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Improving New York State's Telecommunications Taxes

Final Report and Recommendations

George E. Pataki
Governor

Michael H. Urbach
Commissioner of Taxation and Finance

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Executive Summary

New York State's economy relies on a healthy and growing telecommunications industry.
Telecommunications represents one of the most dynamic industries in the world. Originally conceived as a method of transporting telegraphic, and then voice messages from one place to another over wires, telecommunications now encompasses many new and advanced technologies. New York State's economy relies on a healthy and growing telecommunications industry. The preliminary report issued in August 1996 illustrated the importance of this industry to the State's economic well-being. As technology advances and the importance of the industry grows, the current tax structure has become increasingly outdated. It cannot handle all the questions emanating from these new technologies and market forces.

Legislation enacted in 1995 mandated the Department of Taxation and Finance to study telecommunications and recommend changes.
These factors provide the backdrop for this study. Legislation enacted in 1995 mandated the Department of Taxation and Finance (the Department) to conduct a study of telecommunications taxes in New York State. Appendix A contains the entire mandate language. The legislation also provided for the appointment of an advisory panel (see Appendix B) consisting of representatives from affected telecommunications providers, users of telecommunications, and government. We thank the panel members for their crucial assistance in preparing this report.

Through our panel meetings, several issue areas were identified in the preliminary report as needing possible revision. These issues are analyzed in this final report. During the fall of 1996, Department staff met several times with the advisory panel to gather information in the analysis phase of the study. This information was then presented to Commissioner Michael Urbach for his recommendations. These recommendations are made in the context of looking at the tax structure for this industry and they do not account for other competing desires for the State's resources and the associated impact on the State's financial plan. Government policy makers, therefore, must balance these recommendations against those competing needs.

The issues raised by the panel centered on three areas, corporate tax issues, general sales tax issues, and cellular telephone issues. The particular issues for each area are presented, along with the Department's recommendations. At the end of this summary, a discussion of the priorities from the perspective of the advisory panel is offered to help frame future policy choices.

Corporate Tax Issues

Net Income Taxation

Issue
The corporate section of the report contains several intertwined issues. The first issue concerns the proper method for taxing telecommunications companies. Currently, providers principally engaged in telecommunications pay tax on a gross receipts basis. The report discusses whether it is desirable to move these companies to a tax based on net income.

Recommendation
The Department believes that a change to a tax based on net income may represent an ultimately desireable tax policy goal. However, the interaction of such a major change with existing regulatory and local tax policies suggests that it is not the best approach today. The interaction of the effects of ongoing regulatory reforms with those of such major state tax changes is not at all certain at this time. Therefore, in the context of these concurrent events, it is premature to recommend at this time a switch to a net income tax.

Changes to the Gross Receipts Tax
Issue

The current corporate taxes imposed on telecommunications companies do not apply equally to all companies. In addition, these taxes apply to a broad array of services at rates that are significantly higher than in most other states.

It is premature to recommend a switch to a net income tax. The Department recommends that the Section 184 additional franchise tax imposed on local telephone businesses be eliminated.
Recommendation

Changes to the current tax structure under Article 9 are warranted. As fiscal constraints permit, the Department recommends that, first, the Section 184 additional franchise tax imposed on local telephone businesses be eliminated. This will level the playing field among providers and eliminate tax distinctions based on the type of service provider. Second, the Section 186-a tax on the nontelecommunications income of PSC regulated companies also creates inequities. This report suggests a concept for removing this inequity by instituting a replacement tax under Section 183. The Department recommends that the industry continue to work with us to refine these ideas into a workable solution that achieves tax equity without hindering competition in New York. Finally, the Department recommends reducing the tax rate on Section 186-e to improve the competitive position of all telecommunications providers and to lower the costs of service to consumers of telecommunications services in this State.

General Sales Tax Issues

Internet Service Providers

Issue

The Department was asked how Internet service charges should be treated for purposes of the sales tax and the gross receipts tax. Other states treat these charges as either taxable telecommunications services, information services, computer programming services or nontaxable services.

Recommendation

Internet services are unenumerated services not subject to the sales tax.

New York finds that Internet services are unenumerated services not subject to the sales tax. Because they are not telecommunications, these receipts are also outside the scope of the Section 186-e gross receipts excise tax. Additional consultation with Internet service providers is needed to develop concise definitions and to distinguish these services from taxable information and entertainment services, and from taxable telecommunications. Further, New York believes that nexus with the State is <u>not</u> created merely by having a non-New York company's advertising appear on a New York server or through a New York Internet service provider.

Prepaid Phone Cards

Issue

New York's current policy is that sales and gross receipts taxes are imposed on prepaid phone cards when consumers use the cards. Some members of the advisory panel asked that the policy be changed to consider the taxable event to occur when the card is sold at retail. In particular, they preferred that the card be considered tangible personal property, not telecommunications, to alleviate taxability under Section 186-e.

Recommendation

The study recommends that an industry/government task force be organized to promote as much uniformity among the states as possible on issues arising from the use of prepaid phone calls.

New York should retain its current policy of taxing the cards when used. The legal defects in the options to tax the entire retail sales price of the cards when sold, either as telecommunications or tangible personal property, make them difficult to recommend given New York's narrow sales tax base on telecommunications. The possibility of taxing calls that are not subject to sales tax (e.g., interstate and international calls) is too great to warrant a policy change at this time. However, New York recognizes the need to have uniform rules across the states to avoid the possibility of multiple taxation. The study recommends that an industry/government task force be organized to promote as much uniformity among the states as possible on issues arising from the use of prepaid phone cards.

Sales Tax Production Exemptions

Issue

The current sales tax exemption for central office switching equipment has become outdated. It does not reflect the new types of equipment used in producing telephone calls.

Recommendation

New York's central office switching equipment exemption needs revision.

The first priority is to update the current statute to exempt all machinery and equipment used directly and predominately in initiating, switching or receiving telecommunications at destination. The exemption should also include equipment that processes and amplifies signals. This extends the exemption beyond the current "central office switch." To the extent that fiscal constraints allow, the exemption could later be broadened to include all network property and utility services used directly and predominately in telecommunications. This exemption would also include telephone lines, poles and towers and it would provide a similar exemption to the one found in New Jersey. A third priority would be to enact new sales tax exemptions for equipment used to provide television programming services.

Coin-Operated Telephone Services

Issue

The sales tax exempts telephone charges of 10 cents or less made from coin-operated phones. Some panel members noted that the exemption has not kept pace with industry changes where the base charge now costs twenty-five cents.

Recommendation

The Public Service Commission should modify its rate making rules to ensure that the coin telephone rates include the sales tax.

The Public Service Commission should modify its rate making rules to ensure that the coin telephone rates include the sales tax. Therefore, the twenty-five cent charge would be comprised of approximately twenty-three cents for the call and approximately two cents in sales tax. This solution would avoid tax equity issues raised by exempting phone calls made from pay phones. It also sets the stage for impending deregulation of pay phones under recent FCC rules.

Cellular

Cellular Telephone Services

Issue

The mobile nature of cellular telephone service raises questions on how to assign calls to particular localities. Cellular companies are looking to the Department for guidance on how to apply local sales tax rates. Cellular calls made when “roaming” outside of one’s home area raise additional questions about which company should collect the tax and what local tax rate applies.

Recommendation
The Department recommends using a service address concept based on the location of primary use to source cellular charges.
For purposes of determining local sales tax rates, the Department recommends using a service address concept based on the location of primary use to source cellular charges, other than separately stated roaming charges. A customer’s billing address works in most cases. Nevertheless, much work needs to be done to clarify the guidelines to administer this approach. Thus, members of the cellular industry are invited to work with the Department to develop these rules to ensure that they are clear and meet the needs of this rapidly changing technology. The cellular industry has formed its own task force to examine the tax treatment of roaming charges for calls made outside of a subscriber’s home area. A report from this group is due by the end of January 1997. The Department prefers to await the outcome of that report before proceeding to develop guidelines for roamer calls.

Other Sales Tax Issues

Through our discussions with the advisory panel, several other common sales tax issues became evident. There appears to be a lack of guidance provided by the Department, especially to new entrants into the telecommunications field. The recommendations contained in this study should aid in achieving the goal of providing timely and accurate information to some of these businesses. The Department will continue to work with industry to clarify other areas not specifically addressed in this report. As an example, some panel members raised the issue of the application of the rules for capital improvements under the sales tax. Part of this process may involve reviewing the current regulations and guidelines to make them more relevant to today’s telecommunications environment.

Recommendation Priorities

Discussions with the advisory panel helped shape the recommendations found in this report. The panel also provided insights as to which of these recommendations need to be implemented first, should policy makers choose to enact them. The recommendations may be classified into two areas, those that can be done administratively by the Department, and those that require a change in the statute. This report enunciates the Department’s policy on Internet service providers, prepaid phone cards, and cellular telephone services. In each case, Department/Industry cooperative efforts will be needed to clarify unresolved issues. Regarding possible legislative changes, the survey of panel members conducted this past summer showed that amending the current sales tax exemption for telephone central office switching equipment was important. This was followed by reforms to the Article 9 gross receipts tax including the elimination of Section 184, fixing the problems in Section 186-a, and lowering the overall tax burden by reducing the Section 186-e tax rate.

Additional Issue Areas

The Department recommends that a local tax task force comprised of industry members, local government representatives, and appropriate State agencies be formed to examine areas where local taxes could be modernized and administration and compliance simplified.

Two additional issues require attention. First, the advisory panel was concerned about the effect of local taxes on telecommunications companies. New York State's local governments impose and administer a myriad of sales taxes, gross receipts taxes, property taxes and franchise fees. Additionally, the bases of some of these taxes do not always correspond with comparable State taxes. Many of the important issues raised in our discussions with the advisory panel about these taxes go beyond the scope of this report. However, the Department recommends that a local tax task force comprised of industry members, local government representatives, and appropriate State agencies be formed to examine areas where local taxes could be modernized and administration and compliance simplified.

Second, the recommendations in this report represent the Department's best efforts as of December 1996. However, the telecommunications industry is evolving continuously. Several years, or even months, from now some of the situations described in this report may not exist or may have changed. Because of the importance of this industry to New York, the Department recommends that the conclusions of this report be reevaluated in a few years time to see if the recommendations are still valid, and how any statutory or administrative changes adopted subsequent to this report have affected the telecommunications industry.

The Effectiveness of Chapter 2 of the Laws of 1995

Chapter 2 of the Laws of 1995 restructured the gross receipts tax on telecommunications providers. Section 42 of the legislation also mandated that the Department of Taxation and Finance (the Department) conduct a study of telecommunications taxation in New York State (the complete language is found in Appendix A).

This section of the study will evaluate the effectiveness of the 1995 law changes in improving the taxation of telecommunications services in New York State. It describes the principal law changes and analyzes the revenue impact of those changes, where applicable.

The 1995 legislation was intended to create a new tax structure that would reduce Article 9 taxes by an amount approximately equal to the prospective revenue loss imposed by the Court in the AT&T law suit[1]. The Department estimated that the Court-ordered solution would decrease revenues by about $30 million per year (excluding surcharges)[2]. The revenue effect of the Court decision on the State's 1995-96 financial plan would have been greater if the four major interexchange carriers (IXCs), AT&T, MCI, Sprint and Frontier Communications International, Inc. (formerly RCI Long Distance), had not agreed to forgo certain refund claims for prior years. While there exists a revenue loss from Chapter 2 of the Laws of 1995 in later years, one must remember that the Court's decision would have produced a comparable revenue loss. The Legislature intended consumers to benefit from any tax savings realized from the 1995 law changes including the amount equaling the revenue loss from the Court-ordered solution[3]. As directed by the Legislature, the Public Service Commission (PSC) sought to ensure that these tax savings were passed-on to ultimate consumers through reduced rates for telecommunications services.

The following revenue analysis examines the overall revenue effects of the new law relative to the tax structure that existed prior to the AT&T telecommunications case. The analysis identifies certain revenue estimation issues, including data limitations, and then describes the specific changes to Section 184 and Sections 186-a/e and the revenue impact of those changes.

Revenue Estimation Issues

To reconcile the estimated and actual revenue changes, one would typically look at the pattern of Article 9 collections between 1994 (pre-Court decision) and 1995 (new law). However, the bill became law in July of 1995, effective for tax years beginning January 1, 1995. By the time taxpayers learned of the new law in July, many taxpayers had already remitted estimated payments for their Section 184 and Section 186-a taxes in March and June of 1995. Monies paid into these accounts were eventually credited to the new Section 186-e accounts in the following year. Additionally, some taxpayers filed their 1994 return and initial 1995 estimated taxes in accordance with the Court-ordered solution. Thus, collections for 1995 do not accurately reflect the changes made in the legislation.

Given the difficulties in undertaking a meaningful comparison of 1994 and 1995 collections, the next best approach would be to analyze the impact on 1995 tax liability of these legislative changes. One way to approach this would be to compare the 1995 Article 9 liability under the new law with a hypothetical 1995 tax liability in the absence of the law change and the Court decision.

The analysis cannot accomplish this comparison for two reasons. First, the 1995 liability needs to be estimated as many taxpayers opted to file full-paid extensions on the due date of the return in March. For these taxpayers, only the estimated liability for each section of Article 9 is available to conduct the analysis. Second, because of the differing tax bases under the new law and the old law (or even under the Court-ordered solution), one will never know what the 1995 liability would have been in absence of the law changes.

A third best approach, and the one actually followed, was to compare estimated 1995 tax liabilities under the new law with actual 1994 liability as an approximation of what the companies might have paid in 1995 had the law not changed. The actual 1994 liability figures had to be supplemented with historical data for those companies that filed their 1994 returns under the Court-ordered solution.

To aid the Department in its analysis of the revenue effects of these law changes, 45 telephone companies provided data regarding their estimated 1995 Section 186-e tax liability[4]. Therefore, this analysis of the revenue impact of the 1995 law changes requires combining data from final returns (where available), from estimated returns, and from the detailed information provided by individual companies. For these reasons, the analysis of the revenue impact should be considered preliminary.

The temporary business tax surcharge fell from 12.5 percent to 7.5 percent from 1994 to 1995, respectively. This alone accounted for a substantial decrease in liability. However, to isolate the impacts of the telecommunications law changes, the analysis which follows reflects liability prior to the imposition of the surcharge.

Table 1 shows the original revenue estimates (prepared in 1995) and the preliminary results of these changes based on the methodology described above. Not counting tax surcharges, we estimate that the 1995 law change resulted in approximately a $40 million revenue loss from the pre-Court decision tax base. The original estimate was approximately $33 million. The less than $7 million difference amounts to about one percent of the total telecommunications taxes under Article 9. The following section describes the specific changes in the 1995 law and their related revenue impacts.

Table 1: Revenue Impact of Chapter 2 of the Laws of 1995

Provisions	Orig. Estimate (1) ($ Millions)	Prelim. Results (1) ($ Millions)
Section 184		
Repeal Section 184 for IXCs:	(29.70)	n/a (2)
Exclusion of interLATA, interstate and international receipts of non-interexchange carriers:	(1.70)	n/a (2)
Section 184 Subtotal	(31.40)	(35.00)
Section 186-a/e (3)		
Eliminate access deduction for IXCs and allow full deduction for LECs:	(43.70)	n/a (2)
Change to *Goldberg* allocation method:	42.00	n/a (2)
Section 186-a/e Subtotal	(1.70)	(5.00)
Grand Total	(33.10)	(40.00)

Notes:
(1) These data exclude the temporary business tax surcharge and the MCTD (Metropolitan Commuter Transportation District) surcharge.
(2) These data are presently unavailable due to the large number of major taxpayers that filed extensions for tax year 1995. Taxpayers can file up to four 3-month extensions under Article 9. Therefore, complete 1995 tax return information will not be available until March 15, 1997. Subtotals were derived using the estimated annual tax liability claimed on taxpayers' extensions.
(3) Liability exists for telecommunications providers subject to PSC supervision under Section 186-a and Section 186-e. All others have liability under Section 186-e only.
Source: Office of Tax Policy Analysis, NYS Department of Taxation and Finance.

Section 184 Changes

Repeal of Section 184 for Interexchange Carriers (IXCs)

The 1995 law amended the Section 184 additional franchise tax on transportation and transmission corporations so that the tax only applies to telecommunications companies principally engaged in a local telephone business. The tax excludes companies principally engaged in providing long distance services (e.g., IXCs) for taxable years beginning on or after January 1, 1995.

As Table 1 shows, the original estimate of the revenue loss associated with this provision was approximately $31 million. As a result of these changes, non-local telecommunications companies (approximately 70 companies) no longer need to file the Section 184, or the related Section 184-M, tax returns. Also, because of substantial differences between the former Section 184 and Section 186-a tax bases, telecommunications providers subject to both taxes had to maintain separate books and records for compliance purposes[5]. This had long been a point of contention with the industry.

Exclusion of InterLATA, Interstate and International Receipts

The new law also contained an exclusion to equalize the tax treatment of services provided by both IXCs and local exchange carriers (LECs), which remain subject to the Section 184 tax. Effective January 1, 1995, Section 184 excludes receipts from sales for ultimate consumption of interLATA[6], interstate, or international services. The original estimate of the revenue loss associated with this provision equaled less than $2 million.

Exclusion of 30 Percent of IntraLATA and Interregion Regional Calling Plan Service Receipts

Another exclusion to equalize the tax treatment of services provided by IXCs and LECs became effective on January 1, 1996. Section 184 now excludes 30 percent of receipts from sales for ultimate consumption of intraLATA toll services, including interregion regional calling plan services. This provision seeks to exclude intraLATA toll charges not related to carrier access, or its equivalent, from the purview of the tax. This provision was instituted to level the playing field between IXCs and local telephone companies providing long distance services within a LATA. The revenue impact of this provision is not presented herein as the provision first applies in the 1996 tax year.

Section 184 Revenue Analysis

As Table 1 shows, the original revenue loss resulting from the repeal of the Section 184 tax for IXCs and the exclusion of interLATA, interstate, and international receipts of local telephone businesses still subject to the tax was estimated to be $31.4 million.

Section 184 liability decreased by approximately $35 million from 1994 to 1995. Some portion of this amount may relate to factors other than the legislation. Alternatively, the revenue difference could be somewhat larger depending on the year-to-year growth experience of these companies between 1994 and 1995.

Due to the number of taxpayers filing extensions under Section 184, it is not possible to disaggregate this number to precisely determine how much of the reduction in liability relates to each factor. There can be no doubt, however, that the repeal of the tax for IXCs accounted for the vast majority of this liability change. In 1995, approximately 70 taxpayers previously required to file a Section 184 return no longer filed. A smaller amount of the revenue loss relates to the exclusion of interLATA, interstate and international receipts of local telephone businesses under Section 184.

Section 186-a/e Allocation and Access Deduction Changes

The legislation also shifted the 3.5 percent excise tax on receipts from telecommunications services from Section 186-a to a new Section 186-e. However, providers subject to the supervision of the Public Service Commission (the so-called "class 1" utilities) still owe tax under the original Section 186-a on their nontelecommunications receipts[7].

Section 186-e Allocation Method

The replacement of the property factor apportionment of interstate and international receipts with a more certain method effective for taxable years beginning on or after January 1, 1995, caused a discernible revenue impact. The original estimate for this change equaled $42 million in increased revenue between tax year 1994 to 1995.

Section 186-e uses the Goldberg allocation method to determine New York taxable telecommunications receipts.

The new Section 186-e uses the *Goldberg* allocation method to determine New York taxable telecommunications receipts from interstate and international services. This method gets its name from the U.S. Supreme Court case *Goldberg v Sweet* (488 U.S. 252) (1989). It allows states to impose an excise tax on 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[8].

A critical feature considered by the U.S. Supreme Court in validating the *Goldberg* method was the presence of a credit mechanism for like taxes paid to other states. The credit prevents the unlikely event of multijurisdictional taxation of the same interstate and international services. Section 186-e includes this credit provision. The credit applies to like taxes paid to other states and countries on the same telecommunications services. The maximum credit permissible equals the amount of like tax actually paid.

The vast majority of states that impose their gross receipts and/or sales and excise taxes on receipts from interstate and international telecommunications services use the *Goldberg* method to allocate these receipts[9]. *Goldberg* is more representative of actual business activity carried on in a particular state. This contrasts with New York's prior method of allocation.

Before the 1995 legislation, New York State apportioned interstate and international receipts with a property factor. This factor equaled the average value of transmission property within New York State divided by the average value of such property everywhere. Changes in technology and industry practice rendered this method an increasingly obsolete measure of business activity in the State.

The property factor allocation method served as a disincentive to locating telecommunications property in the State of New York. It also created an "uneven playing field" among different telecommunications providers as New York consumers faced lower taxes if they purchased telecommunications services from companies with very little property in the State.

The allocation of receipts for purposes of calculating the temporary tax surcharge in the Metropolitan Commuter Transportation District (MCTD) in downstate New York also now follows the *Goldberg* rules discussed under Section 186-e. New York State earmarks receipts from the surcharge for the Mass Transportation Operating Assistance Fund that supports public transportation.

Section 186-e Access Deduction

The legislation also moved the "sale for resale" deduction for carrier access purchased in New York back to the initial seller when they sell access to an IXC or local carrier. For other sales for resale, the law allows a credit to purchasers that subsequently resell these services. The estimated pre-surcharge revenue loss attributable to this provision equaled approximately $44 million from tax year 1994 to 1995.

Section 186-a/e Revenue Analysis

The net revenue loss associated with the Section 186-a/e changes was originally estimated at under $2 million. This figure was equal to the net of the $42 million revenue gain from the switch to the *Goldberg* allocation method and the $44 million loss from the shifting of the access deduction from the IXCs to LECs.

The preliminary estimates of the net revenue loss from these provisions equaled approximately $5 million. Again, these data are preliminary because many of the IXCs and LECs filed for extensions for filing their 1995 tax returns. In addition, the lack of detail means that a disaggregation of this net revenue is not possible.

Once corrected for a 1994 liability reduction due to the settlement of the AT&T lawsuit (see the preliminary report for more detail), the 3.5 percent tax on telecommunications receipts remained fairly constant at over $450 million in both 1994 and 1995. However, IXCs had a higher liability mainly from the new *Goldberg* allocation method, while local companies saw a reduction in their liability due to reinstitution of the access deduction at the LEC level. About $420 million of the total comes solely from those companies providing information to the study.

The companies that provided information on their Section 186-e excise tax liability also provided information about some of the computations they made in determining this liability.

Table 2: Telecommunications Charges and Section 186-e Excise Tax for Selected Companies in 1995

Type of Service	Gross Charge ($ Millions)	NYS Gross Charge ($ Millions)	NYS Excise Tax Due ($ Millions)
Intrastate	7,240	6,483	225
Interstate and International (1)	6,500	4,714	163
Ancillary Services	172	160	6
Incidental Services	148	17	1
Equipment provided in connection with the service	82	80	3
Total	14,446	12,075	419

Notes:
(1) Includes only those originating or terminating in New York and charged to a New York service address.

As Table 2 shows, over half of the Section 186-e liability comes from telephone services within New York State. Most of the difference between the gross charge and the New York gross charge is due to the carrier access deduction and the general sale for resale deduction/credit.

Other Section 186-e Provisions

The new Section 186-e also contained several provisions without discernible revenue impacts. The following describes these changes.

Removing the Prohibition Against Stating Tax on Customer Bills

The legislation eliminated the long-standing prohibition against telecommunications providers separately stating the tax on customer bills. This provision existed under the old Section 186-a, but does not apply under the new Section 186-e.

