

Economic Update

Update on economic issues affecting Seattle's tax revenue performance

The newsletter of the City of Seattle's Economics Team/March 2004

SPECIAL TOPIC

Future of Seattle's Telecommunications Tax Revenue Threatened by Federal Legislation

U.S. legislators have worked hard to keep access to Internet connections and many forms of Internet communication free from regulation and taxation. In 1998, legislation popularly known as the Internet Tax Freedom Act was signed into law. This Act imposed a three-year moratorium on certain state and local taxes relating to the Internet and electronic commerce. It was extended, with no changes to the 1998 legislation, to November 1, 2003. The debate has intensified since the extension expired in 2003. Congress is currently deliberating two bills: S.2084 and S.150, and as of this writing, are hammering out amendments to both.

S.2084 would essentially extend the current moratorium for two more years. In contrast, S.150 would make the temporary ban on internet taxation permanent, broaden the scope, and wipe out existing taxes that had been grandfathered in under the previous law. Moreover, because Internet technology is so intertwined with telephone service, its passage could significantly reduce Seattle's tax revenue from the telecommunications industry. The purpose of this paper is to clarify the potential ramifications to Seattle's tax base should S.150 become law.

Seattle's Tax Authority

Under state law, Seattle is authorized to impose a Business and Occupation tax, commonly known as the B&O tax. In addition to the sales and the property taxes, this tax is one of the main sources of tax revenue to fund City government services. The B&O tax is imposed by applying a rate to gross receipts. The rate varies according to the type of activities conducted by the business or person. Generally, the rate ranges from 0.215 % to 0.415%. In contrast, businesses providing certain utilities are taxed under a considerably different rate structure. Using authorization by state statute, Seattle imposes a utility tax of 6% on gross receipts

for the provision of electricity, telephone, natural gas, and steam services.

Internet and telecommunications taxation in Seattle

Seattle currently levies the Utility rate of 6% on the provision of telephone services and the B&O rate of 0.415% on the providers of Internet service (ISPs). The original Internet tax moratorium allowed continuation of these taxes because it included a "grandfather" provision that allowed states that presently tax Internet access to continue doing so, but forbade states from passing additional levies related to the Internet. Additionally, it made a distinction between the Internet and telecommunications. In contrast, S.150 specifically:

1. strikes out the grandfather provision that allowed state and local taxes on Internet access if such tax were generally imposed and actually enforced before October 1, 1998, and
2. adds to the definition that "Internet access does not include telecommunication services, *except to the extent such services are used to provide internet access*"

While the elimination of the grandfather clause jeopardizes the B&O tax base derived from the ISPs, the larger potential tax loss would come from the broader definition of Internet access, insofar as the addition of the italicized words in 2) above includes services currently taxed under the telephone utility tax rate.

The Seattle Municipal Code defines telecommunications broadly and generally includes access to a local telephone network to transmit a wide array of data. Using this definition, Seattle has taxed basic telephone service, long distance, digital subscriber lines (DSL)

and cable modems at the 6% telecommunications utility tax rate. In 2003, revenue from the telephone industry totaled \$31 million. The risk of losing this tax base increases with technological change. The following describes the vulnerabilities of the components that make up the telephone industry.

DSL and Cable Modems

At first glance, the most vulnerable segment of the telephone tax revenue base would be from DSL and cable modems. Both technologies provide a high speed connection to the Internet. This is a significant but relatively small part of the industry accounting for about 5-10% of the telephone tax revenue. The new language in S.150 states that all types of Internet access – ranging from dial-up connections and high-speed DSL to cable modems – cannot be taxed.

Basic telephone lines and long distance

In Seattle, the majority of residents and businesses have wired telephone service and pay a monthly fee for the ability to make local and long distance calls. The 6% utility tax is assessed on the monthly fees and the fees associated with long distance calls. Together, basic phone service and long distance account for the largest share of tax revenue from this industry. Taxing these services remains unaffected by S.150; however, recent technological developments have increased the vulnerability of this segment as a stable revenue source.

VoIP phone service

Major telecommunications companies are embracing a technology called Voice over Internet Protocol (a.k.a.

VoIP). VoIP technology allows the user to make local and long distance phone calls through a broadband internet connection. If VoIP is not taxable under the proposed legislation, the real risk lies in the extent businesses and individuals replace their conventional phone service with VoIP.

The emergence of VoIP has ignited a debate among regulators, telecommunication companies and state and local governments. Central to this discussion is whether and how the Federal Communications Commission will define and regulate Internet phone service.

Adding to this puzzle is that VoIP can be many things. Some systems are hybrids that use both the Internet and the public switched telephone networks. An example of this is AT&T’s use of its Internet backbone to carry long-distance calls with its traditional phone system to begin and end calls. Another hybrid system is offered by Vonage Holding Corporation. Customers make calls with a broadband connection, but Vonage can deliver calls to conventional phones on the public switched network. At the other end are systems that bypass the phone network entirely with special phones that communicate with each other over broadband Internet connections. Pulver.com’s Free World Dialup is an example of this service.

