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REPORT TO THE GOVERNOR AND THE LEGISLATURE

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# Improving New York State's Telecommunications Taxes

## *A Background Study and Status Report*

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# Contents

## Charts

# Executive Summary

New York State's taxation of telecommunications dates back to the nineteenth century when telephone operations consisted of a readily identifiable, government regulated monopoly franchise, principally owned by the Bell Telephone System. Over the past two decades the world of telecommunications experienced significant changes in terms of market competition and new technologies, yet New York's tax structure failed to keep pace with these developments.

As new communications technologies emerged, the old methods for determining who is subject to tax, what revenues are taxed, and how much tax is owed, became harder to apply. Often, this led to litigation between taxpayers and the State to settle these types of questions. Clearly, it is time to revisit and update New York State's telecommunications tax structure.

The situation described above exemplified the scene creating the impetus for this study. New York State and AT&T were litigating a provision of the Tax Law instituted in 1990 which affected long distance telecommunications companies. The parties settled the suit through a compromise of reduced refund claims and an improved tax statute going forward. As part of the revamped gross receipts tax legislation contained in Chapter 2 of the Laws of 1995, the State mandated that the Department of Taxation and Finance (the Department) conduct a study of telecommunications taxation in New York State. Appendix A contains the entire mandate language.

The study mandate also provides for the appointment by Commissioner Michael Urbach of an advisory panel consisting of representatives from affected telecommunications providers, users of telecommunications, and government. Forty individuals comprise the telecommunications advisory panel. Appendix B lists each of their names and affiliations. The advisory panel met several times with Department staff to discuss issues and possible solutions that the panel felt the study should examine.

This preliminary report presents background information necessary for developing and evaluating tax policy options that will modernize New York's telecommunications taxes. Embarking on this endeavor is important for New York because telecommunications represents the path by which future economic growth will travel. The communications industry generates just over 111,000 jobs, sales of $29 billion, and yields State and local tax revenues of over $1.7 billion. Nearly two-thirds of all New York State non-agricultural employees occupy jobs that rely heavily on telecommunications.

Although New York's economic welfare depends on a robust telecommunications industry, the applicable tax structure is outdated and may indeed hinder economic development opportunities. The background section of this report provides an overview of the industry and describes all of the state and local taxes and fees telecommunications companies shoulder as they endeavor to do business in this State. It also compares New York's tax system with those in other states.

The issues sections of this report outline issue areas brought forward through discussions with the advisory panel. The issues center on three tax areas, including sales tax on cellular telephone service, general sales tax issues and corporate tax issues. Cellular and other forms of mobile telecommunications pose interesting problems when applying a tax, such as the sales tax, that is based on delivery of a product or service to a specific location. The technology used to deliver mobile service, and the myriad of different local tax rates throughout the State, make sourcing mobile calls quite difficult.

The sales tax also contains definitions and various exemptions for telecommunications that date back several decades. Advanced technologies may make these concepts obsolete, and in some cases it is not clear how the sales tax should apply to technologies that did not exist at the time the State enacted the tax.

The sales tax exemption for central office switching equipment provides a good example of the first situation. Today, telephone calls travel over digital networks where calls between geographically adjacent areas may actually be transmitted across the country. The machinery necessary to transmit the voice may look nothing like a central office switch of the 1960's. Yet it achieves the same goal . . . the routing of a telephone call. The study will examine whether the sales tax exemption for switching equipment needs alteration.

The issue of Internet access illustrates the second case. When the State enacted the sales tax in 1965, no one ever heard of the Internet. Today, it is a common term. However, there exists a large issue regarding the taxation of Internet access. The final report will address this issue.

Corporate taxes provide many areas for discussion in the final report. Most states tax telecommunications companies on a net income basis. New York relies on a combination of capital stock and gross receipts taxes, while its general business corporations typically pay tax on their net income. The final report will study the ramifications of shifting telecommunications companies from a gross receipts tax to a net income tax.

The 1995 amendments to the telecommunications gross receipts tax law, while improving the tax structure, created an anomaly. This anomaly applies to companies principally engaged in a nonlocal telephone business, but not subject to the supervision of the Department of Public Service (DPS). These entities, through a confluence of factors, do not pay any tax on their income derived from nontelecommunications sources. Other companies that do not fit this particular fact pattern owe tax on these income sources. The final report will examine policy options for rectifying this anomalous result.

The final telecommunications report will also contain an analysis of the data derived from the 1995 amendments to the Tax Law affecting telecommunications companies. The report is due December 1, 1996.

# Background

## Telecommunications Industry History

Telecommunications represents one of the fastest changing industries in the United States economy. This rapid change presents a challenge for New York State policy makers; how to reform a tax system for a continually evolving industry such that the system taxes companies fairly while promoting, or at least not hindering, new investments in telecommunication technology. To begin to understand the methods for achieving these goals, one must possess a sense of the historical background of how telecommunications developed in the United States. This part of the report summarizes the origins of telecommunications and its evolution to the current time.

The modern period of telecommunications began with Alexander Graham Bell's invention of a telephone transmitter and receiver in the 1870's. Before that time, telegraphy provided the most advanced means of communications. Patents issued to Bell for his invention gave the Bell Telephone Company a virtual monopoly on two-way voice communications in the United States. When the patents expired in 1894, many small independent companies entered the markets for providing telephone service and manufacturing equipment. By 1900, independent companies controlled 38 percent of the market.[1] The independents generally operated as monopolies in small towns and rural areas while competition existed in the larger metropolitan areas with the Bell System.

The technology at this time was quite primitive by today's standards. Voice communication was transported over limited capacity cables and wires strung throughout the country. This made the provision of telecommunications an expensive proposition, especially for long distance service. Thus, the Bell System became the sole provider of long distance telecommunications with competition in local urban markets.

The early 1900's represented a period of upheaval in telecommunications as the Bell System faced serious competition in some of its markets. This led to several mergers and acquisitions by Bell. Further, this period in American history was marked by the development of monopolies and other organizational structures that fostered restraint of trade. The rise of trusts in the 19th century, particularly railroad and petroleum trusts, led to the passage of a series of federal laws enacted at the turn of the century and into the beginning of the next century that curtailed predatory pricing and other practices that restrained trade.[2]

The Bell System responded to the growing antitrust sentiment by working with governments to develop workable regulatory policies. Regulation protected utilities such as the telephone company from antitrust laws by granting them government-sanctioned monopolies. In exchange, the companies subjected their pricing decisions to the regulatory authorities. Regulation also protected consumers from unfair monopoly prices while guaranteeing the telephone companies a reasonable rate of return on their investment. In 1907, New York became one of the first states to create a regulatory body to oversee telephone operations.

The period from the early 1900's through the late 1970's saw relative stability in telecommunications. The Bell System was the predominant local carrier and the only long distance carrier. Any other local company had to work with Bell to become connected to the rest of the national communications network. Regulation insured the proper balance between adequate service provision, reasonable prices, and fair profits.

The year 1984 represents a significant turning point in the history of telecommunications in the United States. This was the year that saw the dismantling of the Bell System. The process began decades earlier when the U.S. Justice Department sued AT&T (the parent company of the Bell System) and Western Electric (an AT&T subsidiary) over monopoly practices in the market for telephone equipment. The parties to the suit reached a settlement in 1956. Under the terms of the settlement Western Electric could only manufacture equipment used by the Bell System in its regulated telephone business. The Justice Department sued AT&T again in 1974 for continuing to monopolize both telephone manufacturing and telephone service supply. After much litigation, in 1984, the parties to the suit entered into a court-approved settlement which became known as the Modified Final Judgment (MFJ).

The MFJ required AT&T to divest its holdings of local telephone assets. The judgment divided these assets into seven separate Regional Bell Holding Companies (such as NYNEX), euphemistically known as "Baby Bells." These holding companies owned 22 local Bell Operating Companies (BOCs). The BOCs could not discriminate between AT&T and its affiliates and other companies in procuring products and providing services. More important, the MFJ created Local Access Transport Areas (LATAs) and prohibited the BOCs from providing long distance telephone services between LATAs (interLATA service). In addition, BOCs were prohibited from suppling information services or manufacturing telecommunications equipment.

Under the system after divestiture, local exchange carriers (LECs), such as the New York Telephone Company (one of the two BOCs held by NYNEX), provided services within a LATA. Further, because the interexchange carriers (IXCs) had interLATA networks but not local networks, the IXCs purchased "access" service from LECs which enabled the IXCs to transport the initial and final stages of an interLATA call over a LEC's network.[3] Long distance IXCs, such as AT&T, provided telecommunication services between LATAs. Regulation of rates continued as the State Department of Public Service (DPS) sets intrastate rates. The Federal Communications Commission (FCC) regulates interstate rates.

## Recent Developments

The implementation of the MFJ in 1984 set into motion a new era in telecommunications service provision. Deregulation and increased competition blossomed as companies such as MCI and Sprint became strong forces in the market for long distance service. These new long distance competitors created their own networks independent of AT&T. Local companies also experienced new forms of competition from "bypass" companies or competitive access providers (CAPs). CAPs connect users to an IXC without going through a LEC, thereby avoiding the LEC's access fee.

As telecommunications competition ensued through the 1980's and into the current decade, advancements in technology moved at an even faster pace. Some key innovations during this period include rapid improvements in computer equipment and software, advances in optical technology such as fiber optic cable, and new forms of telecommunications equipment. This includes new infrastructures that use digital technologies that can transmit voice and data over the same connection at high speed. Even the Internet now includes providers who offer voice transmissions through a personal computer.[4]

Telecommunications in the 1990's has become mobile as well. No longer are users chained to the telephone in their homes or offices. Cellular technology exploded over the last few years providing telecommunications anytime, anywhere. In the future, personal communications services (PCS) will use microwave technology to link portable phones to landline networks.

The new era of competition and advanced technology in telecommunications spurred the federal government to enact sweeping reforms in the Telecommunications Act of 1996. The Act ends decades of government rules that erected barriers that separated local and long distance carriers, and precluded primarily nontelecommunications industries from entering the market. The government originally set up these regulations in response to the earlier lawsuits brought against the Bell System. LECs will now be able to enter long distance markets and IXCs can provide local service. Additionally, the law allows cable television companies and electric utilities to offer telecommunication services.

The effect of the new law on the telecommunications industry will not be fully known for years. However, there already exist examples of the forces of change in the market for telecommunications. Companies in related communications fields have discovered new economies through mergers and acquisitions. For example, AT&T merged with McCaw Cellular

Communications. Other megamergers followed that united various segments of the entertainment/broadcasting/cable TV industries. These megamergers included Disney's purchase of ABC, the CBS-Westinghouse merger and U.S. West purchasing one quarter of Time Warner Entertainment. These mergers may further facilitate the bundling of telephone, cable television, and Internet access to consumers. There now exists a fast paced, communications-based economy that conducts much of its business over digital transmission highways.

One of the most significant changes in the telecommunications industry since divestiture came last September when AT&T announced that it was breaking itself up, this time of its own volition, into three independent companies. The companies include AT&T for communications, Lucent Technologies for technology development and manufacturing, and NCR for computer systems and services. Upheavals in telecommunications are likely to continue for years as companies assimilate the new rules and grasp the full advantages of the new technologies.

## Importance of Telecommunications

One of the important lessons that economic history teaches is that commerce centers around points of origin, destination or the links between these points. Successful development also requires the establishment of an infrastructure to support the economic expansion. Early American cities developed around shipping centers with access to the ocean. Settlers pushed west in this State along the man-made Erie Canal. Railroads furthered the economic expansion during the late 1800's and early nineteenth century. The growth of the U.S. economy since World War II can be tied to the popularity of motor vehicles and the concomitant building of highways and mass transportation systems.

Today's economy is no different except that the lifeblood of the 1990's is not waterways, railbeds or interstate highways; it comes from the ability to transport information. The transformation of the economy from a manufacturing base to a service base increases the need for quality telecommunications. Firms, hospitals, educational institutions, and governments now require modern telecommunication systems to compete in the global economy and provide essential services.

Telecommunications provide many tangible economic benefits for New York. First, telecommunications companies employ thousands of workers in this state. Information from the 1992 Economic Census (see Table 1) shows that telephone, telegraph and other miscellaneous communications services employed nearly 70,000 workers in New York State while generating gross revenues of over $15 billion. When broadcasting and cable television companies are considered, they add over 40,000 employees and over $13 billion in sales. The entire communications classification generates just over 111,000 jobs and $29 billion in revenues.

Table 1: 1992 Economic Characteristics of Telecommunications and Broadcasting Companies in New York State

| Industry | Number of Establishments | Revenues ($ billion) | Number of Employees |
|---|---|---|---|
| Telephone Companies | 1,151 | 15.1 | 68,031 |
| Telegraph Companies | 47 | 0.2 | 787 |
| Misc. Communications | 101 | 0.2 | 870 |
| Subtotal | 1,299 | 15.5 | 69,688 |
| Radio & TV Stations | 381 | 9.3 | 27,439 |
| Cable TV Services | 221 | 4.2 | 14,013 |
| Subtotal | 602 | 13.5 | 41,452 |
| Communications Total | 1,901 | 29.0 | 111,140 |

Source: 1992 Economic Census, U.S. Department of Commerce, Bureau of the Census.

While the telecommunications industry is an important contributor to New York's economy, its strength as an employer has diminished over time. From 1984, the year of divestiture, through 1995, the entire communications industry in New York State lost over 21 percent of its employment, almost 30,000 jobs. The telephone and telegraph sectors accounted for approximately all of those jobs.[5]

Another method for examining this employment phenomenon is through the use of location quotients (LQ). LQ measures the degree from which employment trends in an industry diverge from what can be explained by the general trend in the economy. The LQ equals the percentage of state employment in an industry relative to the same proportion for the nation. Over time, changes in the LQ show how a state or region becomes more or less specialized in particular industries. An industry with a location quotient greater than one means there is particular concentration of employment in that state.

Table 2 shows LQ's for the New York State communications industry from 1984 through 1995. LQ's all exceed one reinforcing the fact that New York remains a communications center for the United States. However, the trend shows declining LQ's from 1.26 in 1984 to 1.16 in 1995. This means that New York is becoming less specialized in communications relative to the rest of the nation.

Table 2: Location Quotients for Communications Employment in New York State, 1984-1995

| Year | Location Quotient |
|---|---|
| 1984 | 1.26 |
| 1985 | 1.24 |
| 1986 | 1.15 |
| 1987 | 1.14 |
| 1988 | 1.17 |
| 1989 | 1.07 |
| 1990 | 1.18 |
| 1991 | 1.21 |
| 1992 | 1.20 |
| 1993 | 1.21 |
| 1994 | 1.18 |
| 1995 | 1.16 |

Source: U.S. Department of Labor, Bureau of Labor Statistics. Calculations performed by the Office of Tax Policy Analysis.

Telecommunications also affects the performance of other industries that use these services. Table 3 illustrates the industries in New York State that rely heavily on telecommunications. This includes information-intensive industries like financial services, wholesale and retail trade, personal and business services, and computer and electronic equipment manufacturing. Over 5 million jobs, nearly two-thirds of all New York State non-agricultural employment in 1995, fell into these categories.

Table 3: 1995 New York State Employment in Telecommunication-Intensive Industries

| Industry | Employment (000) | Percent of Total Employment |
|---|---|---|
| New York State Non-Ag. Employment | 7,871.3 | - |
| Communications | 111.1 | 1.41 |
| Transportation & Utilities | 402.8 | 5.12 |
| Communication Equipment | 12.8 | 0.16 |
| Electronic Equipment | 83.8 | 1.06 |
| Computer & Office Equipment | 22.1 | 0.28 |
| Finance, Insurance, Real Estate | 724.1 | 9.20 |
| Wholesale & Retail Trade | 1,614.3 | 20.51 |
| Business Services | 440.6 | 5.60 |
| Personal Services | 73.3 | 0.93 |
| Health Services | 732.1 | 9.30 |
| Legal Services | 103.9 | 1.32 |
| Miscellaneous Services | 864.8 | 10.99 |
| Total | 5,185.7 | 65.88 |

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Telecommunications also has direct implications on business locational decisions. A recent telecommunications study[6] cites a survey of businesses involved in locational decision making. The survey focused on New Jersey companies, although mailings were sent to companies in other states. Over half the respondents said that telecommunications were important for their company to compete in the current business environment. Another quarter of the survey group answered that telecommunications was critical in this endeavor. Over 80 percent responded that telecommunications would be either important or critical to compete in the future.

The survey also asked the respondents to rank 22 factors in their locational decision. The companies ranked telecommunications seventh, ahead of factors such as energy costs and availability, housing costs and availability, and proximity to suppliers.[7]

Telecommunications firms also contribute significant tax revenues to the state and local fisc. Table 4 shows that communications companies pay over $1.7 billion in State and local taxes in New York. The State collects just under $1 billion mainly from gross receipts and sales taxes, while local governments collect over one-half billion dollars mostly from sales and property taxes.

Table 4: New York State Telecommunications Taxes

| Tax | $ Millions |
|---|---|
| State Taxes | |
| Article 9 (1) | |
| Section 183 | 40.6 |
| Section 184 | 119.1 |
| Section 186-a (2) | 460.1 |
| Article 9-A (3) | 24.2 |

| | |
|---|---|
| Sales Tax (4) | 305.0 |
| Total State Taxes | 949.0 |
| Local Taxes | |
| Sales Tax (5) | 305.0 |
| Utility Taxes (6) | 70.9 |
| Real Property Taxes (7) | 350.0 |
| Cable TV Franchise Fees (8) | 73.5 |
| Total Local Taxes | 799.4 |
| Total State & Local Taxes | 1,748.4 |

(1) 1994 calendar year liability.
(2) Includes hotel resellers.
(3) 1992 liability for Communications SIC.
(4) Estimate based on taxable purchases for period 3/94 to 2/95 for Communications SIC.
(5) Estimate based on taxable purchases for period 3/94 to 2/95. Statewide local tax rate of 4 percent assumed.
(6) 1994 New York City utility tax plus an estimate for the rest of the state based on a proration of information contained in the Office of the State Comptrollers's Special Report on Municipal Affairs.
(7) Estimated 1994 property tax for special franchise property and other real estate based on annual filings with the Department of Public Service.
(8) 1994 cable TV revenues times an average franchise fee provided by the Department of Public Service.

