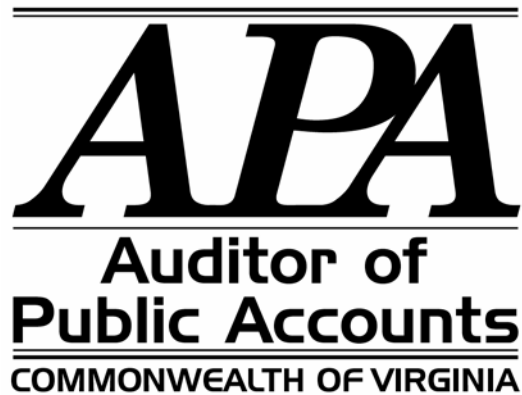


**STUDY OF
TELECOMMUNICATION TAX STRUCTURE**

OCTOBER 2004



EXECUTIVE SUMMARY

The Joint Subcommittee to Study the State and Local Taxation of the Entire Telecommunications Industry and Its Customers within the Commonwealth has been reviewing ways Virginia could restructure its telecommunications taxes and fees. In reviewing this restructuring, the joint subcommittee recognized the need for more information on the revenue impact from existing state and local telecommunications taxes and fees. Therefore, the General Assembly requested that the Auditor of Public Accounts collect information, before the 2005 Session, to determine whether the new tax structure will fully replace revenues provided to state and local governments by current telecommunications taxes and fees.

The results of our study found that projected revenue, based on maximum rates in the legislation, does not generate sufficient revenues to fully replace all revenues resulting from the current state and local taxes and fees that are subject to repeal. There is an estimated \$34 million deficiency between the current revenue base of \$391 million and the projected revenues of \$357 million.



Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
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Walter J. Kucharski, Auditor

October 15, 2004

The Honorable Harry J. Parrish
Chairman, House Finance Committee

The Honorable John H. Chichester
Chairman, Senate Finance Committee

Dear Delegate Parrish and Senator Chichester:

Chapter 634 of the 2004 Acts of Assembly (HB 1174) requests that the Auditor of Public Accounts determine the revenues received by the Commonwealth and by its individual counties, cities, and towns for the fiscal year ending June 30, 2004, derived from various taxes and fees collected by telecommunication service providers. These taxes and fees include the gross receipts tax in excess of 0.5 percent; the Virginia Relay Center Assessment; the local consumer utility tax; and the 911 taxes and fees.

Background

The Joint Subcommittee to Study the State and Local Taxation of the Entire Telecommunications Industry and Its Customers within the Commonwealth (HJR 651, 2003; HJR 209, 2002) has been reviewing ways Virginia could restructure its telecommunications taxes and fees. The joint subcommittee has, in conjunction with the Commission on the Revision of Virginia's State Tax Code and the Streamlined Sales Tax Project Agreement, developed a set of guiding principles for telecommunications tax and fee restructuring. These principles seek to restructure state and local telecommunications taxes and fees, so that the tax burden falls equitably on all users of telecommunications services. The principles are to reduce consumer confusion, consolidate taxes and fees, make taxes and fees uniform statewide, reduce the tax rate on the vast majority of Virginians, make taxes and fees competitively neutral, preserve state and local government revenues, and establish a single point of administration. The joint subcommittee intends that any new tax structure fully replace revenues provided to state and local governments by current telecommunications taxes and fees.

In reviewing this restructuring, the joint subcommittee recognized the need for more information on the revenue impact from existing state and local telecommunications taxes and fees before making any specific telecommunications tax and fee restructuring proposal. Therefore, the General Assembly requested that the Auditor of Public Accounts collect information before the 2005 Session, so that the joint subcommittee could consider the impact of any proposed telecommunications tax restructuring legislation before introduction during the 2005 Session.

Under consideration during the 2005 Session is a new method of taxation, which would become effective July 1, 2005, to replace the following taxes and fees, which would be repealed.

- local consumer utility tax on consumers of local exchange and wireless services (§[58.1-3812](#));
- the gross receipts tax in excess of 0.5 percent (§ [58.1-3731](#));
- the Virginia Relay Center Assessment (§ [56-484.6](#)); and
- state and local E-911 taxes and fees (§§ [58.1-3813.1](#) and [56-484.12](#))

Replacing these taxes and fees would be a yet-to-be-named (proposed) tax levied on all retail telecommunications service revenues. The tax would not be less than 4.5 percent and would not exceed the state and local retail sales and use tax rate. In addition, there would be a uniform statewide 911 tax not to exceed \$0.75 levied on all local exchange lines and a uniform statewide 911 fee not to exceed \$0.75 levied on all wireless service lines.

