

It Came From Outer Space: The Strained Logic of Satellite Taxes

by Billy Hamilton



Texas is experiencing epic budget problems that may add up to a \$27 billion two-year spending gap or could be as “little” as \$15 billion, depending on how you count things like the cost of children newly entering the public schools in the next two years. How to fill that gap is on everyone’s mind in

Austin as this year’s legislative session plows through its second month.

The legislative appropriations committees are working on a budget that, as introduced, is based solely on the revenue that’s projected to be available and is balanced almost exclusively by budget cuts. The results aren’t pretty, with massive cuts in public and higher education and human services, and the prospect of cutting more than 9,000 jobs. The Austin school district is discussing cutting 1,000 jobs. Some of the cuts will stick, but the remainder of the legislative session will be taken up with trying to find resources to reduce the damage.

There are options. To help fill the gap, there’s more than \$9 billion in a rainy day fund. There are various accounting tricks that can be used to shift the problem to the next budget period. Fees can be raised. Tuition can be raised. Costs can be shifted to local governments. Those are familiar options that most states have used during the recession. Then there is the option that dares not speak its name — taxes.

To date, the state’s three top leaders — Gov. Rick Perry (R), Lt. Gov. David Dewhurst (R), and Speaker of the House Joe Straus III (R) — have insisted that whether the problem is \$15 billion or \$27 billion, taxes won’t be raised. In his State of the State speech in early February, Perry reiterated his commitment to balancing the budget without raising taxes. He said:

Balancing our budget without raising taxes will keep us moving forward out of these tough economic times, creating more jobs and opportu-

nity and leaving Texas more competitive than ever. Are we facing some tough choices? Of course, but we can overcome them by setting priorities, cutting bureaucracy, reducing spending and focusing on what really matters to Texas families.

To judge from the various official pronouncements, what really matters to Texas families is not having their taxes raised, regardless of the effect on state services. The budget as introduced provides a preview of what that would mean. There’s time to consider other options, but for now, everyone is resolved to cut first and deal with the consequences later. Dewhurst told a reporter from the *Los Angeles Times*: “A lot of the things we are doing arguably aren’t priorities for the people of Texas. People could stake me and Gov. Perry on the ground and torture us, and we still would not raise taxes.” California Treasurer Bill Lockyer (D), in the same article, could scarcely contain his glee at the Lone Star State’s reduced circumstances: “Someone just turned the lights on in the bar, and the sexiest state doesn’t look so pretty anymore.”

‘People could stake me and Gov. Perry on the ground and torture us, and we still would not raise taxes,’ Dewhurst said.

Sticks and stones. Undaunted, Perry actually would like to see taxes cut, although not as aggressively as some governors who have lately proposed corporate and other tax cuts as a way to stimulate their states’ recovery. He wants to continue a temporary business franchise tax (margin tax) exemption for small businesses with income up to \$1 million, which would cost about \$150 million. He also wants to institute a tax credit for employers that assist dropouts earning a high-school diploma or GED, at a reported cost of about \$5 million.

Despite the high-level assurances, many people in Austin are worried about taxes. Most of the stress

emanates from lobbyists afraid that if the budget problem proves more intractable than expected, their clients might be staring down the barrel of fee increases, revenue enhancements, or tax reforms — or whatever euphemism is chosen as the vehicle for the bad news.

There also are cases in which lobbyists are quietly advocating higher taxes. The spending advocates obviously would like to see taxes increased to prevent the startling cuts in the base budget document. Representatives of the gambling industry would like to see gambling expanded, probably to racinos, slot machines at horse and dog racing tracks, where there's already gambling, or more improbably to casinos.

There are, however, other groups quietly at work advocating — or at least scheming on the idea of advocating — higher taxes. That isn't a selfless gesture for the common good. What they want are higher taxes on their competitors. Let me take one idea that's been in the air recently to show how this sort of agenda plays out in a legislative session short on money and long on needs.

The idea is a satellite tax, a proposal that has surfaced in Texas in past legislative sessions and has been debated in various states over the past several years. The idea and motives behind the tax illustrate one particularly bad form of tax policy-making — policy that's really a function of inter-industry squabbling.

As the name implies, satellite taxes are special taxes on television and related services delivered from orbiting satellites rather than through cables in the ground. The satellite tax battle, though obscure, has raged lately in other states such as Ohio, Kentucky, and Utah. The tax has been adopted in a handful of states and has been challenged in court in most of them. There have been efforts nationally to secure federal legislation prohibiting the taxes. If you are unfamiliar with the satellite tax concept, the issue as it has emerged in Texas provides a reasonable facsimile of how it is presented in most states.

The germ of the issue in Texas dates back to 2005, when lawmakers passed legislation that opened up to wider competition video markets that were previously the domain of cable providers. The legislation paved the way for satellite television services in the state and set up a competitive market that gave consumers the choice of satellite services or cable services.