## Telecommunications Taxes in New York State

New York State and its local governments impose a variety of taxes on telecommunications providers and their consumers. The first part of this section of the study describes these current taxes. The second part provides some historical detail on how the major taxes originated and the rationale for their enactment. Table 5 summarizes New York's tax treatment of telecommunications providers and services under the three major taxes: the Article 9 Corporation and Utility tax (which actually includes several discrete taxes), the Article 9-A Corporation Franchise Tax, and the Article 28 Sales and Compensating Use Tax.

### Description of Current Telecommunications Taxes in New York State

*Article 9: Corporation and Utility Tax*

Article 9 of the Tax Law applies taxes to a variety of specialized businesses, including telecommunications providers. Most of these entities are considered transmission companies or utility service providers that make them subject to Article 9 taxation. Article 9 also imposes initial taxes and fees on domestic and foreign corporations.

Taxes that apply to telecommunications providers include the franchise tax on transportation and transmission corporations and associations (Section 183), the additional franchise tax on transportation and transmission corporations and associations (Section 184), the excise tax on the furnishing of utility services (Section 186-a), and the excise tax on telecommunications services (Section 186-e). A description of each of these taxes follows.[8]

<u>Section 183 Franchise Tax on Transportation and Transmission Corporations and Associations</u>

Section 183 imposes a franchise tax on corporations, joint stock companies, or associations *principally engaged* in transportation, telephone, or other transmission businesses. Principally engaged means that more than 50 percent of the firm's receipts must come from telecommunications or transportation activities. The tax equals the highest of the following calculations: 1) 1.5 mills on each dollar of net value of issued capital stock; 2) If the share of dividends paid on capital stock is 6 percent or more, 0.375 mills per dollar of par value for each percent of dividends paid; or 3) $75.

<u>Section 184 Additional Franchise Tax on Transportation and Transmission Corporations and Associations</u>

Section 184 imposes an additional franchise tax on corporations, joint stock companies, or associations *principally engaged* in transportation, local telephone business, or other transmission businesses. It applies a rate of 0.75 percent on gross earnings from all sources in the State. For telecommunications companies, this tax also applies to an allocated portion of receipts from interstate and international activities. The tax contains no general sale for resale deduction.

For local telephone businesses, Section 184 excludes sales for ultimate consumption of the following from taxable receipts: 1) inter-LATA, interstate, or international telecommunications services and 2) 30 percent of intra-LATA toll telecommunications services, including inter-region regional calling plan services.

Section 186-a Gross Receipts Tax on the Furnishing of Utility Services

Only certain businesses providing telecommunications services are subject to the excise tax under Section 186-a, in addition to the Section 186-e tax on telecommunications services (described below). These taxpayers provide telecommunications services, but are also subject to the supervision of the Public Service Commission.

These companies pay the Section 186-a tax of 3.5 percent on their gross income from sources other than the sales of telecommunications services. Receipts from sales of telecommunications services are subject to the Section 186-e tax. Nontelecommunications receipts may include receipts from the sale of property within this State, receipts from interest, dividends, and royalties derived from sources within this State, and profits from any other transactions (except sales for resale and rentals) within this State.

Section 186-e Tax on Telecommunications Services

Section 186-e imposes an excise tax of 3.5 percent on receipts from the sale of telecommunications services. The tax applies to sales of telecommunications services regardless of whether the provider is principally engaged in that business or subject to the supervision of the

Table 5 begins on this page and continues through page 19.  See document labeled “teltbles.wpd.”

Public Service Commission.  The statute defines telecommunications services to include services provided by wires, cables, satellites, fiber-optics, lasers, microwaves, radio waves or similar media.

Section 186-e uses the *Goldberg* allocation method to determine New York taxable telecommunications receipts from interstate and international services.  This method, sanctioned by the U.S. Supreme Court in *Goldberg v. Sweet*, authorizes states to tax the entire receipt from telecommunications interstate services to New York if the call either originates or terminates in this State, and the call is charged to a services address in this State.

An exclusion exists for sales for resale, where a sale is made to either an interexchange carrier, a local carrier or a facilities-based cellular carrier.  If this exclusion does not apply, the service provider in a sale for resale must include the sale in its Section 186-e tax base.  However, the law allows a credit to purchasers that subsequently resell telecommunications services.

MTA Surcharge

Since 1982, a temporary surcharge (currently at a rate of 17 percent) applies to tax otherwise due, after deduction of credits, allocable to the 12-county Metropolitan Commuter Transportation District.[9]  This includes the City of New York, Long Island and the mid-to-lower Hudson River Valley.  The surcharge remains in effect through tax years ending on or before December 31, 1997.  The allocation of receipts for purposes of calculating the surcharge follows the *Goldberg* rules discussed under Section 186-e.  The receipts from the surcharge are earmarked for the Mass Transportation Operating Assistance Fund which supports public transportation.

Temporary State Business Tax Surcharge

Since 1990, all business taxpayers also pay a temporary State surcharge on the tax computed after application of available tax credits.  However, there are no credits allowed under Article 9.  For all business taxes, legislation enacted in 1994 phases out the State business tax surcharge.  For Article 9 taxpayers, the surcharge dropped from 15 percent to 12.5 percent for the 1994 tax year, to 7.5 percent in 1995, to 2.5 percent in 1996, and zero percent after that.

*Article 9-A: Corporation Franchise Tax*

General business corporations pay taxes computed under Article 9-A of the Tax Law.  Article 9-A imposes tax on corporations for the privilege of exercising their corporate franchise in New York.  It applies to general business corporations not taxed under another specified article of the Tax Law.  Telecommunications providers *not principally engaged* in providing telecommunications services pay franchise tax under Article 9-A instead of

Article 9. However, these providers also pay the Article 9 Section 186-e excise tax on telecommunications services. Companies may deduct Section 186-e taxes paid from income in the computation of the Article 9-A tax.

Article 9-A taxpayers also pay tax surcharges much like companies subject to tax under Article 9. Since 1982, Article 9-A companies pay the MTA surcharge (currently at a rate of 17 percent) which applies to the amount of tax otherwise due, after deduction of credits, allocable to the 12-county Metropolitan Commuter Transportation District. They also pay the temporary State business tax surcharge on the tax computed after application of available tax credits. For calendar year taxpayers, the surcharge dropped from 15 percent to 12.5 percent for the 1994 tax year, to 7.5 percent in 1995, to 2.5 percent in 1996, and zero percent thereafter.

Tax Bases and Rates

Corporations compute tax under four bases, and pay tax on the base yielding the highest liability. The four bases include 1) a tax of 9 percent (or between 8 and 9 percent for businesses with less than $290,000 of entire net income) on allocated entire net income, 2) a tax of 0.178 percent on business and investment capital allocated to New York after deduction for short-and long-term debt (the maximum tax on this alternative equals $350,000), 3) a 3.5 percent tax on the alternative minimum taxable base, or 4) a separate minimum tax at fixed dollar amounts. An additional tax applies based on the corporation’s subsidiary capital allocated to New York, at a rate of 0.09 percent.

The fixed dollar minimum tax varies from $325 to $1,500 depending on the size of gross payroll. However, corporations whose gross payroll, total receipts and average value of gross assets each equal $1,000 or less must pay an $800 fixed dollar minimum tax.

The business tax surcharge applies to each base and the allocated subsidiary capital base. However, no surcharge applies to S corporation taxpayers with entire net income of $200,000 or less.

The entire net income base equals federal taxable income modified for income and deduction items that New York treats differently than the federal government. For example, New York’s tax base excludes certain subsidiary income items and includes deductions directly and individually attributable to subsidiaries.

New York uses a three-factor formula to allocate business income. The factors generally include property, payroll (excluding general executive officers) and receipts, with the latter double weighted.[10] Taxpayers allocate investment income by a formula that reflects the New York presence of the issuers of the obligations generating such investment income.

The alternative minimum taxable income base equals entire net income plus certain federal items of tax preference and adjustments. Beginning in 1994, taxpayers may use a net operating loss deduction (NOLD) in computing alternative minimum taxable income.[11]

S Corporations

General business corporations that file as S corporations for federal tax purposes may also elect S status for New York State franchise tax purposes. This election requires the shareholders to report their proportional share of S corporation income or loss and deductions on their personal income tax returns.

S corporations pay an entity-level tax under Article 9-A. For tax years beginning after 1995, S corporation tax on net income equals the difference between the taxes calculated at the applicable corporate rate and the 1994 top personal income tax rate, or, if larger, $325. In 1996, the difference in the two rates varies from 0.125 to 1.125 percent before consideration of the business tax surcharge. The $800 fixed minimum tax for inactive corporations and the metropolitan transportation business tax surcharge do not apply to S corporations.

For taxable year 1996, the State surcharge applies to the S corporation tax on net income, computed on the difference between the applicable corporate tax rate and the 1994 top personal income tax rate. S corporations qualifying as small business taxpayers pay no surcharge if their entire net income equals $200,000 or less.

Tax Credits

New York provides tax incentives in the form of tax credits. These incentives encourage business investment and economic development within the State. Major provisions include:

- An investment tax credit (ITC) of 5 percent of the first $350 million of investments, plus 4 percent for investments over that amount, for certain eligible property;

- A refundable ITC for certain new businesses;

- An ITC on research and development property at an optional rate of 9 percent;

- An employment incentive credit (EIC) available to employers who add jobs and are eligible for the ITC. A sliding scale links larger EIC amounts with increasing employment; and

- Various credits for certain activities conducted in economic development zones (EDZs).

Taxpayers may apply credits against tax computed on the apportioned entire net income base or the apportioned business and investment capital base. However, credits may not reduce a taxpayer's liability below the higher of the tax on the alternative minimum taxable income base, or the fixed dollar minimum tax.

*Article 28: Sales and Compensating Use Tax*

The State sales and compensating use tax applies primarily to sales of tangible personal property in New York State, not for subsequent resale. The sales tax also applies to a variety of services, notably, service to real or personal property, information services, intrastate telephone services and commercial energy. Generally, the tax base includes tangible personal property unless the law provides a specific exemption and does not include services unless the law specifically enumerates the service as taxable.

Concerning telephone service, intrastate telecommunications services fall within the purview of a taxable utility service. The tax applies to:

> "... every sale, other than sales for resale, of telephony and telegraphy and telephone and telegraph service of whatever nature except for interstate and international telephony and telegraphy and telephone and telegraph service and from every sale, other than sales for resale, of a telephone answering service."[12]

Sales tax regulation Section 527.2(d)(2), Sale of utility and similar services, indicates that the term "telephony and telegraphy" includes the use or operation of any apparatus for transmission of sound, sound reproduction or coded or other signals. The regulation explicitly includes dispatch services (used by taxis), one-way paging, message switching services transmitted to a computer, facsimile transmissions, and teletypewriters. The regulation excludes cable television, the initiation and distribution of music services, and incidental telephony and telegraphy that is only part of another service.

The regulation does not directly address services like cellular mobile services, the use of prepaid phone cards and other types of calling cards, electronic mail, voice-mail, telephone charges made by a hotel or motel, private network services, wide area toll services (800 numbers) and features such as call forwarding, call waiting, touch-tone and voice mail.[13]

Identification of intrastate wireline service is based on the call both originating and terminating in New York. With the advent of nationwide toll-free numbers, private networks, computer-related services, satellite based services and cellular mobile telecommunications, correctly separating interstate calls from intrastate has become difficult. In one case involving a private line service, the Tax Appeals Tribunal concluded that the "overall nature" of the service determined whether it represented intrastate or interstate service.[14] However, ascertaining a telephone service's overall nature can be subjective and has led to some seemingly inconsistent results.

New York's sales tax does not apply to cable television service or other forms of television programming.[15] Charges for incidental tangible personal property supplied to customers with cable service (e.g., remote control units and converter boxes) represent minor elements of the total charge for the cable television transmission and are also exempt. However, charges to a customer to install cable service or to service cable equipment are subject to tax.[16] Also, sales tax applies to the equipment that cable television companies purchase.

Tax Rates

The current statewide State tax rate equals 4 percent. Many cities, and most counties, impose an additional tax of 3 percent for a combined State and local rate of 7 percent. In addition, the majority of New York residents live in counties or cities that received legislative authorization to exceed the 3 percent rate. (Table 6 shows the combined State and local sales tax rates by community.) The State collects the local portion of the sales tax and distributes net collections to localities.

The State also imposes the Metropolitan Commuter Transportation District tax of 0.25 percent in 12 downstate counties. Receipts from this tax are earmarked for the Mass Transportation Operation Assistance Fund which supports public transportation. (Table 6 shows combined State and local sales tax rates in each county and in cities that impose sales and use taxes.)

## Table 6: New York State and Local Sales Tax Rates, by Community, as of September 1, 1996

| State | | | | | |
|---|---|---|---|---|---|
| The State sales tax rate is 4% in each county | | | | | |
| **Counties** | | | | | |
| The following shows the combined State and county sales tax rates currently in effect: | | | | | |
| County | Rate | County | Rate | County | Rate |
| Albany | 8.00% | Herkimer | 8.00% | Richmond (1) | 8.25% |
| Allegany | 8.00% | Jefferson | 7.00% | Rockland (1) | 7.25% |
| Bronx (1) | 8.25% | Kings (1) | 8.25% | St. Lawrence | 7.00% |
| Broome | 8.00% | Lewis | 7.00% | Saratoga | 7.00% |
| Cattaraugus | 8.00% | Livingston | 7.00% | Schenectady | 7.00% |
| Cayuga | 8.00% | Madison | 7.00% | Schoharie | 7.00% |
| Chautauqua | 7.00% | Monroe | 8.00% | Schuyler | 7.00% |
| Chemung | 7.00% | Montgomery | 7.00% | Seneca | 7.00% |
| Chenango | 7.00% | Nassau (1) | 8.50% | Steuben | 8.00% |
| Clinton | 7.00% | New York (1) | 8.25% | Suffolk (1) | 8.25% |
| Columbia | 8.00% | Niagara | 7.00% | Sullivan | 7.00% |
| Cortland | 8.00% | Oneida | 8.00% | Tioga | 7.50% |
| Delaware | 6.00% | Onondaga | 7.00% | Tompkins | 8.00% |
| Dutchess (1) | 7.25% | Ontario | 7.00% | Ulster | 7.75% |
| Erie | 8.00% | Orange (1) | 7.25% | Warren | 7.00% |
| Essex | 7.00% | Orleans | 8.00% | Washington | 7.00% |
| Franklin | 7.00% | Oswego (4) | 4.00% | Wayne | 7.00% |
| Fulton | 7.00% | Otsego | 7.00% | Westchester (1) | 6.75% |
| Genesee | 8.00% | Putnam (1) | 7.25% | Wyoming | 8.00% |
| Greene | 8.00% | Queens (1) | 8.25% | Yates | 7.00% |
| Hamilton | 7.00% | Rensselaer | 8.00% | | |
| **Cities (2)** | | | | | |
| The following shows the combined State, County and City sales tax rates currently in effect: | | | | | |
| City / County | Rate | City / County | Rate | City / County | Rate |
| Auburn/Cayuga | 8.00% | Ithaca / Tompkins | 8.00% | Oswego / Oswego | 7.00% |
| Batavia / Genesee | 8.00% | Johnstown / Fulton | 7.00% | Rome / Oneida | 8.25% |
| Canandaigua / Ontario | 7.00% | Mount Vernon / Westchester (1) | 8.25% | Salamanca / Cattaraugus | 8.00% |
| Corning / Steuben | 8.00% | New York City (1)(3) | 8.25% | Sherrill / Oneida | 8.00% |
| Fulton / Oswego | 7.00% | New Rochelle / Westchester (1) | 8.25% | Utica/Oneida | 8.00% |
| Geneva / Ontario | 7.00% | Norwich / Chenango | 7.00% | White Plains / Westchester (1) | 7.75% |
| Glens Falls / Warren | 7.00% | Ogdensburg / St. Lawrence | 7.00% | Yonkers / Westchester (1) | 8.25% |
| Gloversville / Fulton | 7.00% | Olean / Cattaraugus | 8.00% | | |
| Hornell / Steuben | 8.00% | Oneida / Madison | 7.00% | | |

Notes:
(1) Rate includes 0.25% additional tax for the Metropolitan Commuter Transportation District (MCTD).
(2) Total combined rates shown. These do not reflect the amount that the city actually retains.
(3) New York City includes the counties of Bronx, Kings, New York, Queens and Richmond.
(4) In April 1996, the Oswego County Legislature approved the introduction of a 3 percent county sales tax.
Source: NYS Department of Taxation and Finance, Office of Tax Policy Analysis.

An additional 5 percent State tax applies to information and entertainment services furnished by telephone (e.g., "900" numbers) and received exclusively aurally. The tax is in addition to the regular State and local sales tax on these services.

The applicable local tax rate on telecommunications generally equals the rate in the county, city or school district where the customer placed or received a call. Usually this coincides with the customer's telephone number and billing address. However, when a person has different telephones at a single location, and each phone has a telephone number associated with a different geographic area, the telephone number determines the local tax rate. Here, the physical location from where the caller made or received the calls does not matter.

Also, callers may charge calls to a different telephone number than that of the telephone from which they make the call (e.g., using a telephone calling card). In these cases, the applicable tax rate is based on the location of the phone equipment where the call originated.

Exemptions

To stimulate economic development, New York State and its localities exempt machinery and equipment used directly and predominantly in manufacturing property for sale. The State and most localities also exempt tools and equipment, parts, ingredients and supplies, fuels and utility services used in manufacturing property for sale.[17]

Similarly, the sales tax exempts "...telephone central office equipment or station apparatus or comparable telegraph equipment for use directly and predominantly in receiving at destination or initiating and switching telephone or telegraph communication..."[18] Only vendors of telephone services qualify for the exemption.

The State and New York City sales taxes also exempt installing, maintaining and repairing exempt equipment. However, these services are subject to local sales tax outside New York City. Nevertheless, if the installation qualifies as a capital improvement to real property, it is exempt from both State and local sales tax. The energy used to operate exempt telephone equipment is not exempt from tax.

