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SFA



BILL ANALYSIS

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Senate Bill 716 (as enrolled)
Senate Bill 721 (as enrolled)
Sponsor: Senator Bill Bullard, Jr.
Committee: Finance

PUBLIC ACT 193 of 1997
PUBLIC ACT 194 of 1997

Date Completed: 1-7-98

RATIONALE

The use of prepaid calling cards or authorization numbers has become a popular way to make long-distance calls. Calling cards are essentially telephone debit cards, through which a certain amount of telephone service is purchased in advance. While there are several types of prepaid calling cards, the standard cards generally are sold in retail outlets such as convenience stores. To make a call, the cardholder dials an 800 number and is connected to the telecommunications carrier's "software platform". A voice response unit prompts the cardholder to enter an identification number contained on the card, and notifies the cardholder of the card's expiration date and the amount of calling time available. The cardholder then dials his or her desired telephone number or waits for an operator to complete the call.

Prepaid authorization numbers function similarly, without the involvement of a card. A customer may purchase a certain amount of calling time by phoning a telecommunications provider or other seller (who may have purchased a block of time for resale). The customer pays for the service with a credit card and receives an access code to dial when using the purchased service.

According to an article in *State Tax Notes* (12-16-96), prepaid calling cards were expected to generate sales in the United States of \$1 billion in 1996 and, based on MCI prepaid marketing information, sales are expected to reach \$3 billion by the year 2000. Although prepaid calling cards give consumers a convenient means of making telephone calls, the cards evidently present many tax difficulties for the prepaid industry, as well as for the taxing jurisdictions. The article reports that the states do not have a unified position regarding the taxation of the sale or use of prepaid calling cards. Six states apparently have determined that prepaid calling cards are subject to sales tax at the card's

point of sale to the retail customer, and two other states reach the same result in practice. Approximately 30 states reportedly have ruled formally or informally that prepaid cards are not taxable at the point of sale but are subject to applicable state telecommunications taxes when used. These states, however, "...are not unified as to who is responsible for collecting and remitting the tax or on what base the tax is computed". Evidently, although the company that sells a prepaid card is supposed to pay a use tax when the card is used, the state in which a call actually originates and terminates cannot be reliably determined, and telecommunications carriers cannot track usage of each individual card for reporting purposes. According to the authors of the *State Tax Notes* article, these tax issues can be resolved by subjecting prepaid calling cards to the general retail sales tax at the point of sale.

In Michigan, statutory law did not specifically address the taxation of prepaid calling cards or authorization numbers, but telephone calls are taxed under the Use Tax Act. It was suggested that the State should tax these cards under the General Sales Tax Act, instead.

CONTENT

Senate Bill 716 amended the General Sales Tax Act to specify that "sale at retail" includes the sale of a prepaid telephone calling card or a prepaid authorization number for telephone use, rather than for resale. "Sale at retail" also includes the reauthorization of a prepaid telephone calling card or a prepaid authorization number.

Senate Bill 721 amended the Use Tax Act to provide an exemption from the tax for the use or consumption of telephone service by means of a prepaid telephone calling card, a prepaid

authorization number for telephone use, or a charge for Internet access.

The bills were tie-barred to each other. Senate Bill 716 specifies an effective date of January 1, 1998.

MCL 205.51 (S.B. 716)
205.94 (S.B. 721)

BACKGROUND

The following information is based on the December 16, 1996, article in the *State Tax Notes*: "One Approach to State and Local Taxation of Prepaid Calling Cards".

There are three general types of prepaid calling cards: standard cards, promotional cards, and collector cards. Standard cards are sold directly or through distribution channels to end-users. These cards typically may be purchased in convenience stores, office supply stores, airports, grocery stores, and other retail outlets, as well as purchased directly from telecommunications providers.

