

## **Telecommunications Tax Policy in Washington State (September 2007)**

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## **I. Introduction**

The Department of Revenue's current Strategic Business Plan (SBP) communicates the Department's priorities and establishes a framework for conducting business during FY 07- FY 11. This is accomplished through the inclusion of prioritized initiatives. Those initiatives most important to the Department are ranked as "Tier One Initiatives."

One of the goals identified in the SBP is to provide tax information and analysis that is forward looking and responds to the changing business environment. Several initiatives in the SBP focus on this goal, including a Tier One Initiative referred to as "Trends in Industry Practices." The goal of this initiative is to identify long-range industry trends and practices in order to develop and update tax-related policies that will help foster economic growth in the state. In furtherance of this initiative, the Department has decided to initially focus on the telecommunications industry.

Since deregulation of the telecommunications industry in the mid-1980s, new technologies and increased convergence and competition have radically changed the landscape for this industry. Distinctions have been blurred between telephone and other forms of communications and services. As the industry rapidly expands, tax policy, debate, and discussions at the federal, state, and local levels have immediate as well as future impacts to telecommunication businesses operating in this state. As technologies are evolving and new technologies are being created, application of existing tax laws to these new and evolving technologies often present difficult questions of interpretation.

In order to gain a better understanding of the current state of the telecommunications industry and, perhaps more importantly, where the industry is headed in the future, the Department has invited the telecommunications industry to participate in a conference in late September 2007. Other interested persons have also been invited to the conference. The Department hopes that the conference will provide a forum for participants to learn about changes and long-term trends in the telecommunications industry, challenges facing the Department and taxpayers in applying existing laws to new and evolving technologies, and to engage in meaningful discussions on current and emerging issues.

This document was prepared in conjunction with the September conference, and its purpose is to provide: (1) a brief description of the most recent efforts made towards addressing tax policy issues within the state's telecommunications industry; (2) a broad introduction of current and emerging telecommunications businesses, technologies, and terminology; (3) an analysis of Washington taxes, policies, and issues that impact the telecommunications industry; and (4) recommendations for addressing immediate and anticipated tax policy concerns.

## **II. 1996 and 1997 Telecommunications Reports**

Governor Mike Lowry, by executive order in 1994, established the Governor's Telecommunications Policy Coordination Task Force and directed it to assess current telecommunications policies and recommend ways the state can better attract

telecommunications companies and jobs while encouraging the deployment of advanced networks to Washington businesses and residents. The Director of the Department of Revenue served as the Chair of the 11 member Task Force. In 1996, the Task Force issued an in-depth report titled, *Building the Road Ahead: Telecommunications Infrastructure in Washington State* (1996 Report), providing background and analysis on telecommunications issues. In addition, the report set forth coordinated policy recommendations to the Legislature for the 1997 legislative session. The summary of the report's recommendations are as follows:

1. Achieving regulatory consistency in converging industries.
2. Leveling the taxation playing field.
3. Balancing local interests with state infrastructure needs.
4. Bringing infrastructure to rural areas.
5. Leveraging the state's role as a large purchaser, user, and provider of telecommunications services.

As part of recommendation number 2 (Leveling the taxation playing field) above, the report specifically proposed the following:

An assessment of the tax structure as it applies to telecommunications industry in the state and an analysis of the comparable tax burdens among telecommunications sectors. If any inconsistencies in tax structure or burdens are identified, the Task Force shall recommend policies for fair and equitable tax application.

(Executive Order 94-10)<sup>1</sup>

On January 31, 1997, the Governor's Telecommunications Policy Task Force provided a Second Report, *Telecommunications in Washington State: Implementing the Telecommunications Act of 1996 and Tax Alternatives* (1997 Report), with a discussion of local telephone competition in the state following the passage of the federal Telecommunications Act of 1996 and several proposals to equalize state tax burdens among telecommunications providers.

The Legislature adopted and signed into law a number of these recommendations including proposals regarding cellular tower siting, utility pole attachment, telecommunications infrastructure along state rights-of-way, and the deployment of a shared K-20 telecommunications infrastructure able to provide points of presence to advanced information services to citizens throughout the state. However, as executive and legislative priorities evolved, much of the tax-related policy recommendations to the Legislature were not substantively addressed.

### **III. Telecommunications Sectors and Technologies**

#### **a. *Nature of the Industry*, (U.S. Department of Labor)<sup>2</sup>**

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<sup>1</sup> EXECUTIVE ORDER 94-10, Establishing the Governor's Telecommunications Policy Coordination Task Force, September 13, 1994.

The telecommunications industry is at the forefront of the information age delivering voice, data, graphics, and video at ever increasing speeds and in an increasing number of ways. Whereas wireline telephone communication was once the primary service of the industry, wireless communication services and cable and satellite program distribution make up an increasing share of the industry.

During the late 1990s, the telecommunications industry experienced very rapid growth and massive investment in transmission capacity. Eventually this caused supply to significantly exceed demand, resulting in much lower prices for transmission capacity. The excess capacity and additional competition led to either declining revenues or slowing revenue growth, which has led to consolidation within the industry, as many companies merged or left the industry.

### Wireline Carriers

The largest sector of the telecommunications industry continues to be made up of wired telecommunications carriers [although the wireless sector is rapidly growing]. Establishments in this sector mainly provide telephone service via wires and cables that connect customers' premises to central offices maintained by telecommunications companies. The central offices contain switching equipment that routes content to its final destination or to another switching center that determines the most efficient route for the content to take. While voice used to be the main type of data transmitted over the wires, wired telecommunications service now includes the transmission of all types of graphic, video, and electronic data mainly over the Internet.

These new services have been made possible through the use of digital technologies that provide much more efficient use of the telecommunications networks. One major technology breaks digital signals into packets during transmission. Networks of computerized switching equipment, called packet switched networks, route the packets. Packets may take separate paths to their destination and may share the paths with packets from other users. At the destination, the packets are reassembled, and the transmission is complete. Because packet switching considers alternate routes and allows multiple transmissions to share the same route, it results in a more efficient use of telecommunications capacity as packets are routed along less congested routes.

The transmission of voice signals requires relatively small amounts of capacity on telecommunications networks. By contrast, the transmission of data, video, and graphics requires much higher capacity. This transmission capacity is referred to as bandwidth. As the demand increases for high-capacity transmissions, especially with the rising volume of Internet data, telecommunications companies have been expanding and upgrading their networks to increase the amount of available bandwidth.

One way wired carriers are expanding their bandwidth is by replacing copper wires with fiber optic cable. Fiber optic cable, which transmits light signals along glass strands, permits faster, higher capacity transmissions than traditional copper wirelines. In some areas, carriers are extending fiber optic cable to residential customers, enabling them to offer cable television,

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<sup>2</sup> Excerpt taken from U.S. Department of Labor, Bureau of Labor Statistics, generally describing the "Nature of the Industry."

video-on-demand, high-speed Internet, and conventional telephone communications over a single line. However, the high cost of extending fiber to homes has slowed deployment. In most areas, wired carriers are instead leveraging existing copper lines that connect most residential customers with a central office, to provide digital subscriber lines (DSL) Internet service. Technologies in development will further boost the speeds available through a DSL connection.

### Wireless Carriers

Wireless telecommunications carriers, many of which are subsidiaries of the wired carriers, transmit voice, graphics, data, and Internet access through the transmission of signals over networks of radio towers. The signal is transmitted through an antenna into the wireline network. Other wireless services include beeper and paging services. Because wireless devices require no wireline connection, they are popular with customers who need to communicate as they travel, residents of areas with inadequate wireline service, and those who simply desire the convenience of portable communications. Increasing numbers of consumers are choosing to replace their home landlines with wireless phones.

Wireless telecommunications carriers are deploying several new technologies to allow faster data transmission and better Internet access that should make them competitive with wireline carriers. One technology is called third generation (3G) wireless access. With this technology, wireless carriers plan to sell music, videos, and other exclusive content that can be downloaded and played on phones designed for 3G technology. Wireless carriers are developing the next generation of technologies that will surpass 3G with even faster data transmission. Another technology is called “fixed wireless service,” which involves connecting the telephone and/or Internet wiring system in a home or business to an antenna, instead of a telephone line. The replacement of landlines with cellular service should become increasingly common because advances in wireless systems will provide data transmission speeds comparable to broadband landline systems.

### Cable and Satellite Providers

Cable and other program distribution is another sector of the telecommunications industry. Establishments in this sector provide television and other services on a subscription or fee basis. These establishments do not include cable networks. Distributors of pay television services transmit programming through two basic types of systems. Cable systems transmit programs over fiber optic and coaxial cables. Direct broadcasting satellite (DBS) operators constitute a growing segment of the pay television industry. DBS operators transmit programming from orbiting satellites to customers’ receivers, known as minidishes.