*Article 29: Local Sales Taxes*

The State adopted Article 29, known as the Local Enabling Act, in 1965 when it enacted the State sales and use tax.[19] Under Article 29, a city or county can impose a general sales tax on the same goods and services as the State tax at a uniform rate.[20] It also allows a city or county which does not impose a general sales tax to selectively tax any of four categories of goods and services included in the general sales tax base.[21] These include:

- utility services (gas, electric, refrigeration and steam and telephone services);
- restaurant meals;
- hotel room occupancy; and,
- certain admission charges.

Currently, all counties that impose a sales tax and most cities that impose a sales tax levy the tax on the same goods and services as the State tax. However, five cities impose a selective sales tax. They are: Lockport, Newburgh, Niagara Falls, North Tonawanda, and Port Jervis.[22]

Article 29 also provides the authority for certain school districts to impose a tax on utility services. This tax is at a rate of up to 3 percent, exclusive of city and county tax rates. As a result, the tax imposed on these services may equal a combined rate of 6 percent, plus any special additional local rates. School districts that are coterminous with, or wholly or partly located within a city of less than 125,000 inhabitants, may impose consumer utility taxes *besides* a city or county tax. Currently, twenty city school districts impose these taxes.

*New York City Tax on Utility Services*

New York City imposes a separate excise tax on the final sales of utility services within the City of New York for the privilege of "... exercising its franchise or franchises, or of holding property, or of doing business in the city..."[23] The New York City tax formed the basis for the State's gross receipts tax under Section 186-a. Under the City tax, utilities pay 2.35 percent of all gross income, while vendors of utility services pay 2.35 percent of gross operating income from the sale of utility services. The tax applies only to receipts from sales rendered within the City.

*Local Gross Receipts Taxes*

Municipalities other than New York City may also impose selective gross receipts taxes on the sales of utility services within their jurisdictions. Cities, other than New York City, and villages may impose taxes of 1 percent on the gross income of utilities operating in the State pursuant to General City Law[24] and Village Law.[25]

Local utility taxes conform to the State Section 186-a tax as it existed on January 1, 1959. Currently, all 60 cities, other than New York City, and some 344 of 556 eligible villages impose this tax. The Legislature granted special authority to the cities of Rochester, Yonkers and Buffalo to impose the tax at a rate of 3 percent.

*Real Property Taxes*

An ad valorem tax applies to most real property in New York State. The real property tax comprises one of the major sources of local government and school district revenues. The New York State Office of Real Property Services (ORPS), formerly known as the State Board of Equalization and Assessment, assesses certain utility property known as “special franchise property.”

Special franchise property is located in public rights-of-way. The value of this property includes the intangible right to operate in the public rights of way. Local governments assess utility property located on privately owned land.[26] In many other states, a central state authority assesses all utility property. As a result, property in these states is often valued using either the “income,” “market” or “cost” approaches. They then apportion the total market value of the utility among local government taxing units. By contrast, central assessment applies only for special franchise property in New York. The locally assessed component is done on a piecemeal basis, where each piece of property is valued using a “cost” approach for the components.

Approximately 1,300 separate assessing units exist within the State. In 1993, the total assessed value of utility property in New York State, including locally assessed property, equaled approximately $50 billion. Some $13 billion of this total is located in New York City.

*Cable Television System Franchise Fees*

The U.S. Cable Communications Policy Act of 1984 confirmed that cable service came under federal jurisdiction. Federal law (47 USC Section 542) stipulates that municipalities may negotiate with cable businesses for their franchise rights. The maximum fee equals 5 percent of the revenues attributable to the franchise locality.[27] Federal law also limits the pole charges made by utilities.[28] Wireless cable company competitors, such as Direct Broadcast Satellite (DBS) providers, do not operate in public rights-of-way, and are, therefore, not subject to these franchise fees.

The Department of Public Service (DPS) now regulates cable providers at the State level. The State’s purview includes customer relations, franchising procedures and standards, technical standards, and accounting practices. State law limits the duration of local franchise agreements to ten years. The recent trend for renegotiated franchise rates is generally to increase the fee to its statutory maximum of 5 percent.

As of December 31, 1994, the former State Commission on Cable Television showed that 62 companies, serving 1,397 municipalities, provided service in New York. In total, 1,508 franchises existed because more than one company serves some communities. Four and one-half million households subscribed to cable television in New York at that time.

DPS estimates that the average cable franchise rate is currently 4.2 percent, and that gross revenues for 1995 were over $1.8 billion. Based on these figures, the franchise fees paid by cable operators probably exceed $75 million annually.

*Article 9: Corporation and Utility Tax*

The Railroad Era

New York State first adopted statewide taxes on utility corporations in 1880.[29] Adoption of these taxes, in part, reflected public discontent with the "... greed and tyranny of the railroad corporations..."[30] The new taxes included a tax on allocated capital stock and excess dividends (now known as the Section 183 franchise tax on transportation and transmission corporations and associations), levied on most corporations doing business in the State at that time. They also included a tax of 0.5 percent on the gross earnings of utility corporations (now known as the Section 184 additional franchise tax on transportation and transmission corporations and associations). The taxes only applied to earnings from business activity of a wholly intrastate nature. Specified corporations subject to tax included railroads, canals, steamboats, ferries, express companies, pipelines, and telegraph and telephone companies.[31]

Chapter 908 of 1896 created Article 9 of the Tax Law. It amended the purview of the utility tax to include electric, gas and steam utilities (the origin of the Section 186 franchise tax on water-works companies, gas companies, electric or steam heating, lighting and power companies).[32]

In 1917, New York State enacted the forerunner of the current franchise tax on corporate net income (Article 9-A).[33] However, the tax specifically excluded utility corporations along with many other businesses. These companies remained subject to tax on their gross earnings under Article 9.

Originally, Article 9-A applied only to "manufacturing and mercantile" companies. The tax rate equaled 3 percent on net income. Although the law imposed this new tax, the law also exempted these companies from local taxation of their personal property, machinery and equipment. To compensate, revenues from the tax were designated for New York's local governments.[34]

The adoption of this legislation solely for manufacturing and mercantile companies begs the question why these companies were subject to disparate (and reduced) taxation compared with other corporations subject to tax under Article 9. According to one analysis of the 1917 law:

> "It must be frankly admitted that it has been the policy of the American Commonwealths to favor the manufacturing industry, as compared with other forms of wealth. This policy has taken the form, not only of what is equivalent to a lower rate of taxation, but also, in many cases of an absolute exemption from taxation."[35]

This preference did not remain unchallenged. Within several years, litigation followed which challenged the constitutionality of the disparate benefit for manufacturers. As a result, the Legislature amended Article 9-A in 1919 to cover all general business corporations but those specifically exempt.[36] Exempt business corporations included realty companies, holding companies, public service and public utility corporations, banks, and insurance companies.[37]

According to a history of transportation taxes in New York State published in 1983, there were several possible reasons why New York utility corporations remained subject to tax under Article 9. These include:

- The inherent reliability of gross receipts taxes over net income taxes;

- The ease of administration, measurement and verification under a gross receipts tax regime; and

- The suitability of a gross receipts tax for highly-regulated corporations.[38]

The taxation of telecommunications providers on a gross, instead of net, income basis was also the standard form of taxation for these companies for much of the nation's history. As Walter Hellerstein notes:

"The historical rationale for many of these levies was that they constituted a quid pro quo for the special rights and privileges that the states granted to utilities, such as monopoly power within a defined service area, the power of eminent domain, and the right to use public rights-of-way."[39]

The Depression Era

The next significant change in New York's taxation of utility corporations occurred during the Depression era. First, the Legislature amended Sections 183 and 184 to apply to not only businesses formed specifically to provide transportation and transmission services, but also businesses "principally engaged" in those businesses.[40]

Next, to pay for the cost of unemployment relief, the State enacted the "temporary" Section 186-a additional tax on utilities; initially for just one year. The tax was based on a similar New York City law first adopted in 1933.[41]

Unlike the earlier gross earnings taxes (Sections 184 and 186), Section 186-a applied to both regulated utility corporations and other providers of utility services. It imposed tax only on final sales for ultimate consumption. Section 186-a attempted to tax the many submeterers of gas and electric service, and hotels providing telephone service, in New York City.[42]

The tax applied only to sales occurring within the State of New York. The tax rate equaled 2 percent on gross income, for utilities subject to the supervision of the Public Service Commission, or 2 percent of gross operating income for other providers. Like the original gross earnings tax, this tax applied only to receipts from business activity of a wholly intrastate nature.[43]

Chapter 321 of 1937 also granted New York's cities temporary authority to impose a similar 1 percent tax on the gross income and gross operating income, respectively, of utilities and their nonutility competitors. Section 20-b of the General City Law contains the authority to adopt a local tax.[44]

Like Section 186-a, the authority to adopt a local law expired after a period of only one year. Again, the stated reason for imposition of this tax was to fund unemployment relief. Section 186-a provided the basis for this local tax. It applied only to receipts derived from transactions consummated within the territorial limits of the cities.[45] The State subsequently extended Section 186-a and Section 20-b taxes for several years.

In 1941, the Legislature clarified Section 186-a vis-a-vis the taxation of the nonregulated competitors of traditional public utility corporations. The declaration of legislative intent made it clear that, despite several Court of Appeals decisions to the contrary,[46] the Legislature always intended submeterers of utility services to be subject to tax under Section 186-a on final sales to consumers.[47] To remedy the situation, the State renamed the tax an "emergency tax on the furnishing of utility services," instead of a tax on utilities. The tax applied to all persons selling utility service, not just those engaged in the business of selling the services. It also redefined "utilities" subject to tax to include sellers "...regardless of whether such activities are the main business of such person or is only incidental thereto, or of whether use is made of the public streets..."[48] The next significant change to the Section 186-a occurred in 1947. Chapter 89 of that year made the tax permanent.

<u>Taxation of Interstate/International Service</u>

Article 9 remained relatively unchanged until the early 1980's. In 1981 and 1983, respectively, the State amended the Section 184 gross earnings tax, and the Section 186-a gross receipts tax, to include an apportioned share of interstate receipts under the taxes.[49] Several court decisions that broadened the ability of the states to tax interstate commerce made the change to the tax base possible.[50] Neither piece of legislation explicitly stated the apportionment method. A Technical Services Bureau Memorandum initially instructed taxpayers to assign taxable earnings to New York based on the proportion of total property in New York.

The 1981 legislation provided that companies should allocate gross earnings to New York in the manner prescribed by the rules and regulations promulgated by the Department. However, the Department did not adopt regulations until 1987. The 1987 Section 184 regulations required that taxpayers engaged in interstate or international business that employed a uniform system of accounts, as prescribed for federal or State regulatory purposes, allocate their receipts from telecommunications services to New York through separate accounting.[51]

Taxpayers not using separate accounting were to use a combination of the proportion of property in New York and circuit miles. It phased in property as the only factor in the computation of the allocation percentage over several years as follows:

| Taxable Year | Allocation Formula |
|---|---|
| 1986 | 65% Property Factor + 35% Revenue-producing circuit miles factor[52] |
| 1987 | 72.5% Property Factor + 27.5% Revenue-producing circuit miles factor |
| 1988 | 82.5% Property Factor + 17.5% Revenue-producing circuit miles factor |
| 1989 | 92.5% Property Factor + 7.5% Revenue-producing circuit miles factor |
| 1990 | 100% Property Factor |

Property used in the computation of the apportionment formula for interstate and international receipts included the taxpayer's real property, tangible personal property, and intangible assets within New York used in connection with interstate and/or foreign transmission services. Dividing the average value of property within New York State by the average value of property everywhere yielded the percentage of property attributable to New York. The calculation included both owned and rented property.[53] Most telecommunications taxpayers traditionally used the property allocation factor, rather than separate accounting, to assign income to New York.[54]

Taxpayers also allocated nontelecommunications receipts to New York. For example, taxpayers assigned rental income to New York if they rented real or tangible personal property in New York. They also allocated income from interest and dividends to New York if they held the investment, managed, or controlled it in New York.

Section 186-a did not specifically refer to the regulations in computing the allocation percentage to calculate Section 186-a tax liability. The Department relied on the Section 184 regulations to allocate receipts from telecommunications services under Section 186-a. Taxpayers subject to the supervision of the Public Service Commission also paid tax on their nontelecommunications receipts. They allocated receipts to New York in the same way as they did under Section 184.

The Department also relied on the regulations for Section 184 in instructing taxpayers how to compute the portion of their tax attributable to its business activities carried on within the Metropolitan Commuter Transportation District. That is, the Department required the use of a property factor. The numerator of the property factor equals the average value of property in the Metropolitan Commuter Transportation District and the denominator equals the average value of property in New York.

<u>Legislation from 1985 to 1993</u>

The tax rate on gross earnings under Section 184 remained at 0.75 percent since 1971[55], except a five-year period between January 1, 1985 and December 31, 1989 when the State reduced the tax rate to 0.30 percent for telephone companies only.[56] Legislation enacted in 1986 provided for an economic development zone credit, starting July 30, 1986. However, this credit expired at the end of 1993.[57]

Recent legislative activities dealt with the treatment of access charges under the Section 186-a excise tax. In 1989, legislation addressed the tax treatment of the resale of carrier access services and other telephone and telegraph services.[58] The amendment codified policy that existed before 1989. This policy allowed a local exchange carrier to exclude from its tax base receipts from the sale of access services within New York to an interexchange carrier. It also required interexchange carriers to pay taxes on the sale of carrier access services.[59]

In addition, the 1989 legislation required local exchange carriers to pay tax on receipts from the sale of resold services other than access services. To alleviate double-taxation, while at the same time generating tax revenue, the amendment allowed interexchange carriers a deduction for resold services that they purchased in New York.[60]

Budget legislation enacted in 1990 conformed the treatment under Section 186-a of access charges to the treatment of other resold services by shifting the income exclusion for the local exchange carriers to a deduction for the interexchange carriers. From July 1, 1990, local exchange carriers could no longer exclude receipts from the sale of access services to an interexchange carrier. Instead, the law granted a deduction to interexchange carriers for New York access charges paid to local exchange carriers.

The 1990 amendment required interexchange carriers to deduct access charges purchased in New York before apportionment of gross receipts to New York. Because most interexchange carriers had a lower percentage of their total property in New York than local exchange carriers, the shift in the access charge deduction to the interexchange carriers resulted in increased revenues to the State.

Table 7 shows the computation of tax liability for providers of telecommunications services under the law prior to enactment of Chapter 2 of

1995 that created the new Section 186-e. Under this structure, companies deducted New York access from worldwide interstate and international receipts. They multiplied the difference by the apportionment percent based on the proportion of New York property to total property. The product equaled the New York tax base.[61] A tax rate of 3.5 percent applied to this base. The total tax due also included the Metropolitan Commuter Transportation District surcharge, if applicable, and the temporary business tax surcharge.

Table 7: Computation of Section 186-a Tax Liability Under Old Law

| | |
|---|---|
| | Interstate and International Receipts (a) |
| - | NYS Access Charges and Other Resold Services |
| = | Net Interstate and International Receipts (b) |
| x | NYS Apportionment Percentage |
| = | NYS Section 186-a Tax Base |
| x | Tax Rate (3.5%) |
| = | NYS Tax Due (Before Surcharge) |
| + | Tax Surcharges |
| = | Total Taxes Due |

(a) The tax base for intrastate receipts is calculated separately since 100 percent of these receipts are attributable to New York.
(b) Based on the ratio of New York property to total worldwide property.

Later in this report, the discussion of the most recent changes to Article 9 continues, including a description of the AT&T litigation and the subsequent reforms of telecommunications taxes in 1995.

*Article 28: Sales and Compensating Use Tax*

Apart from a short-lived emergency tax on retail sales in 1933-34, New York had no general State sales tax until 1965. Since 1965, Article 28 of the Tax Law has imposed State sales and use taxes, and provided authority for similar taxes in New York State's counties and cities.

Prior to the State sales tax, New York City and 12 upstate municipalities imposed their own sales taxes. The State modeled its tax on these existing sales taxes, particularly that of New York City. New York City introduced its sales tax in 1934.[62] Like other sales taxes developed in the 1930's, New York City's tax was primarily a tax on tangible personal property. However, the list of taxable items did include some services including repair services, information services and certain utility services.

The State sales tax took effect on August 1, 1965 at a rate of 2 percent. The State subsequently increased the rate to 3 percent in 1969 and 4 percent in 1971. The State rate has remained unchanged since then.

Article 28 traditionally exempted cable television services from the sales tax. An Appellate Division decision in 1976, in the *New York Cable Television*

*Association* decision, confirmed this interpretation. This decision also found cable television not to be a telephone or telegraph service but, instead, television entertainment.

The Telephone Equipment Exemption

A 1989 State Supreme Court case, *Eastman Kodak v. Department of Taxation and Finance*, addressed the general application of the central office equipment exemption. The Court stated that the term "telephone central office equipment," as used by the Public Service Commission in 1965, only referred to equipment owned by vendors of telephone service and conveyed "a public services connotation." Because of that conclusion, and because the Legislature placed the exemption within the production exemption, these factors limit the exemption to equipment used by vendors of telephone services.

*Local Gross Receipts Taxes*

As previously noted, Chapter 321 of 1937 granted cities in New York the authority to impose a "temporary" 1 percent tax to fund unemployment relief. Chapter 591 of 1950 extended similar authority to villages. This amendment was one recommendation of the State Comptroller's Committee on Local Non-Property Taxes. Like the tax for cities, this tax was based on the State Section 186-a tax and applied only to receipts derived from transactions consummated within the territorial limits of the village.

*Cable Television System Franchise Fees*

Throughout the 1950's and 1960's, cable television service provided rural customers a means to enhance poor reception of nearby broadcast television. These Community Antenna Television (CATV) businesses required usage permits from localities. These permits represent the origin of local franchising. CATV businesses also negotiated with electric and telephone utilities for pole charges.

As cable service expanded into suburban and urban communities, local governments and utilities began to increase their fees. By 1966, the Federal Communications Commission imposed its federal jurisdiction to the industry on the grounds of interstate commerce considerations.