Under the Texas state sales tax, satellite and cable services are treated the same. The 6.25 percent tax applies to both. The main difference under the sales tax is that satellite services aren't subject to local sales tax because of a provision in federal law that exempts providers of direct-to-home satellite services from collecting local taxes and fees, a

critical distinction.¹ Local sales taxes vary by jurisdiction in Texas but can add up to an additional 2 percent, making the total state and local rate 8.25 percent in most cities.

The local sales tax is part of the issue, but the real bone of contention is local fees. Many cities impose fees on cable and other video providers whose services are distributed over landlines (cable or telephone lines). These fees are a specific charge for a specific benefit — access to and use of the public right of way. As you know if you've seen workers fixing a broken water main, there's a complicated hidden world beneath our feet and our car tires. The National League of Cities describes it this way:

Below the surface . . . a variety of users place permanent facilities that cannot easily be removed, repaired or relocated. Among the facilities permanently placed within the public rights-of-way are water mains, natural gas pipes, sewage systems, power lines, high-pressure steam ducts, telephone wires, and cable television system cables. Right-of-way is a limited public resource that must accommodate every users' unique system design, specific space and depth requirements, and particular maintenance techniques and schedules.²

The fee compensates the local governments for the cost of keeping up with this mess and making sure that all of the services work most of the time — and for the costs associated with fixing the problem when they don't.

The franchise fees are assessed by individual cities according to terms set out in municipal franchise agreements. Some cities levy no fee, but others levy fees that in Texas range from 2 percent to a maximum of 5 percent of gross revenue. Most large cities impose 5 percent fees.

Because they obviously don't use the rights of way, satellite providers don't pay local franchise fees. The cable operators would like to remedy that fact by persuading lawmakers to impose a separate tax on satellite service. Legislation was introduced in Texas in 2009 that would have created a new definition for direct broadcast satellite service and imposed a new tax at a rate of 7 percent of gross revenue on the service when beamed into an incorporated area.³ The existing sales tax would still apply, and so the effective tax on satellite service

¹Federal Telecommunications Act of 1996; P.L. 104-104, section 602.

²National League of Cities, "Telecommunications and Rights of Way: Local Official's Guide," 2002, available at <http://www.nlc.org/ASSETS/8AB9FB13430F480EAF83CA22420E175D/Local%20Officials%20Guide%20-%20Telecommunications%20and%20Rights-of-Way.pdf>.

³HB 3829, sponsored by Rep. René O. Oliveira (D), 2009 legislative session.

would have been 13.25 percent, the same as the combined state and local sales tax plus the local right-of-way tax that cable providers pay in large cities. Coincidence? I think not.

The 2009 legislation would have generated more than \$120 million a year when fully implemented; however, because federal law prevents local governments from imposing a satellite tax, the state would have kept the money. The bill didn't get far in 2009, better days financially for the state. It was heard in committee and left pending and eventually died. But such legislation is seldom dead. Like a virus, it hibernates, and it's likely to awaken this session. The state needs money and this is an obscure tax that appears to have equity as one of its major talking points.

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Those are the rough contours of the argument in this battle. Proponents see the separate tax as leveling the playing field while opponents view it as tilting the playing field in the cable companies' favor. This is almost the classic definition of what is known in the lobby as an "industry bill," and because the industry is in all states, so is the bill.

At present, the states are all over the map when it comes to taxing satellite services. About half the states tax satellite services, typically under their sales taxes as Texas does. Seven states — Florida, Kentucky, Massachusetts, North Carolina, Ohio, Tennessee, and Utah — have tax structures under which satellite companies pay a higher state tax than cable providers. In at least six of those states, the major satellite providers have taken the state to court in an attempt to overturn the tax. The most recent of those suits was filed in Utah last December.

You may have heard about the issue recently because of a court decision handed down by the Ohio Supreme Court in late December. In a 5-2 decision, the court upheld the state's satellite tax. The court ruled that the tax does not violate the U.S. Constitution's commerce clause because it's based on differences in the nature of the businesses and doesn't favor in-state interests at the expense of out-of-state interests.

The Ohio tax was first imposed in 2003 but was mostly lost in the thicket of a larger budget compromise. It required satellite companies to pay a 5.5 percent tax that was limited to satellite providers and not local cable companies, which aren't taxed at the state level but do pay local franchise fees that range from 2 to 5 percent, similar to those in Texas.

Satellite providers filed a lawsuit challenging the tax in the Franklin County Court of Common Pleas, literally hours after then-Gov. Bob Taft signed into law the bill that included the tax. The suit sought a declaratory judgment holding that the satellite-only tax was unconstitutional, and requested a permanent injunction against its enforcement.

