

Research Report

March 2000



A Unified Communications Tax Should Increase Taxpayer Fairness and Understanding, Reduce Compliance Costs and Remove Anti-Competitive Barriers

The taxation of communications in Florida, particularly telecommunications, is a confusing jumble of multiple taxes, multiple rates, multiple jurisdictions, multiple tax bases and multiple exemptions. The result is taxpayer confusion, administrative nightmares and a climate that creates competitive imbalances, stifles developing technology and discourages economic development.

This report examines the issue of simplifying electronic communications taxation. It highlights the problems created by the current tax structure, and analyzes how a "unified" communications tax a single, broad-based, statewide tax levy should address these problems.

The issue of simplifying communications taxes is not a new one. Prior to the breakup of the Bell System in 1984, telecommunications was a monopoly. As competition began to creep into the picture, and innovations in communications technology began to occur, the existing system of taxation became an increasingly difficult fit.

These problems are rapidly increasing in magnitude, just as competition and technological innovation are mushrooming. Federal and state laws encouraging competition have been enacted and, while the regulatory system has changed, the taxation structure has not.

The creators of the current tax structure which is based on the delivery of one distinct product delivered one way could not have envisioned the communications landscape of today. Now there are hundreds of providers providing a myriad of services in a variety of ways. There are cellular and other wireless telephone, cable and satellite TV, computers and the Internet. The convergence of telephone and cable services has begun. Unlike yesteryear's communications company, the company which today provides a service is not always the company that sells and bills for that service.

These problems and those discussed below demonstrate that the current system is badly in need of a fix. A carefully crafted unified, or simplified, communications tax could address many of the shortcomings of the current tax system.

Problems Created by the Current Taxation System

Multiple taxes and varied applications. Complicated tax systems are never a good thing. Taxpayer understanding and confidence, compliance and administrative efficiency all suffer. This is especially true of communications taxes in Florida. Floridians today face a multitude of telecommunications taxes:

1. State Sales and Use Tax - 7% on telecommunications, 6% on cable
2. State Gross Receipts Tax - 2.5%
3. Local Option Sales Surtax - up to 1.5%
4. Local Public Service Tax (also known as Municipal Utility Tax or MUT) - up to 10%
5. Local Franchise Fees - 1% for telecommunication, 5% for cable
6. Telecommunications Access System Act Fee (TASA) -\$.09 per telephone line
7. 911/E911 Fee - up to \$.50 per line

The sheer number of different taxes on phone bills and the total tax burden they create is one of the most common citizen complaints received by Florida TaxWatch. Not surprisingly, providers report customer confusion and frustration regarding the number of taxes appearing on their customers' phone bills. A large portion of their customer service effort is devoted to handling tax related inquiries and complaints.

While the number of different levies is confusing enough, the non-uniformity with which they are applied only makes administration and understanding even more difficult. For example, whereas a 7% sales tax applies to telephone service, cable and satellite TV are assessed 6%. Some telephone services (line maintenance and equipment rental), however, are taxed at 6%, while two-way cable is taxed at 7%. Further, most residential phone services are exempt from sales tax, but residential cable is not. On the other hand, wireless customers whether residential or commercial are subject to sales tax. The 2.5% gross receipt tax that applies to most phone service, does not apply to cable (except two-way). Some business phone services that are subject to state sales tax are not subject to local option sales taxes. The municipal utility tax (MUT) has a maximum rate of 10% on some telecommunications services, 7% on others, but some services are exempt. MUT does not apply to cable or satellite except pay-per-view and two-way cable. Franchise fees can reach 5% for cable while only 1% for telecommunications; the tax base for the two industries are different measures of revenue.

Multiple jurisdictions. Nearly 300 municipalities and charter counties in Florida independently impose municipal utility taxes and franchise fees. Providers may file hundreds of tax returns each month. In fact, one telecommunications company reports that it files 12,000 state and local returns a year in Florida. With so many taxing jurisdictions, there is no uniform application of taxes and fees. In addition to the differences in rates, there also are differences in interpretation of the tax base. Some local jurisdictions apply the tax and fees more broadly than others. It also must be determined

whether each new feature or service is "telecommunications" or not. When 300 jurisdictions make that determination, differences of opinion are inevitable.

