

BRIEFINGS

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Center for a Competitive Florida

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LEGISLATURE MUST ACKNOWLEDGE THE DANGER OF THE TAX ON SUBSTITUTE COMMUNICATIONS SYSTEMS AND REPEAL IT IN 2005 SESSION

The 2005 Florida Legislature must act to repeal the tax on substitute communications to avoid a large unintended tax increase that would have a chilling effect on the state's economy and the competitiveness of our state's businesses.

Florida TaxWatch's Substitute Communications Tax Task Force concluded the tax is unworkable and its potential application is a dangerous threat to Florida's business climate. The Task Force--chaired by David Smith, President & CEO of PSS World Medical—noted that no other state has such a tax and decided the only sound course of action was repeal.

Representative John Stargel (HB 49) and Senator Mike Haridopolos (SB 818) have filed bills to remove the tax and passage is the most important tax issue the Legislature will face this session.

WHAT IS THE TAX?

The Substitute Communications Systems tax—as defined in 202.11(16), *Florida Statutes*—is a tax on any system capable of providing communications services used as a substitute for any switched service or dedicated facility by which a dealer of communications services provides a communications path.

This tax was enacted in 1985 to serve a very narrow purpose. After the divestiture of AT&T, the legislature created this tax for companies that attempted to bypass the phone companies by setting up their own internal phone systems, such as connecting two offices with a private line.

Although this tax has existed for twenty years, only a handful of companies have paid it and the current tax generates less than \$400,000 annually. Since phone companies no longer charge monopoly prices, there is little incentive to bypass telecommunications companies for traditional phone service. Substitute Communications Systems are subject to the Communications Services Tax, which includes state and local levies and averages about 14%, ranging as high as 18%.

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WHY IS IT A PROBLEM NOW?

The issue of taxing substitute communications came to the forefront in the aftermath of the Communications Services Tax law, which was passed by the 2000 Legislature. This very good law—a joint effort by telecommunications and cable television industries and state and local governments—simplified Florida’s telecommunications tax laws by replacing a hodgepodge of multiple taxes. The law simplified administrative burdens, acknowledged new technologies and the convergence of telecommunications, cable and satellite services, and clarified taxpayer information.

The substitute communications provisions from the old law were not considered problematic and were carried forward to the new law with little discussion and little change. However, the Florida Department of Revenue (DOR) for the first time was directed by the law to promulgate rules for administering the tax.

A draft rule by DOR, which would have applied the tax very broadly, received a strong negative reaction from the business community. The potential reach of this tax, as evidenced by the draft rule, is huge and potentially encompasses every business or home with: two or more computers networked together; an intercom system; a wireless dispatch system that transmits/switches voice or data among remote receivers and a central base system; or a system that transmits, routes and switches data to permit monitoring the activities and operations of manufacturing equipment, pipelines, rail systems or utilities. This is not just a business tax, it has tax implications for individuals as well.

THE CONCEPT OF TAXING SUBSTITUTE COMMUNICATIONS DOES NOT FIT IN TODAY’S LANDSCAPE

Under the law, a taxpayer’s liability is determined based upon the actual cost of the “substitute communications system,” and includes materials, labor, depreciation, and other costs attributable to the operation and maintenance of the system. Systems that cover a wide geographic area require that these costs be allocated to various local jurisdictions to compute the tax due to each jurisdiction. Compliance and enforcement of this tax would be a daunting task.

The statutory language for this tax is incredibly broad, lacking specificity as to what should be taxed. While this tax language may have been suitable 20 years ago when communication was ostensibly limited to phone service, it is damaging to businesses operating in today’s Internet, networked, and wireless world.

With changes in technology and the marketplace, a tax on "substitute" systems is even less workable now than it was when the concept was enacted. In 1985 there were a few, readily identifiable telephone companies, which provided a few, readily identifiable services.

There are now thousands of communications providers and the services they offer continually change and evolve. A taxpayer cannot practically keep track of all the communications vendors and of all their services, nor make judgments about whether their own systems are "substitutes" for these services.

TAX PRESENTS SARBANES-OXLEY ACT COMPLIANCE PROBLEMS

Another problem with leaving the tax on the books involves the new federal Sarbanes-Oxley Act. The goal of the Act is to increase the quality and reliability of financial reporting. It requires a report—know

as the Section 404 report—to be included in a company's annual report to the Security and Exchange Commission, beginning November 15, 2004.

Section 404 requires corporations to demonstrate that they have adequate internal controls in place over their financial reporting, including potential tax liabilities. Section 404 must assert a company's reported tax liability is complete—that all taxes in all jurisdictions in which the company is potentially liable are identified. The company must comply with all federal, state and foreign tax laws, accurately determine the tax and report liabilities in financial reports.

The difficulty in determining a company's substitute communications tax liability makes full compliance with Sarbanes-Oxley questionable. Not only is accuracy a problem, but public companies may be forced to report large tax liabilities that may not ever materialize. Even while the tax is effectively in limbo, it could hurt companies.

ENFORCEMENT OF THE LAW WOULD CONSTITUTE A NEW TAX AND A POTENTIALLY HUGE UNINTENDED TAX INCREASE

Any attempt to apply this tax uniformly would constitute a tax increase, in conflict with the Communications Services Tax Law, which was intended to be revenue neutral. No revenue from taxing substitute communications was included when the new tax rates were calculated.

As mentioned earlier, revenue now collected from substitute communications is minimal, less than \$400,000 (only about \$200,000 in state revenue.) Therefore, repeal of the law would have little impact on forecasted state revenues. This means that repeal would not significantly reduce the amount of money the legislature has to spend as it fashions the 2005-06 state budget.

REPEALING THE TAX SHOULD STAND ON ITS OWN

Resistance to repeal of this tax comes from two sources. First, local government sees it as an untapped revenue source and has encouraged its enforcement. One change the new Communications Services Tax law made was the addition of "substitute communications systems" to the local government tax base. The pre-Communications Services Tax local public service tax did not apply to such systems.

Second, some are concerned that new technologies could create future shortfalls to the Public Education Capital Outlay fund (PECO).

The potential impact on PECO from technologies such as Voice Over Internet that may reduce traditional phone calls is not an immediate threat and should be addressed separate from the Substitute Communications Tax issue. It would be difficult to fashion a worse response to that concern than the current substitute communications law. The negative impact of the widespread application of this tax on Florida's economy would be immediate and the resulting effects on business closures, cutbacks and relocations would also reduce state and local revenues.

CONCLUSION: REPEAL THE SUBSTITUTE COMMUNICATIONS TAX

Legislators must ask themselves if they would vote for the substitute communications tax if it were introduced in a bill as a new tax. With all the strong arguments against it--and no real merits—it is likely that support would be non-existent.

Opposition to the tax is virtually universal in the business community—among those who are aware of it. A strong and very capable coalition of over 40 companies and associations has formed to make repeal a priority.

Governor Bush recently included repealing the substitute communications tax as part of his 2005-06 budget recommendations. The state's economic development arm--Enterprise Florida—also supports repeal.

Bills to repeal the tax were debated in 2004. An amended bill to prevent the collection of the Substitute Communications Systems tax until 2006 passed the Senate unanimously, but the House did not take it up. Most consider its failure was due to political considerations, not real support for the tax or perceived problems with the bill.

Legislators should resist any consideration of a moratorium, which solves nothing and maintains a dark cloud of unpredictability over the state's business climate, making Florida a far less attractive place to do business. It also just prolongs problems, such as those created by Sarbanes-Oxley.

Repeal is the only real option.

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