substantial value assigned to these wireless providers by the business community also attracted the attention of tax administrators looking to raise additional revenues. As a result, the taxation of wireless telecommunications services differs from the taxation of wireline telecommunications services and varies from jurisdiction to jurisdiction.

The cable industry has historically been regulated and taxed at the local level through the use of local franchises. The basis was again a *quid pro quo* of the monopoly cable franchise in exchange for the payment of, typically, a 5% franchise fee. Since 1996, there has been a flurry of

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[4] *Goldberg v. Sweet*, 488 U.S. 252 (1989).

[5] Initially, wireless telecommunications providers were also subject to limited regulation by a number of states; however, in 1993, Congress preempted the state and local regulation of wireless providers.

activity at the local level as many localities have attempted to impose cable-like franchise fees on telecommunications providers who use public rights-of-way. The localities base their arguments on language in the Telecommunications Act of 1996 that states that "nothing in [the particular] section affects the authority of State or local governments to manage the public rights-of-way or to require fair and reasonable compensation from telecommunications providers" for use of public rights-of-way[7]. Although the localities take the position that these impositions are "fees," the proposed ordinances usually contain language that is virtually identical to the language typically contained in state and local sales tax statutes.

Expansion of State and Local Sales Taxes to Services

In the late 1980s and early 1990s, many states experienced revenue shortfalls that resulted in the expansion of the state sales and use tax to "services" in such states. The sales tax had typically been imposed only on sales of tangible personal property. However, a series of state policy papers highlighted government's concern that the economy was shifting from a manufacturing-based economy toward an increasingly service-based economy, which necessitated an expansion of the tax base to specific (taxable) services. As a result, in the early 1990's many states expanded their sales and use tax to telecommunications services, including long-distance telecommunications services. In 1999, virtually every state that has enacted a sales and use tax statute has extended the tax to telecommunications services.[8]

The extension of state (and local, in some instances) sales and use tax statutes to telecommunications services was generally not coupled with an elimination of the industry-specific taxes that historically applied to telephone services under the public utility taxes. In addition, the industry has historically been subject to a number of fees that are applied at the state

[6] Frequently, the wireless provider was the "sister" company of the wireline provider in a particular jurisdiction.
[7] New Section 253(c) of the Communications Act of 1934, added by the Telecommunications Act of 1996.

and federal level to fund the FCC and the state regulatory commissions that regulate the telecommunications industry. In recent years, a number of additional fees were imposed to fund special public service programs, such as 911 emergency services and hearing impaired services (TDD). In addition, the 1996 Telecommunications Act also added a new fee, the Universal Service Fund fee.

The result is that in some states hundreds of different state and local taxes and fees apply to sales of telecommunications services. Certain of the impositions are defined as "fees," but are generally more appropriately characterized as "taxes" under the standards set forth in state case law for classification as a tax. These separate impositions must be collected by the providers and remitted to the applicable taxing jurisdiction, requiring the filing of as many as 55,748 different returns. The sheer number of state and local impositions creates both confusion and a financial burden for new entrants into the industry, because typically the providers are not compensated for the cost incurred in collecting the taxes and fees.

The increase in the taxation of telecommunications services over the past fifteen years impacts the cost of telecommunications service for both business and residential consumers. The Study reflects that a consumer's purchase of telecommunications services is subject to a nationwide average effective rate of taxation of 18%[9].

Convergence in the Telecommunications Industry

Although communications technology is changing so fast that predictions regarding what services and providers will dominate in just a few years are impossible, the trend is towards fewer distinctions between historically different forms of communication. Accordingly, taxes that are

[8] A few states that either do not have a sales tax or do not tax services under the sales tax statute impose special excise taxes on telecommunications services (*e.g.*, Delaware and Virginia).
[9] Reflects an average state and local effective tax rate of 14.15% plus an additional 4% to reflect federal taxes and fees.

tied to the historic regulation or categorization of an industry are likely to become inequitable and increasingly difficult to administer. The telecommunications tax system should be overhauled to ensure that where equivalent services or products are available from different providers telecommunications businesses are not burdened by a taxing scheme designed for a regulated environment.