"The satellite-only tax flies in the face of both the Ohio and U.S. constitutions," Michael Palkovic, senior vice president and CFO at DirecTV, a satellite provider, said at the time. He argued:

Applying a discriminatory tax on satellite providers that provide virtually the same product to the same customer gives a direct commercial advantage to local cable services that access and place a burden on the state's public infrastructure, while discriminating against out-of-state satellite television services that do not use the public infrastructure nor put demands on the state for the delivery of their services.

As you might gather, the satellite companies argued that the tax was pushed by local cable television operators that used Ohio's budget crisis to get the measure before lawmakers and the governor. The case has been winding its way through the courts ever since, and the stakes have been mounting. The state has collected tax all along, taking in about \$300 million through the years.

The satellite companies won in the court of common pleas but lost in the state court of appeals. The case wound up in the Ohio Supreme Court. Interestingly, in their plea to the high court, the satellite companies attracted an amicus brief opposing the tax from an odd assortment of 15 legal scholars, including Ken Starr (yes, that Ken Starr), now at Pepperdine University. The brief, written by former Ohio Solicitor Douglas Cole, argued that the Ohio Appeals Court decision "unmoors the dormant Commerce Clause from its traditional roots" and "runs contrary to a multitude of Supreme Court cases."

The state of Ohio didn't seem overly concerned about this outpouring of legal scholarship. In court documents, it argued that the lawsuit was "not worthy" of the state supreme court's valuable time. The case, it said, "does not even present a clean constitutional issue." Rather, it is nothing more than "a failed equal protection claim that the Satellite Companies have masqueraded as a dormant Commerce Clause issue" in an effort to keep a competitive edge over their cable company rivals.

Lawrence Pratt, chief of the taxation section in the Ohio Attorney General's Office and the state's lead attorney in the suit, said that the states "have the right to differentiate between taxpayers . . . so long as there is a rational basis for the distinction." He pointed out that the cable industry pays a franchise fee, which the satellite industry does not.

The state's brief also dismissed "the unique wild theory" that the cable companies are local businesses "because they use in-ground cable to transmit the last leg of their programming signal," while the satellite providers effectively are out-of-state companies "because they use an orbiting satellite and the airways to deliver the last leg of theirs." The plaintiffs, the state wrote, have "shopped their 'fool's gold' from one state and federal jurisdiction to another and found no buyers," an odd description given that the satellite companies aren't the ones proposing the tax and are instead on its receiving end.

All the legal heavyweights were of no avail. The satellite companies lost again. Writing for the majority, Justice Terrence O'Donnell said the justices concluded that Ohio lawmakers "imposed a sales tax that makes no distinction between local and interstate commerce, but rather distinguishes based on the mode of distributing television programming." In a dissenting opinion, outgoing Ohio Chief Justice Eric Brown stated flatly that the tax was unconstitutional. "It treats sellers of the same service differently," he wrote. "That's discrimination." It seems that Ohioans don't mince words.

Had the decision gone against the state, there was the small matter of \$300 million in potential refund claims. Or maybe not. Perhaps sensing that the court might be a little overly sensitive to the state's fragile fiscal condition, attorney E. Joshua Rosenkranz, who represented DirecTV and Dish Network, called the refund issue "the elephant in the middle of the courtroom" during oral arguments and tried to defuse the situation by saying the satellite operators weren't looking for a refund but for fair competition with cable. Rosenkranz said: "This case is about leveling the playing field prospectively, and we renounce any intention to file the millions of claims individually that need to be filed to receive a refund." Of course, when they say it isn't about the money, it's about the money, but apparently it was worth forgoing the money in this case to win the larger point.

After the state supreme court decision came down, the satellite companies said in press statements that the decision was unfair to consumers, and on the other hand, that the state is losing out on millions in revenue because the tax doesn't apply both to satellite and cable. The state was still feeling feisty. Ohio Attorney General Richard Cordray said in an interview that the decision ended the satellite TV industry's unfair tax advantage in Ohio. "In essence, they were enjoying a loophole in Ohio's structure of its tax laws and this leveled the playing field as we see it," he said. Begging to differ, the industry's attorneys indicated that the ruling likely will be appealed to the U.S. Supreme Court.

As it is in Ohio, so it is in other parts of the country. In addition to the seven states with the taxes, the Stop Satellite Tax website highlights

another 10 states where the issue has come up in legislatures recently, a confluence of similar tax policy thinking that you don't often see.⁴ So far the satellite providers have been better at stopping the tax from being enacted than at winning court cases once it becomes law. Besides the Ohio loss, federal courts in two other states — Kentucky and North Carolina — have upheld the satellite taxes on the grounds that overall, the states taxed the satellite and cable industries at similar levels.

