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Texas Telecommunications Taxes: An Overview

This is the first in a series of papers covering telecommunications taxes and fees in Texas. The next two will examine franchise fees and universal service.

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Introduction

The maze of telecommunications[i] taxes is as hard on consumers' pocketbooks as it is difficult for them to understand. Taxes and tax rates vary across the country, as do the companies and services being taxed. Although the integration of technologies is in many cases simplifying consumer choices, figuring out who is taxed for what has become almost mind-boggling.

However, it is readily apparent that most telecommunications services are taxed at an extremely high rate when compared to other products and services.

According to a 2004 study by the Telecommunications Tax Task Force of the Council On State Taxation (COST), the average effective transactional tax rate[ii] for telecommunications services in the United States is 14.17 percent, compared to 6.12 percent for general businesses.[1] Depending on the state, the tax rate can top 30 percent.

Texans pay an average of 25.29 percent in state and local telecom taxes—third highest in the nation.[2] This includes state and local sales taxes, municipal franchise fees, and charges for the Texas Universal Service and Texas Infrastructure funds. The average Texas local telecom tax rate is 11.32 percent and the average state tax rate is 13.97 percent. Adding federal taxes to the mix means that the average Texan's total telecom tax bill is just under 30 percent, almost one-third of the cost of telecommunications services.[3] The general business tax rate in Texas is 8.25 percent.

It is important to note, though, that these are average rates on voice communications via traditional local exchange telephone and cellular services. Different technologies and different providers are taxed at greatly disparate rates. The average tax rates above are most representative of the tax burden on traditional local exchange service. Cellular service in Texas is taxed less because it is not subject to the municipal franchise fee. Cable service has an average rate in Texas of about 14 percent,[4] though cable companies offering traditional phone service generally face a similar level of taxes and fees on that service as phone companies.[iii] Satellite service faces an even lower burden, having to pay only state and local sales taxes. Of course, some new telecom services—like online voice and video messaging—are not only untaxed, but provided free of charge.

Additionally, these tax figures do not reflect the cost of a number of mandates and subsidies that further

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[i] The term 'telecommunications' as used in this paper refers to all of the technologies discussed here, and all of the companies that offer them. So cable companies, for instance, are telecommunications companies just like their local telephone competitors. In this day of the convergence of voice, video and data, it is useful to have one term that can serve as umbrella.

[ii] This paper is focused on transaction taxes. The COST report explains, "Transaction taxes for telecommunications services include any state and local taxes applied to the cost of the service or the provision of the line to the consumer. Transaction taxes for general businesses are based on the traditional sales tax imposed on sales of tangible personal property and comparable transaction taxes."

[iii] The tax status of Voice over Internet Protocol (VoIP) telephone service that some cable operators offer is uncertain, and is discussed later in this paper.

increase prices paid by many telecommunications consumers.

The high level of taxation is a relic of the old system of monopoly regulation. Until recently, local telephone service was a monopoly. Rates and carriers were heavily regulated, giving consumers little choice in the provider of their local service. In such an environment, policymakers were free to use telephone service as a vehicle for raising revenue for just about everything.

For instance, Congress imposed a one cent per call "luxury" excise tax on telephone service in 1898 to help finance the Spanish-American War. It was reinstated in 1914 to pay for World War I, and was eventually made permanent at a 3 percent rate in 1990.

In Texas, policymakers have generally been better about tying telecom taxes to telecom-related projects. However, the revenues often far exceed the costs and are used to fund general government at both the city and state level.

The complexity of the tax system stems from several factors. Regulators from 50 states and the federal government have sought to tax telecom in a variety of ways as they fought for a piece of the pie. Additionally, different technologies emerging at different times have faced different levels of taxation.

In the regulated past, the costs of these taxes to consumers, while substantial, were limited to the actual levy of the tax. Today, in a relatively free-market system, this high level of taxation adds to a reduction in consumer welfare by distorting the system and making the economic decisions of consumers and businesses less efficient.

Many of the charges or mandates on telecommunications services are not traditionally considered taxes, but since they are used to subsidize the cost of particular services, they function essentially like a dedicated tax. Examples of these "cross-subsidies" that mask the actual cost of certain services include the Universal Service charge, the intrastate long-distance access charge and federal subscriber line charge.