Clarification of Existing Tax Policy

The legislation clarified several matters concerning New York State's existing telecommunications tax policy. First, the statement of legislative intent contained in Chapter 2 of the Laws of 1995 notes that, by enacting the new Section 186-e, the Legislature did not intend to affect the existing distinction between telecommunications services and information services as established in prior court decisions such as *Quotron Systems v Gallman* (39 NY2d 428) and *Holmes Electric Protective Co. v McGoldrick* (262 App Div 514 affd 288 NY 635)[10]. The Section 186-e definition of telecommunications draws this distinction by stating that telecommunications services exclude: ". . . charges for any service which alters the substantive content of the message received by the recipient from that sent.[11]"

A 1988 Tax Appeals Tribunal Decision, *Matter of Capital Cablevision Systems* (TSB-D-88(3)C, June 9, 1988), established that cable television providers are taxable on their net income under Article 9-A as general business corporations. Before this time, these companies were subject to tax as "transmission companies" under Article 9. Chapter 2 of the Laws of 1995 includes a specific exclusion for cable television service, provided by either wire, cable or microwave, that reflects this decision[12].

Lastly, Section 186-e also exempted certain companies from the purview of Section 186-e. The exemption pertains to corporations principally engaged in providing telecommunications services between aircraft and dispatchers, air traffic control, or ground stations[13].

Definition of Telecommunications Services

The legislation also clarified the definition of telecommunications services in the new Section 186-e tax to clearly include services provided using any transmission means such as wire, satellites, fiber-optic, laser, microwave or radiowave. The definition also provides examples of the types of services subject to tax. The old Section 186-a language referred to "utilities" that delivered telephony or telegraphy services through, or furnished by means of "wires.[14]" The new Section 186-e was not intended to change the tax base. Rather, it was intended to modernize the definition and prevent the positions put forth in *GTE Spacenet* "wires" case from becoming precedent for future periods.

Allocation of Receipts from Private Telecommunications Services

Chapter 2 of the Laws of 1995 defines private telecommunications services as: ". . . dedicated telecommunication service that entitles the user or users to the exclusive or priority use of a communications channel or group of channels from one or more locations to one or more locations.[15]" Because private telecommunications services are often interstate in nature, and lack definite points of origination and termination, allocation of receipts from these services is not possible using the *Goldberg* method.

Before enactment of Chapter 2 of the Laws of 1995, New York State Tax Law and regulations did not specifically address the tax treatment of these services. Allocation of these receipts took place using the general property factor allocation method. As a result, the same issues surrounding the apportioning of New York receipts existed for private telecommunications services as for receipts from other telecommunications service.

The law calculates the portion of these "flat" charges attributable to New York State as follows:

- one hundred percent of the charge imposed at each channel termination point within New York; plus

- one hundred percent of the charge imposed for the use of a channel between termination points within New York; plus either:

  (A) 50 percent of charges imposed for service between the first termination point outside New York and the nearest New York channel point (if separately charges apply for each channel point); <u>or</u>

  (B) an allocated portion of interstate and international channel charges based on the ratio of New York channel points to channel points everywhere.

Telecommunications providers select the appropriate allocation method based on how they bill their customers for the provision of private interstate or international telecommunications services. Both methods ensure that Section 186-e applies only to the portion of interstate and international receipts attributable to New York State business activity. No data exist to separately estimate the impact of this change.

Endnotes

1 *American Telephone and Telegraph Company v. New York State Department of Taxation and Finance,* 155 Misc2d 806; rev'd 191 AD2d 61; aff'd 84 NY2d 31; rearg denied 84 NY2d 838. See also the Preliminary Report (pp. 43-46) for details about the AT&T litigation.

2 The revenue estimate for the 1995 legislation, was $33 million, slightly larger than the court ordered solution.

3 Ch. 2, L. 1995, Section 24.

4 These 45 companies account for approximately 85 percent of estimated Section 186-e tax liability.

5 See the present and former Section 186-a(2)(b). For a discussion of the Section 184 tax base, see *Matter of Howgen Transport Co., Inc.*, TSB-D-89(l)C. For instance, Section 184 allows no sale for resale deduction. Section 184 taxes only gross earnings growing out of the employment of capital. In contrast, gross income under Section 186-a included all receipts without deductions except for sales for resale and bad debts.

6 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*, civil action no. 82-0192 in the U.S. District Court for the District of Columbia. InterLATA services consist of telephone calls and other telecommunications services which do not originate and terminate within the same LATA.

7 Utilities subject to PSC supervision are those companies that are subject to the meaningful regulation of the PSC as to rates and/or terms and conditions of service. These include all LECs, most facilities-based IXCs, and certain cellular companies.

8 In certain cases special rules apply. For instance, if the service is obtained by charging telecommunications equipment not associated with the origination or termination of the call (e.g., by means of a credit card or similar alternative payment mechanism), the service address is deemed to be the location of origination of the call.

9 See the preliminary report for information on which states apply their respective gross receipts and/or sales and excise taxes to receipts from interstate and international telecommunications services.

10 Ch. 2, L. 1995, Section 24. A recent Tax Appeals Tribunal decision, *Matter of Sprint International Communications Corporation*, TSB-D-95(5)C, also pertains to this distinction.

11 Tax Law Section 186-e(l)(g).

12 Tax Law Section 186-e(2)(b)(2).

13 Tax Law Section 186-e(2)(b)(3).

14 For a discussion of the pertinent issues of *GTE Spacenet Corp., et al v New York State Department of Taxation and Finance*, 201 AD2d 429, NY2d, October 10, 1996, lv to app. denied the "wires" case, please refer to the preliminary report. Since the publication of the preliminary report, the Court of Appeals denied the State's motion to hear an appeal of this decision.

15 See Tax Law Section 186-e(1)(D). This term includes the traditional concept of dedicated private "lines."

Issues and Policy Options

The preliminary report described the evolving nature of telecommunications and the need for state tax laws to keep pace with these changes. New York's tax laws have not done this. The State instituted its telecommunications laws decades ago when telephone utilities did not face meaningful competition and one could easily distinguish telephone service from other services.

In 1995, New York revised the taxation of telecommunications providers under Article 9 of the Tax Law in response to the settlement of a law suit brought by AT&T. The new law provides considerable clarity over the former statute. However, the State realized that additional reforms may be necessary to adapt New York's laws to the advancements in telecommunications technology and market structure. Discussions with the advisory panel helped the Department formulate the issue areas that the State still needs to address.

The preliminary study outlined the three main issue areas that this report will analyze. The areas include sales tax on cellular telephone and other mobile communications services, general sales tax issues and corporate tax issues.

Issues Survey

In order to gauge the opinions of advisory panel members to the various issues raised in the preliminary report, the Department surveyed the panel on a wide array of policy options. The Department conducted the survey in June of this year, mailing it to the 40 panel members plus ten other interested individuals. The survey recipients returned twenty completed surveys for a return rate of 40 percent. Appendix D contains the survey, the distribution of respondents by industry type, and the summary of the responses.

A general question section provided an interesting perspective on the issues raised in the survey. Survey recipients were asked to rank in order of preference a list of tax policy options. The purpose of this question was to measure the intensity of the respondents' feelings toward various options. Respondents indicated that reducing local taxes and fees was the most important option. This was followed by the provision of a sales tax telecommunications production exemption. The respondents equally ranked repealing Section 184 and unifying the Article 9 taxes as third in importance.

Most of the other survey questions first posed a particular telecommunications issue followed by a series of questions that offered particular policy solutions. The survey instructed respondents to check whether the solution, in their opinion, represented good, neutral or bad tax policy.

Corporate tax questions related to either converting from the current gross receipts tax structure to one based on net income, or instead, reforming the existing gross receipts tax. Many respondents indicated that either change would be good policy, but it was not a majority opinion. Several IXCs indicated that conversion to a franchise tax measured by net income was bad policy. Cable television providers are considering entry into the telephone business and seek assurance that changes in the tax expense of existing telephone companies will be flowed through in a manner that would not adversely affect competied that the Public Service Commission should first project the likely impact of these changes on rates before the issue is discussed.

A series of sales tax questions related to revising the exemption for central office equipment to a more current definition. Most respondents did not support updating the exemption with a more current list of equipment. The majority supported a broad, function-based definition that references property involved in the sale of telecommunications transmission services. The respondents also supported expanding the exemption from switching equipment to property and utility services used in all aspects of telecommunications production and transmission.

The responses to the questions regarding cellular services generally did not display a consensus. However, those respondents more directly involved in cellular service did show a preference for a uniform statewide blended rate for applying tax on intrastate services. Most respondents also thought that separately sourcing roaming charges was a bad policy choice. They felt that the outcollect carrier would be the appropriate party to collect and remit sales tax on roamer charges.

It was clear, in the context of this survey, that the respondents thought that moving telecommunications companies to a net income based tax was not the most important tax option. This option ranked fifth overall. Also evident from the survey was that the survey group felt that maintaining the status quo was the worst outcome.

The remainder of the study examines each of the policy options raised in the preliminary report. The report presents these options as individual “white papers” with descriptions, policy analysis and recommendations for each option.

Analysis of Corporate Tax Reform Options

How should telecommunications companies be taxed in New York?
The advisory panel raised various issues about reforming the nature of corporate taxes faced by telecommunications companies. The issues deal with the way telecommunications companies should be taxed in New York. Currently, companies principally engaged in telecommunications pay franchise tax under Article 9. Other businesses, including some competitors of telecommunications companies, pay tax on a net income basis under Article 9-A.

The first section of this corporate analysis addresses the issues surrounding taxing telecommunications companies under the franchise tax imposed by Article 9-A. However, our discussions with the advisory panel brought forward alternative perspectives regarding retention of Article 9. The second and third sections explore these issues. The options in the second section propose changes to address various equity and competitiveness issues as well as changes that would reduce the overall tax burden. The third section addresses the equity issues surrounding the interaction of various sections of Article 9.

The rest of this section will describe each of these three areas with discussions of the particular issue, current practice in New York, possible options to remedy the issue, previous history, and practices in other states. After each of the three sections are presented, an overall policy analysis and recommendation is provided.

In analyzing the burden of taxation, a company's burden includes all of its state and local taxes.
While all of these taxes and fees are important, this report focuses on state imposed or administered taxes.
Before embarking on this discussion, it is important to note that in analyzing the burden of taxation, a company's burden includes all of its state and local taxes. Local taxes include the locally imposed telecommunications taxes which range from one to three percent of gross receipts. They also include property taxes. Finally, they include locally imposed franchise fees on cable companies which can range up to five percent of gross receipts. The preliminary report contains a complete discussion of these various taxes and fees, which may cause different services to face different state and local tax burdens. While all of these taxes and fees are important, the analysis of comparative taxes in this report focuses on state imposed or administered taxes. A complete analysis of the burden imposed by local taxes and fees is beyond the purview of this section.

Movement to Net Income Taxation

Issue

Changes in the telecommunications industry make the reexamination of the current corporate tax structure essential.

Recent changes in the telecommunications industry make it essential to reexamine the current corporate tax structure as it applies to telecommunications companies. One important factor is the increasing competitiveness of the industry. Emerging competition and technological advances spurred the federal government to enact the Telecommunications Act of 1996. The Act seeks to reduce the remaining barriers in the telecommunications marketplace by fostering competition in the provision of local telephone services. The Act also establishes guidelines for provision of cable television services by telephone companies. Competition, it is hoped, will reduce prices, spur technological advancement, and result in innovative service options for consumers[1]. This raises the question about the proper way to tax telecommunications providers for franchise tax purposes.

A second issue concerns the proliferation of new and emerging services which have both telecommunications and nontelecommunications components. Many of these services blur the distinction between telecommunications and nontelecommunications businesses. New York's laws were designed to impose telecommunications taxes based upon a principally engaged test. Today, this distinction is not at all clear in every case.

The above issues have led to ongoing discussions both within the industry and among policy makers regarding the feasibility and efficacy of taxing the telecommunications industry under the Article 9-A corporate franchise tax rather than the Article 9 gross receipts tax. This first section discusses this possible change in taxation. Appendix E contains a discussion of the transition issues that surround such a change.

Current Law

A company pays its franchise tax under Article 9 if more than 50 percent of gross receipts are from the sale of telecommunications services.

As discussed in the preliminary report, a company pays its franchise tax under either Article 9 or Article 9-A depending upon a principally engaged test. If more than 50 percent of a company's gross receipts are derived from the sale of telecommunications services, that company pays the Article 9 franchise tax. This consists of the Section 183 tax for all companies principally engaged in telecommunications, and the Section 184 gross receipts tax for local telephone companies. If, however, a company offers telecommunications services, but more than 50 percent of its activities are derived from a non-telecommunications activity, that company pays an Article 9-A franchise tax typically based on net income[2].

In addition to franchise tax liability, all companies offering telecommunications services pay a 3.5 percent gross receipts excise tax on receipts from telecommunications services under Section 186-e of Article 9 of the Tax Law.

Possible Options

One option would tax all telecommunications companies under the Article 9-A franchise tax based primarily upon net income. Options for dealing with transition issues inherent in changing from gross receipts to net income taxation are discussed in Appendix E. Various options also exist for how these companies would allocate their income, source their property and receipts, and combine with other subsidiaries under an Article 9-A tax. In addition, the option needs to address concerns regarding the regulatory and rate making implications of any resulting tax savings.

Allocation Formulas Under a Net Income Franchise Tax

For the most part, companies presently paying tax under Article 9-A allocate their net income according to a three factor formula based on property, payroll and receipts, with receipts double weighted. Some companies, airlines and trucking firms, for example, utilize alternative allocation formulas designed to better approximate their income derived within the State. One option would provide a special allocation formula for principally engaged telecommunications companies based on receipts only. An alternative would be to apply the same allocation formula to these companies as currently exists in Article 9-A, but to develop special rules to deal with the sourcing of receipts and extraterrestrial (satellite) property of telecommunications companies.

Sourcing of Receipts and Property

Regardless of the allocation formula applied to telecommunications companies, issues of the proper sourcing of receipts and extraterrestrial property exist. One option would source receipts according to the *Goldberg* method. In addition to sourcing all intrastate receipts to the state where the service is provided, receipts from interstate or international calls would be sourced to a state if the calls either originate or terminate in the state and the calls are charged to a service address in the state. Another option would adopt the sales tax method for sourcing a receipt. This approach sources a receipt to the state only if it both originates and terminates in the state. A third option would adopt the service address as a method of sourcing the receipt.

Options exist for the treatment of extraterrestial property in the calculation of the property factor. Extraterrestrial property could be treated as “nowhere” property. In this case, the value of the extraterrestrial property is not included in the property factor. Alternatively, this property could be treated as “somewhere else” property. Here, the property’s value is included in the factor, however none of its value is sourced to that state. Finally, the property could be treated as “partly here” property. Consequently, some of the value of the property would be sourced to that state.

Combination With Non-telecommunications Subsidiaries

In Article 9-A, companies with many subsidiaries may be permitted or required to file a combined return. Such a return treats the parent and all subsidiaries filing that return as one corporation. Thus they can eliminate inter-company transactions in the calculation of their taxable income.

If telecommunications companies under Article 9-A use the same allocation formula as other Article 9-A companies, then the existing rules for combination under Article 9-A would apply. If, however, these companies received a unique allocation formula based on being principally engaged in telecommunications, then combination becomes problematic. In the case of trucks, railroads, and airlines (all of whom received unique allocation formulas), the law specified that combination would not be permitted.

Rate Making Implications

Finally, members of the advisory panel expressed a concern that the tax savings from a shift from Article 9 to 9-A be reflected across-the-board in reduced rates. Therefore, any discussion of this option needs to address the implications for rate-making. In particular, it needs to consider a company's ability to reflect the tax changes in the rates it charges its customers from the replacement of a gross receipts tax with a tax based on net income.

Currently, the appropriate regulatory agency permits the "pass through" of the gross receipts taxes, both franchise and excise taxes, to the final consumers by permitting a rate surcharge to reflect the tax. A pure "pass through" of a net income tax is not as straight forward. Income taxes and franchise taxes based on income are treated as an ordinary business expense, and therefore are included in the base price. Depending on the rate making procedures companies have with the Public Service Commission (PSC) or the Federal Communication Commission (FCC), companies may face different restrictions in their ability to reflect these tax changes in their rates.

A related issue pertains to companies which must buy services from a PSC regulated telecommunications provider and at the same time compete with such provider. For example, cable television companies must purchase pole access from the local service provider. The way in which the changes in taxation are passed through to them can affect their ability to compete.

History

Recent legislative initiatives have proposed eliminating the gross receipts tax and subjecting companies to an Article 9-A franchise tax[3]. None of these bills addressing telecommunications taxation under a net income based tax have passed both houses of the State Legislature. Most provide for transition rules to lessen the fiscal impact of such a proposal. In addition, most of these bills provided for a change in taxation for gas and electric public utilities and other Article 9 companies as well as telecommunications companies. Legislation enacted in the 1996-97 budget permitted trucking and railroad companies to pay their franchise tax in accordance with Article 9-A beginning January 1998. However, these companies may elect to remain taxable under Article 9.

Other States

The preliminary report discussed other states' taxation of telecommunications in detail. Many states currently tax telecommunications under their regular corporate franchise tax based on net income. Other states tax providers of local services under a gross receipts tax while taxing providers of interstate and international services under the corporate income tax. Some states still tax all telecommunications providers under a gross receipts tax.

Many states currently tax telecommunications under their regular corporate franchise tax based on net income.

Forty-one states impose corporate income taxes on LECs. Forty-four levy a corporate income tax on interexchange carriers. In addition, nineteen states impose a gross receipts tax on the intrastate earnings of LECs. Twelve states impose tax on the intrastate receipts of interexchange carriers. Finally, only six states apply their taxes to an allocated portion of gross receipts from interstate and international services. These states include Florida, Maryland, New York, Rhode Island, West Virginia, and Wisconsin. It is important to note that generally, at present, only interexchange carriers have interstate and international receipts.

Those states which tax telecommunications companies under the corporate net income tax use different sourcing rules for receipts. For example, Connecticut and New Jersey use the origination of the call to determine where the call is sourced; Pennsylvania, Vermont, and Michigan use the billing address; Ohio and Texas use origination and termination; and Florida uses origination or termination and billed to a Florida customer to situs the receipt.

States that impose a net income tax on telecommunications companies also treat extraterrestrial property differently for purposes of calculating the property allocation factor. Three basic approaches are used. First, the satellite property may be considered to be somewhere outside the state. For example, Connecticut and Massachusetts do not include satellite property in the numerator of the property factor, but they do include it in the denominator. Second, states may view the property as residing partly within the state, but it must be apportioned in some fashion. California, Florida, and Ohio take this approach. They include satellite property in both the numerator and denominator, although they use different rules for determining what part of the property is sitused in their state. Finally, states may consider the property to be nowhere. For instance, Michigan excludes satellite property from both the numerator and denominator of the property factor.

The following section describes various ways to repair the existing Article 9 statute. This could be done either as an alternative to a net income tax or as a part of a phase in to a new tax structure.

Reforms to Article 9

Issue

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New York imposes a variety of taxes on telecommunications providers operating in the State. However, not all taxes apply equally to companies providing telecommunications services. In addition, these taxes apply to a broad array of telecommunications services at significantly higher rates than in most other states. Tax rate reductions or relief for specific telecommunications services could have a positive effect on the competitive position and locational decisions of New York businesses.

Current Law

Table 3 shows the array of corporate taxes imposed on telecommunications providers operating in New York State[4]. Providers of telecommunications services principally engaged in a telephone business pay tax exclusively under Article 9. Only companies principally engaged in a local telephone business pay the Section 184 gross earnings tax. Providers not principally engaged in a telephone business are subject to franchise tax under Article 9-A instead of Article 9. The Article 9-A tax applies to net, rather than gross, income. However, all providers of telecommunications, regardless of whether they are principally engaged, must also pay the Article 9, Section 186-e excise tax on their receipts from telecommunications services. The preliminary report includes a complete discussion of these taxes.

Table 3: Summary of Corporate and Excise Taxes Imposed on Telecommunications Providers

Tax	Type	Eligibility	Rate
Article 9			
Section 183	Franchise	Principally engaged in telephone business	1.5 mills on net value of issued capital stock; .375 mills of par value (if dividends exceed 6 percent) paid; or $75

Section 184	Franchise	Principally engaged in local telephone business	0.75 percent on gross earnings from all sources excluding 100 percent of interLATA, interstate, international, and 30 percent of intra-LATA toll telecommunications receipts
Section 186-a	Excise	Subject to Department of Public Service supervision	3.5 percent on gross income from non-telecommunications
Section 186-e	Excise	All providers of telecommunications services	3.5 percent of receipts from telecommunications services
Article 9-A			
	Franchise	All companies offering telecommunications services, but not principally engaged in a telephone business	9 percent on net income; or 3.5 percent on minimum taxable income; or .00178 of the capital base capped at $350,000; or fixed dollar minimum

Possible Options

Possible options include reducing the rates of the component taxes of Article 9, in some cases to the point of elimination, or, alternatively, reducing rates for specific telecommunications services[5]. Specific options include:

- Phase out or eliminate the Section 184 tax;
- Across-the-board reduction of the Section 186-e tax rate;
- Differential rate reduction for selected services in Section 186-e; and
- Total exclusion or rate reduction on receipts derived from interstate and international 800/WATS (and like services) and private telecommunication service6s under the Section 186-e tax[7].

History

With few exceptions, Article 9 tax rates increased over time, rather than decreased.
There is very little prior Article 9 history akin to these proposals. With few exceptions, Article 9 tax rates increased over time, rather than decreased. One exception was a reduced Section 184 tax rate for telephone companies for several years. During the period January 1, 1985 to December 31, 1989, the Section 184 tax rate equaled 0.30 percent instead of current 0.75 percent.

More recently, the statute was amended to apply a differential tax regime to local and non-local telephone businesses under Section 184. Pursuant to Chapter 2 of the Laws of 1995, only companies principally engaged in a local telephone business are subject to the Section 184 tax. A local telephone business is defined as being principally engaged in providing carrier access or services that originate and terminate with the same local access and transport area (“LATA”) or the similar areas such as the Rochester non-associated independent area[8].

Several recent legislative proposals have included Article 9 rate reductions. These rate reductions often accompany proposals that transition telecommunications providers and other taxpayers from taxation under Article 9 gross receipts taxes to the Article 9-A franchise tax on net income[9].

Neither the old Section 186-a nor the new Section 186-e tax provides exclusions for receipts from specific telecommunications services[10]. As noted, recent Article 9 reform proposals have generally focused on wholesale reform (e.g., switching companies from Article 9 to Article 9-A taxation), rather than piecemeal reforms such as specific service exclusions or rate reductions[11].

Other States

Comparative Tax Rates

The preliminary report contains an extensive discussion of the taxes imposed on telecommunications providers in neighboring and other major states. Table 4 summarizes how New York and these states tax telecommunications providers under corporate net income tax, gross receipts, and sales/excise taxes.

It is important to consider corporate net income tax, gross receipts, and sales/excise taxes when examining state tax policy toward telecommunications providers.

It is important to consider each of these taxes when examining state tax policy toward telecommunications providers. The most common state tax regime for these companies is a combination of a corporate net income tax and a sales tax on intrastate, interstate and international services. Moreover, existing state exemptions for specific services, such as 800/WATS and private line (or telecommunication) services, are often found under state sales and excise taxes.

