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REPORT ON TAXATION OF TELECOMMUNICATION SERVICES

Submitted by the Department of Finance and Administrative Services
Bureau of Maine Revenue Services
Anthony J. Neves, Executive Director

December 2001

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EXECUTIVE SUMMARY

This report on the taxation of telecommunication services and electronic commerce is submitted in accordance with 36 MRSA section 112, subsection 9-A. It includes comments submitted by both public and private parties involved in telecommunications and electronic commerce and members of the public.

The Task Force to Study Telecommunications Taxation (Task Force) recommended that this report be prepared and also recommended the following:

1. The definition of "telephone and telegraph service" under the sales tax law be revised to clarify ambiguities and to ensure that the sales of unbundled network elements to other telecommunications providers are excluded from taxation. This recommendation was enacted in PL 1999, c. 488, § 10.

2. Exempt from sales tax the sale of cable television converter boxes. This recommendation was enacted in PL 1999, c. 488, § 3.

3. Tax prepaid calling arrangements at the point of sale. This recommendation was enacted in PL 1999, c. 790, Pt. A, § 46.

4. Exempt from sales tax machinery and equipment used to provide communications service. This recommendation was not enacted.

5. Exempt from sales tax the first $16 of residential telephone charges. This recommendation was not enacted.

6. Phase out the state telecommunications personal property tax and provide the authority to tax this property to municipalities. This recommendation resulted in enacted Legislation to gradually reduce the state property tax on this property from the current rate of 27 mills to 20 mills in 2009. Pertinent law cite: PL 1999, c. 731, Pt. W, § 1.

The current status of the telecommunications industry remains consistent with the findings of the Task Force. Competition between the telecommunication providers remains keen. Disparities in tax treatment continue between the distinctly different types of business that are competing to provide similar types of telecommunication services. For example, a sales tax is levied on a two-way intrastate phone call, but not on a two-way intrastate Internet conversation.

In the area of taxation of e-commerce, progress is being made on developing a solution to the problems associated with the collection of sales tax on goods and services sold through electronic commerce. A group of 32 states including the state of Maine have, through legislation or executive order, agreed to consider the enactment of model legislation to simplify and modernize the administration of the sales and use tax laws. The project is called the Streamlined Sales Tax Project (SSTP).

The objective of the project is to overcome the issues cited in the *National Bellas Hess v. The Department of the State of Illinois and Quill v. North Dakota* rulings whereby the complexity of sales tax structures from state to state present an undue burden on remote sellers and on interstate commerce. Participating states hope that the removal of the complexity barriers will encourage voluntary compliance by e-commerce retailers and/or convince Congress to enact legislation paving the way for states to rely on retailers for the collection of sales tax on e-commerce activity.

The Executive Director recommends the following:

1. In 2002 the state legislature consider enacting legislation to adopt the Streamlined Sales Tax Act and the Streamlined Sales Tax Agreement.

2. In 2002 the state legislature consider making the necessary changes to the definition of mobile telecommunication services to achieve compliance with the federal Mobile Telecommunications Sourcing Act.

3. In 2002 compare the sourcing rules for telecommunication services proposed by the Streamlined Sales Tax Project, the sourcing rules required by The Mobile Telecommunications Sourcing Act, the sourcing rules of other states with the tax laws of Maine to identify inconsistencies and make recommendations to the legislature for changes that promote uniformity and equity.

A review of the impact of structural and technological changes in the telecommunications industry.

No significant structural changes have occurred in the telecommunications industry since the report of the Task Force to study telecommunications taxation was submitted January 15, 1999. However, changes are continually occurring in the type of services offered to consumers including various packages that bundle services often offered at flat rates.

The evolution from communicating by printed-paper and by telephone conversations to communicating over fiber optic cable, microwave and satellite relays continues as expected. Although the cable service providers are increasing their market share of Internet customers, the telephone system providers are constantly introducing new technology that enables users to have access to information using mobile phones and other similar devices. Sophisticated users are purchasing both desktop and portable devices to conduct personal and commercial business communications.

A review of federal and other national activities relating to the taxation of telecommunication services.

The federal Advisory Commission on Electronic Commerce (Commission) released its report to Congress in April of 2000. The mandate of the Commission was to study federal, state, local and international taxation of transactions. The Commission not only looked at the taxation of transactions, but also looked at the taxation of telecommunications services and providers.

The Commission recognized that, although the traditional telephone system (dial-up circuits and modems) continues to be the most widely used transmission system, consumers are seeking more powerful access to services and are migrating to broadband communication services available through cable lines, satellites and upgraded telephone lines. As these service providers compete for customers, the Commission recommends that regulatory policies that impose taxation must keep pace with the changes that have and will occur in the telecommunications industry.

