Report of the Working Group on Taxation of Telecommunication Services

February 18, 1999

1997 Minn. Laws Chap. 231
Art. 5 Sec. 18 Subd. 4

Introduction

The Legislative Coordinating Commission's working group to study the taxation of telecommunication services was created by Laws 1997, chapter 231, article 5, section 18. Its chairs and members are as follows:

Co-chairs: Senator Steve Kelley
Representative Alice Johnson
Brian Baxter, Baxter Books

Members: **Senate members** – Senators Ellen Anderson, Steve Kelley, David Knutson, John Marty, Steve Murphy, Linda Runbeck

House members – Representatives Andy Dawkins, Alice Johnson, Dee Long, Ann Rest, Howard Swenson, Torrey Westrom

Public members – Brian Baxter, Baxter Books; Michael O'Conner, Go.Fast.net; Richard Lehman, IBM; Bobby Wangaard, Minnesota High Technology Association

Legislative Charge

The enabling legislation requires the working group to undertake the following responsibilities:

- study existing and emerging tax policies, both federally and nationally, that apply to telecommunications and computer industries and identify any inequities which may exist in the current system of taxation as it applies to those industries;

- identify potential for erosion of the sales tax base as a result of evolving technologies in the telecommunications and computer industries;

- consider methods of addressing potential impediments to extension of state taxes to emerging technologies; and

- suggest options for changing the tax system to maintain or broaden the sales tax base and to provide equitable tax treatment for users of existing and emerging technologies.

Meetings

The working group met on the following dates to discuss the relevant issues, hear staff presentations, and take public testimony. Handouts from major presentations are included in the appendices.

July 14, 1998 – Organizational meeting
– Alan Johanningsmeier, Greg Heck, and Joan Tujetsch, Department of Revenue, presented an overview on Taxation of Telecommunications services.

Oct. 7, 1998 – Oral update on the Internet Tax Freedom Act bill by Richard Lehman, IBM
– Presentation by Nancy O'Brien of IBM on the Internet, intranets, and extranets
– Larry Wilkie and Alan Johanningsmeier, Department of Revenue, the 1996 Sales Tax Policy Team Report on Telecommunications (Appendix B)

Oct. 30, 1998 – Presentation by Scott Mackey, National Council of State Legislatures, on the NTA/FTA Communications and Electronic Tax Project (Appendix C)
– Presentation by Greg Heck, Department of Revenue, on sales tax and Nexus issues as it relates to Electronic Commerce (Appendix D)
– Presentation by Tom Ellerbe, Department of Revenue, and Pat Dalton, House Research, on the effect of electronic commerce on Minnesota sales tax revenues (Appendix E)
– Testimony from retail and local government representatives: Brian Baxter, Baxter Books; Annette Henkel, Minnesota Retail Merchants Association; Gary Carlson, League of Minnesota Cities

Nov. 12, 1998 – Presentation by Keith Carlson - Director, Senate Tax Analysis, and Jeanne Cochrane, House Research, on state taxes and fees applicable to communication and data service providers (Appendix F)
– Testimony from industry representatives: Mike Martin, Minnesota Cable Communications Association; Paul Fortney and Mr. Adkins, U.S. West; David Jones, Hubbard Broadcasting Inc.; Dennis Fazio, MNNet/Minnesota High Technology Association

Dec. 3, 1998 – Presentation by Keith Carlson - Director, Senate Tax Analysis, on intangible goods and "functional equivalents" sold over the Internet (Appendix G)
– Presentation by Greg Heck, Department of Revenue, on Minnesota sales tax policy as it relates to intangibles (Appendix H)

Dec. 30, 1998 – Discussion and adoption of recommendations for the report

Jan. 27, 1999 – Discussion and adoption of recommendations for the report

Working Group Recommendations

Recommendation #1

That the state support a federal or national solution to the issue of imposing sales tax on Internet and other remote commerce.

Under the commerce clause of the U.S. Constitution, the states are limited in their ability to require Internet and other remote sellers to collect sales and use taxes. Federal legislation could permit states to require collection of these taxes and the working group recommends that a memorial resolution advocating such federal legislation be adopted by the legislature and transmitted to Congress. A draft of the resolution is attached in Appendix A.

As an alternative to federal legislation, several national groups are working toward an agreement to enable states to collect taxes due on electronic and other remote commerce in exchange for the states' participation in a simplified sales and use tax structure and means of administration. The working group recommends that the legislature and the executive branch support efforts to reach a national solution regarding taxation of the Internet and of electronic commerce, including a solution which may limit Minnesota to a single statewide use tax rate. In assessing any proposal for a national solution, the legislature and the executive branch should consider the degree to which the proposal gives the states flexibility in adopting and administering their own sales and use tax policy.

In light of the possibility that a national solution may limit Minnesota to a single statewide use tax rate, the working group also recommends that caution be used in reviewing future requests for new local option sales taxes.

Recommendation #2

The Department of Revenue should monitor the NTA telecommunications work group and the Internet Tax Freedom Act commission efforts and report to the tax chairs of the house and senate on a regular basis regarding any significant developments.

The National Taxpayer Association (NTA) is currently hosting meetings between representatives of state and local government, representatives of the business community, and academics in an effort to develop a proposal that is agreeable to all parties regarding taxing Internet and other remote sales. This group is planning on making recommendations on a national solution to the Internet Tax Freedom Act Commission within the next six months.

The Internet Tax Freedom Act set up a commission to recommend to Congress a national solution regarding taxing the Internet and electronic commerce. The commission is to make its final report within 18 months of the commission's appointment. The commission is made up of representatives from the federal government, state, and local governments and various sectors of the business community. The commission is to consider any recommendations made by the NTA telecommunications working group.

In order for the legislature to react or provide input to any proposals made by these national groups on the issue of Internet and electronic commerce taxation the legislature needs to be kept informed of their discussions. The Department of Revenue is currently monitoring the activities of these groups. We ask that the Department share that information regularly with members of the legislature.

Recommendation #3

Expand, clarify, and modernize the definition of telecommunications used in the sales tax law to reflect technology changes in the provision of telecommunications services and provide for a level playing field among the providers of telecommunications services.

The current sales and use tax law does not contain a definition of "taxable telecommunications" or "telephony." The law instead enumerates various types of telephone services that are subject to tax along with other taxable "utilities." Cable television services are taxable under another provision and data transmission is not currently taxable.

As the technologies for providing two-way voice, video, and data services converge, the transmission system becomes divorced from the type of telecommunications provided. In the future two-way voice, video, and data services may be provided to a consumer over the same transmission system and a transmission system that currently can carry only one type of telecommunication service will be able to carry all types. In addition, the transmission carrier may or may not be the "provider" or seller of the telecommunications service.

The Department of Revenue should propose to the legislature a new definition of taxable telecommunications for sales tax purposes. Because of the technical knowledge needed to understand the impact of the new technologies on the sale and delivery of telecommunication services, the Department should establish an advisory group of technology experts from the telecommunications industries to assist in the development of the definition. The goal will be a workable definition that will be fair and understandable to all telecommunications providers and their customers, specific enough to allow administration of the tax, and broad enough to encompass technology changes that occur in the future.

In addition to developing a new definition of taxable telecommunications, the Department of Revenue should study the issue of taxing "bundled services," particularly as it relates to telecommunications. The department should enact rules that will allow for consistency and equity in assessing the sales and use tax on taxable services bundled with other services.

Recommendation # 4

Improve consumer awareness of the existing use tax and eliminate obstacles to consumer compliance.

Although federal law currently prohibits the state from forcing out of state sellers to collect the Minnesota sales tax, businesses and individuals still owe a complementary use tax on these purchases. Most businesses are aware of this obligation and generally remit the tax. Additionally the Department of Revenue audits businesses to insure compliance with the use tax.

Most individual consumers however are not aware of their obligation to pay use tax. Under current law individuals owe use tax if their personal purchases subject to use tax exceed $750 per year. The only notice most individuals receive of this tax obligation is in the individual income tax instruction booklet. A brief discussion, along with a telephone number for further information and forms, appears on the bottom of page 5, right after the section on use of information provided on income tax forms. The Department makes no effort to audit individuals for use tax payment.

In national discussions, representatives of Internet sellers and direct marketers have questioned why they should be required to collect state use taxes when the states make no effort to collect this tax from individuals. In addition, the lack of awareness of this current tax obligation causes buyers to cry "tax increase" whenever there is discussion of shifting the collection of these taxes to the remote seller.

The Department of Revenue should make an effort to educate taxpayers regarding their current obligation to pay use tax. The process of paying the tax should also be simplified as much as possible. Both administrative and legislative actions should be considered in accomplishing this goals. One possible action, requiring legislative approval, for raising the visibility of the use tax and increasing the ease of compliance would be to include a use tax line on the individual income tax form.

Recommendation # 5

Provide a sales tax exemption for currently taxable goods that face significant competition from the electronic sale of "functional equivalents" sold over the Internet.

"Functional equivalents" are products that can be digitized or otherwise transferred electronically and serve the same purpose as the product in its tangible form. The most commonly mentioned examples of these functional equivalents are virtual books, and music and video downloaded from the Internet.

The sales tax in Minnesota generally applies to tangible personal property and a limited number of services. The tax does not apply to most intangible products; the exception being canned computer software which is defined as taxable regardless of its form. Economic distortion and inequities occur because sales of the tangible products are subject to sales tax while sales of their "functional equivalents" are not.

It is difficult to impose the state sales tax on these functional equivalents for two reasons. First, the sellers of these intangible goods are often from out of state and therefore do not have nexus for the purpose of collecting the sales tax. The larger problem however exists with "siting" an electronic sale. If a Minnesota resident while traveling bought a book in Texas, they would pay the Texas sales tax. However, if a Minnesota resident while traveling in Texas ordered a virtual book on his laptop from a firm in Massachusetts and had it downloaded to his PC at home, it is not clear where the sale occurred. The problems with taxing intangible goods may require a national solution.

Because of the current difficulties in imposing a sales tax on functional equivalents and recognizing the inequities caused by different tax treatments for intangible and tangible goods, the working group recommends that the legislature consider exempting the goods listed in the table below from the sales tax. The estimated state revenue impact of exempting these goods is also included in the table.

Estimate of Potential Sales Tax Loss from Current Tangible Examples of Creative or Intellectual Properties

(in millions of dollars)

• fiscal year	2000	2001	2002	2003
• periodicals	(3.0)	(3.5)	(3.5)	(3.5)
• books	(19.8)	(22.2)	(22.8)	(23.4)
• print ads	(13.8)	(15.7)	(16.2)	(16.8)
• music	(13.7)	(15.8)	(16.7)	(17.6)
• videos	(17.1)	(19.8)	(20.9)	(22.2)
• software	(75.9)	(87.4)	(92.3)	(97.5)
• Total	(143.3)	(164.3)	(172.4)	(181.0)

Recommendation # 6

Impose the TAP fee on cellular telephones.

