The Florida Senate

Interim Project Report 2004-119 *November 2003*

Committee on Communication and Public Utilities James E. "Jim" King, Jr., President

FEASIBILITY AND REVENUE IMPACT OF BUNDLING TELECOMMUNICATIONS SERVICES FOR TAX PURPOSES

SUMMARY

Last session, SB 2666 was introduced to provide for taxing bundled communications service offerings. The bill died in committee in part because the fiscal impact was indeterminable.

When communications companies bill for their services, they are required to list each service and the appropriate tax on the customer's bill. Those companies that choose to not separately list each service must apply the highest applicable tax to the total charge. How much revenue impact Florida would incur if companies were allowed to bundle under the provisions of SB2666 depends on what services the company offers in a bundle.

Federal legislation that makes permanent a moratorium on taxing Internet access is pending before Congress. The House and Senate bills also ban state and local governments from taxing all forms of Internet access including digital subscriber-line service, cable, satellite, or dial-up services used to access the Internet. Should these bills become law, the fiscal impact of a bill similar to SB 2666 would be negligible.

BACKGROUND

During the 2003 Legislative Session, Senate Bill 2666 – Taxable Price of Bundled Transactions – was introduced. The bill provided for taxation of a "bundled transaction," which was defined as a transaction consisting of distinct and identifiable properties and services that are sold for a single, non-itemized price but which are treated differently for tax purposes. The bill pertained to the Communications Services Tax which currently applies to telephone services, both landline and wireless, and cable and satellite TV.

The legislation addressed the issue of how to tax bundled service offerings while ensuring that exempt services remain exempt and taxable services remain taxable. This was to be accomplished by allowing companies to remit tax on the taxable components of the bundle while exempting the non-taxable parts of the bundle. The Revenue Estimating Conference was unable to quantify a fiscal impact should the bill have been implemented. Apparently various communications companies currently have different interpretations about the taxability of services used to connect consumers to Internet providers, and there is no uniform practice in the industry so the impact would vary from company to company.

The objective of this project is to determine the feasibility of a bill that allows affected companies to collect tax on taxable components of their service bundle while not collecting for the non-taxable elements of the bundle and to quantify the fiscal impact.

METHODOLOGY

Staff met with staffs of the Senate Committee on Finance and Tax and the Department of Revenue (the Department). Staff also met collectively and individually with representatives of the incumbent and competitive local exchange telecommunications companies, wireless and cable companies and sent out a questionnaire to these companies. Responses to these questionnaires were provided generally in the aggregate. Staff spoke with a staff member of the National Conference of State Legislatures and conducted general research.

FINDINGS

Current Law -

Chapter Law 2000-260, Laws of Florida, created the Communications Services Tax Simplification Law[1] that simplified the previous taxing scheme of telephone, cable, satellite and wireless services. Under this law , customers were supposed to understand their bills more easily, and the various service providers would be able to collect the tax more efficiently, since both the state and local components would be administered by the Department. In addition to the state and local taxes, these communications services are subject to federal taxes and jurisdiction.

Because of technological developments and changing marketing practices, various communications services are provided by many types of companies. For example, local exchange companies (LECs) may offer through their subsidiaries wireless or cellular service and long distance service. In addition, they can provide internet service via technologies such as integrated services digital network (ISDN) and digital subscriber line (DSL) service over their current network.

In addition to its traditional offerings of cable television, pay-per-view or movie offerings, cable offers high speed Internet access and will soon offer telephone service (local and long distance) that would most likely be first deployed in selected areas and then expanded. Wireless telecommunications service is also expanding by offering local and long distance service for a set price that also includes vertical services and Internet access. The scope of the Internet access depends on the type of cell phone and services chosen by the customer.

All of these companies are trying to gain more customers by combining different services that may be purchased elsewhere and offering those services at a discounted price (as opposed to the price when purchased separately) with the added convenience of a single bill. It is the combining of these different services that raises taxation issues. The different services that are and can be combined may be taxed at different rates or possibly exempted from taxation. For examples, residential local telephone service, wireless, and satellite are taxed at different rates, while Internet access is exempt from tax.