The Commission examined four areas of federal, state and local telecommunications taxation. Because the Commission's report on taxation received a majority and not unanimous vote, their recommendations are not considered formal recommendations. Their recommendations are as follows:

1. The Commission recommends the elimination of the 3% federal excise tax levied on all local and long distance service. The Commission concluded that the boundary between taxable communication services and other telecommunication services is often unclear: i.e. telephone service v. cable service.

2. Eliminate the excess tax burdens on telecommunication companies' real, tangible and intangible property. The Commission also cites inconsistent assessment levels between states, different tax rates levied by states on telecommunication property and states offering tax exemptions to business but excluding telecommunications companies.

3. Afford similar treatment of telecommunications infrastructure in states that exempt purchases of certain types of business equipment from the sales and use tax. The Commission concluded that many states levy transaction taxes on telecommunication equipment, but exempt businesses that are engaged in manufacturing for resale.

4. Encourage state and local governments, within the next three years, to work with and through the National Conference of Commissioners on Uniform State Tax laws in drafting a uniform telecommunications state and local excise tax act which would require states to follow one of two simplified tax structure models. This report will focus on a combination of most of the recommendations of both models which calls for:

    a. allow only one state transactions tax (i.e. one tax rate per state);

b. require each telecommunications service provider to file only one tax return per reporting period per state with state distribution of funds;

c. allow only one audit at the state level;

d. establish nationwide uniform sourcing methods;

e. establish nationwide uniform definitions;

f. provide for 120 days lead time for implementing tax base and rate change;

g. state administered addresses, jurisdictions, and rate database in a nationwide uniform format that would assign addresses to appropriate taxing jurisdiction and provide the rate;

h. telecommunications service providers would be held harmless if they rely on the database;

i. provide for vendor compensation.

Establish a process (or timeline) for states to adopt the uniform telecommunications state and local excise tax act and to remove excess and multiple taxation of telecommunications services.

The Mobile Telecommunications Sourcing Act

Federal legislation, effective in August 2002, entitled the " Mobile Telecommunications Sourcing Act" provides states with a uniform rule for determining the location of the sale and purchase of mobile telecommunications services when that determination is necessary *for the proper application of a state or local tax.* In a nutshell, this legislation preempts conflicting existing state tax law and prescribes the determination of where the sale and purchase of telecommunication services subject to state taxation is occurring. This legislation does not provide authority to a taxing jurisdiction to impose a tax not authorized by the jurisdiction.

The uniform rule of the Act is that taxing jurisdictions may impose transaction taxes only on customers whose place of primary use is within the jurisdiction's territorial limits.

States have the opportunity to provide an electronic database to wireless providers that match a specific street address to a taxing jurisdiction. If a state does not provide a database, the provider may use a database of their choice provided it complies with the American National Standards Institutes and standards approved by the Federation of Tax Administrators and the Multi-state Tax Commission. The wireless providers are held harmless in using either database from taxes not collected due to errors or omissions in the database.

Prepaid calling cards are exempt from this legislation.

This legislation sets the stage for the policy under development by the Streamlined Sales Tax Project in the sourcing of all wire-based and wireless-telecommunication transactions.

In sum, current Maine law will conflict with the federal law in that Maine taxes mobile intrastate calls regardless of the customer's primary place of use. There will be a loss of revenue under current Maine law due to the taxes lost on Maine intrastate mobile calls made by customers whose primary place of use is outside the territorial limits of Maine. The peak periods of revenue loss will likely be during the tourist seasons.

A review of federal and other national activities relating to the taxation of electronic commerce.

In response to the recommendations of the Commission and with the support of the National Governors Association, the Federation of Tax Administrators, the Multi-State Tax Commission and various private retail companies and associations, several states established the Streamlined Sales Tax Project.

The Streamlined Sales Tax Project (SSTP) is an effort on the part of state and local governments, with input from the private sector, to simplify sales and use tax law and administration by adopting uniform definitions, simplified exemption administration procedures, simplified tax filing procedures, uniform sourcing rules and a limited scope audit process. Legislatures will continue to choose what is taxable and exempt.

Thirty-two states, including Maine, have enacted enabling legislation, or their governors have issued executive orders directing their revenue departments to participate in the project.

Four work groups under the direction of a steering committee are building the model. The groups are Tax Base and Exemption Administration, Tax Rates and Registration/Returns/Remittances, Technology and Audit and Sourcing. Maine Revenue Services (MRS) is a member of the Tax Base and Exemption Administration work group.

The Project will be implemented in two phases. Phase 1: Model legislation was completed and adopted in December 2000 and is being considered by several of the 32 participating states in 2001. The National Conference of State Legislatures (NCSL) has adopted a second similar model. As of June 1, 2001, 13 states have adopted either the SSTP model or the NCSL model. Phase 2: This phase to be completed by December 2001 involves the development of a uniform tax return and several additional definitions and rules.