The TAP fee is used to fund the Telephone Assistance Program, a program which provides financial assistance to low-income elderly and disabled persons for basic telephone service. The monthly TAP fee is currently $0.06 per access line. Cellular phones are the only form of local voice transmission that is currently exempt from this fee.

At the time the TAP fee was first adopted, cellular phones were not common and were viewed as a "secondary" phone. Most people who owned a cellular phone also had a traditional line-based service and were paying the TAP fee on that access line. Today cellular telephone use is widespread and growing. Because of reduced costs, many cellular phone companies are now advertising these as "the only phone you'll need." If cellular phone service replaces wire-based service as the primary service for many people, there will be an erosion in TAP fee revenue.

To impose the TAP fee on cellular phone service would require modifying M. S., section 237.69, subdivision 5, the definition of "access line" that is subject to the surcharge. A bill that, among other things, extended the TAP fee to cellular phone services was passed during the 1998 legislative session (1998 Laws, Chapter 378) but was vetoed by the governor.

Recommendation # 7

Enact legislation to clarify that the 911 surcharge applies to telephone service provided by competing local exchange carriers (CLECs).

The 911 surcharge is imposed on telephone users to fund the 911 and enhanced 911 emergency service system. Currently the monthly charge is $0.27 on each telephone service capable of making a 911 call. This applies to service provided by incumbent local exchange carriers

(ILECs)[1] and cellular phone companies but does not apply to "telecommunications carriers" as defined in M.S., section 237.01, subdivision 6. Telecommunications carriers include both long distance telephone companies and competitive local exchange carriers (CLECs). To correct this inequity, M.S., section 403.11, subdivision 1e should be modified to require customers of "telecommunications carriers providing local exchange service" to pay the 911 surcharge.

Currently some but not all CLECs are collecting the 911 surcharge from their customers, even though not required by law. US West indicated that they currently collect this fee for CLECs who resell their service. Some facilities-based CLECs may also be collecting this surcharge.

Recommendation # 8

Extend the sales tax exemption on capital equipment to include equipment used in providing telecommunications services.

There are several reasons for exempting capital equipment used in providing telecommunications services. The current tax on this equipment causes economic distortion by favoring businesses that provide telecommunications services through technology that does not require property in the state to deliver the service. Satellite telecommunications is given a competitive advantage over lined based telecommunication services.

In the last few years, the state has moved in the direction of reducing sales taxes on business inputs and making the sales tax more of a pure tax on final consumption. Exempting capital equipment purchases by telecommunication industries would be consistent with this goal. It would reduce double taxation or "pyramiding" of the sales tax within these industries. It would also send a welcoming message to telecommunication firms looking to locate in this state. This would require legislative action. The estimated state revenue loss from exempting capital equipment purchases by telecommunications firms, if enacted for purchases after June 30, 1999, would be as follows:

FY 2000	\$ 41.5 million
FY 2001	\$ 46.8 million
Biennium	\$ 88.3 million
FY 2002	\$ 50.6 million
FY2003	\$ 53.5 million
Biennium	\$104.1 million

[1] An ILEC is the established local telephone company that provided service in an area before competition was permitted by law. In contrast, a CLEC is a company which competes for local telephone business with the ILEC. CLECs may be a reseller who buy capacity from an ILEC and resells it, or a firm that has its own telecommunications equipment and facilities.

Appendix A

A house resolution

memorializing the President and Congress to permit states to require Internet and other remote sellers to collect state sales and use taxes.

WHEREAS, without action by Congress the United States constitution may prohibit states from requiring certain Internet and mail or telephone sellers to collect state sales and use taxes; and

WHEREAS, this prohibition may cause states to lose sales and use tax revenues as more commerce occurs by means of Internet and mail or telephone sales; and

WHEREAS, the inability to require Internet and other remote sellers to collect sales and use taxes results in a competitive disadvantage to local businesses who must collect use taxes; and

WHEREAS, the inability to require Internet and other remote sellers to collect sales and use taxes creates an inequity between consumers who have Internet access and those who do not; NOW, THEREFORE,

BE IT RESOLVED by the Legislature of the State of Minnesota that Congress should speedily enact legislation to permit the states to require Internet and other remote sellers to collect sales and use taxes, and that such legislation should provide the states as much flexibility as possible in adopting and administering their own sales and use tax policies to best meet the particular needs of their state and local governments.

BE IT FURTHER RESOLVED by the Legislature of the State of Minnesota that in the absence of Congress enacting legislation as requested above, that congress should support a national multi-state agreement or solution that would permit states to require Internet and other remote sellers to collect sales and use tax. Support by Congress should include enacting any legislation needed to make the agreement enforceable.

BE IT FURTHER RESOLVED that the Secretary of State of the State of Minnesota is directed to prepare copies of this memorial and transmit them to the President of the United States, the President and the Secretary of the Senate, the Speaker and Clerk of the House of Representatives and Minnesota's Senators and Representatives in Congress.

Appendix B

Final Report

Sales Tax Policy Team on Telecommunications

July 31, 1996

Introduction

This report is prepared and presented according to the instructions given at the team's inception. The team's task was to study, evaluate and recommend actions affecting Department of Revenue policies on the taxation of telecommunications. This report presents the team's consensus and the team made every effort to comply with the guidelines for the Sales Tax Policy Project.

Discussed in more detail elsewhere in this report, the term telecommunications requires a working definition before continuing. The team used part of the definition proposed by the Multistate Tax Commission's Uniform Principles Governing State Transactional Taxation of Telecommunications (adopted in July 1993). The first two paragraphs of the proposed definition proved invaluable to the team and stands as the definition used for this final report. It reads as follows:

Telecommunication, ...includes, without limitation,

(1) any one way transmission or any two way, interactive transmission of sounds, signals, or other intelligence converted to like form, which effect or are intended to effect meaningful communications by electronic or electromagnetic means via wire, cable, satellite, light waves, microwaves, radio waves or otherwise;

(2) the transmission of messages, programming or information through use of local, toll and wide area telephone service; private line services; channel services; telegraph services; teletypewriter; computer exchange services; cellular mobile telecommunication service; specialized mobile radio; stationary two way radio; paging service; or any other form of mobile and portable one-way or two-way communications; or any other transmission of messages, programming or information by electronic or similar means between or among points by wire, cable, fiber-optic, laser, microwave, radio, satellite or similar facilities.

Examples of services under this definition include:

1) On-line computer access (e.g. Prodigy, America On-Line)
2) Dow Jones/Quotron services (i.e. stock market quotations)
3) News services (e.g. UPI, AP)
4) Direct access satellite
5) Teller machines/electronic funds transfer
6) Cable television
7) Telephone, telegraph

8) Medical monitoring (e.g. remote heart monitors)
9) Security services (i.e. monitored alarms)
10) Pagers
11) Global Positioning Satellites/Services (GPS)
12) Video dial tone (i.e. movies over telephone lines)
13) Interactive television
14) Additional charges for customized services on the above basic services

History of current laws and interpretations

Appendix A is a discussion on the history of telecommunications taxation in Minnesota.

The following paragraphs summarize our current situation (as known at the publication date of this report).

Minnesota taxes certain specific telecommunications services, such as telephone and cable television services, and some by reference, such as remote monitoring of alarms taxed as detective services. Other telecommunications services, like Internet access, are not currently subjected to Minnesota's sales and use tax.

The majority of states examined impose tax on telecommunications services through specific industry taxation. The most common industry is telephone companies, while the next most common industry appears to be cable television services. The statutory language is usually broadened only with references to similar services.

A notable, and quite recent, exception is Texas. At this date, no statutes or regulations have been obtained by the team, but an article in a tax publication refers to law changes enacted that tax Internet access, web pages, Automated Clearing House transactions, creating logos or graphics and database access on the Internet.

New York is another state working on changes to taxation of services, including telecommunications.

Changes in other states highlight the need to examine our own statutes for adequacy in taxing telecommunications as those services change from traditional telephone and cable television services or are offered through non-traditional means.

Stakeholders

The pervasiveness of telecommunications in everyday life at the end of the century ensures that every business and every individual will be affected by technology. Any changes to existing statutes will necessarily affect everyone in Minnesota to some degree. Everyone becomes a stakeholder.

Two very broad categories of stakeholders are affected by any taxation of telecommunications--public and private. Arguably the most affected group would be the public sector. As consumers of telecommunications services, the public sector appears to be the single largest industry, segmented by level of administration. The Federal government, at the top level, is largely exempt from taxation at lower levels but can affect any and all taxing authorities by changing federal definitions, enacting laws and imposing preemptive regulations.

The state would be affected in several ways. First, as a consumer, the taxation of previously untaxed services will have potentially budget-reducing effects if new revenues are earmarked or budgets remain constant or are reduced. Of course, most of the services used are currently taxed under Minnesota statutes. Only newer services that may be used, like Internet services (if purchased), would be more costly. Second, the costs of administration would increase depending on the type of taxation method employed.

Local levels of government would likewise experience increased costs. Their costs could be more sensitive to changes if services were contracted rather than provided internally. Administrative costs would only marginally increase since the imposition of the tax is at a higher level. The greatest loss to local governments might well be cable television revenue should enactment or change to a higher-level tax supersede or exempt local fee charges.

Private industry segments include service providers and service users. Recent changes incorporated in the recent Federal Telecommunications Act allow consolidation and merger of previous competitors in the industry. The new entities are able to offer alternate (non-taxable) services in competition with currently taxable services. Many of these new companies, as well as traditional companies offering new products, find themselves offering both. These service providers will be the primary collectors of tax on their services and will, in some instances, be purchasers of services.

Discussions with private industry segments revealed an overall agreement that currently taxable services were facing increased competition from non-taxable services. These industries expressed the concern that such disparate treatment might continue to the detriment of their taxable services, unless these competing services were also taxable. A level playing field is the main criteria for any changes, or requested changes, to current statutes.

The final stakeholder is, of course, the consumer--that individual who pays the bills each month and notices the increasing cost of services. Although each of the previous stakeholders is a consumer to some extent, the ultimate burden falls on the individual who pays all taxes and supports the government, the industry and each other. This stakeholder would prefer to avoid paying more taxes in any form but also increases demand for services provided by government.

Problems with Taxing Telecommunications

Services currently available and those projected for the future will test both the patience and fairness of the taxing authority and the creativity and tax avoidance desires of the businesses offering the services. Telephone service is an example. Today, most can identify an instrument as a telephone because it has one end for listening, one end for talking and a series of numbers selected to connect to the other party with whom we wish to speak. Let's move forward in time, not too far, where we speak a name, a device interprets that name, issues connectivity commands, connects to the other party, shows us an image of them and an image of us to them and we speak as if we are sitting having coffee. Is that telephone service?

