

Statement of

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Regulatory Aspects of
Voice over Internet Protocol Technology

Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives

July 23, 2004

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on behalf of the Federation of Tax Administrators**

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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear before you today on the important question of the appropriate federal policy regarding the regulation and taxation of Voice over Internet Protocol (VoIP) technology. My name is Stephen M. Cordi. I am the Deputy Comptroller for the State of Maryland, and I appear before you today on behalf of the Federation of Tax Administrators, an association of the principal state tax administration officials from the 50 states, D.C. and New York City.¹ I am the Immediate Past President of the Federation.

My comments today will be limited primarily to the issue of potential federal legislation that would eliminate, limit or otherwise preempt the ability of state and local governments to impose taxes on VoIP services. There are important issues involving potential federal preemption of state authority to regulate VoIP services, but I leave those to others with expertise in the area. Further, I will direct my comments principally to the state and local taxation provisions in H.R. 4129, The VoIP Regulatory Reform Act of 2004, that was introduced by Rep. Pickering and others since that is the clearest expression of potential federal policy in existence today.²

¹ The Federation of Tax Administrators is an association of the state tax agencies in the 50 states, District of Columbia and New York City with principal programs in information exchange, training and intergovernmental coordination. FTA policy regarding federal preemption of state taxing authority was adopted by the membership at its 2004 Annual Meeting. That policy statement is attached.

² H.R. 4129 would, among other things, prevent any state or political subdivision from imposing any tax, fee or other charge on the offering or provision of VoIP services. It would also preempt any state regulation of VoIP services and would limit the extent to which the Federal Communications Commission could regulate VoIP services.

The thrust of my comments today can be summarized as follows: Congress should not take action at this time that would preempt the ability of state and local governments to impose taxes on VoIP communications services. Such an action would discriminate against other providers of voice communications services using technologies that are subject to tax and would deprive states and localities of significant amounts of revenue in the very near future. In addition, such an action would run counter to our system of federalism and to the traditional Congressional posture of not intervening in state taxing matters. Finally, we believe that no case has been made that would warrant federal intervention at this point, and that federal action of the sort envisioned in H.R. 4129 would obviate any possibility of a cooperative state-industry dialogue to identify and resolve any issues that may be present in state and local taxation of VoIP services.

Federal Preemption Would Create Discriminatory System

There is no doubt that VoIP is an exciting new technology that holds significant potential to provide enhanced, more convenient communications services to some consumers and businesses at costs that are sometimes lower than they face today. Each week seems to bring the announcement of another VoIP offering, not only from start-up companies, but also from established telecommunications companies of all types.³ At its core, however, we must remember that VoIP is one of several competing technologies that can be used for providing voice communications services.

One of the primary goals of tax policy is to treat similar taxpayers and similar goods or services in a similar fashion when it comes to taxation. Only by taxing similar or functionally equivalent services in the same fashion, can we ensure that consumer choices are based on price and quality of service and not distorted by tax policy. Preempting state and local taxation of VoIP services as proposed in H.R. 4129 would create an unprecedented tax preference for one form of voice communications services (VoIP), and it would place other traditional land-line and wireless voice providers at a substantial competitive disadvantage because they would still be obligated for existing state and local taxes. Such a policy creates an unlevel playing field that works against those providers not employing VoIP and will cause a misallocation of resources in the

³ There are several types of VoIP services and a variety of consumer features available from various VoIP providers. Some VoIP services do not use the publicly switched telephone network (PSTN), but estimates are that currently 90 percent of all VoIP calls either originate or terminate on the PSTN.

economy. Enacting such a discriminatory arrangement will undoubtedly create additional calls for federal intervention in an effort “to level the playing field.”

In considering the appropriate tax policy for VoIP, Congress must consider function over form. That is, the function of VoIP is to provide voice communications services, and it is the functional equivalent of other forms of voice communications services. It should be taxed in a manner similar to other voice communications services to avoid distorting consumer choices and to avoid placing Congress in the position of choosing winners and losers from among competing telecommunications providers. H.R. 4129 runs directly counter to that proposition.

