

**September 2003**

## **The New Law on Substitute Communications Systems Needs To Be Revised to Avoid Major Tax Increases and Unintended Ill Effects to Florida's Economic Competitiveness**

The 2000 Legislature passed a bill creating a new Communication Services Tax (CST) that took a very important and much needed step in modernizing Florida's tax structure by overhauling the way the state and local governments tax communications services. However, as part of the implementation process, the Florida Department of Revenue is currently developing a rule that could offset the good done by the law by significantly raising taxes, creating administrative burdens and seriously effecting the competitiveness of our state's businesses.

How could this possibly happen? Largely because the statute that DOR is attempting to interpret under its rule-making authority to implement the tax is written so broadly as to lack specificity or clarity regarding legislative intent. In such an instance, any agency would want to promulgate a rule that would err on the side of inclusiveness of a statute's applicability. Whereas DOR presumably also would like to avoid promulgating a rule that exceeds legislative intent, on the other hand, it clearly would want to assure that all taxes due under the statute are collectable —thus, the current debacle.

The taxation of communications in Florida, particularly telecommunications, was a confusing jumble of multiple taxes, multiple rates, multiple jurisdictions, multiple tax bases and multiple exemptions. This resulted in taxpayer confusion, administrative nightmares and a climate that created competitive imbalances, stifled developing technology and discouraged economic development. The new simplified or "unified" communications tax rolls the current taxes on communications —the state sales and use tax, the gross receipts tax, the local option sales surtax, the local public service tax, local franchise fees, and local permit fees— into one tax with a state and local component. The varying taxation of different types of communication services will be largely unified, and providers will have one point of contact (the state) instead of having to deal with multiple jurisdictions.

The law directs the Department of Revenue (DOR) to develop rules to implement the tax, including one dealing with substitute communications systems. It appears that this proposed new rule, as written, would apply the tax very broadly, affecting every business with a computer network, telephone system or other communications system. The DOR rule would apply the tax to any communications system that allows switching, including in-house phone and computer networks, thereby taxing any system that allows intra-company communications based on the actual cost of that equipment. This has profound implications for virtually any business in Florida.

### **Defining a Substitute Communications System**

The basis for taxing substitute communication systems is the theory that a business should not escape taxation by creating something in-house that is a direct substitute for a product or service that is taxed when supplied by other providers. Representatives of the business community participating in a workshop on the proposed DOR rule suggested that legislative intent was that a substitute communications system would be taxable if it were a switched system for which a communications services dealer provided the communication path.

In fact, the old law had a provision, dating back to the 1980s, for taxing substitute telephone systems. These were systems that provide that person with telephone service or telecommunication service which is a substitute for any telephone company switched service or a substitute for any dedicated facility by which a telephone company provides a communication path (Section 203.01 (1)(c), 2000 Florida Statutes). This statutory provision did not result in uniform compliance and administration among all taxpayers.

The proposed DOR rule goes much farther. It defines a substitute communications system as any system capable of providing communications services that are a substitute for any switched service or dedicated facility that a dealer would use to provide communications services. It must be capable itself of providing and may be operated on a stand alone basis or be interconnected to communications services or systems provided by a dealer.

It also defines switched service as any service that uses a mechanical, electrical, optical, or other device that opens or closes circuits, completes or breaks an electrical or other path along which signals travel, or selects paths or circuits to allow for the transmission, conveyance, or routing of communications signals between and among points.

This would apply the tax to a myriad of systems, including partial taxation of personal, home computer networks. The proposed DOR rule offers the following examples of taxable systems:

- A telephone system with switching and routing capabilities allowing for intercom and other self-contained communications at the taxpayer's facility.
- A computer local area network (LAN) system that uses a router to provide switching capabilities necessary to connect the multiple computers used by the taxpayer's employees.
- A wireless dispatch system that transmits and switches voice or data signals to provide a communications path between and among remote receivers and a central base station.
- A taxpayer buys telephone transmission and receiving equipment located at various sites where the taxpayer does business and acquires and installs a tower for the purpose of providing communications services between those sites in lieu of using a local exchange provider and long distance provider.
- A system to transmit, route, and switch data to permit monitoring the activities and operations of manufacturing equipment, pipelines, rail systems, or utilities.
- A home personal computer network that uses a router that receives the signal from one computer and sends it to the other over a cable. The purchase cost would not be taxable, but if there were any actual costs identifiable to operating the system--such as installation and repair--the individual would be liable for some of tax (The individual would be exempt from 6.8% of the state portion under the residential exemption in Florida law.).
- A small business has five computers, each connected to a central router that allows the computers to share printers, files and documents, and other business related activities.
- A two-way mobile radio system that includes a base station, a central tower used for signal switching, and several mobile radio units and for which the company does not buy airtime or switching services from a provider.

