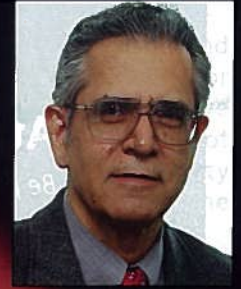


# The Tax Implications of the Telecom Revolution



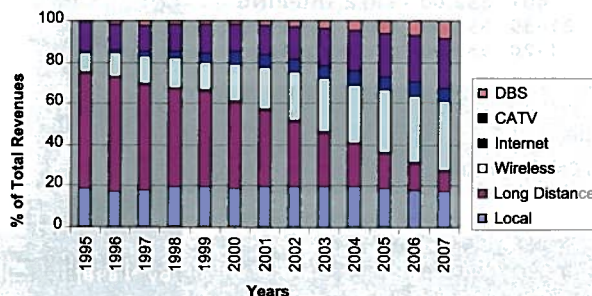
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*It is just a matter of time for the traditional telephone services to totally disappear and the landscape to be covered by Broadband services, including broadband wireless like WiFi and WiMax.*

The telecommunications technologies, services and regulatory policies have been on a rapid spiral of evolution in the recent years. When we conducted a study of telecom taxes and fees in NJ in 2001[1, 2], it became clear that the state policies on taxation of telecommunications services and service providers, and the systems of compensation of local governments for the use of public resources by cable television and telecommunications companies have not kept pace with this rapid change. The telecom revenues were rapidly shifting from traditional wireline services to wireless, CTV and Internet services (See Figure 1)

VERIZON TRIPLE PLAY AND COMCAST TRIPLE PLAY ARE ONLY DIFFERENT IN SPEED AND THE AMOUNT VIDEO PROGRAMS. SO, ARE THESE COMPANIES COMPENSATING THE STATE AND MUNICIPALITIES THE SAME? THE ANSWER IS NOT YET.

Relative Distribution of NJ Communications Revenues by Service

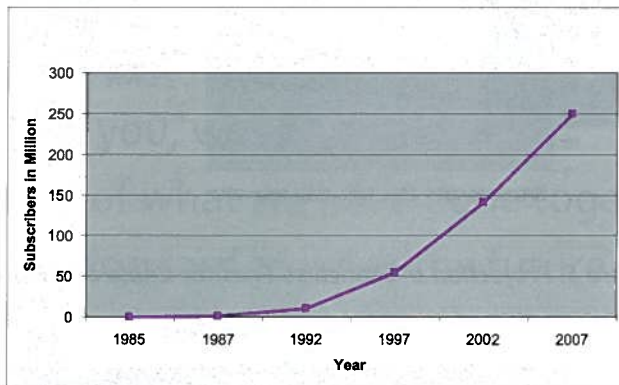


**Figure 1. Relative Distribution of NJ Communications Revenues by Service**

This shift has had great impact on the revenue stream of the state and municipalities. The New Jersey statutes do not allow local government to impose taxes and fees on the telecom services and service providers outside the franchise fee for the CTV'. The study brought the problem to the attention of policy makers and legislators in NJ, but no action was taken to level the playing field for the service providers in traditional and advanced services, and secure fair compensation for the municipalities from the use of public resources. It seems though the technology evolution and the forces of competition between cable and telecom companies is pushing the change in the right direction. In the rest of this article, I will discuss briefly this evolution and how it is impacting the state and local governments' revenue.

**Technologies that Changed Telecom**

For almost 100 years, a twisted pair of wire was the technology to bring telecom services, primarily voice services, to customers across the country. The introduction of new technologies: Cable TV, Wireless Mobile and Broadband has fundamentally changed the communications paradigm. The cellular technology invented by Bell Labs in mid 1960's has been on a rapid of growth. In 2007, the number of wireless subscribers in the United States reached 250M (see Figure 2). The convenience of wireless technology is pushing consumers to abandon their wirelines in favor of wireless. The average wireline residential toll minutes have been dropping at a compounded rate of 15 percent since 2000, and the wireless interstate minutes of use (MOU) has been growing at a compounded rate of 40 percent. Six percent of the households today have only mobile service [3]. So the shift from wireline to wireless has been much more dramatic than our estimate in 2001 [4].

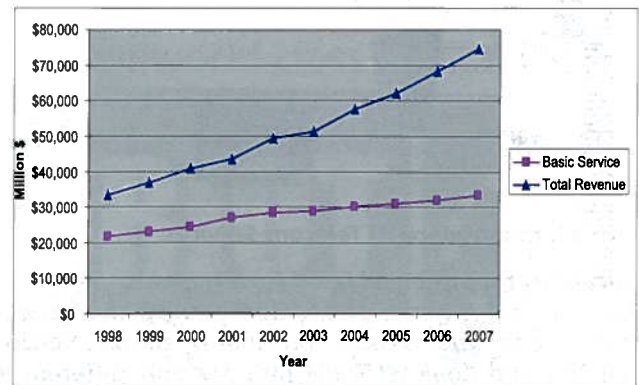


**Figure 2. Growth of Wireless Subscribers in US**  
Source of data: Cellular Telecommunications & Internet Association (CTIA)

The second technology that had fundamental impact on telecommunication has been introduction of Cable TV. The Cable Act of 1984 brought CTV under FCC regulation and established a franchising process for municipalities to negotiate with the cable companies, and put a limit of 5 percent on the franchise fee. The Act also prohibited telephone companies from providing video services. These

restrictions kept CTV distinct from telecom service, and prevented the telephone companies from competition with the cable companies in providing video services.