Establishments in the cable and other program distribution industry generate revenue through subscriptions, special service fees (primarily installation ) and advertising sales. They also charge fees for services, such as the transmission of specialty pay-per-view or video-on-demand programs; these often are popular movies or sporting events.

Some cable and satellite systems facilitate the transmission of digital television signals. Digital signals consist of simple electronic code that can carry more information than conventional

television signals. Digital transmission creates higher resolution television images and improved sound quality. It also allows the transmission of a variety of other information. Digital television also uses compression technology to expand the number of channels.

Changes in technology and regulation now allow cable television providers to compete directly with telephone companies. An important change has been the rapid increase in two-way communications capacity. Conventional pay television services provided communications only from the distributor to the customer. These services could not provide effective communications from the customer back to other points in the system, due to signal interference and the limited capacity of conventional cable systems. As cable operators implement new technologies to reduce signal interference and increase the capacity of their distribution systems by installing fiber optic cables and improved data compression, some pay television systems now offer two-way telecommunications services, such as video-on-demand and high-speed Internet access. Cable companies are also increasing their share of the telephone communications market both through their network of conventional phone lines in some areas and their growing ability to use high-speed Internet access to provide VoIP (voice over Internet protocol).

#### *Voice over Internet Protocol*

VoIP is sometimes called Internet telephony, because it uses the Internet to transmit phone calls. While conventional phone networks use packet switching to break up a call onto multiple shared lines between central offices, VoIP extends this process to the phone. A VoIP phone will break the conversation into digital packets and transmit those packets over a high-speed Internet connection. Cable companies are using the technology to offer phone services without building a conventional phone network. Wireline providers' high-speed Internet connections also can be used for VoIP and cellular phones are being developed that use VoIP to make calls using local wireless Internet connections. All of the major sectors of the telecommunications industry are or will increasingly use VoIP.

#### *Resellers and Others*

Resellers of telecommunications services are another sector of the telecommunications industry. These resellers lease transmission facilities, such as telephone lines or space on a satellite, from existing telecommunications networks, and then resell the service to other customers. Other sectors in the industry include message communications services, such as e-mail and facsimile services, satellite telecommunications, and operators of other communication services, ranging from radar stations to radio networks used by taxicab companies for global positioning and communication purposes.

### **b. NAICS Classification of Telecommunications**

The North American Industry Classification System (NAICS) is used by business and government to classify and measure economic activity in Canada, Mexico and the United States. NAICS takes into account the huge economic change towards service businesses. The Department uses NAICS codes to classify industry types. NAICS codes are in the process of replacing the older Standard Industrial Classification (SIC) codes; however certain government

departments and agencies, such as the U.S. Securities and Exchange Commission (SEC), still use the SIC codes. NAICS codes are published by the federal government, Office of Management and Budget (OMB), and updated about every four years. NAICS is the first industry classification system that was developed in accordance with a single principle of aggregation, the principle that producing units that use similar production processes should be grouped together. NAICS also reflects, in a much more explicit way, the enormous changes in technology and in the growth and diversification of services that have marked recent decades. The following descriptions of the varying industry types are provided by NAICS codes.

### 517 - Telecommunications

Industries in the Telecommunications sub sector include establishments providing telecommunications and the services related to that activity. The sub sectors are primarily engaged in operating, maintaining, and/or providing access to facilities for the transmission of voice data, text, sound, and video. A transmission facility may be based on a single technology or a combination of technologies. Establishments primarily engaged as independent contractors in the maintenance and installation of broadcasting and telecommunication systems are classified in Sector 23, Construction.

#### 5171 - Wired Telecommunication Carriers

This industry group comprises establishments primarily engaged in operating, maintaining or providing access to facilities for the transmission of voice, data, text, sound, and video using wired telecommunications networks. Transmission facilities may be based on a single technology or a combination of technologies. These industries are engaged in (1) operating and maintaining switching and transmission facilities to provide point-to-point communications via landlines, microwave, or a combination of landlines and satellite linkups or (2) furnishing telegraph and other non-vocal communications using their own facilities.

#### 5172 - Wireless Telecommunication Carriers (except Satellite)

This industry group comprises establishments primarily engaged in operating, maintaining or providing access to facilities for the transmission of voice, data, text, sound, and video using wireless telecommunication networks. Transmission facilities may be used based on a single technology or a combination of technologies. These industries are engaged in operating and maintaining switching and transmission facilities that provide omni-directional communications via airwaves. Included in this industry are establishments providing wireless telecommunications network services, such as cellular telephone or paging services.

#### 5173 – Telecommunication Resellers

This industry comprises establishments primarily engaged in purchasing access and network capacity from owners and operators of the networks and reselling wired and wireless telecommunication services (except satellite) to businesses and households. Establishments in this industry resell telecommunications; they do not operate and maintain telecommunications switching and transmission facilities.

### 5174 – Satellite Telecommunications

This industry comprises establishments primarily engaged in providing point-to-point telecommunication services to other establishments in the telecommunication and broadcasting industries by forwarding and receiving communications signals via a system of satellites or reselling satellite telecommunications.

### 517910 – Other Telecommunications

This industry comprises establishments primarily engaged in (1) providing specialized telecommunications applications, such as satellite tracking, communication telemetry, and radar station operations; (2) providing satellite terminal stations and associated facilities operationally connected with one or more terrestrial communications systems and capable of transmitting telecommunications to or receiving telecommunications from satellite systems.

### 518111 – Internet Service Providers

This industry comprises establishments known as Internet service providers. Establishments in this industry provide clients access to the Internet and generally provide related services such as Web hosting, Web page designing, and hardware or software consulting related to Internet connectivity. Establishments in this industry may provide local, regional, or national coverage for clients or provide backbone services (except telecommunications carriers) for other Internet service providers. Internet service providers have the equipment and telecommunication network access required for a point-of-presence on the Internet.

## **c. Glossary of Widely-used Telecommunications Terminology**

### **Asynchronous Digital Subscriber Line (ADSL)**

A technology that allows high speed data to be sent over a single pair of existing copper telephone lines, with data rates for receiving data differing from data rates for sending data. ADSL supports data rates of 1.5 to 9 Mbps when receiving data (known as the *downstream* rate) and from 16 to 640 Kbps when sending data (known as the *upstream* rate). (See DSL)

### **Broadband**

The term “broadband” refers to advanced communications systems capable of providing high-speed transmission of services such as data, voice, and video over the Internet and other networks. Transmission is provided by a wide range of technologies, including digital subscriber line and fiber optic cable, coaxial cable, wireless technology, and satellite. Broadband platforms make possible the convergence of voice, video, and data services onto a single network.

### **Cable Modem**

Device providing data connectivity over a cable television network; allows high speed Internet access through your cable television network.



### **Competitive Local Exchange Carrier (CLEC)**

Carriers/providers established after the AT&T divestiture offering competitive local telecommunications services. CLECs give consumers an alternative to the incumbent telecommunication provider (ILEC).

### **Digital Subscriber Line (DSL)**

A generic name for a family of data connectivity services including ADSL (Asymmetric Digital Subscriber Line), HDSL (High Bit Rate Digital Subscriber Line) and SDSL (Symmetric Digital Subscriber Line). DSL lines typically operate on Unshielded Twisted Pair (UTP) copper telephone facilities. DSL works by sending digital pulses in the high-frequency area of telephone wires. Since these high frequencies are not used by normal voice communications, DSL can operate simultaneously with voice connections over the same wires.

### **Fixed Wireless**

A network service in which wireless devices or systems are situated in fixed, stationary locations (such as an office or home) as opposed to a network service supporting mobile wireless devices, such as cell phones or PDAs.

### **Incumbent Local Exchange Carriers (ILECs)**

Companies that provided local telephone services before the AT&T divestiture.

### **Integrated Services Digital Network (ISDN)**

An international standard that provides end-to-end digital connectivity using existing telephone plant to support a wide range of voice, data, and video services. It uses a single connectivity channel for all forms of data transfer. However, the technology required is more expensive and less flexible than newer DSL technologies.

### **LAN/WLAN**

Local Area Network. Usually refers to a network connecting devices within a single building or facility. If implemented using wireless connectivity, becomes a WLAN (wireless local area network).

### **Local Access and Transport Area (LATA)**

Federally defined geographic area in which telephone services are provided. LATA boundaries are arbitrary and generally don't conform to any existing geographic town/county/region. LATAs only apply to ILECs and CLECs.

## **Local Exchange Carrier (LEC)**

A company that provides telephone service for subscribers in a geographical area encompassing one Local Access and Transport Area (LATA).