Section 202.11(14), Florida Statutes,[2] provides that the sales price, and thus the taxable amount, shall not be reduced by certain charges unless those charges are separately stated on the bill. The sale price cannot be reduced by any separately identified components of the charge unless expressly excluded from the definition of "sales price" and if separately stated on the customer's bill. Therefore, items that would be exempt if separately stated would be taxed at the highest tax rate when aggregated or bundled with taxable items. (It also follows that services that would ordinarily be taxed at different rates, when combined, would be taxed at the highest rate unless separately stated on the bill, although this particular situation is not specifically addressed in the statutes.)

Senate Bill 2666 -

During the 2003 Legislative session, SB 2666 was filed

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[1] Chapter 202, Florida Statutes.

[2] Currently s. 202.11(14), F.S., defines "sales price" and provides, in part:

> (14) "Sales price" means the total amount charged in money or other consideration by a dealer for the sale of the right or privilege of using communications service in this state, including any property or other services that are part of the sale. The sales price of communications services shall not be reduced by any separately identified components of the charge that constitute expenses of the dealer, including, but not limited to, sales taxes on goods or services purchased by the dealer, property taxes, taxes measured by net income, and universal-service fund fees.
> . . .
> (b) The sales price of communications services does not include charges for any of the following:
> . . .
> 7. Charges for property or other services that are not part of the sale of communications services, if such charges are stated separately from the charges for communications services.

Section 202.115(4), F.S., provides:

(4)(a) If a mobile communications service is not subject to the taxes administered pursuant to this chapter, and if the sales price of such service is aggregated with and not separately stated from the sales price of services subject to tax, then the nontaxable mobile communications service shall be treated as being subject to tax unless the home service provider can reasonably identify the sales price of the service not subject to tax from its books and records kept in the regular course of business.

by Senator Atwater. Senate Bill 2666 added s. 202.165, F.S., which defined a bundled transaction as "a transaction consisting of distinct and identifiable properties or services which are sold for a single non-itemized price but which are treated differently for tax purposes." The bill further provided for the taxing of bundled services by allowing dealers to apply the exemption or the various tax rates to the bundled transaction without separately stating the charge for each component on the bill, if they allocate the portions of the non-itemized sales price in their books and records. It should be noted that the Department raised concerns as to what constitutes a dealer's books and records and the reasonableness of the allocation. (By allocating a larger portion of the total charge to the non-taxable component, a dealer could reduce the tax on the transaction and jeopardize state and local revenue.) When SB 2666 was agendaed to be heard in the Finance and Taxation Committee, Senator Margolis filed an amendment[3] to address these concerns. The bill was not considered at that meeting and died in committee.

The fiscal impact, if any, of this change in policy was never resolved. The staff analysis by the Senate Committee on Communication and Public Utilities stated:

> The Revenue Estimating Conference met on the bundled transaction proposal on April 4, 2003, and was unable to quantify a fiscal impact. It appears that various communications companies currently have different interpretations about the taxability of services such as Internet access, and that there is no uniform practice in the industry. Given this, the conference could not determine how the bill would affect tax revenues.

Questionnaires -

In order to determine the fiscal impact of allowing communications services providers to bundle various services, the following questions arise. A questionnaire was submitted to telecommunications companies (incumbent and competitive), wireless providers, cable and satellite companies for response.

1. Do you currently bundle services that are both taxed and exempt?
2. Do you currently bundle services that are taxed at different rates?
3. If you do bundle such services, what would be the difference in the tax revenues that you currently collect with the tax revenues than you would collect if you could allocate the appropriate taxes in your books and records?
4. What services do you plan to bundle in the future that would include both taxable and exempt services? If you were to bundle such services, what would be the revenue impact between what you would collect if separately stated on the bill and if you could allocate the exemptions in your books and records?
5. What services do you plan to bundle in the future that would include services that are taxable at different rates? If you bundled such services, what would be the revenue impact between the revenues collected if the different rates could be allocated in your books and records?

Based upon the questionnaire sent to various companies and their associations[4], the following answers can be provided to the above questions:

Wireline companies do not bundle services that are both taxable and exempt but wireless and cable companies do bundle such services. Some cable companies responded that these services are separately stated with the appropriate tax on the bill.

Respondents replied that they do not believe there would be a difference in the revenue to the state if they were to separately state charges for different services with the appropriate tax amount on the bill as opposed to stating a total charge for a bundled service with an aggregate tax amount and providing for the regulators books and records that provide the broken out information.

Respondents stated that because they could not predict what services they may offer in a bundle, they would not be able to predict the revenue impact to the state of Florida depending on a particular tax treatment. Some stated that they may realize an impact depending on whether their billing systems would have to undergo program changes. Generally, the respondents stated that the less their billing systems have to itemize on a customer's bill, the lower their costs will be.