Third Party Authority or Administrator

The working group of industry and local government representatives that has been assisting the joint subcommittee will recommend an authority or third party to receive and disburse the revenues to the state and local governments. Service providers will collect the proposed tax from each end user's monthly bill for taxable retail service. In addition, local exchange and wireless providers will collect the 911 tax and the 911 fee respectively, on a per access line and wireless service line basis by adding the tax or fee to each end user's monthly bill. After the end user pays the taxes and fees to the appropriate service provider, the service provider shall hold all taxes and fees paid in trust until remitted to the authority or other third party.

The service providers will remit the proposed tax and the 911 tax collections to a special fund maintained by an authority or other third party, which in turn will remit appropriate shares of the revenue to the state and individual local governments. The wireless service providers will remit 911 fee collections directly to the Wireless 911 Board.

The third party administrator will distribute the revenues in the special fund using a methodology that will initially provide the state and each local government with revenues that are at least equal to those amounts received in fiscal year 2004, and in the case of local governments, from taxes and fees adopted by local ordinance on or before July 1, 2003. The distribution methodology will also account for differences in future telecommunications revenue growth within the various localities.

Scope and Methodology

The legislation requests that the Auditor of Public Accounts determine revenues received by the Commonwealth and by its individual counties, cities, and towns for the fiscal year ending June 30, 2004, for the various taxes and fees collected by the service providers. The legislation also requires that the local governments and the telecommunication service providers cooperate with the Auditor of Public Accounts and provide information as requested.

We worked with a working group of industry representatives and legislative staff to develop a comprehensive confirmation instrument to obtain tax collections remitted to the state and localities, and to determine the revenue base for the future tax structure. Upon completing the confirmation instrument, the Auditor mailed a reporting package to all 267 service providers registered with the State Corporation Commission (SCC).

We planned to accumulate the confirmation results for further verification with the localities. However, due to a slow response from the service providers, we decided to confirm consumer tax collections directly with all cities and counties. Once again, the confirmation rate from the localities was slow.

Study Results

We received 103 responses from the 267 confirmations (39 percent) sent to the telecommunication service providers. We concentrated our efforts on the larger service providers, receiving responses from 22 of the 25 largest providers. As a result of obtaining information from the reporting service providers, our review achieved coverage of approximately 86 percent of the telecommunication revenues that would serve as the basis for the new tax structure.

From the localities, we received responses from 64 of the 134 confirmations sent. The information received from the responding localities showed that the information received from the service providers was reliable. While we did not receive the desired level of response from either the service providers or localities, it was sufficient to draw the necessary conclusions to this study.

Current Revenue Base

Using the confirmation results, we estimate that the current revenues collected for the Commonwealth and the localities total approximately \$391 million.

	<u>In Millions</u>
Paid to Localities:	
Consumer utility taxes	\$245
Gross receipt tax in excess of .5 percent	4
Wireline 911 taxes	99
Paid to Wireless Service Board:	
Wireless 911 surcharge	34
Paid to SCC:	
Telecommunication relay service surcharge	<u>9</u>
Total	<u>\$391</u>

Sources and Assumptions Used to Determine Revenue Base: Based on telecommunication service providers representing 86 percent of taxable receipts reported to the SCC, we extrapolated the reported \$211 million of consumer utility taxes to the total for an estimate of \$245 million. We estimated wireline 911 taxes based on reported 911 revenues provided by the service providers and amounts reported in the 2003 Comparative Report of Local Government Revenues and Expenditures. We used total annual revenues received by the Wireless Services Board for the wireless 911 surcharge. We received telecommunication relay service surcharges paid to the SCC.

Projected Revenue

Using the maximum rates allowed in paragraphs 3 and 4 of the legislation, we have projected the taxes and fees that the current telecommunication revenues would generate to the Commonwealth and the localities. Based on a 5 percent proposed tax on all retail telecommunication service revenues, a uniform statewide 911 tax on local exchange lines of \$0.75, and a uniform statewide fee on wireless service lines of \$0.75, we project total revenues of \$357 million.