FCC may hold key to telecommunications taxation

By year end, the FCC is expected to set a broad strategy for regulating Internet phone technologies. This is important because FCC governance of an industry would categorize that industry as telecommunications

Major VoIP Offerings

FCC Cases	Features	FCC ruling
AT&T – hybrid	<ul style="list-style-type: none"> • calls start and end on traditional phone system but are partially carried on Internet • don’t need broadband connections • don’t need computer 	FCC is expected to reject AT&T’s claim that their VoIP calls should be exempted from costly fees to local phone companies.
Vonage - hybrid	<ul style="list-style-type: none"> • calls made from telephone systems that tap into Internet and from PCs • requires DSL or cable modem connections 	FCC judgment still pending
Free World Dialup	<ul style="list-style-type: none"> • software allows free calls from PC via broadband connection • requires special phones • never taps into phone system • can only call others on same system 	FCC ruled in February that this form of VoIP is not subject to government regulation

thereby supporting its taxation under that classification. This could have important bearing in court cases in determining the extent to which a Federal moratorium on the provision of Internet service precludes State and local taxes on Internet-related telecommunication services. It would also influence U.S. Congressional debates on this topic.

Preliminary “mock” debates before FCC staff members give hints to how it may rule on several cases. One key case involves AT&T. In a recent closed-door mock debate, AT&T has argued that it should be exempt from paying costly fees to local-phone companies if much of a call travels over the Internet rather than the public phone system. According to FCC and industry officials, the FCC is expected to reject AT&T’s claim.

However, a second decision may set the point of distinction for federal regulators. The FCC ruled in February that Free World Dialup, a computer-based Internet phone service, isn’t a telecommunications service under federal rules and is not subject to government regulation. The FCC has never regulated computer-like communications that don’t use the phone network. Free World Dialup allows consumers to download software from the Internet that enables them to make free phone calls from their personal computers to other Free World users anywhere in the world. The difference between the two applications is that calls made using AT&T internet service don’t originate on the Internet – only the long-distance portion of the call is by a different means of transport. Free World Dialup

is a type of software application that works on PCs. With regard to Vonage, the FCC is expected to put off that decision.

Summary

Two U.S. bills concerning internet taxation have dramatically different outcomes for Seattle’s tax base. The scenario for preserving Seattle’s telecommunications tax base is that S.2084, the bill which extends the current Internet Taxation Act for two more years, prevails over S.150. This would most likely allow Seattle to continue taxing telecommunication services, including DSL and cable modems, at the 6% utility rate and ISPs at the 0.415% B&O rate.

The passage of S.150 would have the following impacts on Seattle’s tax base: immediate loss of revenue from the taxation of ISPs, cable modems, and DSL service; and more significantly, the potential inability to tax telecommunication services that use the Internet to provide local and long distance telephone service. Recent negotiations among U.S. legislators indicate a willingness to support S.150 if internet-based telephone calls are not included in the tax moratorium. This would lessen the risk of losing internet-related telephone service from Seattle’s telecommunications tax base, potentially its largest chunk of revenue. Ultimately, taxation issues related to the internet and telecommunications may hinge on the FCC as its decisions on impending telecommunication cases will guide the level of impact of a permanent Internet taxation ban on Seattle’s telecommunications tax base.

2003 Yearend Report

Comparing year-over-year revenues for general fund taxes and other major revenues

March 2004

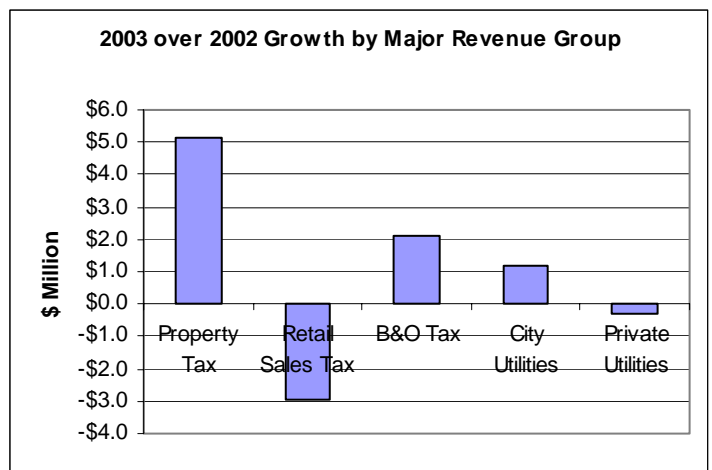
Reeling from a weak and uneven recovery from the 2001 recession, 2003 was a year of modest growth for the national economy, particularly in the early months of the year. However, after the conventional phase of the Iraq War ended in early May, the national economy showed marked improvement. Productivity grew at a rapid pace in both the second and third quarters, and employment has grown at a modest pace from September-December. The improving economy was reflected in a 4.1% growth rate for real gross domestic product (GDP) in the fourth quarter of 2003.

