



**House
Legislative
Analysis
Section**

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TELECOMMUNICATION EXEMPTION

**House Bill 4834 (Substitute H-3)
House Bill 4835 (Substitute H-2)
First Analysis (4-24-96)**

**Sponsor: Rep. Deborah Whyman
Committee: Tax Policy**

THE APPARENT PROBLEM:

The General Sales Tax Act and the Use Tax Act each provide an exemption to telecommunication companies for tangible personal property located on the premises of the subscriber and the "necessary exchange equipment." The exemption for such property is provided to those engaged in a service the use or consumption of which is taxable under Section 3a(a) of the Use Tax Act (MCL 205.93a). That section applies to intrastate telephone, telegraph, leased wire, and other similar communications, including local telephone exchange and long distance telephone service that both originates and terminates in Michigan, but excluding telephone service by coin-operated installations, switchboards, concentrator-identifiers, interoffice circuitry and their accessories for telephone answering service, and directory advertising proceeds.

There have been disagreements between telecommunications companies and the Department of Treasury over the application of this provision. Generally, the disagreements have been over what type of equipment should be exempt and under what circumstances, including whether the exemption applies only to equipment used in local telephone service or to equipment used in long-distance services as well. An industry representative has said the department's determination of what equipment is eligible for the exemption is based on outdated definitions that do not recognize the state of telecommunications today, with the deregulation of long-distance service, the passage of new state and federal telecommunications laws, and the growing blurring of the difference between providers of local telephone service and long-distance service. In two recent cases, the Michigan Tax Tribunal, generally speaking, decided against the department's interpretation of the statutes and granted more expansive exemptions. In a case involving Michigan Bell, the tribunal said (in a decision entered February 2, 1996) equipment used to provide both taxable and non-taxable telecommunications services was fully exempt and that the department could not apportion the equipment so as to tax the percentage used for non-taxable services as it had proposed. (The department's position in the case was that such a decision would expand the exemption beyond that intended by the legislature in enacting it.)

In a case involving MCI (dated April 4, 1995), the issue was the definition of "necessary exchange equipment" and whether that term, and the tax exemption, applied to certain disputed categories of equipment. The case grew out of a department audit of the company. A department auditor's view was that none of the equipment qualified for the exemption because the term "necessary exchange equipment" applied to local exchange services while MCI was engaged in long-distance services. The tribunal rejected that reasoning, saying the exemption was not to be granted only for local telephone exchange services but for inter-exchange services as well. The department had also argued that exchange equipment was equipment used in the switching function and not the transmission function. The tribunal preferred the definitions provided by MCI's expert witness in categorizing exchange equipment. The decisions are being appealed.

Industry representatives say they began proposing modernizing amendments to the telecommunications exemption provisions long before the two recent tax tribunal cases to deal with narrow interpretations and inconsistent applications of the exemptions and to address the revolutionary changes in the industry's technology and in its regulation. Legislation has been introduced on this subject.

THE CONTENT OF THE BILLS:

The bills would exempt from the sales and use taxes the purchase of certain machinery and equipment for use or consumption in the rendition of "any combination of services," the use or consumption of which is "described" under Section 3a(a) or 3a(c) of the Use Tax Act. The exemption would be limited to tangible personal property located on the premises of the subscriber and to central office equipment or wireless equipment directly used or consumed in transmitting, receiving, or switching or the monitoring of switching of a two-way interactive communication. Distribution equipment including cable or wire facilities would not be included as central office equipment or wireless equipment for the purposes of the new provision.

House Bills 4834 and 4835 (4-24-96)

House Bill 4834 would amend the Use Tax Act (MCL 205.94). House Bill 4835 would amend the General Sales Tax Act (MCL 205.54a). The bills would take effect April 1, 1997.

Section 3a(a) of the Use Tax Act refers to intrastate telephone, telegraph, leased wire, and other similar communications, including local telephone exchange and long distance telephone service that both originates and terminates in Michigan, and telegraph, private line, and teletypewriter service between places in Michigan, but excluding telephone service by coin-operated installations, switchboards, concentrator-identifiers, interoffice circuitry and their accessories for telephone answering service, and directory advertising proceeds. Section 3a(c) of the act (added by Public Act 326 of 1995) refers to interstate telephone communications that either originate or terminate in this state and for which the charge for the service is billed to a Michigan service address or phone number by the provider either within or outside the state including calls between the state and any place within or without the United States outside the state. The section specifies that the tax does not apply to a wide area telecommunication service or a similar type service, an 800 prefix service or similar service, an interstate private network and related usage charges, or an international call either inbound or outbound. (The use or consumption of the services mentioned above is taxed under the Use Tax Act.)

FISCAL IMPLICATIONS:

The Department of Treasury estimates the loss of revenue at \$5.1 million. (4-23-96)

ARGUMENTS:

For:

Telecommunications industry officials say that the bills will eliminate disparate and inconsistent treatment among companies providing services in Michigan and will recognize the changes in the industry and provide a fair application of the exemption to equipment used by all providers of intrastate and interstate telecommunications services. They also codify recent tax tribunal decisions. The distinction between providers of local service and long distance service (and the equipment involved in delivering such services) is disappearing and competition between companies is increasing. Industry officials say these bills establish clear statutes that will be equally available to all providers of telecommunication providers. The bills recognize that tax statutes cannot remain stagnant when the world they apply to is changing rapidly. The legislation also will provide additional incentives for companies to invest in telecommunication services in the state and will foster economic development. In that

sense, the legislation is consistent with the exemption provided to industrial processors under the sales and use tax acts. Sales to industrial processors are exempt if their products are for ultimate sale at retail or to another processor for further processing for ultimate sale at retail. Telecommunications industry representatives point out that the industrial processing exemption is not subject to jurisdictional or taxability requirements as have been imposed on telecommunications. The bills will make Michigan a more attractive place for telecommunications companies to invest.

Against:

The treasury department opposes the expansion of the exemption for telecommunications equipment, and in particular opposes the exemption for equipment used in providing a service that ultimately is not taxed. The exemption as it is currently written should be understood to apply to equipment used in providing a service that is subject to the use tax. Where a service is not subject to the use tax, the property should not be exempt. Where property is used in providing both taxable and non-taxable services, the exemption should be based on an apportionment or allocation process. A department representative has testified that while the department recognizes there have been changes in the telecommunications industry and has been engaged in discussions with the industry, there is not yet agreement over the tax treatment of certain kinds of equipment. The department is appealing recent decisions by the tax tribunal that it believes has expanded the exemption beyond what the statutes intend. Further, the analogy between this legislation and the industrial processing exemptions is not apt; those exemptions are based on a different tax theory and also are related to the transforming of property. Telecommunications companies are engaged in a service. That service is one of two services specifically subject to tax, the other being hotel rooms.

POSITIONS:

Representatives of AT&T, MCI, and Ameritech appeared before the House Tax Policy Committee in support of the bills. (4-18-96)

Sprint supports the bill. (4-22-96)

The Michigan Pay Telephone Association supports the bill. (4-22-96)

The Department of Treasury opposes the bills. (4-18-96)

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.