The U.S. Cable Communications Policy Act of 1984 confirmed that cable service came under federal jurisdiction. Federal law (47 USC Section 542) stipulates that municipalities may negotiate with cable businesses for their franchise rights. In New York State, the regulatory functions fell to the nowdefunct New York State Commission on Cable Television.  This organization has since merged in the Department of Public Service.

## Current Litigation and Responses

This section of the study briefly describes some of the more recent events in the evolution of telecommunications taxation in New York State.  This includes recent court decisions and a description of the 1995 Tax Law amendments.

### Litigation

One major problem associated with taxing corporations under different tax articles is that unless the distinctions in the law are absolutely clear, there exists a high potential for disagreement.  The definitions and tax regime that comprise Article 9 began decades ago during a time that allowed for clean definitions of a "utility."  Today, the lines of demarcation between a telephone utility and other telecommunications and transmission companies are much less certain.

This uncertainty creates greater chances for disagreement and for adversarial litigation between the Department and taxpayers.  This part of the report briefly describes some recent court cases challenging the Department's interpretation of who is subject to Article 9 and on how taxpayers should compute tax.

*Article 9 v. Article 9-A, Taxability of Cable Television*

Before 1988, the Department's policy interpreted "transmission companies," subject to tax under Article 9, to include cable television providers.  A 1988 Tax Appeals Tribunal decision, *Matter of Capital Cablevision Systems*, overruled this policy.  The Department may not seek Court review of adverse Tax Appeals Tribunal decisions.  The decision held that these companies were not engaged in the conduct of a transportation or transmission business. Rather, they provided television entertainment and were, therefore, not subject to the Article 9, Section 183 and 184 taxes.  Instead, cable companies would pay a corporate franchise tax under Article 9-A.

Since *Capital Cablevision*, most cable television providers currently file tax returns as general business corporations under Article 9-A, although there exist small numbers of sole proprietorships, limited liability companies and limited liability partnerships.  In a 1993 case, *Matter of New Channels Corporation*, the Tax Appeals Tribunal allowed Article 9 treatment for this cable television provider for periods before 1988.

After *Capital Cablevision*, the Department determined that they should treat New Channels as a general business corporation for retrospective periods. However, the company preferred that the Department treat them as a transmission company under Article 9 for these prior periods.  The Tribunal accepted the New Channels argument that the State should tax the company as a transmission company under Article 9 for the retrospective periods.

*GTE Spacenet Corp., et al v New York State Department of Taxation and Finance (the "Wires" case)*

<u>Background</u>

GTE Spacenet, successor-in-interest to American Satellite company, is a satellite transmission company that transmits and receives telecommunications at a New York facility. Spacenet customers connect to their New York facility by means of wires within the New York Telephone Company (now NYNEX) system.

The Spacenet New York facility uses either microwave relays or fiber optic cables to communicate with an earth station in New Jersey. That station then transmits the messages to a satellite that, in turn, relays the message to a receiving earth station. Because it does not provide intrastate communications, Spacenet is not subject to the supervision of the New York Public Service Commission (PSC). The FCC regulates the company as a "wireless" carrier.

GTE Spacenet sued in New York County Supreme Court claiming, first, that the company did not meet the definition of a "utility" then subject to tax under Section 186-a -- i.e., the company did not deliver its service through, or furnish its service by means of, wires. They based their claim on the contention that the company provided only a wireless service. GTE Spacenet gave several reasons including: the FCC regulated the company as a "wireless" carrier; the fiber-optic cables used to communicate with the earth station are not "wires"; and that they do not own or control the "wires" in the publicly switched NYNEX network by which their customers connect to the Spacenet facility in New York.

In contrast, the Department claimed that, for the purposes of Section 186-a, Public Service Law and Tax Law should be read together. The Department argued that the intention was that the tax would apply to utilities regulated by the PSC and other companies that directly compete with them. Further, the Department argued that the statutory term "wires" encompasses fiber optic cables, and that the presence of any wires within the transmission path, whether or not the communications provider owned the wires, should result in the service being subject to the tax.

<u>Supreme Court</u>

In September 1994, the New York County Supreme Court granted a motion for summary judgement holding that GTE Spacenet was not subject to tax under Section 186-a. The judge ruled that the tax did not apply to providers of wireless telecommunications, because the statute requires that the delivery of the service be by means of wires. Furthermore, GTE Spacenet did not own the NYNEX wires used to connect to the Spacenet facility. The Court also determined that fiber optic cables do not qualify as wires for the purposes of the tax.

Appellate Division

The Department subsequently appealed this decision to the Supreme Court, Appellate Division, First Department. The Appellate Division rendered its decision on January 23, 1996. In a two-paragraph opinion, the Court affirmed the order that granted the plaintiff's motion for summary judgement and declared that GTE Spacenet was not subject to tax under Section 186-a. The State has since filed a motion for leave to appeal to the Court of Appeals.

In its decision, the Appellate Court agreed that GTE Spacenet was not a "utility" for purposes of the tax. Relying on the plain language of the statute, the court reasoned to be considered a "utility" the company must provide service by or through "wires." The court noted the Federal Communications Commission (FCC) classified the company as a provider of service by "radio" rather than "wire." The Court also noted that although the transmissions used some wires, the telephone company (e.g., NYNEX) owned the wires rather than GTE Spacenet.

The Court discounted application of the Department's claim that the Legislature intended to subject to tax all companies in competition with regulated utilities. The court noted that the plaintiff's technology did not exist at the time of enactment. It noted that the Tax Law "...must be read and given effect as it is written by the Legislature..."

*GTE Spacenet Corp., et al v New York State Department of Taxation and Finance (the "Partnership" case)*

On February 15, 1996, the Appellate Division, First Department affirmed a judgement and order of Supreme Court, New York County. The Court held that the two corporate general partners of a partnership operating the satellite telecommunications company are merely passive investors. They were not engaged in the conduct of any of the businesses enumerated in Article 9, Sections 183 and 184. The State has filed a motion for leave to appeal to the Court of Appeals.

*Matter of Sprint International Communications Corporation*

On July 27, 1995, the Tax Appeals Tribunal ruled that a taxpayer, *Sprint International Communications Corporation*, engaged in the business of providing packet-switching services to customers, was not a telegraph business. The business was not principally engaged in transmission services because it did not provide the transmission lines itself (it leased lines). Therefore, the company was not subject to tax under Sections 183 and 184 of Article 9. As previously noted, the Department may not seek Court review of adverse Tax Appeals Tribunal decisions.

Sprint transmitted data using regular telephone lines and packet-switching technology. The company leased telephone lines from an interexchange carrier (IXC). The company used packet switching technology before transmission to send the data in a more efficient and accurate manner. They remodified data into its original form when it reached the receiver of the data. The Tribunal accepted the proposition that the data conversions occurring both before and after transmission were a separate activity distinguishable from the actual transmission of the converted data.

*AT&T v. New York State Department of Taxation and Finance*

In December 1991, AT&T challenged the constitutionality of the 1990 amendment to Section 186-a regarding access fees in State Supreme Court. They argued that it discriminated against interstate and foreign commerce.[63] As previously discussed, the 1990 budget legislation required interexchange carriers to deduct access charges purchased in New York prior to apportionment of gross income to New York. Because most interexchange carriers had a lower percentage of their total property in New York than local exchange carriers, shifting the carrier access income exclusion for local exchange carriers to a deduction for interexchange carriers resulted in increased revenues to the State.

In 1992, the State Supreme Court upheld the constitutionality of the statute. AT&T appealed the decision, and on June 15, 1993 the Appellate Division overturned the State Supreme Court decision. The Appellate Division found that the statute allowed a higher deduction of New York access fees for companies doing a greater proportion of business in New York.

According to the Appellate Division, discrimination against interstate and foreign commerce occurred because:

> "Section 186-a permits long distance carriers to deduct only access fees paid to *New York* local exchange carriers. Thus, the deduction is already apportioned to New York by virtue of the fact that a long distance carrier is only permitted to deduct access fees paid to New York local exchange carriers. However, Section 186-a(2-a) further reduces the long distance

carriers' deduction by the extent to which it does business outside of New York (*emphasis added).*"[64]

The Appellate Division declared the statute[65] unconstitutional, and ordered a refund for AT&T. To calculate the refund, the Appellate Division selected the method suggested by AT&T (discussed below).

The Appellate Division's remedy (Court's remedy) allowed AT&T to deduct New York access fees *after* the apportionment of total receipts (Table 8 illustrates how to compute tax liability under the Court's remedy). As mentioned previously, the law before the Appellate Division's decision required taxpayers to deduct access fees purchased in New York *before* apportionment.

Table 8: Computation of Telephone Company Tax Liability Under Court's Method

| | |
|---|---|
| | Interstate and International Receipts (a) |
| x | NYS Apportionment Percentage (b) |
| = | NYS Interstate and International Receipts |
| - | NYS Access Charges & Other Resold Services |
| = | NYS Section 186-a Tax Base |
| x | Tax Rate (3.5%) |
| = | NYS Tax Due (Before Surcharge) |
| + | Tax Surcharge (15% of Tax Due) |
| = | Total Taxes Due |

(a) The tax base for intrastate receipts is calculated separately since 100 percent of these receipts are attributable to New York.
(b) Based on the ratio of New York property to total worldwide property.

Although the Court's remedy resulted in constitutionally sound law, it used both apportionment (i.e., to calculate New York receipts) and separate accounting (i.e., to calculate the access charge deduction) in computing the tax base. Because the Court allowed two different accounting rules, the computation could have resulted in a negative tax liability (i.e., a subsidy) for the taxpayer. The decision resulted in applications for refunds from other long distance telecommunication providers.

Section 186-a also provided a deduction for other resold services, such as resold long distance or toll services. The deduction for other resold services was identical to that for access charges under New York's statute. Therefore, companies could also have sought requests for refunds for resold services other than access charges.

New York State appealed the Appellate Division's decision to the Court of Appeals. The State argued that the provision in question was indeed constitutional. The State further argued that if the Court of Appeals found the provision unconstitutional, then the Appellate Division's remedy was incorrect. The decision was at odds with the Legislature's intent to increase State tax revenues. The State argued that if the Appellate Division decision was correct, then the appropriate remedy was to eliminate the unconstitutional deduction. On June 16, 1994, the Court of Appeals affirmed the Appellate Division's decision and on September 1, 1994, it denied the State's motion for rehearing.

In 1993, the State began settlement negotiations with the four major interexchange carriers, AT&T, MCI, Sprint, and Frontier Communications International, Inc. (formerly RCI Long Distance). The combined refund potential for these companies was approximately $100 million for the period July 1, 1990 through December 31, 1993.

On December 30, 1994, the Department and the four major interexchange carriers signed a closing agreement. The companies agreed to forgo 50 percent of their refund claim if the State passed corrective legislation, as outlined in the agreement, during the 1995 legislative session.[66]

Both the companies and the Department believed that the method of assigning the income of telecommunications companies to New York then in use, based on the property factor, was antiquated. It did not accurately measure the business activities of telecommunications companies operating in New York. Therefore, the parties to the negotiation attempted to structure an improved tax system; one that would result in the same aggregate tax liability for the major interexchange companies as would occur under the Court's remedy.

## 1995 Telecommunications Legislation

Chapter 2 of the Laws of 1995, the 1995-96 State budget legislation, included reforms of the corporate taxation of telecommunications services in New York State. The State enacted this piece of legislation as part of a settlement of the AT&T litigation. The corrective legislation contained the following provisions:

*Section 184 Elimination for Long Distance Companies*

The legislation provided that the Section 184 additional franchise tax on transportation and transmission corporations and associations would apply only to companies principally engaged in a local telephone business. Therefore, Section 184 excluded companies principally engaged in long distance services from the tax of 0.75 percent on gross earnings. This provision applies to taxable years beginning on or after January 1, 1995.

In addition, the new law contained two exclusions to equalize the tax treatment of telecommunications services provided by both local carriers (which remain subject to the Section 184 tax), and long distance carriers. Section 184 excludes receipts from sales for ultimate consumption from (1) interLATA[67], interstate, or international services (effective on January 1, 1995), and (2) 30 percent of intraLATA toll services, including interregion regional calling plan services (effective on January 1, 1996).

*New Section 186-e Excise Tax on Telecommunications Services*

The law shifted the Section 186-a 3.5 percent excise tax on receipts from telecommunications services to a new Section 186-e. However, providers subject to the supervision of the Public Service Commission (the so-called "class 1" utilities) would still owe tax under Section 186-a on their nontelecommunications receipts.

The legislation clarified the definition of telecommunications services. Telecommunications services include services provided using any means, such as wire, satellites, fiber-optic, laser, microwave or radiowave. This moves away from the antiquated notion that telecommunications only occurs over copper wires.

The law also provides a more modern approach for taxing interstate and international telecommunications receipts. The following provisions apply to taxable years beginning on or after January 1, 1995:

- The law eliminated the property factor apportionment of interstate receipts subject to the excise tax, and replaced it with the *Goldberg* method discussed earlier in this report.

- The law changed the "sale for resale" deduction to the ultimate seller (retailer) for services purchased in New York. Now under Section 186-e, an exclusion to the initial seller (wholesaler) exists in cases where the ultimate seller is either an interexchange carrier or a local carrier. Telecommunications providers do not receive a sale for resale exclusion for a sale to other than an interexchange carrier or a local carrier. However, the law allows a credit to purchasers that subsequently resell these services.

- The law eliminated the old Section 186-a provision that prohibited providers from separately stating the tax on customer bills.

The legislation also included several other provisions that retain exemptions for certain companies, or excluded their receipts, from the purview of Article 9. These included corporations principally engaged in providing telecommunications services between aircraft and dispatchers, air traffic control, or ground stations, and a specific exclusion for cable television service.

## Telecommunications Taxes in Other States

The taxation of telecommunications providers throughout the fifty states has changed greatly since divestiture of the Bell System in 1984. As significant industry competition began to emerge in various industry sectors, many states altered existing tax systems first adopted when monopolistic companies with exclusive franchises and guaranteed rates-of-return dominated the industry. This section of the study examines how other states tax telecommunications providers.

Telecommunications providers pay various taxes throughout the fifty states. These typically include taxes on corporate income, gross receipts, retail sales, and real property. States generally impose corporate income, gross receipts and sales taxes. Local governments may have the option of imposing additional tax rates. In contrast, real property taxes are usually local in nature. However, states often perform a central assessment function for localities.[68]

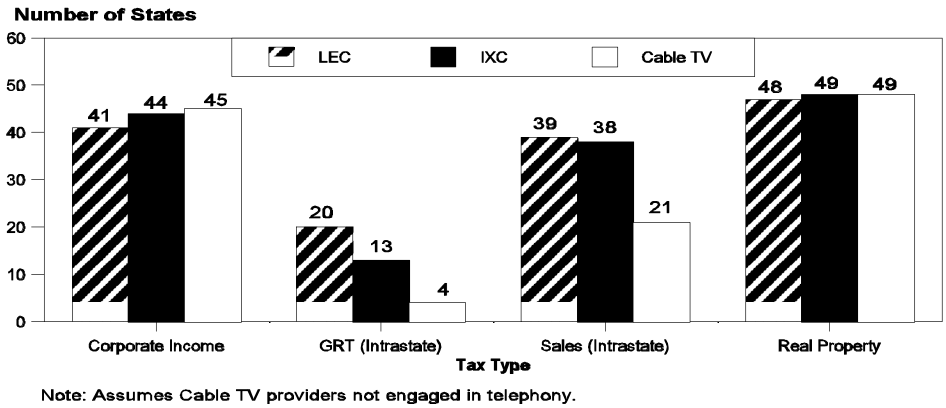
Table 9 summarizes how each of the fifty states, including New York, treat LECs, IXCs and cable television companies for purposes of corporate tax, sales tax, and real property tax. Chart 1 graphically shows the frequency of types of taxes by the number of states. Most states impose a real property tax. The vast majority of states use a corporate tax based on net income. Gross receipts taxes represent the least frequent type of tax used by states. Most states also impose some form of sales tax.

### Corporate Income Taxes Imposed on Telecommunications Providers

Most states impose some form of income tax on telecommunications providers.[69] However, a number of exceptions exist. In addition to Nevada, South Dakota, Texas,[70] Washington and Wyoming, which do not impose a corporate income tax, Maryland and New Jersey exempt LECs from their net income tax. LECs and IXCs paying New York's Article 9 franchise taxes do not pay Article 9-A corporate franchise taxes on net income. LECs and IXCs subject to Ohio's gross receipts tax do not pay a corporate tax on net income. LECs, IXCs, and cable television companies subject to Rhode Island's gross receipts tax do not pay the state's tax on net income.

Table 9 begins on this page and continues through page 53.  See document labeled “teltbles.wpd.”

Chart 1: State Taxation of Selected Telecommunications Providers




As Table 9 shows, forty-one states impose corporate income taxes on LECs. Forty-four levy a corporate income tax on interexchange carriers and forty-five impose this type of tax on cable television companies.

*The Multistate Tax Compact*

The Multistate Tax Commission (MTC) recommended uniform principles governing state transactional taxation of basic telecommunication services.[71] The proposal imposes the tax on each purchase or sale of the provision of telecommunications. It also provides that the provision of telecommunication becomes subject to tax if it originated or terminated with the taxing State and the purchase or sale of the telecommunication was attributable to a service address in the taxing state. The MTC's proposal excludes certain items from the tax base, such as equipment charges when separately identified and taxes, including the federal telecommunications excise tax.

Over thirty states belong to the MTC. The MTC has not surveyed any of its member states to determine support for its proposal. At this time, it remains unclear which states will adopt the proposed telecommunications taxation principles in whole or in part. California, Florida, and Illinois have adopted substantially all of the MTC regulations. The remaining states in this analysis, Connecticut, Massachusetts, New Jersey, Ohio, Pennsylvania, Vermont, Michigan and Texas have not adopted the MTC regulations, although New Jersey, Pennsylvania and Vermont have some similar regulations.

