The Impact of Changes in the Telecommunications Industry on Maine State Revenues
Maine Revenue Services
December, 2004

Executive Summary. Recent changes in communications technology, in the telecommunications industry and in the legal and regulatory framework within which that industry operates place significant Maine revenues at risk. Like most if not all states, Maine taxes the property and services of the telecommunications industry more heavily than those of other industries. However, the telecommunications industry is currently undergoing a period of rapid and fundamental transformation. Tax statutes that were created for a very different environment are becoming increasingly burdensome, inequitable, and difficult to administer.

Taxation of the Telecommunications Industry. Real property of telecommunications providers is subject to local property taxes in the same way as other business property. However, "telecommunications personal property" is subject to a state property tax in lieu of local property taxation. The rate is currently being phased down from 27 mills to 20 mills at the rate of 1 mill reduction per year (the rate for 2004 was 26 mills). Revenue from this tax for FY 2004 was $27.8 million, continuing a gradual downward trend that reflects a modest decline in the assessed value of the property subject to the tax as well as the beginning of the phase-down of the mill rate. Not only is telecommunications personal property taxed at a rate that is well above the statewide average local property tax applied to other business property, but telecommunications providers are also excluded from eligibility for reimbursement of personal property taxes under the BETR program.

Billings for intrastate calls (local service and intrastate long distance) are subject to the 5% Service Provider Tax, which replaced the sales and use tax on most taxable services as of July 1, 2004. This tax applies to wireless and Internet telephone services as well as to traditional switched network telephone service. Interstate calls are exempt. Prepaid calling services (phone cards) are still subject to the 5% sales tax. The sales tax on sales of telecommunications services by telecommunications companies produced $33.2 million in FY 2004, the lowest amount since 1997[1].

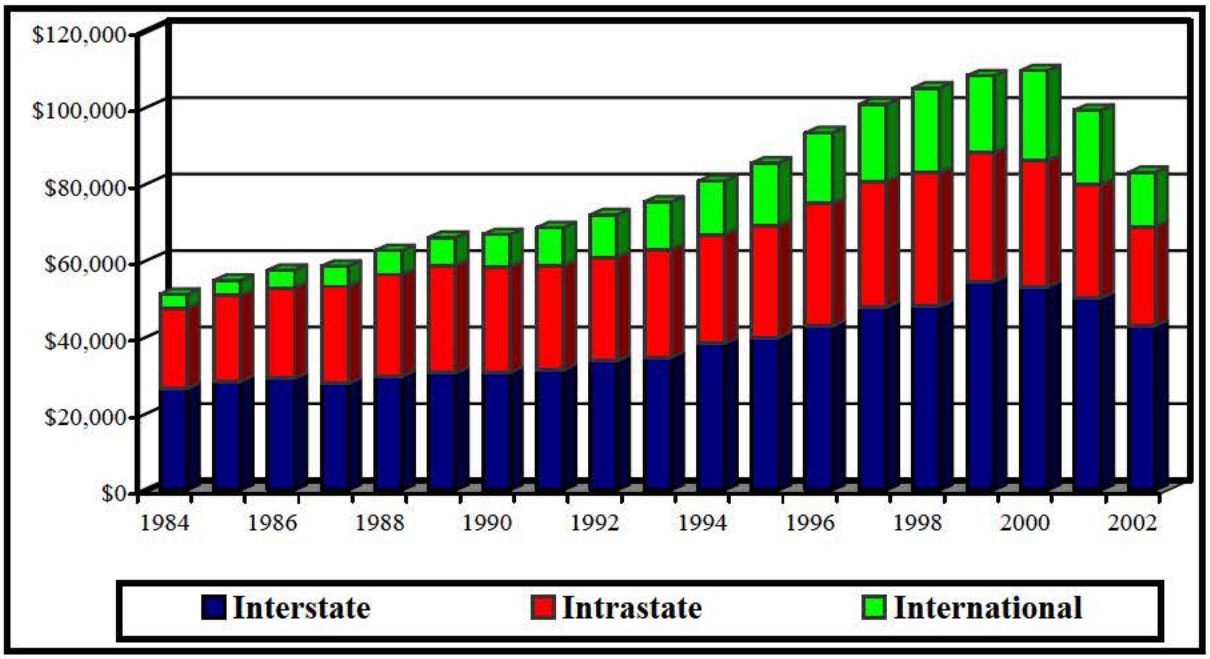
Businesses that provide telecommunications services in Maine are subject to sales and use taxes and income taxes in the same way as other business taxpayers. Telecommunications services are also subject to a 3% federal excise tax and a number of federal- and state-imposed fees and surcharges.

