REPORT OF THE

JOINT SUBCOMMITTEE STUDYING

THE TAXATION OF TELEPHONE COMPANIES

TO

THE GOVERNOR

AND

THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 22

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Report of the
Joint Subcommittee Studying

The Taxation of Telephone Companies
Richmond, Virginia
January, 1980

To: Honorable John N. Dalton, Governor of Virginia
and
The General Assembly of Virginia

I. INTRODUCTION

House Joint Resolution No. 324 established a Joint Subcommittee to study the taxation of publicly regulated telephone companies and private companies providing telephone services and equipment to the general public and determine whether the total tax structure applicable to these companies is equitable. The resolution reads as follows:

HOUSE JOINT RESOLUTION NO. 324

WHEREAS, House Joint Resolution No. 93 of the 1978 Session of the General Assembly established a joint subcommittee to study whether interstate toll service revenue of telephone companies should be included in the franchise or license tax base; and

WHEREAS, the joint subcommittee during their study received much testimony from public service telephone companies regarding the unfair differences in taxation between public and private telephone companies; and

WHEREAS, the joint subcommittee felt that it was desirable to study the taxation of all telephone companies to ensure that the tax structure applicable to these competitors is equitable but that such a study could not and should not be conducted under the purview of House Joint Resolution No. 93; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That a joint subcommittee be established to study the taxation of publicly regulated telephone companies and private companies providing telephone services and equipment to the general public and determine whether the total tax structure applicable to these companies is equitable.

The joint subcommittee shall be composed of nine members who shall be appointed in the following manner: three members appointed by the Chairman of the House Finance Committee from the membership of that committee, two members appointed by the Chairman of the House Committee on Corporations, Insurance and Banking from the membership of that committee, two members appointed by the Chairman of the Senate Committee on Commerce and Labor, and two members appointed by the Chairman of the Senate Finance Committee from the membership of that committee.

The members of the joint subcommittee shall receive such compensation as is authorized by law for members of the General Assembly and be reimbursed for their expenses incurred for the work of the joint subcommittee. The Division of Legislative Services shall serve as staff to the joint subcommittee. The officials and employees of all State agencies shall cooperate fully with the joint subcommittee.

The joint subcommittee shall report its findings and recommendations to the Governor and the General Assembly not later than November one, nineteen hundred seventy-nine.

Pursuant to this directive, the following were appointed to serve on the Joint Subcommittee: Delegate Lewis W. Parker, Jr., Chairman; Senator Clive L. DuVal, 2d, Vice-Chairman; Delegate Bernard G. Barrow; Senator John C. Buchanan; Senator Joseph T. Fitzpatrick; Delegate George W. Jones; Senator Willard J. Moody; Delegate Alson H. Smith; Delegate Erwin S. Solomon.

The Joint Subcommittee was assisted in its study by the staff of the Division of Legislative Services. Specific staff assigned were John A. Garka, Economist, and E. M. Miller, Jr., Senior Attorney.

II. PURPOSE

Last year, a Joint Subcommittee of the Virginia General Assembly examined the tax treatment of the interstate toll service revenue of telephone companies (Virginia telephone company revenue from interstate calls) and submitted comprehensive legislation to the Virginia General Assembly (House Document No. 4, 1979 Session). As a result, legislation was enacted to increase the base of the franchise tax (also known as gross receipts tax) to include the proportionate part of interstate revenue attributable to Virginia from interstate long-distance telephone calls originating or terminating within this State. This legislation also reduced the franchise tax rates proportionately with the increased base reducing the tax in 1984 and thereafter from 2% to 1.3%. In addition, the legislation required the State Corporation Commission, during its rate review for all utilities, to establish rates and charges which reflect all savings realized by such companies from the recordation tax reduction and the franchise tax reduction enacted by the General Assembly.

During the course of last year's study, the Joint Subcommittee received considerable testimony regarding the increasing competition to the publicly regulated telephone companies from telephone companies which are entering the industry but which operate with little or no public regulation. The Subcommittee found that these companies appear to receive preferential treatment vis-a-vis the publicly regulated telephone companies. The Joint Subcommittee viewed this as a serious problem, but one which was beyond the scoe of its charge.