The Cable revenues have been growing in recent years due to bundling of basic and enhanced services, and providing video-on-demand (Figure 3).



**Figure 3. Cable Revenue Growth in NJ from 1998-2007**  
Source: National Cable & Telecommunications Association, September 2007

The third technology that has impacted telecommunications fundamentally is high speed access or Broadband. Broadband is provided through Cable network, Telephone companies' DSL, Wireless network, satellite, and recently fiber to premises. Broadband access has led to convergence of devices and services. Cable companies are no longer cable TV companies, they are also providing Internet access and voice services through VoIP. So are the cable companies still distinct from telecom companies? No, the distinction has been totally wiped out. That has forced giant telecom companies like Verizon to realize that the game has changed. Verizon has been making an effort to compete with the cable companies by installing fiber to premises. It is just a matter of time for the traditional telephone services to totally disappear and the landscape be covered by Broadband services, including broadband wireless like WiFi and WiMax. Broadband has also brought integration of services, so multiple devices can communicate with each other through a single box (Figure 4).



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Figure 4. Convergence of Telecom Services

Implications for State and Local Governments

There is no longer a distinction among the service providers as to what is cable and what is telecom. Verizon Triple Play and Comcast Triple play are only different in speed and the amount video programs. So, are these companies compensating the state and municipalities the same? The answer is not yet. Part of the problem has been the federal government and part has been the shortcoming of the state policy makers. The Cable Act offers a maximum of 5 percent franchise fee on the gross profit of cable service in lieu of all other taxes and fees. In NJ the franchise fee was set at 2 percent of the basic service revenue far short of what the Cable Act allowed.

Verizon also decided that it can not negotiate a franchise agreement one municipality at a time. So it pushed for a more efficient state-wide franchise by offering 3.5 percent of gross revenues to municipalities and 0.5 to the state. This opened up the New Jersey franchise fee to higher rate. However, cable franchise agreements are for 10 years. The municipalities can not change the agreement before the contracts are expired unless the state enacts a new law forc-

ing the change. Under the current law, the cable companies are subject to higher fee when Verizon is able to service at least 60 percent of the households in a community [5].

Congress also prohibited applying taxes to Internet access service and e-commerce. What about VoIP service? The traditional phone services and wireless services are subject to sales tax. Many states have opted to treat VoIP as traditional telephone service, subject to sales tax. The New Jersey Sales and Use Tax Act of 2005 imposes sales tax on VoIP service.

Two issues for state legislatures: 1) The discrepancy in franchise fee between Cable and telecom companies is costing municipalities and the state. A rough estimate of the projections over the next few years is shown in Figure 5. 2) The second issue is that New Jersey has one of the lowest overall combined state and local telecom tax rate as shown in Figure 6.

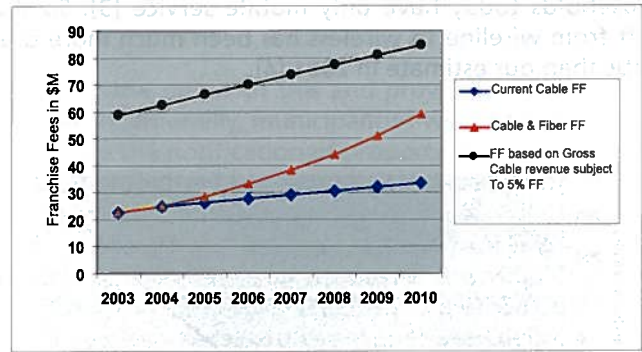


Figure 5. Projection of Franchise Fees for Cable and Fiber

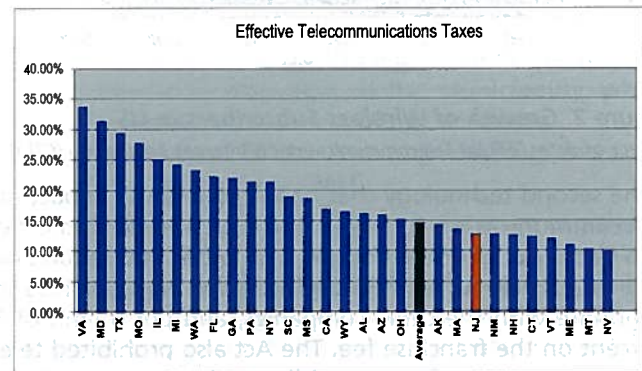


Figure 6. Telecommunications Tax Rates by State

Source: Council on State Taxation 2004.

Summary

This article tracks the evolution of telecommunications and cable services and the issues with the franchise fees in New Jersey. Although the state has passed laws piecemeal over the past few years including a statewide franchise agreement for Verizon, and declaring VoIP a telecom service subject to sales tax, the state legislatures should take up the issue and to pass a uniform tax rate for all communications services and perhaps increase the rate to the average of the states. ▲

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 1 New Jersey Statutes § 54:30A-124 and§ 48:5A-30.

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