Historical background. For most of its history, the telecommunications industry in the United States functioned as a regulated monopoly. AT&T and its subsidiaries carried the vast majority of local calls and almost all long-distance calls. In its monopoly days the industry had little reason to object to high levels of taxation and complex administrative requirements, since it faced no meaningful price competition and was generally allowed to pass these government-imposed costs through to consumers within the government-regulated rate structure.

[1] Sales tax reported by retailers in Business Code 35, Telecommunications Services (Source: Maine Revenue Services). This amount modestly understates the revenue derived from taxing sales of telecommunications services, and may modestly overstate the rate of decline in those revenues, because it does not include sales of telecommunications services by nontraditional providers such as cable TV companies or sales of prepaid calling services by other types of retailers.

In recent years, a number of events have disrupted this arrangement. The first and most obvious was the court-mandated breakup of the Bell System (completed January 1, 1984) pursuant to a consent decree settling allegations of violations of federal anti-trust laws. Other important developments include the federal Telecommunications Act of 1996, which significantly reduced government regulation of the industry; the emergence and rapid expansion of the Internet; the "convergence" of telecommunications providers with providers of other kinds of information and entertainment services; and the development of competing technologies such as wireless telephony (cellular phones) and VoIP (Voice over Internet Protocol).

Toll Revenues by Market Segment
(Dollar Amounts Shown in Billions)



Source: Federal Communications Commission

The Decline of the Switched Network. By most measures the size of the switched telephone network in the United States peaked around 2000 and has been in significant decline since. For example, according to the FCC, total toll service revenues for all carriers dropped from their all-time high of $109.6 billion in 2000 to $78.6 billion in 2002[2]. The net value of plant assets of incumbent local exchange carriers dropped from a high of $172 billion in 2000 to $146.3 billion in 2003[3]. The total number of residential and nonresidential telephone lines in the U.S. dropped from 192.2 million in 2000 to 185 million in 2002[4]. Although weakness in the overall economy during the last few years is undoubtedly a factor, this decline is likely to prove permanent.

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[2] Federal Communications Commission, *Trends in Telephone Service* (Washington DC, May 2004), 9-5. These figures include revenues of wireless providers, which probably increased modestly during the period; the decline for landline providers only, therefore, would be even greater.

[3] Federal Communications Commission, *Statistics of Telecommunications Common Carriers 2003/2004* (Washington DC, October 2004), 172.

[4] Op. cit., 7-6. The decline appears to primarily reflect substitution by households that previously had 2 or more telephone lines of wireless service for the additional lines, and to a lesser extent discontinuation of second lines used primarily for dial-up Internet access by subscribers who had switched to broadband. As of 2002 growth in the number of households that had completely discontinued all switched network service was still less than overall growth in the number of households; this seems unlikely to continue.

Movement by the telecommunications industry to less capital-intensive technologies such as wireless and VoIP means that the amount of telecommunications personal property subject to state taxation is declining. The value of existing telecommunications infrastructure is also declining, due to excess capacity and functional obsolescence. Moreover, technological advances mean that the cost of new telecommunications property is typically lower than the cost of the property it replaces. The assessed value of telecommunications personal property is trending gradually downwards, and the industry would undoubtedly argue that the assessed value does not yet fully reflect the reduction in value of its assets. All of this means that, even with no change in the way this property is assessed, revenues derived from this source will continue to shrink.