A 2005 Texas Public Policy Foundation study by Robert Crandall (Brookings Institution) and Jerry Ellig (Mercatus Center at George Mason University) estimated that these cross-subsidies have reduced overall economic welfare by at least $200 million and hampered the development of competition in the local telephone market.[5]

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Overview of Texas Telephone Taxes

There are a variety of charges, fees, taxes, and mandates related to telecommunications services in Texas. Some are collected by the providers and sent directly to the appropriate government account. Others are collected so that providers can be reimbursed for fees they have already paid. Some are even collected and kept by the providers under the authority of a government that wants to subsidize certain services. Finally, there are some services that providers are mandated by law to offer below cost, so they must charge other users higher prices to recoup the lost revenue.

Not all of these are traditionally viewed as taxes. For instance, the Texas Attorney General found that the "'municipal franchise charge' which appears on telephone bills represents a rental payment for the use of city streets and not a tax."[6] But tax, fee, or mandate, they all raise the cost of telecommunications services to consumers. This paper uses a broad definition of tax in its assessment of the high costs imposed on the telecommunications industry by government.

Telecommunications Infrastructure Fund Fee

The Telecommunications Infrastructure Fund (TIF) fee was originally passed to fund the installation of Internet and other communications infrastructure at a variety of public institutions. It is funded by a

State and Local Texas Telecom Taxes and Fees

Taxes and Fees	Tax Rate
State Sales Tax	6.25%
Local Sales Tax	2.00%*
Telecommunications Infrastructure Fund	1.25%
911 Tax—Enhanced	0.30%
911 Tax Local	2.77%*
Poison Control Fee	0.30%
State USF	5.64%*
PUC Gross Receipts	0.17%
PUC Access Line Fee	0.25%*
Municipal Franchise Fee	6.35%*

*Source: 2004 COST State Study and Report on Telecommunications Taxation. Taxes on traditional telephone and cellular service. *average rate on an average phone bill in Austin and Dallas*

monthly charge of 1.25 percent on taxable telecommunications receipts. The tax had been due to expire in 2003 and again in 2005. However, the Texas Legislature extended it through 2011 at a cost to consumers of about $200 million per year, and diverted the funds into general revenue.

The TIF fee is essentially a gross receipts tax. It applies to local exchange telephone, interstate and intrastate long distance and cellular services.

Universal Service Charges

Texas established its Universal Service Fund (USF) in 1987 to pay for a number of programs intended to enable all state residents to obtain basic telephone service at low prices. It is funded by a charge on the monthly phone bill equal to about 5.65 percent of local and intrastate phone service. USF payments for FY 2004 were estimated to be $586 million.[7]
The Universal Service program subsidizes revenues for telephone companies so they can offer local phone service in high cost or rural areas at below cost. It subsidizes low-cost service for low-income customers through the Lifeline and Linkup[i] programs. It is also used to aid some phone companies with certain costs associated with long-distance service and pays for telecommunications relay service so that individuals who are speech- or hearing-impaired can use the phone network. The vast majority of the funding is for the high-cost and rural subsidies.[8]

However, many areas that were considered rural or high-cost when the funding formulas were last adopted in the late 1990s are no longer rural or high-cost today. So some of the subsidies are going where they are no longer needed, subsidizing rural consumers who generally pay less for local phone service than their urban counterparts.

Though Universal Service charges are clearly a tax and costs many consumers money, they should not be counted as such for comparison with taxes on general businesses, since the USF payments are funneled directly back to telephone companies for the purposes mentioned above.

Senate Bill 5, the major telecommunications reform legislation passed during the 2nd Called Session last year, established a new Audio Newspaper Program to be paid out of the USF and requires steps to expand enrollment in the Lifeline Service. Additionally, SB 5 required the Texas Public Utility Commission (PUC) to study the USF and report it findings to the legislature, and allows the PUC to modify USF per-line support after September 1, 2007.

The state's Universal Service charge applies to local exchange telephone, cellular, intrastate long-distance, and DSL Internet services provided over a telephone line.