## **POTS**

Plain old telephone service, or POTS, is a term which describes the voice-grade telephone service that remains the basic form of residential and small business service connection to the telephone network in most parts of the world. The name is a reflection of the telephone service still available after the advent of more advanced forms of telephony such as ISDN, mobile phones and VoIP.

## **Radio Frequency (RF)**

Any frequency within the electromagnetic spectrum associated with radio wave propagation. When an RF current is supplied to an antenna, an electromagnetic field is created that then is able to propagate through space.

## **VoIP**

Voice over Internet Protocol, also called VoIP, IP Telephony, Internet telephony, Broadband telephony, Broadband Phone and Voice over Broadband is the routing of voice conversations over the Internet or through any other IP-based network. VoIP services convert your voice into a digital signal that travels over the Internet. If you are calling a regular phone number, the signal is converted to a regular telephone signal before it reaches the destination. VoIP can allow you to make a call directly from a computer, a special VoIP phone, or a traditional phone connected to a special adapter. In addition, wireless "hot spots" in locations such as airports, parks, and cafes allow you to connect to the Internet and may enable you to use VoIP service wirelessly.

## **WAN/WWAN**

Wide Area Network. Usually refers to a network connecting devices located in multiple metropolitan areas, nation-wide or worldwide. If implemented using wireless connectivity, becomes a WWAN (wireless wide area network).

## **Wireless Fidelity (Wi-Fi)**

Another name for IEEE 802.11b. Products certified as Wi-Fi by WECA (Wireless Ethernet Compatibility Alliance) are interoperable with each other even if they are from different manufacturers. A user with a Wi-Fi product can use any brand of access point with any other brand of client hardware that is built to the Wi-Fi standard.

#### IV. Taxation of Telecommunications

**NOTE: This document contains some telecommunications terms and definitions not contained in the Streamlined Sales and Use Tax Agreement (SSUTA). Washington has adopted the SSUTA definitions, some of which do not take effect until July 1, 2008. The SSUTA definitions do not present substantive tax administration changes for the telecommunications industry in Washington.**

Telecommunications services include wireline telephone service, wireless communications, cable television service, satellite-based services, and Internet services.

For excise tax purposes, telephone services are taxed differently than cable television services, satellite-based services, and Internet services.

Generally, the purchase of tangible personal property by telecommunications companies for their use and the sale of tangible personal property to the end user will be subject to the sales and use tax. In addition, all companies offering telecommunications services are subject to the property tax. However, telephone companies are centrally assessed, whereas cable television companies are locally assessed.

##### **a. Sourcing Telephone Services<sup>3</sup>**

RCW 82.32.520 establishes the law for sourcing (determining the taxing jurisdiction) of telephone service for purposes of state and local taxation.

For purposes of sourcing telecommunications services, “place of primary use” means the street address representative of where the customer’s use of the telecommunications service primarily occurs, which must be the residential street address or the primary business street address of the customer. In the case of mobile telecommunications services, “place of primary use” must be within the licensed service area of the home service provider.

Determining where telephone services are sourced is based on the following six categories:

##### **1. Call-by-Call Basis**

“Call-by-call basis” means any method of charging for telephone services where the price is measured by individual calls. Telephone services (as defined in RCW 82.04.065) sold on a call-by-call basis are sourced to:

- The taxing jurisdiction where the call both originates and terminates, or
- The taxing jurisdiction where the call either originates or terminates and in which the service address is also located.

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<sup>3</sup> See Washington Department of Revenue Special Notice, *Place of Sale for Telephone Services*, April 29, 2004.

## **2. Other than Call-By-Call Basis**

Except for the telephone services described below and telephone services sold on a call-by-call basis, all other telephone services are sourced to the customer's place of primary use.

## **3. Mobile Telecommunications Services**

"Mobile telecommunications services" means commercial mobile radio services, as defined in section 20.3, Title 47 C.F.R. as in effect on June 1, 1999. Mobile telecommunications service is commonly referred to as cell phone or wireless service. Sales of mobile telecommunications services, other than air-ground radiotelephone service and prepaid calling service, are sourced to the customer's place of primary use.

## **4. Prepaid Calling Services and Prepaid Wireless Calling Services**

"Prepaid calling service" means the right to access exclusively telecommunications services, which must be paid for in advance and which enables the origination of calls using an access number and/or authorization code, whether manually or electronically dialed, and that is sold in predetermined units or dollars of which the number declines with use in a known amount. For example, the purchase of calling cards at a retail outlet is the purchase of a "prepaid calling service."

"Prepaid wireless calling service" means a telecommunications service that provides the right to use mobile wireless service as well as other non-telecommunications services, including the download of digital products delivered electronically, content, and ancillary services, which must be paid for in advance that is sold in predetermined units or dollars of which the number declines with use in a known amount.

A sale of prepaid calling services or prepaid wireless calling services is sourced as follows:

- 1.** When the service is received by the purchaser at a business location of the seller, the sale is sourced to the business location, that is, at the retail outlet.
- 2.** When the service is not received by the purchaser at a business location of the seller, the sale is sourced to the location where received by the purchaser or the purchaser's donee.
- 3.** When 1 and 2 do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller.
- 4.** When 1, 2, and 3 do not apply, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of a purchaser's payment instrument, if no other address is available.
- 5.** When 1, 2, 3, and 4 do not apply, the sale is sourced to the address from which the prepaid calling service or prepaid wireless services was provided. Or, in the case of prepaid wireless calling services, the sale may be sourced to the location associated with the mobile telephone number.

## **5. Postpaid Calling Services**

“Postpaid calling service” means the telecommunications service obtained by making a payment on a call-by-call basis either:

- Through the use of a credit card or payment mechanism such as a bank card, travel card, credit card, or debit card, or
- By charge made to a telephone number which is not associated with the origination or termination of the telecommunications service. For example, a call made from a telephone in a hotel room to a restaurant in another city but billed to the caller’s place of primary use (in this example, the caller’s home number).

A postpaid calling service includes a telecommunications service, except a prepaid wireless calling service, which would be a prepaid calling service except it is not exclusively a telecommunications service. For example, a prepaid card that may be used at a specific location for the purchase of gasoline and food items as well as for use of a telephone is a postpaid calling service.

A sale of postpaid calling services is sourced to the origination point of the telecommunications signal as first identified by either:

- The seller’s telecommunications system, or
- Information received by the seller from its service provider, where the system used to transport such signals is not that of the seller.

## **6. Private Communication Services**

“Private communication service” means a telecommunications service that entitles the customer to exclusive or priority use of a communications channel or group of channels between or among termination points. This includes switching capacity, extension lines, stations, and any other associated services that are provided in connection with the use of such channel or channels.

A sale of private communication service is sourced as follows:

- Service for a separate charge related to a customer channel termination point is sourced to the jurisdiction in which such customer channel termination point is located.
- Service where all customer termination points are located entirely within one jurisdiction is sourced in the jurisdiction in which the customer channel termination points are located.
- Service for segments of a channel between two customer channel termination points located in different jurisdictions and which segment of channel are separately charged is sourced fifty percent in each jurisdiction in which the customer channel termination points are located.
- Service for segments of a channel located in more than one jurisdiction and which segments are not separately billed is sourced in each jurisdiction based on the percentage determined by dividing the number of customer channel termination

points in the jurisdiction by the total number of customer channel termination points.

**b. Definitions of Competitive Telephone Service & Network Telephone Service**

The definition of **competitive telephone service** is quite narrow and refers only to the sale, installation, repair or maintenance of telephone equipment. The definition of network telephone service, however, is quite broad:

"**Network telephone service**" means the providing by any person of access to a telephone network, telephone network switching service, toll service, or coin telephone services, or the providing of telephonic, video, data, or similar communication or transmission for hire, via a telephone network, toll line or channel, cable, microwave, or similar communication or transmission system. "Network telephone service" includes the provision of transmission to and from the site of an internet provider via a telephone network, toll line or channel, cable, microwave, or similar communication or transmission system. "Network telephone service" does not include the providing of competitive telephone service, the providing of cable television service, the providing of broadcast services by radio or television stations, nor the provision of internet service as defined in RCW 82.04.297, including the reception of dial-in connection, provided at the site of the internet service provider.

The state Supreme Court held that the state definition of network telephone service includes paging services. *Western Telepage v. Tacoma*, 104 Wn.2d 599 (2000).

This definition has been interpreted by Washington courts and the Department of Revenue to include a wide variety of telecommunication services. The statutory definition of network telephone service is not dependent upon the type of technology or equipment used to provide the service and includes a traditional telephone network, or other similar communication or transmission system. As such, this definition is intended to be technology neutral.