50-STATE STUDY ON TAXATION OF THE TELECOMMUNICATIONS INDUSTRY

Purpose of the Study

The goal of the Study is to identify the transaction and property taxes that are applied to telecommunications companies as compared to general business. The Study was prepared by representatives of the tax departments from companies that are members of the COST Telecommunications Tax Task Force. Each state (and Washington, D.C.) was analyzed by one telecommunications company and reviewed by a second telecommunications company. For each state, the data was collected by assuming a statewide general business (*i.e.*, the business would have at least one store in each taxing jurisdiction) and a statewide provider of telecommunications. Instances where the different types of telecommunications services are taxed differently are footnoted. Selected results of the Study are summarized in various graphs included in Appendix A. Particular charts and graphs used to present the Study to the Advisory Commission of Electronic Commerce are to be included in Appendix B.

The Study looked at the number of state and local transactional taxes, fees and property taxes in each state that apply to telecommunications and general business. The Study examined the nature

of each tax and fee – its rate, its base, frequency of remittance filings, uniformity of tax base, number of jurisdictions, and uniformity of tax exemptions. The results of the Study are discussed in two parts. The report first examines the various levels and types of taxes that are applied to telecommunications companies, their property and the services they sell. The report then discusses the administrative complexity of complying with all of the various state and local taxes and fees.

Differences in the Level of Taxation on Telecommunications

Effective Rate of Tax Applied to the Sale of Telecommunications Services -- The Study shows that telecommunications services are subject to effective rates of transactional taxes applied to sales of telecommunications services that exceed the effective rate of transactional taxes applied to sales by general business. The average total effective tax rate for the telecommunications industry (including federal excise taxes and fees) of 18.15% is almost three times the average effective tax rate applied to general business (approximately 6.31%). Sales by general businesses are typically subject only to state and local sales taxes. The high effective tax rates applicable to telecommunications are due to the multitude of state and local taxes targeted toward either the telecommunications industry or public utilities – the total effective rate of state and local tax for ten states exceeds 20%. For a large multi-jurisdictional business, the amount by which the effective rate of tax on telecommunications services exceeds the effective rate of tax on general business translates into significant additional costs of doing business. Because the high tax rates yield substantial tax revenues, many states and localities have been aggressive in their classifications of telecommunications services and providers.

Effective Property Tax Rate -- The Study shows that many states apply property taxes to the intangible value of telecommunications companies while the intangible values of general

businesses are not subject to tax. Fourteen states apply special property taxes to the intangible value of telecommunications companies. The Study also shows that the effective tax rate applied to the real and tangible personal property of telecommunications providers is often higher. The higher effective rate is normally due to the state using a higher assessment ratio for telecommunications versus general business. A higher effective property tax rate is applied to the tangible personal property of telecommunications companies in fifteen states. These two factors result in tax assessments that are generally larger than property taxes applied to general business. In addition, resellers of telecommunications services, who have little or no property, may also be subject to property tax assessments that exceed the value of the property actually owned by the provider in the state, based on their use of telecommunications assets with "intangible value."

Administrative Complexities of Applying State and Local Taxes

As indicated above, multi-jurisdictional companies are responsible for building and maintaining very complex billing systems to collect and remit a myriad of taxes and fees on behalf of state and local jurisdictions. Since telecommunications companies often operate in more than one state and in many local jurisdictions within each state, they are affected by these complexities to a greater extent than general business. Set forth below is a description of the tax collection process and the results of the Study that highlight the parameters in the process that make the collection of taxes so difficult. The purpose of the Study is to document the magnitude of the burdens imposed on telecommunications providers and in doing so to avoid the extension of the telecommunications tax system to others.

Where Did the Sale Take Place? In order to collect a tax or fee on behalf of the taxing jurisdiction, the business must determine where the sale took place. For general business, the sale of goods (services are usually not taxed) generally takes place at the point of sale or the location where goods are delivered. For most telecommunications services, the sale generally takes place

at the residence of the customer or business address (referred to as the service address). However, with respect to mobile communications such as wireless and calling cards, there are no clear answers to the question of where the sale of the service occurs. For example, revenue from a calling card call may be deemed to take place at the equipment where the call originates; the service address for a cellular call may be the first cellular tower from which the call is transmitted or the customer's billing address. Although the determination of where a sale takes place is not a variable analyzed by the Study, the complicated technology involved with new technologies and services add a degree of complexity to the tax determination for telecommunications companies.