	<u>In Millions</u>
Estimated retail service revenues \$5.376 billion at 5 percent yet-to-be-named tax	\$269
Estimated 911 tax on local exchange lines 6.1 million lines at \$0.75 monthly	55
Estimated 911 fee on wireless service lines 3.7 million lines at \$0.75 monthly	<u>33</u>
Total	<u>\$357</u>

Sources and Assumptions Used to Determine Projected Revenue: We estimated total retail services revenues based on revenues from reporting service providers totaling \$4.613 billion plus the SCC taxable receipts for the non-reporting service providers reduced by estimated exemptions. We estimated the exemptions for non-reporting providers using an exemption percentage rate of 18 percent, which we based on exemptions taken by the reporting providers. We estimated 911 taxes on local exchange lines using the access lines based on reported lines as a percentage of reported revenues from the reporting service providers. We used total wireless service lines provided by the Wireless Services Board for the estimated wireless 911 surcharge.

Conclusion

The projected revenue based on maximum rates does not generate sufficient revenues to fully replace all revenues resulting from the current state and local taxes and fees that are subject to repeal. There is an estimated \$34 million deficiency between the current revenue base of \$391 million and the projected revenues of \$357 million.

Other Matters for Consideration

The working group of industry and local government representatives that has been assisting the joint subcommittee will also recommend a distribution methodology for apportioning the revenues. During the course of our work, we received questions concerning this distribution methodology and its effect on future increases and decreases in revenues. During our review, localities without current taxes and fees expressed concerns about exclusion from the distribution. Also, those localities with lower tax rates will not be able to increase their proportionate share.

Acknowledgements

We would like to acknowledge the assistance provided by the working group of industry representatives in developing the confirmation instrument and addressing our technical inquiries. We appreciate the cooperation received from those telecommunication service providers and local governments that responded to our requests for information.

We are available to answer any questions you may have regarding the results of this study.

AUDITOR OF PUBLIC ACCOUNTS

WHC/kva

kva:47

SUMMARY ANALYSIS OF PROJECTED AND CURRENT REVENUES
AS PROVIDED FOR IN CHAPTER 634

Projected revenues - Taxes and fees:

Net taxable revenues reported	\$ 4,613,173,656
Estimated taxable revenues for nonreporting providers	<u>762,993,719</u>

Total taxable revenues	5,376,167,375
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Proposed (yet-to-be-named) tax rate of 5%	<u>0.05</u>
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Total estimated yet-to-be-named tax	\$ 268,808,369
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Number of access lines:

Estimated local exchange lines	6,108,500
Uniform statewide 911 monthly tax on local exchange lines	<u>0.75</u>

Total estimated statewide 911 tax on local exchange lines	54,976,500
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Estimated wireless service lines - reported by Wireless Service Board	3,732,105
Uniform statewide 911 monthly fee on wireless service lines	<u>0.75</u>

Total estimated statewide 911 tax on wireless service lines	<u>33,588,945</u>
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Total projected revenues - taxes and fees	<u>357,373,814</u>
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Current revenues - Taxes and surcharges:

Paid to localities:

Estimated consumer utility taxes paid to localities	245,295,943	
Gross receipts tax in excess of 0.5% paid to localities	3,798,791	
911 taxes on local exchange lines	<u>99,012,784</u>	348,107,518

Paid to the Wireless E-911 Services Board:

Wireless E911 surcharges	33,995,907
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Paid to the State Corporation Commission:

Virginia Relay Center assessment surcharge	<u>8,863,988</u>
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Total current revenues - taxes and surcharges	<u>390,967,413</u>
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Deficiency of projected revenues under current revenues	<u><u>\$ (33,593,599)</u></u>
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CALCULATION OF PERCENTAGES USED FOR EXTRAPOLATION