*The Uniform Division of Income for Tax Purposes Act*

The Uniform Division of Income for Tax Purposes Act (UDITPA) provides a model apportionment formula for interstate income for states levying taxes on, or measured by, net income. The model specifies a method for the division and assignment of income of a corporation doing business within and without a state to each separate state for income tax purposes. UDITPA has not issued any proposed provisions on the apportionment of income by telecommunications companies.

States in the analysis that have adopted UDITPA or have enacted statutory provisions that substantially duplicate it include: California, Florida, Illinois, Massachusetts, and Pennsylvania. Connecticut, Michigan, New Jersey, Ohio, Texas, and Vermont have some similar provisions.

*Neighbor States*

The following paragraphs describe the features of telecommunications taxes imposed by New York's neighbor states.

**Connecticut**

Telecommunications companies pay a corporate franchise tax. For taxable years beginning in 1996, Connecticut's corporate franchise tax rate equals 10.75 percent of net income.[72] Telecommunications companies taxable in states other than Connecticut apportion net income to Connecticut based on the sum of a property factor, a payroll factor, and a double-weighted receipts factor.[73] Connecticut treats other corporations, such as manufacturers, the same as telecommunications companies.

The receipts factor for telecommunications companies depends on the origination of the call. A taxpayer attributes a receipt to Connecticut if the call originates in the state. Connecticut includes satellite property in the denominator of the property factor, but not the numerator. Connecticut does not allow any special depreciation rules for telecommunications companies. Beginning on or after January 1, 1997, Connecticut allows telecommunications companies and other corporations a tax credit for personal property taxes paid on electronic data processing equipment.

**Massachusetts**

Massachusetts imposes a utility franchise tax on every incorporated telephone and telegraph company. Telecommunications companies conducting business within and without the Commonwealth pay a tax of 6.5 percent of net allocable income. The allocation formula represents a single weighted formula consisting of property, payroll and sales. Massachusetts treats other corporations differently than telecommunications companies.

Massachusetts does not have any specific telecommunications rules for allocation under the sales factor. Generally, all corporate taxpayers determine the sales factor by the cost of providing the service in Massachusetts. For example, if the taxpayer performs the service in Massachusetts, the sale becomes attributable to Massachusetts. Taxpayers include satellite property in the denominator of the formula, but not the numerator. Massachusetts' corporate excise tax credits apply to eligible telecommunications companies.

**New Jersey**

New Jersey assesses a franchise and gross receipts tax on local exchange telephone companies.[74] This tax is separate and distinct from the corporate business tax on regular corporations. New Jersey provides a ride share credit specifically for telecommunication providers under the franchise and gross receipts tax.

Companies providing interLATA telecommunication services do not pay tax under the franchise and gross receipts tax. These companies pay tax under the corporate business tax measured by net income. The current rate equals 9 percent. Beginning July 1, 1996, telecommunications companies and other corporations may apportion net income to New Jersey by multiplying entire net worth and entire net income by a formula based on property, payroll and double-weighted sales. Telecommunications companies determine the sales factor according to the origination of the call, regardless of where billed. Cable television companies pay tax at the local level.

**Pennsylvania**

Telecommunications companies pay a corporate excise tax measured by net income. The current tax rate equals 9.99 percent. Telecommunications companies allocate income using a property factor, a payroll factor, and a double-weighted sales factor. Other corporations, such as manufacturers, allocate income in the same manner.

The sales factor for telecommunications companies depends on the billable address of the customer in Pennsylvania. For example, taxpayers include in the sales factor services billed to a Pennsylvania customer. The taxpayer would not include services billed to a customer outside Pennsylvania. Pennsylvania does not allow any special credits for telecommunications companies.

**Vermont**

Telecommunications companies pay a telephone personal property tax or may opt to pay a gross earnings tax.  If paying on a gross earnings basis, the company also becomes subject to the corporate income tax.  These taxpayers apportion net income to Vermont using the average of a property factor, a payroll factor, and a sales factor.[75]  Other corporations, including manufacturers, use the same apportionment formula.  The sales factor for telecommunications companies depends on the billing address of the customer.  Vermont does not allow any special credits for telecommunications companies.

*Other Major States*

The following paragraphs describe the taxation of telecommunications companies in other major states.

**California**

Telephone companies and cable television companies pay a corporate franchise tax on net income.[76]  The current tax rate equals 9.3 percent. Taxpayers apportion net income to California by multiplying net income by a fraction where the numerator consists of the sum of a property factor, a payroll factor and a double-weighted sales factor.[77]  California treats other corporations in the same manner.

Telephone companies providing interstate or international services determine the sales factor according to California net plant facilities used in the call compared with total plant facilities.  The property factor includes satellite property in both the denominator and numerator.[78]  If the satellite system connects directly or indirectly to facilities located in California, then the taxpayer includes satellites in the numerator based on the ratio of the value of property in California (excluding satellites) to the value of total property everywhere (excluding satellites.)  This represents the value of the taxpayer's interest in the satellite in relation to its connection with land-based facilities. California does not allow any special credits for telecommunications companies.

**Florida**

Telecommunications companies pay a corporate franchise tax measured by net income.  The current tax rate equals 5.5 percent.  Taxpayers with operations in other states apportion taxable income to Florida using a weighted three-factor formula where property and payroll equal 25 percent each, and sales equal 50 percent.[79]  Florida treats other corporations, such as manufacturers, the same as telecommunications companies.

A telephone company attributes a sale to Florida for purposes of computing the sales factor if the call originates or terminates in Florida, and the company charges the service to a Florida customer. For purposes of computing the numerator of the property factor for satellite property, the taxpayer determines the percentage of earth stations serviced in Florida. The denominator equals the total number of earth stations serviced by the company. Florida does not allow any special credits for telecommunications companies.

**Illinois**

Telecommunications companies and cable television companies in Illinois pay tax under the corporate income tax and a personal property replacement tax. The tax rates equal 4.8 percent and 2.5 percent, respectively. Taxpayers allocate income using a three-factor allocation formula. The formula consists of a property factor, a payroll factor, and a double-weighted sales factor. Illinois does not provide any special credits for telephone or cable television companies.

**Michigan**

Telecommunications companies pay Michigan's Single Business Tax (SBT) based on a three-factor formula of property, payroll and double-weighted sales. The current tax rate equals 2.3 percent. Michigan generally treats other corporations the same as telecommunications companies.[80] A receipt becomes attributable to Michigan if the customer has a Michigan billing address. Michigan does not include satellite property in the numerator or the denominator of the property factor.

**Ohio**

Telecommunications companies providing local services pay a gross receipts tax in lieu of the corporate franchise tax. The rate equals 4.75 percent. Cable television companies and companies providing long distance telephone services pay under the corporate franchise tax. These companies apportion income to Ohio using a three-factor formula consisting of payroll, property and double-weighted sales. The current rate equals 8.9 percent. Ohio taxes other corporations, such as manufacturers, under the corporate franchise tax.

For long distance telephone companies, a sale becomes attributable to Ohio if the telephone call originates and terminates within the State. Satellite property becomes taxable if it has a situs in Ohio. Situs depends on varying circumstances of each company. In certain cases, taxpayers may apportion the satellite property to Ohio based on a fixed property ratio. In other cases, it may depend on a rent expense ratio. Ohio does not provide any special credits for telecommunications companies.

**Texas**

Telecommunications companies pay the corporate franchise tax and apportion income using a single sales factor. Texas bases its corporate franchise tax on net taxable capital and earned surplus. The rate equals 0.25 percent of net taxable capital plus 4.5 percent of net taxable earned surplus. Texas treats other corporations in the same manner. The sales factor for telephone companies depends on the origination and termination of the telephone call. If the telephone call is *wholly* within Texas, it is considered a Texas sale. Otherwise, it is not attributable to Texas.

## Gross Receipts Taxes

Gross receipts taxes can vary greatly depending largely on the selected tax base, deductions and tax exemptions. These taxes resemble sales taxes, but the major difference is that gross receipts taxes are business taxes. They apply to the telecommunications provider, not the service. However, receipts from specific service may be exempt from a particular tax.

One way in which states have altered their tax systems in recent years is to eliminate gross receipts taxes on telecommunications providers. As recently as 1986, a total of 30 states imposed gross receipts taxes on telecommunications providers.[81] Table 9 demonstrated that approximately 20 states still impose these taxes in one form or another.[82]

Chart 2 shows that most state gross receipts taxes apply only to providers of intrastate services. Twenty states impose a gross receipts tax on the intrastate earnings of local exchange carriers, whereas only 13 states impose the tax on the intrastate receipts of interexchange carriers. Cable television providers furnishing cable television service pay a gross receipts tax on intrastate receipts in only four states (Connecticut, Delaware, Louisiana, and Rhode Island).

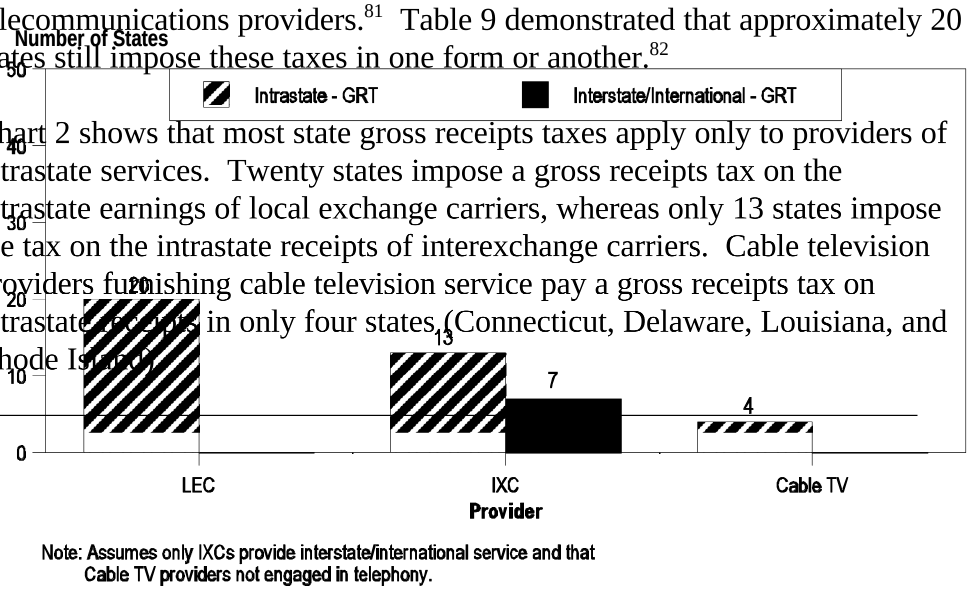



Chart 2: State Gross Receipts Taxation of Selected Telecommunications Providers

Only seven states apply their taxes to an allocated portion of gross receipts from providers of interstate and international services. These states include Florida, Maryland, New York, Rhode Island, Washington, West Virginia, and Wisconsin. It is important to note that generally, at present, only interexchange carriers have interstate and international receipts.[83]

States that include revenues from interstate and international telecommunications services in their gross receipts or sales tax bases use different methods to apportion these revenues. The predominant method used is the *Goldberg* approach that the U.S. Supreme Court validated in *Goldberg v. Sweet* (488 U.S. 252 (1989)).[84]

Before adoption of the *Goldberg* method in 1995, New York State apportioned interstate and international receipts with a property factor. This factor equaled average value of property within New York State divided by the average value of property everywhere.

At one time, West Virginia used a unique method for allocation of interstate and international receipts under its gross receipts tax. They allocated receipts based on the proportion of in-state versus total transmission channel mileage. However, West Virginia's tax no longer applies to companies which face market competition. As a result, the tax now in effect only applies to local exchange carriers. At present, these companies do not have interstate and international revenues that require allocation.

Wisconsin's gross receipts tax also applies to interstate and international receipts. The State currently allocates these receipts using a combined property and receipts factor.

*Goldberg Apportionment of Interstate & International Revenues*

Under the *Goldberg* method, states tax all revenues from interstate and international calls that originate or terminate within the state charged to an in-state service address. The term "service address" refers to the address at which the actual telephone equipment used to originate or receive the call is situated.

In *Goldberg v. Sweet*, the Supreme Court addressed the question of whether Illinois' telecommunications excise tax act violated the Commerce Clause of the U.S. Constitution. Illinois imposed a 5 percent tax on gross charges on all interstate calls that originated or terminated in Illinois and charged to an Illinois service address. The key issue in the case was whether Illinois fairly apportioned the tax to the taxpayer's activities in the state. The Court's decision in *Goldberg* sustained Illinois' tax on the receipts from interstate telecommunications services, and it opened the door for other states to follow suit.

*Gross Receipts Taxes in Lieu of Other Taxes*

Often, states impose gross receipts taxes instead of other taxes. For instance, in New York, companies principally engaged in a transmission business, such as local exchange or interexchange carriers, are subject to Article 9 franchise taxation on their gross receipts. This tax applies instead of the Article 9-A general business franchise tax based on their net income.[85]

Similarly, Ohio and Rhode Island telecommunications providers that pay gross receipts taxes are exempt from tax on their net income. In Maryland, local exchange carriers paying the gross receipts tax may credit their corporate income tax against their gross receipts tax liability. As a result, they are effectively exempt from the corporate income tax. Local telephone companies paying New Jersey's gross receipts tax do not pay corporate income tax.

*Recent State Telecommunications Tax Actions*

Wisconsin recently enacted Assembly Bill 1048, a telecommunications tax reform package. Wisconsin is the only state to enact significant tax reform for telecommunications providers this year. The Legislature intended that any tax reductions created by the legislation would comprise the remainder of tax refunds claimed pursuant to *GTE Sprint Communications Corporation, n.k.a. U.S. Sprint Communications Company vs. Wisconsin Bell, Inc., and the State of Wisconsin*, (No. 89-0272, May 15, 1990).[86]

Under a previous reform bill, Act 39 of 1991, LECs and IXCs were both subject to the state's license fee assessment on gross receipts from 1994 to 1997. However, LECs were exempt from the real property tax. Rates were to decrease through 1997. Tax rates were set at 5.70 percent for 1996 and 5.40 percent for 1997. The tax was due for elimination in 1998, but only for IXCs and long-distance resellers. After that, these carriers would be subject to an ad valorem tax on real and personal property.[87]

Assembly Bill 1048 increases the tax rate on all Wisconsin telecommunications companies to 5.77 percent for both 1996 and 1997. Beginning in 1998, companies will pay an ad valorem tax on real and personal property. The tax will be deductible under the state corporate income/franchise tax. The rate will be set at the same rate as if the property was subject to local property taxes. In 1999 and 2000, LECs and cellular telephone providers will pay a transitional adjustment fee equal to the difference between a 5.77 percent gross receipts tax and the ad valorem tax, if the former exceeds the latter.[88]

The legislation also repeals the current sales tax exemption for receipts from coin-operated telephones. It also establishes a Property Tax Relief and Technological Equipment Fund. The fund will provide property tax relief and pay for purchases of equipment.[89]

*Classification and Definition of Telecommunications Services*

For the purposes of comparing how different states tax certain telecommunications services, this report classifies these services into five distinct groupings: wireline services, wireless services, computer-related services, television and video-programming services, and miscellaneous services. Specific services included in these categories consist of the following:

- *Wireline* services include local telephone, toll service, additional services,[90] 800/900 transmission service, wide area transmission service (WATS), coin-operated telephones, and telegraphy provided by means of wires or fiber-optic cables;

- *Wireless* services include cellular telephone, personal communication services (PCS), beepers/paging, mobile radio, and radio dispatch provided by means of satellites, microwaves or radiowaves;

- *Computer-related* services include electronic mail (E-mail), Internet access, and computer exchange service (bulletin boards);

- *Television and video programming* includes cable television service and direct broadcast satellite (DBS) service; and

- *Miscellaneous* includes facsimile (FAX) service, packet-switching, voice-mail, and voice messaging.

Many of these services, such as wireline services or cable television, have been available for decades and pose no definitional problems. The taxation of these services is generally easy to discern from standard reference works. The list of specific services presented is not exhaustive, but does encompass the services that generate the vast majority of present industry revenues.

Regardless, the technical nature of the subject matter and subtle, and not so subtle, differences in state tax policy make some of these services troublesome to classify and define.  For instance, “Internet access” comes in many different forms.  Providers furnish access separately or packaged with other services (e.g., E-mail, information services, entertainment, etc.).

States may treat these services differently for tax purposes based upon their characterization of the service in question (e.g., as transmission or as an information or computer service), on the nature of the user (residential or business), or the billing method.  Several states recognized the complexity surrounding the taxation of these services in recent months and they initiated comprehensive reviews of the taxation of these services.

*Neighbor States*

Table 10 summarizes the following descriptions of how New York’s neighbor states impose their respective gross receipts taxes on certain telecommunications services.  The table divides taxable services into the five categories noted above.

### Connecticut

Connecticut's gross receipts tax does not apply to most telecommunications providers, including local exchange or interexchange carriers. The tax applies only to intrastate services. The only wireline service subject to tax is telegraphy. Connecticut taxes all receipts from television and video programming services (cable television and direct broadcast satellite services). The tax rate on telegraphy and cable television services equals 4.5 percent. A 5 percent rate applies to an alternate form of cable television, known as community antenna television service (CATV).[91]

### Massachusetts

Massachusetts does not impose a gross receipts tax on telecommunications providers.

### New Jersey

New Jersey's gross receipts tax applies only to receipts from intrastate services provided by the two local exchange carriers operating in the state and telegraphy providers. No general percentage tax rate exists. Rather, the state imposes per-unit tax rates. Tax applies only to receipts from wireline services.

### Pennsylvania

Pennsylvania imposes a 5 percent gross receipts tax on certain telecommunications providers. The tax applies only to intrastate services. Receipts from all wireline service are taxable. The tax does not apply to wireless or television and video programming receipts. The taxability of the remaining services -- computer-related and miscellaneous services -- is unclear. The Department of Revenue is currently reviewing the issue of taxation of these services and hopes to issue specific regulations to clarify their existing law topic.

### Vermont

Vermont does not impose a gross receipts tax on telecommunications providers.

Table 10 begins on this page and continues through page 67. See document labeled "teltbles.wpd."