Technology will continue to change. The rate of change will become more rapid. Statute review will be mandatory on an annual basis.

A standard authority for the definition of services or categories of services that fall under this line of business is going to be a requirement for fairness to the businesses that offer the services and a protection against innumerable court cases at the state level. This may have to come at the federal level. The alternative is a proposal by the states through organizations such as the Federation of Tax Administrators or Multi-State Tax Commission.

Whoever sets the definition needs to work with industry and consumer groups to make certain the stage is set prior to enacting legislation.

This is going to take time. A go forward position may have to be to "take the lead" depending on how a state desires to promulgate services or raise revenues. Sharing experiences among states will be a definite advantage in the process of clarifying the work to be done.

It is likely that assessing these taxes simply as an additional contribution to the General Fund may be met with opposition from service providers and consumers. It will be viewed as simply another way of "raising existing taxes" or an imposition of a "new tax." Neither will be viewed as palatable in and of themselves. Florida is a good example of how the "taxability issue" has waffled in both directions in the last year as it attempted to enforce existing statutes.

If these revenues or additional revenues are raised to "assist in providing universal access service", there may be support from both providers and consumers. Texas, for example, has enacted a Telecommunications Infrastructure Fund to assist in this process.

The public policy issue of "information haves and have-nots" will become more visible as the range of offerings via networks becomes more stable. A part of that stability comes from reasonable expectations by the provider that the service can be profitable and by the consumer that it can be obtained at a fair cost in a reasonable time period. The ability to offer incentives to providers, similar to the Communications Act of 1934, benefits both parties to the transaction.

It will be less expensive for entities, both public and private, to offer information, whether for marketing or the common good, via electronic resources. Citizen groups are already gearing up for the expected fight for "universal access." The state needs to prepare to address these issues when any tax legislation or rulings are made.

Costs of compliance

If purchases over networks become as prevalent as some suggest ($2.5 billion to "tens of billions" by the end of the millennium), significant revenue losses can be expected by all states unless some agreements are reached in the interim. Difficulty in establishing nexus, a tangible personal property identity and other issues involved with electronic commerce will see a dramatic decline in transaction-based sales and use tax revenues unless the electronic commerce transactions can be legally, rationally and effectively identified.

Compliance will be costly unless the definitional phase is accomplished on a consistent basis across states. Although states may currently differ in the products they tax, clothing, medications, etc., the challenges to differences in the taxation of electronic commerce will likely be many. If there is no physical presence, no tangible property and the wires are the same in every state, different taxation levels in one state versus another is going to be a hard question to address and still achieve the goal of a level playing field for all the players. Uniformity among states is desirable, but if leveling the playing field means that every state taxes or exempts every transaction identically, that is unattainable.

Options Identified

The advantages and disadvantages of each option are discussed, as well as how each recommendation fits the Model Revenue Systems criteria of understandability, fairness, competitiveness, reliability and efficiency.

Option 1: Expand the sales tax law to include telecommunication services.

An option is to expand the current sales tax law to include telecommunications services. The sales tax statutes would include the following definition of telecommunications adopted from the Multistate Tax Commission (MTC).

Telecommunication, ...includes, without limitation,

(1) any one way transmission or any two way, interactive transmission of sounds, signals, or other intelligence converted to like form, which effect or are intended to effect meaningful communications by electronic or electromagnetic means via wire, cable, satellite, light waves, microwaves, radio waves or otherwise;

(2) the transmission of messages, programming or information through use of local, toll and wide area telephone service; private line services; channel services; telegraph services; teletypewriter; computer exchange services; cellular mobile telecommunication service; specialized mobile radio; stationary two way radio; paging service; or any other form of mobile and portable one-way or two-way communications; or any other transmission of messages, programming or information by electronic or similar means between or among points by wire, cable, fiber-optic, laser, microwave, radio, satellite or similar facilities.

Advantages

Ambiguities of what is taxable as telecommunication services may be clarified by expanding the current sales tax statutes. Gray areas and variations in the law may be reduced if the sales tax law specifically adds language defining telecommunication services. Although additional amendments to the existing statute may seem to add to an already complex law, the basics of the law are in place and an addition to the law would be easier to understand than an entire new set of rules.

A specific telecommunications services definition in the statute may eliminate the need to have issues litigated in court.

Adoption of the MTC definition may encourage other states to follow our lead. Uniformity with other states may increase compliance in the telecommunications area and increase consistency among states.

The structure for administering the tax is already in place so the administrative costs will be minimal if the sales tax law is modified to include telecommunications services. No new forms will be necessary and taxpayers know how to complete existing returns.

Expansion of the sales tax law to include telecommunication services should level the playing field for all service providers. The services, as opposed to the means of supplying the services, will be taxed equally for all providers.

Disadvantages

Adoption of the MTC definition seemingly encompasses technology on the horizon but is likely to be subject to interpretation as it relates to emerging technology. It is unrealistic to think that any definition will include all potential changes. The definition may also have less flexibility pertaining to changing technology since many transactions will be beyond the states reach under existing statutes and case law.

As with any aspect of the sales tax law, the telecommunications area may encounter potential revenue losses from the federal government and qualified exempt organizations. The expanded law may also open doors for an increased potential for new exemptions.

Law changes may create nexus and use tax issues not previously addressed.

Another problem may be the lack of consistency of taxable items among states which encourages tax shopping by businesses and for tax purposes can create nowhere transactions.

Model Revenue System Criteria

Understandability:
Since the sales tax statutes would only contain an addition to the existing sales tax law, the new law should be understandable; stakeholders are not learning new laws but merely an expansion of the current law.

Fairness:
All industries would be taxing the same services regardless of the means; therefore, the option is fair.

Competitiveness:
Competitiveness may also be accomplished if telecommunication services are taxed uniformly throughout other states.

Reliability:
Expanding the sales tax statutes to include telecommunication services would be reliable. Taxing telecommunication services equally for all providers would enable revenues to grow with economy over time while still being fairly well cushioned from business cycle fluctuations. If the law anticipates emerging technology, further statutory amendments may be avoided.

Efficiency:
Efficiency is apparent in low administrative costs due to a sales tax structure which is already in operation.

Option 2: Impose a separate tax on telecommunications services

Many states and the federal government levy excise or gross receipts taxes on telecommunications companies, principally telephone companies. Minnesota's gross earnings tax, repealed effective January 1, 1992, was imposed on telephone companies in lieu of real property taxes. Between 1967 and 1986 telephone companies were exempt from sales and use tax on central office equipment as well. Governments often have justified those taxes as convenient substitutes for others that are more difficult to administer uniformly, such as locally assessed property taxes, or as privilege taxes in exchange for exclusive franchises and the use of public and private rights of way.

Telecommunications is far more than telephone and cable television service. That diversification will only increase. Its magnitude may be uncertain, but its occurrence is not. Under any taxing scheme, legislatures and administrators will constantly struggle to amend and apply tax law to a highly dynamic industry. After the U. S. Supreme Court upheld Illinois' allocation of revenues from interstate telephone service in Goldberg v. Sweet, Stanley Cichowski, manager of the Illinois Department of Revenue's Sales and Excise Tax Legal Division, observed:

> It was clear that changes in Illinois law were needed. With deregulation of the industry, the emergence of new technology, new services and new retailers providing services, the ability of a state to identify taxable transactions, taxpayers and to allocate revenues subject to tax was reduced.

A discussion of the advantages and disadvantages of a separate tax follows.

Advantages

A tax imposed on particular services may best achieve its goals under a new statute. Additional definitions, exemptions, rates or other provisions added to Chapter 297A will further complicate an already complicated body of tax law. Significant departures from existing sales and use tax law, if policy argues for it, can be more clearly and usefully organized in a separate chapter.

Future policy decisions would be more easily implemented if they are not constrained by sales tax statutes, case law, rules and other precedent. An example is exemptions under Ch. 297A. A separate law imposing a tax on the purchaser would not have to grant exemptions to nonprofit organizations. Placing the tax on the telecommunications service provider rather than the customer would allow taxation of business done with the federal government and Indian governments. States are preempted from taxing them directly due to supremacy provisions in the U. S. Constitution.

A separate tax allows for greater flexibility in a number of areas: who is the taxpayer, tax rate(s), reporting requirements, administrative procedures, etc. Such a chapter also may be more readily adaptable to future amendments.

Nexus standards may be lower for a receipts or excise tax than they are for a sales tax, reducing or eliminating the need for a use tax.

In the 1996 legislative session, a bill was proposed to tax telecommunications services to fund equal and affordable Internet access for all regions of the state. Designating revenues would be easier with a separate tax than with the existing sales tax. We recognize, however, that this "advantage" is contrary to the general policy against earmarking revenues. The benefits of taxing telecommunications would be more easily evident if a telecommunications tax were a being unto itself, especially if the receipts were dedicated.

Technical and policy expertise would develop if there was a special telecommunications tax with staff devoted to that industry and its specific tax issues. A more deliberative policy, a greater appreciation of the industry's nuances and, as a result, more even-handed policy and legislative proposals would be encouraged.

Disadvantages

Depending on the course we take, we may have no model after which to design a comprehensive telecommunications tax. If so, the body of administrative practice and case law would be less developed. Legal and administrative precedent would be inferred from other statutes, including other states' laws, with similar provisions. MinnesotaCare is a recent example of new tax law with its attendant growing pains, learning a group of related businesses, policy development and litigation.

Additional administrative costs would be incurred whether it be a new division or unit or an additional burden distributed among existing staff. Additional costs would be incurred for taxpayer education; forms design, printing and distribution; processing; accounting;

systems design; audit; enforcement; possible equipment purchases; staff time, either additional or diverted from existing duties; and other miscellaneous items.

Whenever a new tax is imposed on a particular classification of taxpayers, identifying and notifying all affected taxpayers is a large task and one highly susceptible to errors of omission and over-inclusion.

An additional compliance burden would be placed on taxpayers. They likely would have another form to file and another tax law with which to become familiar.

Coordination with or within Sales Tax would be required to assure that a tax in lieu of sales tax did not produce any double taxation or gaps, i.e., transactions inadvertently escaping any form of taxation.

Writing the law would be laborious. As with many new tax laws, there would likely be amendments for the first several years to resolve ambiguities and address situations not considered in the original legislation. In addition, advancing technology would require continual examination of the statute to keep it current.

Defining the tax base may remain elusive under any tax scheme. A new tax law is not a panacea.

A new tax law, no matter how carefully crafted, might invite litigation that otherwise would not take place. Depending on the statute, litigation might include constitutional challenges. Any new tax, even if revenue neutral, would face resistance simply because it is new.