If Congress chooses to base its tax policy decisions on the technology employed in VoIP services, rather than the function of VoIP, it is likely to find itself continually one step behind the technology curve and facing a continuing set of requests for intervention. A prime example of this result is the passage of the Internet Tax Freedom Act in 1998 that was written when dial-up access was the predominant, if not exclusive, method of providing Internet access. Within a relatively short period of time, however, other technologies developed and not all were treated in the same manner under the federal law as juxtaposed against state tax systems. This led to demands for further interventions and preemptions by the Congress as it considered extending the Act this year.

In short, preempting state and local taxation of VoIP services, while leaving the taxation of other forms of voice communication intact, constitutes an unsound tax policy that discriminates against traditional voice communication providers. This is not to suggest that there are not likely bona fide issues of the manner in which state and local taxes should be applied to VoIP services. Such issues can only be identified and resolved through an honest and constructive dialogue among the affected parties. Adoption of policies such as those contained in H.R. 4129 would prevent such a dialogue from occurring and create a discriminatory tax environment.

Federal Preemption Would Have a Substantial Revenue Impact on States and Localities

According to the Congressional Budget Office, state and local governments collect about \$10 billion annually in general purpose transaction taxes (including sales taxes and

telecommunications excise taxes) on sales of telecommunications services at the present time.⁴ Further, CBO estimates that under current projections, it is expected that up to one-third of traditional voice traffic would migrate to VoIP within five years, thus implying a revenue loss to states and localities of upwards of \$3 billion annually by that time. Enacting a tax exemption for VoIP services would undoubtedly accelerate that revenue loss and lead to the loss of a substantial portion of the \$10 billion in a relatively short period of time.

In addition, depending on interpretations of the breadth of the tax preemption in H.R. 4129 as well as the interpretation of the state prohibition on regulating VoIP services in the bill,⁵ a substantial portion of the \$7 billion that CBO estimates states and localities collect from business taxes (property taxes, business profits taxes, and taxes on purchases) on telecommunications providers could be preempted as well.⁶ That is, as assets of traditional telecommunications providers are shifted to VoIP services or are taken out of service due to the migration of traffic to VoIP providers, revenue from these business taxes will also be lost to state and local governments.

In short, a broad preemption of state and local taxation of VoIP services would have a substantial detrimental revenue impact on states and political subdivisions. It would, in fact, constitute a de facto repeal by the Congress of an entire category of taxes on which states and localities have long relied – taxes on telecommunications services and providers. States and localities would have two alternatives to deal with the preemption: reduce expenditures or raise the revenues from other taxpayers. Given that approximately 55 percent of all state and local expenditures are for education, social services and public safety, the impact of expenditure reductions will likely be felt in services considered critical by the citizens.⁷

⁴ Letter to Senator Lamar Alexander from CBO Director Douglas Holz-Eakin regarding S. 150, the “Internet Tax Nondiscrimination Act,” dated February 13, 2004. This does not include about \$3-4 billion in 911 and Universal Service Fund fees that would be preempted under the bill as well.

⁵ In the bill “regulate” is defined to mean “any governmental action that restricts, prohibits, limits or burdens, or imposes any obstacle, obligation or duty, or interferes with, [a VoIP] application

⁶ For further discussion, see Michael Mazerov, “Proposed ‘Voice over Internet Protocol Regulatory Freedom Act’ Threatens to Strip States and Localities of billions of Dollars In Annual Tax Revenues, Center on Budget and Policy Priorities, Washington, D.C., July 20, 2004.

⁷ U.S. Bureau of Census, Preliminary Estimate, State and Local Government Finance, 2002 Census of Governments, found at <http://www.census.gov/govs/www/estimate02.html>.

