SB 787

Department of Legislative Services
Maryland General Assembly
2001 Session

FISCAL NOTE

Senate Bill 787 (Senator Neall)
Budget and Taxation

Telecommunications Taxation

This bill: (1) repeals the public service company franchise tax for companies engaged in a telephone business in the State; (2) imposes the State sales and use tax on the sale of most retail interstate and intrastate telecommunications services, except Internet access service; (3) exempts from the sales and use tax the sale of machinery and equipment to a telecommunications provider for use in the conduct of a "telecommunications business," an "internet service" business, or a "web hosting" business; and (4) makes other changes to State taxation of telecommunications.

The bill takes effect January 1, 2002.

Fiscal Summary

State Effect: State general fund revenues could increase by $15.5 million in FY 2002 (based on the January 1 effective date). Out-year forecasts incorporate annualization and the growth rates of the individual revenue components. State expenditures for telephone services could decline by $1.2 million (all funds) annually, while administrative expenditures by the Comptroller's Office could increase by $20,000 in FY 2002 only.

($ in millions)	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
GF Revenue	$15.50	$30.90	$30.80	$30.40	$29.60
GF Expenditure	(.70)	(.72)	(.72)	(.72)	(.72)
SF Expenditure	(.24)	(.24)	(.24)	(.24)	(.24)
FF Expenditure	(.24)	(.24)	(.24)	(.24)	(.24)
Net Effect	$16.68	$32.10	$32.00	$31.60	$30.80

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: None.

Small Business Effect: Meaningful.

Analysis

Bill Summary: This bill:

- repeals the public service company franchise tax as to companies engaged in a telephone business in the State;
- imposes the State sales and use tax on the sale of most retail interstate and intrastate telecommunications services, except Internet access service;
- alters the calculation of the vendor credit allowed for the expense of collecting and paying the sales and use tax so that a seller who is not required to collect the sales and use tax, but agrees to accept the collection rules as though it were required, receives a credit of 3% of the gross amount of sales and use tax that the vendor is to pay to the Comptroller (versus the current vendor credit of 0.9% after the first $1,200);
- provides a credit against the sales and use tax for excise, sales and use, or gross receipts taxes paid in another state on the sale of the same interstate telecommunications services, up to the maximum amount of tax owed;
- incorporates the sourcing rules for sales taxation of mobile telecommunications to bring Maryland in conformity with the federal Mobile Telecommunications Sourcing Act;
- provides that nontaxable charges that are aggregated with taxable charges are included in the taxable price for sales and use tax purposes unless the service provider can reasonably identify nontaxable charges from its books and records;
- exempts from the sales and use tax the sale of machinery and equipment to a telecommunications provider for use in the conduct of a “telecommunications” business, an “internet service” business, or a “web hosting” business; and
- requires the Comptroller to implement a pilot direct payment permit program.

Current Law: Telecommunications firms are subject to the 2% public service company franchise tax for their land line services (local and long distance). Other telecommunications services, such as cellular and other mobile telecommunications services, as well as custom calling features added to land line services (e.g., Caller ID), are subject to the 5% sales and use tax.

Background: Worldcom, Inc. advises that 13 other states and the District of Columbia, including all the states that surround Maryland as well as New York, New Jersey, North Carolina, and Connecticut exempt telecommunications or broadband equipment from the sales tax. The Department of Legislative Services (DLS) was unable to verify the exemptions in any of these states except New York and Connecticut. The estimated reduction in tax revenues from the exemptions in these states ranged from $8 million (Connecticut) to $68 million (New York) with the variance attributable to the size of the state and the range of exempted equipment.

State Revenues: In total, it is estimated that the bill would increase State general fund revenues by $15.5 million in fiscal 2002 (accounting for the January 1 effective date) and increasing thereafter based on annualization and the growth rates of the individual revenue components. The impact on State revenues of each of the bill's major provisions is discussed below.

Repeal of the franchise tax on telecommunications providers

The State Department of Assessments and Taxation (SDAT), which collects the franchise tax, reports that fiscal 2000 collections from telecommunications providers totaled $68.4 million. While telecommunications services in general have grown at a rapid rate recently, revenues from land lines (and corresponding tax revenues) have grown at a slower rate (approximately 5%) due to price competition in long distance service and competition in local service from wireless communications. It is therefore estimated that fiscal 2002 revenue losses from the elimination of the tax would be $75.4 million, with the loss growing by 5% per year thereafter.

Imposition of sales tax on retail telecommunications purchases

Replacing the 2% franchise tax with a 5% sales tax on telecommunications services would increase the revenue base (before adjustments) by 250%. Certain revenues collected under the franchise tax, however, would not be collected under a sales and use tax. The franchise tax is based on gross receipts and includes revenues received by the phone companies for telecommunications provided to the federal government, the State, local governments, and charitable nonprofit organizations. None of these purchasers, however, would be subject to the sales and use tax. The lost revenue associated with these groups is estimated at approximately 19% of total revenues, or $35.3 million in fiscal 2002.

In addition, certain services, such as custom calling features (e.g., Caller ID), "900" calling services, and telephone answering services are subject to the sales tax, but are also included in the gross receipts subject to the franchise tax. Any estimate of increased sales taxes from the transfer of telecommunications taxation from the franchise tax to the sales tax under this bill must therefore be reduced by the sales of these services, which are already collected under the sales tax. These services are estimated at approximately $13.1 million in fiscal 2002, and growing at a rate of approximately 15% per year.