*Other Major States*

Table 11 summarized the following descriptions of how other major states tax telecommunications services. The classification method for taxable services is the same as used in the description of neighbor states (see above).

**California**

California does not impose a gross receipts tax on telecommunications providers.

**Florida**

Florida imposes a 2.5 percent gross receipts tax on most telecommunications providers except providers of cable television and direct broadcast satellite services. The tax applies to receipts from all wireline, wireless, computer-related,[92] and miscellaneous services. Receipts from television and video programming services are not subject to tax.

**Illinois**

Illinois does not impose a gross receipts tax on telecommunications providers.

**Michigan**

Michigan does not impose a gross receipts tax on telecommunications providers.

### Ohio

Ohio imposes a 4.75 percent gross receipts tax only on LECs. Telecommunications providers not primarily engaged in providing local exchange service are exempt from the tax and pay the corporate income tax instead. The gross receipts tax applies only to receipts attributable to intrastate services.

LECs traditionally provide the majority of wireline services. As a result, receipts from these services, except exempt 800/900 and WATS services, are subject to tax. Likewise, LECs provide a large share of wireless services. Therefore, the table shows these services as taxable. The remaining service classifications -- computer-related, television and video programming, and miscellaneous services -- are not subject to tax. LECs rarely provide these services.

### Texas

Texas does not impose a gross receipts tax on telecommunications providers.

## Sales and Excise Taxes

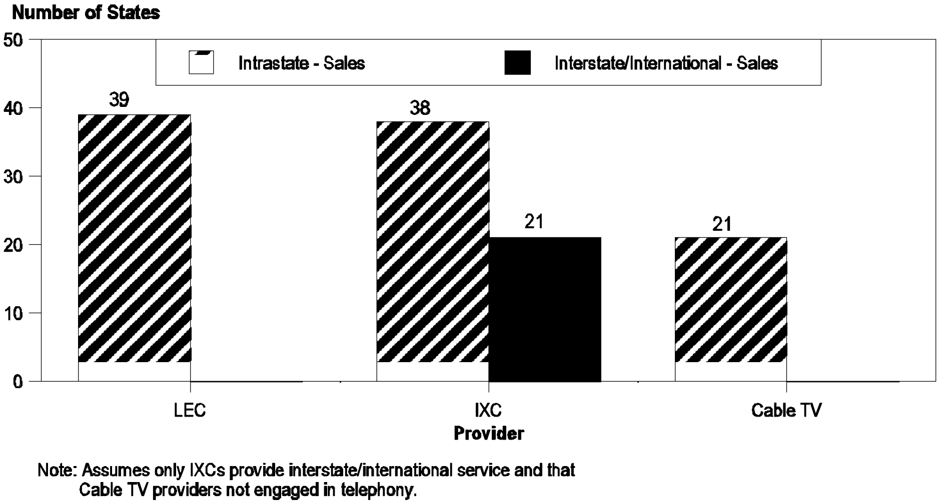
Sales and excise taxes differ from gross receipts taxes in that they apply to consumers purchasing telecommunications services, rather than the business providing the services. However, like gross receipts taxes, specific services may not be subject to tax.

In 1984, 35 states imposed a sales or excise tax on intrastate telecommunications. However, only five of these states also imposed sales tax on interstate and international telecommunications. By 1992, the number of states levying a sales tax on telecommunications increased to forty-one. Twenty states applied their sales tax to both intrastate and interstate/international services.[93]

Nationwide, a total of 45 states currently impose general sales taxes. As Chart 3 shows, some 39 states impose sales taxes on the telecommunications services typically provided by local exchange carriers. In contrast, 38 states impose sales tax on the intrastate sales of interexchange carriers. Only 21 states impose sales and excise taxes on sales of cable television services.

Table 11 begins on this page and continues through page 71. See document labeled “teltbles.wpd.”

Chart 3: State Sales Taxation of Selected Telecommunications Providers




Only 21 states apply sales and excise taxes to sales of interstate and international services typically provided by interexchange carriers. Michigan provides a unique case. They apply their sales tax to sales of interstate services, but exempt sales of international services.[94]

Generally, states that eliminated gross receipts taxes adopted a combination of both sales taxes and net income taxes. Many states extended their sales tax to include interstate and international telecommunications. They often did this to offset revenue loss from eliminating gross receipts taxes.

*Telephone Equipment Exemptions*

As previously noted, beside collecting tax from customers, telephone companies also pay sales taxes as consumers of tangible personal property and taxable services. Only ten states, including New York, provide a sales tax exemption for telephone production equipment. In six states (Indiana, New Jersey, Ohio, Pennsylvania, Virginia and West Virginia) the exemption is available to most purchases by a public utility.[95] In four states (Michigan, New York, North Carolina and Wisconsin) the exemption is available for specific types of equipment used by telephone service providers.[96]

*Recent State Telecommunications Tax Actions*

One state, Arizona, recently enacted legislation (SB 1001) designed to attract an advanced satellite and data uplink facility to the state. Specific incentives include a tangible personal property sales tax exemption and income tax credits (individual and corporate) for materials used in construction of the facility. The legislation also includes a sales tax exemption for Direct Broadcast Satellite (DBS) transmission services.[97]

New Jersey’s recently enacted Business Employment Incentive Program Act provides a sales tax exemption for certain property purchased by cable and satellite television program providers.  The exemption includes broadcasting equipment such as transponders, microwave dishes, transmitters and receivers.

*Neighbor States*

Table 11 also summarized how neighbor states impose their respective sales taxes on certain telecommunications services.  The following description uses the same classification of services as in the prior section (wireline, wireless, computer-related, television and video programming, and miscellaneous):

**Connecticut**

Connecticut imposes a 6 percent sales tax on sales of all telecommunications services, including interstate and international services.  All wireline, wireless, computer-related, television and video programming, and miscellaneous services are taxable.

**Massachusetts**

Massachusetts imposes a 5 percent sales tax on a broad array of telecommunications services.  The tax applies to sales of interstate and international services, in addition to intrastate service.  All wireline services are subject to tax, but there is a flat residential service exemption of $30. Any amount over $30 is taxable.  Wireless, computer-related and miscellaneous services are taxable.  However, television and video programming services (cable television and direct broadcast satellite services) are exempt from taxation.

**New Jersey**

New Jersey imposes a 6 percent sales tax on sales of most, but not all telecommunications services.  The tax applies to sales of interstate and international services.  All wireline, wireless, and miscellaneous services are taxable.  New Jersey also taxes cable television programming services. However, the intermediate transmission of video programming using telecommunications systems is exempt from the tax on telecommunications services.

**Pennsylvania**

Pennsylvania imposes a 6 percent sales tax on sales of many telecommunications services. The City of Philadelphia and Allegheny County also impose a 1 percent local sales tax added to the state rate. The tax applies to interstate/international services in addition to intrastate services. Coin-operated service is the only wireline service not taxed.

Tax applies to all wireless services. Computer-related services such as E-mail, Internet access and computer exchange, are subject to sales as either telecommunications or computer services. Premium television and video programming services are taxable, but basic cable television services are not subject to tax. Computer-related services, packet-switching, voice-mail or voice-messaging may be taxable as computer services instead of telecommunications services depending on the specific form of service provided.

**Vermont**

Vermont's sales tax does not apply to sales of telecommunications services. However, the tax does apply to sales of both cable television and Direct Broadcast Satellite (DBS) services.

*Other Major States*

Table 11 also summarized how other major states impose their respective sales taxes on certain telecommunications services. The following describes the data in the table:

**California**

California's sales tax does not apply to sales of telecommunications services.

**Florida**

Florida's sales tax applies to sales of most telecommunications services. The tax base includes interstate and international services. The state tax rate equals 7 percent. A local option exists for an additional 1 percent rate. Wireline services, except coin-operated calls, are taxable. Residential local telephone service and toll calls are not subject to the sales tax, but sales to commercial customers are taxable.

**Illinois**

Illinois imposes an excise tax known as the Illinois Telecommunications Excise Tax. The tax rate equals 5 percent and applies to most telecommunications services, including an allocated portion of interstate and international services. All wireline services, except receipts for coin-operated calls, are taxable. Wireless services are also taxable.

E-mail and Internet access are usually exempt. However, if bills separately state charges for these services, they are taxable. Television and video programming services are exempt from tax. Miscellaneous services, except packet-switching, are also subject to tax.

**Michigan**

Michigan imposes a 6 percent sales tax on a limited range of telecommunications services. The tax applies to intrastate and interstate services, but specifically exempts international services. Of the wireline services, only local telephone, toll, additional services and telegraphy are taxable. 800/900, WATS, and coin-operated calls are exempt. All wireless services, except one-way beepers and pagers, are taxable. All computer-related, television and video-programming, and miscellaneous services are exempt.

**Ohio**

Ohio imposes a 5 percent sales tax on the sale of many telecommunications services. In addition, localities may also impose an additional sales tax of up to 2 percent. The tax applies to intrastate and interstate/international services. Local exchange carriers (LECs) and other providers of local exchange service pay the gross receipts tax and are exempt from the sales tax. As a result, most wireline services are effectively exempt under the sales tax. However, the toll revenues of interexchange carriers (IXCs) and other providers of long-distance services are taxable. These providers also often provide 800/900[98] and WATS services. 800 and WATS services are exempt from the tax, but 900 service is not.

All wireless services, except beepers and paging, are taxable. Ohio does not tax beepers and paging as they are essentially one-way, not two-way, services. Although, rental charges for the beeper and paging units themselves are subject to sales tax. Computer-related services used for business purposes are taxable. However, they are considered “electronic information services” rather than telecommunications services. Television and video programming services are not subject to the sales tax. Miscellaneous services are taxable on the same basis as computer-related services.

**Texas**

Texas imposes a 6.25 percent sales tax on sales of telecommunications services. All wireline, wireless, computer-related, television and video programming and miscellaneous services are taxable. The tax applies to sales of interstate and international services. Localities may impose an additional tax of 2 percent. Since September 1995, Texas has imposed an additional 1 percent "Telecommunications Infrastructure Fund Assessment" on the sales tax base, but the burden of the assessment falls on the provider (instead of the consumer). The rate equals 1 percent.

## Real Property Taxes

Table 9 showed that most states, or their localities, impose real property taxes on some, or all, telecommunications providers.[99] Forty-eight states impose, or allow imposition, of real property taxes on local exchange carriers (LECs). One exception is Hawaii. It exempts utilities from real property taxation upon application.[100] New Hampshire considers buildings owned by telecommunications companies to be taxable real property. However, telecommunications equipment, machinery, poles and wires are considered personal property which is exempt from property tax.[101] In Wisconsin, LECs pay a gross receipts tax instead of real property taxes. They pay some ad valorem tax, but only on property not used in their business.[102]

Forty-nine states permit taxation of real property of interexchange carriers (IXCs). As noted above, Hawaii does not levy ad valorem taxes on utility real property. Forty-nine states impose real property taxes on cable television company real property. Only Connecticut (see page 78) exempts cable television companies from real property taxation.

*Assessment Methods*

States and localities employ several distinct methods to assess the value of the real property of telecommunications providers. Generally, assessment is based on the "full value" of the real property. This is the amount that a willing buyer would pay to a willing seller for a particular property in an arm's length transaction. Some states take a unitary approach to valuation. That is, they estimate the value of the real property of the entire entity (e.g., a railroad or utility system), rather than the specific items of real property. Values are then allocated to individual taxing jurisdictions. However, this approach is not always feasible in many states, such as New York, where assessment is both a central and local function.

Appraisers essentially estimate market value in one of three separate ways:

- In the *market approach*, appraisers compare the subject property to at least five similar properties that have recently sold and make adjustments for varying characteristics;

- In the *income approach*, appraisers figure the net rental income after expenses for income-producing properties such as apartments and stores. They then estimate how much an investor would pay to receive such income, using current market conditions as a guide; and

- In the *cost approach*, appraisers calculate the replacement cost, at current construction costs, for factories, utilities and unique residential properties. They then subtract depreciation and obsolescence and add the current value of land on which the property is located.

*Neighbor States*

The following describes how neighbor states, and their localities, impose their respective real property taxes on the property of telecommunications providers.[103]

**Connecticut**

Connecticut municipalities may impose ad valorem property taxes on real property and tangible personal property. Assessment of property is local except telecommunications system property. The property of cable television companies is exempt from tax. Municipalities assess all property at a uniform rate of 70 percent of present true and actual value. Unitary valuation is not used. The primary valuation method used is the cost approach. Rates equal the aggregate of all legal levies.

**Massachusetts**

Massachusetts allows municipalities to impose an ad valorem tax on real and tangible personal property. For telecommunications companies, the latter includes underground conduit, cables, aerial plant on private property, and power machinery. Assessment of property is on full and fair cash value basis. All telecommunications and telegraph property assessment is a central function performed by the Division of Revenue. Providers pay property tax locally at equal class three (commercial) or class 4 (industrial) rates. Massachusetts' Proposition 2½ limits rates to 2.5 percent of full value and annual rate increases to the same amount.

### New Jersey

Real property and enumerated personal property of utilities, other than railroad property, are subject to local taxation. There is no unitary valuation. Local assessors perform assessment in the respective tax districts. The primary valuation method is the cost method. County tax boards decide assessments appeals. A State Tax Court may review their respective decisions. Rates on the property of telecommunications providers equal the general real property tax rate in the tax district.

### Pennsylvania

Utility companies, including many telecommunications providers, are exempt from local property taxes in Pennsylvania. Instead, these companies pay a state tax, known as the Pennsylvania Utilities Real Property Tax (PURTA), on taxable value. The State collects the tax and distributes revenues to localities. Practically speaking, the Department of Revenue calculates taxable value as cost minus reserves for depreciation. There is no unitary valuation. Localities assess non-operating property.

### Vermont

Telecommunications providers owning lines or businesses in Vermont are exempt from local ad valorem taxation on their personal property. Instead, they pay a state tax equal to 2.37 percent on net book value of their Vermont personal property. Real property is taxed at the local level. Intangibles are exempt. Resellers are not generally subject to the tax as they typically do not own the lines they use.

*Other Major States*

The following describes how other major states, and their localities, impose their respective real property taxes on the property of telecommunications providers.

### California

Real and personal property (including intangible personal property) is subject to local ad valorem property tax in California. Intangible assets of a cable television system are specifically exempt from taxation. The State Board of Equalization assesses all telecommunications utility property on a unitary basis. Assessments are at full value; however, annual increases (or decreases) are limited to 2 percent based on a 1975-76 base year. The State permits reassessment only after new construction or the transfer/sale of property built before the adoption of Proposition 13.

**Florida**

Florida localities may impose an ad valorem tax on both real and personal property. Municipalities value property at full cash value. Local assessment applies to the property of utility companies and other telecommunications providers. There is no unitary valuation of the real property of telecommunications providers. The companies themselves provide self-assessed valuations. Assessment authorities subsequently review these reports. However, county appraisers employ the market (sales) assessment method to value real property.

**Illinois**

Illinois localities impose an ad valorem tax on all real property. Illinois has not taxed personal property since 1978. Most real property assessments are done locally on a unitary basis, but the State Department of Revenue engages in advisory appraisals for certain large properties.

**Michigan**

Michigan and its localities impose ad valorem taxes on both real and personal property of telecommunications providers. Total tax rates vary, but all include a state education tax of six mills. The State Board of Assessors make assessments based on reports filed with the Board by the companies. The Board assesses property at 50 percent of true cash value on a unitary basis. The primary valuation method is the cost approach.

**Ohio**

Ohio’s localities may impose ad valorem taxes on both real and personal property. The state values all utility operating property, and the counties assess all other property, using the unitary valuation approach. The primary valuation method used is the cost method. Taxable values may not exceed 35 percent of cash true value.

## Texas

All Texas real and personal property is taxable. However, intangible personal property is exempt from taxation. Localities impose the tax. The state may not impose an ad valorem tax. Assessments are at 100 percent of the value appraised by county assessors. The primary valuation method varies by county. There is no unitary valuation. Reappraisal must occur at least once every three years.

# Endnotes

1. See Karl E. Case, State and Local Tax Policy and The Telecommunications Industry, 1992, p.2.

2. The Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914 were the most notable antitrust legislation of this period.

3. For example, an AT&T call from New York City to Chicago would be handled as follows. The call would be initiated by a customer and transported over New York Telephone's network to the AT&T network in New York. AT&T would then transport the call over its network to Chicago, where the call would be picked up by Illinois Bell's network and transported to its destination.

4. America's Carriers Telecommunication Association (ACTA) filed a petition to the FCC on Internet phone access. ACTA alleges that providers of Internet phone software and hardware operate as uncertified and unregulated common carriers in contravention of FCC rules. They seek a declaratory ruling from the FCC requiring these Internet phone providers to cease and desist operations.

5. On the other hand, the communications sector's cable industry employment between 1988 and 1995 increased by over 3,300 jobs, or over 28 percent.

6. See Policy Research Center, Georgia State University, The Taxation of Telecommunications in Ohio, October 1994, pp. 54-59, citing a 1991 Deloitte and Touche study of the New Jersey telecommunications infrastructure.

7. Businesses across the country ranked access to major airports first, followed by labor costs, major highway access, proximity to major markets, market conditions, skilled labor force. Access to telecommunications was ranked seventh out of 22 business location decision making factors.

8. Since 1988, cable television systems have been subject to tax on their net income under Article 9-A of the Tax Law. Prior to that time, cable television companies were subject to Article 9 taxation as transmission companies.

9. Counties in the Metropolitan Commuter Transportation District (MCTD) include counties in New York City (Bronx, Brooklyn, Manhattan, Queens, Richmond) and Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk, and Westchester Counties.

10. Special allocation formulas apply to certain industries like aviation businesses and, beginning in 1998, trucking and railroad businesses that opt for taxation under Article 9-A.

11. See TSB-M-94(5)C for more details.

12. Article 28, Section 1105(b). Like other utility services, the compensating use tax does not apply to telephone and telegraph service. However, a use tax does apply to telephone answering services.

13. It is important to note that under Article 9, receipts from interstate and international telecommunications are taxable while they are exempt from sales tax.