### **Proposed Rule Would Create a Huge Tax Increase**

One area in which the proposed DOR rule would violate legislative intent is revenue neutrality. The new communications services tax was, to the extent possible, supposed to produce the same amount of revenue that the old taxes were expected to produce --no more, no less. In calculating the new rates, DOR did not include the revenue windfall that would be raised from taxing these additional things specified in the proposed DOR rule.

The additional revenue that would be raised is significant, both in terms of total state and local revenue and the impact to individual businesses. There has been no attempt to estimate the fiscal impact, but the proposed DOR rule, as written, would impose a new tax on at least most businesses. The tax rate on communication services can reach as high as 16% (9.17% state tax plus varying local rates.) That is a major tax increase on any base of new transactions. The tax rate would be applied to the actual cost of the system, or any materials, labor, and other costs that are directly attributable to the operation and maintenance of it. Examples of costs are depreciation of

equipment and facilities, lease or rental expenses associated with equipment and facilities, repair and maintenance, storage costs, insurance costs, tools and equipment used to maintain the system, utilities used to operate the system, taxes, licensing and franchising costs, interest expense, and employee salaries and benefits.

Since the depreciation costs are those amounts used for federal income tax purposes, the accelerated amounts would result in large unforeseen taxable costs.

One participant at the workshop estimated his company's annual tax burden would be \$2 million and another company has told Florida TaxWatch that its taxes could increase by tens of millions of dollars and that such a taxing scheme would result in it leaving the state.

## **Conclusion**

It must be noted that this proposed DOR rule is still very much a work in progress. DOR staff has told Florida TaxWatch that the proposed rule was just a starting point for discussion and that final adoption is months away. ” The Department of Revenue has just finished soliciting written comments from taxpayers, and, once those have been evaluated, another workshop will be scheduled.

It is clear that the proposed DOR rule would constitute a very large and unforeseen tax increase and have a chilling effect on many businesses and Florida's economy as a whole. The communications services tax was a step in the right direction and the rulemaking process needs to keep in mind the same principles that drove the development of the law –tax modernization, simplicity, competitiveness, promotion of technology and economic development and revenue neutrality.

The current statutory language is simply too broad. DOR should go no further in its interpretation of the tax's applicability than the Legislature intended, especially with regard to the law's objective of revenue neutrality. It is imperative that they not go too far with their rule making. The Legislature clearly could help out with some added direction.

Florida TaxWatch will continue to monitor this process and work to promote a good rule and sound tax policy that is modern, practical, equitable and one that encourages –not discourages –sound capital formation and solid job growth in and throughout Florida.

*The proposed rule 12A019.036 can be viewed on the Department of Revenue's website:*

<http://sun6.dms.state.fl.us/dor/rules/12a19substitute.pdf>

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## *About Florida TaxWatch*

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Florida TaxWatch is the only statewide organization entirely devoted to protecting and promoting the political and economic freedoms of Floridians as well as the economic prosperity of our state. Since its inception in 1979, Florida TaxWatch has become widely recognized as the watchdog of citizens' hard-earned tax dollars. The nationally distributed *City and State* magazine (now *Governing* magazine) published a poll of the nation's statewide taxpayer research centers. Based on this poll, the publication cited Florida TaxWatch as one of the six most influential and respected government watchdogs and taxpayer research institutes in the nation.

In recent years, news stories about Florida TaxWatch have run in all Florida newspapers, *The Wall Street Journal*, *The New York Times* and *The Washington Post* and *Fortune* magazine. In addition, Florida TaxWatch has been featured on the prestigious *MacNeil/Lehrer Newshour*.

Florida TaxWatch is a private, non-profit, non-partisan research institute supported by voluntary, tax-deductible membership contributions and philanthropic foundation grants. Membership is open to any organization or individual interested in helping to make Florida competitive, healthy and economically prosperous by supporting a credible research effort that promotes constructive taxpayer improvements. Members, through their loyal support, help Florida TaxWatch to bring about a more effective, responsive government that is accountable to the citizens it serves.

Florida TaxWatch is supported by all types of taxpayers – homeowners, small businesses, corporations, professional firms, labor unions, associations, individuals and philanthropic foundations – representing a wide spectrum of Florida's citizens.

Florida TaxWatch's empirically sound research products recommend productivity enhancements and explain statewide impact of economic and tax and spend policies and practices. Without lobbying, Florida TaxWatch has worked diligently and effectively to build government efficiency and promote responsible, cost-effective improvements that add value and benefit taxpayers. This diligence has yielded impressive results: through the years, three-fourths of TaxWatch's cost-saving recommendations have been implemented, saving taxpayers over \$6.2 billion (according to an independent assessment by Florida State University). That translates to approximately \$1,067 in added value for every Florida family.

With your help, we will continue our diligence to make certain your tax investments are fair and beneficial to you, the taxpaying customer who supports Florida's government. Florida TaxWatch is ever present to ensure that taxes are equitable, not excessive, that their public benefits and costs are weighed, and that government agencies are more responsive and productive in the use of your hard-earned tax dollars.

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