Model Revenue System Criteria

Understandability:
A separate tax on telecommunications services may be more understandable than a further amended sales tax. Perhaps not all sales tax law is applicable to telecommunications. Modifying Chapter 297A to accommodate telecommunications policy will make the chapter more unwieldy for those seeking information related to telecommunications only. As sales tax law develops in general, it may move further from model telecommunications tax policy and thus require even further amendments to Chapter 297A if that remains the instrument of telecommunications taxation. To address unique issues and organize telecommunications tax law, a separate chapter would be a great benefit.

Some policy and administrative issues may remain uncertain as the law develops.

Fairness:
If a separate tax is inherently better able than sales tax to address telecommunications and do so comprehensively, then it is fairer because like services will be accorded equal treatment. Taxation (nexus issues aside) will be uniform regardless of the method of transmitting voice, data and pictures. That assumes, of course, that the political process creates no advantages for certain technologies or classifications of taxpayers. Fairness does not depend on a separate tax, however.

Competitiveness:
Minnesota's ability to compete for business activity depends on whether or not we tax telecommunications, not necessarily on the type of tax that is imposed. In fact, states are increasingly departing from uniform tax treatment to entice businesses to locate or expand in their jurisdictions. Businesses that rely heavily on telecommunications might find tax policy affecting their business either for good or ill. Competitiveness depends on a variety of factors including tax base, rates, overall tax burden, overall costs, availability of suitable labor, other states' business climate, and government services delivered.

Reliability:
Telecommunications is a growing field. Its growth rate will likely depend on economic prosperity and emerging technologies. Traditional services, such as local exchange telephone and lower tier cable television service are less affected by economic fluctuations than other market sectors. Some communication services may wax and wane with the general economy. A balanced, stable telecommunications tax, whether a separate tax or a sales tax of some kind, should be fairly reliable. It would also afford businesses some assurance in doing their tax planning.

Efficiency:
A separate tax on telecommunications would be less efficient than other alternatives in that it would require taxpayers to learn another tax law and likely file another form. The department would incur additional costs as outlined earlier.

If a separate tax made compliance easier, taxpayers and the department may gain some efficiency by reducing office and field compliance costs.

Option 3: Separately tax each type of telecommunications service

As technology in the telecommunications area has changed, Minnesota sales and use tax law has been modified to tax or exempt specific products and services. This option is retention of the status quo: continued use of the sales and use tax statutes to define what is specifically taxable and exempt as technology is introduced.

Advantages

This is the familiar approach to taxing new technologies. Both the Department of Revenue and the legislature are used to addressing a new technology's status within the framework of current law. As with any issue, continuation of an established process is often the easiest course of action.

A well-established body of sales and use tax law already exists. Drafting changes to revise current law is infinitely easier than writing new law. It also avoids the unanticipated effects that attend introduction of any new tax law: misinterpretations, loopholes and inevitable court challenges. By specifically defining a product or service as taxable or exempt, gray areas are minimized.

The disbursement cost of this choice is the least of all choices, save doing nothing. An administrative framework for applying, collecting and auditing the sales and use tax law already exists. Except for educating taxpayers and DOR employees each time there is a change, very few costs are incurred with identification of specifically taxable or exempt telecommunications products and services.

Identifying specific areas and seeking to tax or exempt them is not an all-or-nothing approach. If the legislature does not pass a certain law, only that product/service is affected. The implications of such a legislative failure are far less significant than the failure of other options outlined in this report. Since history shows that both the legislature and the public are more likely to accept incremental change, this option has been accepted by a broad coalition of people.

Disadvantages

This is an inherently reactionary approach. As such, it requires continuous review of emerging technology and how it fits into the sales and use tax law. It is, however, a piecemeal approach using narrowly defined language that will create loopholes when technology inevitably takes forms not imagined when drafting the law. Additionally, the specific identification of a product/service reduces the flexibility that would exist in adopting a special tax or a broadly conceived telecommunications definition.

Sections of the statutes rely on other agencies' definitions which reduces DOR's flexibility when modifying sales and use tax statutes.

Modifying the statutes "junks them up," further defying comprehensibility of a complex law. In modifying the statutes, the subject product or service must be classified within the context of the current law; in certain instances, it just doesn't fit.

The public's perception of each attempt to change the law can affect the likelihood of passage. For example, a groundswell of public or legislative opinion regarding a proposal can create winners and losers vis-à-vis a product or service; thus, the level playing field remains elusive.

Nexus issues are as big as ever; this approach does nothing to ease the myriad problems in that area.

Model Revenue System Criteria

Understandability:
As previously noted, adding complexity to the current law further reduces understandability for the average taxpayer. The nature of this approach is recurring modification of an already complex law.

Fairness:
Industry spokespersons have repeatedly stressed that there is not a level playing field for different technologies. Despite the best intentions, maintaining this reactionary approach to telecommunications is not likely to resolve recurring issues of fairness in a timely manner.

Competitiveness:
This option is likely to affect, at the very least, the perception that Minnesota is a more or less attractive place to do business. Publicity inevitably accompanies specific identification of a product or service as taxable or exempt. Whether the perception is accurate is often not immediately known.

Reliability:
Experience has shown this approach to be reliable in achieving what it intends: taxation or exemption of a specific product or service. The inevitable surprises are addressed through further modification of the law.

Efficiency:
As noted earlier, the near-term costs of this option are among the lowest of any option we have discussed. The major investments include personnel time to assure changes are made in all required sections of the law; education of department personnel; and education of taxpayers. However, the cost of doing this repeatedly is substantial.

Option 4: Do nothing.

Doing nothing is always an option. That is to maintain the *status quo* in the statutes while the world to which they apply changes.

Advantages

Doing nothing avoids any controversy over telecommunications and the taxation of new and emerging technologies.

Disadvantages

The biggest disadvantage of this option for government is erosion of the tax base. Indications of growth rates appear to be exponential, rather than arithmetic or geometric. New products, services and sites on the Internet grow by the hundreds on a weekly and, more often now, daily basis.

By doing nothing, Minnesota could be pressured to adopt uniform taxes, rules and regulations that are enacted by other states as the telecommunications industry matures. Cooperation from the industry will be gained by using standard terms and definitions. Piecemeal or dissimilar statutes are more likely to draw criticism from all telecommunications service providers as unwieldy or unenforceable. The industry desires uniform statutes among all jurisdictions if the industry will be subject to taxation.

Model Revenue System Criteria

Understandability:
Current statutes are followed by those affected industries, most notably the telephone and cable television industry. While some portions of the statutory language are subject to interpretation, the major industries comply with the current law. New statutes will be

subject to interpretation by the courts, if challenged, and will require education of new businesses offering non-traditional telecommunications services

Fairness:
Current law is not taxing all sources of telecommunications equally. New and changing technology offers many alternative avenues to use when communicating within and outside the state of Minnesota. All industry spokespersons for the telephone and cable television companies voiced concern that they will continue to collect sales taxes while new companies, particularly network access providers, will avoid any taxation.

Competitiveness:
Competitiveness will be reduced with no changes to current law since companies will seek to avoid uncertainty. Doing nothing is postponing the inevitable.

Reliability:
The option of doing nothing may reduce reliability in the same fashion that it may reduce competitiveness. The certainty that things will change increases the uncertainty of the states statutes in this arena as legislation addressing the issue is postponed. We must also recognize that attempts to shoehorn new businesses and services into existing statutory language further reduces reliability.

Efficiency:
Here, doing nothing has no near-term effect on efficiency since nothing changes. Business as usual does not increase current costs. However, change delayed could mean more costs and confusion when it does happen.

Conclusions

The overriding conclusion of the policy team, at this point, is that some change to current tax policy regarding telecommunications is necessary. The research into other states taxes, stakeholders and the technology itself shows rapid change occurring with high potential for acceleration in the near future.

Appendix A

Selected History of Telecommunications Taxation in Minnesota

Minnesota first imposed a gross earnings tax on telephone companies in 1887. The legislature soon repealed the tax and reimposed it for 1897 and years thereafter. Telephone and telegraph companies paid the gross earnings tax in lieu of taxes on real property and certain other taxes, because they owned property that was located throughout several assessing jurisdictions and thought to be difficult to value. Instead, they paid a tax which substituted earning power of ad valorem taxes. Case history and attorney general opinions are replete with the dictum that the earnings themselves were not directly subject to tax but rather served as a convenient method to determine property value.

As a result, several seemingly convoluted practices, though logical in their own right, prevailed in determining taxable earnings. For example, uncollectible accounts were not deductible because earning power, the property's value, did not depend on collecting amounts billed. The history contains numerous discussions on what did or did not constitute double taxation and what constituted earnings from business versus services merely incidental to telephone business or services performed as a convenience for a customer. Independent telephone companies contracted with directory publishers to solicit advertising and publish and distribute their directories. The various contracts called for the telephone company and the publisher to divide the revenues in a number of ways that were not directly reflected in taxable earnings. Companies often reported as earnings moneys collected and retained by the publisher.

In 1967, Minnesota Statutes section 297A.01, subdivision 3(f) included within the definition of "sale", the furnishing for consideration of local exchange service except when provided by means of coin operated telephones. Minnesota Statutes, section 297A.01, Subd. 3(f) currently includes as a sale and a purchase the following: "The furnishing for a consideration of electricity, gas, water, or steam for use or consumption within this state, or local exchange telephone service, intrastate toll service, and interstate toll service, if that service originates from and is charged to a telephone located in this state. Telephone service does not include services purchased with prepaid telephone calling cards. Telephone services includes paging services and private communications service, as defined in United States Code, title 26, section 4252(d), as amended through December 31, 1991, except for private communication service purchased by an agent acting on behalf of the state lottery. The furnishing for a consideration of access to telephone services by a hotel to its guests is a sale under this clause. Sales by municipal corporations in a proprietary capacity are included in the provisions of this clause. Also included as a sale and a purchase in Subd. 3(g) is the furnishing for consideration of cable television services, including charges for basic service, charges for premium service, and any other charges for any other pay-per-view, monthly, or similar television services".

Minnesota Statutes, section 297A.25, Subd. 4, Constitutional Prohibitions, states that the gross receipts from the sale of local exchange telephone service, which under the Constitution or laws of the United States or under the Constitution of Minnesota the state of Minnesota is prohibited from taxing, is exempt. Minnesota Statutes, section 297A.25, Subd. 36, Interstate WATS Lines, exempts the gross receipts from the sale of long distance telephone services if the service either 1) consists of a wide area telephone line that permits a long distance call to an individual or business located in Minnesota to be made from a location outside of Minnesota at no toll charge to the person placing the call; or 2) entitles a customer, upon payment of a periodic charge that is determined either as a flat amount or upon the basis of total elapsed transmission time, to the privilege of an unlimited number of long distance calls made from a location in Minnesota to a location outside of Minnesota if the customer is a qualified provider of telemarketing services. (The subdivision also includes the definition of a qualified provider of telemarketing services.)