**c. Telephone Service**

**1. Retail Sales Tax**

The retail sales tax applies to telephone service. This applies to providing and servicing equipment (competitive telephone service), access to networks, and toll charges, including interstate toll charges. However, access to networks for residential customers, pay phones, and mobile telecommunications services, including any toll service, provided to a customer whose place of primary use is outside this state are exempt from the sales tax. This exemption includes voice mail, caller identification, and call waiting. RCW 82.04.050(5), 82.04.065, and 82.08.0289. WAC 458-20-245.

All cellular service is subject to sales tax. Excise Tax Advisory (ETA) 2019.08.245. The retail sales tax exemption in RCW 82.08.0289 does not apply to cellular telephone services provided to residential customers since the customer is able to make telephone calls over a wide area, not just a residential location. In addition, cellular service providers are not subject to regulation by the

Washington Utilities & Transportation Commission and therefore no tariffed class of residential service exists for cellular telephone service.

Prepaid calling cards are subject to the sales tax when purchased. No tax is imposed when used. ETA 567.08.245.

## **2. B&O Tax**

The business and occupation (B&O) tax, retailing or wholesaling classification, applies to telephone service. This applies to providing and servicing equipment (competitive telephone service), access to networks, including pay phones, and toll charges, including interstate toll charges, if the call is to a phone in this state and is billed to a person in this state. RCW 82.04.050(5) and 82.04.065. WAC 458-20-245.

Local B&O taxes cannot exceed 6 percent unless approved by the voters. RCW 35.21.860 and 35.21.870. However, pay phone services of independent pay phone operators must be taxed by cities at the 0.2% retailing rate rather than the 6.0% utility rate. RCW 35.21.710.

### **d. E-911**

Counties are authorized to impose an enhanced 911 excise tax of up to \$0.50 per switched access line per month and \$0.50 per month per radio access line (cellular) for an emergency services communication system. RCW 82.14B.030.

A state enhanced 911 excise tax is also imposed of up to \$0.20 per switched access line and radio access line per month. RCW 82.14B.030. The E-911 tax does not apply to VoIP service.

### **e. Telephone Relay Service (TRS)**

In addition, a statewide telephone relay service (TRS) excise tax on each switched access line is authorized to fund the Washington Telecommunications Relay Service. This service allows hearing-impaired and speech-impaired persons to communicate through telephones using a third party interpreter. Some type of program like TRS is required under the Americans with Disabilities Act. Legislation that passed in 1992 directed this service to be contracted to a private entity for operation. The statutory tax ceiling was raised in 1993 from 10 cents to 19 cents per line per month. The Department of Revenue sets the rate based on the proposed budget. For fiscal year 2007, 9 cents per month was charged; in 2008 the tax increased to 12 cents per month. RCW 43.20A.725 and 82.72.020; WAC 458-20-270.

### **f. Washington Telephone Assistance Program (WTAP)**

A statewide Washington telephone assistance program (WTAP) excise tax on each switched access line is also authorized. WTAP is a program that helps provide access to residential access line service for low-income persons. The statutory tax ceiling is 14 cents per line per month. For fiscal year 2007, 14 cents per month is charged. RCW 80.36.430 and 82.72.020; WAC 458-20-270.

**g. Cable Service**

**1. B&O Tax**

Cable television services are taxed as a service under the B&O tax and are not subject to the sales tax.

Cities may tax cable television services under their general B&O tax or as a utility. The maximum city B&O tax rate is 0.2% if measured by gross receipts, but any city with higher rates on January 1, 1982, may keep the higher rates and provide for an increase of up to 10% higher. RCW 35.21.710. Although the rate for electricity, telephone, natural gas, and steam energy businesses cannot exceed 6 percent unless approved by the voters, there is no limit for other utilities. RCW 35.21.860 and 35.21.870.

**2. Franchise Fees**

The federal Cable Act allows local franchise authorities to assess fees of up to 5 percent of gross revenues on cable television services.

**h. Satellite Service**

The federal Telecommunications Act exempts direct-to-home satellite service from taxes or fees imposed by any local jurisdiction. Although the state is not prohibited from taxing satellite service, the state may not be able to impose a tax if the direct satellite service provider is a nonresident with no physical presence within the state.

**i. Internet Access and ITFA**

Telephone service does not include Internet service. RCW 82.04.065. Internet services are therefore taxable as a service under the B&O tax. Cities and towns were prohibited from imposing new taxes and fees on Internet service until July 1, 2006. RCW 82.04.297 & 35.21.717.

In 1998, Congress enacted the Internet Tax Freedom Act (Title XI of P.L. 105-277 (H.R. 4328) Laws of 1998). The act does not prohibit the imposition of sales taxes on sales made over the Internet. The act prohibits states from imposing new taxes on Internet access and services and discriminatory taxes on electronic commerce (transactions over the Internet). Internet access and service taxes include taxes such as bit taxes, web-search taxes, and e-mail surcharges. A discriminatory tax includes a tax that is imposed on sales over the Internet that would not be imposed if the sale were made by other means, like by mail order. All state tax laws on Internet access and services enacted before July 1, 1998, were protected.

On December 3, 2004, President Bush signed the Internet Tax Nondiscrimination Act of 2004, P.L. 108-435 (S. 150). This legislation reinstated and extended, to November 1, 2007, the



moratorium on taxes on Internet access by amending the Internet Tax Freedom Act (ITFA). The legislation expanded the definition of tax-exempt Internet access by including telecommunications services that are purchased, used, or sold by an Internet service provider (ISP) to provide Internet access to its customers. Some have argued that this expanded definition of Internet access includes the type of services provided by network telephone service businesses to ISPs and their customers. This includes services used to connect an ISP to the Internet backbone or to ISP customer locations, such as the provision of transmission capacity over dial-up connections, coaxial cables, fiber optic cables, T-1 lines, frame relay service, digital subscriber lines (DSL), wireless technologies, or other means.

However, the Department's position is that Washington's taxation of network telephone service used to provide Internet access qualifies under the first grandfather clause of ITFA and, as a result, will continue to be taxed.<sup>4</sup>

#### **j. Voice over Internet Protocol (VoIP)**

Sales of VoIP services in this state are subject to retailing B&O tax and retail sales tax, if the service permits a subscriber to place calls to persons using the public switched telephone network. WAC 458-20-245. Sales of VoIP services in this state are subject to service and other activities B&O tax if the system only permits calls to be made computer-to-computer and does not involve the use of the public switched telephone network. Many VoIP providers may lack taxable nexus with the state. And unlike most items subject to retail sales tax, there is no comparable use tax due on telecommunications services.

#### **k. Property Taxes on Telecommunications (Central Assessment)**

The 1996 report by the Governor's Telecommunications Policy Coordination Task Force recommended the following regarding property tax policies affecting the telecommunications industry:

As the infrastructure and services of telecommunication companies and cable television become increasingly similar, current laws and definitions related to property taxation must be reviewed. Existing statutes, including those defining a "telephone company" in the central assessment laws, are outdated. Current statutes were adopted in 1935 and, with the exception of eliminating three obsolete industries from central assessment, have remained virtually unchanged for 60 years. Yet traditional "telephone companies" are facing potential and actual competition for voice and data services from a variety of sources, including cable television and personal communication network providers, using both wireline and wireless technologies.

Current central tax assessment statutes should be amended to recognize the changing nature of the industry and to incorporate **cable television** [bolding ours] within the purview. Such changes will ensure that providers of telecommunication services are treated similarly in terms of central assessment, proving neither competitive advantage

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<sup>4</sup> See ETA 2029.04.245 (February 24, 2006).

nor disadvantage to the various companies that serve the same telecommunications marketplace.

Specifically, central assessment provisions contained in [Chapter] 84.12 RCW [Assessment and Taxation of Public Utilities] should be amended to recognize the changing nature of the telecommunications industry and the emergence of a variety of service providers, including cable television. In this regard, the definition of "telephone company" should be revised to include cable systems operating on an intercounty or interstate basis, as well as other current and future telecommunications technologies. Moreover, the formula for determining taxes owed by Public Utility Districts in lieu of property tax should be amended to take into account revenues from any future telecommunication service offerings.

Generally, property is valued for property tax purposes by the county assessors. However, the Department of Revenue assesses the property of companies operating in multiple counties or states and that are within the purview of chapter 84.12 RCW (railroads, airlines, electrical utilities, telephone companies, telegraph companies, gas companies, and pipeline companies) or chapter 84.16 RCW (private car companies). Cable companies are not included in the central assessment statutes, and therefore are not centrally assessed by the Department. Their omission is due primarily to the historical distinctions between their services and those provided by centrally assessed companies, the fact that they came into existence well after the central assessment statutes were enacted, and the fact that they were historically small and independently operated and did not operate initially on an intercounty or interstate basis.