In Which Taxing Jurisdiction Did the Sale Occur? After determining the address where the sale took place, the business must determine the appropriate taxing jurisdictions to assign the sale. For most multi-jurisdictional general businesses, this is a complicated process to determine the appropriate taxing jurisdiction. For telecommunications companies, this process is magnified because many jurisdictions impose taxes with finer distinctions regarding the appropriate taxing jurisdiction to assign each service address of each customer making it harder to be accurate, particularly with respect to mobile services. For each service address the company must determine: 1) the state in which the address is located; 2) the county in which the address is located, 3) the city in which the address is located; and/or 4) the appropriate local taxing jurisdictions to which to situs the address. In many states, general business is not subject to as many local taxes avoiding the detailed investigation required of telecommunications businesses.

In addition to knowing where the service address is today, the telecommunications company must know when and where jurisdictional boundaries change and re-map their customer service addresses. Although general business must also be aware of jurisdictional boundary changes, they generally need only concern themselves with the boundaries that affect their own business operations.

The Study shows that the number of taxing jurisdictions that telecommunications carriers (nationwide) have to maintain (and therefore map each of their customer's service addresses to) is approximately 10,857. In addition, general businesses are subjected to tax by nearly the same number, approximately 10,638 taxing jurisdictions.

Which Taxes Does Each Taxing Jurisdiction Impose? Once the seller has determined which taxing jurisdictions have the right to tax a sale, the seller must determine which taxes might apply to the sale. According to the Study, general businesses nationwide must apply approximately 103 state and local sales taxes to sales of their products. Telecommunications companies must apply approximately 310 state and local sales, gross receipts, 911 and other taxes to their services. This process is complicated for all multi-jurisdictional businesses because most localities do not have a centralized system for the recordation of ordinances.

Is the Sale of the Product or Service Subject to Tax? Once the seller has determined which taxing jurisdictions have the right to tax a sale, it must determine whether the sale of the product or service is subject to tax. Just as general business must determine whether the sale of a book or other product is subject to a particular tax, telecommunications businesses must make such a determination for each of its services. Unless each tax is based on the same tax base (*i.e.*, for each tax, the same products or services are taxable or not taxable), this service by service determination must be made for each tax. The determination of taxable services is cumbersome for any multi-jurisdictional business which sells taxable services. Due to the multitude of state and local taxes that are applicable to telecommunications, there are approximately 687 different tax bases that a telecommunications business must maintain as compared to approximately 184 different tax bases that general businesses must maintain. This non-uniformity of tax bases is

very costly and time-consuming for telecommunications companies (and general business) to maintain.

Accurately maintaining the tax base for each tax is also difficult since state statutes and local ordinances do not take into account technological changes. Telecommunications businesses often must make difficult decisions, supportable upon appeal or in litigation, regarding which products are subject to each tax.

Is the Customer Exempt from the Tax? Before applying tax to the sale, sellers must determine if the customer is exempt from one or all of the applicable taxes. Because exemptions vary from tax to tax, a customer may be exempt from one tax and not another. Documentation of each tax exemption must be maintained by the seller to prove the exemption in subsequent audits.

Tax exemptions are costly for both general and telecommunications businesses to administer since the tax-exempt customers usually vary from tax to tax and jurisdiction to jurisdiction. Similarly, a customer exemption certificate can vary from tax to tax and jurisdiction to jurisdiction. Moreover, telecommunications businesses often incur the additional cost of the tax itself, particularly where the business allows a customer to claim an exemption from a tax from which such customer is not properly exempt (the business is responsible for the uncollected tax).

Tax exemptions can be especially confusing to the telecommunications customer who may be exempt from sales taxes but is not exempt from special telecommunications taxes. Due to the multitude of taxes that apply to telecommunications services (and the accompanying inconsistencies of claiming exemptions and proper documentation), the proper and accurate allowance and maintenance of customer exemptions is especially difficult and costly for telecommunications businesses.