Federal Preemption Would Run Counter to Our System of Federalism

Our system of federalism is founded on the concept that both the states and the federal government are sovereign entities and that both possess the sovereign ability to tax. The shared sovereignty with regard to taxation is a core element of political sovereignty. Moreover, our system is based on a precept that state and local elected officials, respecting the safeguards afforded all citizens by the U.S. Constitution, are in the best position to determine the appropriate tax policy for their citizens and for economic activity occurring within their borders.

Despite its plenary authority to regulate interstate commerce, Congress historically has been respectful of state tax sovereignty and has substantially limited the instances in which it has preempted state taxing authority.⁸ Congressional preemptions (beyond those assuring respect for the Supremacy Clause) have generally been limited to relatively narrow areas where there has been a substantial showing of excessive burden or need for uniformity. Examples include the individual income tax treatment of workers in interstate commerce, treatment of nonresident pension income and property taxation of certain interstate transportation industries. In addition, Congress has in some instances fostered state tax sovereignty. Examples include the federal Tax Injunction Act that prohibits the federal courts from restraining the collection of a state tax where an adequate remedy exists in the state courts and the Mobile Telecommunications Sourcing Act that endorsed a resolution to the need for a single rule in sourcing wireless telecommunications services that was developed by the industry and the states.

Enactment of H.R. 4129 or similar policies preempting states from taxing a particular technology would represent a substantial departure from traditional Congressional positions and our federal system. Congress would be substituting its judgment for the judgment of state and local elected officials and effectively determining that states and localities should no longer tax voice communications services.⁹ This stands in sharp contrast to the rich tradition of federalism on

⁸ For a more complete discussion (as well as an evaluation of certain current federal preemption proposals), see Charles E. McLure, Jr. and Walter Hellerstein, "Congressional Intervention to State Taxation: A Normative Analysis of Three Proposals," State Tax Notes, March 1, 2004.

⁹ Most observers expect a rapid migration to VoIP even without a tax preference. Michael K. Powell, the chairman of the Federal Communications Commission, was quoted as saying, "We think pretty quickly there's no reason why virtually any communication service [won't be Internet-based]." Yuki Noguchi, "Identity Crisis," The

which our government was founded and which has served our country well. As our national and state economies have evolved, states have developed their tax policies with an eye toward accommodating new technologies as members of a stable marketplace. This system has worked well, and no evidence has been presented to suggest that state tax policies have impeded the growth of new technologies or state or national economies.

Case for Federal Policy of Tax Preemption Has Not Been Made

We believe that enacting the broad regulatory and tax preemptions contained in H.R. 4129 is unwarranted in that there has been no showing of a need for federal intervention.¹⁰ Moreover, a policy of preemption would likely impede or preclude the development of sound long-term policy for VoIP that treats all voice telecommunications providers in an equitable fashion and that is respectful of the tax sovereignty of the states.

The types of VoIP services that will be offered are still evolving as is the understanding of the issues involved in the taxation and regulation of VoIP. On the tax front, there has not, to my knowledge, been any attempt to demonstrate a need for federal preemption on the basis of complexity or lack of uniformity. A review of recent tax literature reveals only one article examining state tax issues associated with VoIP,¹¹ and the bulk of the issues identified in that piece involve whether VoIP would qualify as a telecommunications service under state tax statutes, not issues of complexity or uncertainty that would make a tax on VoIP services difficult to administer or comply with. While there may well be issues that should be addressed, we do not believe it is appropriate to preempt all state and local taxation on the theory that there may be issues to deal with. Through efforts such as the Mobile Telecommunications Sourcing Act and

Washington Post, Oct. 23, 2003. Preempting taxation of VoIP would constitute a de facto repeal of all taxes on voice telecommunications because all or nearly all forms of voice telecommunications would move to VoIP.

¹⁰ The U.S. Senate has twice taken action to clarify that its actions are not intended to preempt state and local taxation of VoIP services. The Internet Tax Nondiscrimination Act (S. 150) as passed by the Senate in April 2004, contains a provision contained in a Manager's Amendment stating, "Nothing in the Act shall be construed to affect the imposition of tax on a charge for voice ... service utilizing Internet protocol...." On July 22, 2004, in a mark-up of its version of the "VoIP Regulatory Reform Act" (S. 2281), the Senate Commerce Committee approved an amended version of the bill that does not contain a preemption of state and local taxing authority and a dialogue with the sponsor of the bill established that the bill was not intended to preempt taxing authority.