There is also a federal Universal Service charge that is used for similar purposes. It is charged on interstate and international long distance calls, on cellular service and on DSL Internet services provided over a telephone line.

Municipal Franchise Fees

Municipal franchise fees are levied on telecommunications services by cities for the use of the public right-of-way. There are three different forms of the franchise fee: 1) the municipal franchise fee for tele-

[i]Lifeline provides low-income customers with a 50 percent discount on phone service, up to $12.28 a month. Line-Up offers low-income customers a 50 percent discount, up to $30, for telephone installation charges.

phone service, the cable franchise fee, and the new statewide video franchise fee.

There are three different categories of the telephone municipal franchise fee: residential, single business line, and multiple business/private line. The charge is levied on each access line,[i] and varies by city. For instance, Huntsville charges $0.95, $2.00, and $2.00, respectively, for each access line, while Houston charges $1.58, $5.37, and $15.28, respectively.[9] The average impact of this fee is 6.35 percent of local telephone service.[10]

Until recently, only telephone service provided by a company certificated by the PUC was subject to this fee. But SB 5 imposed this fee on any company that "provides voice service" using "facilities located at least in part in the public right-of-way." Cellular service is specifically excluded as a voice service, but this provision appears intended to capture all providers of telephone service who use Voice over Internet Protocol (VoIP) technology.

Cities are allowed to change their rates once a year, and the PUC annually adjusts the rate by half of the change in the Consumer Price Index.[11]

The cable municipal franchise fee is very similar to its telephone counterpart. It is capped at 5 percent under federal law, which is usually the amount that cable companies have to pay under agreements negotiated with the cities. Additionally, cities generally require in-kind services as part of the franchise agreement. This cost is also passed on to consumers, usually in the form of a fee on a cable bill. It generally runs from 1 percent to 2 percent.

The statewide video franchise fee is imposed on video and cable providers that offer services under new statewide video franchise provisions. As local cable franchise agreements expire, state law requires that cable and video service be provided under the state franchise—already, cable providers are making the switch.

The fee is 5 percent of gross revenues of the service provided. Eventually, there will also be an additional 1 percent tax in lieu of in-kind services. The fee is sent to cities where the franchisees do business. Cable franchises have claimed this fee, which will total 6 percent, violates federal law which sets a 5 percent cap on cable franchise fees.

Municipal franchise fees have become divorced from paying for the cost of managing the right-of-way. Many Texas cities want to have franchise fees apply to any provider of voice services regardless of their physical presence in the right-of-way.[12] And in fact, Texas is well on its way to this end, taxing services provided over copper, co-axial, and fiber lines, rather than charging rent for the lines themselves. For instance, telephone companies that offer both voice and video over the same physical line will now have to pay two franchise fees. The same is true for cable companies that offer cable and voice service over one cable line. Even though there are additional services being offered over the lines, cities have no additional costs in managing the rights-of-way.

Municipal franchise fees have turned into just another revenue source for cities. While there is little publicly available information on this, it is clear that revenue from the fees exceeds the costs of managing the right-of-way.

Both the PUC and the Texas Legislature are currently looking into the right-of-way management issue.

Long Distance Access Charges

Access charges are assessed by local telephone companies on long distance carriers seeking to initiate or complete long-distance phone calls within Texas. The average intrastate access rate in Texas, which is set by law, is approximately 6 cents per minute, compared to about 1 cent per minute for interstate access.

While not a traditional tax, and not included in the COST study calculations, this regulated charge functions as a hidden tax on consumers of intrastate long distance. If this charge were deregulated, intrastate rates would surely decrease. As it stands today, the charge is effectively used by the state to subsidize local phone service, particularly in rural areas, just like the USF.

[i] Cities charge the municipal franchise fee on a per-access line basis. The number of access lines is essentially the same as the number of phone numbers used by a business or residence. However, this does not include a phone number associated with a service like distinctive ring.

Senate Bill 5 required transitioning companies[i] to reduce their intrastate access charges to parity with interstate charges with four equal annual reductions, beginning July 1, 2006 for companies already having that designation. The rates, however, are adjusted to reflect the mix of regulated and deregulated markets the companies serve—in effect allowing these companies to charge access rates above parity.