Total taxable receipts reported to the State Corporation Commission		\$ 6,468,415,349
Total taxable receipts for reporting service providers to this study		<u>5,537,935,204</u>
Percentage of taxable receipts for reporting service providers	86%	
Net - taxable receipts for nonreporting service providers		<u><u>\$ 930,480,145</u></u>
Total taxable revenues for reporting service providers		\$ 4,542,018,957
Total taxable receipts for reporting service providers to this study		\$ 5,537,935,204
Percentage of taxable revenues compared to taxable receipts reported to SCC	82%	
Total taxable revenues for reporting service providers		\$ 4,542,018,957
Additional taxable revenues not reported to the SCC		<u>71,154,699</u>
Total reported taxable revenues		4,613,173,656
Taxable receipts for non-reporting service providers	\$ 930,480,145	
Estimated exemptions based on reporting service providers	<u>82%</u>	
Estimated taxable revenues for non-reporting service providers, adjusted for estimated exemptions (930,480,145 x 82%)		<u>762,993,719</u>
Total estimated taxable revenues		<u><u>\$ 5,376,167,375</u></u>
Consumer utility taxes collected by reporting service providers		\$ 210,954,511
Divided by the percentage of taxable receipts from reporting service providers		<u>86%</u>
Total estimated consumer utility taxes		<u><u>\$ 245,295,943</u></u>

CHAPTER 634

An Act to establish a schedule for, and initiate Virginia's transition to, a new system for taxing telecommunications services in the Commonwealth.

[H 1174]

Approved April 12, 2004

Whereas, it is in the best interest of the citizens of this Commonwealth to restructure state and local telecommunications taxes and fees so that the tax burden falls equitably on all users of telecommunications services; and

Whereas, it is the intent of the General Assembly that any new tax structure fully replace revenues provided to state and local governments by current telecommunications taxes and fees; and

Whereas, the Joint Subcommittee to Study the State and Local Taxation of the Entire Telecommunications Industry and Its Customers within the Commonwealth (HJR 651, 2003; HJR 209, 2002) has been reviewing ways Virginia could restructure its telecommunications taxes and fees; and

Whereas, the joint subcommittee has, in conjunction with the Commission on the Revision of Virginia's State Tax Code and the Streamlined Sales Tax Project Agreement, developed a set of guiding principles for telecommunications tax and fee restructuring; and

Whereas, those guiding principles are to reduce consumer confusion, consolidate taxes and fees, make taxes and fees uniform statewide, reduce the tax rate on the vast majority of Virginians, make taxes and fees competitively neutral, preserve state and local government revenues, and establish a single point of administration; and

Whereas, a working group of industry and local government representatives has been meeting under the auspices of the joint subcommittee to develop draft legislation for consideration by the joint subcommittee and the affected parties; and

Whereas, more information on the revenue impact from existing state and local telecommunications taxes and fees is needed before specific telecommunications tax and fee restructuring legislation can be enacted; and

Whereas, it is the intent of the General Assembly to collect this information prior to the 2005 Session so that telecommunications tax restructuring legislation may be introduced during the 2005 Session, to become effective July 1, 2005; now, therefore,

Be it enacted by the General Assembly of Virginia:

1. § 1. That the General Assembly; the counties, cities and towns of the Commonwealth; and those providers of telecommunications services in Virginia are requested to work together to assist in the preparation of legislation for the 2005 General Assembly Session establishing a new telecommunications statewide tax and fee structure to become effective July 1, 2005.

§ 2. During the 2005 Session, the intent is for a new method of taxation to be enacted, effective July 1, 2005, to replace the following taxes and fees, which will be repealed: local consumer utility tax on consumers of local exchange and wireless services (§ [58.1-3812](#)); the gross receipts tax in excess of 0.5 percent (§ [58.1-3731](#)); the Virginia Relay Center Assessment (§ [56-484.6](#)); and state and local E-911 taxes and fees (§§ [58.1-3813.1](#) and [56-484.12](#)).

§ 3. In place of these taxes and fees, the intent is for legislation to be introduced during and enacted by the 2005 General Assembly, levying a yet-to-be-named tax on all retail telecommunications service revenues. The tax shall not be less than 4.5 percent and to the extent the state and local retail sales and use tax rate is greater than 4.5 percent, the tax may not exceed the state and local retail sales and use tax rate. This tax will be assessed in lieu of any other state or local sales and use tax.

§ 4. The 2005 legislation shall also provide for a uniform statewide 911 tax not to exceed \$0.75 levied on all local exchange lines and a uniform statewide 911 fee not to exceed \$0.75 levied on all wireless service lines. The rate shall be set at the level needed to ensure that revenues from it, when combined with revenues from the yet-to-be-named tax, are sufficient to fully replace all revenues that would have resulted from those state and local taxes that are being repealed.