This year's study, pursuant to House Joint Resolution No. 324, resulted from a recommendation of last year's Subcommittee to examine the taxation of publicly regulated telephone companies vis-a-vis private communications firms to insure that the taxation structures applicable to all the firms in each of these industries are equitable.

III. BACKGROUND

This country's telecommunications network and policy did not arise from a single source, but rather was a result of a period of experience which led to the supplying of telephone service through what has been termed a "natural monopoly". It was felt that telephone service could be provided at a lower cost to society by single suppliers which were exclusively franchised to serve designated areas rather than by allowing two or more suppliers to provide the same telephone service in a given area. At that time it was recognized that the public interest may be better served through regulation than by competition.

For the last forty-five years, this country's telecommunications policy has been guided by the Communications Act of 1934 which bound the telephone system with the Bell system, the independent telephone companies, and the telephone cooperatives working as partners to provide this nationwide telephone network. Thus, competition was allowed, but each entity was regulated and responsible for the service it provided the public within its own operating territory.

The Communications Act of 1934 made it a national policy to make available, as far as possible, to all people of the United States a rapid and efficient communications system at a reasonable charge. This charge, along with the price regulation of the industry, has caused its basic charges for telephone service to be priced on something other than an actual direct cost basis. That is, certain portions of the telephone business subsidize the less profitable portions of the business. For example, basic residential telephone rates are relatively low because the pricing of optional services, particularly long distance service, is well above its direct cost. In other words, long distance services subsidizes local service.

At the same time, certain high profit long distance services subsidize less profitable long distance service that a telephone company must provide when a franchise is granted. This uniform availability of service when coupled with the pricing policy that charges similar amounts for long distance between points a like distance apart (even though cost may vary widely) means that the high profit, high density routes subsidize those routes with lower traffic density. If this was not the case, telephone service from, for example, Paduka, Kentucky, to Wise, Virginia, would probably be prohibitively expensive since the lower level of usage of this line would mean a higher cost per call than compared to a call between two points where there is a greater telephone density (e.g., Washington to New York City). This type of pricing system, based on a direct cost, would have appeared to have run counter to national policy because it would not have allowed service to all people because the prohibitive cost would rule out the use of telephone services for certain areas of the country.

The telephone industry has experienced a number of profound changes recently through a series of decisions by the Federal Communications Commission. The "Carterfone" and "MCI" decisions by the FCC in the late sixties opened up competition in two areas of the telephone industry.

The shift from a regulated monopoly to competition began in 1968 with the FCC's landmark "Carterfone" decision which allowed terminal equipment not supplied through the telephone companies to be interconnected with the national telephone network operated by telephone companies. Terminal equipment would include main and extension telephones, PBX's, switchboards, etc.

There are probably numerous advantages that stem from buying or leasing terminal equipment from interconnect suppliers. First, the interconnect suppliers appear to be relatively free to write their own price tags while telephone companies must have theirs approved by regulatory commissions, often after months of proceedings. Second, the terminal equipment companies would probably compete only for those products in which they feel they have a competitive advantage while the telephone companies would be required to provide all products.

Three years later, in 1971, the FCC authorized Microwave Communications, Inc. (MCI) to offer private telephone line service between Chicago and St. Louis. Since that time, a large and growing number of similar companies with substantial assets or subsidiaries of large established firms like ITT, RCA, Southern Pacific Railroad, have entered the area. These firms are known as specialized common-carriers and offer private line service between a number of large cities where there is a relatively large amount of telephone traffic density (e.g., Chicago-New York, Washington-New York, etc.). These services are provided only for telephone traffic between the cities that are served by the specialized common-carriers. It should be noted that these firms are rapidly expanding the number of cities which are being served. In 1978, these specialized carriers collected revenues of approximately $216 million (furnished by the Ad Hoc Committee for Competitive Telecommunications, Washington, D. C.). (Please see Appendix A.)