One transitioning company, however, was singled out in this legislation. AT&T must decrease intrastate access rates to interstate parity in three equal annual reductions beginning July 1, 2006, despite the fact that they serve both regulated and deregulated markets. The intrastate access rates of regulated companies, which serve over seven million Texans, were not affected by SB 5.

Federal Subscriber Line Charge

This charge was instituted in 1984 to cover the costs of a portion of the local phone network. The revenue serves as a replacement for lost revenue from reductions in long-distance rates and access charges. This charge is assessed only on local exchange telephone service. It is not a tax, since the companies get to keep the revenue from it, and is not included in the COST study calculations. But it is a federally mandated charge that distorts pricing signals in the market. In Austin, the monthly charge is $5.25 on a residential line.

Private Network Service

Texas incumbent local exchange carriers (ILECs) are required by the Public Utility Code to offer High-Speed Internet access (such as T-1 lines), or private network service, to a variety of users at reduced rates. The entities eligible to receive this subsidy include public schools, institutions of higher education, public libraries, non-profit hospitals, and the Texas Education Agency.

While some ILECs are reimbursed for this from the USF, others are not. To the extent that these costs are not reimbursed by the USF, this also functions as a hidden tax (this mandate is not included in the COST study calculations). And even when covered by USF, this requirement adds to the distortions of cost shifting and makes it more difficult to reduce the USF assessment.

Private Network Service not only costs taxpayers money, it is clearly anti-competitive. Since these services are being provided to these entities at below cost, competitors have no chance of entering this market and offering competing products.

Under the Public Utilities Code, companies that previously elected to be regulated under Chapters 58 and 59 were required to provide private network service for six years at fixed rates from the date of their election. However, SB 5 extended this time period, and requires these companies to continue providing this service with no price increases until January 1, 2012, regardless of their election date.

SB 5 also required the PUC to evaluate “a new funding mechanism to provide financial support to all telecommunications utilities that provide discounts or private network services at prescribed rates.”

So not only has the subsidy for private network service been extended, i.e., increased, it is quite possible that there may be future tax increases to pay for it.

9-1-1 Emergency Service and Poison Control Fees

The 9-1-1 fee is an amalgamation of state and local taxes for two different purposes. The state 9-1-1 equalization charge is 0.3 percent of state and local service. The local portion of the tax, set by 9-1-1 regional planning authorities, averages 2.77 percent. A few years ago the state’s Poison Control fee was wrapped into the 9-1-1 fee. It represents another 0.3 percent charge on local and intrastate service, and funds the Poison Control Information Network. On cellular service, the 9-1-1 fee is a flat 50 cents.

Regulatory Fees

Both the state and federal governments charge many telecommunications companies for the cost of regulating them.

In Texas, this takes the form of the Utility Gross Receipts Assessment, which is levied only on providers of local exchange and long-distance services. It is equal to one-sixth of 1 percent of the provider’s gross receipts on services provided to consumers.

[i] A transitioning company is one that serves both regulated and deregulated markets. Regulated and deregulated markets are distinguished by section of statute under which they are regulated, with companies being given much more freedom to market products and set prices in deregulated markets. There are only three transitioning companies in Texas, though they serve about 15 million Texans.

This charge is usually passed through to consumers in the base cost for local service, although long-distance customers may see it on their bills.

The federal government levies similar charges on long-distance, local exchange, and cable services.

Sales and Excise Taxes

Sales taxes are charged by the state and most local governments on many general business sales, including almost all telecommunications services. The total sales tax rate is approximately 8.25 percent, with the state collecting 6.25 percent and local governments up to 2 percent.[i] The tax is levied upon local exchange, cellular, long-distance, cable, satellite, and video services.

The sales tax is also levied on manufacturing equipment purchased by phone companies. Other manufacturing companies, including electric utilities and cable providers, do not have to pay sales tax on these purchases.

As mentioned above, the federal government has a 3 percent excise tax, which is levied upon local exchange, long-distance, and cellular services.