In addition, the bill specifically exempts from the sales tax those revenues from certain services that are currently subject to the franchise tax, including coin pay phone calls, toll-free ("800") services, and private line phone networks (internal network exchanges used by large businesses). Because the tax returns provided to SDAT do not provide an itemization of the sources of revenue, the amount of corresponding lost sales tax revenue from these items cannot be precisely estimated, but is assumed to be approximately $1.0 million in fiscal 2002, growing at a rate of approximately 20% per year (primarily due to growth in private lines).

Increase in vendor credit for out-of-State vendors

The bill provides for a 3% discount for sellers who are not required to collect the sales and use tax under current rules but who agree to do so voluntarily. (The regular discount is 1.2% up to $6,000 of liability and 0.6% for amounts above $6,000.) Firms that would be eligible for the higher credit include mail-order and Internet firms that sell products to Marylanders but otherwise have no physical presence in the State. By federal law, these firms are not required to collect State sales taxes. The Comptroller estimates that sales tax losses from such remote transations will reach approximately $150 million per year.

The Comptroller's Office advises, and DLS concurs, that it is highly unlikely the additional discount will be sufficient to encourage out-of-State vendors to impose the tax on Maryland customers. Collecting the sales tax would require the vendor to essentially increase costs to its customers by 5%, while taking on the administrative burden of correctly applying the tax and subjecting itself to the potential of State tax audits. Any additional revenue from this provision is therefore assumed to be minimal.

Recent efforts by the National Conference of State Legislatures (NCSL) to encourage remote vendors to collect and remit out-of-state taxes have been unsuccessful to this point. NCSL is currently encouraging states to simplify their sales tax structures and is encouraging development of computer systems that could correctly apply the different sales tax rates of state and local governments to remote transactions. Absent progress on these fronts, it is unlikely that a remote vendor would elect to collect Maryland sales tax simply due to the extra vendor credit.

Sourcing of mobile-telephone charges and credits against other states' taxes

Maryland currently sources these charges from mobile telephone services to the residential or business address of the customer in accordance with federal legislation enacted in August 2000. It is not clear what impact the bill's proposed changes would have on revenues. Moreover, any potential increase in revenues could be offset if the taxpayer can demonstrate that a tax has been paid on the same service in another state and receive a corresponding credit against State taxes owed.

Exemption from the sales and use tax for certain telecommunications equipment

The revenue loss for equipment sales tax exemption of the bill is estimated at $32.8 million in fiscal 2002. This estimate is based on industry-provided data for fiscal 2001 (covering the six largest known telecommunications providers), increased by 5% to reflect sector growth. **DLS cannot independently verify this estimate and notes that actual sales tax losses could be substantially higher if the exemption is utilized for more equipment than is estimated by the industry group or if other firms beyond those in the industry group meet the definition of "telecommunications provider."** Future year growth is projected at 5% per year.

Implementation of pilot direct payment program

The bill would require the Comptroller to establish a direct pay pilot program. The Comptroller previously had a direct payment program, but legislation in 1992 prohibited the Comptroller from issuing new permits. Permits issued up until then were grandfathered in. Under this program, permit holders do not pay the tax at the time of purchase, but at a later date when the goods are actually used. It is estimated that a direct payment program would result in a net revenue loss, but the amount of such loss would depend on the scope of the pilot program and cannot be reliably estimated at this time.

Net Impact

The impact of each of the components discussed above (except where the impact was estimated to be indeterminate or minimal), and the net impact, is shown in **Exhibit 1**:

Exhibit 1
HB 768 / SB 787 – Estimate of Revenue Impact by Component
($ in millions)

	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Lost Franchise Tax Collections	($75.4)	($79.2)	($83.1)	($87.3)	($91.7)
Gross Increase in Sales Tax	$188.5	$198.0	$207.9	$218.2	$229.2
Less Organizations Exempt from Sales Tax	($35.3)	($37.1)	($39.0)	($40.9)	($43.0)
Less Telecom. Services Already Taxed	($13.1)	($15.1)	($17.3)	($19.9)	($22.9)
Less New Exemptions: Coin Pay Phones, 800 #s, and Private Lines	(1.0)	(1.2)	(1.4)	(1.7)	(2.1)
Less New Exemption: Telecoms Equipment	(32.8)	(34.5)	(36.2)	(38.0)	(39.9)
Net Sales Tax Increase	$106.3	$110.1	$113.9	$117.7	$121.3
Net Revenue Increase	$15.5	$30.9	$30.8	$30.4	$29.6

*Numbers may not total due to rounding.

State Expenditures: State expenditures would be affected in two ways under the bill. Administrative expenditures by the Comptroller's Office would increase by approximately $20,000 on a one-time basis to publicize the increase in the vendor credit. More significantly, it is estimated that the State expenditures for telephone service could decrease by $1.2 million annually if the State's telephone service providers decrease their charges to the State by 2% to reflect the elimination of the franchise tax. These savings are estimated to be 60% general funds, 20% federal funds, and 20% special funds.

Small Business Effect: Residences and small businesses would bear a disproportionately large share of the tax increase under the bill versus the impact on large businesses. The vast majority of revenue collected by the franchise tax on telecommunications firms is associated with residential and small business telephone lines. Increasing the effective tax rate from 2% to 5% on telecommunications charges paid by small businesses could have a meaningful impact on an individual firm if the firm was heavily dependent on telecommunications (as a share of its costs). Large businesses already pay a disproportionately smaller share of the franchise tax because they utilize private line networks to minimize the number of leased land telephone lines. These private line networks would also be exempted under the new sales tax.

Additional Information

Prior Introductions: None.

Cross File: HB 768 (Delegate Bozman, *et al.*) - Ways and Means.

Information Source(s): Comptroller's Office, Office of the People's Counsel, Public Service Commission, State Department of Assessment and Taxation, Department of Legislative Services

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jm/jr

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