Table 4: Taxation of Telecommunications Providers Under State Corporate Income, Gross Receipts and Sales/Excise Taxes: Selected States

State	Corporate Income Tax	Gross Receipts Tax	Sales/Excise Tax (2)
New York	N/A (3)	4.25 percent tax on local telephone receipts; 3.5 percent on non-local, interstate, and international services. (4)	8.50 percent sales tax on intrastate service.
Neighboring States			
Connecticut	Most providers pay a corporate franchise tax at a rate of 10.75 percent on net income.	All telecom. services except intrastate telegraphy, cable TV, CATV, and DBS exempt.	6.00 percent sales tax on intrastate, interstate, and international services.
Massachusetts	Providers pay a utility franchise tax at a rate of 6.50 percent on net allocable income.	N/A	5.00 percent sales tax on intrastate, interstate, and international services.
New Jersey	Most providers pay a corporate franchise tax at a rate of 9.00 percent on net income.	Per unit basis tax. Applies only to local exchange carriers.	6.00 percent sales tax on intrastate, interstate, and international services.
Pennsylvania	Providers pay a corporate excise tax at a rate of 9.99 percent on net income.	5.00 percent tax applies only providers of intrastate services.	7.00 percent sales tax on intrastate, interstate, and international services.
Vermont	Providers may opt to pay a personal property tax or gross earnings tax. Providers paying the latter also pay a corporate income tax at a rates of 5.50 - 8.25 percent on net income.	N/A	All telecom. services except Cable TV/DBS exempt.
Other Major States			
California	Providers pay a corporate franchise tax at a rate of 9.30 percent on net income. (5)	N/A	All telecom. services exempt.
Florida	Providers pay a corporate franchise tax at a rate of 5.50 percent on net income.	2.50 percent tax on intrastate, interstate, and international services.	8.00 percent sales tax on intrastate, interstate, and international services.
Illinois	Providers pay corporate franchise tax and personal property taxes at rates, respectively, of 4.80 percent on net income and 2.5 percent.	N/A	5.00 percent excise tax on intrastate, interstate, and international services.
Michigan	Providers pay the Single Business Tax (SBT) at a rate of 2.30 percent on business income.	N/A	6.00 percent sales tax on intrastate and interstate services.
Ohio	Long-distance providers pay a corporate franchise tax at a rate of 8.90 percent on net income.	4.75 percent tax applies only to LECs.	7.00 percent sales tax on intrastate, interstate, and international services.
Texas	Providers pay a corporate franchise tax at a rate of 0.25 percent on net taxable capital and 4.50 percent on net taxable earned surplus.	N/A	8.25 percent sales tax on intrastate, interstate, and international services.

Notes:
This table excludes from the analysis all locally imposed taxes such as local utility gross receipts taxes. It does include the local sales tax rate for those services included in the state sales tax base.
N/A = Does not impose tax on most telecommunications providers or services.
(1) In addition to gross receipts and sales/excise taxes, states impose a variety of surcharges, assessments and fees based on gross receipts for specific purposes (e.g., 911 surcharges, regulatory assessments). These are not included herein.
(2) Reflects maximum combined state and local tax rate.
(3) Cable television providers and a small number of telecommunications providers not principally engaged in a telephone business pay this tax. However, the latter pay the Section 186-e tax on their telecommunications receipts in addition to the Article 9-A corporate franchise tax.
(4) The 4.25 percent rate reflects the Section 184 tax (0.75 percent on gross earnings) and the 186-e tax (3.50 percent on gross receipts, but not the Section 183 tax on capital and dividends. Non-local telephone pay only the 3.50 percent Section 186-e tax.
(5) The rate will decrease to 8.84 percent beginning in 1997.
Source: Adapted from the preliminary report entitled Improving New York State's Telecommunications Taxes: A Background Study and Status Report (Albany, N.Y.: New York State Department of Taxation and Finance, August 1996).

Most states impose corporate income taxes on the net income of telecommunications providers. All neighboring states impose these taxes on most, if not all, providers. The same holds true for the other major states shown in the table.

As previously noted, a dwindling number of states impose gross receipts taxes on telecommunications providers. Few of New York's neighboring states impose these taxes. Connecticut's gross receipts tax applies only to intrastate telegraphy, cable television, community antenna television (CATV), and direct broadcast satellite services (DBS). New Jersey imposes a per unit basis gross receipts tax on the intrastate receipts of LECs. Pennsylvania imposes a 5 percent tax on the receipts of all providers of intrastate services.

As for other major states, California, Illinois, Michigan and Texas do not impose gross receipts taxes. Florida imposes a 2.5 percent gross receipts tax on intrastate, interstate and international services. Ohio's 4.75 percent tax applies only to the receipts of LECs.

Most states impose sales or excise taxes on sales of telecommunications services. In New York, a maximum combined state and local sales tax rate of 8.5 percent applies, but only on intrastate receipts. All of New York's neighboring states impose these taxes on intrastate, interstate and international services, except for Vermont which exempts all telecommunications services. Maximum combined tax rates are as follows: Connecticut, 6 percent; Massachusetts, 5 percent; New Jersey, 6 percent; and Pennsylvania, 7 percent.

California exempts all telecommunications services from its sales tax. Michigan imposes a 6 percent tax on intrastate and interstate, but not international, services. The remaining states impose sales/excise taxes on intrastate, interstate, and international services as follows: Florida, 8 percent; Illinois, 5 percent; Ohio, 7 percent; and Texas, 8.25 percent.

Specific Service Exemptions

Other states have created exemptions from tax for specific telecommunications services such as private telecommunication services and 800/WATS services. Table 5 shows that several states around the country exclude receipts from interstate and international 800/WATS and private telecommunication services from their gross receipts and sales or excise taxes. As few states impose gross receipts taxes on interstate and international services, it is instructive to review the tax treatment of these services under similar taxes, many of which apply to interstate and international services.

Table 5: Specific Exclusions for Interstate and International 800/WATS and Private Telecommunication Services Under Gross Receipts and Sales/Excise Taxes (1996)

	Gross Receipts Tax (GRT)		Sales/Excise Tax	
	800/WATS	Private Telecom.	800/WATS	Private Telecom.
A. Neighboring States				
Connecticut	N/A	N/A	Taxable	Taxable
Massachusetts	No GRT	No GRT	Taxable	Taxable
New Jersey	N/A (1)	N/A (1)	Taxable	Taxable
Pennsylvania	N/A (1)	N/A (1)	Taxable	Taxable
Vermont	No GRT	No GRT	N/A	N/A
B. Other Selected States				
California	No GRT	No GRT	N/A	N/A
Florida	Taxable	Taxable	Taxable (2)	Taxable
Illinois	No GRT	No GRT	Taxable	Taxable
Kansas	No GRT	No GRT	800/WATS services are exempt, but 900 service is taxable	Exempt
Michigan	No GRT	No GRT	800/WATS services are exempt, but 900 service is taxable (3)	Exempt (3)
Ohio	N/A (4)	N/A (4)	800/WATS services are exempt, but 900 service is taxable (4)	Exempt (4)
Oklahoma	No GRT	No GRT	800/WATS services are exempt, but 900 service is taxable.	Exempt
Texas	No GRT	No GRT	Taxable	Taxable

Notes:
N/A - State does not impose tax on receipts from interstate/international services or telecommunications services in general.
(1) In these states, GRT applies to intrastate services only. 800/WATS and private telecommunication services are taxable.
(2) The total tax on any interstate telecommunications service is limited to $50,000 per calendar year, provided that more than half of the services are used for communications originating outside Florida and terminating in Florida. This limitation is of great benefit to certain large consumers of interstate telecommunications services.
(3) Michigan exempts all receipts from international telecommunications services.
(4) In Ohio, the GRT applies only to intrastate services, but 800/WATS and private telecommunication services are exempt. The sales tax exempts intrastate and interstate/international 800/WATS and private telecommunication services.
Source: OTPA compilation from CCH State Tax Guides for the respective states.

None of New York's neighboring states offer these exclusions. As previously noted, two states, Vermont and California, provide blanket exemptions for almost all telecommunications services. Connecticut's gross receipts tax applies only to intrastate telegraphy and cable television services. Similarly, cable television and direct broadcast satellite services (DBS) are subject to Vermont's sales tax.

Some other large states offer exclusions for these services. As previously noted, all telecommunications services are exempt from California's sales tax. Florida taxes interstate and international 800/WATS and private telecommunication services under its gross receipts tax. These services are also taxable under Florida's sales tax, but the total tax on any particular provision of interstate telecommunications service is limited to $50,000 per calendar year if more than half of the services are used for communications that originate outside Florida and terminate within Florida. This limitation benefits certain large consumers of interstate telecommunications services such as 800/WATS services.

Kansas, Michigan, Ohio, and Oklahoma imposes a sales tax on most telecommunications services. However, their tax bases exclude receipts from interstate 800/WATS services and private telecommunication services. None of these states extend the same exclusion to 900 services.

The third section of this discussion on corporate taxes focuses on the interaction of the various provisions of Article 9. It also provides ways to address inequities that may arise from these interactions.

Inconsistency in Gross Receipts Tax Between Regulated and Nonregulated Companies

Issue

The current gross receipts taxes imposed on telecommunications providers under Article 9 interact to create the following result. Companies principally engaged in providing non-local telecommunications services, and that are not subject to regulation by the PSC, pay no tax on their nontelecommunications income (e.g., interest, dividends, capital gains.)

Current Law

The distinction between regulated and nonregulated companies existed under the old Section 186-a law. Prior to the 1995 legislation, all companies principally engaged in a telephone business paid a franchise tax of 0.75 percent on all their gross earnings (under Section 184). In addition, under Section 186-a, telecommunications companies regulated by the PSC paid an additional 3.5 percent excise tax on their gross income, while nonregulated companies paid 3.5 percent only on gross operating income[12].

Legislative changes in 1995 limited the imposition of Section 184 to those companies principally engaged in a local telephone business. It also replaced the 3.5 percent tax on the gross receipts from the provision of telecommunications services under Section 186-a with Section 186-e. Finally, it retained the Section 186-a gross income tax on the nontelecommunications income of telecommunications companies regulated by the PSC. As a result, non-local telecommunications providers no longer pay the 0.75 percent tax on their income. In addition, if the PSC does not regulate these companies, then they do not pay tax on their nontelecommunications income[13]. For more detailed information on the current and prior tax structure see the preliminary report.

During the 1995 budget negotiations, all parties recognized this inconsistency. They also noted that this situation only occurred in limited instances. The parties agreed that this study should examine the issue and present possible alternatives to correct the anomalous result.

Possible Options

If it is ultimately decided to move telecommunication companies to the franchise tax under Article 9-A, then this issue disappears. All companies, regulated or not, would be subject to Article 9-A taxation on their nontelecommunications income. This issue exists only if an overall shift to Article 9-A is not recommended, or if such a transformation is phased in over several years. Two main options exist to address this issue. Both involve replacing the existing Section 186-a tax. Option A would replace Section 186-a with a net income tax on nontelecommunications income. Option B would replace Section 186-a by expanding Section

183 to include a tax on net investment income and on net proceeds from sales of certain types of tangible personal property.

Option A

This option would replace Section 186-a for telecommunications companies with a net income tax on nontelecommunications income for companies principally engaged in telecommunications. This net income tax would use similar rules and procedures to those found in Article 9-A. Taxpayers would need to distinguish between their telecommunications and nontelecommunications income. Next, they would have to classify their nontelecommunications income as either business, investment, or subsidiary income. (For the most part, their telecommunications income is their business income, however, taxpayers may have components of their nontelecommunications income that are also business income.) After classifying the types of nontelecommunications income, taxpayers would have to attribute their expenses to telecommunications income, nontelecommunications business income, nontelecommunications investment income, and nontelecommunications subsidiary income.

The option would also require establishing separate allocation rules for business and investment income. The option could exclude subsidiary income from tax (as Article 9-A does). This option would require detailed rules for each step of the procedure described above. Some of these rules could be similar to those found under Article 9-A for attributing subsidiary and investment expenses[14].

Option B

This option would repeal Section 186-a for telephone companies regulated by the PSC. It would replace it with two additional bases under Section 183 franchise tax for companies principally engaged in telecommunications. These bases would measure the two different kinds of nontelecommunications income -- investment income, and profits from the sales of tangible personal property not related to the provision of telecommunications. The rate of tax on these bases would be substantially lower than under the current Section 186-a.

The first additional base would impose a gross income tax on nontelecommunications investment income. The sourcing of this income to New York would follow the same rules as under Section 186-a of Article 9[15]. However, the rate of tax on this *gross* income would approximate the Article 9-A rate of 9 percent *on net* income. A preliminary estimate indicates that a gross income tax rate of about 0.2 percent on all nontelecommunications investment income would approximate a net income tax effective rate.

The second additional base under Section 183 would impose a tax on New York sales of tangible personal property not related to the sale of telecommunications services. For example, this base would include the wholesale receipts on cellular phones to retailers. This base would equal total New York sales less New York cost of goods sold. A tax rate of 0.65 percent on this base would approximate the effective rate under Article 9-A on the net profit of similar sales. Total Section 183 taxes for telephone companies would equal the current tax on capital stock, plus the new tax on nontelecommunications investment income, plus the new tax on sales of tangible personal property. If the sum of these taxes were less than $75, taxpayers would remit the current $75 minimum tax.

Because Section 183 is a franchise tax imposed on all principally engaged telecommunications companies, the structure for the imposition of these taxes is already in place. This would also permit these companies to file the same number of returns as they do under current law.

History

This is a new issue.

Other States

This issue is unique to New York.

Analysis of Corporate Tax Options

Although important changes were made with the 1995 telecommunications legislation, the current system results in some taxpayer inequities. Forthcoming competitive changes within the industry will exacerbate these inequities.

Taxpayer Equity

The current structure places heavy reliance upon the principally engaged test, which determines under what Article of tax (9 or 9-A) companies pay their franchise tax. The principally engaged in a local telephone business test determines whether a company is subject to the additional Section 184 franchise tax. However, in situations where companies may not be principally engaged in providing a service (either telecommunications in general, or local service more specifically), but they still provide some of that service, the service will not be taxed consistently. For example, as interexchange carriers (IXCs) begin to offer intraLATA services, they will be competing directly with local telephone companies. The IXCs pay no Section 184 tax, while the local telephone companies do.

A similar hypothetical situation could occur between principally engaged telecommunications companies and other companies. For instance, a provider that primarily offers video service and also some telecommunications services, would pay franchise tax on a net income base. A principally engaged telecommunications company would pay their franchise tax under Article 9. These two companies would be offering the same service, but because one does not meet the principally engaged test, they would face different tax burdens. Although this situation is theoretically feasible, it rarely occurs in practice. In reality, due to the interaction of various regulatory and legal constraints, most nontelecommunications companies engaged in telecommunications activities organize separate business entities to offer telecommunications services. In such cases, there would not be a differential tax burden.

A shift to net income taxation represents one way to improve taxpayer equity. This option would eliminate the two existing principally engaged tests (the telecommunications principally engaged test and the local service principally engaged test) so that all telecommunications service providers face the same franchise tax structure[16]. In addition, it would provide tax equity between telecommunications companies and other general businesses corporations. The historical rationale for taxing telecommunications companies differently from other businesses derived from the granting of a monopoly franchise, and the general regulatory prohibitions limiting competition. This historical rationale is discussed in the preliminary report. As those discussions point out, many of the justifications for this differential taxation no longer exist.

A major reform such as a move to a net income base from a gross receipts base without the consideration of the regulatory and rate-making implications, may have tax equity disadvantages. In contrast to the pass-through of gross receipts taxes, the pass-through of a net income tax is potentially less direct. As long as some companies must rely on access and other services provided by their competitors, it must be clear how a net income tax would be passed on to the purchasers of these services. The pass-through of the net income tax should not disproportionately impact any particular consumers of telecommunications services. Clear direction to the PSC regarding the dissemination of the benefits accrued from a tax cut must accompany any major tax reform in order to assure tax equity.

Another issue with respect to tax equity of moving to a net income tax base derives from the difficulty in measuring taxable income. Industry representatives have pointed out that taxpayers have greater ability to construct their operations so as to minimize a net income tax than they would under a gross receipts tax. Taxpayers' relative abilities to engage in such tax planning can introduce inequities. However, this effect is no different than what is typically found in any other competitive business environment.

The option to eliminate Section 184 significantly improves taxpayer equity. It would eliminate the principally engaged test for local telephone companies. As IXCs offer intraLATA service, and LECs enter the interexchange market, all companies would compete on a more equal basis. In addition, the Section 184 tax is imposed on all gross earnings. Thus, local telephone companies face disparate treatment of their nontelecommunications income when compared with IXCs.

Reducing the Section 186-e tax rate does not directly affect equity among telecommunications providers. All taxpayers offering telecommunications services pay the same rate of 3.5 percent on all of their telecommunications receipts. However, it does have equity ramifications for consumers of telecommunications services. Providers pass this tax on to their customers. Businesses that are highly dependent on telecommunications services are disadvantaged compared to those with no such reliance. A reduction in the Section 186-e rate would reduce this disadvantage.

Introducing differential rates between intrastate and interstate and international receipts in Section 186-e would increase the disparity of treatment between local and long distance services. However, many states currently tax intrastate calls differently from interstate and international calls. Many states exempt interstate and international calls completely from their gross receipts excise tax. In New York, this differential treatment is most notable in our sales tax.

The option to reduce the rate, or completely exempt certain services from Section 186-e also has tax equity implications. Because not all Section 186-e taxpayers provide 800/WATS and private telecommunication services, some might view these proposals as creating inequitable treatment among taxpayers. Consider, for instance, the fact that New York's local exchange carriers have only just begun to offer interstate services. At this time, the majority of 800/WATS services are interstate in nature[17]. Companies that provide these services also earn differing proportions of their gross receipts from these services. In addition, these services may directly compete with other services that would remain fully taxable.

Total exclusion of receipts from interstate and international 800/WATS and private telecommunication services would not automatically change the taxability of affected providers under Article 9. These receipts would still be considered telecommunications receipts. Consider the extreme case of a provider whose only receipts are from interstate 800/WATS and/or private telecommunication services. If principally engaged in a transmission business, the taxpayer would remain subject to tax wholly under Article 9. The provider would pay the Section 183 tax, the Section 186-a tax on non-telecommunications income (if subject to PSC supervision), and the Section 186-e tax (albeit with no tax liability). Admittedly, the taxpayer would have a lower aggregate Article 9 tax liability than comparable taxpayers not providing these specific services.

The inconsistency in gross receipts taxation between regulated and nonregulated companies is eliminated by the adoption of net income taxation. The issue paper discussing this inconsistency presented two other alternative options for eliminating this inconsistency. One option proposed a net income tax on nontelecommunications income. The other option imposed a tax rate on gross receipts from non telecommunications income at a net income effective rate. Both of these alternative options eliminate the difference in taxation attributable to the distinction between regulated and nonregulated companies. It is important to remember that this inconsistency currently results in very small inequities. Most, but not all, companies are able to organize in such a way as to avoid the accrual of nontelecommunications income occurring in companies subject to PSC regulation or insure that this income is sourced out of New York.

Competitiveness

The telecommunications industry is an important part of the New York economy.
The telecommunications industry is an important part of the contemporary New York economy in several ways. First, the telecommunications industry is a major New York State employer. Secondly, nearly two-thirds of all New York State nonagricultural employment is in information-intensive industries. These industries include those engaged in financial services, wholesale and retail trade, personal and business services, and computer and electronic equipment manufacturing. In addition, businesses often cite telecommunications as a significant factor in their locational decisions[18]. Therefore, the competitiveness analysis primarily addresses the question of how any of the options would affect the final business consumers of telecommunications services.

A switch to a net income tax would currently have implications for interstate and international rates. Currently, multistate telecommunications companies, when setting their rates for interstate and international services, include state corporate net income taxes, as well as many other state and local taxes, in the overall rate base (just as any other cost of doing business.) In contrast, state gross receipts taxes are separately surcharged to the customers in the state which imposes the gross receipts tax. Discussions with the advisory panel indicate that recently, the FCC has expressed a willingness to allow separate surcharging of some of these state taxes currently included in the overall rate base.

Eliminating Section 184 which is imposed only on principally engaged local telephone companies, would reduce the overall cost of doing business. Virtually all businesses consume some local services. This would particularly impact small businesses whose telephone bills are comprised of mostly intrastate services. Those industries in New York with heavy reliance upon telecommunications services consume a large portion of nonlocal services, however[19]. While this option would reduce everyone's local telephone bill, it does not address the interstate and international services that are essential to many businesses.

Conversely, when compared to other states[20], New York's aggregate taxes imposed on interstate and international calls are competitive with surrounding states. Table 6 shows that both New Jersey and Connecticut impose a 6 percent sales tax on interstate and international calls. Although New York imposes a 3.5 percent gross receipts tax on these calls, they are not subject to New York's sales and use tax.

Table 6: Combined Gross Receipts and Sales/Excise Taxes on Intrastate, Interstate, and International Telecommunications Services: Selected States (1)

State	Intrastate	Interstate	International
New York	12.75%	3.50%	3.50%

Neighboring States			
Connecticut	6.00%	6.00%	6.00%
Massachusetts	5.00%	5.00%	5.00%
New Jersey	6.00% (2)	6.00%	6.00%
Pennsylvania	12.00%	7.00%	7.00%
Vermont	N/A	N/A	N/A
Other Major States			
California	N/A	N/A	N/A
Florida	10.50%	10.50%	10.50%
Illinois	5.00%	5.00%	5.00%
Michigan	6.00%	6.00%	N/A
Ohio	11.75%	7.00%	7.00%
Texas	8.25%	8.25%	8.25%

Notes:
N/A = Does not impose tax on most telecommunications providers or services.
(1) Excludes additional local gross receipts taxes, local consumer utility taxes, and local franchise fees.
(2) LECs also subject to individual per unit gross receipts tax.

New York's competitive tax stance does not fare as well for the taxes imposed on intrastate revenues. The combined gross receipts and sales tax rate of 12.75 percent far exceeds Massachusetts' 5 percent sales tax and Connecticut's 6 percent sales tax. New York's tax on intrastate calls also exceeds Pennsylvania's 12 percent combined gross receipts and sales tax rate on intrastate calls.

The complete elimination of Section 186-e would result in a substantial tax decrease for most telecommunications providers. If steps were taken to assure an appropriate pass through of these savings to those that consume the telecommunications services, as well as those who rely on telecommunications companies for access and pole attachments, this option would provide significant competitive gains.

Total exclusion of interstate and international receipts from 800/WATS and private telecommunication services or rate reductions for these services would have a positive impact on the business customers of New York telecommunications providers. These companies purchase the interstate and international 800/WATS and private telecommunication services subject to exclusion or reduced rates. This tax relief would also benefit the customers of these businesses by reducing the operating expenses of New York businesses. This would allow businesses to reduce prices for their goods and services. As a result, these proposals may attract new businesses to New York. Similarly, profit margins or business activity may increase to the level where increased numbers of existing businesses would choose to stay in New York.

Administration and Compliance

Gross receipts taxation is easier for the taxpayers to comply with than net income taxation primarily because the base of taxation is simpler to compute. These companies file federal tax under a net income tax, therefore, filing a state net income tax return may not be that much more difficult. However, the entity filing a Federal tax return (including all subsidiaries) may not be the same as the entity filing a State Article 9-A return. In this case, the costs of complying could be increased.

The elimination of Section 184 would reduce the taxpayers' costs of compliance in that it would reduce the number of tax returns taxpayers file. Repeal of Section 184 would eliminate a tax form for principally engaged local telephone companies.

The administration and compliance burdens for both taxpayers and the Department would increase only slightly under any of the Section 186-e rate reduction options. Neither differential tax rates nor specific exclusions for certain telecommunications services would pose significant new administrative burdens. However, establishing clear definitions for the specific services exempted remains troublesome given the dynamic nature of the industry's products and services.

Of the two proposed options to eliminate the inconsistency within the gross receipts tax, the first, establishing a net income base within Article 9, would be difficult to administer and difficult for the taxpayer to comply with. The option would require a new tax, new regulations, and an additional form. The necessary attribution and sourcing rules could be a complex part of such a statute or system of regulations.

The second option, establishing a gross receipts tax at a very low rate, that would on average approximate the effective tax under a net income base, would be a far simpler proposal for administration and compliance. It relies on existing sections of the Tax Law for its imposition and the sourcing of most of the receipts. By utilizing an average tax rate on the gross receipts, it avoids the complex attribution rules while achieving, on average, a net income equivalent tax on nontelecommunications income. However, as with any average, it may impose a higher effective rate on some taxpayers, and a lower effective rate on others. Finally, such a derived rate may not be robust over time. The various impacts of inflation, business cycles, and structural changes in the industry may interact such that the rate no longer approximates the effective net income rate. An analysis conducted over recent business cycle years shows that this could present a bias. This bias could be moderated by using a five-year average for computing the gross receipts effective rate. If such an option is temporary, then the potential bias is even less.