What Tax Rate Applies to the Sale? Once the seller has determined whether the product or service is subject to a tax and whether the purchaser is tax exempt or not, it must determine the applicable tax rate. It must also apply any special calculations such as a tax on a tax (the collection of one tax may be part of the base of another tax), ceilings (*e.g.*, tax of 3% up to $3.00), or floors (*e.g.*, the first $25 of a service is exempt from tax). Based on the Study, both telecommunications companies and general businesses must maintain tax rates for over 10,000 jurisdictions nationwide. With state and local jurisdictions continually changing their rates, it is a challenge for both telecommunications businesses and general businesses to maintain and apply proper rates for every tax or fee imposed on goods and services.

According to the Study, an average telecommunications customer is billed approximately 7 taxes (including federal). Because there are normally differing tax bases for each tax, customers are often confused about the nature and number of taxes that appear on their bills. Because of the complexity of applicable taxes it is difficult, if not impossible, for customer-care representatives to adequately answer the thousands of inquiries received each month.

Does the Taxing Jurisdiction Pay Vendor's Compensation to the Seller? Before remitting the tax, the vendor may be allowed to keep a percentage of the tax collected as compensation for collecting and remitting the tax. Although many state and local sales statutes provide vendors a modest amount of compensation for collecting sales tax, few of the telecommunications taxes provide for such compensation. Thus, in many cases, the telecommunications carrier is not compensated at all for collecting and remitting the tax to the taxing jurisdictions. In addition, penalties may be imposed if errors are made in the process.

Where is the Tax Remitted? Once the seller collects the tax it must be remitted to the appropriate taxing authority. According to the Study, telecommunications companies remit in excess of 1000 transactional tax returns in fifteen states each year as compared to general business which must remit in excess of 1000 transactional tax returns in only two states. With each return, a check must be included to cover the tax imposed by the jurisdiction. Obviously, the administrative burden placed on telecommunications companies is enormous and is substantially greater than the corresponding burden on general businesses.

Has the Tax Been Properly Applied? Most businesses are eventually audited by respective taxing jurisdictions to determine if taxes were properly applied. The company being audited must commit a substantial amount of resources to providing data, answering questions and, in many cases, defending assessments. Due to the number of taxing jurisdictions that impose a tax on telecommunications, the number of audits telecommunications businesses must administer is, again, substantially greater than for general businesses. In addition to the administrative burden, if tax is under-collected, the telecommunications business must remit tax, interest, and penalties. If tax is over-collected, the telecommunications business must determine a fair methodology to refund taxes to customers (customers at the time of refund are not necessarily the same customers as during the audit period).

Because the taxation of telecommunications is so complex, the cost of the computer programming required to refund the taxes often exceeds the amount of the refund itself. In addition, many telecommunications businesses have been subject to lawsuits filed against them claiming that they did not properly collect the tax or inappropriately collected the tax. Simplification of the tax system would reduce the risks for businesses that they will become subject to costly and time-consuming litigation.

Tax Policy Concerns Regarding Efficiency, Equity and Administrability

There are a number of tax policy principles that are pertinent when analyzing the appropriate level of taxation of telecommunications services in a deregulated environment. The three principles that are discussed in this report are competitive efficiency (economic neutrality), equity and administrability. Each of the principles needs to be balanced with the others to develop a workable tax structure.

Efficiency is critical to a good tax system because taxes should not distort economic decision-making. Many of the industry-specific taxes that have historically applied to regulated telecommunications services impact consumer decision-making by significantly increasing the cost of telecommunications services provided over the telecommunications networks. The tax system documented in this Study is no longer workable. Accordingly, it would be inefficient to apply the existing telecommunications tax system documented in this Study to any other industry.

Equity focuses on fairness, the concept that functionally equivalent transactions or property should not be treated differently simply because the historic regulatory classification of the provider differs. The existing telecommunications tax system is inequitable if the historic classification of telecommunications providers creates arbitrary distinctions in the tax treatment of providers of equivalent services. For example, inequities in the tax treatment of equivalent services sold by different providers could arise from differences in how tax jurisdictions define the tax base as well as differences in the methods used by tax jurisdictions to source telecommunications revenues. In addition, inequities could also be attributable to differences in the property taxation imposed on telecommunications business versus general business, such as

different assessment ratios applied to telecommunications property or differences in the treatment of the intangible value of business assets.