The specialized common-carriers have expanded because they have undercut the rates of the established carriers by serving only where the traffic density is the greatest, thus, where the profit is the greatest, while the telephone companies must provide service to all areas. As we have stated before, because telephone charges are similar for similar distance calls, these high density routes provide the profit which cushion the telephone companies from the losses incurred from the low density routes.

The publicly regulated telephone companies argue that the loss of the high profit markets will mean that prices for its other services will have to increase. In other words, part of the cost burden will be shifted from the big business caller and people who use long distance relatively frequently to the average and rural telephone user.

It is important to emphasize that Virginia has no control over the degree of "competition" that the FCC allows in the telephone communications area. Virginia can, however, by unequal taxation treatment cause one to unfairly receive a competitive advantage over the other.

IV. THE TAXATION OF TELEPHONE COMPANIES

Before discussing the taxation structure of the telephone companies the Joint Subcommittee wishes to note that the data it received and examined for the publicly regulated utilities was excellent and complete while the Joint Subcommittee had difficulty obtaining data for the non-publicly regulated firms. Sales, revenue and tax data on a firm by firm basis was not available to the members of the Joint Subcommittee. As with all private, non-regulted firms this type of information is confidential and unavailable unless the individual firm wishes to make it public. This is particularly true for these firms because of the tremendous growth in this area and because of the competition among these firms.

From the very beginning of its study, the Joint Subcommittee realized the different standards that are applicable to firms in this area. The Joint Subcommittee has examined the different firms in the telecommunications industry. Although, the Committee did not obtain all the data that it wished, it found sufficient data to compare the taxation structures of the various types of firms.

The Joint Subcommittee first examined the major state tax that is imposed on these firms–the corporate income and franchise tax.

Unlike private corporations which operate on an unregulated, competitive basis, publicly regulated uitlities operate under a different structure. As a result, the Commonwealth, as well as most other states, impose different taxes on publicly regulated utilities. In Virginia, publicly regulated utilities, under the regulation of the SCC are subject to a franchise tax for the privilege of operating in Virginia. For telephone companies this franchise tax rate is 2.8% for tax year 1979 and is in the process of gradually being phased down to 1.3% for tax years 1984 and thereafter.

The specialized common carriers and the firms which provide telephone and terminal type equipment are subject to the Virginia corporate income tax for the portion of the profit that they derive from operations in Virginia. The current corporate income tax rate is 6%.

In the past, the publicly regulated utilities have argued that the burden of a franchise tax based on gross receipts was much greater than the income tax which was levied on other corporations. The Virginia General Assembly has acknowledged that the franchise tax based on gross receipts has caused a much greater tax liability than the corporate income tax. The 1976 Session provided a gradual annual decrease in the franchise tax to reduce this inequity. When the gradual reduction is completed in the 1984 tax year, the tax burdens should become roughly comparable between the franchise tax and a corporate income tax.

In appearing before the Joint Subcommittee, representatives of various telephone companies testified that for some telephone companies tax burdens will be roughly comparable by 1984. Others testified, however, that the franchise tax will still leave a greater tax liability than an income tax. The actual comparison for each utility will depend on a number of factors including among other things the level of profitability, size of the firm, and the portion of interstate toll service revenue.

The franchise tax reduction when completed should approximately equalize the burden of the corporate income tax and the franchise tax.

The Joint Subcommittee notes that if this corporate income tax structure was modified for telephone companies to take care of any inequities, that in itself would create more inequities because then the corporate income tax would differ for private telephone related companies from all other private companies. Thus, if any adjustment need to be made, the franchise tax should be altered. The Joint Subcommittee believes that the current franchise tax reductions should run their course and after that time the income and franchise tax burdens should again be re-examined.

At the local level, the major taxes that are imposed are the property tax, the local consumer utility tax, the sales and use tax, and the local gross receipts tax.

In regard to local property taxes, the Joint Subcommittee has found that generally the property tax is equitably levied. Generally, all real and personal property must be appraised and assessed at 100% of fair market value and extended at the same tax rate as applicable to all other real and personal property in such locality.