14. See Matter of Southern Pacific Communications Company (TSB-D-91(41)S, March 22, 1990). The issue presented there was whether certain New York components of an interstate "private line" service, which have intrastate attributes may be segregated out and separately taxed. In comparison, see for example TSB-A-93(26) where a New York link for an interstate private line circuit was held taxable as an intrastate service; and TSB-A-94(33) holding that a monthly fee for a nationwide toll-free number would be taxable if the service was available to both intrastate and interstate customers.

15. These services are not the sale of telephone or telegraph services. See *NYS Cable Television v. State Tax Commission* (3rd Dept., 1977, 59AD2d81.)

16. See TSB-M-94(2)S for information regarding sales tax on equipment furnished in conjunction with cable television service.

17. New York City imposes a 4 percent sales tax on fuel and utility services used in production. The City does provide a credit against its business income taxes for sales of electricity used in production.

18. Tax Law Section 1115 (a)(12).

19. Chapter 93, Laws of 1965.

20. Authority for adopting the State base is found in Tax Law Section 1210(a). Localities that adopt the State tax base are authorized to diverge from the State base and uniform rate in only two instances; residential energy services and certain types of personal property used to construct or rehabilitate buildings in economic development zones.

21. Authority for adopting selective sales taxes is found in Tax Law Section 1210(b).

22. A city's selective sales tax preempts any county general sales tax. Therefore, cities retain 100 percent of the maximum 3 percent rate on the selective base, even if the county imposes the general sales tax (Tax Law Section 1224(a) and 1224(b)). However, in no case would the combination of city and county taxes exceed the maximum 3 percent rate. Moreover, a city or county opting for the selective tax on utility services may impose a different rate of tax on residential energy services pursuant to Section 1210(b)(3).

23. Ch. 11, New York City Administrative Code.

24. General City Law Section 20-b.

25. Village Law Section 5-530.

26. <u>Survey of Railroad and Utility Taxation Practices Among the States</u> (Albany, N.Y.: State Board of Equalization and Assessment, December 1993), p. 91.

27. Section 626 of the Real Property Tax Law provides a credit for special franchise fees paid to municipalities against special franchise property assessments made by ORPs for the municipal assessing unit.

28. 47 USC Section 224.

29. Ch. 542, L. 1880.

30. New York Times, May 28, 1880, p. 5.

31. Ch. 542, L. 1880, Section 6.

32. <u>Transportation Taxes in New York State</u> (Albany, N.Y.: State of New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, 1983), p. 19.

33. Ch. 726, L. 1917.

34. Frederick D. Bidwell. <u>Taxation in New York State</u>. (Albany, N.Y.: J.B. Lyon Company, 1918), p. 120.

35. <u>Ibid</u>., pp. 126-127.

36. Ch. 628, L. 1919.

37. Henry M. Powell. <u>Taxation of Income Corporate and Personal: New York</u> (New York, N.Y.: Matthew Bender & co., Inc., 1919), pp 77, 81.

38. <u>Transportation Taxes in New York State</u>, pp. 19-20.

39. See Walter Hellerstein "Critical Issues in State Taxation of Telecommunications" in Thomas F. Pogue, ed. <u>State Taxation of Business: Issues and Policy Options</u> (Westport, CT: Praeger Publishers/National Tax Association, 1992), p. 151.

40. Ch. 745, L. 1935.

41. <u>The Revenue Outlook for the State of New York for the Fiscal Years 1937-38 and 1938-39</u>. (Albany, N.Y.: New York State Commission for the Revision of the Tax Laws, 1938), p. 25.

42. <u>Ibid</u>., p. 26.

43. Ch. 321, L. 1937, Section 1.

44. See the section on local gross receipts taxes for further details on this and other such taxes.

45. Ch. 321, L. 1937, Section 2.

46. See *Matter of 320 West 37th Street, Inc. 281 N.Y. 132* and *Matter of 339 Central Park West, Inc. 260 App. Div. 265, affirmed*, respectively, which challenged the application of the New York City tax and New York State Section 186-a tax on submeterers.

47. Ch. 137, L. 1941, Section 1.

48. <u>Ibid</u>., Sections 1-2.

49. Ch. 486, L. 1981 and Ch. 15, L. 1983, respectively.

50. Coopers & Lybrand, Inc. <u>State Policy and the Telecommunications Economy in New York</u> (Albany, N.Y.: Report for the New York State Office of Economic Development, 1987), pp. IV-43, 45).

51. NYS Regulations, Part 72 Allocation of Gross Earnings by Telephone and Telegraph Corporations Pursuant to Section 184 of the Tax Law.

52. The property factor was computed as the ratio of the average value of property in New York to the average value of property within and without New York. The revenue-producing circuit miles factor was computed by dividing (1) the product of the average length in miles of revenue-producing communications pathways within New York State used in connection with interstate and/or foreign transmission services and the number of revenue-producing channels within such pathways by (2) the product of the average length in miles of revenue-producing communications pathways within and without New York State used in connection with interstate and/or foreign transmission services and the number of revenue-producing channels within such pathways.

53. The value of rented property was determined by multiplying gross rent by eight. The value of owned property was determined without allowance for depreciation or amortization.

54. This is based on a review of telecommunications companies' tax returns and experience of the Department's Audit Division.

55. Ch. 70, L. 1971.

56. Ch. 410, L. 1991.

57. Ch. 708, L. 1993.

58. Chapter 61 of the Laws of 1989. These provisions became effective on July 1, 1989.

59. In 1984, after the AT&T divestiture, New York Telephone sought an advisory opinion from the New York State Tax Commission regarding the tax treatment of access services provided by a local exchange carrier to an interexchange carrier. The Commission ruled that the access services constituted an exempt sale for resale. Thus, the Commission found that receipts from the sale of access services by New York Telephone Company to an interexchange company should be excluded from New York Telephone Company's tax base, but included in the tax base of the interexchange company.

60. The amendment allowed interexchange carriers to deduct from gross income the cost of other resold services on which tax under Section 186-a was paid by the utility which furnished

such services to the reseller.

61. A taxpayer could use the accounting rule allocation method to allocate interstate and foreign gross operating income if it employed a Uniform System of Accounts as prescribed for federal or state regulatory purposes, and if these accounts reflected the amount of gross operating income from interstate and foreign transmission services attributable to New York State.

62. Ch. 873, L. 1934.

63. AT&T challenged neither the apportionment formula nor the percentage assigned to it by its utilization.

64. *American Telephone and Telegraph Company v. New York State Department of Taxation and Finance*, Supreme Court Appellate Division, First Department, April 1993.

65. Section 186-a(2-a).

66. The companies would forgo approximately $50 million in potential refunds (before interest payments).

67. A "LATA" is a local access and transport area as established on July 1, 1994, pursuant to the modification of the final judgement in *U.S. v. Western Electric Company*. InterLATA services consist of telephone calls and other telecommunications services which do not originate and terminate within the same LATA.

68. This is the case in New York State where the Office of Real Property Services (ORPS), formerly known as the Division of Equalization and Assessment, assesses certain "special franchise" property.

69. For the purposes of this description, the term "telecommunications providers" includes all providers of telecommunications services, including cable television companies providing cable television services.

70. Texas does impose a corporate franchise tax on net taxable earned surplus.

71. This is distinguished from *enhanced* telecommunication services.

72. Connecticut's corporate franchise tax rate drops to 10.5 percent beginning in 1997, 9.5 percent in 1998 and 8.5 percent in 1999.

73. Commerce Clearing House. <u>All States Tax Guide</u> (Corporate Income Taxes), Sections 10-291, 10-297.

74. See the gross receipts tax section of the report for a discussion of this tax.

75. <u>All States Tax Guide</u>, Sections 10-876, 10-897.

76. California has begun an analysis of its taxation of telecommunications companies. The California Franchise Tax Board anticipates issuing proposed regulations in the near future.

77. <u>All States Tax Guide</u>, Sections 10-261, 10-264.

78. The treatment of satellite property in the numerator was based on a decision rendered in *Communications Satellite Corporation v. Franchise Tax Board* (1994)156 Cal. App.3d 726.

79. <u>All States Tax Guide</u>, Sections 10-336, 10-340.

80. Special rules apply for apportionment by corporations whose tax bases derive from transportation, financial, or insurance carrier services.

81. <u>State and Local Tax Policy and the Telecommunications Industry</u>, p. 1.

82. The number of states imposing gross receipts taxes frequently varies by author. This is because several states impose license fees or regulatory assessments based on gross receipts or impose these taxes on certain providers only.

83. We assume here that local exchange carriers and cable television companies, by definition, provide only intrastate service. This market segmentation will soon no longer exist as providers diversify their businesses in response to the reforms contained in the federal Telecommunications Act of 1996.

84. See Patrick J. Nugent. “Apportionment of Telecommunications Interstate Attributes for Income, Consumption, and Property Tax Purposes,” in Thomas F. Pogue, ed. <u>State Taxation of Business: Issues and Policy Options</u> (Westport, CT: Praeger Publishers/National Tax Association, 1992); and Albert G. Lauber, Jr., “Recent U.S. Supreme Court Decisions,” (Paper delivered at the George Washington University Law Center 1989 Institute on State and Local Taxation) for a detailed discussion of *Goldberg v. Sweet.*

85. Companies not principally engaged in a transmission business also pay the Section 186-e excise tax on telecommunications services in addition to the Article 9-A tax.

86. AB 1048 Legislative Fiscal Bureau Memo (March 22, 1996), p. 6.

87. Ibid., p. 2.

88. Ibid., pp. 2-3.

89. Ibid., p. 5.

90. As used here, the term “additional services” refers to non-basic services such as touch-tone, Call ID, call forwarding, centrex service, etc.

91. Community antenna television service (CATV) was the original form of cable television service.  At first, long line antennas were used to improve reception of existing local broadcast stations in rural and remote areas.  For background on the cable television industry see Joshua N. Koenig.

“Taxation of Cable Television Systems in New York State” Pace Law Review, vol. 7 no. 1 (Fall 1986), pp. 29-33. CATV is an alternate form of cable television.

92. Although technically taxable, as of this writing there is a temporary moratorium on collections of tax on receipts for computer-related services pending a review of the current taxation of these services.

93. Legislative Fiscal Bureau Memo, p. 7.

94. For a more detailed description of Michigan’s sales tax, see the following section on other major states.

95. A “public utility” is generally defined as a carrier required to have a certificate of convenience and necessity issued by a state regulatory board or a federal regulatory body.

96. Ohio, in addition to its public utility exemption, has a specific equipment exemption for other telephone services providers.

97. SB 1001 Joint Legislative Budget Committee Staff Memorandum (June 25, 1996), pp. 1-2.

98. 800 service are calls that offer consumers information provided free of charge. 900 service is pay-per-call information services provided through 1-900, 1-960, 1-976, or similar exchanges, where the consumer (caller) is charged on a per call or per time basis for the information.

99. As previously noted in Table 9, in a number of states, the poles, wires and cables of telecommunications companies are considered personal property.

100. Survey of Railroad and Utility Taxation Practices Among the States (Albany, N.Y.: State Board of Equalization and Assessment, December 1993), p. 48.

101. Currently, there is litigation on the taxation of these items ongoing in the New Hampshire court system.

102. All States Tax Guide, Section 20-937.

103. The two primary sources used for this section are the previously cited Survey of Railroad and Utility Taxation Practices Among the States and All States Tax Guide.

# Issues for the Final Report

The final report on telecommunications taxes in New York State, due in December, will examine various options for modernizing and improving the current tax structure. The background section of this report showed that the current system is in need of some modification. The State developed this system at a time when telecommunications utilities did not face meaningful competition and telephone service was easily distinguishable from any other service. Today, rapid changes in telecommunications due to forces of competition and advanced technology require a careful reappraisal by policy makers.

Throughout the past several months, the telecommunications advisory panel suggested different ideas for consideration in the final report. The Department conducted a survey of the panel regarding various tax policy options. The final report will detail the results of the survey.

This section outlines some options that will appear in the final report. The discussion centers on three tax areas, including sales tax on cellular telephone services, general sales tax issues, and corporate tax issues.

## Sales Tax on Cellular Telephone Services

The final report will examine several important issues raised by mobile communications services. These include specific issues related to:

- Identifying intrastate calls;
- Collecting tax on roamer charges; and
- Determining the "correct" local tax rate.

### Identifying Instrastate Calls

*Description*

In order for a state to tax a particular telephone call, a telephone service has to have a connection with that state. Traditionally, states rely on the service being provided to a location in the state, as evidenced, for example, by a local billing address and the physical location of a phone within the state.

The nature of cellular and mobile communications makes it difficult to source a call to a particular jurisdiction. Cellular phone users travel while using their phones. Subscribers of paging devices and other mobile services also travel while receiving services. Often, this travel occurs within a state's boundaries. However, it also can occur between states. Thus, the first challenge cellular companies face is determining which state subscribers are in when they originate or receive a call.[1]

In many areas of the State, this does not present an issue. However, where a cellular geographic service area (CGSA) overlaps different states, distinguishing intrastate calls from interstate calls presents difficulties. For example, the New York City CGSA encompasses portions of New Jersey, and the Binghamton CGSA contains portions of Pennsylvania.[2] Cellular telephone providers servicing these areas indicate that they cannot always tell whether their customer originates or receives a call while in New York. Therefore, they cannot be certain if the customer made an intrastate call or an interstate call.

Cellular technology also leads to problems in CGSAs located near the State's borders. In certain border areas a cell site in a Connecticut or Vermont CGSA will handle a New York cellular phone user's intrastate call. For all practical purposes, the call would appear to the New York service provider as an exempt interstate call originated while their customer traveled in Connecticut or Vermont. In fact, it represents a taxable intrastate call.

*Potential Solutions*

The final report will examine different approaches for resolving these issues. Some approaches could be adopted administratively while others may require statutory changes. Some potential solutions include:

- relying solely on the telephone number(s) called to or from;
- using a customer's billing address or other address as indicative of where the customer primarily uses the cellular or mobile phone device;
- using a combination of the telephone number(s) and the customer's billing address or other address; or,
- using the geographic location of a radio tower, cell base station or mobile telephone switching office (MTSO) or similar place as an indicator of where the caller originated or received a call.

*Other States' Practices*

States employ a variety of practices in response to this issue.[3] Some examples follow.

Connecticut- Connecticut taxes intrastate and interstate cellular telephone services. Connecticut sources cellular calls to its state using the cell base station's location. Connecticut taxes any cellular calls that originate or terminate from a Connecticut-based cell base station and are charged to a telephone number, customer or account in the State.

Maryland- To determine which calls it can tax, Maryland uses a combination of telephone number and billing address. It will tax a call if the cellular phone has a Maryland telephone number and the company bills the call to a Maryland address.

New Jersey- New Jersey relies solely on a cellular phone's telephone number to source calls to its state. New Jersey imposes sales tax on intrastate and interstate telephone service charged to a service address in New Jersey, no matter where billed or paid. For cellular calls, New Jersey deems the phone number the service address.

## Collecting Tax on Roamer Charges

*Description*

In the mobile communications industry, roaming occurs when subscribers place or receive calls while traveling outside their "home" territory.[4] This can also occur with paging services and cellular service.

A principal issue associated with roaming relates to which company is the "vendor" for purposes of collecting and remitting the sales tax on the telephone service provided in a roaming situation. On the one hand, the "serving carrier" could be considered to make the retail sale to the roaming customer. There, the "home carrier" merely acts as a billing agent and not as a service reseller. On the other hand, one could view the home carrier as a vendor who has purchased service for resale to the roaming customer.

Some advisory panel members report that they consider the serving carrier to represent the vendor in a roaming situation. This practice raises several issues. Those identified thus far include:

- The serving carrier collecting tax from a roamer needs to know the correct local tax rate to charge. The New York company may have little information upon which to base the tax consequences of the call.[5]

- The home carrier needs to know how to treat any separately stated "roaming" charges that it makes to its customers related to roaming service.

- Both carriers would need to know how to process charges to tax exempt purchasers. Generally, an exempt organization, such as a church or hospital, would file tax exemption documents with its home carrier. That way, it would not have to pay sales tax on its cellular telephone service. In a roaming situation, in order for the serving carrier to provide the same tax exemption, it too would have to have these documents on file.[6]

Other advisory panel members reported that they had considered the home carrier the retail vendor. A major issue that this practice raises concerns dealing with roamers from other states. Under this approach, when a nonresident roams in New York, the out-of-state "home" company would be responsible for remitting the tax. The home carrier also needs to know the correct local tax rate to charge.[7]

*Potential Solutions*

A combination of solutions emerge in response to roaming issues. These solutions turn on two critical choices:

(1) establishing which company should charge, collect and/or remit the sales tax, or establishing that either company may, and

(2) deciding if the State should tax roaming with, or separately from other taxable cellular service charges.

The final report will examine the implications of each possible choice.

*Other States' Practices*

Many states recognize the serving carrier as the service provider responsible for collecting sales tax on the portion of the telephone service that it provided to the roamer. In these cases, the serving carrier bases the state and/or local tax on the rate in effect at the cell base station or MTSO that first handled the call.

## Determining the "Correct" Local Tax Rate

*Description*

A third significant issue involves determining the "correct" local tax rate. On average, a New York CGSA contains six local taxing jurisdictions. With fourteen local taxing jurisdictions, the New York City CGSA contains the most taxing jurisdictions. The Chautauqua CGSA, with twelve local taxing jurisdictions, has the second highest number. Only two CGSAs (Elmira and Poughkeepsie) contain just one local tax jurisdiction.[8] In five of the seventeen CGSAs, the difference between the highest and lowest tax rate equals 4 percent. In another five CGSAs, the difference is 3 percent.[9]

The Tax Law and the tax regulations do not discuss how local sales tax applies to mobile telephone services. However, the Department has provided some guidance in a Technical Services Bureau Advisory Opinion (TSB-A-89(38)S issued October 11, 1989).[10] The opinion advised the cellular company that the local tax rate on activation, monthly access fees and usage charges is the highest local rate imposed in the area covered by the subscriber's assigned telephone number exchange.