Moreover, the competition induced by reduced regulation of the telecommunications industry and by the emergence of competing technologies is exerting downward pressure on prices. This seems likely to reduce or at least slow the growth of both the billings subject to transaction taxes and the amount of gross income entering into the income tax computation. It is also reasonable to expect a consequent reduction in the amount of capital available for investment in telecommunications infrastructure subject to property taxation.

The rise of VoIP. Voice over Internet Protocol, commonly referred to as VoIP, is a technology for passing voice information over a data network (typically the Internet). Analog sound information is digitally encoded and converted into discreet data packets. These packets are then, as with other Internet transmissions, transported by the most efficient path to their destination, reassembled, and converted back into sound. Packet switching is inherently much more efficient than the circuit switching technology that has traditionally been used for routing of telephone calls.

No one now doubts that, within a few years, VoIP will have become the "normal" way of moving voice data for telecommunications purposes. Although estimates of VoIP expansion vary considerably, growth from 1 million U.S. households today to 10 million three years from now seems probable (business uptake could be considerably faster). The Wall Street Journal reported earlier this year that one out of eight households in the Portland, Maine area had subscribed to Internet telephone service offered by Time Warner Cable in the first year it was offered[5]. Skype, a Luxembourg-based company that offers a free software download that enables its users to make free Internet calls to other Skype users, claims to have carried over 1 billion minutes of traffic in its first year of operation.

Convergence and Bundling Issues. It is becoming increasingly difficult to apply Maine's existing statutory definition of "telecommunications business" because the line between telecommunications businesses and other businesses that provide telecommunications services is disappearing. Telecommunications companies are expanding into other related business areas, and other kinds of companies are expanding into telecommunications services. Although the language of the telecommunications personal property tax statute appears to say that any business that sells telecommunications services is a telecommunications business, in practice MRS has not sought to impose the telecommunications property tax on other types of businesses, such as cable television companies, that have diversified into telecommunications. One concern is that designating these businesses as telecommunications businesses would have the effect of removing their "telecommunications personal property" from the local property tax base. However, it is also becoming more difficult to apply the statutory definition of "telecommunications personal property." The statute does not address the assessment of property that may be employed in providing both telecommunications services and other kinds of

[5] *Heavy Toll: Phone Industry Faces Upheaval as Ways of Calling Change Fast* (August 25, 2004).

information and entertainment services. The FCC recently adopted rules governing the provision of high-speed Internet access over electric power lines; this implies the use of electric power lines to transmit Internet telephone calls and is another development that, while insignificant today, could have a major impact on the value of dedicated telecommunications infrastructure at some time in the future.

As telecommunications companies expand into other related business activities it is also becoming more difficult to determine exactly what is a sale of "telecommunications services." The definition could be construed to include services that are not ordinarily regarded as telephone service, while excluding services that are marketed as and regarded by consumers as being equivalent to traditional telephone service but are provided using innovative technologies. Non-traditional providers of telecommunications services such as cable TV companies have sought to increase their market share by offering telephone service "free" or at artificially low rates to customers of their other services, and telecommunications companies have retaliated by offering package deals that include satellite TV service. Exempt interstate calls and taxable intrastate calls may be combined with wireless, cable TV, paging, or Internet access services in a single monthly charge. An Australian company has started bundling telephone service and Internet access with distribution of electricity and natural gas[6].

The current tax structure perpetuates artificial distinctions between businesses, property and services based on whether they have traditionally been regarded as part of the telephone system. We are already at least very close to the point where similarly situated companies and their customers experience significantly disparate tax consequences predicated solely on what line of business the company was primarily engaged in a few years ago. When the only substantive difference between two competing suppliers is the level of taxation imposed on them, the more heavily taxed competitor is placed at a disadvantage, and the State is placed in the position of picking "winners" and "losers" in the deregulated telecommunications marketplace. In a competitive environment, businesses are more likely to contest tax schemes they view as inequitable and are also more likely to weigh the tax consequences of business decisions (such as, for example, locating business activities and property in jurisdictions that impose relatively low levels of taxation).