In accordance with 36 MRSA § 112 (9-A), before issuing the attached report, the Executive Director of Maine Revenue Services is required to solicit comments from various entities in both the public and private sectors. Below are the major pertinent excerpts from the responses:

Verizon Maine/Daniel B. Breton

" My underlying priority in making comments is to strive for a competitively neutral tax policy on telecommunications services. When achieved, all companies who compete to provide vital services to Maine consumers and businesses will do so from the same starting point, and will ultimately be encouraged in the same fashion to make capital investments in Maine.

Page 1, second paragraph from the bottom – add the following sentence at the end of the paragraph:

> An example of a disparity in personal property tax treatment is in the area of high-speed Internet access in which CATV companies (using cable modems for Roadrunner service) are not taxed at the same rate as their direct competitors the Telephone companies (providing Digital Subscriber Line [DSL] service). This places the Telephone companies (and the customers they serve) at a disadvantage from a cost and price perspective to the CATV companies who already dominate the marketplace (CATV companies currently have 70% of the high speed Internet access market).

Page 2, in the section **"A review of the impact of structural and…."**, I recommend adding a reference to the current voice services trial the Time Warner Cable is conducting in Maine. The point being that there *are* significant changes taking place from a structural and technological vantage point. My industry considers the next wave of competition to come from the AOLs and Microsofts of the world who are developing ways to use the Internet for data, video and voice traffic. To these points, consider adding the following:

> There are significant changes that have recently taken place that further highlight the disparity in the manner the service providers are taxed. Time Warner (*aka* AOL-Time Warner) Cable currently provides voice telephone services to their customers in Maine as part of a trial. Their rates are lower than the incumbent telephone company, and they are not required at this time to apply the various surcharges to their rates (E911, Universal Service Fund, Schools and Library Technology) which are mandated on the incumbent local exchange carriers and which fund state and federal programs. Fair and accurate imposition of personal property tax will be difficult, as Time Warner is using the same network to provide CATV and telephone services. Furthermore, companies like AOL and Microsoft are expected to enter the telecommunications marketplace in a much larger way using Internet protocol technology, further confusing and confounding current tax policy.

Page 3, item #2, add the following to complete this item: "Telecommunications companies in Maine are not eligible for the BETRS [sic] program."

Page 3, item #3, second sentence, following "The Commission concluded that many states" add the words 'including Maine' so that it is clear to readers that Maine is one of the states that levies a transaction tax on telecommunications equipment but exempts businesses that are engaged in manufacturing for resale. This topic was hotly debated by our task force in 1998/99, but the recommendation put forward to eliminate this tax was dropped by the 119th Legislature's Taxation Committee."

<u>AT&T/Deborah R. Bierbaum</u>

"The Task Force recommended exempting equipment used to provide telecommunications from the sales tax similar to the current treatment of manufacturing equipment. The draft report notes that the majority of the Commissioners on the Advisory Commission on Electronic Commerce also recommended that states should extend their manufacturing exemptions to telecommunications. The National Governor's Association in a best practice paper also highlights the need for states to eliminate the discriminatory treatment of this property that is the backbone of the new economy. The draft report makes no recommendation with respect to this provision. AT&T encourages Maine to consider the high cost of placing this infrastructure in Maine and eliminate the sales tax on telecommunications equipment as the fiscal condition of the state permits.

Page 3 of the report in bullet 1 seems to say that cable service is a telecommunications service. It should note that cable telephony is a telecommunications service. Cable television service <u>is</u> not a telecommunications service."

<u>Maine Municipal Association/Geoff Herman</u>

"On the first page, under paragraph #6, the report notes that there was a recommendation to phase out the state telecommunications property tax and provide that taxing authority to the municipalities. Instead of shifting the authority to the municipalities (where we believe it clearly belongs), the Legislature merely instituted a phase-down of the state-imposed property tax rate from 27 mills to 20 mills over an extended period of time. From our perspective, no meaningful element of the original recommendation was enacted.

On page 3, I'm sure the various recommendations of the federal Advisory Commission on Electronic Commerce are worthy of recitation, at least without some Maine-based references and reality checks. Generally, the Commission would appear to have had a healthy make-up of industrial representatives because most of its recommendations call for achieving the tax equity among the providers by reducing state-level taxes on telecommunications in any number of ways. It is perhaps, to easy for the Commission to freely give away important state revenues. It would be helpful to point out the financial consequences to the state if all the reductions and exemptions the Commission recommended were implemented.

On page 3, subsection 4, there is the Commission recommendation for uniform state tax laws with respect to state and local excise taxes on telecommunications providers. It might be helpful to point out the current status of a local telecommunications excise taxes in Maine. Unless I'm missing something, there are none. The municipalities place a property tax on the ever-dwindling supply of "one-way" telecommunications personal property, and they get some franchise revenue from cable t.v. providers (up to 5% of the basic-rate revenue)."