The central tenet behind the first two principles is equality of tax treatment – special taxes should not apply to certain telecommunications services merely because of the historic classification of the provider and telecommunications services should not be subject to multiple taxation. The failure to address efficiency and equity concerns could adversely affect the potential growth of business conducted over the nation's telecommunications networks.

Finally, the taxation of telecommunications must also be administrable. The current compliance burden with respect to taxes imposed on both general business and telecommunications is confusing and, increasingly, economically overbearing.

Existing Telecommunications Tax System Inappropriate in a Digital Economy

The nation's telecommunications networks are a critical component of the continued economic growth of virtually every industry. The availability of modern, reliable and relatively inexpensive telecommunications services is now a critical component of the decision-making process of where to locate new business operations. There has been an increasing demand by residential consumers and businesses for more affordable, advanced and accessible communications. Many employment and educational opportunities will be tied to an individual's ability to access the nation's telecommunications networks. An effective state and local transactional tax rate of as much as 28% could significantly impact how citizens will be able to access and utilize such services in the 21st century. The state and local tax system must be updated to keep pace with rapidly advancing technology as well as the changes attributable to deregulation. It may also be advisable to provide incentives for continued updating and expansion of the telecommunications

systems through an exemption for business inputs, both for new network equipment used in the transmission, switching and routing of telecommunications services, and updated, flexible sale for resale transactional tax provisions.

Telecommunications is one of the four most highly taxed industries in the United States today, along with tobacco, alcohol and gasoline. The historical justification for the existing level of taxation is no longer appropriate and a failure to address the telecommunications tax system following deregulation could create inefficiencies and inequities in the economy. The cumulative costs of taxes, fees and assessments at all levels of government, combined with the cumbersome costs of compliance, threaten to impede the telecommunications industry's ability to meet the public's ever-expanding telecommunications needs.

OPTIONS FOR TAX SIMPLIFICATION

The Advisory Commission on Electronic Commerce was directed to conduct a thorough Study of international, federal, state and local taxation of Internet access and transactions conducted on the Internet and was specifically authorized to examine ways to simplify the imposition of state and local taxes on telecommunications services. Because telecommunications play an integral part in transporting information over the Internet and allowing the public to access the Internet, a simpler and fairer system of state and local taxation for telecommunications companies is essential for the development of this medium and the growth of electronic commerce. This is particularly true in light of the fact that the telecommunications industry is becoming increasingly competitive. In undertaking this Study, the primary purpose of the Task Force was to identify and quantify the substantive and administrative burdens placed on the telecommunications industry. Although general businesses are not completely spared, the Study dramatically illustrates that, by and large, telecommunications consumers and companies pay a greater share of state and local taxes and

shoulder a disproportionate compliance burden with respect to those taxes. Having identified the problems, the Task Force now submits the following specific proposals to address those problems.

Eliminate or Simplify Industry-Specific Taxes Imposed on Telecommunications Services

The Study clearly shows that, compared to general business, more types of taxes are applicable to telecommunications companies and services, and the rates of those taxes are higher. In some jurisdictions, the fees, taxes and assessments applicable to telecommunications may represent more than 20% of a carrier's annual intrastate revenues. The state and local transactional tax and fee burden ranges from 4% to 29% across the areas surveyed for telecommunications companies. This compares to 0% to 14% for general business. From a tax policy standpoint, it is necessary to determine whether telecommunications, which is expected to stimulate growth in other sectors of the economy, should be subject to this higher rate of tax. Industry-specific taxes on telecommunications include specific property tax assessment methods and disparities in the taxation of business inputs such as equipment and services, discussed in more detail in the following sections.

Reform Property Taxation Applicable to Telecommunications Businesses

The Study indicates that there are currently a number of states that require telecommunications property to be taxed based on an assessment ratio that is greater than the assessment ratio applicable to general business property. In addition, due to the widespread use of the "unit value" approach in the central assessment of telecommunications companies in those and many other states, the value of intangible assets is often included as part of the assessment of

telecommunications property and therefore subject to property taxes. The property of general businesses, on the other hand, is generally valued at the local level based on the cost or market value of individual items of tangible property. Accordingly, there is generally little, if any, intangible value included within such assessments.