Both the sales tax and the excise tax function as taxes on a tax, since they are levied on several other telecom taxes. In the case of the sales tax, it is levied on the Federal Universal Service charge, the Texas Universal Service charge, the TIF assessment, the Utility Gross Receipts Assessment, and Municipal Franchise Fees. This tax on a tax costs Texas consumers over $90 million a year.[13]

Other General Business Taxes

Telecommunications companies with facilities based in Texas also pay local property taxes. But unlike general businesses, telecommunication provider's personal property is assessed as a "unit" (rather than by asset) and the valuation of the unit utilizes an "income" approach (general business personal property is usually valued utilizing a cost/depreciation table approach). According to the 2005 COST report, the property tax in Texas represents an average effective tax rate of 2.7 percent on property value of telecommunications providers.[14]

Depending on how they are organized, telecommunications companies may also be subject to the state's franchise tax. Of course, they are also subject to federal income taxes. None of these taxes are included in the COST study calculations.

Tax on a Tax

Texas includes numerous telecom specific taxes in the base of the sales tax. The following taxes are included in the sales tax base:

- The utility gross receipts assessment imposed under subchapter A, Chapter 16, Utilities Code;
- The state universal service fund assessment imposed under Subchapter B, Chapter 56, Utilities Code;
- The federal universal service fund charge;
- The telecommunications infrastructure fund assessment imposed under Subchapter C, Chapter 57, Utilities Code; and
- A municipal franchise fee or right-of-way fee authorized by Chapter 283, Local Government Code.

The Current Tax Landscape

Having lacked a major overhaul for the last decade, Texas telecommunications law was definitely in need of an update last year.

However, one of the benefits of outdated regulations is that technology and markets may have developed in a way so that the regulatory and tax burden on an industry has actually been reduced for some services. This seems to have been the case in Texas prior to SB 5.

For instance, VoIP technology was not contemplated in the last major rewrite of Texas telecommunications law in 1995. So it was both under-regulated and under-taxed, while providing subscribers with low cost, innovative voice communications.

Another example is Internet Protocol Television (IPTV), a video product provided over a telephone line. Both federal cable law and state telephone law had left it largely unregulated and untaxed.[ii]

[i] The local portion is dependent upon local discretion. Both cities and transit authorities can charge this tax. In most instances, but not all, the full 2 percent of the local portion is levied on telecommunications services.

[ii] The actual regulatory and tax status of IPTV prior to SB 5 was subject to a significant dispute among different segments of the industry. Telephone companies argued that it was distinguished from cable and could be offered without being subject to municipal franchise agreements and taxes. Cable companies disagreed, as did cities.

The effects of new technologies were seen in several ways. Municipalities experienced declines in revenue from their franchise fees on phone lines as consumers switched to wireless and VoIP services. Video satellite service had bypassed cities' cable franchise fees, and IPTV was ready to follow suit.

So while Texas has one of the highest telecommunications tax rates in the nation, technology has been paving the way for significant tax reductions in the future as these and other new technologies are deployed.

However, last year the legislature ran across a speed bump on the path toward regulatory reform and lower telecom taxes. Marvin Kirsner, an attorney who specializes in industry-specific tax issues, provides a national perspective on the problem:

> State and local governments are scrambling to maintain revenues they feel are being threatened by new technologies. The explosive growth in e-commerce, for example, is threatening sales tax revenues, because an e-commerce vendor without a physical presence in a state is not obliged to collect sales tax.
>
> The potential loss of tax revenue from VoIP service also terrorizes tax collectors. Likewise, state and local governments feel the popularity of satellite TV and radio service could result in decreased tax revenues and are fighting back by imposing tax structures on satellite TV that do not apply to cable.
>
> State and local governments are concerned about losing revenue from income taxes, property taxes, and franchise fees.[15]

The significant pro-deregulation sentiment in the Texas Legislature last year was hindered by the concern of the state and cities over decreases in revenue. Additionally, some businesses objected to deregulation of their competitors without a subsequent reduction in Universal Service subsidies. Immediate Universal Service reform was of concern to the companies who receive subsidies and legislators not anxious to see phone rates rise in rural Texas.