This issue of central assessment continues to be an area of large debate, particularly involving cable companies. The main argument in support of central assessment is that current law does not acknowledge the convergence of cable and telephone, nor does it acknowledge other actual or potential competitors in this rapidly developing marketplace. Government efforts to promote a "level playing field" in the telecommunications industry requires adherence to the principle that businesses providing similar services be treated similarly for regulatory and tax purposes.

The cable industry's concern that their property tax assessments will greatly increase if they become subject to central assessment by the Department should be further analyzed. The past experiences of several states that switched to central assessment showed that overall assessment amounts increased dramatically. The Property Tax Division of the Department of Revenue is making preparations to conduct this analysis in the near future.

**I. Chart: Taxes and Dedicated Funds<sup>5</sup> (Jan. 2006)**

All Local Exchange Companies in Washington collect and remit the following excise taxes levied upon all end users of regulated telecommunications services.

1. <u>Washington Telephone Assistance Program (WTAP)</u>	
Tax rate per access line per month:	\$ .14
Threshold Rate (8/93)	\$8.00

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<sup>5</sup> Courtesy of Washington Utilities and Transportation Commission

2. Telecommunications Relay Services (TRS)  
Tax rate per access line per month: \$ .10
3. E-911 State Excise Tax  
Tax rate per access line per month: \$ .20
4. E-911 County Tax  
Tax rate per access line per month: \$ .50
5. E-911 King County Tax  
Tax rate per access line per month: \$ .50
6. Federal, State, County, Municipal utility excise taxes.  
All telecommunications companies must collect and remit.
7. State Universal Service Fund (USF)  
State access charge structure provides for a mill levy on intrastate switched access minutes of use originating and terminating on incumbent LEC networks. New LEC=s must collect and remit if they offer switched access services.  
USF rate pre minutes of use: \$ .00152

Note: E911: New Local Exchange Companies abide by a Amodel@ E911 tariff/price list. This is practice if the LEC ceases to use an incumbent LEC tandem to transmit calls to Public Safety Answer Points (PSAPS). New LECs currently route 911 calls to the LEC to handle in the same manner as that of a PBX, including all proper functions of keeping the Automatic Location Identifier database current.

**m. Chart: Telephone (Wireline & Wireless) Taxes Imposed<sup>6</sup>**

<b>FEDERAL</b>		<b>W I R E L I N E</b>	<b>W I R E L E S S</b>
<b>TAX</b>	<b>SUMMARY</b>		
<b>Federal Charge Service Provider Number</b>	Not a tax, but a fee charged by the local phone company for “service provider number portability.” This service enables customers to keep their telephone numbers when they change from one local telephone company to another. Local phone companies are allowed to charge this fee for five years, and may not begin charging the fee until they can provide the ability to the end-user of retaining their phone number in the event of switching local telephone companies. 47 USC 251(b)(2); 47 CFR 52.33(a).	%	

<sup>6</sup> Chart furnished by Washington State Senate, Water Energy Telecommunications Committee (originally created by Jinnah Rose-McFadden, revised June 2006).

<b>Federal Access Charge</b>	Also called a “subscriber line charge,” this is not a tax but a local phone company charge. The FCC allows local telephone companies to assess this charge to help cover the cost of providing service. The FCC caps this amount at various levels. 47 USC 69.152(d); 47 USC 69.104(n).	%	
<b>Federal Universal Service Fee (Universal Connectivity Charge)</b>	The FCC requires long-distance companies to pay a percentage of their revenues into various funds that support affordable phone service for low-income customers, and customers in areas that are expensive to serve. Another fund subsidizes Internet and other advanced services for schools, libraries and rural health care providers. Most long-distance carriers have chosen to cover this increased cost by charging customers. Some companies assess fixed amounts and others assess a percentage. The amount varies among companies. 47 USC 254(d); 47 USC 254(b)(3); 47 USC 254(c)(3); 47 CFR 54.706(a).	%	%
<b>Federal Excise Tax</b>	This 3% federal excise tax is imposed on local telephone service. 26 USC 4251. <u>IRS announced on May 25, 2006, that it would discontinue collecting the tax on long distance service and would issue refunds for the last three years of collections.</u>	%	%
<b>Wireless Local Number Portability Charge (LNP)</b>	This is not a tax. Wireless consumers may keep their phone numbers when switching to other wireless or wireline companies in the same geographic area. Wireless companies may charge fees to transfer phone numbers. The FCC does not regulate the specific amount of the fees; however, the charges must be just and reasonable.		%

<b>STATE</b>		<b>W I R E L I N E</b>	<b>W I R E L E S S</b>
<b>TAX</b>	<b>SUMMARY</b>		
<b>State E 911 Tax*</b>	State enhanced 911 excise tax is imposed as follows: <ul style="list-style-type: none"> <li>▪ 20 cents per month, per access line; and</li> <li>▪ 20 cents per month, per radio line. RCW 82.14B.030(3)(4).</li> </ul>	%	%
<b>Telecommunications Relay Services Excise Funds</b>	“Telecommunications Relay Services.” The Washington State Legislature created this program in 1987. Its purpose is to provide devices and services to the hearing impaired so they can make and receive telephone calls. While the program is administered by the Office of Deaf and Hard of Hearing Services, Department of Social and Health Services, the WUTC determines the amount of the tax. By statute the TRS excise tax may not exceed 19 cents per month per. Currently, the tax is 14 cents per month. RCW 43.20A.725(5); WUTC Docket UT-030350 (2003).	%	

<b>Washington Telephone Assistance Excise Tax</b>	The Washington State Legislature created the Telephone Assistance Program in 1987. Its purpose is to help eligible low-income households pay for local telephone service. The WTAP excise tax is collected from wireline telephone users at a rate of 13 cents per month, per line. This tax pays for the WTAP program, which provides: (1) free basic installation; (1) waiver of any deposit required by a local phone company; and (3) a monthly cap on the amount a participant paid for basic local phone service. RCW 80.36.420 - 430; WAC 388-31-010; WUTC Docket UT-990429 (1999).	%	
<b>State B&amp;O Tax (Retailing)</b>	Gross proceeds of business sales, multiplied by 0.471%. RCW 82.04.250; RCW 82.04.220; RCW 82.04.050; RCW 82.04.065.	%	%
<b>State B&amp;O Tax (Wholesaling)</b>	Gross proceeds of business sales, multiplied by 0.484%. RCW 82.04.270; RCW 82.04.220; RCW 82.04.060.	%	%
<b>State Sales Tax</b>	There is a tax levied and collected on each retail sale in this state, equaling 6.5% of the selling price. RCW 82.08.020; RCW 82.08.0289 (Residential wirelines are exempt.)	%	%

<b>LOCAL</b>		<b>W I R E L I N E</b>	<b>W I R E L E S S</b>
<b>TAX</b>	<b>SUMMARY</b>		
<b>County E 911 Tax*</b>	The legislative authority of a county may impose, by ordinance, a county enhanced 911 excise tax of up to: <ul style="list-style-type: none"> <li>▪ 50 cents per month, per access line; and</li> <li>▪ 50 cents per month, per radio line. RCW 82.14B.030(1)(2).</li> </ul>	%	%
<b>Local Utility Tax</b>	A city may impose, by ordinance, a local utility tax on telephone services of up to 6%. The city may impose a higher tax, if first approved by a majority of the voters of the city. RCW 35.21.870(1). [If utility tax is charged, then B&O and local sales taxes cannot be charged. Most cities choose the utility tax because it is higher.]	%	%
<b>Local B&amp;O Tax</b>	The local B&O tax rate may not exceed 0.2% of gross receipts or gross income from sales, unless voters approve a higher rate or the city had a higher rate prior to 1982. RCW 35.21.710; RCW 35.21.711.	%	%
<b>Local Sales Tax (City and/or County)</b>	A city or county may each impose up to a 1% retail sales tax. [For wireless and business landlines, the total bill is taxed. For residential landlines, only long distance is taxed.] RCW 82.14.010; RCW 82.14.020(5)(a)(b); RCW 82.14.030. There may also be various local option taxes depending on the jurisdiction, such as the King County stadium & exhibition center tax.	%	%

\* **Enhanced 911 Excise Tax (*E 911 Tax*):** Every county must have the ability to identify the location of a 911 caller. This enhancement, along with other 911 communication costs, is covered through state and county taxes. 911 taxes collected by local phone companies are held in trust until they are paid to the Department of Revenue. Tax proceeds are then deposited into the enhanced 911 account. RCW 38.52.510; RCW 82.14B.010; RCW 82.14B.020; RCW 82.14B.042; RCW 35.52.540

## **V. Provision of Telecommunications Services by Public Utility Districts (PUDs) to Internet Service Providers (ISPs)**

Local PUDs are authorized to provide certain utility services to citizens within their respective jurisdictions. Under RCW 54.16.330, a PUD may operate telecommunications facilities for the district's own internal telecommunications needs and to provide "wholesale telecommunications services within the district . . . ." The statute specifically states that "[n]othing in this section shall be construed to authorize public utility districts to provide telecommunications services to end users." It is the Department's general understanding that in enacting this section, the Legislature intended to permit PUDs to provide telecommunications services to other, private companies that would provide service directly to an end-user consumer. PUDs were not intended to compete with private companies by providing telecommunications services directly to end-user consumers. This compromise approach would take advantage of the PUDs' unique capabilities to encourage the development of broadband capabilities in rural Washington without unfairly competing with private enterprises willing to provide service in those areas.