§ 5. Service providers shall collect the yet-to-be-named tax from each end user's (other than federal, state and local governments) monthly bill for taxable retail service. In addition, local exchange and wireless providers shall collect the 911 tax and the 911 fee respectively, on a per access line and wireless service line basis by adding the tax or fee to each end user's (other than federal, state and local governments) monthly bill. The yet-to-be-named tax, the 911 tax and the 911 fee, when billed, shall be stated as a distinct item separate and apart from the monthly charges for service. Until the end user pays the yet-to-be-named tax, the 911 tax and the 911 fee to the service provider, the yet-to-be-named tax, the 911 tax and the 911 fee shall constitute a debt of the end user to the authority or other third party (yet to be determined) maintaining a special fund, as set forth in § 6 below. After the end user pays the taxes and fees to the appropriate service provider, all taxes and fees paid shall be deemed to be held in trust by such service provider until remitted to the authority or other third party. Provisions regarding how bad debts and sales for resale/access are to be treated shall be included in the 2005 legislation, if it is determined they are necessary.

§ 6. The 2005 legislation shall provide for the yet-to-be-named tax and the 911 tax collections to be remitted from the service providers to a special fund maintained by an authority or other third party (yet to be determined), which in turn will remit appropriate shares of the revenue to the state and individual local governments. The 911 fee collections shall be remitted from the wireless service providers directly to the Wireless 911 Board. To the extent that the 911 fee established as set forth in § 4, above, is inadequate to replace the total Wireless 911 Board revenues identified by the Auditor of Public Accounts as set forth in § 10, below, the difference will be transferred from the special fund to the Wireless Board. Also, sufficient funds will be transferred to the appropriate authority to adequately support the relay service centers.

§ 7. The 2005 legislation shall authorize the authority or other third party to conduct an annual audit, at their discretion, by means of a centralized and uniform method of any or all service providers to verify the accuracy of collections and special fund receipts. All expenses associated with the audits shall be paid from the special fund.

§ 8. The 2005 legislation shall establish a distribution methodology for the revenues in the special fund that will initially provide the state and each local governmental entity with revenues that are at least equal to those received in FY 2004, and in the case of local governments, from taxes and fees adopted by local ordinance on or before July 1, 2003. The distribution methodology shall also account for differences in future telecommunications revenue growth within the various localities. In addition, revenues distributed from the special fund shall not constitute state aid to localities for state budgeting purposes.

§ 9. The legislation shall also subject pre-paid calling arrangements to the Virginia retail sales and use tax in Chapter 6 (§ [58.1-600](#) et seq.) of Title 58.1, at the point of sale.

§ 10. In order to determine the amount of revenues generated by the current tax system to be replaced by the yet-to-be-named tax, the 911 tax and the 911 fee, the Auditor of Public Accounts shall determine revenues

received by the Commonwealth and by its individual counties, cities, and towns for the fiscal year commencing July 1, 2003, and ending June 30, 2004, at rates adopted on or before July 1, 2003 for the following taxes and fees collected by the service providers: the gross receipts tax in excess of 0.5 percent; the Virginia Relay Center Assessment; the local consumer utility tax; and the 911 taxes and fees, where they exist. Local governments and service providers shall cooperate with the Auditor of Public Accounts and provide information to him as requested. The Auditor or his agent shall not divulge any information acquired by him in the performance of his duties under this section that may identify specific service providers. The Auditor shall report his findings to the chairmen of the House and Senate Finance Committees no later than October 15, 2004.

§ 11. In the event the Auditor of Public Accounts determines that the rate limitations established in sections 3 and 4, above, for the yet-to-be-named tax, the 911 tax and the 911 fee, respectively, are insufficient to fully replace all revenues that would have resulted from those state and local taxes and fees that are intended to be repealed, no telecommunications tax restructuring legislation related to this study shall be introduced during the 2005 General Assembly Session.

§ 12. The working group of industry and local government representatives that has been assisting the joint subcommittee is requested to continue its work and to develop recommendations on the following issues, as well as any others that may arise prior to the 2005 General Assembly Session: an authority or third party to receive and disburse the revenues to the state and individual local governments; a distribution methodology for apportioning the revenues; and a centralized and uniform method for auditing the revenues produced by the taxes and fees. The working group shall report its findings and recommendations to the chairmen of the House and Senate Finance Committees no later than November 15, 2004.