The resulting legislative compromise importantly provided for significant deregulation and a more rapid deployment of new technologies, but came at the cost of potentially limiting future tax reductions.

Telecom taxes will also be part of the larger debate this spring as the Texas Legislature takes up the issue of funding public education. One of the possibilities being considered for reforming the state's franchise tax is some form of gross receipts tax. As has been noted, providers of traditional phone and cellular service already pay a tax on gross receipts via the TIF fee. Applying a gross receipts tax to these companies through the state franchise tax would amount to double taxation and simply add to the already high tax burden that ultimately falls on consumers.

> Just as Texas has become the national leader in deregulation of telecommunications, it should also become the national leader in reducing telecommunications taxes.

Leading the Way to Lower Taxes: Recommendations

There are still promising signs of future tax/fee reductions on the horizon. AT&T's reduction of access fees will substantially lower the cost of intrastate long distance. The current focus on Universal Service provides at least the potential of significant decreases. It is unclear if most VoIP providers will become subject to the state's municipal franchise fee. Finally, there is significant potential for innovations that can provide voice, video, and data communications completely outside the state's regulatory reach.

One thing is clear: *The high telecommunications tax burden on Texas businesses and consumers should be reduced.* This time of transition in telecommunications markets and regulation should be used to benefit consumers instead of seeking ways to replenish diminishing revenue streams of the state and local governments.

It is also time to institute a sensible tax policy that levels the playing field (down, not up) between voice, video, and data transmission. In this day of technological convergence, taxes should not discriminate between the type and means of delivery of these increasingly similar products. Telephone service should not be taxed at twice the level of cable, or more than three times the level of satellite. Of course, a reasonable right-of-way fee is certainly appropriate for those companies that choose to build in the right-of-way.

Just as Texas has become the national leader in deregulation of telecommunications, it should also become the national leader in reducing telecommunications taxes. Considering Texas now sits near the top of the rankings of high-tax states, this is a realistic goal for Texas policymakers. The recommendations in this paper would save Texans over $382 million per year. But these savings will only be realized if a concerted effort is made to overcome the challenges created by the reliance of government on these existing tax revenues.

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Policy Recommendations

The following recommendations provide some ideas for leading the way to lower telecom taxes[i]:

- ***Sales Tax***. Eliminate the tax on a tax aspect of the state and local sales taxes. Taxpayer Savings: $90 million per year.
- ***Telecommunications Infrastructure Fund Fee***. Eliminate the TIF fee. Taxpayer Savings: $200 million per year.
- ***Universal Service***. Bring rates for all basic residential phone service to parity with urban rates and provide for a corresponding reduction in Universal Service charges. Taxpayer Savings: $90 million per year.
- ***Municipal Franchise Fees***. Restructure these fees to more closely reflect the cities' costs of managing the right-of-way. Taxpayer Savings: Unknown.
- ***Private Network Service***. Eliminate mandated provision of Private Network Service. Taxpayer Savings: $2 million per year.

[i]The estimate for the amount of savings from the sales tax recommendation is based on the fiscal note to HB 1121, 79th Regular Session. The estimate for the amount of savings from eliminating the TIF fee is based on the Comptroller's 1972-2003 Sources of Revenue Growth. The estimate for the amount of savings on Universal Service charges is based on the author's calculations using data on access lines and basic local telephone rates from the appendix of the 2005 Crandall and Ellig study. The available data allows for only a rough estimate, and does not allow for the estimation of the potential loss of revenue based on customers substituting other services in response to price increases.

Endnotes

[1]Telecommunications Tax Task Force of the Council On State Taxation, *State Study and Report on Telecommunications Taxation* (May 2005) 3.
[2]Ibid., 16.
[3]Ibid., 16.
[4]Sean Parnell, "Budget & Tax News," Heartland Institute (Aug. 1, 2005).
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[8]Ibid, 107.
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[13]Kent Lassman, "Should a Tax Tax a Tax?" Citizens for a Sound Economy (Feb. 2001) available at http://www.freedomworks.org/informed/issues_template.php?issue_id=764.
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