As a result of the enactment of RCW 54.16.330, some PUDs have developed fiber optic telecommunications networks within their districts. These networks are used for the districts' own telecommunications purposes and excess capacity on the networks has been sold to ISPs and other businesses. The ISPs use the PUD networks to provide Internet services directly to residential, business, and educational consumers. The PUD has no contractual relationship with the end-user consumers for the telecommunications service or the Internet services; the PUD is obligated only to provide the telecommunications backbone to ISPs that is needed to allow end-user consumers to communicate with the ISPs for access to the Internet, e-mail, and other related Internet services.

It has been suggested that the PUD network is actually part of the Internet, and, therefore, permitting access to the PUD network is the equivalent of providing access to the Internet. However, the Department's position is that when PUDs contract with an ISP to provide access to their fiber optic networks, the PUDs are providing network telephone service, not Internet access. This activity is a retail sale, and retail sales tax applies. The application of retail sales tax to the provision of telecommunication services by PUDs to ISPs falls under the grandfather clause of ITFA, which was extended to November 1, 2007, by the Internet Tax Nondiscrimination Act of 2004, P.L. 108-435 (S. 150).

In contrast to sales of network telephone service to ISPs, when a PUD sells network telephone service to a person who resells that service as telephone service (as opposed to Internet service), that sale is considered to be wholesale sale.

## **VI. Role of Washington Utilities and Transportation Commission (WUTC)**

The WUTC played a key role as a member of Governor Lowry's Telecommunications Policy Coordination Task Force. As part of the 1997 Second Report, the Task Force issued a comprehensive status report on implementing the Telecommunications Act of 1996 in Washington. In the last decade since then, the telecommunications industry has significantly increased its presence in Washington.

On September 1, 1995, there were 282 telecommunications firms registered with the WUTC and offering services to consumers in the state.<sup>7</sup> As of June 18, 2007, there were 427 registered telecommunications companies reporting to the WUTC including local exchange companies (LECs), competitive local exchange companies (CLECs), payphone companies, and pre-paid calling card companies.<sup>8</sup>

As a result, the WUTC has undertaken its own study of trends in the telephone industry as part of its strategic plan for 2007-2009, and is beginning the inquiry with stakeholders.<sup>9</sup>

Changes in technology have fundamentally altered the telecommunications industry. Until recently, companies providing “plain old telephone service” [POTS] enjoyed monopolies in their service areas, and states regulated them to ensure that rates were fair, just, and reasonable. Today, these same companies face real or potential competition for many services from cable, wireless, Internet, and other local exchange companies. As the regulated companies increasingly face competition, the commission must review the need for traditional rate-of-return regulation, the best policies to protect consumers during the transition from monopoly to competitive service, and the proper level of staffing and resources during the transition.<sup>10</sup>

Commission staff will prepare a comprehensive report identifying and analyzing trends in the telecommunications industry, including the degree of competition in the marketplace, the level of customer service, anticipated changes in federal and state law, the need for consumer protection measures and continued universal service programs. It will consult with industry and consumer representatives and other stakeholders in preparing the report. It will use this research to help identify what continued regulation, if any, is appropriate for telephone companies, determine the proper role for the WUTC in this changing environment and assess the appropriate levels of staffing and resource allocation for telecommunications-related activities.<sup>11</sup>

## **VII. Streamlined Sales and Use Tax Agreement (SSUTA)**

The Streamlined Sales Tax Project (SSTP) is a cooperative effort of 43 states, the District of Columbia, and representatives of the business community, to simplify and make more uniform

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<sup>7</sup> *Building the Road Ahead: Telecommunications Infrastructure in Washington State*, First Report of the Governor's Telecommunication Policy Coordination Task Force, p. 21 (April, 1996).

<sup>8</sup> Washington Utilities and Transportation Commission.

<sup>9</sup> Refer to WUTC Website ([www.wutc.wa.gov](http://www.wutc.wa.gov)) for Telecom Trends Report Inquiry.

<sup>10</sup> Refer to WUTC Website ([www.wutc.wa.gov](http://www.wutc.wa.gov)) for Telecom Trends Report Inquiry.

<sup>11</sup> Refer to WUTC Website ([www.wutc.wa.gov](http://www.wutc.wa.gov)) for Telecom Trends Report Inquiry.

sales tax systems across the nation. Measures to accomplish this include common definitions, simplified rate structures, centralized automated registration and reporting, monetary allowances for sellers, amnesty for sellers who voluntarily agree to collect sales taxes, and many others. These requirements are embodied in the Streamlined Sales and Use Tax Agreement (SSUTA). The Agreement took effect and the Governing Board was established on October 1, 2005. States that have currently implemented all the SSUTA requirements are full members. States that have enacted all requirements, but with future effective dates, are associate members.

During the 2003 legislative session, the Legislature enacted legislation at the request of the Department of Revenue to implement the uniform definitions and administrative provisions of the SSUTA. However, the legislation did not implement several provisions that are necessary for the state to conform fully to the SSUTA, including a provision that would require the state to change its local sales and use tax sourcing rules.

Legislation was enacted during the 2007 legislative session (SSB 5089)<sup>12</sup> to bring Washington into full conformity with the SSUTA effective July 1, 2008. As a result, Washington has been accepted as an associate member of the SSUTA.

SSB 5089 included several SSUTA telecommunication definitions. These are changes to terminology in current law, but do not change current law regarding taxability and exemptions.

## **VIII. Tax Policy Issues**

### **a. Industry Outlook: 2004 COST Study**

In 2004, the telecommunications industry commissioned a study by the Telecommunications Tax Task Force of the Council on State Taxation (COST), titled *2004 State Study and Report on Telecommunications Taxation*. The following companies participated in the study:

ALLTEL Corporation, AT&T Corporation, BellSouth Corporation, Cingular Wireless LLC, Level 3 Communications, Nextel Communications, Qwest Communications, SBC Communications, Sprint Corporation, Telephone and Data Systems Inc., T-Mobile USA, Verizon Communications, and Verizon Wireless.

The purpose of the study was intended to highlight the tax burdens on the telecommunications industry to national policymakers:

The state and local tax laws continue to impose high levels of industry specific taxation on telecommunications services. While some states have begun the process of reforming the state and local tax structure, much more is needed to reduce the high levels of telecommunications taxation...<sup>13</sup>

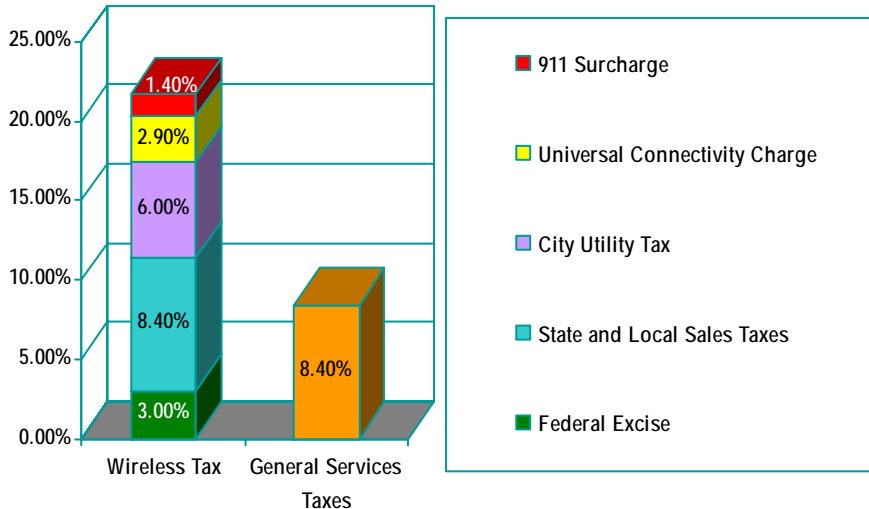
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<sup>12</sup> See chapter 6, Laws of 2007.

<sup>13</sup> 2004 COST Study, p. 7.



The COST Study summarized that the average effective rate of state and local transaction taxes is 14.7%, compared to only 6.12% for general businesses nationwide.<sup>14</sup> The diagram below was presented by a wireless telecommunications provider to the Water, Energy, Telecommunication Committee of the Washington State Senate.



