Montana Department of Revenue

Dan Bucks
Director

Brian Schweitzer
Governor

To: Dan Bucks, Director

From: Dan Dodds, Senior Economist

Date: July 19, 2012

Subject: Alltel Decision and Telecommunications Revenue

This memo addresses the difference between actual revenue from the retail telecommunications excise tax (RTET) and revenue predicted in the fiscal note and the revenue impact of the recent Alltel case.

The Fiscal Note and Actual Revenue

The 1999 Legislature created the RTET as part of a general revision of taxes on telecommunications companies in HB 128. HB 128 replaced the old telephone company license tax and reduced the tax rate for property taxes on telecommunications property. The fiscal note projected that collections for FY 2001 would be $25.936 million.

The legislature intended HB 128 to be revenue neutral, but it quickly became apparent that the new RTET was not bringing in as much revenue as expected. Actual collections for FY 2001 were $18.838 million.

The department launched a major effort to find out why. There were two main causes. The more important is that HB 128 went into effect at the same time that growth of the tax base slowed dramatically. Long distance service was opened to competition, the new entrants created excess capacity, and long distance rates dropped. A less important cause of the revenue shortfall was that department staff, working with industry representatives, had used data on telephone company revenue from the Federal Communications Commission to estimate the tax base without realizing that the data included revenue that would be exempt from the new tax.

If collections for FY 2001 had been as predicted in the fiscal note, actual growth of collections since then would have resulted in revenue of $30.358 million for FY 2011. Actual collections for FY 2011 were $22.050 million.

The Alltel Decision

The RTET statute exempts charges 'that have been prepaid by a prepaid calling card that enables the origination of calls by using an access number or authorization code' (15-53-129(3)(b)(xi), MCA). The department interpreted this as exempting traditional calling cards, where the customer can make calls from any phone by entering an access code, but not exempting prepaid wireless service, where the customer may use an access code to activate a phone, add air time or extend the service period. The 2007 Legislature amended the TDD fee statute (53-19-311, MCA) to specifically make prepaid wireless charges subject to the fee. The 911 fee statute provides one exemption, for coin-operated pay phones (10-4-202, MCA).

The department audited Alltel and determined that they had not been applying the RTET or the TDD fee to revenue from pre-paid wireless customers and had not been applying the RTET to revenue from digital downloads. The department assessed back taxes, which Alltel contested in district court. The First Judicial District Court decided in Alltel's favor, in Alltel Communications, LLC v. Montana Department of Revenue (CDV-2010-981).

The court ruled that the RTET statute and the pre-2007 TDD statute do not apply to prepaid wireless customers. Part of the court's reasoning was based on language in 15-52-129(2) that defines taxable telecommunication services as, among other things, 'billed to a customer with a Montana address.' The court concluded that prepaid wireless customers are not taxable because they are not sent a bill. The court also relied on the fact that the 2007 Legislature amended the TDD statute. The court concluded that the 2007 Legislature added language applying the TDD fee to prepaid wireless charges because the old law did not apply the fee to those charges.

The court also ruled that the federal Internet Tax Freedom Act prevents the state from taxing the sale of digital products to be downloaded when it does not tax the sale of similar digital products through other outlets.

Short and Long-Term Impacts of the Alltel Decision

There may be companies that have paid tax on pre-paid wireless revenue, and companies that have could request a refund. None have yet, and the amount of possible refunds is unknown.

The legislature's revenue estimates for the 2013 biennium are based on average telecommunication company taxable sales from 2003 through 2010, with essentially no growth. Few if any pre-paid wireless sales were being reported as taxable in the base period for this forecast, so the forecast implicitly assumes there will be none in the current biennium. Since there are no pre-paid wireless sales in the forecast, it does not need to be adjusted downward to take the Alltel decision into account.

Additional revenue that would be collected in the current biennium if pre-paid wireless were taxable is uncertain because the extent of prepaid wireless sales is unknown. However, prepaid wireless appears to be growing rapidly, and the Alltel decision could significantly affect revenue in the future.

Pre-paid was originally marketed to customers who made few calls and to those who could not qualify for, or did not want, a long-term contract. Over time, cell phone companies have added new types of pre-paid plans to compete for additional market niches. This now includes high-end plans, such as “all-you-can-eat” packages where smartphone or tablet users can pay a fixed fee in advance for unlimited voice, text, and data access. Most customers buying these prepaid plans are probably switching from another type of plan rather than buying an additional phone or device. Over time, this is likely to lead to an increasing share of telecommunications services being outside the tax base.

Cell phones appear to account for 60% to 65% of tax revenue. The Federal Communications Commission’s Annual Reports on Wireless Competition cite estimates that the nationwide share of wireless customers with pre-paid service was 15% at the end of 2006 and 20% at the end of 2009. The only information we have on prepaid wireless in Montana is from audits from 2006 and 2007, which appear to show a lower initial prepaid share.

If, in the future, 25% of wireless service switched to prepaid, this would reduce the telecommunications tax base by about one-sixth. Assuming no growth in overall telecommunication sales, this would result in a revenue reduction in the range of $3.5 to $4 million.