Unlike the national economy, which accelerated in the 4th quarter, the results for the Puget Sound economy are mixed. During the period from December 2000 to December 2003, employment in the 4-county region dropped by more than 90,000 jobs, approximately 6.5% of its employment base. On a positive note, Boeing announced plans to build the 7E7 in Everett, which is estimated to result in 800-1,200 new jobs, and more importantly, increase the likelihood that Boeing employment will remain stable or expand in the future rather than decline.

As the table below shows, City tax revenues in 2003 exceeded 2002 by \$7.5 million, despite a large de-

cline in sales and natural gas taxes. Offsetting these losses were gains from property tax, B&O tax, and the public utilities.

Collections for admission tax are \$1.5 million greater than 2002. The strong year-over-year growth results from strong performance from general entertainment venues, and from the rescission, in 2003, of City policy to allocate 20% of revenues from this tax (excluding revenue from pro sports teams) to the Arts Account.



2003 Major General Fund Revenues

Revenue Source	2003 Actuals preliminary	2003 Revised Forecast	\$ Difference	Percent Difference	2002 Actuals	Yr/Yr \$ Difference	Yr/Yr
							Percent Difference
General Property Tax	173,428,751	172,883,889	544,862	0.3%	168,292,760	5,135,991	3.1%
Property Tax - EMS Levy	19,043,719	19,046,000	(2,281)	0.0%	18,516,980	526,739	2.8%
Retail Sales Tax	112,461,281	113,772,411	(1,311,130)	-1.2%	115,334,274	(2,872,993)	-2.5%
Retail Sales Tax - Criminal Justice Levy	10,802,953	10,781,545	21,408	0.2%	10,874,436	(71,483)	-0.7%
B&O Tax (90%)	115,570,515	114,500,664	1,069,851	0.9%	113,442,248	2,128,267	1.9%
Utilities Business Tax - Telephone (90%)	30,384,453	30,038,287	346,166	1.2%	30,464,897	(80,444)	-0.3%
Utilities Business Tax - City Light (90%)	30,190,871	30,021,200	169,671	0.6%	30,594,392	(403,521)	-1.3%
Utilities Business Tax - SWU & priv.garb. (90%)	7,640,566	7,552,578	87,988	1.2%	7,509,790	130,776	1.7%
Utilities Business Tax - City Water (90%)	8,051,280	8,171,000	(119,720)	-1.5%	7,077,704	973,576	13.8%
Utilities Business Tax - DWU (90%)	13,254,032	13,327,272	(73,240)	-0.5%	12,741,699	512,333	4.0%
Utilities Business Tax - Natural Gas (90%)	7,813,957	7,495,000	318,957	4.3%	8,704,591	(890,634)	-10.2%
Utilities Business Tax - Other Private (90%)	9,263,340	8,871,000	392,340	4.4%	8,559,922	703,418	8.2%
Admission Tax	6,757,285	6,380,000	377,285	5.9%	5,251,220	1,506,065	28.7%
Other Tax	4,952,104	5,049,000	(96,896)	-1.9%	4,706,292	245,812	5.2%
Total Taxes	549,615,106	547,889,846	1,725,260	0.3%	542,071,205	7,543,901	1.4%
Licenses and Permits	12,397,198	12,020,660	376,538	3.1%	10,212,453	2,184,745	21.4%
Parking Meters/Meter Hoods	11,244,714	11,744,800	(500,086)	-4.3%	10,674,005	570,709	5.3%
Court Fines	15,978,071	15,845,000	133,071	0.8%	14,178,091	1,799,980	12.7%
Interest Income	2,097,382	1,851,000	246,382	13.3%	3,053,278	(955,896)	-31.3%
Revenue from Other Public Entities	8,418,649	9,045,736	(627,087)	-6.9%	11,476,082	(3,057,433)	-26.6%
Service Charges & Reimbursements	39,131,733	38,580,251	551,482	1.4%	41,134,246	(2,002,513)	-4.9%
All Else	966,785	797,910	168,875	21.2%	1,724,481	(757,696)	-43.9%
Total: Revenue & Other Financing Sources	639,849,638	637,775,203	2,074,435	0.3%	634,523,841	5,325,797	0.8%
Use of Fund Balances	5,251,632	5,248,633	2,999	0.1%	11,303,894	(6,052,262)	-53.5%
Total, General Subfund	645,101,270	643,023,836	2,077,434	0.3%	645,827,735	(726,465)	-0.1%