The only serious challenge to the states imposition of tax on telephone services came in 1966. In Mankato Citizens Telephone Co. v. Commissioner of Taxation, 145 N.W.2d 313 (Minn. 1966), the Minnesota Supreme Court upheld the commissioners assessment of gross receipts tax against a telephone company. The issue in the case turned not on the validity of the taxes, but rather on the rate imposed. The tax in this case was imposed by Minn. Stat. § 295.34, which was repealed in 1988.

The validity of taxation of telephone services seems to be presumed in Minnesota. The Minnesota Tax Court found the imposition of tax by Minn. Stat. § 297A.01, Subd. 3(f) to be valid in Garden Valley Telephone Company v. Commissioner of Revenue, Minnesota Tax Court Docket No. 5156 (1990). In that case the court stated that, [i]t is clear that the furnishing of telephone services is included within the sales tax base.

The early years of the Department of Revenues policy letters regarding telecommunications issues mainly addressed telephone, messaging and cable services.

Policy letters written in 1978 fully exempted canned, bundled and custom software. Information received on-line, such as stock market information, was also exempt.

By 1984 the position on software changed and canned software became taxable. Also in 1984, a policy letter reiterated the position on on-line information, and fax transmission services were deemed exempt.

Per a 1985 policy letter, pay-per-view service in hotels is taxable.

In 1986, a letter stated that Minnesota sales tax should be charged on billings to mobile telephone service when the location of the mobile unit cannot be determined.

In the 1980s, telephone companies became very active in their quest to have the gross earnings tax repealed. Also, the Latimer Commission proposed its elimination. Clearly the tax had become an anachronism. After one delay attributable to budget concerns, the tax was phased out. Tax rates declined progressively beginning in 1989. The tax base narrowed. Telephone companies began to pay locally assessed property taxes beginning with 1989 taxes payable in 1990. Telephone companies were exempt from sales tax on central office equipment until 1987, when the exemption disappeared.

At its peak in 1988, the telephone gross earnings tax produced $104 million, considerably more than the replacement property tax burden.

The case law regarding telecommunications is limited. The following three cases support the idea that a good or service which is purchased through telecommunications should be taxed the same as if purchased through some other means, which is based on the Fourteenth Amendment to the Constitution prohibiting disparate treatment of similar situations.

AT&T Communications v. Colorado Dept. of Revenue, 778 P2d 677 (1989). In this case, AT&T contested the imposition of tax on the sale of local telephone services which were used in connection with interstate telephone calls. AT&Ts argument was sustained by the trial court, because the taxation of interstate access services violates the Commerce Clause of the U. S. Constitution by interfering with interstate commerce. AT&T also tried to claim that, even if it was not in violation of the interstate commerce clause, the Colorado statute was more restrictive than current federal doctrine, because it was created during a period when state could not tax interstate commerce.

The Colorado Supreme Court held that the taxation of access services was not in violation of the interstate commerce clause and allowed the application of the old statute to impose the tax.

Oklahoma Broadcasters Association v. Oklahoma Tax Commission, 789 P.2d 1312 (1990). In this case, the taxpayers were radio and television broadcasters who were taxed on the sale of advertising time and on licensing agreements. The taxpayers argued that they should be taxed the same as newspapers and periodicals.

The Supreme Court of Oklahoma held for the taxpayers. The court stated that the tax commission needed a compelling reason to impose sales tax on licensing agreements and advertising in broadcast media while not taxing print media the same way, which was in violation of freedom of the press and the equal protection clause of the First and Fourteenth Amendments to the Constitution.

Contel of Missouri, Inc. V. Director of Revenue, 863 S.W.2d 928 (1993). The taxpayers in this case were telecommunication companies providing regulated telephone services to various Missouri subscribers. As part of their services, they offered inside wire maintenance services, where they would repair inside telephone wiring without any charges for labor.

The court found that the taxation of these wire maintenance services provided by telecommunications companies was valid under current case law.

In 1991, Minn. Stat. Chapter 297A.136, Tax on 900 Pay-Per-Call Services, imposed a tax on pay-per-call services. Revenue Notice # 91-09, Implementation of Tax on 900 Pay-Per-Call Services, and Revenue Notice # 91-10, Billing and Collection Services on Minnesota Calls to 900 Pay-Per-Call Services, were issued clarifying the taxable services and the billing treatment for the tax, respectively. On August 26, 1991, three revenue notices were issued relating to the gross earnings tax on cellular services: Revenue Notice 91-11, Gross Earnings Tax Rate on Cellular Services; Revenue Notice 91-12, Scope of Application of Gross Earnings Tax to Earnings Derived From Cellular Services; and Revenue Notice 91-13, Penalties for Late Payment of Estimated Gross Earnings Tax Related to Cellular Services. However, the gross earnings tax was repealed on December 31, 1991.

On December 2, 1991, Revenue Notice 91-18, Sales and Use Tax - Telephone Services, was issued to clarify the Department of Revenue's position on Minn. Stat. Chapter 297A.01, Subd. 3(f).

The 1991 Rules and Regulations, Chapter 8130.1000, Lodging, excludes separately stated telephone charges from the facility charge effective March 1969. Chapter 8130.8900, Florists and Nurserymen, Subp. 3, Telegraphic Orders, defines the rules that florists should apply when conducting transactions via the telephone, telegraph, or other means of communication effective November 20, 1974. Chapter 8130.6100, Telephone Central Office Telephone Equipment, was repealed by L 1992 c 511 art 7 s 26. Chapter 8130.1100, Utilities, included provisions for telephone services in the 1991 Rules but was revised July 19, 1993, to no longer include those services.

On February 3, 1992, Revenue Notice 92-06, Sales and Use Tax - Detective and Security Services, clarified Minn. Stat. Chapter 297A.01, Subd. 3, Paragraph (j), Clause (iv). Telecommunications issues relating to this statute are also referred to in Fact Sheet 114, Detective and Security Services. Fact Sheet 119, Telephone Service; Fact Sheet 139, Libraries; and Fact Sheet 141, Hotels and Lodging Facilities, also briefly address telecommunications issues.

A summary of issues addressed in current policy letters follows.

Teleconferencing Services. A teleconference in Minnesota is a non-taxable service provided to the attendees of the conference. The service provider is responsible for paying sales tax on all equipment used, including the telephone lines. The taxability does not change when other states are involved.

Financial Data Broadcast Services. Charges for an out-of-state company's fixed monthly, initial activation, and one-time usage fees for financial data transmission services are exempt from sales tax. Data transmission via cable, satellite, or FM audio transmission are currently nontaxable services in Minnesota. Tax is due on any tangible personal property used in receiving the data transmission.

Private Communications Services. Data communications services provided by a telecommunications services provider to residents of Minnesota are not taxable.

In a letter written November 14, 1994, the charges for transmission of television programming are clearly different from those related to transmission of data. The annual subscription fee for programming via satellite is taxable. The fixed fee for broadcasting special events is taxable, as is the access fee enabling the purchasers decoder to receive the signal. This access fee is taxable independently of the taxability of the equipment used to decode the signal(s). The charges for pay-per-view events are taxable.

Appendix C

The NTA Electronic Commerce Tax Project: An Update

Scott Mackey
Chief Economist
National Conference of State Legislatures

October 30, 1998

Challenge of Taxation

- **Tax system is not in sync with economy and business activity**
  - **Designed in 1930s and before**
- **Focus on manufacturing and retailing**
  - **Physical presence requirements**
- **Administration developed independently**
  - **No regard for multistate and burden issues**
-

Results

- **States apply law to new circumstances**
  - **Uncertainty, unfairness, complexity for taxpayers**
- **Future erosion of sales tax base**
  - **Shift to remote selling accelerated**
- **Serious political reaction**
  - **Potential federal intervention / preemption**

Internet Tax Freedom Act

- **Driving forces**
  - **Fear/Inability to deal with complexity**
  - **Desire for single set of rules**
  - **Avoid taxation**
  - **International implications**

National Tax Association Project

- **16 government —**
  - **State — NCSL, NGA, tax administrators**
  - **Local — cities, counties, Mayors**
- **16 business**
- **5 academics**

NTA Project - Business Goals

-
- **Rate Uniformity --"One rate per state"**
- **Base Uniformity -- uniform definitions of goods, services**
- **Single return -- "Base state" model**
- **Single or simplified audit**

Key Issues for Legislators

- **How to set "one rate per state"**
- **Revenue sharing for local governments**
- **Federal legislation or multistate compact?**
- **Is additional revenue worth loss of sovereignty?**
-

Conclusion

- **Continued vitality of sales tax is at risk**
- **Requires good faith effort on part of both industry and states**
- **Is a deal possible in the current political environment?**

Appendix D

TELECOMMUNICATIONS STUDY

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July 14, 1998 1:00 P.M.
State Capitol Room 107

Nexus Limitations

Identifying taxpayer's activities in a state that are sufficient to subject the taxpayer to a state's taxing jurisdiction remains one of the most perplexing problems facing state revenue departments today. Taxpayers have an equally difficult time determining the jurisdictions in which their activities may be sufficient to subject it to tax collecting and remitting responsibilities. Although states have the implicit jurisdiction to impose a tax, their jurisdiction to tax is subject to some limitations. Those limitations are the Federal constitutional limitations found in the Commerce Clause and the Due Process Clause and those limitations which a state may voluntarily impose upon itself. Public Law 86-272 that limits nexus for income tax purposes, does not apply for sales or use tax purposes.

Generally, a state has the power to require a taxpayer to collect sales and use tax if the taxpayer has sufficient contacts or "nexus" with the state. From a legal standpoint, the word "nexus" refers to a state's ability to exert legal jurisdiction over a person or property for a legal matter. In a tax context, however, the term generally means a certain level of contacts between a state and a taxpayer which would subject the taxpayer to the state's taxing jurisdiction. To make a determination as to whether a taxpayer's contacts with a state constitutes nexus it is often necessary to make a complex analysis of various federal and state constitutional, statutory and case law doctrines.

Because federal statutory protection against state taxation is very limited in scope, the U.S. constitution is often the standard by which a state's attempts to establish nexus is judged. The "due process" clause and the "commerce clause" restrict a state's ability to assert nexus. Section 1 of the 14th Amendment which contains the due process clause reads as follows:

> "nor shall any state deprive any person of life, liberty, or property without due process of law..."

Article I, Section 8 of the Constitution contains the Commerce Clause which delegates to Congress the power "to regulate commerce with foreign nations, and among the several states, and with Indian tribes.

Despite the Tenth Amendment's granting to states all powers that are not delegated to the federal government or that are not prohibited under the U.S. Constitution, a state's interpretation of nexus is valid only if it does not violate the Commerce Clause or the Due Process Clause. For the purpose of determining the validity of a state tax, it is important to distinguish those elements required by the Commerce Clause from those required by the Due Process Clause. In general, the primary focus of the Due Process Clause is to treat taxpayers fairly, while the primary focus of the Commerce Clause is to assure evenhanded trade between the states and other taxing jurisdictions.