The disparate treatment afforded telecommunications property for property tax purposes is a remnant of an age in which a very limited number of telecommunications services were provided by heavily regulated monopoly providers. Regardless of whether such treatment was justifiable then, times have changed dramatically and it is not justifiable any longer. In a time when investment in new and more robust telecommunications facilities should be encouraged, there appears to be little basis for distinguishing between telecommunications property and other business property in either the assessment ratios or the valuation methodologies used for property tax purposes.

Exempt Communications Equipment and Other Business Inputs from Transactional Taxes

The concept of taxing certain components of business expenditures more than once is contrary to sound tax policy. Transactional taxes, such as sales taxes, are intended to be consumption-based taxes and therefore such taxes generally apply only to the retail sales of goods or services. Most current sales and use tax systems reflect this policy by providing exemptions from the tax if the products or services purchased are for resale or to be incorporated in another product or service that ultimately will be sold at retail. On a global basis, value-added tax mechanisms also recognize this policy and provide credits or subtractions for taxes previously paid on inputs.

Approximately forty-five states currently provide some type of exemption or reduced rate of tax for purchases of equipment used in the manufacture of tangible personal property. In contrast,

only twelve states and Washington, D.C. currently exempt telecommunications equipment from sales tax, although at least eight others are considering such an exemption. It is commonly accepted that the rationale for exempting manufacturing equipment from sales taxes is to avoid pyramiding (*i.e.,* imposing a tax on a tax) and to encourage industrial expansion. There should be no question that these rationales apply equally to the telecommunications industry.

Similarly, telecommunications services are often not included within sale-for-resale exemptions, even though such services are routinely purchased in wholesale transactions and resold by other telecommunications service providers. Moreover, even where the law includes telecommunications within the resale exemption, the application of the exemption is often narrowly construed. The result of such narrow construction is that many transactions that are clearly not retail sales are nevertheless subject to tax. Sale-for-resale exemptions should include all intermediate transactions involving telecommunications services, such that only those services actually provided to end users are subject to transactional taxes.

Simplify the Bases to Which Transactional Taxes Apply

The Study indicates that the tax bases to which transactional taxes apply vary widely among (1) different taxes imposed by the same jurisdiction, (2) the state and the local jurisdictions within that state, (3) different local jurisdictions within a state, and (4) different states. These differences apply not only to the inclusion or exclusion of certain items from the tax base, but extend also to the definitional provisions and exemption provisions. While these differences often apply to many general businesses as well as telecommunications, the problems associated with the differences are especially acute for the telecommunications industry for a number of reasons. In particular, unlike tangible personal property, the sale of which is almost uniformly subject to sales taxes, different telecommunications services are often treated very differently for tax purposes.

Any difference in the tax base requires a company to maintain a separate tax matrix in its billing system for each tax, in order to collect and remit the proper amount of tax.

While it may not be feasible, or even desirable, to mandate complete uniformity among the bases subject to tax in the various states, it is desirable to increase uniformity within individual states. This can be done at a number of different levels. First, terms should have the same meaning for purposes of all transactional taxes levied by the state and its political subdivisions. Second, persons and transactions should be subject to the same exemptions for all such transactional taxes. Finally, increased uniformity in the application of taxes to products should be considered. At the very least, the base to which local taxes are applied should be the same for all local taxes imposed in a state even if the local tax base differs from the state tax base. By simplifying the tax base in these ways, not only will compliance burdens be reduced substantially, but the job of tax administrators auditing taxpayers' compliance will also be greatly simplified.

Provide Uniform Rules for Sourcing Telecommunications Revenues

As discussed above, in determining the location of interstate telecommunications services for transactional tax purposes, most taxpayers and tax administrators currently attempt to apply the principles articulated by the U.S. Supreme Court in *Goldberg v. Sweet*. While this test worked fine for traditional long distance telephone calls from one business or residence to another, the *Goldberg v. Sweet* sourcing model is becoming increasingly inadequate. For example, in the case of mobile telecommunications, there is simply no service address in the sense contemplated in *Goldberg v. Sweet*. Consequently, there is a great deal of uncertainty among taxpayers and tax administrators alike over the proper location for transactional tax purposes of many telecommunications services. Because of this uncertainty and the inconsistent positions resulting from it, taxpayers are sometimes subject to claims by more than one jurisdiction for tax on the same transaction.