Situsing. Another major problem created by the current system for the industry is "situsing," or the placing of a consumer of taxable product or service in the proper taxing jurisdiction. Although municipalities are required to provide detailed address listings of all streets within their boundaries, situsing is very difficult to achieve. To complicate matters, city annexations result in changing jurisdictions, but multiple jurisdictions may claim the same address. Initial development and continuing maintenance of street listings is costly for municipalities. The same is true for providers who must input listings in billing systems, adjust for their quarterly update and add new listings, as required. Providers claim that the lists developed by municipalities often contain errors, but municipal errors can be compounded by inputting errors made by provider personnel. This compounding of errors creates a significant audit exposure. Moreover, providers claim that it is very difficult to get a refund of taxes remitted to the wrong jurisdiction, even though the wrongly remitted taxes plus penalties are subsequently remitted to the proper jurisdiction.

Bundled services. The growing trend toward "bundled" services also conflicts with the current taxing scheme. Bundled services are when a single provider offers different services--telephone, cable and Internet access together. However, the services in a bundle can be subject to different taxes, at different rates and on different bases. As bundling becomes more popular and includes more services, this problem will grow in magnitude.

Compliance burden. The compliance burden placed on communications service providers is substantial. Developing and maintaining billing systems to handle the myriad of taxation issues, as well as maintaining compliance systems, can be quite expensive. One provider currently implementing a billing system claims that the intricacy of the tax system is adding \$8 million to the cost of developing the system. Such costs create a barrier to new providers seeking market entry.

The difficulty faced by providers to comply with the law not only creates significant audit exposure. Recent years have seen several class action lawsuits brought against providers on behalf of customers. The suits allege that providers applied one or more of the taxes incorrectly and over-collected taxes from the customer.

Competition and economic development. The current tax system creates problems for maintaining balanced competition and encouraging economic development in Florida. For a healthy business climate to exist, the state must assure equal taxation of sellers of similar goods and services, that tax rates are not so high as to prevent services from being offered, and the costs associated with compliance with the tax system are not prohibitive.

Another problem is that communications are taxed in Florida at much higher rates than are most other goods and services. This can be an impediment to Florida's efforts to attract high technology businesses and have a detrimental effect on the development of new technologies. The effective tax rate of all levies on business telecommunications

service can exceed 24% and reach 13.5% for residential telephone users. Cable taxes can reach 12.5%.

Some methods of delivering communications services do not require a physical presence (nexus) in the state wherein the service provider's customers reside. Examples are wireless telephone, satellite and the Internet. Service providers with no nexus in Florida can serve Florida customers, thereby creating competitive disparity with providers having a nexus.

Among Florida industries, there clearly exists a lack of vertical taxation equity the communications industry is taxed at a relatively higher level than other industries. As the lines between competing communication providers (telephone, cable, Internet) blur, the disjointed taxation of them creates horizontal taxation inequities as well.

Problems for governments. The current tax system creates unnecessary administrative costs and other complications not only for industry, but for state and local governments as well. Such complexities create several opportunities for erosion of the tax base. Without uniformly applying taxes and fees to the fastest growing communication services, a shrinking tax base results. Further, newly developed ways of providing communications can cause problems not covered by the current law. For example, as more and more communication, including voice communications, occurs over the Internet, taxable communications (the telephone) are reduced. The nexus issue also can reduce revenues. Different prices can lead to consumers shopping for a cheaper tax jurisdiction, such as out-of-state providers.

Telecommuting and home offices are other potentially problematic examples because of the current exemption for residential phone-use. Because providers have no sure way of knowing whether a phone is business or residential, the increasing utilization of the home as a work environment could further erode the communications tax base.

Looking for a Solution: The "Unified Tax"





The application of sales and gross receipt taxes to services such as Internet access, e-mail and other computer services was ambiguous in its interpretation and implementation until 1995 when the Florida Department of Revenue declared Internet services taxable, effective June 1996. After vetoing a bill passed to address the issue by The 1996 Legislature, Governor Chiles created the Florida Telecommunications Taxation Task Force. Chiles charged the Task Force to undertake a comprehensive study of all communications taxes but requested that taxation of the Internet be deferred until completion of the study.