*Potential Solutions*

The advisory panel identified at least five possible approaches for consideration as potential solutions. They include:

- computing the sales tax on all intrastate services, including roaming, at the subscriber's fixed location of primary use (e.g., a billing address in New York);

- computing the sales tax on all intrastate services, except roaming, at the subscriber's fixed location of primary use. Separately source roaming charges using an average combined State and local rate for the CGSA where the service occurred or some other mechanism (e.g., location of MTSO or cell base station);

- computing the sales tax on all intrastate services, including service to roamers, using a blended state and local rate established for each CGSA;

- computing the sales tax on all intrastate services, except service to roamers, using a blended state and local rate established for each CGSA. Separately source roaming charges using an average combined State and local rate for the CGSA where the service occurred or some other mechanism (e.g., location of MTSO or cell base station); or

- computing the sales tax on all intrastate services, including service to roamers, using a uniform statewide blended rate whatever the rate in any particular jurisdiction.

*Other States' Practices*

To see how other states deal with local sales taxes, we examined the sales taxes in Florida, Georgia, Minnesota, Ohio, Texas and Washington. Like

New York, these states tax cellular telephone service. They also have local sales taxes on cellular service.

Overall, these states have settled on a customer's "service address" as the means to assign a call to a particular locality. For purposes of cellular telephone and other mobile communications services, the customer's service address usually means the billing address. When the charges relate to a roamer, the serving carrier is often directed to collect tax using the rate at the cell base station or MTSO that first handled the call.

The State of Washington's sales tax illustrates how other states address local issues. It determines the local tax based on the cellular phone subscriber's "service address." A service address refers to the location of the telecommunications equipment from which a taxpayer originates or at which a taxpayer receives a call.

For most situations, Washington defines the service address as the billing address. However, when the billing address does not represent the actual service address (e.g., the Washington cellular customer lives in the border state of Oregon), Washington determines the local tax rate based on "service location." Washington encourages the cellular company to ask new customers if the billing address differs from the service address and to choose the applicable local tax rate accordingly.

## Sales Tax Issues

The previous section of telecommunications issues dealt with the application of sales tax rules to mobile services. However, mobile services represent just one area where the sales tax has not kept pace with the advances in the telecommunications industry. This section of the study describes other important sales tax issues identified by the advisory panel. These issues include:

- Uncertainty about services taxed as telephone and telegraph;
- Sales tax paid on purchases made by service providers;
- Inconsistencies between the Article 9 taxes and the sales tax; and,
- Various other issues, such as the sales tax resale exemption, the high combined rates of locally imposed school district taxes, prepaid phone cards and the coin-operated telephone exemption.

This section briefly describes each of these issues and outlines some possible options that the final report will consider.

## Uncertainty About Services Taxed As Telephone and Telegraph

*Description*

New York imposes its sales tax on "telephony and telegraphy and telephone and telegraph service of whatever nature . . . " The statute does not define those terms. With the introduction of each new technology and communication service, industry members and the Department find themselves confronting questions of taxability.

The advisory panel identified Internet connection service as one example of an area not clearly addressed by the Tax Law or regulation. Although New York's law does not specifically list Internet connection services, or gateway services,[11] as examples of telephony or telegraphy, the law does tax telephony and telegraphy of whatever nature.

*Potential Solutions*

The final report will examine the sales tax to better identify what New York State should tax. It will also evaluate ways to modernize the sales tax law and/or regulations to provide additional guidance.

One possible solution is to reform the statute so that it lists out taxable and exempt telecommunications services. Another option is to develop tax regulations that provide more detail regarding taxable and exempt services.

*Other States' Practices*

Many states' tax laws explicitly list taxable and exempt telecommunications services. The Department's research found that in New York's neighbor states and certain other major states, the tax laws and regulations generally provide more detail than does New York regarding taxable and exempt telephone services.

Other states resemble New York in that they impose a nonspecific tax on telephone and telegraph service. Michigan represents such a state. It imposes a sales tax on intrastate telephone and telegraph service without specifically describing those services.[12] However, when we compared tax administration in the two states, we found significant differences. Michigan does not tax wide area toll services (WATS), one-way paging service, one-way mobile radio service, E-mail, facsimile service, packet switching services, voice mail, or voice messaging. New York taxes all these services.

## Sales Tax on Purchases Made by Telephone Service Providers

The advisory panel highlighted a significant issue surrounding New York's sales taxes on telecommunication service providers and companies in related industries; that is, New York often imposes sales tax on the goods and services which, in turn, a business uses to produce telecommunication services.

*Sales Tax Paid on Machinery and Equipment*

The sales tax exempts central office switching equipment and related station apparatus. However, these terms are outdated. This has several consequences for industry members. First, as the industry develops new telecommunications equipment, it is not always clear if it fits the definition of "central office" equipment.[13]

Second, the exemption does not encompass certain types of the machinery and equipment necessary for providing telephone service via microwave transmission and fiber optic technology. These technologies have different equipment requirements than traditional landline service. They require equipment that amplifies and boosts signals as they travel across the state and country. Because such equipment does not "receive at destination," "initiate" or "switch" the telephone signal, it does not qualify as exempt switching equipment.

Third, the telephone exemption is narrow in comparison to the exemptions for other manufacturers and utilities. Besides being limited to certain types of machinery and equipment, the energy used to operate exempt telephone equipment and to provide the telephone transmission is not exempt from tax. The industry's exemptions are also narrow compared to the exemptions granted certain other industries, such as oil and gas producers. That industry's exemption includes the distribution systems needed to bring the oil or gas to the point of sale to the first commercial purchaser.

Finally, although cable television companies and certain information services providers purchase similar type equipment, they are not eligible for the sales tax exemption.

*Sales Tax Paid on Installation, Maintenance and Repair Services*

New York levies the sales tax on installing, maintaining and servicing real property and tangible personal property. Installing, maintaining and repairing exempt telephone equipment is exempt from State tax, and from local tax in New York City,[14] but not from local sales tax outside the City. However, installing tangible personal property is exempt from State and local tax if, when installed, the tangible personal property results in a capital improvement to real property.[15]

The capital improvement exemption has significant implications regarding the installation of telephone lines and fiber optic cables, satellite earth stations and cellular base stations.

*Potential Solutions*

The final report will examine how the sales tax on purchases made by telephone service providers impacts New York's efforts to develop and improve its telecommunications infrastructure. It will also examine the impact the tax may have on decisions to place telecommunications facilities within New York.

Some potential legislative solutions to the issues raised thus far include:

- modernizing the statutory language by replacing current terms such as "station apparatus" and "central office switching equipment" with a list of appropriate current terms;
- replacing the current exemption, which focuses on specific types of equipment, with a broader, process-based exemption similar to exemptions granted producers of tangible personal property and various other utility services for sale;
- replacing the current exemption with a broad exemption for the tangible personal property and utility services used in all aspects of telecommunications production and transmission;
- providing parallel exemptions for cable television services providers; and
- clarifying the application of the capital improvement exemption with respect to the kinds of purchases made by telecommunication service providers.

## Conformity with Article 9

*Description*

The recent changes to Article 9 of the Tax Law established the Section 186-e excise tax on telecommunications service providers. This tax now represents a transaction-based tax, much like the sales tax. However, as currently structured and administered, the two taxes have some differences that add to compliance costs. For example,

- the sales tax does not allow early payment discounts to reduce its tax base while the Section 186-e tax does; and

- the sales tax does not include interest charged for late payment in its base, while the Section 186-e tax does.

*Potential Solutions*

The advisory panel and the Department will work together to review where the sales tax and the Section 186-e tax could be administered similarly. They will also identify statutory changes which could improve administration.

## Other Sales Tax Issues

In discussions with the advisory panel, some miscellaneous sales tax issues surfaced. These items, although not the primary focus of the study, will receive consideration in the final report. These issues include the application of the sale for resale exemption to telecommunication service providers, the threshold for exempt coin-operated telephones, guidance regarding the use of prepaid phone cards and the burden of local school district taxes.

**The sale for resale exemption:** Telephone services purchased for resale are not subject to sales tax. To qualify for the exemption, the purchaser must resell as telephone service the service originally purchased. For example, when an IXC purchases access from a LEC, that purchase is exempt from tax. However, telephone services used to provide telecommunication-intensive services, such as information services provided by telecommunications, cannot be purchased for resale. This contrasts with how the resale exemption applies for companies that produce tangible personal property for sale. There, the resale exemption includes goods or services purchased as a component part of the property held for sale.

**The coin-operated telephone exemption:** The sales tax exempts telephone and telegraph charges of ten cents or less paid by inserting coins in coin-operated telephones. Some representatives of the advisory panel note that the exemption for coin-operated telephone calls is another provision which has not kept pace with industry changes. The exemption covers only ten cent calls, though the current base charge for a coin-operated call is twenty-five cents.

**Prepaid Phone Cards:** Prepaid phone cards provide a convenient way for consumers to make telephone calls when away from home. They also raise tax administration issues. New York has ruled that selling the phone card itself does not represent the sale of telephone service or tangible personal property.[16] However, this ruling does not address many issues such as determining the correct local tax jurisdiction, how the State taxes any price mark-ups between the cost of the phone service and the price of the phone card, or the tax collection responsibilities of an out-of-state telephone company whose phone card was used in New York to make an intrastate call.

**Local School District Taxes**: Certain industry representatives noted in panel meetings that, particularly in light of developments in mobile communications, school district taxes have become harder to comply with. Furthermore, the additional rates impose a high tax burden on telecommunications users in that district.

## Corporate Tax Issues

The two previous sections of telecommunications issues dealt with application of sales tax rules to mobile and wireline services. The other major tax affecting telecommunications providers, administered by the Tax Department, is the corporate tax. The background sections described New York's treatment of telecommunications companies under a series of possible taxes. Many combinations of sections of Article 9 and/or Article 9-A, or even Article 22 (the personal income tax), could apply depending on the outcome of several tests. These tests include how the business is organized - as a corporation, partnership, etc., whether the provider is principally engaged in telecommunications, whether it is a local telephone company, and whether it is subject to PSC (same as the Department of Public Service) supervision.

Two major parts comprise this section. The first part describes the more global question of how to tax telecommunications companies. One option suggested by members of the advisory panel included shifting telecommunications companies from the Article 9 gross receipts tax to the net income tax under Article 9-A. This report will briefly touch on some issues raised by this concept.

The second part of this section briefly examines more limited options for instituting reforms to the existing tax structure. This part will outline possible options that address shortcomings in the law, and other issues raised by the Legislature during the negotiation of the 1995 law, or by industry.

The options contained in these two parts are not mutually exclusive. Their appropriateness may be one of timing. For example, should a recommendation be made in the final report that telecommunications companies be taxed under Article 9-A, it may require a transition period to achieve that goal. In such an event, it could still necessitate an examination of potential solutions to existing problems in the tax structure.

## Nature of Corporate Taxation for Telecommunications Companies

*Description*

States imposed gross receipts taxes on telecommunications companies at a time when the government exacted a fair exchange from them for their monopoly franchise. However, not all other providers of telecommunications services necessarily pay tax on a gross receipts base. Depending on the "principally engaged" test described earlier in this study, some companies may already pay tax on a net income base. Therefore, companies in direct competition with each other to provide services could be taxed differently.

*Potential Solutions*

One option, adopted by many other states, is to tax telecommunications providers under the general corporate franchise tax, Article 9-A. Under this approach, telecommunications companies would no longer pay franchise tax under Article 9. This would eliminate Sections 183 and 184. Instead, all companies would pay franchise tax under Article 9-A. In addition, it would repeal the Section 186-a excise tax for regulated telecommunications providers. A phase-out or repeal of Section 186-e could also accompany this proposal.

A variety of technical issues surround such an option. Some of these issues would include necessary transition rules to change companies from gross receipts taxation to net income taxation such as depreciation and net operating loss deductions. For instance, the treatment of depreciation expenses differs between book accounting and tax accounting. Ignoring these differences could result in substantial implications for companies' financial statements. They could also result in a mismatching of expenses and revenues in determining taxable income. The final report will explore these types of issues in more detail.

Other nontransition issues could arise as well. For example, such an option would have to specify reasonable sourcing and allocation rules. The method of receipts sourcing under a gross receipts tax may not be applicable for sourcing receipts under a franchise tax measured by income. Such an option would have to examine the applicability of the current three-factor formula used to allocate income under Article 9-A. A discussion of this policy option would require analysis of combination of telecommunications companies with their nontelecommunications subsidiaries.

Finally, the discussion of this option will address the implications for rate-making, including the competitive concerns surrounding the manner in which a company "flows through" a franchise tax based on net income to its consumers. Currently, the appropriate regulatory agency insures the "pass through" of the gross receipts tax to final consumers by permitting a surcharge to reflect the tax. A pure "pass through" of an income tax may not be as straightforward. The final report will examine this issue.

A variation on this alternative would allow taxpayers an election. They could pay tax under either Article 9 or Article 9-A. If a taxpayer did not make an election to stay as an Article 9 taxpayer, the company would become an Article 9-A taxpayer from that time forward.

*Other States' Practices*

Case discusses the changes in the state taxation of telecommunications services. Since 1986, 12 of the 30 states that imposed a gross receipts tax abandoned this system of taxation of telecommunications services.[17] Our research, contained in an earlier section of this report, shows that 20 states still impose some type of gross receipts tax on telecommunications companies. However, the scope of the tax base varies considerably among the states.

## Limited Corporate Tax Options

*Description*

Although the 1995 amendments to Article 9 repaired certain defects in the former law, problems remain that were not addressed in 1995. One problem results from the interaction among the various sections of the restructured Article 9. The statute provides that only principally engaged local providers remit tax under Section 184 (a 0.75 percent tax on gross receipts from all sources). Long distance providers are no longer subject to Section 184. In addition, the legislation established a new section of tax, Section 186-e, that essentially replaced Section 186-a. However, it provided for a different calculation of telecommunications gross receipts. PSC regulated telecommunications companies continue to pay a 3.5 percent gross receipts tax under Section 186-a on their nontelecommunications income.

Currently, all providers principally engaged in telecommunications pay a franchise tax under Section 183, a tax on capital. However, only providers principally engaged in local telephone service pay a gross receipts tax on all of their income under Section 184. Additionally, telecommunications providers subject to PSC regulation pay a 3.5 percent gross receipts tax on their nontelecommunications income under Section 186-a. Section 186-e imposes a gross receipts tax on income from telecommunications services.

Therefore, a company pays tax on 0 percent, 0.75 percent, 3.5 percent, or 4.25 percent of its nontelecommunications gross income depending on the combination of factors that apply to it.

The interaction of the various sections of the Tax Law results in long distance companies not subject to PSC supervision paying no tax on their nontelecommunications income. This anomaly in the law results in an unlevel playing field. These types of providers pay no tax on their nontelecommunications income, while other providers (e.g., those regulated by the PSC) of the same service pay tax on the income derived from these services.

*Potential Solutions*

Parties to the negotiation of the 1995 statute agreed that this study would examine solutions to the problem. One approach would establish some form of taxation of nontelecommunications income for companies currently paying franchise tax under Article 9. This approach would alter the existing Article 9 structure such that telecommunications companies would pay tax on their nontelecommunications receipts. This includes those companies that provide local service or are subject to PSC regulation. The tax on this income could apply on either a net income or gross receipts basis.

*Description* & *Potential Solution*

An additional option for changing the current taxation of telecommunications companies includes exempting certain types of services from the definition of taxable telecommunications services. Examples of the types of exemptions include private lines, toll-free numbers, or packet-switching operations. Adopting certain exemptions for services consumed primarily by businesses could provide economic development incentives. Such an option might, for example, benefit the financial services sector and other large volume consumers of telecommunications services. This option would not, however, solve the existing problems in the taxation of telecommunications discussed above.

*Description* & *Potential Solution*

Another possible option for altering the current tax structure of telecommunications companies would leave the structure essentially unchanged (except for fixing the anomaly), but it would reduce the rate imposed under Section 186-e. A phased in reduction could help achieve a desired revenue target. Reducing the Section 186-e rate would lessen the impact of the current layering of taxes upon telecommunications services.

# Endnotes

1. This discussion relates to separately stated charges for particular telephone calls or other telephone transactions, (e.g., separately stated charges for airtime or a separately stated toll charge.) In general, the discussion does not relate to “basic” monthly subscription charges or flat rate charges billed to a New York customer.

2. Appendix C lists local tax jurisdictions for each CGSA.

3. Distinguishing intrastate calls from interstate calls is not a significant issue in every state. First, many states do not have CGSAs which overlap state boundaries. When customers place a call from another state, they are identified as “roaming.” Second, a number of states tax interstate calls. Therefore, calls remain taxed whether intrastate or interstate.

4. See the Glossary for additional detail on roaming services.

5. Issues surrounding local rates are discussed later in this section.

6. Or make arrangements to receive them within 90 days of providing the service.

7. Issues surrounding local rates are discussed later in this section.

8. Appendix C lists the local tax jurisdictions for each CGSA.

9. In the remaining seven CGSAs, the difference between the highest and lowest tax rate is 2 percent or less.

10. Taxpayers who wish an interpretation of any tax which the Department administers may request an Advisory Opinion. An Advisory Opinion is binding on the Department for the particular taxpayer who requested it. They are limited to the specific facts set forth in the request and are not binding with respect to others.

11. The Internet uses the term gateway or router to describe a machine that performs relaying functions between networks (Uyless Black, Emerging Communications Technologies, Prentice Hall, 1994). Some Internet service providers provide only “gateway” services to their customers.

12. Michigan’s statute also states that the tax encompasses leased lines, wires, or other similar communications.

13. The Regulation does not define qualifying “central office equipment or station apparatus.” In fact, only one example describes qualifying exempt equipment. This example states that a telephone company may purchase “switchboards and hand sets for installation at a subscriber’s premises” exempt from tax. Furthermore, no TSB-M describes this exemption in detail. The Department has issued some advisory opinions that list qualifying equipment.

14. New York City provision becomes effective on September 1, 1996.

15. If the installation qualifies as a capital improvement, the contractor or installer pays tax on the materials it purchases, but does not charge any tax to the customer. If not, the contractor or installer must charge tax on materials and labor.

16. TSB-A-94(33)S.

17. Karl E. Case, State and Local Tax Policy and The Telecommunications Industry, 1992, p. 5.