Revenue Analysis

In the revenue analysis that follows, each of these options is estimated independently. The estimates are primarily based on 1995 data, grown to 1998. Members of the industry task force were extremely helpful in providing data both for their New York State Article 9 liability, as well as critical components from their federal tax returns. This data was especially crucial in deriving reliable estimates for net income taxation. The analysis combines the data from industry members with data from their State tax returns to estimate the fiscal impact of the proposals.

Because the analysis is based on historical information, it cannot account for any structural changes in the industry. In addition, the analysis could look substantially different as a result of mergers and acquisitions yet to be concluded in the telecommunications industry. The analysis represents an estimate based on the information available at the time. Table 7 summarizes the results of the analysis.

This table presents the impacts of the various proposals for the entire industry. However, these impacts are not spread proportionately throughout the industry. For example, companies whose operations are property intensive, and therefore have large depreciation deductions, are more likely to have lower net income taxes than other companies with the same gross receipts.

Table 7: Revenue Impact of Various Corporate Tax Proposals (Dollars in Millions)

	Total
Article 9 to 9-A (1)	
Replace franchise tax (§183 & §184) plus §186-a with Article 9-A	$80.0

Replace franchise tax (§183 & §184) plus §186-a with Article 9-A and eliminate §186-e	($380.0)
Replacing 186-a with 183 tax	($2.0)
Rate Reduction	
Section 184	
0.5 percent (Telecom. Providers Only)	($47.0)
Total Elimination (Telecom. Providers Only) (2)	($72.0)
Section 186-e	
0.5 percent	($66.0)
Total Elimination	($460.0)
Private telecommunication exemption (2)	($14.0)
800/WATS exemption (3)	($25.0)

(1) The estimates for net income taxation assume the normal three-factor formula with double weighting of receipts. The receipts are sourced using the *Goldberg* method. The property factor is equivalent to that in Article 9. No transition adjustments are included in the estimates. No Investment Tax Credits are assumed in the analysis.
(2) This number is comprised of $39 million in MTOA (Metropolitan Transportation Operating Assistance) funds and $33 million in general fund revenues.
(3) The estimate for both the private telecommunication and 800/WATS exemption are based on data from a specific prior tax year (1993), increased to account for inflation. Changing market conditions and alternative growth scenarios may alter these estimates significantly.

The above estimates reflect the revenue reduction from each proposal. They are derived using currently available data, and specific assumptions. To the extent that better data become available, or a specific proposal incorporates different assumptions, the revenue estimates could change substantially.

The option to replace the Article 9 franchise taxes with an Article 9-A franchise tax coupled with complete elimination of the Section 186-e excise tax is the most expensive option. The net effect of the option is a loss of approximately $380 million in State revenues. However, the option to only replace the franchise tax component of the Article 9 tax, would result in a tax increase for most telecommunications companies. This increase would be greatest for long distance companies. This is because they currently pay only the Section 183 franchise tax, and the 186-a tax on their nontelecommunications income, if they are PSC regulated.

Recommendation

The major issue upon which recommendation must be made deals with the way telecommunications companies should be taxed in New York. Changing the taxation of companies principally engaged in telecommunications from Article 9 to the corporate franchise tax paid by other businesses, constitutes a major reform. Currently, the industry is undergoing rapid structural and technological change. There exists substantial uncertainty regarding the ultimate configuration of the industry. In addition, regulatory reform in rate making at both the federal and state level, will continue to affect how the industry operates. The interaction of these regulatory reforms with major state tax changes is not completely understood at this time. Therefore, any major state tax policy option must be evaluated in the context of these concurrent events. What may be viewed as good tax policy, may not be good overall state policy once all of these interactions are considered. For this reason, although a move from Article 9 to Article 9-A for telecommunications companies may be the right answer for the long run, it is premature at this time.

Attention should focus on reducing the overall tax burden borne by telecommunications companies.
If a move to net income taxation is not contemplated at this time, attention should focus on ameliorating the existing inequities in Article 9, and reducing the overall tax burden borne by telecommunications companies. As fiscal demands permit, the Department recommends that the Section 184 tax (applicable only to local

telephone businesses) be repealed. This tax provides the clearest case of taxpayer inequity. Eliminating this tax will treat local telephone businesses the same as nonlocal telephone businesses in their provision of local services. Many of the nonlocal service providers may soon be in direct competition with local telephone businesses.

Another area of taxpayer inequity under Article 9 concerns the treatment of regulated and nonregulated telecommunications providers. Currently, regulated providers pay a 3.5 percent gross receipts tax on their nontelecommunications income under Section 186-a. Providers not regulated by the PSC do not pay this additional tax. The report contains a suggested remedy - taxation of nontelecommunications income for all principally engaged providers at a greatly reduced rate under Section 183. This remedy, however, is only a suggested approach. The Department recommends that it continue to consult with industry to develop a workable solution that achieves tax equity without hindering competition in New York.

All providers of telecommunications in New York currently pay the Section 186-e excise tax on telecommunications services at a rate of 3.5 percent. Such a high rate of taxation greatly affects New York's telecommunications dependent industries and individual consumers. Therefore, the Department also recommends reducing the Section 186-e tax rate as fiscal conditions permit.

Endnotes

1 Berge Ayvazian. “The New Integrated Telcos: Demystifying the Telecom Act of 1996.” Forbes Magazine, August 12, 1996, pp. 58-59.

2 The preliminary report discusses these taxes in more detail.

3 See 1995 bills, S-3955, A-6354B, S-5265, A-8258A.

4 The table excludes the State and local sales tax. It also excludes various local taxes such as locally imposed utility gross receipts taxes, and franchise fees.

5 The option to eliminate the Section 186-a tax on telecommunications providers regulated by the PSC is discussed in the issue paper in this section addressing the inconsistency in gross receipts taxation between regulated and nonregulated companies.

6 A private telecommunication service is defined under Section 186-e as: “. . . a dedicated telecommunication service that entitles the user or users to the exclusive or priority use of a communications channel or group of channels from one or more locations to one or more locations.” This includes the concepts of both a dedicated physical private line and a dedicated ‘virtual’ group of circuits or channels.

7 The exclusions or rate reductions discussed here do not apply to 900 services. As noted later, most states that exclude receipts from interstate and international 800/WATS and like services specifically state that receipts from 900 services are taxable.

8 See Tax Law Section 184(1).

9 For example, see A.6354-B, A.8258-A, S.3955 and S.5265, all introduced in 1995.

10 The one exception to this is the Section 186-e exclusion of sales of telecommunications to air carriers for the purpose of air safety and navigation.

11 One exception is S.7165, introduced on April 17, 1996. This bill included an exclusion under Section 186-e of one quarter of the receipts attributable to business telecommunications services. The bill also excluded receipts from high speed service (in excess of 128,000 bits per second, or bps) provided by a “local carrier.”

12 The major difference between gross income and gross operating income derives from the income from rents, dividends, and investment. In addition, profits from the sale of tangible personal property unrelated to the sales of telecommunications services is considered gross income not gross operating income.

13 Utilities subject to PSC supervision are those companies that are subject to the meaningful regulation of the PSC as to rates and/or terms and conditions of service. These include all local exchange carriers, most interexchange carriers, and certain cellular companies.

14 Taxpayers subject to Article 9-A must attribute expenses to their subsidiary or investment operations. This historically has been an area of confusion and uncertainty for taxpayers, and has often become an audit issue. The Department recently worked with industry to provide more certainty and clarity for business. (TSB-M-95(2)C).

15 Under Section 186-a, investment income is sourced using issuer's allocation percentages for interest and dividend income. This is the same method used for sourcing investment income under Article 9-A. In addition, profits from the sales of securities are sourced to where the asset is held managed or controlled.

16 The elimination of the principally engaged test occurs only if special allocation formulas for telecommunications companies are not provided within the Article 9-A structure.

17 This is based on data provided by the four major interexchange carriers and PSC data concerning local exchange carriers.

18 For a discussion of the economic importance of New York's telecommunications industry, see the preliminary report, pp. 9-13.

19 For a discussion on telecommunications dependent industries in New York, see the preliminary report, pp. 11-12.

20 This analysis compares the aggregate rates of the gross receipts taxes and sales taxes in New York and other states. Although some of the states in the comparison also impose a net income tax. However, as the discussion above points out, determining the actual incidence of a net income tax in a state upon that state's final consumers is very difficult. Therefore, for purposes of this rough comparison, the net income taxes in other states are excluded.

Internet Services Providers

Issue

Some states have assessed telecommunications taxes on Internet access services. Concerned about those rulings, certain industry members have asked the Department if Internet access service represents a telecommunications service under New York's laws. This section of the report will address this question. It will also address a related issue raised by advisory panel members concerning whether an out-of-state business that does not have nexus with New York, would gain a nexus by placing advertisements or otherwise doing business through a New York Internet service provider (ISP). However, other Internet related issues, such as how New York treats commerce taking place using the Internet, remain outside the scope of this study.

Current Law

New York has not taken a position on the applicability of its current tax laws to Internet service providers and Internet access service. Whether or not Internet services represent telecommunications is important because New York imposes some taxes specifically on telecommunications providers and telecommunications services. This section of the report outlines the telecommunications services that New York taxes. It also summarizes how the sales tax applies to certain related services.

Sales Tax on Telephone Services

Section 1105(b) of the Tax Law imposes sales tax on telephony and telegraphy and telephone and telegraph service of whatever nature. The sales tax regulation has interpreted the term telephony and telegraphy to include use or operation of any apparatus for transmission of sound, sound reproduction or coded or other signals. The regulation does not directly address enhanced telephone services like E-mail, voice mail and data transmission services. However, the Department has, in certain factual cases, interpreted these services as telephony and telegraphy[1].

The sales tax does not apply to telephone services sold by nonprofit tax-exempt organizations[2]. Moreover, the compensating use tax does not apply to telephone services.

Article 9 Corporation and Utility Taxes

The preliminary report described the franchise taxes imposed by Section 183 and Section 184. These taxes apply to businesses principally engaged in transportation, telephone, or other transmission businesses. Section 186-a applies to the non-telecommunications income of utilities providing telephone service operating under the supervision of the Public Service Commission[3]. Besides those taxes, Section 186-e imposes a 3.5 percent excise tax on receipts from the sale of telecommunications services.

Section 186-e provides a definition of telecommunications services that is applicable throughout Article 9. Section 186-e defines telecommunications services to mean telephony or telegraphy, or telephone or telegraph service, including, but not limited to, any transmission of voice, image, data, information and paging, through the use of wires, cables, satellites, fiber optics, lasers, microwaves, radio waves or similar media.

Section 186-e defines the taxable receipt as the amount received in or by reason of any sale of telecommunications services or in or by reason of the furnishing of telecommunication services.

Sales Tax on Computer-Related Services

New York's sales tax base includes tangible personal property unless the law provides a specific exclusion or exemption. However, New York's sales tax does not include services unless the law specifically enumerates the service as taxed. New York's sales tax does not enumerate computer-based services, such as data processing services. However, New York does tax certain information services.

Information Services - Some vendors sell information or entertainment services over telephone lines, such as games, other entertainment, news, financial information, etc. Information and entertainment services are subject to sales and compensating use tax under Sections 1105(c)(1) and 1105(c)(9) of the Tax Law. However, the tax does not apply to information or entertainment services sold by nonprofit tax-exempt organizations. Furthermore, the tax does not apply to newspapers and periodicals delivered by telecommunications[4].

Computer Software and Related Services - The sales and compensating use tax applies to prewritten computer software, whether sold as part of a package, as a separate component, or otherwise, and regardless of the medium by means of which such software is conveyed to the purchaser[5]. The sales and use tax does not apply to computer services such as data processing, computer timesharing or computer programming. These services are not enumerated in the sales tax and remain outside its scope[6].

A 1993 Technical Service Bureau Memorandum (TSB-M-93(3)S) addressed how New York's sales tax applied to computer software, bulletin board services and online information services. At that time, online services typically collected and compiled information and placed that information in their own computers. For a fee, subscribers accessed information stored in those computers. Some online services also provided a medium for the exchange of software and subscriber information. An example in the TSB-M described a typical arrangement where a commercial online information service charged a specific fee to its customers for downloading prewritten software programs and for using its bulletin board service. In the example, the bulletin board provided software support and technical advice by computer experts regarding the prewritten software. The charges for the prewritten software were taxable as tangible personal property, while the charges for accessing the bulletin board service were a taxable information service.

Article 9 Corporation and Utility Taxes

The Section 186-e tax does not apply to any service that alters the substantive content of the message received by the recipient from that sent. It also specifically excludes cable television service, defined as transmitting to subscribers programs broadcast by one or more television or radio stations or any other programs originated by any person by means of wire, cable, microwave or any other means.

History

The Internet is a global network of interconnected computer networks[7]. Individual computer networks connect with each other by establishing telephone and software links. A key attribute of the Internet is the technology that enables millions of independently operated computers, each using different hardware, operating systems, and software application programs to link to each other by a common protocol[8]. Simply put, the Internet represents the computer space created by people voluntarily connecting all these dissimilar networks[9].

As a resource easily accessible by the public, the Internet only dates to the early 1990's[10]. The Internet has existed since 1969. However, research scientists and computer enthusiasts were the most frequent users. Generally, they reached the Internet through mainframe computer networks that nonprofit government and educational institutions established[11]. The World Wide Web software protocol transformed the Internet into something that anyone able to switch on a computer could use.

An Internet service provider (ISP) provides commercial access to the Internet. An ISP can range from a small firm operating locally to a large corporation providing services globally. The Interactive Services Association describes an ISP's purpose as providing customers a convenient way to access the Internet, for example, by simply dialing a phone number[12]. Besides simply "providing access," some ISPs handle file transfers and process subscriber data, for example by making the necessary computer software protocol conversions. In addition, some ISPs give subscribers E-mail privileges, navigational software and limited informational news or newsletters as part of their regular subscription charge.

ISPs gain access to the Internet by becoming part of it[13]. An ISP invests in the necessary computer hardware and software. It also purchases the telecommunications services necessary to link its computer network with all other networks. Alternatively, a company can purchase computer hardware to connect to an existing Internet provider. In that case, the provider "resells" Internet access service.

Other States

Around the country, other states are viewing Internet service providers as providing one of five different services:

- information services;
- telecommunications services;
- computer software;
- computer services; or,
- an entirely new service.

What is most interesting in comparing the other states is how the states fit Internet access into the existing tax structure. For example, Connecticut, Massachusetts, New Jersey and Pennsylvania each tax telecommunications services. However, concerning Internet access, only Massachusetts taxes it as a telecommunications service. Connecticut and Pennsylvania consider Internet access a computer service while New Jersey considers it a nontaxable service providing access to information furnished by others.

Table 8 summarizes our findings for New York and eleven other states. The table contains two parts. The first part presents four columns (Columns A - D) showing how the selected states tax information services, telecommunications services, computer software, computer services, and Internet services. The Internet column first shows if the service is "taxed" or "exempt." Next, it indicates in parenthesis the basis (the four services listed in columns A through D) for taxing Internet services. For example, showing Internet as "T(D)" means that Internet access is taxed in that particular state as a computer service.

Table 8: Sales Taxation of Internet Access and Selected Other Goods and Services - Selected States (1996)*

State	(A) Information Services	(B) Telecommunications	(C) Computer Software	(D) Computer Services	Internet Services
California	E	E	T (1)	E	E
Connecticut	T	T	T (2)	T	T (D)
Florida	T	T	T (1)	T (3)	T (D)?
Illinois	E	T (4)	T (1)	E	E
Massachusetts	T	T	T (1)	E	T (B)
New Jersey	E	T	T (1)	E	E
New York	**T**	**T (5)**	**T (1)**	**E**	**?**
Ohio	T	T	T (1)	T	T (A)
Pennsylvania	T	T	T (2)	T	T (D)
Tennessee	E	T	T (2)	E	T (B)
Texas	T	T	T (2)	E	T (A)
Wisconsin	E	T	T (1)	E	T (B)

Notes:
* "E" refers to items either specifically exempt from sales tax, or outside the scope of the tax (e.g., unenumerated services). "T" refers to items subject to tax.
? Tax policy not yet determined or currently under review.
(1) Sales of pre-written ("canned") software only taxed. In California, prewritten software taxed if sold in a tangible format.
(2) Sales of pre-written ("canned") and custom software subject to tax.
(3) Florida taxes "computer exchange" services.
(4) Illinois imposes a separate excise tax on telecommunications services in lieu of sales tax.
(5) Intrastate Telecommunications services only
Source: Adapted from CCH State Tax Guide and telephone interviews with State Tax Department staffs.

California

California does tax prewritten software, as tangible personal property, but only when sold in a tangible form. It does not tax information services or computer services unless the service is only a component part of a sale of tangible personal property. California also does not tax telecommunications services.

California does not tax Internet services.

Connecticut

Connecticut taxes computer and data processing services, canned software and intrastate and interstate telecommunications services.

Connecticut has stated that Internet access is taxable as a computer and data processing service.

Florida

Florida taxes information services when reports are furnished in a tangible form (e.g., a printed paper report). Florida's sales tax also applies to canned software, various computer-related services and most telecommunications services.

Florida taxes Internet services as "computer exchange services." However, Florida placed a temporary moratorium on collections pending a review of the current taxation of these services.

Illinois

Illinois taxes most telecommunications services, intrastate and interstate, under a telecommunications excise tax.

Illinois considers Internet access a nontaxable service.

Massachusetts

Massachusetts taxes information services when reports are furnished in a tangible form (e.g., a printed paper report). Massachusetts also applies it sales tax to canned software and telecommunications services, but exempts computer services.

Massachusetts taxes Internet access as a telecommunications service.

New Jersey

New Jersey's sales tax applies to canned computer software and telecommunications transmissions. Information and computer-related services are exempt from tax.

New Jersey does not tax Internet access.

Ohio

Ohio imposes sales tax on canned computer software, information services and telecommunications services. Ohio also taxes computer processing services, but only for business use. In Ohio, the sales tax specifically applies to electronic information services. Ohio defines those services as "providing access to computer equipment by means of telecommunications equipment for the purpose of . . . (i) examining or acquiring data stored in or accessible to the computer equipment; and (ii) placing data into the computer equipment to be retrieved by designated recipients with access to the computer equipment."

In Ohio, Internet services are taxable electronic information services.

Pennsylvania

Pennsylvania imposes sales tax on all forms of computer software (it considers custom software as a taxable computer programming service), computer processing, information and telecommunications services.

Pennsylvania treats Internet service providers as taxable computer services.

Tennessee

Tennessee imposes sales tax on all forms of computer software, both canned and custom. Tennessee also taxes telecommunications services.

Tennessee taxes Internet services as interstate telecommunications.

Texas

Texas imposes sales tax on telecommunications services, including interstate and international. It also taxes information services, including information furnished by telecommunications and including electronic data retrieval or research. Texas also taxes all forms of computer software.

Texas first ruled that Internet access represented a taxable telecommunications service. It later modified that ruling to tax Internet access as an information service.

Wisconsin

Wisconsin's sales tax applies to telecommunications services and to sales of canned computer software.

Wisconsin considers Internet access a taxable telecommunications service.

Findings and Analysis

New York finds that Internet services are unenumerated services not subject to the sales tax. The Department concludes that Internet access, and its related services, are not telephone, telegraph services or other telecommunications services. Internet services are also not taxable entertainment or information services. Furthermore, amenities such as navigational software, E-mail privileges and access to certain ISP home pages and banners, as part of its fees, are incidental to the overall service that ISPs provide and do not make Internet services taxable.

Through their ISP, customers access not only the ISPs computer facilities, but access the Internet's global resources. Once "logged on," customers have many options. ISPs provide customers with electronic "mailboxes" so that customers can communicate with others via electronic mail. Customers can also use their time to conduct research, advertise products, complete financial transactions, listen to music, take college courses, watch video, make purchases, read the news or a book.

As a new medium, the Internet was not contemplated when New York enacted its sales tax in 1965, and was certainly not a part of the sales tax's depression-era roots. Unlike Connecticut, Ohio, Pennsylvania and others, New York has not enacted specific new taxes on high-tech, computer based services. In New York, allowing a customer to use a computer to access information that the customer, or a third party, put there is not taxed.

Internet services are also unlike other computer-based networks which the Department has found taxable. In fact, Internet services are unlike any other service - taxed or exempt - reviewed over the past several years.

A related issue raised by advisory panel members concerns whether an out-of-state business that does not have nexus with New York, would gain nexus by placing advertisements or otherwise doing business through a New York ISP. New York believes that nexus with the State is not created merely by having a non-New York company's advertising appear on a New York server or through a New York Internet service provider.

These findings have various implications for how New York taxes the sales, purchases and income of ISPs. Additional consultation with Internet service providers is needed to develop concise definitions and to distinguish these services from taxable information and entertainment services, and from taxable telecommunications. It also has implications for taxpayer equity, competitiveness and tax administration.

Taxpayer Equity

The ISP, as a provider of an unenumerated service, represents the consumer of taxable goods or services used in providing Internet access services. An ISP's taxable purchases would include intrastate telephone services, computer hardware and prewritten computer software.

One potential issue concerns Internet service provided by a telephone company. New York does not impose a compensating use tax on telephone service. Therefore, any intrastate telephone service used by a telephone company to provide Internet access would not be subject to tax. Similarly, a telecommunications company which used its own transmission services to provide Internet services, because it would not have a "receipt" from furnishing telecommunications, would not owe the Section 186-e excise tax on those services. However, if the company was regulated by the PSC, it would be required to pay tax under Section 186-a. These situations do not create equity problems when a telecommunications company offers Internet services through a separate affiliated company.

Competitiveness

This finding makes New York competitive with most other states for individuals and business which purchase Internet services.

The sales tax exemption for interstate and international telephone services also makes New York a competitive location for Internet service providers. Furthermore, our finding that using a New York ISP does not, by itself, establish nexus, should help promote the ISP industry within New York.

Administration and Compliance

This finding will require the Department and vendors to make further distinctions between telecommunications services, information services and Internet services. For instance, it must distinguish between an ISP whose customers use the Internet to access an informational database and an information service which purchases and electronically resells the same database. In addition, some businesses package "access" and "content." For example, an information service provider could resell Internet access as a component part of a subscription to its information services.

Revenue Analysis

Department staff identified seventy-three Internet service providers that sold Internet services in New York and filed a sales tax return during at least one sales tax quarter in the 1996 sales tax year[14]. Based on an analysis of the taxable sales reported by these vendors, this policy will reduce State sales tax collections by an estimated $4 million. Local governments imposing sales tax would experience a similar decline in sales tax revenue.

This estimate does not consider the possible positive indirect effect of not taxing Internet services. For example, this policy could help to encourage Internet service providers to locate in New York. Furthermore, by keeping State and local sales tax out of the cost of purchasing Internet access, it could help encourage more New York businesses and residents to make full use of the Internet. Such economic development benefits could ultimately reduce the sales tax revenue implications of this policy.

Endnotes

1 See for example, TSB-A-89(25)S and TSB-A-89(45)S.

2 Such organizations are described in Tax Law Section 1116. See TSB-A-90(36)S for discussion of the application of that tax section to telephone services.

3 See pp. 14-15 of the preliminary report for additional information about these taxes.

4 See Tax law Section 1101(b)(6) defining "electronic" newspapers and periodicals as tangible personal property and Section 1115(a)(5) which exempts newspapers and periodicals from the sales tax imposed on tangible personal property. Also, in order to qualify for exemption, with the exception of advertising, the vendor must electronically ship or deliver the entire edition or issue of the printed newspaper or periodical.

5 Tax Law Section 1101(b)(6).

6 See TSB-78(1), issued February 2, 1978. Also, see TSB-A-95(12)S, issued April 21, 1995 concerning a flat monthly fee charged to access and utilize a computer. However, where the end result of the service is a sale of tangible personal property or of an information service, the transaction would be taxed.