In order to eliminate the uncertainty and the possibility of inconsistent positions and multiple taxation, all state and local jurisdictions should adhere to uniform rules for determining the location of a telecommunications service for transactional tax purposes. These rules must also overcome the shortcomings of the *Goldberg v. Sweet* tax model by identifying a tax situs even if there is no fixed service address and even though the origination and/or termination of individual calls may not be determinable.

Simplify the Rate Structure of Transactional Taxes

Like the tax bases to which transactional taxes apply, the rates of those taxes vary widely from tax to tax and jurisdiction to jurisdiction. Also, while these rate differences often apply to general businesses as well as the telecommunications industry, the Study indicates that the impact on telecommunications providers is more pronounced. Ideally, there would be a single tax rate for each state, and tax revenues would be distributed by the state to local jurisdictions. Failing that, however, all local taxes within a state should be imposed at the same rate. Rate simplification would not only reduce significantly the complexity of complying with state and local transactional taxes, but would also minimize the exposure, complexity and costs associated with audits of these taxes.

Simplify Tax Administration Through Unified Filing, Unified Audits, and Unified Exemption Rules

The Study demonstrates that telecommunications carriers are required to file an enormous number of separate tax returns with various jurisdictions in order to comply with the myriad of transactional taxes currently imposed throughout the country. The sheer number of such filings, as well as the differences in rates, bases, and exemption rules, renders it virtually impossible for many carriers to timely and accurately comply with the various tax laws. Moreover, these

separate filings most often result in separate audits by the different taxing jurisdictions, which places yet another burden on the resources of the carriers. The maintenance of proper data sources and system interfaces to track and comply with the variety of taxes in over 10,000 taxing jurisdictions will bring the most sophisticated tax systems to their knees. These problems are particularly challenging for new entrants.

Uniformity of tax bases among local jurisdictions and/or uniformity with the state tax base would eliminate the need for multiple filings. Regardless of whether individual jurisdictions impose tax at different rates, only one unified tax return should be required per state. In addition to greatly simplifying and easing the current compliance burden, this would also permit unified audits within states. Unified audits would greatly benefit both taxpayers and tax administrators by eliminating much of the redundancy and duplication of effort inherent in the current system of separate audits by individual jurisdictions.

CONCLUSION

There was a time, when present state transactional tax structures were developed, that the imposition of specialized taxes on telephone services made sense. They were imposed on monopoly companies, in some measure to compensate the state for the monopoly powers granted to telephone companies. The companies found those structures acceptable because regulatory authorities enabled them to pass the taxes on to customers through regulated rates for service. This schematic was appropriate insofar as the companies were assured the authority to recover costs and earn a stipulated return on investment.

The advent of competitive telecommunications, now more than thirty years ago, began to challenge the rationale for industry-specific taxes. These competitive telecommunications providers never enjoyed the monopoly protections for which such taxes were intended to compensate the state. Still, because much of the industry remained in a regulated condition, the rationale for continuing those specialized taxes held.

Over the years, telecommunications providers have had some success eliminating certain industry-specific taxes imposed in exchange for monopoly status. However, although technological developments and deregulation have created a new telecommunications environment, much of the historical tax structure has remained relatively intact. For example, effective state and local transactional tax rates of between 20% and 29% impact the economy in nine states. In addition, thousands of tax returns must still be filed each year by general businesses, and tens of thousands of tax returns must still be filed by telecommunications providers. As different services are bundled together and offered by a single provider, the continuation of dissimilar tax structures is likely to become increasingly problematic.

In considering various tax systems, the telecommunications model illustrated in this Study provides an example of a tax system that is broken and doesn't work well with regard to new technologies. Like other industries of the digital age, the telecommunications industry continues to evolve in response to consumer preferences for new products and services. Unless substantially simplified and revised, the existing taxing scheme for telecommunications businesses, based on an earlier era, will hinder the evolution and development of the nation's telecommunications networks – essentially the backbone in our growing digital and information-based economy.