Additionally, under the Commerce Clause, Congress has the complete power to authorize or to forbid taxation which affects interstate commerce. The Due Process Clause, however, does not give any powers to Congress. As such, if a state tax is found to be unconstitutional under the Due Process Clause, Congress cannot pass legislation to allow it. However, if a state tax is declared unconstitutional under the Commerce Clause, Congress has the power to pass legislation to allow or to control the tax.

Nexus Under the Commerce Clause

The U.S. Supreme Court, in the landmark case of *Complete Auto Transit, Inc. v. Brady*, 430 US 274, 97 S Ct 1076 (1977), first announced the test used to uphold a state tax against a Commerce Clause challenge and, in doing so, firmly rejected the proposition that interstate commerce is immune from state taxation. The Court set forth the modern "four-prong" test used to determine the constitutional validity of state taxes. This test requires that, for purposes of the Commerce Clause:

(1) the activity must have sufficient contacts with the state to justify a tax;
(2) the tax must be fairly apportioned;
(3) the tax must not discriminate against interstate commerce; and
(4) the tax must be fairly related to the services provided by the taxing state.

However, the term "substantial nexus" was not defined by the Court in *Complete Auto*. Later, in the case of *Quill Corporation v. North Dakota*, 112 S Ct 1904 (1992), the Court provided some insight into the interpretation of this term. In *Quill*, the Court stated that "substantial nexus" under the Commerce Clause requires a "physical presence". The physical presence requirement has been described by the Court as a "bright-line" rule. The questions of what types of contacts qualify as a physical presence and how many contacts are required for that presence to be "substantial" remain the issues that are currently being tested in state courts.

Nexus Under the Due Process Clause

With respect to state taxation, the Due Process Clause has been interpreted by the courts to mean that a state cannot impose a tax unless there is "some definite link, some minimum connection, between a state and the person, property, or transaction that it seeks to tax." *Miller Bros. Co. v. Maryland*, 347 US 340, 344-45 (1954). The U.S. Supreme Court has stated that, in general, the jurisdictional requirement under the Due Process Clause necessitates only "minimum contacts" between a nonresident corporation and the state in which a suit is to be brought to the extent that maintenance of the suit does not offend the traditional notions of fair play and substantial justice. *International Shoe Co. v. Washington*, 326 US 310, 66 S Ct 154 (1945).

Nexus Under Both Due Process and Commerce Clauses

In order to have nexus under both the Commerce and the Due Process Clauses, there must be an adequate connection between the state and the taxpayer upon which a tax or a tax collection requirement is being imposed and a physical presence of the taxpayer in the state. Generally, the Commerce Clause is a higher standard in that a "physical presence" which satisfies the Commerce Clause's "presence" requirement is probably sufficient to satisfy the "Due Process" "presence" requirement. With respect to nonresident taxpayers, the types of physical presence that the courts have determined to be sufficient in satisfying the nexus requirement of the Commerce Clause include the presence of employees, agents or tangible personal property within the taxing state.

The minimum connection under the Due Process Clause, however, does not require the same "physical presence" that is required by the Commerce Clause before a state may exercise its taxing power. See *International Shoe Co.* The confusion regarding the degree of presence required to satisfy both Clauses can be traced back to the case of *National Bellas Hess v. Dept. of Rev. of Illinois*, 386 US 753 (1967).

Bellas Hess Case

In this case, the Court held that a state could not impose a use tax collection responsibility on an out-of-state seller whose only contact with the state occurred when it had advertised its products by mailing catalogs and flyers from a place outside of the state to customers within the state and, subsequently, filled orders from those customers by common carrier or mail from a place outside the state. The seller had no place of business in the state, had no individuals soliciting sales on its behalf within the state, and had utilized no advertising that had been entirely local. The decision was 6-3 and the dissent felt that since the taxpayer engaged in the business of regularly, systematically, and on a large scale offering merchandise for sale in Illinois in competition with local merchants, the application of the use tax statute was not unconstitutional. The majority relied on three arguments:

1. protection of the national market;
2. the need for some minimum linkage between the taxpayer and the state, as evidence of the benefit provided by the taxing state to the taxpayer; and
3. the high cost of complying with the tax in multiple jurisdictions.

The Court's opinion did not separately analyze the nexus requirements for each of the Clauses. This led many lower courts to interpret the decision to mean that a physical presence was not only sufficient for jurisdiction under the Due Process Clause, but was also necessary. The nexus requirements for each Clause were later distinguished in the case of *Quill Corporation v. North Dakota*, 112 S Ct 1904 (1992).

Quill Case

In *Quill*, the U.S. Supreme Court provided its most extensive discussion of nexus to date. The Court, citing *Bellas Hess*, held that an out-of-state mail-order seller with no physical presence in a state, who merely mails catalogs into the state and fills orders by U.S. mail or common carrier, is protected by the Commerce Clause from the imposition of a use tax collection responsibility in the destination state. In *Quill*, the taxpayer, was a mail order seller that solicited business in the state by distributing catalogs and flyers in the U.S. mail, placing advertisements in periodicals, and by telephone. Quill had no direct physical contacts with the taxing state, other than a few computer disks sent to North Dakota customers, and did not utilize the services of an agent located in the state.

North Dakota claimed to have taxing jurisdiction based upon Quill's "economic" presence, rather than its "physical" presence in the state. The trial court ruled in Quill's favor and rejected the state's assertion of an economically based jurisdictional standard. On review, however, the North Dakota Supreme Court concluded that the U.S. Supreme Court's decision in *Complete Auto Transit*, along with the Supreme Court's rulings in several Commerce Clause cases, had signaled a retreat from the formalistic constrictions of the physical presence standard in favor of a more flexible approach focusing on a taxpayer's overall contacts with the taxing state, including economic contacts. The North Dakota Supreme Court stated:

> . . . within the context of contemporary society and commercial practice, we conclude that the concept of nexus encompasses more than mere physical presence within the State, and that the determination of nexus should take into consideration all connections between the out-of-state seller and the state, all benefits and opportunities provided by the State, and should stress economic realities rather than artificial benchmarks.

The North Dakota Supreme Court concluded that the nexus standard under both the Due Process and Commerce Clause was identical and that a seller's economic exploitation of a state's consumer market was sufficient to permit the state to impose a use tax collection responsibility on a non-resident mail-order seller.

The U.S. Supreme Court did not agree with the North Dakota Supreme Court's decision. The Supreme Court held that, under the decision rendered in *Bellas Hess*, an out-of-state mail order seller, whose sole contact with a state's taxing jurisdiction is through common carrier or the U.S. mail is still protected by the Commerce Clause from use tax collection responsibility. Although the Supreme Court agreed with the North Dakota Supreme Court's reasoning that the "minimum contacts" requirement of the Due Process Clause did not demand a physical presence, it stated that the Commerce Clause required an even higher level of contacts, i.e., a "substantial nexus" with the state.

In applying these nexus requirements to Quill's activities, the Court stated that the magnitude of contacts which had been purposefully directed toward North Dakota residents, along with the fact that the use tax was related to benefits which Quill received by having access to the state, was more than sufficient to satisfy the Due Process Clause. However, the Court could not find a substantial "physical" presence as required by the "bright-line" rule, which the Court noted had been originally established in *Bellas Hess*. Therefore, the Court found that North Dakota's use tax collection requirement violated the Commerce Clause. In essence, the Court threw the responsibility of changing the rules it had established for finding nexus into the hands of Congress.

Nexus After Quill

Despite its emphasis on the bright-line physical presence rule under the Commerce Clause, the Court did not state whether this rule extended beyond mail order sellers and did not clearly define the term "substantial nexus" for its use in the Commerce Clause test. As a result, many states and taxpayers are grappling with these issues in attempting to find the amount of "presence" required under both Clauses.

In an attempt to ascertain what constitutes "substantial nexus" there have been a number of state court cases where the state has attempted to attribute nexus to an out-of-state seller based not on its activities, but rather, on the activities of an instate affiliate of the seller. The commentators have referred to this as "attributional nexus" and it has met with mixed results from the courts. States have attempted to find attributional nexus by using the theories of agency, alter ego and unitary business.

Under the agency theory, if an in-state person or entity performs business activities in the state and then is found to be representing the interests of , and acting as the agent of, its out-of-state principal, nexus will be attributed to the out-of-state taxpayer as though it had performed the activities itself.

Under the alter ego theory, a state will attribute nexus to an out-of-state taxpayer when a related taxpayer, which is acting as a continuous part of the out-of-state taxpayer, is present within the state.

Under the unitary theory of taxation, separate corporate entities that are engaged in a "single business" or "unity" are treated as a single entity. In general, a "single business" or "unity"" is assumed if there is a high degree of interrelationship and interdependence among the related companies.

Portions of the materials in this presentation were excerpted from Thomas, "Attributional Nexus: Waiting for the Levee to Break", Taxes, January 1995.

Appendix E

Sales Tax and E-Commerce

Presentation to the Working Group on the Taxation of Telecommunication Services

Tom Ellerbe, Department of Revenue
Pat Dalton, House Research

October 30, 1998

Definitions of E-commerce

- **Narrow:** Retail sales to consumers that take place on open networks such as the Internet
- **Broad:** All transactions that take place electronically including ATM transactions, EDI, and EFT
- **Middle ground:** Business that occurs on open networks such as the Internet

Examples of transactions included in the middle- ground E-commerce definition

- Retail sales to consumers and businesses
- Internet access
- Web page design
- Purchase of space on Internet servers (host computers)
- Advertising on web browsers

How much E-Commerce?

Problems with estimation:

- Multiple definitions of e-commerce
- Current economic systems not set up to account for it (SIC includes Internet sellers with direct marketers)
- Most current numbers are self-reported by entities with a stake in the industry
- Phenomenal growth over a small base does not lend itself to extrapolation of future growth

Estimates of Current Amount of E-Commerce (1997 U.S. Total)

• Narrow Definition	$ 1.4 Billion
• Broad Definition	$ 75.2 Billion
• Middle-ground Definition	$ 20.8 Billion

Estimates of Current Amount of E-Commerce in Minnesota (1997)

- Narrow Definition $ 26 Million
- Broad Definition $1,400 Million
- Middle-ground Definition $ 400 Million

Breakdown of the E-Commerce Purchases in Minnesota

- 80% are Business-to-Business Sales ($320 million - middle ground estimate)

- 20% are Business-to-Consumer Sales ($80 million - middle ground estimate)

E-Commerce and Minnesota Sales Tax Erosion

Factors to consider:

- Is there a sales price?
- Is the sale taxable in Minnesota?
- Is the tax collectable?
- Is this sale a substitute for a currently taxable sale or for a sale for which no tax is currently collected?