7 The federal Communications Act, as amended by the Telecommunications Act of 1996 defines the Internet as "the international computer network of both federal and non-federal interoperable packet switched data networks." Each networked computer (node) can send and receive information. In addition, any node can route and reroute messages sent from any other node. Thus, a message or data sent over the Internet can literally pass through dozens or even hundreds of nodes before reaching its final destination.

8 Frieden, Karl A. and Michael E. Porter, "The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce," <u>State Tax Notes</u>, November 11, 1996, p. 1363.

9 Pfaffenberger, Bryan, <u>Internet in Plain English</u>, MIS Press (1994).

10 A large portion of this discussion is drawn from Waters, Craig, "An Internet Primer for Florida Legal Researchers," <u>The Florida Bar Journal</u>, November 1996.

11 The Department of Defense and the National Science Foundation, for example, played key roles in development of the Internet.

12 Interactive Services Association, <u>Logging on to Cyberspace Tax Policy, Executive Summary</u>, issued November 7, 1996.

13 As a network member, the ISP gains Internet Protocol addresses (IP addresses) identifying the host computer's location on the Internet. The tasks of coordinating Internet links, providing the necessary information and addressing engineering challenges falls to the Internet Society, a nonprofit professional organization. However, there is no single agency that runs the Internet. Each participating network pays its share of the operating costs. For example a university would pay a regional service provider to get linked to the Internet. The regional service provider, in turn, would pay a national or international "backbone" provider. For additional information see Pfaffenberger, Internet in Plain English or other Internet literature. Also, see the description of the Internet in *American Civil Liberties Union, et al., v. Janet Reno, Attorney General of the United States*, United States District Court, E.D. Pennsylvania, 929 FS824, June 11, 1996.

14 The 1996 sales tax year runs from June 1, 1995 to May 31, 1996. This represents the latest year for which detailed, taxpayer specific sales tax information is available. Generally, data from the fourth quarter (March - May 1996) is preliminary. Where fourth quarter data was unavailable, we made an estimate using data from the comparable quarter of the prior year and the average remittance during the first three quarters. Taxable sales are the portion of a vendor's total sales that are subject to sales tax.

Sales Tax Exemptions for Equipment Used to Produce Telecommunications Services for Sale

Issue

The sales tax exemption for telephone central office switching equipment and related station apparatus excludes important network equipment used to provide telephones service in today's high-tech world[1]. Moreover, the terms that describe the exemption (e.g., central office equipment) may have lost their original meanings as technology has changed the telecommunications landscape.

Finally, cable television companies purchase equipment that they use to provide television programming services for sale using similar "telecommunications" technology. However, television programming services are not telecommunications services. Consequently, such equipment is not exempt from tax.

Current Law

The sales tax exempts " . . . telephone central office equipment or station apparatus or comparable telegraph equipment for use directly and predominately in receiving at destination or initiating and switching telephone or telegraph communication . . . "

Only those telecommunications assets which function as central office equipment or station apparatus, used directly and predominately in receiving telephone communication at its destination, or initiating and switching telecommunications, qualify for the tax exemption (from now on "exempt equipment")[2]. The sales tax regulations provide, as an example of an exempt purchase, a telephone company's purchase of switchboards and hand sets for installation at a subscriber's premises[3]. Other equipment found to qualify for the exemption includes antenna systems, multiplex equipment and radio equipment when installed at a central terminal site[4].

The regulation also points out that only vendors of telephone services qualify for the exemption. However, the exemption is not limited to "telephone companies." Any telecommunications service provider (e.g., a business that sells telephone or telegraph service) can benefit from the exemption[5].

The State and local sales taxes also exempt parts with a useful life or one year or less and tools and supplies used or consumed directly and predominately in or on exempt telephone equipment. This exemption also applies to comparable telegraph equipment[6]. In addition, the Tax Law exempts from the State sales tax and from the sales tax imposed in New York City installing, maintaining and repairing exempt equipment[7]. These services are subject to local sales taxes outside New York City unless the exempt equipment is purchased installed, as a capital improvement to real property. As a capital improvement, the installation is exempt from both State and local sales tax[8].

The energy used to operate exempt equipment is taxed. However, New York does not tax custom computer software used in telecommunications equipment, or in any other application.

Possible Options

This section analyzes two options to change the central office equipment exemption. A separate issue sheet addresses creating a new exemption for the equipment used to provide other telecommunications-related services (e.g., the equipment used to provide cable television services).

The report does not analyze an option that would update the statutory language, replacing terms like “station apparatus” and “central office switching equipment” with appropriate current terms. When the Department surveyed advisory panel members for their opinions regarding these potential solutions, survey respondents did not support updating the exemption with a more current list of equipment. The current exemption omits important equipment used in today’s telecommunications industry. Thus, even if carefully described, the exemption would not address the industry’s needs.

Option A

Option A would replace the current exemption with a broad, function-based exemption. Legislation could accomplish this by exempting all machinery and equipment used directly and predominately by telecommunications service providers to initiate, receive at destination and switch telecommunications, not just “central office equipment.” In addition, under this option, the State could extend the exemption to machinery and equipment that telecommunications service providers use to receive, amplify, process and retransmit telecommunications signals. The option could also amend the Tax Law to exempt the electricity used directly and exclusively in providing telecommunications service for sale.

However, this option would not extend the exemption to telephone wires, lines or cables used to carry telecommunications through the distribution process. Moreover, it would not exempt the structures that support telephone equipment (e.g., telephone poles, microwave towers and radio towers).

Option B

Option B would amend the current exemption to provide a new, broad exemption for all network property and utility services used directly and predominately to provide telecommunications service for sale. Not only would it cover the equipment exempt under Option A, but it also would exempt the equipment used to transmit telephone, telegraph or other telecommunications signals. This would include telephone lines and cables. It could also include structures such as telephone poles, microwave towers and radio towers.

History

In 1965, when New York adopted its sales tax, the service provided by telephone companies was primarily voice transmission. The technology of that time required a hierarchically structured telephone network. Telephone companies routed telephone communications by switching telephone signals through large centralized switching offices. As discussed in the background study, the government regulated most aspects of the telephone industry. In fact, the words “central office equipment” and “station apparatus” refer to specific accounts used to figure out costs recovered through the rate making process. The central office equipment account represents financial information about telephone transmission and switching equipment and all other items at the central office (e.g., tables, desks, chairs and other items). The station apparatus account represents information about the telephones and other equipment owned by the telephone company but located at a customer's premises.

When the Legislature enacted the sales tax exemption in 1965, telephone central office equipment and station apparatus was "real property" for purposed of local real property taxes. Legislation in 1985 modified the Real Property Law to exclude station apparatus and some electronic and telecommunications equipment. However, it retained real property taxes on central office equipment[9]. Chapter 416 of the Laws of 1987 amended the Real Property Tax Law to delete telephone central office equipment from the definition of real property. The Real Property Tax continues applying to poles and wires.

In the early 1980's, competition began taking hold in the telephone industry. At this time, concerns surfaced regarding the sales tax exemption. Telephone service providers that put new transmission technologies, such as microwave, satellite, fiber optics and cellular radio, into use on a large scale basis found that the sales tax exemption did not always apply to their equipment purchases. These technologies do not feature the same level of centralized call switching[10].

Other States

New York represents one of ten states that have a sales tax exemption for telephone equipment used to provide telephone service for sale. However, New York grants a narrow exemption in comparison to six of those states[11]. These six states, Indiana, New Jersey, Ohio, Pennsylvania, Virginia and West Virginia, exempt most purchases by a telecommunications company. Some examples follow.

New Jersey

New Jersey exempts telephones, telephone lines, cables, central office equipment or station apparatus, or other machinery, equipment or apparatus, or comparable telegraph equipment purchased by a service provider subject to the jurisdiction of the Board of Public Utilities or the Federal Communications Commission, for use directly and primarily in receiving at destination or initiating, transmitting and switching telephone, telegraph or interactive telecommunications for sale to the public.

Ohio

Ohio provides a sales tax exemption covering tangible personal property and services used directly and primarily in transmitting, receiving, switching, or recording any interactive, two-way electromagnetic communications, including voice, image, data, and information, through the use of any medium, including, but not limited to, poles, wires, cables, switching equipment, computers and record storage devices and media, and component parts for the tangible personal property.

Virginia

Virginia exempts tangible personal property sold or leased to telecommunications companies which use such tangible personal property directly in providing telecommunications services. Virginia defines the term "directly" to mean any essential tangible personal property used immediately and principally by the company. Beside encompassing local exchange carrier and interexchange carriers, the exemption includes radio common carriers (e.g., paging service providers) and cellular telephone companies.

Policy Analysis

Taxpayer Equity

Option A would result in a more uniform tax treatment of telecommunications service providers which use different technologies (i.e., providers using centralized wireline technologies and providers using decentralized wireless technologies). It also would help improve the relative tax equity among the telecommunications industry, companies providing other utility services and New York companies producing tangible personal property.

However, within the telephone industry, Option A could give wireless communications a competitive advantage. Companies that employ wireline technologies require an expansive distribution system to carry the telephone signals to their customers. Maintaining and upgrading the wires and cables represent significant costs which Option A would not exempt. Option B would resolve this equity issue. It would exempt all network equipment, regardless of whether a company transmitted the service with wires or through the air.

A general policy concern with either option is that, while improving tax fairness in the telecommunications industry, it expands a sales tax benefit currently not provided for most service industries. New York taxes most tangible personal property purchased for use in providing a service. For example, a business that provides nontaxable telemarketing services or nontaxable cable television service pays sales tax on most machinery and equipment it uses. It also pays sales tax on any taxable services, including intrastate telephone service. Most businesses that sell taxable services (i.e., information services and repair services) also pay sales tax on their purchases[12]. Furthermore, Option B gives telecommunications companies preferential treatment compared with most manufacturers and utility companies which generally do not receive sales tax exemptions for property used in product distribution[13].

Competitiveness

Both options would reduce the sales tax costs associated with placing telecommunications equipment in New York. Thus, they would enhance New York's business climate for telecommunications infrastructures. Currently, the broader exemptions in states like Ohio and New Jersey may represent a factor that encourages telecommunications companies to put equipment in those states and not New York.

Option B would give New York one of the most generous exemptions in the country. It puts New York's telephone common carriers on equal footing with those operating from New Jersey. The exemption provided by Option B might also play a role in decisions to upgrade or expand existing local distribution systems.

Administration and Compliance

Option A and Option B could provide greater certainty to telecommunication service providers regarding the equipment exemption. Right now, tax administration pigeonholes today's high-powered digital computer-based telecommunications equipment into a tax exemption directed to the earliest generation of telephone equipment. Too often this has not worked to the taxpayer's benefit. However, even with an amended exemption, the Department and industry would need to work together to develop specific technical guidance.

Revenue Analysis

In estimating the revenues implication of this option, the Department mostly relied on industry information provided by advisory panel members. The Department combined this information with information from the Public Service Commission, the United States Department of Commerce and Value Line Publishing. Finally, we supplemented it with internal Department data. The estimates suggest the amount one might expect this industry to spend on the related equipment over the next year. Significantly, they exclude any potential market driven plant expansions. For example, they do not capture the potential equipment purchases that would result from a company's expansion into new markets. Moreover, the estimate does not consider the possible behavioral effect of the exemptions under study. That is, the estimate does not attempt to predict equipment purchases based on the possible increased investment resulting from the tax exemption. Therefore, the analysis may bias the estimates low. Finally, the estimates do not include expenditures for the energy used to power exempt equipment.

Option A would replace the current exemption with a broader, function-based exemption. We estimate that such an exemption would affect approximately $80 million in taxable equipment purchases. It would reduce current State sales tax revenue by about $3.2 million annually in the near term. Localities imposing sales taxes would experience a similar revenue reduction.

Option B, extends the exemption to include poles, cables and wires purchased by telecommunications service providers to carry telecommunications signals. We estimate that exempting that category of equipment would cover an additional $350 million in telecommunications industry purchases. It would reduce annual State sales tax revenues by an additional $14 million. The total estimated State revenue reduction from Option B is $17.2 million annually. Localities imposing sales taxes would experience a similar revenue reduction.

Recommendation

The current sales tax exemption for telephone equipment is outdated. This has two negative consequences. First, the exemption fails to cover necessary machinery and equipment used by today's telecommunications service providers. Left alone, the exemption will gradually provide fewer benefits to the industry. Second, the statute's ambiguity and resulting uncertainty do not provide an environment conducive to fostering growth in this industry.

The Department recommends expanding the telephone central office equipment exemption. Option A would eliminate the antiquated "central office" requirement and provide a broader, function- based exemption. The State should enact Option A as soon as budgetary conditions allow. Legislation could accomplish this at a State sales tax revenue cost of about $3 million.

As the State's fiscal resources permit, we recommend providing additional exemptions. Additional exemptions improve the relative equity between different types of telecommunications service providers (e.g., wireline versus wireless) and improve New York's competitive position with other states. A first step would be to provide an exemption for the electricity used directly and exclusively to power exempt telecommunications machinery and equipment. A second step would be to provide a broad exemption, like New Jersey's, that encompasses telephone poles and wires, radio towers, etc.

Endnotes

1 Network equipment consists of transmission systems and switches. Transmission systems include multiplexing equipment, repeaters, line conditioning equipment and wire. Switches complete connections between callers and route information from one network user to another. Switches include central offices switches, packet switches, mobile telephone switching office, microwave switches, and data communications switches.

2 TSB-A-91(71)S.

3 Regulation 528.13(f), example 1.

4 TSB-A-91(71)S.

5 See, for example, TSB-A-96(18)S where a hotel selling a separately stated telephone service subject to tax under Section 1105(b) of the Tax Law rather than Section 1105(e) was found to qualify for the exemption if it meet the requirements of that exemption.

6 See Section 1105-B(a) of the Tax Law.

7 Section 1105-B(b) of the Tax Law exempts these services from the State sales tax. Effective September 1, 1996, the exemption also applies to the 4 percent New York City Municipal Assistance Corporation tax imposed under Section 1107 of the Tax Law (see Chapter 366 of the Laws of 1996). Section 1105-B(c) of the Tax Law exempts from the compensating use tax imposed under Section 1110 of the Tax Law, the use of such equipment described in Sections 1105-B(a) and (b).

8 See Section 1105(c)(5) of the Tax Law. Although, other telephone equipment (equipment not qualifying for the exemption) would also be exempt when purchased on an installed basis as a capital improvement, the contractor installing the equipment would owe sales or compensating use tax on the installed items.

9 Ch. 71, L. 1985.

10 The trend toward decentralized network structure was noted and discussed in a 1987 report (prepared for the New York State Office of Economic Development, 1987). See Coopers & Lybrand. State Policy and the Telecommunications Economy in New York.

11 In the other four states (Michigan, New York, North Carolina and Wisconsin) the exemption is available for specific types of equipment used by telephone providers. Michigan, for instance, exempts “necessary exchange equipment” and any machinery and equipment located on the subscriber’s premises, if used to provide a taxable intrastate telephone service.

12 New York's sales tax already gives telecommunications service providers a competitive advantage in telecommunications intensive industries. For example, if a telecommunications service provider began selling a telemarketing service, it would have a competitive tax advantage because it would not owe tax on the "self produced" telecommunication services it used. Normally, a compensating use tax is owed when a producer uses its own taxable product to provide a different product. However, the State does not impose compensating use tax on telephone service.

13 The sales tax does exempt some items used to distribute tangible personal property. For example, it exempts tractor-trailers. It also exempts commercial aircraft and exempts commercial vessels used on an interstate basis. Finally, natural gas and oil producers have exemptions for distribution systems from the wellhead to the point of the first commercial sale.

Providing a New Exemption for Telecommunications-Related Industries

Issue

New and emerging technology, coupled with the increased competition fostered by telecommunications deregulation, is transforming the historical roles of telecommunications service providers and a variety of other industries. Telecommunications providers can now more easily offer services like television programming and Internet access. Moreover, businesses like cable television companies, electric utilities, are being encouraged to compete in telecommunications market[1]. New York's sales tax exemption for telephone equipment relies on a "predominate use" test. However, in the near future, the same piece of telecommunications equipment may at different times, or even simultaneously, transmit television programming and video, data and voice communication.

As discussed in the preceding section of this report, the Tax Law exempts telecommunications assets that function as central office equipment or station apparatus, used directly and predominately in receiving telephone communication at its destination, or initiating and switching telecommunications[2]. This tax exemption is available to any business that sells "telephone or telegraph service.[3]" Also, the exemption applies without regard to whether the service provider uses the equipment to provide taxable intrastate telecommunications services or, exempt interstate telecommunications services. New York's sales tax does not exempt equipment used directly and predominately to provide television programming services (e.g., cable television service), television broadcasting or other "nontelephone" services which use telecommunications technology.

Some representatives of the cable television industry complain that the equipment used to provide cable television service is excluded from the existing sales tax exemption. Related to this concern, is a concern that cable television companies sometime must pay tax on charges for installing cable television equipment, including charges for installing the cables themselves.

Current Law

Sales and Use Tax

The preceding issue sheet describes New York's exemption for telephone central office equipment, including the related exemptions for installing, maintaining and servicing exempt equipment.

In addition to the specific exemption for telephone equipment, New York exempts any installation of tangible personal property where the installation results in a capital improvement to real property[4]. Department Publication 862 describes the general application of the capital improvement exemption. However, the Department has not published any capital improvement guideline specific to the cable television or telecommunications industry.

New York's sales tax does not apply to service businesses unless the service is specifically listed as taxed. The sales tax does not apply to cable television services, or to other television programming services.

Other Taxes

The background report described how other State and local taxes apply to telecommunications service providers and cable television companies[5]. Significantly, telecommunications providers pay corporate taxes on a gross receipts basis under Tax Law Article 9 while television programming service providers pay taxes on net income under Article 9-A. Telecommunications providers are also generally subject to local gross receipts taxes on local telephone services ranging from l to 3 percent of gross receipts. Cable television companies pay local franchise fees at rates up to 5 percent of gross revenues.

Possible Options

This option would exempt equipment used directly and predominately in providing television programming services, or in providing both telephone and television programming services[6]. The option could also encompass purchases of machinery and equipment by a broader range of service providers which use telecommunications technology, such as information service providers and Internet service providers.

Cable television companies do not "switch" television signals in the same manner that telecommunications companies switch telecommunications. Thus, meaningful tax relief for the cable television industry would require a television programming services equipment exemption that encompassed purchases like cable head-end equipment. (Head-end refers to the point of reception of, or location of, equipment used to receive television and radio signals, and to amplify, process and retransmit those signals to a coaxial or fiber optic cable or microwave distribution system.)

A television programming services exemption could also exempt customer premises equipment purchased by the service provider and used directly and predominately to receive the television programming service at its destination[7]. An exemption could also be provided for the installation, repair and servicing or exempt equipment[8]. Finally, the broadest exemption could exempt the lines and cables used in the distribution process, and structures such as microwave towers.

Likewise, an option that included machinery and equipment used to provide other telecommunications related services would need unique definitions.

History

In 1976, the Department ruled that cable television service represented a taxable intrastate telephone service. In response, the Cable Television Association sued and won the case[9]. During the period when the State deemed cable television a telephone service, the State allowed a limited exemption for the equipment cable companies used to originate and "switch" cable television signals.

Other States

Few states exempt the equipment used to produce television programming services, or other telecommunications-related services. However, one state with such an exemption is the border state of New Jersey. Like New York, New Jersey does not tax television services. However, New Jersey's recently enacted Business Employment Incentive Program Act, effective June 1, 1996, provided a sales tax exemption for broadcasting equipment such as transponders, microwave dishes, transmitters and receivers, purchased by cable and satellite television service providers. Specifically, New Jersey's exemption covers:

> Sales of machinery, apparatus or equipment, including transponders, earth stations, microwave dishes, transmitters and receivers which have a useful life exceeding one year, other than that used in the construction or operation of towers, to a commercial broadcaster operating under a broadcasting license issued by the Federal Communications Commission or to a provider of cable/satellite television program services who may or may not operate under a broadcasting license issued by the Federal Communications Commission for use or consumption directly and primarily in the production or transmission or radio or television information transmitted, delivered or archived through any medium or method[10].

Policy Analysis

Taxpayer Equity

In a competitive telecommunications market, New York's existing sales tax structure provides a level playing field for all companies that purchase similar telecommunications equipment to provide telecommunications services for sale. When purchasing similar equipment, the exemptions apply equally to every company. The sales tax exemptions do not differentiate between different kinds of businesses that sell telecommunications services[11].

However, when telecommunications equipment is put to multiple uses, it is possible under the current exemption for a company offering the same services as other companies, but not meeting the "predominate use" test, to face a higher tax burden than the other companies. This option, by exempting the equipment whether used for providing telephone services or television programming services, improves tax equity in that case[12].

A disadvantage of a narrow option is that it gives the television programming services industry a sales tax benefit other service industries do not have. Except for telephone and utility services, New York's sales tax does not exempt tangible personal property used to produce services for sale. An option that included exemptions for a broader array of service providers would reduce this equity concern. Furthermore, this option would exempt equipment used to produce an exempt service.

Finally, unless the existing central office equipment exemption were expanded, this option would provide television programming services and others with a functionally broader exemption than that received by telecommunications companies. For instance, besides its use to "originate" the provider's television programming signal, head-end equipment provides a transmission function. In addition, residential and business telecommunications customers now usually own their own telephone equipment. Thus, the sales tax exemption for "station apparatus" provides telecommunications service providers with little sales tax benefit. In contrast, the cable television industry and certain direct broadcast satellite services continue to own customer premises equipment. Thus, television programming service companies would gain significant tax benefits from an exemption that included customer premises equipment.

Competitiveness

New York's cable television industry, television and radio broadcasters, Internet service providers and others, compete with service providers located outside New York (e.g., television services provided via a direct broadcast satellite service) where equipment is taxed at lower rates or is exempt. By exempting such equipment in New York, the option enhances the competitiveness of New York based companies. The option also may provide a sales tax incentive for companies servicing areas outside New York (e.g., direct broadcast satellite companies) to locate equipment here.

Administration and Compliance

This option would require the Department to work with industry representatives to develop appropriate guidelines and information about the exemption.

Revenue Analysis

In estimating the revenues implication of this option, the Department relied on historical data provided by cable television companies to the PSC. This information provides an indication of the expenses one might normally expect to occur. Therefore, the estimate does not consider the effect of the exemption on behavior. That is, it does not attempt to adjust the estimated amount of covered expenses based on the possible increased investment resulting from the tax exemption. Furthermore, the estimate is limited by the available data to purchases made by cable television companies. It does not estimate the potential implications of an exemption for other industries, like television and radio broadcasting, information services or Internet service providers.

We estimate that exempting cable head-end equipment and customer premises equipment (e.g., descramblers and remote control units) purchased by the service provider would reduce annual State sales tax collections by an estimated $5.8 million[13]. Localities imposing sales taxes would experience a similar revenue reduction.

A broader exemption would exempt the head-end and customer premises equipment as well as the lines and cables used in the distribution process and structures such as microwave towers. The industry refers to this property as part of the trunk and distribution system[14]. We estimate that an exemption for all trunk and distribution equipment and head end expenses would reduce annual State sales tax revenues by $11.1 million. The exemption would result in similar reduction of local sales tax revenues.

Recommendation

From a tax equity standpoint, a new exemption for the equipment used to provide television programming services, and other telecommunications-related services for sale, does not appear immediately warranted. However, emerging technologies and new service production and marketing strategies may soon result in tax equity concerns. New York must also recognize the economic development issues stemming from our close proximity to New Jersey; a state that provides significant exemptions for telecommunications-related industries.

The Department recommends new sales tax exemptions for television programming and other telecommunications-related industries.

The Department recommends new sales tax exemptions for television programming and other telecommunications-related industries. Such exemptions would nullify impending equity concerns and promote New York’s regional competitiveness.

