Testimony of Stephen P. Kranz to the Senate Select Committee on Budget and Tax Reform Regarding Modernizing New York State's Telecommunications Tax System

Thank you for the invitation to provide comments to the Select Committee as you consider the important issue of telecommunications tax reform in New York State. My name is Stephen Kranz; I'm a partner at Sutherland, Asbill and Brennan, where I specialize in state and local tax policy. I have worked on tax policy issues impacting telecommunications tax reform while at Sutherland and in my previous role as General Counsel for the Council On State Taxation (COST). While at COST, I testified before the U.S. House of Representatives, Subcommittee on Commercial and Administrative Law on this very topic. Since the Congressional hearing, few states have made any progress in reforming telecommunications taxation. Your leadership on this issue signals hope that New York will tackle the thorny issues necessary to modernize its telecommunications tax system. I offer comments on three main areas that will be relevant to your inquiry. First, I will briefly describe the current state of telecommunications taxation in New York State; second, I will discuss the importance of incorporating tax principles contained within the Streamlined Sales and Use Tax Agreement in any reform effort; third, I will discuss the reasons why it is bad tax policy to impose tax on digital goods as part of a telecommunications reform effort.

I. Taxation of Telecommunications Services in New York State

New York imposes a relatively high consumer tax burden on telecommunications services. During my tenure at COST we published several studies regarding the taxation of telecommunications services. The most recent of these studies was the 2004 State Study and Report on Telecommunications Taxation (the "COST Study" or "Study"). This study formed the basis of my previous Congressional testimony and has provided the data for discussion of telecommunications tax reform in every state that has considered the issue. The study documents the administrative and tax burdens imposed on telecommunications service in New York.

The COST Study compared the relative tax and administrative burdens imposed on general business and telecommunications providers and services under state and local transactional and property taxes. The Study shows that the average effective rate of state and local transaction (consumer) taxes for telecommunications services is 14.17%, compared to only 6.12% for general businesses nationwide. Following the completion date of the Study, the average effective rate of state and local transaction taxes in New York for telecommunications services was approximately 19%. In addition to the high tax rates imposed on telecommunications services, the New York tax structure imposes a significant administrative burden on telecommunications service providers. According to the COST Study, there are at least 588 taxing jurisdictions in New York that impose tax on telecommunications service; these separate jurisdictions require that service providers file in excess of 5,632 tax returns each year. Any attempt at modernization should seek to eliminate this discrimination by reducing the rate and number of taxes imposed on telecommunications services.

II. The Guiding Principles Behind the Streamlined Sales and Use Tax Agreement ("SSUTA" or the "Agreement") Should Be Incorporated in Telecommunications Tax Reform

While New York need not necessarily become a member of the Streamlined Sales Tax Governing Board, the definitions and administrative provisions set forth in the Streamlined Sales and Use Tax Agreement (the "Agreement") represent an excellent starting point if reform of telecommunications taxation proceeds. The Streamlined effort was created by the National Governor's Association and the National Conference of State Legislatures in the fall of 1999 to find solutions to the complexity of state sales tax systems. Leaders from both organizations were members of the Advisory Commission on Electronic Commerce (created in 1998 by the Internet Tax Freedom Act) and, as a result of their experience on that Commission set out through the sales tax simplification effort to develop rules for a tax system that would function in a 21st Century economy. Those rules are embodied in the Agreement.

The Agreement is a model state law that contains substantive and administrative rules intended to simplify the sales and use tax regimes and thereby reduce the tax collection burden for main street and remote businesses. Currently, more than one-half of the states that impose sales and use taxes (twenty-three of the forty-five) have enacted legislation that conforms to the Agreement's terms, with additional states expected to follow suit. Further, the Agreement is the result of the cooperative effort of all forty-five states that impose sales and use taxes, the District of Columbia, local governments and the business community to simplify and make more uniform the sales and use tax collection and administration by retailers and states, particularly retailers operating in multiple states. The Agreement has three basic goals: (1) level the playing field between local brick-and-mortar stores and remote sellers; (2) facilitate the collection of tax already owed to the states; and (3) ease the sales and use tax administrative burden on all businesses. The Agreement improves sales tax administration for main street and remote sellers through tax law simplifications, more efficient administrative procedures, and utilization of emerging technologies. The Agreement eases the sales tax burden on businesses by adopting uniform definitions, uniform and simpler exemption administration rules, rate simplification, state-level administration of all sales taxes, uniform sourcing (where the sale is taxable), and state funding of the cost of administration.

The Agreement broadly defines telecommunications service but contains exclusions from the definition of telecommunications services for data processing and information services, advertising, internet access and cable service and digital products. The Agreement also includes detailed definitions and rules for sourcing telecommunications services. Specifically, the Agreement provides special sourcing rules for postpaid and prepaid calling services and private communications services, and sourcing rules based upon the place of primary use and points origin for other services.

III. Taxing Digital Goods Does Not Compute

As New York considers tax reform it is important to distinguish carefully between reforming existing taxes on telecommunications service and expanding the tax base to include products that are electronically delivered. While New York State taxes telecommunications

service it does not tax digital goods delivered electronically. What do I mean by "digital goods"? Digital goods are products and services delivered electronically such as downloaded (intangible) books, movies, music, and software. Historically, these digitally delivered products have not been taxed at the state level because they do not take a tangible, corporeal form, such as a CD or a book. Similarly, most digitally delivered content does not fit within the purview of the state's telecommunications tax structure.

Imposing a new tax on digital goods will greatly discourage online economic activity. Consumers are using the Internet, broadband and mobile technologies for a host of different reasons including education, work, entertainment, health care and energy conservation. New taxes on digital content will increase the cost of these goods and services, thereby hampering growth of new technologies. In addition, unless remote vendors of digital products can be required to collect tax on items they sell, imposing tax on digital products sold by New York companies will impose a competitive disadvantage on those businesses where their out-of-state competitors do not face the same tax burden. Higher prices created by taxing the digital world would encourage digital businesses to move to more tax-friendly states where their consumers are one mouse-click away from tax free shopping.

Finally, imposing tax on digital products discourages the sale and purchase of ecologically sound goods and services. Simply put, a digital download is the greenest way to buy music, movies, books, and software. Downloading digital goods eliminates plastics and packaging, wasteful shipping and the drive to the store. A consumer driving to a store to buy a physical CD uses almost three times the amount of natural resources as a consumer who downloads a digital copy of the same CD.

In sum, I would like to thank the Select Committee for this opportunity to share my testimony with respect to the important issue of telecommunications tax reform in New York. I hope that my comments are useful as you continue your deliberations and I welcome the opportunity to respond to any questions.