Business-to-Business E-Commerce in Minnesota

- Of the estimated $320 million in business-to business sales:
  - about 19% ($61 million) is taxable under current law
  - about 81% ($259 million) is not taxable under current law
- Examples of Taxable Sales:
  - office equipment, machinery and supplies; shelving; computers and related hardware, other electronic equipment; canned software
- Examples of Nontaxable Sales:
  - goods purchased for resale; materials used in production; advertising; custom software; items qualifying as capital equipment; Internet access charges; e-mail; Internet telephony and video teleconferencing; sales to exempt entities

Business-to-Consumer E-Commerce in Minnesota

- Of the estimated $80 million in business-to-consumer sales:
  - about 8% ($6 million) is taxable under current law
  - about 92% ($74 million) is not taxable under current law
- Examples of Taxable Sales:
  - jewelry, flowers, and other giftware;consumer electronics; books; tapes and compact disks; household products and supplies; tickets to events; alcohol and soft drinks
- Examples of Nontaxable Sales:
  - Internet entertainment (pornography*, movies*, music*, interactive games); financial services (electronic banking, bill paying, stock brokerage, insurance); travel tickets and service; Internet gambling; apparel; food products; on-line periodical subscriptions; Internet access charges

* indicates an item that may be taxable in a tangible form

Estimate of the Impact of E-Commerce on Minnesota Sales Tax Revenues

- $1.1 million is estimated to be currently collected from vendors on taxable e-commerce sales. (Excludes use tax paid by the purchaser)
- $3.3 million is estimated as potential additional revenue on taxable e-commerce sales
  - an undetermined portion of this is collected from business purchasers as use tax
- An additional (currently small) amount of sales tax revenue is "lost" due to the purchase of certain items downloaded from the Internet which are taxable in tangible form

E-Commerce Sales Tax Revenue Potential Compared to Mail-Order

- $3.3 million estimated potential additional revenue on currently taxable sales through electronic commerce.

- $104 million estimated potential additional revenue on currently taxable sales through traditional mail-order.

Effect of E-Commerce on Sales Tax Policy

- **Erosion:** E-commerce will have a minimal effect on Minnesota sales tax revenues at least in the near term
- **Equity:** The state's inability to require Internet sellers to collect Minnesota sales tax may give those sellers an advantage over in-state retailers of certain (primarily consumer) products

Appendix F

STATE TAXES AND FEES APPLICABLE TO COMMUNICATION AND DATA SERVICE PROVIDERS

(Income taxes, property taxes and sales taxes on inputs to industrial production apply uniformly to the various business entities covered by the tables and are therefore not included. The state universal service fee, which will apply to all providers of telephone services, is not included because it has not yet been implemented by the Public Utilities Commission.)

Prepared by
House Research and Senate Tax Committee Staff
November 12, 1998

LOCAL VOICE TRANSMISSION

	Incumbent Local Exchange Carrier (ILEC)	Facilities-based Competitive Local Exchange Carrier (CLEC) with traditional local loop telephone service	CLEC Reseller	Cable Telephony (e.g. SERIN and MediaOne)	Cellular
General Operating Revenue Assessment for PUC and DPS expenses[1]	Yes	Yes	Yes	Yes (only on telephony portion of service if separately stated)	No
Local Franchise Fees[2]	No	No	No	No	No
Sales and Use Tax on Purchases of Capital Equipment	Yes	Yes	Yes	Yes	Yes, but the capital equipment exemption applies to purchases prior to 1997 statutory amendment per recent MN court decision
Customer sales tax[3]	Yes	Yes	Yes	Yes	Yes
911 surcharge[4]	Yes	No (exempt by ch. 403.11, subd. 1(e) but some CLEC's collect and remit to the Dept. of Administration)	No (exempt by ch. 403.11, subd. 1 (e) but US West is collecting for reseller lines)	No (exempt by ch. 403.11, subd. 1(e))	Yes
TACIP surcharge[5]	Yes	Yes	Yes	Yes	Yes
TAP surcharge[67]	Yes	Yes	Yes	Yes	No (not within TAP definition)

VIDEO TRANSMISSION

	Cable	Satellite Direct TV	Video over Internet
General Operating Revenue Assessment for PUC and DPS expenses	No	No	No
Local Franchise Fees	Yes	No	?
Sales and Use Tax on Purchases of Capital Equipment	Yes	No (statutory exemption at chapter 297A.2531)	?
Customer sales tax	Yes	Yes, but nexus issue	?
911 surcharge	No	No	No
TACIP surcharge	No	No	No
TAP surcharge	No	No	No

DATA TRANSMISSION

	Broadband digital subscriber services (e.g. MegaBits)	Wide Area Network provided by cable (data only)	Wide Area Intrastate Network provided by telephone company (data only)	Cable Internet Access	Satellite Internet (Direct PC)
General Operating Revenue Assessment for PUC and DPS expenses	Yes	No	Yes	No	No
Local Franchise Fees	No	?	No	? (included under most franchise agreements)	No
Sales and Use Tax on Purchases of Capital Equipment	Yes	Yes	Yes	Yes	Yes
Customer sales tax	Yes	No	Yes	No	No
911 surcharge	Yes	No	No	No	No
TACIP surcharge	Yes	No	No	No	No
TAP surcharge	Yes	No	No	No	No

TRADITIONAL LONG DISTANCE AND LONG DISTANCE TWO-WAY INTERNET VOICE

	Long Distance	Two-way voice over Internet
General Operating Revenue Assessment for PUC and DPS expenses	Yes	No
Local Franchise Fees	No	No
Sales and Use Tax on Purchases of Capital Equipment	Yes	Yes, but nexus issue
Customer Sales Tax	Yes	No
911 surcharge	No	No
TACIP surcharge	No	No
TAP surcharge	No	No

1. The general operating revenue assessment is collected through direct charges or indirect charges. Direct costs result from agency work activity created by a specific company or specified group of companies and the corresponding direct charges relate only to that company or group. Indirect costs result from agency activities which are not linked to a specific company or group and are allocated to all companies in the industry on the basis of company gross operating revenues. Both charges are subject to a cap: for direct charges, two/fifths of one percent for all direct costs; for indirect costs, one/eighth of one percent for telephone companies and one/sixth of one percent for energy utilities. These assessments recover regulatory costs incurred by the Public Utilities Commission, Department of Public Service and the Office of Administrative Hearings (i.e., those which relate to Commission proceedings).

2. Local cable franchise fees are established by agreement up to a maximum fee of 5% of annual gross receipts derived from operation of the cable system, to provide cable services. The maximum rate allowed is commonly the agreement rate.

3. The Minnesota general sales and use tax rate is currently 6.5%

4. This surcharge is imposed on telephone users to fund the 911 and enhanced 911 emergency service system. Currently the monthly charge is $0.27 for each telephone service capable of making a 911 call (including cellular).

5. This surcharge is imposed on telephone users to fund the telecommunications relay program for communications impaired persons. Currently the monthly charge is $0.12 for each service capable of originating a telecommunications relay call (including cellular).

6. The Telephone Assistance Program (TAP) surcharge is imposed on local telephone access lines (land lines only, not cellular) to provide financial assistance to low income elderly and disabled persons for basic telephone service. Currently the monthly charge is $0.06 per access line.

7. The 911, TAP, and TACIP surcharges for each line are combined and appear as a single surcharge on the customer's bill.

DEFINITIONS

Incumbent Local Exchange Carrier (ILEC)- The established local telephone company that provided service in an area before competition was permitted by law.

Wide Area Network- A communications network that connects geographically separated areas.

Competitive Local Exchange Carrier (CLEC)- A company which competes for local telephone business with the ILEC.

Facilities-based CLEC- A CLEC which offers local telephone service using its own telecommunications facilities

CLEC Reseller- A CLEC which offers local telephone service by reselling the services of the incumbent local exchange carrier

PUC- Public Utilities Commission

DPS- Department of Public Service

Operating Revenue Assessment- The assessments recover regulatory costs incurred by the Public Utilities Commission, Department of Public Service and the Office of Administrative Hearings (i.e., those which relate to Commission proceedings). The general operating revenue assessment is collected through direct charges or indirect charges. Direct costs result from agency work activity created by a specific company or specified group of companies and the corresponding direct charges relate only to that company or group. Indirect costs result from agency activities which are not linked to a specific company or group and are allocated to all companies in the industry on the basis of company gross operating revenues. Both charges are subject to a cap: for direct charges, two/fifths of one percent for all direct costs; for indirect costs, one/eighth of one percent for telephone companies and one/sixth of one percent for energy utilities.

Cable Telephony- Telephone service provided over facilities which are traditionally used for cable service

TAP- Telephone Assistance Program: a program which provides financial assistance to low income elderly and disabled persons for basic telephone service. The monthly TAP fee is currently $.06 per access line.

TACIP- Telecommunication Access for Communication-Impaired Persons; a program which provides funding for telecommunications relay service and equipment for eligible communication-impaired persons. The monthly TACIP fee is currently $.12 per access line or basic service.

911- Refers to 911 and enhanced 911 service. This service is funded by a surcharge on local telephone service capable of originating a 911 phone call. The monthly 911 fee is currently $.27 per access line or basic service.

Internet- The myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio. (Definition from the Internet Tax Freedom Act)

Broadband- Digital technologies that can provide simultaneous voice, high-speed data, and video-on-demand to customers through a single facility.

Appendix G

Sales Taxation of Intangibles

Presentation to the Working Group on the Taxation of Telecommunication Services

December 3, 1998

Keith Carlson, Senate Tax Committee

What are examples of intangibles?

- **Creative or intellectual properties traditionally delivered as:**
- books or magazines
- video cassettes, video CD-ROM's and DVD's
- audio CD-ROM's and audio cassettes
- computer software and video game software in the form of diskettes, CD-ROM's and cartridges
- **but now deliverable in digital or electronic form over the Internet**

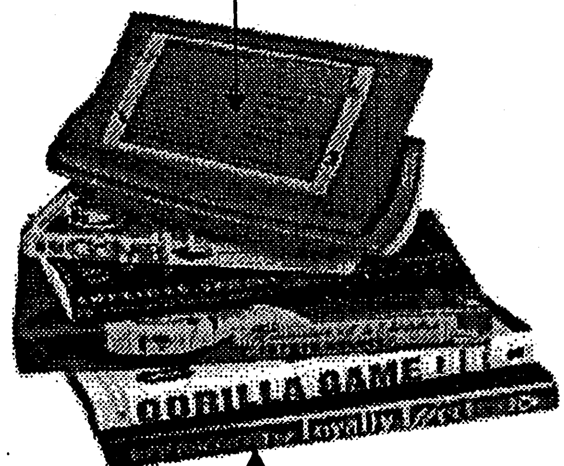
What are the implications for Minnesota's sales tax?