The cable industry’s concern about the capital improvement exemption is a more pressing issue. Cable television companies can find that the same statutory provision found to exempt replacing a broken garage door opener, requires them to pay a sales tax on the labor to string hundreds of miles of coaxial cable or telephone line[15]. A comprehensive review of the capital improvement exemption would benefit telecommunications-related industries, as well as many other New York businesses.

Endnotes

1 Nutter, Jack J., "State Tax Implications of Providing Internet Services," Journal of State Taxation, 1995, p. 68.

2 The term "predominately" means used more than 50 percent of the time.

3 If a cable television company purchased equipment that functioned as telephone central office equipment and that it used directly and predominately in providing a telephone service for sale, it could purchase the equipment exempt from State and local sales tax. See, for example, TSB-A-96(18)S where a hotel selling a separately stated telephone service subject to tax under Section 1105(b) of the Tax Law rather than Section 1105(e) was found to qualify for the exemption if it meet the requirements of that exemption.

4 The Tax Law defines a capital improvement as an addition or alteration to real property which (1) substantially adds to the value of the real property, or appreciably prolongs the useful life of the real property; and (2) becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and (3) is intended to become a permanent installation. See Tax Law Section 1101(b)(9).

5 See the preliminary report, pp. 14-39.

6 For example, if qualifying equipment was used 35 percent of the time to provide telephone service for sale, 35 percent of the time to provide cable television programming for sale, and 30 percent for other uses, it would qualify even though no single exempt use exceeded 50 percent of the equipment's use.

7 Such equipment would be analogous to "station apparatus." However, that kind of exemption would not exempt the equipment that a consumer purchased.

8 See the preceding issue paper regarding the various State and local sales tax exemptions for services to exempt telephone equipment.

9 *NYS Cable Television Association V. State Tax Commission*, 88 Misc 2d 601 affd 59 AD2d 81/.

10 Section 18, Chapter 26, New Jersey Public Laws of 1996.

11 The preceding issue paper, however, discussed how different telecommunications service providers have different equipment needs. In that context, the existing exemption may favor certain technologies over others. Nevertheless, those differences stem from different equipment functions and not from the type of business making the purchase.

12 To the extent that nontelecommunications companies engaging in telecommunications activities organize a separate business entity to offer these telecommunications services, there would not be a differential tax burden. However, that organizational structure may impose other costs on the business.

13 We based this estimate on the PSC's Cable Television Division's review of the equipment expenditures of twenty-one small, medium, and large companies for 1995. The expenditure data does not include expenses by competing television programming service providers such as microwave (MDDS) and direct broadcast satellite (DBS). These companies would also benefit from tax exemption.

14 For purposes of reporting financial information to the PSC, trunk and distribution also includes subscriber devices and other plant in use on trunk and distribution lines. This includes expenses for hardware, make-ready costs charged by utilities, and labor.

15 Department Publication 862 (April 1996) describes exempt capital improvements. The exemption of the installation of a replacement electric garage door opener is listed on page 7.

Prepaid Phone Cards

Issue

Prepaid phone cards have become increasingly popular. Consumers purchase prepaid phone cards in preset dollar amounts or, at a preset value measured in minutes or units. They often purchase prepaid phone cards at retail establishments such as convenience stores. Telecommunications companies and telecommunications resellers also sell prepaid phone cards. In addition, merchants include prepaid phone cards inside other products sold. For example, they may package a prepaid phone card with a greeting card. Finally, businesses sometimes give prepaid phone cards away free as part of a promotional campaign.

Callers can use most prepaid phone cards at any location in the United States, regardless where purchased. Many prepaid phone cards also work in foreign countries. Often prepaid phone cards carry an expiration date. Any unused balance of minutes or units expires at a specific time, usually 30, 60 or ninety days from the date of purchase. When a purchaser uses up the card's value, they usually throw it away. However, consumers can reuse some prepaid phone cards by directly contacting the phone service provider to replenish the phone card account.

To use a prepaid phone card, the caller makes a toll-free call to the phone card provider and enters a unique identification or validation code printed on the card. Next, the provider's computer system tells the caller the card's expiration date and balance (a monetary balance, or a unit balance). The cardholder then places a call or purchases other services[1].

In 1994, New York advised that prepaid phone cards do not represent the sale of telecommunications services or the sale of tangible personal property. Thus, the State imposes the sales tax and the telecommunications excise tax on prepaid phone cards when callers use them, not when callers buy them. Certain members of the advisory panel agree that this represents the most appropriate way to tax prepaid phone cards.

However, New York's policy contrasts with the positions taken in a few other states. Some states view the phone card to represent the sale of a telecommunications service and they tax prepaid phone cards when sold. Other states tax prepaid phone cards as a sale of tangible personal property. Some advisory panel members believe that imposing tax at the point of retail sale, as tangible personal property, represents the best approach for taxing prepaid phone cards.

Advisory panel members also raise several questions about how, under New York's current policy, sales taxes and Article 9 taxes apply to telecommunications service paid for using prepaid phone cards. These questions include:

- Who must remit the taxes?

- What price is tax based on?

- How is the local sales tax rate determined and what is the "service address" for the Article 9, Section 186-e tax?

- What happens when the phone card goes unused?

- Does the tax apply differently to “collectible” cards or to cards packaged with other taxable merchandise?

Current Law

State and Local Sales Taxes

The preliminary report described New York’s State and local sales tax. The sales tax applies to most sales of tangible personal property and to certain services, including intrastate telecommunications service.

In 1994, the Department issued an Advisory Opinion discussing how the sales tax applied to prepaid phone cards[2]. The Department advised that selling prepaid phone cards do not represent selling either a telecommunications service or tangible personal property. Whenever the customer makes an intrastate call within New York State, the total charge for the call will be subject to sales tax.

The sales tax also has general rules that would apply when a retail merchant packages a prepaid phone card with taxable merchandise or sells a prepaid phone card for collection purposes. Concerning prepaid phone cards packaged with other merchandise, if customers cannot purchase the items separately, sales tax would apply to the total selling price[3]. If the retailer offers the items for sale separately, then the retail merchant may separately state the charge for each component and tax them individually. Concerning collectible items, the sales tax applies to tangible personal property sold for collection purposes, including items normally exempt from sales tax (i.e., collectible periodicals and newspapers, stamps and coins)[4].

Corporation and Utilities Taxes

The preliminary report described the taxes imposed by Section 183, Section 184 and Section 186-a[5]. Besides those taxes, Section 186-e imposes a 3.5 percent excise tax on receipts from the sale of telecommunication services. When the caller obtains telecommunications service with a credit or debit card, the location where the telecommunication originates represents the service address.

Possible Options

This section evaluates three options. The first two options would change New York’s current rule so that New York taxed prepaid phone cards when sold. Option A would tax the retail sale as a telecommunications service. Option B would tax the retail sale as tangible personal property. The third option would keep the current rule, taxing prepaid phone cards when used, and would provide guidance in response to industry questions.

History

None.

Other States

State and Local Sales Taxes

Thirty-six other states and the District of Columbia have provided formal or informal sales tax rulings regarding prepaid phone cards[6]. These states do not apply sales taxes to prepaid phone cards uniformly. States disagree on who should remit the applicable taxes and on the appropriate tax base.

Twenty-eight states, including Connecticut, Massachusetts and Pennsylvania, impose the sales tax and any other applicable taxes on prepaid phone cards when used. These states generally view the prepaid phone card as a "cash equivalent," analogous to a voucher or gift certificate. In these states, consumers do not buy a telecommunications service until they use the prepaid phone card to place a call.

Six states; Illinois, Iowa, Missouri, North Dakota, Texas and Washington, have ruled that the card itself represents the sale of telecommunications services. As a practical matter, these states apply the retail sales tax when the customer purchases the card.

Five of those six states tax intrastate, interstate and international telecommunications service. Iowa represents the only state that taxes prepaid phone cards at the point of retail sale while only taxing intrastate calls. All six of these states impose only a sales tax or consumer excise tax on telecommunications service. None of the six impose gross receipts taxes on telecommunications services.

Finally, Arizona and North Dakota apply their sales tax to prepaid phone cards as a sale of tangible personal property. Arizona and North Dakota also tax the underlying telecommunications company's receipts when someone uses the card to purchase an intrastate telecommunications service[7].

One area where states do agree concerns a prepaid phone card's second retail sale (e.g., a prepaid phone card sold as a collectible item). In all thirty-six states, these sales represent sales of tangible personal property.

Table 9 summarizes how the two major approaches influence sales tax administration.

Table 9: Comparison of Other States' Approaches for Applying Sales Taxes to Prepaid Phone Cards

	Tax Prepaid Phone Cards When Used	Tax Prepaid Phone Cards When Sold (as Telecommunications or as Tangible personal property)
When are taxes levied?	When the prepaid phone card is used in a state to make taxable calls.	When the prepaid phone card is sold at retail in the state.
Who remits the taxes?	The company providing the telecommunication service, including resellers.	The retailer or other retail distributor.
What price is the taxed based on?	The amount debited upon each use for the purchase of telephone services, or where the prepaid phone card represents a predetermined number of minutes or units, the price associated with each minute or unit of use.	The prepaid phone card's actual retail selling price.
How is the local sales tax rate determined?	Based on the location where a call originated.	Based on where the retailer delivered the prepaid phone card to the customer.
What happens when the prepaid phone card goes unused?	Income from expired prepaid phone cards is not subject to sales tax.	Expired prepaid phone card time was subject to sales tax when the prepaid phone card was sold.
How does tax apply to collectible prepaid phone cards?	The first retail sale of a prepaid phone card is not taxed. However, subsequent retail sales are taxable sales of tangible personal property.	The first retail sale of a prepaid phone card is taxed as a telecommunications service or as tangible personal property. Subsequent retail sales are taxable sales of tangible personal property.

Corporation and Utility Taxes

Only a handful of states imposes gross receipts taxes that, like New York's tax, encompass intrastate, interstate and international telecommunications services. Among these states are Florida, Maryland, Rhode Island and Wisconsin. Except for Florida's tax, the taxes apply to an allocated share of a company's gross telecommunications service revenues. Thus, the taxes apply to prepaid phone cards only to a telephone common carrier's telecommunications revenue from prepaid phone cards. Because those taxes relate to allocated portions of total nationwide revenue, and not the specific revenue from individual calls made in a state, they reduce prepaid phone card issues.

Florida imposes a 2.5 percent gross receipts tax on most telecommunications providers. Overall, Florida's gross receipts tax mirrors its sales tax on telecommunications, including both intrastate and interstate calls. Concerning prepaid phone cards, Florida imposes the gross receipts tax when a person uses a phone card to originate a call from Florida. The company that provides the telecommunications service pays the tax based on the value of the service. Florida's gross receipts tax does not tax income from expired phone cards or from cards sold for an amount that exceeds the value of the card (e.g., collectible cards).

Federal Taxes

The federal excise tax on communications services operates like a sales tax. This tax is ad-valorem (3 percent) based on the price callers pay for the service. Federal law imposes tax on the person paying for the telecommunications service, and it requires the vendor of the service to collect the tax from them. Because of the similarities, federal issues would parallel state issues.

To date, the Internal Revenue Service has not taken a position on this issue[8].

Policy Analysis

Option A

Option A would change New York's current rule to tax prepaid phone cards when sold. However, it would continue to recognize the transaction as a telecommunications service.

Taxpayer Equity

Under New York's current practice of taxing prepaid phone cards based on use, the State only collects revenue on taxable telecommunication services purchased in New York. By taxing prepaid phone cards at the point of sale, New York could potentially collect more tax than is legally due from some customers.

Unlike five of the six states that tax prepaid phone cards at the point of sale, New York's sales tax exempts interstate and international services. If the purchaser uses the card while in New York, they might only make exempt interstate calls. Therefore, taxing the entire prepaid phone card could result in imposing tax on exempt interstate or international telecommunications services, making this approach susceptible to challenge[9].

Moreover, when a person purchased a prepaid phone card in New York and used the card to make calls from Connecticut, New Jersey, Pennsylvania, or from one of at least twenty-four other states, that person would pay tax twice[10]. While possibly collecting too much tax from people who purchase prepaid phone cards in

New York, this method collects no tax from people who buy prepaid phone cards outside New York and use them in New York, including New York residents who purchase prepaid phone cards from outside New York by direct mail[11].

Taxing prepaid phone cards at the point of sale does provide some benefits. By collecting taxes directly from each customer, purchasers would know exactly how much tax they paid. This also allows tax exempt organizations to buy prepaid phone cards exempt from sales tax. In contrast, under current practice callers do not know how much tax they have paid. Furthermore, when a prepaid phone card represents calling minutes, current practice does not facilitate tax collection directly from each customer. Instead, the card's selling price must cover the service provider's total potential federal, state and local tax liability nationwide. In effect, all card purchasers bear all these taxes no matter where they purchase a card or how they use it.

Competitiveness

New York currently conforms with how neighboring states, and most other states, treat prepaid phone cards. Even so, telecommunications companies outside New York can gain a tax advantage over New York-based companies. Taxing prepaid phone cards when used requires out-of-state telecommunications service vendors to remit New York taxes when their customers make calls in New York. That requirement raises sales tax nexus questions[12]. New York cannot require a phone company outside New York, with no New York nexus, to collect or remit New York taxes.

Taxing prepaid phone cards at the point of sale might improve the competitiveness of New York's telecommunications service providers. Under the option, these companies would sell prepaid phone cards net of most potential New York taxes[13]. However, it would not enhance the competitiveness of New York retailers. New York's comparatively high tax rates on telecommunications service could discourage consumers from buying prepaid phone cards in New York. In most areas of the State, the combined Section 186-e and State and local sales tax approximate 11.5 percent. In localities that impose school district sales taxes, the combined Section 186-e and sales tax approaches 15 percent[14]. Meanwhile, New York's neighboring states would not tax prepaid phone card purchases.

Finally, taxing prepaid phone cards at the point of sale increases taxes for New York businesses that give away prepaid phone cards as free promotional items. Right now, businesses do not pay sales tax on promotional phone cards. Under this option, a business that gave away prepaid phone cards would owe sales taxes on the total purchase price of any cards purchased in New York.

Administration and Compliance

New York's current policy limits the universe of taxpayers to vendors of telecommunications services. Independent distributors and agents that do not provide telecommunications services would not collect State and local sales taxes or pay Article 9 tax. This reduces administrative burdens for New York's business community.

If taxed at the point of sale, as a telecommunications service, convenience stores, vending machine operators, grocery stores and others that sold prepaid phone cards would collect State and local sales taxes. They might have to pay the Article 9 Section 186-a and Section 186-e taxes as well. Paying the Article 9 taxes would place new administrative burdens on those businesses[15].

On the other hand, New York's present approach puts the full compliance burden on the telecommunications service provider or providers. Taxing prepaid phone cards at the point of sale would relieve telecommunications companies of some compliance responsibilities, at least concerning State taxes and local sales taxes.

Option B

Option B would change New York's current rule to tax prepaid phone cards when sold. However, unlike Option A, it would do so by deeming prepaid phone card sales a sale of tangible personal property.

Taxpayer Equity

Option B shares the same equity concerns as Option A. That is, by taxing prepaid phone cards at the point of sale, New York could potentially collect more tax than is legally due from some customers. Moreover, as with Option A, it is susceptible to challenge and has the potential for double taxation.

Besides these concerns, the Article 9 tax implications of this option raises new equity issues. Companies selling telecommunications services through prepaid phone cards could become taxed under a completely different tax structure than other companies selling telecommunications services. The actual tax consequence would depend on whether the prepaid phone card vendor was principally engaged in selling telecommunications service and on where the telecommunications vendor sold the prepaid phone cards.

In some instances, treating prepaid phone cards as tangible personal property would increase the overall tax burden on prepaid phone cards. In other cases, it would decrease the overall tax burden[16]. In the end, under the current tax structure, companies not principally engaged in telecommunications service may gain a tax advantage over New York companies principally engaged in selling telecommunications services. In addition, companies (including companies principally engaged in telecommunications services) "wholesaling" phone cards outside New York would gain a tax advantage over telecommunications services providers selling prepaid phone cards in New York, including those that sold cards at the wholesale level.

Taxing prepaid phone cards as tangible personal property does provide some significant benefits. As with Option A, purchasers would know exactly how much tax they paid on the phone card. It also provides a way to collect the sales tax directly from each customer. In addition, it allows tax exempt organizations to buy prepaid phone cards exempt from sales tax.

Competitiveness

Option B has similar benefits and disadvantages as Option A. However, taxing prepaid phone cards as tangible personal property would not necessarily improve the competitiveness of New York's telecommunications service providers. Some telecommunications companies could continue owing Article 9 Section 184 and 186-a taxes on prepaid phone cards[17]. In addition, as tangible personal property, New York businesses would owe a compensating use tax on any cards purchased out-of-state that a business handed out in New York.

Administration and Compliance

As with Option A, if taxed at the point of sale, every convenience store, vending machine operator and grocery store selling prepaid phone cards would have to collect the State and local sales tax. However, most retailers already collect and remit sales taxes. Also, as with Option A, taxing prepaid phone cards as tangible personal property would relieve telecommunications companies of the administrative burdens of tracking calls for State tax purposes and for local sales tax purposes.

Issues Associated with New York's Current Policy

This option would keep the current rule, taxing prepaid phone cards when used, and would provide guidance responding to the industry's questions. Different choices exist for handling particular concerns. Listed below are the industry's main questions followed by a discussion of possible approaches.

Who must remit the taxes?

Under current law, any company selling a telecommunication service must remit the applicable taxes[18]. In the prepaid phone card industry, this includes common carriers such as MCI and SPRINT, and telecommunications resellers marketing telecommunications services through prepaid phone cards. A convenience store, retail gasoline filling station or other retail vendor selling or distributing phone cards would not usually be responsible for collecting the sales tax or paying the Article 9 taxes on the telecommunications services purchased using prepaid phone cards.

Under this option, the Department would need to provide guidance on how telecommunications resellers differ from prepaid phone card distributors. Possible criteria could be that a reseller typically holds itself out as a provider of telecommunications services and derives its revenues from selling or reselling the phone service. In addition, resellers will often be subject to the jurisdiction of the PSC, the FCC or other regulatory agencies. Resellers will usually provide customer service, billing, and/or take other active roles in providing the telecommunications service. In contrast, distributors have no role in providing the telecommunications service connected with the card.

What price is tax based on?

Where a prepaid phone card represents a monetary value (e.g., $5 or $10), telecommunications service providers can easily base the applicable taxes on the amount debited from the card. That is, the money debited from the card covers the cost of the phone call and the applicable tax.

However, when a prepaid phone card provides a preset number of calling minutes, without stating the monetary value of those minutes, figuring out the appropriate taxable “price” or “receipt” can prove difficult. Most often, the telecommunications seller or reseller does not know how much an independent distributor charged for a particular card. Thus, the telecommunications service provider cannot base taxes on the actual retail selling price of the card.

Basing the tax on the telecommunication provider’s tariffed rate for sides a readily available, objective measure of the selling price. Unfortunately, in a deregulated industry, many prepaid phone card service providers do not charge tariffed rates. Massachusetts ruled that lacking a tariff rate, telecommunications providers should base the sales tax on the price the caller would have paid without the calling card. That could represent an option for New York. However, that price varies depending on the day of the week, the time of day and the provider’s available discount calling plans. Another possible solution is to base the tax on the telecommunications company’s receipt for the telecommunications service sold (e.g., the average price per minute).

How is the local sales tax rate determined and what is the “service address” for the Article 9, Section 186-e tax?

On taxable calls paid for with a calling card, New York bases the local sales tax on the location where a call originates. That policy conforms with the Section 186-e debit card service address rules.

This policy would require a telecommunications provider or reseller marketing service through prepaid phone cards to keep track of the telecommunication activity connected with card use (e.g., points of call origination and termination and the length of the call). That process contains little difference from current practices for standard telecommunications billing arrangements. However, with prepaid phone cards, this tracking is not necessary for customer billing purposes. Moreover, industry representatives have reported difficulties with identifying the geographic location of call origination. Furthermore, for sales tax purposes, it must be determined that the call originated <u>and</u> terminated in New York.

Determining call origination can be difficult under current prepaid phone card policy. The only information which the service provider might have is the phone number called from. Assuming the telephone number is available, that number might not provide enough of a basis to establish a caller's geographic location. In some cases a prepaid phone card service provider purchases a nationwide 800-number service from an IXC. All calls made to that 800-number end at the prepaid phone card company's telecommunications switching equipment. The prepaid phone card service provider may or may not have information about the call's actual origination.

Once the service provider establishes a call's point of origination, it must identify where the call terminates. Again, this can be problematic. For example, the number called could be that of a cellular telephone. It may have little connection to the actual location where the caller receives the call.

One potential solution would require resellers to obtain information about the underlying activity, such as the location of the place where the call originated. A call identification system, for example, may provide information about the street address associated with the telecommunications equipment. However, in cases where the service provider does not have geographical information about the telecommunications's actual location, the Department may need to allow the prepaid phone card company to rely on the telephone number. In addition, where the service provider is unable to obtain information on the location of the call's origination, the Department may have to develop guidelines using a call's point of termination.

What happens when the phone card goes unused?

Prepaid phone cards often expire after a set time. Sometimes the prepaid calling card is lost, destroyed or forgotten before being fully used. A prepaid phone card purchaser might intentionally leave a prepaid phone card unopened, and in its original package, to preserve its potential value as a collectible item.

By taxing prepaid phone cards when used, the State would not tax revenue derived from unused phone card. This is because that revenue would not represent revenue received from providing a telecommunications service. However, PSC regulated corporations subject to Section 186-a and local telecommunications companies subject to Section 184 would pay taxes on their New York source income. This, in turn, raises the related question of how to source that income.

Does the sales tax apply differently to "collectible" cards or to cards packaged with other taxable merchandise?

Consumers sometimes buy and sell prepaid phone cards as collectible items. In addition, merchants sometimes package prepaid phone cards with other taxable items sold. For example, they may package a prepaid phone card with a greeting card.

Under New York's current approach the State would not impose a sales tax on a phone card's original sale unless the retailer packaged it with taxable items. However, sales tax would apply on subsequent sales for collection or investment purposes. The State would tax that transaction as a sale of tangible personal property.

This would conform to the policy already in place for collectible periodicals and newspapers, stamps and coins[19]. However, it does require the Department and retailers to make certain judgements. For example: Was the card previously sold to a retail purchaser? Did the ability of the card to purchase telecommunications service expire? What represents a "normal" selling price? Is the card being sold for collection or investment purposes?

The Department could work with industry representatives and independent prepaid phone card distributors to develop guidelines in this area. In Florida, for example, when a retailer sells a prepaid phone card at a cost that exceeds a reasonable selling price (i.e., they sell a $10 phone card for $25 due to its value as a collectible), the retailer collects sales tax on the increment above the price that covers the phone service.

When a retail merchant packages a prepaid phone card with taxable merchandise, sales tax applies to the total selling price. The fact that a retailer sold a prepaid phone card as part of a taxable item does not change how the tax applies to the card's use.

Revenue Analysis

During 1995, in the United States consumers purchased an estimated $900 million in prepaid phone cards. Prepaid phone cards will represent an estimated $1 billion industry in the United States in 1996 and the industry expects it to reach $3 billion by 2000. Some industry representatives also expect the use of prepaid cards to extend beyond the purchase of phone service to other products and services. Unfortunately, no data exists to estimate how much tax the State currently collects from telecommunications services paid for using prepaid phone cards.

Conceptually, each option has positive and negative revenue implications. For example, under New York's current policy the State may not always receive revenue on a distributor's markup, if any, between the prepaid phone card's price for telecommunications service and the prepaid phone card's actual retail selling price. This happens because the State would not view the retailer's markup on the card as part of the telecommunications service's selling price. On the other hand, the current approach collects some tax on New York phone services paid for with a prepaid phone card purchased outside the State.

Collecting tax at the point of sale, under Option A or Option B, results in collecting tax on the full retail price of the prepaid phone card. However, part of that tax revenue could potentially come from erroneously collecting taxes on telecommunications calls not made in New York and from erroneously collecting sales taxes on exempt interstate and international telecommunications services. Finally, that approach provides little or no revenues from prepaid phone cards purchased outside New York and used in New York.