In the case of the property of non-regulated companies, each locality itself appraises and assesses all real and personal property. In the case of public utilities, the State Corporation Commission is charged with appraising and assessing such property and furnishing this information to the appropriate locality. The SCC has historically been the central State agency for appraising public service corporation property due to its expertise in the area. The Joint Subcommittee has found that the SCC keeps meticulous records of property, especially tangible property. For example, tangible property is divided into the following areas: value of pole lines, conduits, wire lines, land (other than right-of-way) and buildings, central office equipment, station equipment and apparatus, automobiles and trucks, general equipment, and materials and supplies. It appears that the SCC appraises and values virtually all property owned by the public utilities while the non-SCC regulated companies pay property taxes on the typical real property and tangible personal property similar to other corporations. How large a disparity this would cause in a property tax bill is unknown at the present time.

All property appears to be taxed in each locality at the same relationship to value with one exception. A certain portion of public utility property is presently assessed at a greater percentage than all other property in many of the localities. This was especially prevelent before 1966. However, under the Bemiss Bill by 1986 the property tax among all classes of property will be equalized.

The next local tax the Joint Subcommittee examined was local license tax. Localities are allowed to levy a local license tax of up to 1/2% on the publicly regulated utilities. The receipts from long distance telephone calls are not be considered receipts. The localities can levy a local license tax on all private telephone companies. Recent legislation has placed a limitation on this local rate. The limit will eventually be .36%.

Although the Joint Subcommittee has not examined the specific rates that are levied by localities, the Joint Subcommittee believes that there is no evidence that an inequity exists in this area of tax.

The final area of local tax that was examined by the Joint Subcommittee was the sales and use tax and the local consumer utility tax. The Joint Subcommittee notes that this tax area is especially troublesome for publicly regulated utilities vis-a-vis private telephone companies.

The local consumer utility tax is a local option tax on the consumers of utility service but only for service provided by the publicly regulated utilities. The Code of Virginia specifies a <u>maximum</u> monthly tax on residential consumers but not on commercial or industrial users. Certain localities in Virginia have the highest local utility tax in the country. For example, the City of Richmond imposes a monthly tax on commercial and industrial telephone users of 25% of the first $625 plus 5% of the excess. These local utility taxes are largely the reason why Virginia State and local taxes on public utility services are higher than on most other goods and services.

The size of the local consumer utility tax particularly impacts the telephone industry. In comparing the publicly regulated telephone companies and those selling terminal equipment the taxation consequences are unequal. For example, if a firm in Richmond leased telephone equipment with maintenance at no additional charge, the 25% or 5% applies to the bill every month. If, however, the firm purchases the telephone equipment from a private firm while purchasing the line from the regulated company, the terminal equipment would be subject to the one time sales and use tax of 4%.

The taxation disparity is evident. A one time 4% sales tax or a monthly tax of up to 25%. This obviously leads to a competitive advantage to those firms which offer telephone equipment for sale rather than lease. A number of localities have recognized this inequity and have attempted to equalize the tax treatment by either reducing or eliminating the local consumer utility tax on business services which are subject to competition. At present, Norfolk, Remington, Roanoke, Price George and Scottsburg have exempted local business services subject to competition. Lynchburg and Richmond have introduced a reduced rate for these services which over a period of time will equalize the taxes.

The inequity is clearly at the local level and a number of localities have already taken action. If localities do not take action the competitive situation of the publicly regulated companies will deteriorate. The Joint Subcommittee encourages the localities to examine this particular aspect of their tax structure to ensure that the total tax structure is equitable.

V. SUMMARY

The Joint Subcommittee has studied the area of telecommunications and would like to summarize its conclusions.

The provision of telephone service has historically been provided through a natural monopoly. Monopolies which were regulated by the federal and State governments. Two decisions of the Federal Communications Commission have opened up the telephone industry to competition in two specific areas. The first is to specialized common carriers that provide point to point long distance service in high density areas. And second, to companies that provide terminal type equipment which can be purchased for use with the lines provided by publicly regulated telephone companies.