In 2006, a coalition consisting of the National Association of Counties, National League of Cities, U.S. Conference of Mayors, Government Finance Officers Association, and the National Association of Telecommunications Officers and Advisors provided a written response titled, *Local Government Perspective on Telecommunications Taxes: A Response to Industry's 2004 COST Study*, which argued that the study (1) failed to reduce the calculated "transaction taxes" by the substantial amount that is attributable to user fees, (2) failed to reduce the calculated "transaction taxes" by the amount used to fund the 911 emergency system and the universal service fund, and (3) failed to include a comparison of corporate income tax burdens, where other businesses pay more on average than telecommunications companies.

**b. Local Government Issue: Local Franchising Authority<sup>15</sup>**

In Washington, 215 cities impose local utility taxes on telecommunications, and these taxes represent approximately 4 percent of the budget in those cities to help fund essential services. Add franchising fees, and the percentage increases to 19 percent of the budget.

Congress did not act this year on the Advanced Telecommunications Opportunity Reform Act (H.R. 5252). This legislation would preempt state and local tax authority, potentially affecting broadband video competition, local cable television, franchising enforcement, and compliance authority.

However, the Federal Communications Commission (FCC) adopted an order that would federally mandate how video franchising would occur in the United States. The order establishes rules and provides guidance to implement Section 621(a)(1) of the Communications Act of 1934,

<sup>14</sup> 2004 COST Study, p.3.

<sup>15</sup> Excerpt from, *Local Franchising Authority in Jeopardy*, Association of Washington Cities ( Jan. 2007).

which prohibits franchising authorities from unreasonably refusing to award competitive franchises for the provision of cable services. In particular, local governments have no more than 90 days to act on franchise agreement requests and can no longer require networks to be totally built out before service can be offered. In addition, local governments are limited to 5% compensation. Any requests for public, educational and governmental channel non-capital support or institutional networks would be deducted from the 5% franchise fee.

The concern among local governments is that the FCC order would invalidate current franchises, thereby imposing one size fits all judgments without any knowledge of local conditions and without accountability to local elected officials. Some citizens would be burdened more than others. It could also inhibit local authorities to regulate the rights of way and may eliminate the ability of local governments to conduct franchise renewals and ensure that the communications networks are responsive to local needs and interests.

On average, 19% of city general fund revenues come from utility taxes and franchise fees. Should cities lose this revenue, the cities argue that there would be serious implications for their ability to provide other needed services. Exemptions to the definition of Gross Revenues would limit amount cities receive for compensation of valuable public rights of way. And in some cases, it would remove the ability for cities to charge for permits. The basis for charging for land use, street use, and any other type of permits would then be jeopardized.

## **IX. Examples of Reform at the State Level**

### **a. Florida<sup>16</sup>**

The 2001 law establishing the communications services tax was designed to restructure taxes on telecommunications, cable, direct-to-home satellite, and related services. The law replaced and consolidated several different state and local taxes with a single tax comprised of two parts: the Florida communications services tax and the local communications services tax.

<b>Old Tax Structure (Before October 1, 2001)</b>	<b>New Tax Structure (After October 1, 2001)</b>
<p>Number of Taxes = 7</p> <ul style="list-style-type: none"> <li>State Sales Tax</li> <li>Local Option Tax</li> <li>Gross Receipts Tax</li> <li>Public Service Tax</li> <li>Cable Franchise Fee</li> <li>Telecom Franchise Fee</li> <li>Cable and Telecom Permit Fees</li> </ul>	<p>Number of Taxes = 2</p> <ul style="list-style-type: none"> <li>State Communications Services Tax</li> <li>Local Communications Services Tax</li> </ul>

<sup>16</sup> Florida Department of Revenue

Communications services include telecommunications, cable, direct-to-home satellite, and related services. This definition encompasses voice, data, audio, video, or any other information or signals, including cable services that are transmitted by any medium.

Some examples of services subject to the tax are:

- Local, long distance, and toll telephone
- Cable television
- Direct-to-home satellite
- Mobile communications, including detailed billing charges
- Private line services
- Pager and beeper
- Telephone charges made by a hotel or motel
- Facsimiles (FAX), when not provided in the course of professional or advertising service
- Telex, telegram, and teletype

In general, the tax includes a state rate of 6.8 percent plus a gross receipts tax rate of 2.37 percent, for a combined state communications services tax rate of 9.17 percent. Each local taxing jurisdiction may levy its own local tax rate on communications services. The communications services tax has its own annual resale certificate that is separate from the one issued for sales and use tax.

Direct-to-home satellite services are taxed at a total rate of 13.17 percent. Local tax does not apply to these satellite services.

While the state and gross receipts tax rates stay fairly constant, local tax rates can change frequently. Consumers who purchase taxable communications services from a seller that does not collect tax are required to report and remit use tax.

**b. Virginia<sup>17</sup>**

Under legislation enacted by the 2006 General Assembly, House Bill 568, the new Virginia communications sales and use tax, also referred to as the communications sales tax, replaced most of the current state and local taxes and fees on communications services, effective January 1, 2007. The new communications sales tax, which is imposed on the charge for or sale of communications services at the rate of 5%, is generally collected from consumers by their service providers and remitted to the Department of Taxation. In cases where a consumer purchases taxable communications services and no tax is collected by the service provider from the consumer on the purchase by the service provider, the consumer is responsible for paying a communications use tax.

Also, a uniform statewide E-911 tax of \$0.75 per line replaced the local E-911 taxes imposed for landline telephone service. In addition, the public rights-of-way use fee currently imposed on landline telephone service are also imposed on cable television service. House Bill 568 also

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<sup>17</sup> Virginia Department of Taxation

changed the way that cable service providers pay the franchise fees on their local cable franchise agreements.

**Impact on current taxes and fees:** The communications sales tax replaced the following state and local taxes and fees on communications services:

- Local consumer utility tax on landline and wireless telephone service
- Local E-911 tax on landline telephone service
- Virginia Relay Center assessment on landline telephone service
- A portion of the local Business, Professional and Occupational License tax assessed on public service companies by certain localities that impose the tax at a rate higher than 0.5%
- Local video programming excise tax on cable television services
- Local consumer utility tax on cable television services

Along with the new communications sales tax, the landline E-911 tax and the cable television public rights-of-way use fee, the following taxes continue to be imposed:

- State E-911 fee on wireless telephone service
- Public Rights-of-Way Use fee on landline telephone service
- Local Business, Professional and Occupational License tax of 0.5% on public service companies

**How the communications sales tax will be administered:** The communications sales tax is generally administered in the same manner as the Virginia Retail Sales and Use tax. The tax is imposed on communications services at the rate of 5%, and appears as a line item on customers' bills.

**Taxable services:** The services subject to the communications sales tax include but are not limited to:

- Landline and wireless telephone services (including, but not limited to local, intrastate, interstate and international service) including Voice Over Internet Protocol;
- Teleconferencing services;
- Private communications services;
- "Push to talk" services;
- Pager and beeper services;
- Automated or partially automated answering services;
- Facsimile services;
- 800 number services;
- Telegraph, telegram, telex and teletypewriter services;
- Cable television (including but not limited to basic, extended, premium, pay-per-view, digital and music service); and
- Satellite television and satellite radio.

**Nontaxable services:** The following services are not subject to the communications sales tax.

Information services  
Installation or maintenance of wiring or equipment on customers' premises (may be subject to retail sales and use tax)  
Sale or rental of tangible personal property (may be subject to retail sales and use tax)  
Directory and other advertising  
Internet access service  
Digital products that are delivered electronically, such as software, downloaded music, ring tones, and reading materials  
Over-the-air radio and television services broadcast without charge  
Bad check charges  
Charges for billing and collection services

**Taxable and nontaxable amounts:** The communications sales tax is imposed on the sales price of the taxable services. The following items are **not** included in the sales price for purposes of computing the tax:

Excise tax, sales tax and similar taxes that are permitted or required to be added to the sales price of the service, provided the taxes are separately stated on the customer's bill  
Federal, state and local government fees and assessments that are required to be added to the price of service, provided these items are separately stated on the customer's bill  
Coin-operated communications services  
Sale or recharge of a prepaid calling service  
Air-to-ground radiotelephone services  
A provider's internal use of communications services in connection with its business of providing communications services to customers  
Separately stated charges for property or services that are not part of the sales of communications services  
Sales for resale  
Charges for communications services provided to a federal, state or local government entity

### **Landline E-911 tax**

The new state E-911 tax on landline service, imposed at the rate of \$0.75 per line, also appears as a line item on customers' bills.