Recommendation

Prepaid phone cards provide a valuable new way to pay for telephone service. It is particularly important to New York given the high volume of domestic and international travelers in New York City and other metropolitan areas.

At this time, New York should retain its current policy of taxing prepaid phone cards when used.

New York's current tax structure on telecommunications services, combining multiple State taxes at different rates and bases with 100 local sales tax jurisdictions and several hundred locally imposed gross receipts taxes, significantly complicates tax administration for companies which market telephone services through prepaid phone cards[20]. When the phone card is priced and sold in New York and elsewhere, the telephone service provider has little idea about where or how the ultimate purchaser will actually use the card.

In light of this, the prospect of moving the entire tax to the point of retail sale is attractive. However, the tax equity concerns and the potential legal risks in the option to tax the cards when sold, either as telecommunications or tangible personal property, make this difficult to recommend. The possibility of taxing calls that are not subject to tax (e.g., interstate and international calls) is too great to warrant a policy change at this time.

At this time, New York should retain its current policy of taxing prepaid phone cards when used. However, the Department recognizes the urgent need to have uniform rules across the states to avoid the possibility of multiple taxation. The Department also recognizes that efforts to achieve uniformity nationwide could raise the possibility of reconsidering an approach based on the phone card's point of sale.

The study recommends that an industry/government task force be organized to promote as much uniformity among the states as possible on issues arising from the use of prepaid phone cards.

Endnotes

1 For example, consumers can use certain prepaid phone cards to obtain travel information.

2 The opinion answered a question from a telephone common carrier. It did not address issues associated with prepaid phone cards distributed by telecommunications resellers or by retail vendors that are not common carriers. See TSB-A-94(33)S.

3 This tax consequence results from the sales tax "cheese board rule." When a retailer sells tangible personal property, composed of taxable and exempt items, as a unit, it must collect tax on the total price. See Regulation Section 527.1(b).

4 See Regulation Section 526.8 and 528.6(c)(4).

5 See pp. 14-15 of the preliminary report for additional information about these taxes.

6 The discussion of sales taxes in other states is based on information from a presentation by Walter Nagel, MCI Communications Corporation, at the <u>Prepaid Telephone Phone Card Forum</u>, Federation of Tax Administrators, Washington D.C., July 26, 1996; Connecticut Department of Revenue Services Ruling 95-10, August 10, 1995; Massachusetts Department of Revenue, Tax Directive, May 6, 1996; Washington State Excise Tax Bulletin 567.08.245, December 31, 1994; and telephone interviews with staff at the Arizona, Iowa, Missouri, North Dakota and Texas revenue Departments.

7 The District of Columbia recently amended its law to tax prepaid phone cards as tangible personal property. If approved, it takes effect October 1, 1997. The tax will be imposed at a 10 percent rate, rather than at the 5.75 percent sales tax rate. The 10 percent rate is the tax rate of the Toll Telecommunications Service Tax.

8 Based on a November 20, 1996 telephone interview with staff at the Internal Revenue Service, the Internal Revenue Service met with certain industry representatives about prepaid phone card issues. However, it has not received any formal requests for letter rulings and is not currently considering any regulatory actions in this area.

9 See *Matter of Southern Pacific Communications Company*, TSB-D-91(41)S, wherein the court disallowed taxation of the flat access fee paid for a private telephone system which could carry both intra and interstate telecommunications between connected points. It is noteworthy that the Supreme Court decisions in *Central Greyhound v. Mealy*, 334 US 653 (1948), *Goldberg v. Sweet*, 488 US 252 (1989), or *Jefferson Lines v. Oklahoma Tax Commission*, 115 S. Ct. 1331 (1995) do not apply to the taxation of telecommunications in the context of New York's Sales and Compensating Use Tax Law. These cases address whether States must apportion taxation of receipts for services which are performed partly within and partly outside of their jurisdiction for purposes of the satisfying the second (apportionment) prong of the Commerce Clause analysis in *Complete Auto Transit v. Brady*, 430 US 274 (1965). New York's Tax

Law provides a statutory exclusion from taxation for interstate and international calls, and so does not tax telecommunications services performed partially outside of the State.

10 This also happens under current policy because a small number of states tax the cards when purchased. Thus, when people buy cards in one of those states and use the card in New York, the card value has been taxed twice.

11 However, as a convenience purchase, border state tax rates may not significantly influence purchasing decisions.

12 For example, is the use of prepaid phone cards in a state sufficient to create nexus with the phone card company?

13 A resale exemption (Article 9 and sales tax) would need to apply to intermediate prepaid phone card sales. New York telecommunications service providers would still need to factor into prices their potential tax liabilities in any state where the card can be used and would still need to factor in possible local gross receipts taxes in New York.

14 Furthermore, this excludes any local gross receipts taxes, the Metropolitan Transportation Authority surcharge and other Article 9 taxes passed through to customers.

15 Imposing only the sales tax at the point of sale (with the Article 9 taxes collected based on use) would reduce the administrative burden on retail vendors. However, having completely different rules under the two taxes would make the tax system even more complex.

16 For example a New York company principally engaged in telecommunications service and subject to the supervision of the PSC would owe Article 9 Section 184 and 186-a tax on its gross income from selling prepaid phone cards. In addition, the phone card retailer would collect State and local sales tax. On the other hand, a company that is not principally engaged in telecommunications services, or a company principally engaged in telecommunications services that markets prepaid phone cards from outside the State, would have no Article 9 tax liability on prepaid phone card sales. The retailer would collect sales tax or, the prepaid phone card purchaser would owe compensating use tax.

17 The phone cards would no longer constitute an exempt resale of telecommunications services. Instead, wholesale and resale sales of prepaid phone cards would be treated as nontelecommunications income.

18 State and local sales taxes and Article 9 taxes.

19 See Regulation Sections 526.8 and 528.6(c)(4).

20 The 100 local sales tax jurisdictions consists of 82 counties and cities imposing general sales taxes and 18 city school districts imposing additional sales taxes on utility services, including telephone.

Coin-Operated Telephone Services

Issue

The sales tax exempts telephone charges of ten cents or less paid by inserting coins in coin-operated telephones. Some advisory panel members note that the coin telephone exemption has not kept pace with industry changes. Since 1984, the base charge for a coin-operated call has equaled twenty-five cents.

Current Law

The sales tax applies to intrastate telephone calls placed from coin-operated pay phones unless the charge is ten cents or less and is paid by coins[1]. The PSC regulates rates for all coin telephone calls[2]. It sets rates in amounts divisible by five cents. These rates do not specifically include sales tax. The charge for a three minute local call from any public pay phone, whether provided by a regulated or unregulated phone company, cannot exceed twenty-five cents.

The Tax Law and regulations require vendors to compute and collect sales tax in amounts rounded to the nearest cent. For sales below one dollar, the Department provides a sales tax collection schedule eliminating fractions of one cent. For sales greater than one dollar, vendors must round the tax to the nearest one cent. Typically, on a twenty-five cent local phone call, the State and local sales tax is two cents. The payphone provider must compute sales tax on the twenty-five cent price unless it makes the customer aware that the twenty-five cent charge includes sales tax[3].

Possible Options

This section analyzes four options to address coin-operated telephone exemptions. Option A would increase the threshold for exempt coin-operated telephone calls to twenty-five cents. Option B would provide a general exemption for local pay phone calls. Option C would exempt coin-operated pay phone charges where the resulting sales tax would be less than two and one-half cents. On other calls, it would require pay phone operators to round the sales tax to the nearest nickel and to collect the tax at the time of the call. The result would exempt all charges of less than thirty-five cents. At thirty-five cents, the tax would become a nickel. Option D would modify PSC rate making rules to ensure that coin telephone rates recognized the sales tax.

History

The coin-operated telephone exemption for ten cent calls took effect June 1, 1966, ten months after the State enacted the sales tax[4]. The State Legislature provided the exemption to prevent a pay phone vendor from paying sales tax from other revenues. Vendors could end up paying the tax from other revenues because they cannot collect tax on a ten cent sale[5]. Thus, regulated telephone utilities transferred the sales tax liability to the rate base.

Sales tax issues related to pay phones surfaced again in 1979[6]. A sales tax study commission recommended that the PSC permit pay phone operators to reflect the sales tax in coin call charges. For example, when setting coin telephone rates, a forty cent intrastate call would include three cents sales tax. Thus, it would actually represent thirty-seven cents for rate making purposes plus three cents tax. The Commission also supported legislation to allow rounding of tax on coin telephone charges to the nearest nickel. In 1983, the

State Legislature approved a bill to round the sales tax collected on pay phone charges to the nearest nickel[7]. The bill passed both houses of the Legislature but the Legislature subsequently recalled it[8].

In 1984, the PSC approved an increase in public pay phone rates. The basic rate for a three minute local call increased from ten cents to twenty-five cents[9].

Recently, the Federal Communications Commission (FCC) issued new rules that deregulate pay phone services. The new rules continue the FCC's efforts to implement the Telecommunications Act of 1996 and become effective April 15, 1997[10]. The FCC's deregulation plan requires local exchange companies to remove any inherent pay phone rate subsidies beginning April 15, 1997. It also requires local exchange companies to remove any pay phone costs from access charges and to file new access charge rates with the FCC by January 15, 1997. States will continue setting local rates for one year. However, during that year states must examine pay phone regulation and remove any regulation that hinders competition. After that year, the FCC will allow market conditions to set the local rate[11].

Other States

The neighboring states of Connecticut, New Jersey and Pennsylvania each tax telephone service, but exempt certain telephone calls made from coin-operated telephones.

Connecticut

Connecticut exempts any local charge for calls from public or semi-public telephones. In addition, with respect to toll telephone charges paid by inserting coins into pay phones, Connecticut provides that sales tax should be rounded to the nearest five cents.

New Jersey

New Jersey also exempts local calls from public coin-operated telephones[12]. However, New Jersey limits its local exemption to charges paid by inserting coins into the coin-operated telephone. New Jersey taxes all toll telephone calls made from payphones, including those paid for with coins.

Pennsylvania

Pennsylvania taxes most telephone service but exempts basic local residential services. Concerning pay phone charges, Pennsylvania exempts all charges (local and toll) for telephone calls paid for by inserting money into a coin-operated telephone.

Federal Excise Taxes

The 3 percent federal excise tax on telephone service exempts local services paid for by inserting coins in public coin-operated telephones.

Policy Analysis

Taxpayer Equity

All four options would benefit tax equity because they would shift the sales tax liability on coin calls away from noncoin telephone users. Currently, coin phone customers pay very little sales tax, if any, at the time of the call. This happens due to regulatory constraints and the mechanical limitations of coin boxes. For example, the State and local sales tax on a twenty-five cent call typically equals two cents. However, pay phone companies do not ask that pay phone customers deposit twenty-seven cents to complete the call. Thus, the sales tax liability gets transferred to the rate base in regulated utilities or to the general revenues of nonregulated pay phone operators[13].

Only Option D, to include the tax in the price of all calls, would improve sales tax equity with respect to coin calls and callers paying for the call using a calling card. Under any of the other three options, most coin calls would become exempt.

However, Option D may raise nontax equity issues. If a coin call remained priced at twenty-five cents, Option D would reduce the telephone company's sales price to twenty-three cents (the two cents balance would represent sales tax). This would require additional subsidization of local coin telephone rates. However, the FCC's actions to deregulate payphone prices, including specific provisions to remove rate subsidies, may address this concern.

Option C provides a means for pay phone companies to collect tax on coin calls costing thirty-five cents or more. However, by rounding the sales tax to the nearest nickel, the option would sometimes increase the sales tax on those individuals paying with coins compared with those paying for the call by other means. In other cases, it would have the opposite result[14]. In other words, while Option C would resolve some existing tax equity problems, it would create new ones.

Businesses selling tangible personal property through vending machines and other businesses operating coin-operated devices may feel that providing special benefits for pay phone companies is unfair. To rectify their concerns would require providing similar expanded exemptions for these businesses.

Competitiveness

These options would reduce the amount of sales tax remitted by pay phone operators. However, these options would not provide a direct savings to consumers.

Administration and Compliance

Option A would not simplify sales tax administration for payphone companies. An advisory panel member pointed out that one concern is defining a "call." If a customer placed a twenty-five cent local call and completed the call within the allocated time, no tax would be owed. Two separate twenty-five cent calls to the same number (i.e., if the customer hung up and redialed the same number) would also be exempt. However, if the customer deposited five or ten cents (beyond the initial quarter) to obtain more calling time, the call would appear to become fully taxed, including the first twenty-five cents. An alternative would exempt the first twenty-five cents of a call.

Option B exempts "local" pay phone calls. It could present some administrative and compliance issues. The Department would need to work with industry to develop guidelines distinguishing "local" calls from other calls.

Option C would impose new collection burdens on coin telephone operators. The rounding methodology would require pay phone companies to calculate and collect the sales tax at the time of placement of each intrastate call costing thirty-five cents or more.

Option D would require the regulated telephone companies to modify their existing coin telephone rate agreements with the PSC. That, in turn, could have various administrative implications for the effected companies, particularly with federal deregulation on the horizon.

Revenue Analysis

Option A would increase the threshold for exempt coin calls from ten cents to twenty-five cents. We estimate that it would reduce State sales tax revenues by about $6.5 million. Localities that impose a sales tax would experience an estimated $6.3 million reduction in sales tax revenue. The combined State and local sales tax reduction would equal $12.8 million. We base these estimates on industry information indicating that twenty-five cent calls represent 90 percent of intrastate coin telephone revenue[15].

Option B would exempt all local pay phone calls paid for with coins. Assuming that this option would exempt 95 percent of total intrastate coin revenues, it would reduce State sales tax revenues by an estimated $6.9 million, with local sales taxes declining by $6.6 million. The total State and local revenue loss from Option B would be about $13.5 million.

Option C would exempt all calls paid for by inserting coins where the State and local tax amount equaled less than two and a half cents (twenty-five and thirty cent calls). On all other calls, the tax would be rounded to the nearest nickel and paid for at the time of the call. Assuming the exempt calls (calls costing 30 cents or less) would represent 92.5 percent of intrastate coin revenues implies that this option would reduce State sales tax revenues by $6.7 million, with local sales taxes declining by a $6.5 million. The total State and local revenue loss from Option C would equal approximately $13.2 million.

Option D would treat coin payphone charges as reflecting a “tax included” price. If prices stay the same, we estimate that would reduce annual State sales tax revenues by about $0.5 million. Localities that impose a sales tax would experience an estimated $0.4 million annual reduction in sales tax revenue[16]. Furthermore, because this change would reduce the gross receipts from coin phone service, net of sales tax, it would result in reducing State revenue from Article 9 taxes by an estimated $0.5 million annually. The combined annual State and local tax reduction would equal $1.4 million.

Recommendation

The sales tax collection schedule is not conducive to businesses that derive a majority of revenues from a high volume of small coin transactions. Consequently, pay phone operators have little opportunity to recoup the sales tax owed on local phone service. In the past, the monopoly status of the telephone companies, and related rate regulation, provided ways for recovering coin phone losses through other service areas. However, this is not the case today.

Many issues discussed in this paper derive from the partially competitive nature of the pay phone industry. On the one hand, any business is free to enter the pay phone marketplace. However, once in the business, the Public Service Commission dictates the prices they can charge on local telephone service.

The Public Service Commission should modify its rate making rules to ensure that the coin telephone rates include the sales tax.

From a tax policy viewpoint, to the extent possible, pay phone operators should not be treated differently from other telephone service providers or from other retailers that make sales through coin-operated machines. The Public Service Commission should modify its rate making rules to ensure that the coin telephone rates include the sales tax. Therefore, at today's charges, the twenty-five cent charge would be comprised of approximately twenty-three cents for the call and approximately two cents in sales tax. Furthermore, for purposes of the Article 9, Section 186-e tax, this would provide a small tax benefit to pay phone operators.

While providing some relief to this industry, the recommendation avoids the sale tax equity issues raised by a special exemption and the rounding mechanism. It also sets the stage for impending deregulation of pay phones under recent FCC rules.

Endnotes

1 The sales tax does not exempt pay phone calls paid for by making a collect call or paid for with a credit card or calling card. The exemption is found at Tax Law Section 1115(e).

2 See Public Service Law Section 90(3)(3)(a), Section 92-C(10) and 16 N.Y.C.R.R. 650.2(d).

3 Vendors must remit the tax even if they failed to collect it. See Tax Law Section 1137 and Sales Tax Regulation 533.4. Also, see Sales Tax Regulation 532.1 regarding posting "tax included" prices in instances where a receipt is not given to the customer.

4 Ch. 1023, L. 1966.

5 Sales tax collection schedules promulgated in Regulation Part 530 indicate that no tax is to be collected on a ten cent sale. Without the exemption, pay phone vendors would owe tax on all ten cent payphone sales although they had not collected tax on any individual sale. Businesses operating coin-operated vending machines face the same situation and benefit from a similar exemption for sales of ten cents or less.

6 State of New York Governor's Temporary Commission to Review the Sales and Use Tax Laws, Report to the Governor: The New York Sales and Use Tax, (December 15, 1979).

7 The bill aimed to relieve residential and business customers from their subsidization of the sales tax paid on coin-operated phone calls. However, some lawmakers charged that the mechanism for accomplishing this goal yielded a hidden rate hike for pay phone users. "Sales tax on pay phones approved", Troy Times Record, June 28, 1983, page 6.

8 A.7132/S.5966 of the 1983-1984 Regular Session.

9 In the New York Telephone Company's brief on exceptions, the company argued to a adopt a thirty cent charge, pointing out that a twenty-five cent charge would result in about $15 million additional sales tax costs. See, Case 28601 at 24 NY PSC.

10 FCC Report and Order Adopted September 20, 1996 (FCC 96-388).

11 However, if a state can demonstrate market failure, the FCC would allow local rate setting.

12 New Jersey defines "local calls" as calls subject to a local calling rate.

13 Non-coin usage of public telephones correctly include the sales taxes.

14 For example, in an 8 percent sales tax jurisdiction, the tax on a $1.00 coin call would equal ten cents. The tax on the same call paid for with a calling card would equal eight cents. Alternatively, a seventy-

five cent call would result in a rounded five cent tax when paid by coin and a six cent tax when paid by non-coin means.

15 Based on PSC and industry sources, we estimated that intrastate coin telephone services paid for by inserting coins into the coin telephone equals $181 million. This excludes calls made from pay phone which are charged to calling cards, credit cards, etc.

16 For purposes of this estimate, we assume that the option would have revenue implications only for rate regulated utilities providing coin phone service. In other words, we assume that unregulated pay phone companies currently set their prices on a "tax included" basis.

Cellular Telephone Services - Determining a Local Sales Tax Rate

Issue

The mobile nature of cellular telephone service raises questions on how to assign calls to particular localities. This is particularly difficult in situations where the calls cross multiple jurisdictions. Cellular companies express difficulty in pinpointing the applicable local sales tax jurisdiction.

Current Law

Sales Tax

Tax Law Section 1105(b) imposes sales tax on intrastate telephone services. The applicable local tax rate on telecommunications equals the rate in the county, city and school district where the customer receives the telephone service. Usually this coincides with the customer's telephone number and billing address. However, the regulation describes a situation where the telephone company uses "tie-lines" to connect telephone exchanges (numbers) located in different localities to one central phone bank. In that case, the telephone number determines the local tax rate[1].

The Tax Law and the tax regulations do not discuss how sales tax applies to cellular telephone services. The Department provided some guidance on cellular telephone services in a Technical Services Bureau Advisory Opinion[2]. The opinion advised the petitioner that the local tax rate on activation, monthly access fees and usage charges equals the highest local rate imposed in the area covered by the subscriber's assigned telephone number exchange. In coming to this conclusion, the Department compared cellular service to having a phone with a telephone number that corresponded to a different geographic area than the phone's physical location. As with all Advisory Opinions, this advice was only binding with respect to that petitioner.

Section 186-e Tax

The Section 186-e tax applies to all calls that originate and terminate in New York, regardless of the service address. Section 186-e uses the *Goldberg* allocation method to determine New York taxable telecommunications receipts from interstate and international services. For interstate and international calls, Section 186-e taxes the entire receipt from cellular telephone services if the call either originates or terminates in this State, and is charged to a service address (e.g., a telephone) in this State.

Except in case of roaming, for purposes of cellular telephone services, Section 186-e sets the service address as the caller's location of primary use of the telecommunications equipment[3]. The location of primary use is reflected by the cellular subscriber's billing address in New York, a telephone number or authorization code.

Possible Options

This section of the report analyzes two different approaches for determining local sales tax rates on cellular service.

Option A

Under Option A, cellular providers would charge sales tax using the State and local rates based on the subscriber's "service address." Consistent with the Section 186-e tax, the service address would relate to a customer's "location of primary use." In most situations, the Department would deem the subscriber's New York billing address as the service address. However, if the billing address did not represent the actual service address (e.g., a New York cellular subscriber receives their bill at a Pennsylvania residence), the Department and industry would develop guidelines for the company and the subscriber to use in deciding the appropriate State and local sales tax rate. These guidelines would look at factors, such as the telephone number, a sales office location, or the location where a company assigns employees for withholding tax purposes.

Option B

Option B would compute the sales tax using a blended State and local tax rate[4]. Under this approach, cellular telephone service would be subject to one of sixteen sales tax rates, depending on the CGSA where the customer received service. All subscribers within the CGSA would pay the same sales tax rate. Alternatively, the Department would provide a single blended rate applicable statewide. Establishing a blended rate by regulation might be possible. However, it would likely require legislation[5].

The sales tax return would include a new schedule with one line for each CGSA. The cellular companies would report all of their taxable sales on the line(s) used for the CGSA(s) where they do business. With a statewide blended rate, the sales tax return would include a new line where cellular companies would report all of their taxable sales. The Department would have responsibility for allotting local sales tax revenues to the various local taxing jurisdictions[6].

History

In response to industry and local government concerns, the Department started to develop a tax regulation dealing with cellular service and local tax rates. Subsequently, that effort was incorporated into this telecommunications study.

Other States

The neighboring states that tax telephone service (Connecticut, Massachusetts, New Jersey and Pennsylvania) do not have general local sales taxes[7]. Therefore, to see how other states deal with local sales taxes on cellular service, we examined the sales taxes in Florida, Georgia, Minnesota, Ohio, Texas and the State of Washington. Like New York, these states tax cellular telephone service. They also have local sales taxes on cellular service. Overall, other states settled on a customer's "service address" as the means to assign a call to a particular locality. The service address usually means the billing address.

Policy Analysis[8]

Taxpayer Equity

Currently, the methods of determining the local sales tax rate vary from company to company. Three known practices include using a customer's billing address; the location of cellular company's equipment handling the calls; and, the customer's cellular telephone number. To the extent that either option would yield consistency in how cellular companies tax cellular calls, they increase equity. Regardless of the approach taken, customers would generally pay the same local rate of tax no matter from which company they obtained cellular telephone service.

Option A, using the tax rate at a subscriber's location of primary use (e.g., billing address), provides a benefit in that it represents a familiar and easily explained approach. For example, it is similar to how people pay sales tax on their motor vehicles. For those subscribers who rarely use their cellular phone at home, the option allows them to establish a different location as their service address. Businesses with employees traveling to various locations throughout the State would also have the ability to assign another location to the employee.

However, some subscribers may see this as an unreasonable approach. It treats cellular phone users as making all calls from a single defined geographical area, such as a particular County. Consequently, it could tax cellular subscribers who make calls from different locations, at the same rate based on their similar service address. Some cellular telephone subscribers usually use their cellular phone in a higher taxed area than areas where they sometimes use the phone. These subscribers may see this approach as increasing their sales tax on those calls made in lower taxed jurisdictions[9]. Subscribers who frequently travel, particularly business users, may find it difficult to assign a single specific "primary use" locations. To allay these concerns, the Department and industry would need to work together to develop clear guidelines on establishing the location of primary use.