Nexus and Sourcing Issues. With the advent of Internet telephony, a telecommunications provider no longer needs to have facilities in a state in order to sell telecommunications services there[7]. This raises the possibility that some telecommunications services that are legally taxable in Maine could escape taxation because the seller lacks the minimum physical presence ("nexus") needed in order for it to be required to collect Maine sales taxes. For example, Vonage, which is currently the dominant "pure play" VoIP provider in the United States, implies on its web site that it only collects sales tax from New Jersey customers (its corporate headquarters are in that state). For now, this is a minor issue since only a minuscule percentage of telecommunications services subject to Maine tax are sold by providers of this kind. Further, it appears likely that in the short term most growth of VoIP in Maine will be associated with existing major telecoms and cable providers; these companies clearly have substantial Maine nexus. However, there is no guarantee that this will continue into the longer term, particularly if a lack of physical presence in many states confers advantages in terms of a lighter tax and/or regulatory burden. There is also the possibility that in the future some providers may engage in

[6] www.actewagl.com.au

[7] In fact, some resellers of switched network service do not own or control facilities in states where they sell telecommunications services. However, the situation could become far more widespread as Internet telephony develops, and less controlled since the ability of the states to regulate these providers is doubtful.

creative corporate structuring in order to locate taxable sales activity and physical infrastructure in separate entities, thereby perhaps avoiding tax collection responsibilities. A separate but related concern is that prepaid calling services can now be readily purchased over the Internet from sellers with no Maine nexus. Although these purchases are legally subject to Maine use tax, it is probable that much of that tax is never collected.

Current Maine law imposes the service provider tax on intrastate telephone calls while exempting interstate telephone calls. It is becoming increasingly difficult to distinguish intrastate from interstate telecommunications. Providers of Internet telephony tend to argue that it is all interstate, because it is actually quite likely that one or more of the information packets making up a call would travel from, say, Portland to Lewiston by way of Duluth. There is no way to trace the route over which a particular packet travels, and in many cases the provider may really not be able to determine the state in which the caller or recipient is located. A benefit touted by many VoIP providers is the option of obtaining a “local” number in a service area that is remote from the location in which the subscriber actually lives and ordinarily utilizes the service.[8] Moreover, the subscriber can travel anywhere in the world and still originate calls from that number, as long as high-speed Internet access is available. Billing schemes in which the customer pays a set monthly fee for “unlimited” service or for a specified number of minutes that can be used for either local or interstate calling as the customer wishes are increasingly common, and seem well on their way to becoming the norm[9].

Pre-emption issues. The federal government has demonstrated an increasing inclination not only to limit its own oversight of emerging communications businesses but also to pre-empt state and local taxation and regulation of these businesses. Federal legislation was proposed in 2004 that would have exempted VoIP services from carrier access charges and state taxes and prohibited the FCC from delegating VoIP regulatory authority to state and local officials. This legislation succumbed to opposition from various sources, notably the law enforcement community (which was given less wiretapping authority than it wanted) and state and local governments fearing the loss of a substantial revenue source on which they had long relied. However, preemptive legislation seems certain to reappear in the next Congress, and it is very possible that within the next few years federal law will place significant constraints on the ability of the states to tax telecommunications services that are based on emerging technologies. There is a substantial risk that over time consumers will substitute services the states are constrained from taxing for services the states have traditionally taxed.

Conclusion. Although there is no easy or straightforward remedy for most of these problems, policymakers need to be aware that the conditions that supported the level of tax revenue historically generated by the telecommunications industry no longer exist. Maine is likely to experience a significant loss of revenue whether or not legislation is enacted to modernize taxation of the industry.

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[8] This feature makes it possible for someone who makes frequent extended calls to a relative or business contact in another part of the country to have those calls billed as local calls. It can also be attractive to people who simply enjoy the image associated with having, say, a Beverly Hills telephone number.

[9] “Flat-rate pricing has proved appealing to consumers, so providers are striving to offer attractive packages of bundled local and long-distance services. ‘In the next few years, per-minute charges for long-distance calls will probably disappear, and the distinction between local and long-distance will become less meaningful,’ stated Matthew J. Flanigan, TIA president.” Telecommunications Industry Association press release, March 8, 2004.