[3] Bar Code #390420, 2003 Legislative Session.

[4] A list of these companies in staff files located in the Committee on Communication and Public Utilities.

Florida's general policy is to state the amount of the charge and the appropriate tax on the customer's bill. It appears most dealers are currently separately stating services that are taxed at different rates and that are exempt from taxation. No information was provided as to whether any dealers were aggregating services and charging the highest rate, where no separate statement is provided on the customer bill, and therefore any related fiscal impact is not determinable. The same conclusion would be true for bundled taxable and nontaxable services because it appears that most dealers are separately stating the services.

The concern arises when the current law is applied to future product offerings by the companies. For example, based upon current law and current application, if dealers bundle exempt and nonexempt services and do not separately state or break down the charges for the different services, they would be required to tax that bundled service at the highest rate. Under provisions similar to SB 2666, the dealer would apply a lower tax rate and allocate the portion of sales price attributable to the nontaxable services in its books and records. The state would lose an indeterminate amount of revenue that would be the difference between the highest rate that could be charged under current law and the lesser rate if the charges were separately stated. Staff cannot determine the size of that potential revenue impact.

Other States -

Staff reviewed laws from numerous states that addressed this bundling issued and contained provisions similar to SB 2666. Approximately 14 states have enacted bundling legislation or rules. Six more states do not apply sales tax to telecommunications services. Two other states have agreements, the specifics of which were not available to staff. The remaining states are being asked to pass legislation to provide for taxation of bundled telecommunications services. However, staff was unable to determine if any of the 14 states realized a fiscal impact as a result of implementing bundling legislation.

Federal Impacts -

Analysis of this issue, however, cannot end at the state level. Federal Regulations are critical to certain outcomes of the fiscal analysis, specifically with respect to taxation of Internet service because the taxation policy of Internet access will have the most significant fiscal impact to state revenue.

On October 1, 1998, Congress passed the Internet Tax Freedom Act[5] (hereinafter the Internet Act). Provisions of this Act that are salient to this discussion are as follows. State and local governments are barred from taxing Internet services until November 1, 2003.[6] Under the Internet Act, the term "Internet access" is defined to mean "any service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users." The term does not include "telecommunications services" which are generally deemed to be "point-to-point communications offered on a common carrier basis." The fundamental goal of this federal policy is to allow Internet service to develop freely without being overburdened with undue regulations, particularly by taxes.

This federal regulation is relevant to the bundling issue because of its effect on Florida's taxes on communications services. The state may not tax and carriers cannot collect tax for Internet services. Therefore, anyone offering Internet service (cable for example) cannot charge or collect tax on its bill for that service. If Internet services are bundled with taxable services on the cable bill, tax may only be collected on services provided that are taxable.

Determining whether a particular technology or service is a telecommunication service or an information service is a debate occurring all over the country. In Minnesota, the Public Utilities Commission determined that a provider of Internet telephony was required to comply with the state's statutes and rules regarding the offering of telephone service. The provider sought injunctive relief in federal court. The U.S. District Court for the District of Minnesota has granted a permanent injunction against the enforcement of the MPUC order, finding that Internet telephony, which employs a technology called Voice over Internet Protocol (VoIP), was an information service and not subject to regulation as a telecommunications service. The court determined that the MPUC's authority to issue its order was preempted by the federal Communications Act of 1934, as amended.[7]

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[5] P. L. 105-277.
[6] P. L. 107-75.
[7] Vonage Holdings, Corp. v. Minnesota Public Utilities Comm'n., et. Al., No. 03-5287 (D. Minn., Oct. 16, 2003).

In 2002, the Federal Communications Commission (FCC) issued a declaratory ruling that cable broadband Internet access service is an interstate information service and not a cable service, and that there was no separate offering of telecommunications service included therein. This ruling meant that cable modem service would not be regulated as cable service or as a common carrier, but rather less stringently as an information service. The Ninth Circuit Court of Appeals has now reversed that ruling in part, finding that cable modem service includes a component of telecommunications service, along with the information service component of telecommunications service, and is therefore subject to regulation on a common-carriage basis. The court determined that cable broadband service consists of two elements: a pipeline, such as cable broadband or telephone lines, and the Internet service transmitted through that pipeline.[8]