In contrast, Option B recognizes that cellular telephone subscribers travel in many local tax jurisdictions while using cellular telephones. Under Option B, all cellular customers who make or receive calls within in the same CGSA, or anywhere within New York, would be charged the same tax rate.

However, Option B achieves this benefit at the expense of subscribers who only use their cellular phones in local jurisdictions with tax rates below the blended rate. Under Option B, these subscribers would experience a tax increase. A statewide blended rate exacerbates this problem. A statewide blended rate could approach 8 percent[10]. Currently, in twenty-four counties, mostly upstate, the combined sales tax rate is at or below 7 percent. In one county the rate equals 4 percent[11]. In three CGSAs, no local jurisdiction has a combined State and local rate higher than 7 percent[12].

This leads us to a significant question associated with Option B: how would the blended rate be developed? Some ideas include developing a rate based on population or on the distribution of all other taxable telephone services. Other ideas would require cellular companies to keep track of cellular phone traffic at each cell base station. A rate would then be developed taking into consideration the traffic patterns of cellular phone use. Still, other alternatives would require cellular companies to provide information about total taxable sales compiled by zip code. These ideas provide different methods for distributing cellular telephone sales tax revenues collected using the blended rate. However, none relate specifically to cellular telephone use by taxing jurisdiction.

Competitiveness

This issue relates only to distributing local sales tax within New York State. Thus, it has no direct implications on the competitiveness of New York's cellular telephone industry.

Administration and Compliance

Both options, by providing a single, consistent rule, would facilitate compliance. Option A provides specific administrative benefits to cellular companies by borrowing concepts from the Article 9, Section 186-e tax. Furthermore, other states use the billing address as a determining factor for local sales taxes. Thus, cellular companies that operate in other states would be familiar with this method. Implementing Option A would also contribute to simpler sales tax administration if, in the future, companies bundled traditional telephone services with cellular services and other mobile services.

The disadvantage of Option A is that it represents a subjective approach. It requires cellular companies to find out from customers where the customer intends to use the cellular telephone. Cellular companies would need assurance that they could rely on the subscriber's information and not be held liable in cases where the subscriber provided false information.

Option B also benefits tax administration for cellular telephone service providers. It provides a straightforward and objective mechanism for charging and collecting sales tax. The option should also simplify tax return preparation, particularly if the State adopted a single statewide rate. A single statewide rate also minimizes issues associated with subscribers roaming inside New York and with companies doing business statewide.

A possible disadvantage of Option B is that some subscribers may not understand the "blended" rate. This could lead to increased communication with subscribers. Also, cellular companies would need to account separately for cellular telephone service (subject to the blended rate) and other product and service sales. Furthermore, setting a blended rate by CGSA would not provide a usable rule for other mobile telephone services, such as personal communication services (PCS). PCS market service areas, for example, do not equate with CGSAs.

Finally, the different options have different implications for sales tax filing and processing. Taxing cellular services based on a customer's location of primary use would not require any forms changes or tax processing changes. In comparison, Option B imposes new tax administration costs. Option B would require changes to tax processing systems. It would also require forms changes[13].

Revenue Analysis

The Department compiled a sample from the sales tax returns of forty-one vendors. These vendors sold cellular telephone services in New York during at least one sales tax quarter in the 1995 sales tax year[14]. The sample does not include every vendor of cellular telephone services. Moreover, for those vendors identified, the data include all of their taxable sales. For example, it would include taxable sales of cellular telephones. Despite these shortcomings, we believe that it provides a reasonable representation of the taxable cellular calls made in New York[15].

In the twelve month period examined, these forty-one vendors reported $935 million in taxable sales. This would yield a State sales tax liability of around $37 million. An approximately equal amount of local sales tax liability would relate to these services.

In our estimation, neither option would substantially increase or decrease the total amount of cellular telephone services subject to tax in New York. However, the options would impact the amount of local sales tax charged and the distribution of that tax between the localities found within each of the sixteen CGSAs.

Option A would link cellular phone tax revenues to the location of primary use of cellular telephone subscribers as represented by billing address or other indicators, such as the area covered by the telephone number. Thus, it would result in a distribution of the taxable sales among the localities based on that criteria.

Option B would distribute sales tax revenues from services rendered within each CGSA to each of the localities within that CGSA based on some type of formula. If the option imposed a statewide blended rate, the "local tax" portion of the tax revenue collected from cellular services rendered throughout the state would be distributed to all of the local taxing jurisdictions.

Recommendation

For purposes of determining local sales tax rates, the Department recommends using a service address concept, based on the subscriber's location of primary use, to source cellular charges, other than separately stated roaming charges. More work needs to be done to establish guidelines to administer this approach. Thus, members of the cellular industry are invited to work with the Department to develop these rules. The Department also recommends initiating a process to handle disputes regarding the proper local taxing jurisdiction for particular cellular telephone services.

Endnotes

1 Regulation Section 527.2(d)(6).

2 TSB-A-89(38)S issued October 11, 1989

3 The service address means the location of the telecommunications equipment from which the telecommunication originates or at which the telecommunication is received from the provider of telecommunications services.

4 A blended rate refers to a single tax rate representing the State sales tax rate and the local rates of more than one local taxing jurisdiction.

5 Tax Law Section 1137(d), regarding the payment of sales tax, authorizes the Commissioner to fix an effective rate of tax for a particular group or classification of vendors. The effective rate must be fixed at such a percentage rate as to require, so far a practicable, payment of an amount equal to the total taxes imposed by the State and localities. However, Section 1132, regarding the collection of tax from the customer, does not contain similar language. Section 1142 contains general authorization for the Commissioner to make, adopt and amend rules and regulations appropriate to administering the sales tax.

6 The Department could establish the parameters for the revenue distribution based on the same criteria used in formulating the blended rate. For example, if a blended rate derived from population data, the local sales tax revenue collected from cellular telephone service could be distributed to localities also based on population.

7 Pennsylvania does have limited local sales taxation, such as Philadelphia's 1 percent sales tax.

8 This analysis looks at the sales tax benefits and disadvantages of either approach. These options do not directly relate to Article 9 taxes. Thus, the analysis does not reflect any potential issues associated with those taxes.

9 The actual result would depend on how they currently pay tax.

10 The weighted average State and local combined sales tax rate for all taxable sales and all purchases subject to use tax currently equals about 7.85 percent. Furthermore, based on the U.S. Census Bureau's July 1996 population estimates, about 70 percent of New York's population resides in counties where the combined State and local sales tax rates equal 8 percent or higher.

11 Oswego County is currently the only county with no tax. However, it has authorized a county sales tax of 3 percent effective March 1, 1997.

12 The maximum rate imposed by any jurisdiction in the Glens Falls, Elmira and Syracuse CGSAs is 7 percent. The maximum rate in the Poughkeepsie CGSA is 7.25 percent.

13 System development, using blended rates within each CGSA, would be most expensive. Adopting a single statewide blended rate reduces system development costs. However, these cost could still be in the range of up to $500,000. Once the Department established these systems, ongoing operations costs would not be significant.

14 The 1995 sales tax year runs from June 1, 1994 to May 31, 1995. This represents the latest complete year for which detailed, taxpayer specific sales tax information is available. Taxable sales are a portion of a vendor's total sales that are subject to sales tax.

15 Cellular telephone vendors were identified using information from the Federal Communications Commission and the New York State Public Service Commission.

Cellular Telephone Services - Sales Tax on Roaming Services

Issue

Cellular telephone subscribers can travel outside their home cellular geographic service area (CGSA) and still place and receive calls. The industry calls this "roaming." When roaming, a subscriber is using his or her cellular telephone in a different CGSA. While roaming in a different CGSA, the subscriber's call may be handled by a different cellular telephone company. However, because some cellular companies provide service in more than one CGSA, it is also possible that the subscriber's home carrier provides the roaming service.

This report refers to the cellular company that provides the roamer with cellular telephone service as the "serving" carrier[1]. It refers to the subscriber's normal cellular telephone company as the "home" carrier. For purposes of this report, "roaming charges" or "roaming service" includes all charges and services related to the roaming; both for airtime and for local or toll telephone service.

The nature of roaming services raises two main policy issues. The first concerns which company should collect and remit sales tax and pay the Section 186-e tax. A second issue concerns the appropriate local sales tax rate to charge on roaming services.

Current Law

Sales Tax

Every business that sells taxable services is a "person required to collect tax." In addition, when a business sells a taxable service, the Tax Law presumes that all the receipts from those sales are taxable until the service provider establishes the contrary. In the telecommunications industry, any business that sells or resells intrastate telephone services represents a person required to collect tax. Intrastate telephone services are presumed taxable unless the business establishes the contrary, for example by the timely receipt of a properly completed resale certificate.

The Tax Law and the regulations do not specifically discuss how the sales tax applies to cellular roaming services. In addition, the Department has not published any Technical Services Memoranda about this topic. However, the Tax Law presents a framework for applying the sales tax to roaming. The following discusses how that framework could be applied to roaming services.

The "Home Carrier's" Sales Tax Responsibilities

If a home carrier acts as a billing service for serving carriers, then the home carrier has not sold or resold the serving carriers' services. Consequently, the home carrier would not remit the sales tax on those transactions. However, on any customer bills the home carrier must show the total amount of sales tax that it is collecting, including any sales tax collected on behalf of another company.

When the home carrier is not a billing agent for the serving carrier, then the home carrier's "incollect" roamer charges (charges billed to its own customers for roaming outside the home service area) for intrastate service would represent taxable receipts from the sale of a telephone service. In that case, the home carrier can issue the serving carrier a resale certificate or take a credit against its sales tax liability for any sales tax that the serving carrier charged them.

Applying general sales tax rules, the home carrier would base the local sales tax rate on the location where the telephone service was provided. However, the Department has not provided any specific guidance regarding how a cellular company determines that location. If a home carrier, as part of its monthly service charge, billed its customers a monthly fee that included roaming, that fee would be taxed as part of the regular monthly service charge.

The "Serving Carrier's" Sales Tax Responsibilities

A serving carrier's "outcollect" charges (charges billed to other companies' customers for roaming in its service area) from intrastate services are subject to sales tax. To be relieved of the tax liability, the serving carrier must obtain a properly completed resale certificate or other evidence of an exemption. If the serving carrier has not obtained a properly completed exemption document, it must collect State and local sales tax on intrastate calls placed or received by roamers. The serving carrier would base the locarovided. Again, the Department has not provided any specific guidance regarding how the cellular company determines that location.

Section 186-e Tax

The Article 9, Section 186-e tax is an excise tax on providers of telecommunication services. Section 186-e specifies that when a subscriber is outside of their assigned service area, as is the case with roaming, the service address becomes the location of the mobile telephone switching office (MTSO) or similar facility. Therefore, the Section 186-e tax would not apply to roaming service obtained by a New York cellular customer while traveling outside New York, even if the call had originated in New York or terminated in New York and was paid for in New York[2].

Generally, in a roaming situation, the home carrier provides only a billing service to the serving carrier. Therefore, the home carrier would not owe tax on the services sold by the serving carrier. The home carrier would pass through the charges of the serving carrier, including any tax amount, to its subscriber and return the same to the serving carrier through the billing arrangement.

As a serving carrier, a New York cellular company must pay tax on all intrastate, interstate and international roaming services it sells or resells unless the services are sales for resale to an LEC, IXC or a New York facilities-based carrier[3].

Possible Options

A combination of options emerge in response to roaming issues. They turn on three critical choices: (1) establishing which company should charge, collect and/or remit the sales tax, or agreeing that either company may, (2) deciding if the applicable local sales rate equals the local sales tax rate applied to other taxable cellular services, or a different rate, and (3) deciding how a cellular company could determine the local rate when providing services to a roamer.

Option A

Option A addresses the first issue. Under current law it appears possible for either vendor, and for both vendors, to be the sales tax collector or payor. Option A, would change this. It would require that, in roaming transactions, only the serving carrier would compute and remit the sales tax. In addition, only the serving carrier would pay Section 186-e tax for on the revenues associated with the roaming. Under this option, the home carrier would not remit sales tax or pay Section 186-e tax on roaming services provided by a different company. Roaming revenues would always be considered revenues of the serving carrier, not the home carrier.

Option B

Option B addresses the second issue, deciding the applicable local sales tax rate. It would establish a policy for home carriers which sell or resell roaming services to their subscribers[4]. The policy choice there is deciding if the applicable local sales tax rate should equal the local sales tax rate applied to other taxable cellular services, a different rate connected to the location where the roaming occurred, or a statewide blended "roaming rate."

Option C

Option C looks specifically at different ways serving carriers could determine the local sales tax rate on roaming charges. This also relates to issues discussed in Option B. If home carriers had to collect local sales taxes using a rate that related to the area where the roaming occurred, this option would provide the means to determine that rate.

History

In response to industry and local government concerns, the Department started to develop a tax regulation dealing with cellular service and local tax rates. Subsequently, that effort was incorporated into this telecommunications study.

Advisory panel members indicated that companies in the cellular telephone industry have formed their own task force to examine this issue. A report from this industry group is expected by the end of January 1997[5].

Other States

When cellular telephone charges relate to roaming, our research found that many states allow the serving carrier to collect tax based on the rate in effect at the cell base station or MTSO that first handled the call. However, states do not appear to have mandated that practice.

The State of Washington represents one state with such a policy. With roaming charges, Washington recognizes the serving carrier as a retail seller of cellular service. To compute the correct rate of local tax, the serving carrier has two options. It can assign the tax revenues to the locality where the originating cell site is or it can assign the revenues to the locality where the MTSO is found. This policy was first developed to provide guidance where nonresidents roamed in the State. However, cellular companies in Washington found that the rule also worked well when applied to residents roaming inside the State.

Policy Analysis

Option A

Option A, would make it mandatory that serving carriers collect the sales tax on roamer charges and pay the Section 186-e tax.

Taxpayer Equity
With this option, subscribers would always pay sales tax on cellular telephone roaming services based on the geographical area where they placed and received calls. (Option B, part one, presents a second method that could accomplish this same objective.) Consequently, it attempts to tax cellular roaming calls based on where the caller received the telephone service.

With respect to roaming services, it would apply a uniform rule to all cellular companies. Consumers would pay sales tax in a consistent manner whatever company they subscribed with.

Competitiveness
This issue relates only to tax administration and distributing local sales tax within New York State. Thus, it has no direct implications on the competitiveness of New York's cellular telephone industry.

Administration and Compliance
This option could provide administrative benefits. Cellular companies would only have to collect sales tax on cellular telephone services that they provided inside the "home" service area. When their subscriber obtained telephone service from another cellular company, the home carrier would collect those charges from its subscribers and remit them to the service provider but would not be liable for the sales tax.

One disadvantage associated with this option involves tax exempt organizations. More than 70,000 sales tax exempt organizations operate in New York State. These organizations get a tax exemption on telephone services by giving the provider an Exempt Organization Certification. Once the provider files that certificate, all subsequent sales are exempt from sales taxes. In a roaming situation, the serving carrier might not know if it was providing telephone service to an exempt organization. Thus, under this option, it could charge tax on an otherwise exempt service. When billed sales tax for the service, the organization would need to apply to the Department for a refund. Alternatively, the organization would need to provide the serving ication and request a refund from them.

Finally, by mandating that the serving carrier collect the sales tax, the option would limit how cellular businesses can market their services. For example, as part of a monthly subscription, some cellular companies provide wide area services (i.e., a certain number of "free" minutes of roaming). Under such an arrangement, the home carrier pays for the roaming service and resells it as part of the basic monthly charge. Under Option A, the home carrier would have difficulty marketing its services in that manner.

Option B

A second issue about roaming relates to the appropriate local tax rate to charge. This option compares two policy choices to cover situations where home carriers sell or resell roaming services to their subscribers[6]. The option assumes that the State does not adopt Option A, discussed above. Consequently, it would be possible for the home carrier to collect the sales tax on roaming services. The option also assumes that the State does not adopt a statewide blended rate to apply to all cellular telephone services. A statewide blended rate would make this option unnecessary.

The policy choice here is deciding if the applicable local sales tax rate should equal the local sales tax rate applied to other taxable "nonroaming" cellular services provided to New York customers or a different rate connected to the location where the roaming occurred[7].

Taxpayer Equity
Sourcing a local sales tax rate connected to the location where the roaming occurred would benefit taxpayer equity. Subscribers would pay sales tax on cellular telephone roaming services based on the geographical area where they placed and received calls. Moreover, roaming would be taxed in the area where the calling occurred regardless of whether the serving carrier or the home carrier was the vendor of the roaming service.

In comparison, if New York sourced roaming at the same local sales tax rate as other cellular charges, a roaming subscriber whose home carrier resold the roaming service would pay local sales tax based on a local sales tax rate in their home area. A roamer whose home carrier acted as a billing agent for the serving carrier would pay local sales tax based on the rate where the roaming occurred.

Competitiveness
This issue relates only to distributing local sales tax within New York State. Thus, it has no direct implications on the competitiveness of New York's cellular telephone industry.

Administration and Compliance
In concept, basing the local sales tax rate on the area where the roaming occurred provides some consistency with the Article 9, Section 186-e tax. For purposes of determining if a cellular roaming call was charged to a New York service address, Section 186-e relates the service address to the area where the roaming occurred and not to the subscriber's location of primary use. In other words, for purposes of Section 186-e, a cellular subscriber's "service address" moves with them when they roam.

However, as a mechanism for establishing the local sales tax rate, establishing separate local sales tax sourcing rules for roaming, in the area where the roaming occurs, can impose significant new compliance costs. This may represent one reason why survey respondents did not favor this approach. The significance of these costs would depend on the method chosen to establish local sales tax rates on roaming. For example, a statewide blended local rate for roaming would minimize costs for cellular companies. A local rate based on the location of the serving carrier's MTSO or cell base station, would probably be more costly. In the latter case, the serving carrier would have to provide home carriers with information about the local sales tax jurisdiction of the serving carrier's MTSO or cell base station that handled each call. However, in either case, a cellular company may need to establish separate billing mechanisms for "home" charges and "roam" charges.

Allowing home carriers to apply the same local sales tax rate to roaming that they apply to other taxable cellular services in New York simplifies customer billing and sales tax reporting. Nevertheless, it would still require alternative rules for the situation where the home carrier reselling the roaming service was located outside New York and for the situation where the home carrier acted only as the billing agent of the serving carrier.

Option C
Option C looks specifically at different ways serving carriers could determine the local sales tax rate on roaming charges. This also relates to Option B. If home carriers had to collect local sales taxes using a rate

that related to the area where the roaming occurred, this option would provide the means to determine that rate. Two possible methods discussed here are:

- computing the local sales tax using a blended rate developed for the entire state or for each CGSA; and,
- computing the local sales tax using the location of the MTSO or the cell base station first handling the call.

Taxpayer Equity
Neither method can guarantee consumers and local governments that the local tax rate charged directly related to the area from which they called or received a call. A MTSO or cell base station may handle a call for only a short time before handing it off to a different MTSO or cell base station for its duration. Also, different cell base stations could handle two people calling from the same location.

Applying a blended rate alleviates some equity concerns. With a blended rate, all callers roaming in the State, or in a specific CGSA would always pay the same sales tax rate. However, a blended rate also lacks precision. Because local sales tax rates vary, the blended rate would usually not equal the rate that actually applied where calls are placed or received.

Competitiveness
This issue relates only to distributing local sales tax within New York State. Thus, it has no direct implications on the competitiveness of New York's cellular telephone industry.

Administration and Compliance
Either method, by providing a single, consistent rule, would facilitate compliance. A statewide blended local roaming rate would minimize administrative costs the most for cellular companies. When computing the sales tax on separately stated roaming charges, cellular providers would simply refer to a published rate or rates. Problems could arise however, in areas where the CGSA overlaps with other states. Furthermore, linking blended rates with CGSAs would not reflect the way companies market cellular services, including roaming. Increasingly, the federal licensing requirements tied to CGSA boundaries are not germane for marketing purposes.

Using the MTSO or cell base station location also supplies benefits. It parallels the Article 9, Section 186-e tax method of establishing the service address for roamers. Furthermore, it sources calls using a fixed geographic point. Thus it minimizes issues that arise where CGSAs overlap with other states.

Revenue Analysis

As reported in the preceding issue paper, the Department identified $935 million in taxable sales reported by cellular companies in the 1995 sales tax year. Nationally, roaming has accounted for 11 percent of total revenue (both intrastate interstate call revenues)[8]. Based on this national data, and assuming that all roaming related to intrastate calls, New York's cellular companies would provide about $103 million in taxable roaming charges. This translates into a State sales tax liability of about $4 million. Under these assumptions, the combined State and local sales tax revenue would equal about $8 million. To the extent that calls made while roaming are exempt interstate calls, the sales tax collected from roaming would be lower.

In certain cases, Option A would redistribute local sales tax revenue from local jurisdictions within the subscriber's home area to those localities where the caller roams. This would occur where a subscriber's home carrier currently resells the roaming service as part of the monthly service package. It would redistribute this sales tax revenue by requiring the serving carrier to collect and remit the sales tax. In those cases, localities which have a higher percentage of New York resident roamers in comparison to their share of subscribers, would benefit from this approach.

Option B would also redistribute local sales tax revenue from local jurisdictions within the subscriber's home area to those localities where the caller roams. It would redistribute this sales tax revenue by requiring that roaming would always be taxable using the rate in effect where the roaming occurred.

The different methods under Option C would affect the distribution of local sales tax roaming revenues within the CGSAs. A method using the MTSO or cell base station location would benefit those localities in which cellular companies have located those facilities. In comparison, a blended rate would provide result in all local sales tax jurisdictions receiving some portion of the sales tax on cellular roaming services.

Recommendation

As noted in the background report, cellular telephones are a technology as well as a service. The technology involves providing a radio-telephone service within specific cells interconnected with other cells. At the industry's outset, for its own regulatory and licensing purposes, the Federal Communications Commission divided states into the various CGSAs. "Roaming" is an industry term used to describe situations where a company's subscriber is traveling outside a particular CGSA. Although often billed differently than other cellular telephone charges, roaming is not a different type of cellular telephone service.

The Department prefers to await the outcome of the industry's own report before proceeding to develop guidelines for roaming situations.

Some sales tax issues raised by cellular roaming, such as which company is the "vendor" of the service, result because the cellular telephone industry is rapidly changing. The patchwork of intercompany agreements and different company billing practices lead to a variety potential sales tax questions and consequences. Furthermore, even as these questions are under discussion, Personal Communications Services (PCS) are becoming available, raising a host of new concerns and questions.

The current statutory framework appears to allow the Department and industry members to develop workable solutions to the various issues associated with roaming charges. However, the Department prefers to await the outcome of the industry's own report in January 1997 on these issues before proceeding to develop guidelines for roaming situations.

Endnotes

1 Again, it is possible that the serving carrier and the home carrier could be different divisions of the same corporation.

2 Provided that the MTSO handling the call is located outside New York.

3 Generally, interstate and international services are taxable because the roamer is either originating or terminating a call in New York, and the service address is deemed to be the location of the MTSO in New York that handles the call.

4 This option only becomes relevant if policy makers do not adopt Option A in this section. Option A would eliminate a home carrier's responsibility to collect tax on roaming services.

5 The industry group, known as the Wireless Tax Group, is an affiliation of twenty-one facilities-based cellular and PCS companies. A subgroup of seven companies is studying sales tax roaming issues.

6 This option only becomes relevant if policy makers do not adopt Option A in this section. Option A would eliminate a home carrier's responsibility to collect tax on roaming services.

7 The option for taxing roaming at the same rate as other taxable cellular charges (e.g., basic monthly charges) relates only to roaming obtained by customers with a New York State service address. Alternative rules would be needed for roamers which do not have a New York service address (e.g., a nonresident) but whose "home" cellular provider is a registered vendor in New York that chooses to resell roaming services in another state.

8 United States Department of Commerce, U.S. Industrial Outlook 1992, p. 30-2.