The Task Force, chaired by then Florida TaxWatch Chairman David McIntosh, released its report in February 1997. It found that the current system of telecommunications taxes was in need of an overhaul and recommended replacing five taxes (state sales, gross receipts, local sales, municipal utility and franchise fees) with a "single unified tax and privilege fee administered at the state level." The resulting tax base was to be consistent,

encompass most forms of electronic communications (telecommunications and cable) and be administered by the Department of Revenue.

The Task Force recommended that Internet access, e-mail and related online services and some telecommunications services (equipment rental, line maintenance and yellow pages directory listings) be exempt. There currently is a three-year federal moratorium on Internet taxation.

Revenues were still to be distributed to state general revenue, Public Education Capital Outlay (PECO) and local governments and state proceeds revenue neutral. The total tax rate was estimated at 12.6%, including:

-  4.3% for state general revenue;
-  3.8% for local governments;
-  2.5% for PECO; and
-  2.0% for local privilege fee.

The Task Force's recommended unified tax would hold local governments "harmless," recognizing the revenues they were receiving from the current system. All local governments, regardless of their current tax policy, were to share in the revenue growth from the unified tax and a centrally-collected privilege fee.

Although not specifically recommended by the Task Force, the calculation of the unified tax rate did not include preferential treatment of residential telephone service. This was viewed as a matter for the Legislature to decide. It did recommend, however, that if the preference was continued, it should be done with a tax credit, not with differential tax rates and the resulting lost revenue absorbed by state general revenue, not by PECO or local governments.

The complexity of communications taxation is not just a problem in Florida, although it is especially acute here (see side box). A federal commission also is exploring unified taxation. In the Internet Tax Freedom Act, Congress created the Advisory Commission on Electronic Commerce to study Internet and electronic commerce taxation. Included in the Commission's charge was to examine ways to simplify federal, state and local taxes on telecommunications service.

Florida's Communications Tax System is Exceptionally Complex

A report entitled, "50 State Study and Report on Telecommunications Taxation" by the Committee on State Taxation (COST) highlights the complexity of the Florida system. It was presented to the national Advisory Commission on Electronic Commerce in September of 1999. COST is a non-profit trade association. The report evaluated the burden placed on providers by state telecommunications tax systems on a variety of measures. Florida was ranked in the top ten among all states in ten of eleven measures of complexity -- the most appearances by any state and ranked 13th in the other category. This included a number one ranking in the number of state tax bases, and a number two ranking in highest effective tax rate. Other measures include: number of returns, number of taxes and number of jurisdictions.

The Commission responded by soliciting proposals from interested parties. A coalition of telecommunications companies responded by offering two options for the Commission's consideration: (1) a single, statewide transaction tax on telecommunications and (2) a statewide tax with the continuation of local taxes in states where local taxes are currently imposed.

Favoring option number one, the coalition nonetheless recognizes the difficulty it would pose in addressing currently levied local taxes. The proposal's main features are:

- 👉 One state transaction tax per state;
- 👉 A single optional local tax;
- 👉 Uniform state and local tax base and exemptions;
- 👉 A single tax return and state distribution of revenues;
- 👉 One audit administered at the state level; and
- 👉 A state-administered uniform address database and providers held harmless for siting errors due to information in the databases.

Challenges to Developing a Unified Tax

A workable unified tax will have to be crafted in such a way as to resolve numerous potential pitfalls, mostly those affecting local governments, as will be discussed below. Perhaps the biggest single challenge for the 2000 Florida Legislature is effectuating the concept of revenue neutrality and avoiding tax increases. Developing a system that maintains the current revenue levels of both the state and individual local governments, while rolling back the total tax rate to a "revenue neutral" posture, is a difficult task.

The most difficult political obstacle to overcome involves a possibly unavoidable tax increase on some taxpayers. A truly unified tax would be applied as broadly as possible, including residential telephone services currently exempted from the sales tax. Whereas the total, unified tax rate conceivably would be lower than that currently assessed, applying the unified tax uniformly to residential and commercial entities probably would mean increasing taxes for some people. Although the Telecommunications Task Force declared it to be a decision best left to the Legislature, the Task Force's unified plan included taxing residential, citing the need for true unification and the fact that Florida is the only state that offers such preferential treatment.

Could the dilemma possibly be addressed by applying the tax uniformly to residential and commercial customers and then providing a tax credit to residential users? Possibly. Although this would add an additional administrative step, it would be preferable to the current system.