The Federation of Tax Administrators opined that "these two cases may have some implications for state taxation and the Internet Tax Freedom Act debate in Congress. The 9th Circuit holding, by finding that cable modem service has a telecommunications component, raises issue of how much of the service is necessarily exempt from state taxation since 'telecommunications' are excluded from the current definition of Internet access in the Internet Act. The Minnesota VoIP decision could spell trouble for state efforts to tax the burgeoning service as telecommunications. Many observers expect VoIP to account for nearly all voice traffic within the next decade."[9]

Rulemaking at the Florida Department of Revenue -

Digital Subscriber Line (DSL) service raises a particular issue because it includes Internet service and telecommunications service to connect the consumer with the Internet provider. The question for regulators and lawmakers is "Is the entire service an Internet service, or should the transport of the service be separated from the information service?"

Florida Statues do not provide this answer, but the staff from the Department has initiated steps to resolve this question. In a draft rule published July 31, 2003, for the purposes of a rulemaking workshop, staff proposed through definitions to separate the telecommunications transport from the information service and require tax to be applied to the sales or cost price of the transport service. The information service would not be taxed, consistent with federal law.

Beyond taking comments from interested persons, the Department has not moved toward finalizing any such rule. This is partly due to the fact that Congress is considering bills (H.R. 49 and S. 150) that will extend permanently the ban on taxes on Internet services imposed by the Internet Act discussed above. The bill approved by the House of Representatives not only makes permanent the moratorium, but also bans state and local government from taxing all forms of Internet access including DSL, cable, satellite, or dial-up services used to access the Internet. The Senate version is similar to the House version. Final action is expected before the end of October because the moratorium expires November 1, 2003. However, until the bills are voted upon and signed into law, this issue will remain controversial and inconsistent. Should a federal bill pass, the issue before the Department will become moot. Moreover, a significant issue relevant to this study would become preempted by federal law and also moot.

The proposed federal law is not without consequence to the states and to this report. A July 21, 2003, Congressional Budget Office Cost Estimate[10] of H.R. 49 provides an estimation of the bill's impact on state and local government. It states:

> [We] estimate that the change in the definition of Internet access could affect the tax revenues for many states and local governments, but we cannot estimate the magnitude or the timing of any such additional impacts at this time.
>
> States also could lose revenues that they currently collect on certain services if those services are redefined as access under the bill.
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> Revenues could also be lost if Internet access providers choose to bundle products and call the product Internet access. Such changes would reduce state and local revenues from telecommunications taxes and possibly revenues from content currently subject to sales and use taxes. However, CBO cannot

[8] Brand X Internet Service v. Federal Communications Comm'n., No. 02-70518, et. Al. (9th Cir., Oct. 6, 2003).

[9] TaxExpress e-mail, October 20, 2003, - Federation of Tax Administrators. Available in staff file.

[10] Doc 2003-17203 (PDF version).

estimate the magnitude of these losses.

Subsequent reports and commentary state that the moratorium has never applied to these taxes other than transactional taxes.[11] The commentary further clarified that "only telecommunication services that are used to provide Internet access would be covered under the moratorium. A company that is selling voice service or other telecommunication service not used to provide Internet access would still be required to collect telecommunications taxes, even if that services is provided using the Internet protocol."

In conclusion, under the original Internet Act, certain telecommunications services such as DSL were subject to taxation by states and local governments, but not cable modem Internet access. Therefore, DSL internet access and wireless access are at a cost/price disadvantage over cable modem Internet access. The new language in H.R. 49/S 150 remedies this disparity by treating all forms of Internet access the same.[12] However, the bill, if passed as amended, would preempt Florida from taxing those forms of Internet services and the state will lose those revenues. Finally, the potential loss of revenue to the state of a bill similar to SB 2666 excluding any Internet access issues would be minimal compared to the revenue losses under the federal bill.

RECOMMENDATIONS

Staff recommends that no legislation should be considered until the issues of Internet access taxation is settled on the federal level. Once settled, the Legislature can determine whether it needs to define the terms 'Internet' or 'Information Services' and how it wants to approach taxation of communications in the future. If the federal bill passes, the fiscal impact of a bill similar to SB 2666 would then be considered negligible.

[11] *Chicken Little Strikes Again: A Critical Look at the MTC "Study" of Internet Tax Freedom Act Impact*, Kimbell Sherman Ellis, taxanalysts, Publ. , September 24, 2003.

[12] Id.