There is a certain superficial logic in that argument, but the more I think about it, the more strained the logic seems. Cable companies argue that because they pay local right-of-way fees plus state tax (in some cases), the satellite tax helps create tax neutrality between the two technologies. Thus, for example, under the 2009 Texas legislation, cable companies would have wound up paying a tax rate equal to the state sales tax rate *plus* the local sales tax rate *plus* the maximum local right-of-way fee. Is that competitive neutrality or does it twist the logic of the taxes involved? My vote is twist, for a couple of reasons.

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First, satellite services don't pay right-of-way fees because they don't use the public right of way. Cable companies pay right-of-way fees because they are granted access to the right of way for their commercial use, a benefit that not all companies enjoy and that is critical to their business model. That access creates some costs and responsibilities for local governments, for which they are compensated by the fees. These fees are based on benefits received — no benefits, no fees.

Even supposing they made sense, the surrogate right-of-way taxes on satellite companies couldn't truly equate to the right-of-way fees paid by cable companies because federal law prohibits local governments from imposing those fees. Like most things the feds do, that may be questionable policy, but it is reality. Thus, the surrogate tax has to be a state tax. In Texas, this would mean that at the state level, satellite companies would have to collect the general sales tax plus the satellite tax, while cable companies would be responsible only for the sales tax. Thus, as a matter of state policy considered in isolation, you would wind up with two competing technologies taxed at dramatically different rates. That isn't competitive neutrality.

⁴See <http://stopsatelliteta.com/>.

Even if, for the moment, the question of state tax neutrality is set aside and we ignore all the interstate commerce questions that swirl around the issue, the tax rate that has been used will pose technical equity problems. Think for a moment about the Texas legislation. Had it passed, the Texas satellite tax rate would have been levied at a rate of 7 percent of gross revenue, a rate equal to the *maximum* local sales tax rate of 2 percent plus the *maximum* right-of-way fee of 5 percent. Not all areas of Texas have a 2 percent local sales tax rate or a 5 percent franchise tax rate. The net result would not be strict tax neutrality by that formulation but a sort of faux neutrality.

To be truly competitively neutral, the tax really should be applied at some equalized rate to the cable companies that may be paying franchise fees at various rates and local sales at various rates in different municipalities. Contemplating how that would be accomplished in the real world is enough to make your head spin. And of course, local governments still wouldn't get a nickel of the new tax. It would simply be a disproportionately large state tax on one service provider compared with the other based on how their technology works.

That brings me back to my original point — this issue is more about inter-industry fighting than it is about tax neutrality or the lack thereof. Such fights aren't unheard of in the state tax policy arena. The result is seldom better policy, just benefits for the winners and higher taxes for the losers. Sure, the states need the money, but there must be a better way to get it than this. More to the point, assuming this search for neutrality is legitimate, where does it stop? I imagine cable companies pay more in property taxes than satellite companies, too. Should that imbalance be addressed by larding on more state taxes?

Speaking of the property tax, there's one final wrinkle to the satellite tax issue that's worth mentioning because it's an interesting story. In 2001 Los Angeles County briefly flirted with subjecting orbiting satellites to property tax. The issue came up when the Los Angeles assessor did a routine audit of Hughes Electronics, which owned DirecTV and was based in the county.⁵ Eight satellites with an estimated worth of about \$100 million each were found on the company's books, a lot of property value up there hurtling through the heavens.

⁵Hughes Electronics has changed its name to DirecTV Group Inc.

County assessor Rick Auerbach speculated that Los Angeles County might be able to tax the satellites in part because no other government was doing so, always a noble reason, and there was at least a theoretical argument that under California law, corporate property that is not always physically in the county, like construction equipment or aircraft, can be subject to property tax in the county where the company is based. Hughes, of course, saw the issue a little differently. Company officials argued that their satellites weren't comparable to other "movable" property that can be taxed by the city or county where the owner is based. The satellites in question were launched from Florida or French Guiana, and there was also the fact of their location relative to the earth, much less to California. "We would point out that the spacecraft in question are not in the state of California, have never been in California in their useful life and will never be in California," said George Jamison, a Hughes spokesman. "These satellites never have and never will receive any benefits, any protections or any opportunities from the county of Los Angeles." Not even a library card.

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The California State Board of Equalization's legal staff agreed that Auerbach might have a point and recommended taking the issue to the full BOE, which arbitrates such matters for the state. The BOE listened to the arguments and sided with Hughes. It voted 5 to 0 to write a rule prohibiting local levies on spacecraft. A Hughes spokesperson praised the ruling, pointing out yet again that the satellites would never once set down inside the state's borders. On reflection, that's probably a good thing. If one did set down inside the state's borders, it likely would be as a flaming ball of molten metal traveling at hypersonic speed. That would create a bigger mess than the satellite tax controversy, and wouldn't do much for Los Angeles County property values either. ☆

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