A harder obstacle to address would be the resulting tax increase faced by Floridians in jurisdictions which do not levy any or all of the local taxes the mostly unincorporated portions of non-charter counties. Providing relief on other taxes for taxpayers in those

jurisdictions could mitigate some problems, but it also could raise numerous other questions or concerns.

Local Government Concerns

A major concern of city and county government is the erosion of local home-rule and protection of revenue streams. The only taxing options available to local governments are those which the Legislature authorizes. A tax source that locals can decide whether to levy and at what rate (up to the maximum set by law) is not something they will give up easily. Some local governments worry too about the possible loss of local audit verification of these important revenues.

The inclusion of franchise fees in a unified tax also is seen as loss of local autonomy. Although a statewide tax would preserve local revenues from franchise fees, it likely would be viewed as jeopardizing local governments' ability to regulate the use of public rights-of-way. Further, there also would be concerns about what effect the inclusion would have on franchise fees paid by others who use rights-of-way.

Similarly, local governments worry that replacing a local option tax with a state tax sets a precedent for the elimination of other utilities from the MUT tax base.

Needless to say, the distribution of revenues from a unified tax to local governments would be complex and difficult. A fair allocation of such revenues and the assurance that current local revenue levels would be "held harmless" is of no small concern at the local level.

There also are numerous legal ramifications, not within the scope of this report, that must be addressed concerning local governments bonding and issues involving fiscal covenants.

2000 Legislative Outlook

The 1997 Task Force proposal did not move forward due to the concerns discussed above, especially the tax increase. Despite these concerns, the Florida Legislature will re-examine this issue in the 2000 General Session.

A work group has been formed to negotiate a simplified tax proposal for consideration by the Legislature. It is comprised of members of the telecommunications industry, the cable industry, internet providers and city and county governments. Because of their concerns, local governments neither support nor oppose a simplified tax, although they do oppose many of its potential elements.

Difference of opinion between industry and local governments on some issues is substantial, so a proposal has been hard-in-coming. As of the completion of this research report, a proposal has not emerged, but it is likely that one soon will be forthcoming.

It is unlikely that the proposal will resemble the unified tax recommended by the Telecommunications Task Force. The telecommunications industry, as of now, has relented on a number of issues. A probable element of any viable proposal will be a single point of contact for providers for tax administration purposes. Having a single contact (the Department of Revenue) would be a positive step toward resolving the administrative burden. Nonetheless, of multiple taxes, rates, jurisdictions and bases nonetheless would remain.

There currently is disagreement, ostensibly even among the work group, as to whether passing a "watered down" bill would contribute much toward the long-term prospect of tax simplification. As this report goes to press, it appears that the Senate will pass something on communications tax simplification, whereas the House may not. Many key legislators only want to discuss a unified tax, and anything short of that may not pass muster. Whatever course prevails, the tax increase issue looms large and imposing.

Conclusion

The current method of taxing electronic communications in Florida creates a host of problems. Clearly, something needs to be done. It is of utmost importance that tax equity be achieved for communications consumers, providers and the governments that utilize the related tax revenue.

The desired outcome has been labeled variously: a flat tax, a unified tax and a simplified tax. The negotiations between industry and local governments may have all but rendered "flat" and "unified" unfitting labels, but hopefully the viable outcome will be "simplified."

The development of a new, viable communications tax system should, in addressing the issues and concerns presented in this report, include the following guiding principles for action:

- 1.* A single-rate transaction tax replacing current state and local sales taxes, the gross receipts tax, the municipal utility tax and franchise fee. If concerns about revenue distributions and tax increases cannot be resolved, retaining a local-option portion should be explored.
- 2.* A uniform state and local tax base and exemptions.
- 3.* A single tax return and state distribution of revenues.
- 4.* One audit administered at the state level.

A simplified tax scheme should include telecommunications, cable and satellite television. A federal moratorium wisely prohibits the inclusion of Internet services at this time. The issue of Internet taxation, particularly e-commerce, still has to be addressed. Discussions are underway at the national level.

The move to a unified or simplified tax would create administrative efficiencies and savings for not only communications providers, but for the state, county and municipal governments as well. Taxpayer understanding would be improved and barriers to economic development and competitiveness removed.

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