¹¹ Walter Nagel and Ari M. Lev, "VoIP: The Second Battle of the Internet Tax Wars," State Tax Notes, June 3, 2004.

the Streamlined Sales Tax Project, states have shown their willingness and ability to work with stakeholders to address bona fide issues of complexity and uniformity. A broad federal preemption would preclude any such discussions.

Conclusion

VoIP services hold significant potential to provide consumers with more choices for voice communications at lower costs. As the technology evolves, the legal framework governing VoIP will also evolve. There will likely be a number of issues that will need to be addressed, but they are best addressed through meaningful dialogue among affected stakeholders that have a view and an incentive to create “win-win” solutions that benefit all parties. It seems that the prudent thing for Congress to do at this point is to foster that dialogue by taking a holistic approach to examining VoIP technology with an emphasis on promoting competition, preserving state authority, and protecting the public interest, rather than moving forward with a policy that preempts state taxing authority, discriminates against traditional voice communications providers, and disrupts state and local fiscal systems.

**Resolution Seventeen
Preemption of State Authority to Tax**

WHEREAS, the power to define the state tax system is a core element of state sovereignty, and

WHEREAS, the United States Constitution establishes appropriate bounds to the sovereignty of the states in the tax arena, and

WHEREAS, the system of federalism that is defined by the United States Constitution further cedes to state and local governments the responsibility for supplying the majority of the daily services due to its citizens and residents, and

WHEREAS, a vibrant state and local tax system is essential to meeting those needs, and

WHEREAS, the U.S. government has traditionally shown substantial deference to the tax sovereignty of the states, and

WHEREAS, there is an increasing number of groups seeking to preempt state taxation authority in particular areas, and

WHEREAS, federal preemption of state tax authority has the effect of establishing a preferred class of taxpayer and shifting the tax burden to other non-preferred taxpayers, and

WHEREAS, federal preemptions often have unintended consequences, and

WHEREAS, our system of federalism can result in substantial administrative compliance burdens for persons with tax responsibilities in multiple states, and

WHEREAS, many of the legitimate goals that might be pursued in preemptive legislation can be effectively achieved through cooperative state efforts and improved uniformity among the states, now, therefore, be it

Resolved, that the Federation of Tax Administrators respectfully urges the Congress and the U.S. federal agencies to refrain from enacting measures, taking actions or making decisions which would abrogate, disrupt or otherwise restrict states from imposing taxes that are otherwise lawful under the U.S. Constitution or from effectively administering those taxes, and be it further

Resolved, that Congress should undertake an active program of consultation with states as it considers measures that would preempt state tax authority, and be it further

Resolved, that states should actively pursue such uniformity and simplification measures as are necessary and effective in addressing concerns of administrative burden in complying with the tax laws of multiple states.

This resolution shall automatically terminate three years after the Annual Business Meeting at which it is adopted, unless reaffirmed in the normal policy process.

Adopted at the FTA Annual Meeting, June 9, 2004

Biography

Stephen M. Cordi

Stephen M. Cordi has served as Maryland's Deputy Comptroller, with primary responsibility for tax administration, since 1994. He was the first Director of the Compliance Division following its creation in 1993. For 13 years prior to his appointment as Director of the Compliance Division, he was the Director of the Maryland Sales and Use Tax Division. He first entered State service in 1974 as Special Assistant Attorney General for the Comptroller, representing the sales tax, motor fuel tax and tobacco tax divisions. An attorney and certified public accountant by profession, he is a graduate of Haverford College and Georgetown University Law Center. He is past president of the Maryland Government Finance Officers Association, the North Eastern States Tax Officials Association and the Federation of Tax Administrators.