### **Cable franchise fees**

Under the provisions of House Bill 568, cable franchise agreements that are entered into or renegotiated after January 1, 2007, do not include a franchise fee. Agreements in place as of January 1, 2007, will remain in effect until their stated dates of expiration; however, providers will no longer make franchise fee payments directly to localities. Instead, these amounts are reported to the Department of Taxation on a schedule submitted with the communications taxes return. The franchise fees will then be paid to localities from revenues generated by the communications taxes. Although localities will no longer collect their franchise fees directly,

local governments will retain the right to audit cable franchisees and to enforce franchise agreements.

### **Public rights-of-way use fee**

In addition to landline telephone service providers, cable television providers are now required to collect the public rights-of-way use fee from subscribers and include it in their monthly communications taxes return and remittance. The amount of the fee is determined annually by the Virginia Department of Transportation. Initially, the fee will be \$0.64 per subscriber per month.

### **Virginia Relay Center**

The Virginia Relay Center, a telephone relay service for the hearing impaired, will receive funds each month from the communications tax revenue. No separate tax or fee will be assessed on customers' bills for the Relay Center.

### **Disbursement of funds received with communications taxes returns**

After payment for the direct costs of administration of this tax and for the Virginia Relay Center, remaining revenues received from the communications sales tax, the E-911 tax, and the public rights-of-way use fee will be distributed to counties, cities and towns.

### **Role of local governments after January 1, 2007**

Once the provisions of House Bill 568 take effect, localities will continue to audit and collect bills for local communications taxes for periods **prior** to January 1, 2007. In addition, localities may continue to audit cable providers to enforce cable franchise agreements.

## **X. Previous Recommendations for telecommunications tax changes in Washington State**

The 1996 and 1997 reports issued by Governor Lowry's Telecommunications Policy Coordination Task Force provide a starting point for discussions of state and local telecommunications tax reform.

### **a. 1996 First Telecommunications Report and Task Force Recommendations**

The 1996 Report states that the principles of adequacy, stability, and economic neutrality suggest that any change in the taxation of the telecommunications industry should ideally be revenue neutral, meaning that the telecommunications industry as a whole should bear the same total tax burden that applies under the law at that time, though the relative share of total tax burden may shift among various segments of the industry. Moreover, the Report further states that the tax burden on telecommunications users should remain revenue neutral, meaning that all users of

various telecommunications technologies should collectively bear the same total tax burden, even though the tax on a particular group of users of technology may go up or down.

Equity requires that businesses within the telecommunications industry should be taxed in the same manner when providing comparable goods and services. Because of the convergence of technologies, historically distinct segments of the industry have begun to offer similar goods and services. For example, if a cable television company provides two-way voice or data transmission, there is no basis for taxing it differently than a traditional telephone company providing the same services.

Based upon the principle of equity, the Task Force considered three taxation options: (1) a gross receipts tax on providers; (2) a consumption tax on customers; or (3) a combination of both. The Task Force decided that option 3 would be the most desirable in that it places the tax burden on the provider as well as the consumer. Several recommendations by the Task Force included:

- Extend the sales tax to cable services
- Reduce the B&O tax rate paid by cable companies to the 0.471 percent retailing rate
- Reduce the state sales tax on telecommunications to 5.476 percent from the 6.5 percent

The Task Force also acknowledged that the goal of equalizing the tax burden on all telecommunications providers was complicated by differing local tax and franchise fees. One thought was to impose tax only at the state level, but to earmark a portion of the tax for local governments and distribute it according to a formula.

In sum, the Task Force urged Washington to conduct further studies on these issues and potential options presented in the 1996 Report as a means of addressing and ultimately resolving the question of fairness and overall tax equalization for the telecommunications industry.

## **b. Central Assessment**

All telecommunications providers operating in multiple counties or states should be centrally assessed by the Department of Revenue for property tax purposes. Telephone companies are already centrally assessed, but cable companies are currently assessed by local county assessors on property located in each individual county. The 1996 Report urged central assessment of cable companies once they begin providing two-way communication. Today, cable companies are now providing Internet, cable, and voice services.

Additionally, the state should conduct a comprehensive review of city and county franchise and utility tax policies with the goal of ensuring that these tax burdens are equalized among all telecommunications providers.<sup>18</sup>

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<sup>18</sup> Recommendation in *Building the Road Ahead: Telecommunications Infrastructure in Washington State*, First Report of the Governor's Telecommunication Policy Coordination Task Force, p. 49-50 (April, 1996).

**c. 1997 Second Telecommunication Report and Task Force Recommendations**

The excise tax treatment of telecommunication services must be changed in order to simplify the tax structure, remove current inequities, eliminate barriers to innovation, and promote free and fair competition among telecommunications service providers.

The following three options were recommended to meet these goals:

- 1) Telecommunications transmission services, such as telephone services, internet access, basic cable, and basic direct broadcast, provided to consumers would be defined as retail sales. (Currently, telephone services provided to consumers are defined as a retail sale, internet access is taxed as a Selected Business Service (now Service and Other Activities) and basic cable is taxed as a Service & Other Activity.)

Providers of transmission services to consumers would pay Retailing B&O tax at the rate of 0.471%. Providers of transmission services for resale would pay Wholesaling B&O tax at the rate of 0.506% (0.484% as of July 1, 1997).

Consumers of telecommunications transmission services would pay retail sales tax, but under a lower state sales tax rate of approximately 5.9%.

Telecommunications content services, including premium cable and premium direct broadcast, would be taxed as a service activity. Content providers would pay Service and Other Activities B&O tax at the rate of 1.829% (1.75% as of July 1, 1997).

Consumers of content services would pay no state or local sales tax.

The sales tax exemption for telephone service, other than toll service, to residential customers would be retained; however, optional services (such as voice mail, caller identification, and call waiting) provided to residential customers would become subject to sales tax.

Local sales tax rate on telecommunications transmission services would remain the same, but since the local tax base would now include basic cable, basic direct broadcast,<sup>19</sup> and optional services provided to residential customers, local governments would see an increase in local sales tax revenues.

A state B&O credit would be allowed for any local business taxes paid in excess of 6.0% of gross income.

- 2) Same as Option 1, except the state sales tax rate would remain at 6.5%, and there would be no B&O tax credit for local business taxes.

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<sup>19</sup> Assuming that the federal Telecommunications Act of 1996 will allow application of local sales taxes administered by the state.



Local sales tax rate would also remain the same, but since the local tax base would now include cable television service and direct broadcast service,<sup>20</sup> local governments would see an increase in local sales tax revenues.

- 3) All telecommunications services, both transmission and content, would be taxed as a service activity.

Providers would pay Service and Other Activities B&O tax at the rate of 1.829% (1.5% as of July 1, 1998).

Consumers would pay no state or local sales tax.

There would be no B&O tax credit for local business taxes.

There would be a substantial loss of state sales tax revenues, partially offset by higher B&O tax rate on telecommunications providers.

There would be a substantial loss of local sales tax revenues.

Any of these options would equalize the tax burden among telecommunications service providers at the state level; however, none of these changes address the significant differences in tax treatment at the local level. One way to address the problem is to allow a B&O credit for local business taxes.

The Task Force eventually recommended Option 1 as the best preferred option. In doing so, it stated:

Option 1 would "flatten the peaks" somewhat by allowing a partial B&O credit for telecommunications businesses that currently pay local business taxes in excess of 6% of gross income. The credit would be equal to the amount by which local business taxes exceed 6% of gross income. As part of this approach, local governments would be prohibited from taxing these businesses at a rate higher than 6%. (Local governments that currently impose taxes at rates exceeding 6% could continue to do so under a "grandfather clause.")

Though a partial B&O credit for local business taxes would not completely offset the industry's total B&O tax liability, some individual telecommunications businesses may still not have sufficient state B&O tax liability to claim the full credit for local business taxes. This could occur if all or a substantial portion of a provider's business happens to be subject to a particularly high local business tax. For example, a small telephone company doing business in Spokane would never have enough state B&O tax liability to use up the entire credit for local business taxes paid.

A partial B&O tax credit for local business taxes is included as part of Option 1.

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<sup>20</sup> Id.

## **XI. Summary**

New telecommunication technologies have emerged, and existing technologies have advanced. Meanwhile, new and existing telecommunication tax policy issues remain unresolved and open for constructive debate. As issues continue to rise at the federal level, states in general, and Washington in particular, should take the policy lead and continue to substantively address and urge meaningful tax reform at both the state and federal levels.

The Department's September telecommunications conference should begin the process of discussions between the state, local governments, and the telecommunications industry to once again meaningfully address potential telecommunications tax reform in Washington. Many of the issues and discussions surrounding this topic have been laid out in the 1996 and 1997 Reports by Governor Lowry's Telecommunications Policy Coordination Task Force. The technologies may have changed, but the landscape surrounding core telecommunications tax policy issues has not changed since last addressed over ten years ago.