Promotional cards are purchased in order to be given away for the customer's own promotional use. They may be given free with the purchase of goods or service, such as a box of cereal or a tank of gas. When a promotional card is used, a customized message can be played for the caller, or a voice response unit can have the caller enter certain information (e.g., to enter a sweepstakes). In addition, a company might purchase these cards in bulk for internal use; for example, the cards might be given to a corporation's employees for use during business travel.

The third type, collector cards, may be sold at a premium due to some speculative value attributable to their uniqueness, independent of their value as calling cards. These cards may contain pictures of celebrities, vintage automobiles, or works of art, for example. While collector cards can be used to make telephone calls, they generally retain a higher value if they are not removed from their original packaging.

Prepaid cards were first introduced in Italy in 1976 and their popularity grew throughout Europe during the 1970s. By the late 1980s, prepaid calling cards were introduced in the United States. More than 150 telephone companies in more than 135 countries worldwide now issue prepaid cards.

Tax issues surrounding prepaid calling cards include the following:

- Whether the sale of the cards is the sale of tangible personal property, of telecommunications services, or of a future right to purchase telecommunications services.
- Whether tax is due when and where a prepaid card is sold or when and where the telecommunications usage occurs.
- Whether the telecommunications carrier or the retailer is responsible for collecting and remitting the tax.
- Whether the tax is collected from the distributor/retailer or the end-user.
- Whether the taxable base is the wholesale amount paid directly to the telecommunications carrier or the retail amount paid by the end-user.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Taxing prepaid calling cards at their point of sale will address many of the issues identified and resolve many of the problems that arise when the cards are subject to the use tax. Although a majority of the states currently agree that prepaid cards are taxable upon use, there is no uniformity regarding collection of the tax or the tax base. Since telecommunications carriers cannot accurately determine where an individual call was placed and where it terminated, the state to which tax should be paid is not clear. The current system also can result in multiple taxation, since some states impose a use tax on prepaid cards while others charge a sales tax, and a tax might be imposed at various points in the distribution channel. Telecommunications carriers sell cards directly to consumers as well as sell their services and software platform wholesale to resellers. Both carriers and resellers sell prepaid cards wholesale to distributors, who in turn sell them wholesale to other distributors and directly to retailers. Retailers then make direct sales to customers.

By taxing prepaid calling cards under the General Sales Tax Act, Michigan will help to resolve these problems. The tax simply will be collected by a retailer on the amount paid for a card by the consumer. This solution will ease administrative requirements, avoid burdensome telecommunications tax obligations, ease audits, eliminate the need to know the actual location of use, and eliminate multiple taxation.

Senate Bill 716 also will ensure that the State can collect the sales tax when a cardholder purchases additional service on a used card.

Opposing Argument

Under Senate Bill 716, a cardholder who does not use up his or her entire card still will have to pay sales tax on the full amount.

Response: If customers with a partially used card have it recharged, they will not lose time or pay unnecessary tax.

Legislative Analyst: S. Lowe

FISCAL IMPACT

These bills switch the State tax on prepaid calling cards from the use tax to the sales tax. It is estimated that this change will result in a slight revenue gain to State government of \$0.2 million a year. Some of this revenue gain will benefit local governments through higher revenue sharing payments.

This gain in revenue will be due to three factors: 1) It will be easier to assess the sales tax on the retail sale of prepaid calling cards than it was to identify and assess the use tax on the value of each individual call made with the card. 2) Assessing the sales tax at the time of purchase will capture tax on the entire value of the calling card, including any small balances that go unused. Previously under the use tax, any unused prepaid balances were not taxed. 3) The price of prepaid calling cards includes a retail mark-up, and therefore, the retail price is generally slightly more than the actual value of the phone calls that can be made with a card. Therefore, the sales tax assessed on the retail price will generate slightly more than the sum of the use tax assessed on the value of each call.

Due to differences in how the revenues from the sales tax and use tax are earmarked, a switch from the use tax to the sales tax will generate more revenue for the School Aid Fund, and local revenue sharing, and less revenue for the General Fund, compared with the situation under previous law.

Fiscal Analyst: J. Wortley

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.