Current law provide for the sales taxation of tangible personalty.

- A [taxable] "sale" and a "purchase" includes.... any transfer of title or possession, or both, of **tangible** personal property...

- Intangibles are not subject to tax even though the content is identical to that delivered via taxable tangible personalty.

The content being displayed is not subject to sales tax



These are subject to sales tax

Even if the law is amended, other considerations would probably prevent tax parity from being achieved between tangible and intangible products that deliver the same intellectual or creative properties.

The Supreme Court ruling in *Bellas Hess* and *Quill* prevents imposition of sales tax on non-Minnesota vendors

- If you're not here, the state can't tax you even if you are selling products to Minnesota residents.

Even if Congress or the Court overrules *Bellas Hess*, the absence of any way to ID the geographic location of a buyer purchasing intangibles via the Web prevents collection of a sales tax administered on a destination basis

- If the state doesn't know where you are, it can't tax you.

Estimate of Potential Sales Tax Loss from Current Tangible Examples of Creative or Intellectual Properties

• fiscal year	2000	2001	2002	2003
• periodicals	(3.0)	(3.4)	(3.5)	(3.5)
• books	(19.8)	(22.2)	(22.8)	(23.4)
• print ads	(13.8)	(15.7)	(16.2)	(16.8)
• music	(13.7)	(15.8)	(16.7)	(17.6)
• videos	(17.1)	(19.8)	(20.9)	(22.2)
• software	(75.9)	(87.4)	(92.3)	(97.5)
• Total	(143.3)	(164.3)	(172.4)	(181.0)

Appendix H

LEGISLATIVE COORDINATING COMMISSION WORKING
GROUP ON TAXATION OF TELECOMMUNICATIONS SERVICES

Greg Heck, Attorney
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December 3, 1998
Capitol--Room 112

SALES TAXATION OF INTANGIBLES

Today I would like to speak to you about the sales taxation of intangible property. I will be very brief. My research has found very few articles dealing with this subject since as a general rule most states' sales tax laws do no apply to transfers of intangible property. The Minnesota sales tax is imposed upon the gross receipts from retail sales of tangible personal property and the providing of selected services. Taxable sales include (a) the transfer of title or possession to, the leasing of or granting a license to use tangible personal property, (b) the production, fabrication, printing or processing of tangible personal property and (c) the providing of specific enumerated taxable services.

The Minnesota sales tax law was designed for a world in which local merchants sold manufactured products. It is relatively easy to levy sales taxes on local merchants and for merchants to comply with the tax laws of the states where they operate. But when vendors operate across state borders, both compliance and administration become more difficult and add to that the complexities of the digital revolution and you have a tax system in distress. The sales tax law does not address the taxation of electronic commerce or whether sales tax should apply to services and intangible products delivered over the Internet.

Minnesota's, like most other states' sales tax law, when it was enacted applied almost wholly to sales of tangible personal property and sales of intangibles were not subject to the sales tax. The general understanding was that tangible personal property included machinery and equipment, animals, vehicles, books, merchandise and other physical property that you could see, hold, touch or taste. Intangible personal property was property that consisted of rights and privileges having a legal but not a physical existence such as patents, copyrights, licenses and trademarks or a financial asset having no intrinsic value but representing value such as securities, notes, and account receivables. Even then questions arose, however at the borderline between tangibles and intangibles. There has been controversy in some states as to whether currency, gold coins or stamps constitute tangible or intangible property, and whether the transfer of possession of a motion picture film to a theater, together with a license to exhibit the film constitutes a rental of the film or an intangible license to exhibit it.

Changes in technology and the increased use of computers have presented the courts with the often perplexing and complex question as to whether computer software constitutes a taxable sale of tangible personal property or a non-taxable transfer of incorporeal information coupled with an intangible right to use. The early court decisions held that software and data transactions were not taxable since they represented the sale or leasing of intellectual property which was a nontaxable intangible. The courts began to apply various tests to determine whether software was taxable. A number of courts used the "true object" or "essence of the transaction" test to decide the taxability of software. The legislature in Minnesota has addressed this issue by including computer software under the definition of tangible personal property in Chapter 297A. But the Minnesota Supreme Court in the case of Fingerhut Products Company v. Commissioner of Revenue, 258 N.W. 2d 600 (Minn. 1977), held that sale of typed mailing lists were not taxable since they were "merely incidental to the use of the incorporeal information contained in those lists". The Court held that the taxpayer's true object was the incorporeal content of the property and not the physical property itself. Walter and Jerome Hellerstein in their two volume treatise on State Taxation take issue with the test employed by our Supreme Court. The Minnesota Supreme Court again used the true object or essence of the transaction test to decide the case of Questar Data Systems, Inc. v. Commissioner of Revenue, 546 N.W. 2d 925 (Minn. 1996) but with three justices dissenting to Justice Page's majority opinion there is still some doubt as to what the test is and whether it is a workable test.

The Courts in Minnesota and other states have used the true object test to find that many transactions were not subject to the sales tax even though there was a transfer of tangible personal property occurring. Whether you purchase a book or an audio tape at a retail store or whether you download that book or tape from the Internet, it can be argued that the true object of the transaction was the same in some cases. But in my opinion it would be misplaced optimism to think that the Courts would use this test to impose the sales tax on the downloading of these items. It is my belief that the Courts are not going to provide the answers in this area of the law and that it will be up to the legislatures to act.

But I'm not here today to talk about the taxation of stocks and bonds or patents and copyrights. I want to talk about items that are traditionally transferred by a tangible media or medium which can now be transferred in an intangible format. Throughout much of history, information could not be easily stored or transferred. Thus information-intensive services were consumed when and where they were performed. Discovery of efficient methods of storing and transmitting information has changed the nature of commerce in information, and thus in many services. One of the biggest changes has been the coming into its own of electronic commerce. Most obvious, the convenience of purchasing products such as music, videos, games and software, by downloading them from the Internet. Sales tax on tangible products would seemingly apply to such products. But the digital revolution blurs distinctions between tangible products (usually taxed), services (Sometimes taxed,

but commonly not) and intangible products (virtually never taxed). The possibility of providing essentially the same product in more than one way increases the likelihood that the artificial distinctions currently found in state laws will become increasingly troublesome. Charles McClure with the Hoover Institution at Stanford University in the December 1997 edition of the National Tax Journal states that what is needed is "more uniform taxation of such sales, not more exemptions". He goes on to state that all distinctions between tangible products, services, and intangible products, telecommunications and Internet access should be abolished. He believes that they lack both economic substance and a basis in sound policy, especially in the world of electronic commerce, and that they create administrative headaches, economic distortions, and inequities.

As a general rule, whatever goods or services can be digitized or otherwise transferred electronically will find electronic commerce to be a very fast and cost-effective way to reach consumers. According to Nicholas Negroponte, the author of *Being Digital*, we are in the transition from an economy based on the movement of atoms to one based upon bits. According to the author, "The information superhighway is about the global movement of weightless bits at the speed of light". Let me assure you that the sales tax law did not contemplate the taxation of bits. The sales tax has served us reasonably well for the past 30 years but it is not designed to deal with electronic commerce and the digital revolution. The Internet is exploding with new concepts and terminology such as Webcrawlers, routers, hyperlinks and encryption. The old tax rules are not well suited to deal with electronic commerce.

Enough bad news. The good news is that all is not lost. As Pat Dalton and Tom Ellerbe told you last meeting the sky is not falling. We are experiencing a leak but the ship clearly afloat but if we don't address the problem at some point in the near future we could potentially experience major erosion of the sales tax base.

Four-fifths of the states impose a sales tax on the "transmission" component of electronic commerce--the interstate telecommunications and/or intrastate communications. About half of the states impose a tax on specific categories of on-line "content", such as the electronic transmission of canned software or cable television. About one-quarter of the state impose a broader-based sales tax on numerous categories of on-line "content" such as electronic information or computer services.

For example, Texas imposes its sales tax on numerous forms on electronic commerce, including electronically downloaded software, creation of Web home pages, posting of Web home pages, cable television services, credit reporting services, information services, and data processing services. Similarly, New York imposes its sales tax on numerous forms of entertainment and information services provided by telecommunications such as stock quotes, credit reports, computer

bulletin board systems, tax or stock market advisory and analysis reports, and sports highlight lines.

In many respects, the sales and use taxation of electronic commerce overlaps with the sales taxation of services. Most states impose a sales tax on certain personal, business or amusement services. However, some states tax a much broader range of services. Hawaii and New Mexico, each tax 155 different enumerated services, South Dakota taxes 130 different services and New York taxes 74 different services. For the most part, those states that have traditionally taxed more categories of services are also the states that are currently attempting to tax electronic commerce.

As a general rule, most states tax as a telecommunications service only the charges for transmission of information, not any separately stated charges for the information content. About one-quarter of the states currently impose a broad based sales or use tax on on-line "content" transferred by means of electronic commerce. The majority of states do not tax the electronic transmission of information or other on-line content-related transactions. For instance, New Jersey has determined that information transferred electronically is not subject to sales tax because there is no "tangible personal property" involved in the transaction. Other states such as California that have issued regulations or rulings on this issue have also generally relied on the fact that the "content" that is transferred electronically is nontaxable "intangible property" not taxable "tangible property".

Some states may tax electronic commerce services while other states exempt them from taxation even though the states are relying on nearly identical statutory language. The states that do tax electronically transmitted information generally tax it under statutes imposing a tax as information services (New York), as electronic information services (Ohio) or as computer services (Connecticut). Some states such as Texas have taken a broad based approach and its sales and use tax statute defines taxable services to include telecommunications services, information services, and data processing service.

I don't have the answers for you but hopefully I have explained to you some of the problems with the current sales tax law and some of the legislative solutions that could be pursued. McClure in his National Tax Journal article in arriving as his solution to the current problems takes the position that "If a sale is to a consumer, it should be taxed" with the caveat that "all sales to business should be exempt". His conclusion is that what is needed is more uniform taxation of sales (referring to sales of tangible property, services and intangible property) and not more exemptions.

Ultimately the tax policy makers will have to address the following cutting edge issues. Should services be subject to sales and use taxes as extensively as tangible personal property? If the answer is in the negative, the sales tax will have less and less utility as a tax system as time goes on. If the answer is in the affirmative, it will

be necessary to determine what rules should be applied to the complex fact pattern provided by these services--particularly electronic services?

Nicholas Negroponte, *Being Digital* (New York, Vintage Books, 1995).

Excerpts were taken from Charles E. McClure, Jr., "Electronic Commerce, State Sales Taxation, and Intergovernmental Fiscal Relations", *National Tax Journal*, December 1997.

Excerpts were taken from Karl A. Frieden and Michael E. Porter, "The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce", *State Tax Notes*, November 11, 1996.