These two areas of the telephone industry are areas where the competitors to the regulated telephone companies are under minimal federal regulation and no regulation from the state. Clearly, Virginia has no control over the degree of "competition" that the Federal Communications Commission allows in the telephone communications area. The charge to the Joint Subcommittee was to ensure that unequal taxation treatment did not allow one to unfairly receive a competitive advantage over another.

The Joint Subommittee has examined the taxation structure of this industry and finds that the taxation structure imposed on publicly regulated utilities is different than for non-regulated companies.

The major state tax on regulated utilities is the franchise tax on gross receipts. The corporate income tax is the major state tax on non-regulated firms. In the past and even the present there is a significantly greater burden imposed by the franchise tax on regulated firms than by the income tax on unregulated firms, however, this inequity has been recognized and is in the process of being resolved. When the gradual annual reduction of the franchise tax is completed the tax burden of the two taxes should be approximately equalized. At the end of that period, the taxation structure should again be examined.

The Joint Subcommittee has examined the local gross receipts tax and the local proerty tax and finds that these two taxes are equitably applied to both regulated and unregulated firms.

The area of greatest inequity appears to be in the local consumer utility tax and the sales tax. Certain Virginia localities have the highest local consumer utility tax rates in the country. This is a result of high rates and no ceilings and this has placed publicly regulated utilities at a very great competitive disadvantage compared to private telephone companies.

If telephone equipment is leased the monthly local consumer utility tax is applied (up to 25% per month in Richmond). If the equipment is purchased from an unregulated company, a one time 4% sales tax is applicable. A number of localities have recognized this inequity and reduced or eliminated the utility tax on business services which are subject to competition. The Joint Subcommittee urges all localities with this type of disparity to examine and modify their tax structure to ensure that the tax structure is equitable and that certain firms in an industry are not penalized.

The final inequity and probably the major one in Virginia that the Joint Subcommittee wishes to note is not a tax inequity but an inequity of regulating certain firms while not regulating competitors. Prices of certain types of companies are regulated while others are not. This inequity, however, is not one that is within the jurisdiction of the Commonwealth. It appears to be appropriate that more information should be required from some private companies. This type of decision or recommendation, however, is not within the purview of this Joint Subcommittee.

Respectfully submitted,

Lewis W. Parker, Chairman
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(Business & Finance Section)

ITT Asks Bigger Phone Net

By Larry Kramer
Washington Post Staff Writer

The International Telephone and Telegraph Corp. has asked the Federal Communications Commission to allow it to expand its private long distance telephone service to 100 cities, a move that would make it the nation's second largest interstate telephone network, behind only the American Telephone & Telegraph Co.

If approved, the ITT system would enable its users to reach more than 80 percent of all business telephones in the United States, at cost reductions of up to 85 percent from ATT charges, the company claimed.

ITT's long distance service, known as City-Call and offered through its subsidiary, U.S. Transmission Systems, Inc., was first introduced last April. At that time, it was offered in only 11 cities, and was significantly smaller than similar services offered by firms such as MCI, Inc. (about 60 cities) and Southern Pacific Communications (about 70 cities.)

But the entrance of ITT into the $16 billion (annually) interstate telephone market was seen as highly significant because of the sheer size of the company, and its ability to finance large-scale future competition with the Bell system.

In fact, ITT's efforts in the area appear to be moving at breakneck speed. By May, the company announced an increase to 28 cities. And its 100-city system could be in place within 90 days, if FCC approval is forthcoming quickly, said ITT official Patrick Ryan, who is general manager of the subsidiary, USTS.

"We looked at the marketplace and asked what we would have to do to compete," Ryan said in a telephone interview from New York. "When we were out trying to sell our system, people asked how soon we would be going into more cities."

He said ITT will be using both Microwave ground transmission and satellite relay systems to send phone signals across the country. Once the signal reaches the local area, ITT, like all of its competitors, interfaces with the local Bell system telephone company for the last leg of the phone call. For that portion of the call, the Bell system is paid a fee determined by the FCC.

Although the present ITT system allows only for toll billing—payment based on the number and length of each telephone call—Ryan said it is only a matter of weeks before ITT will introduce a system similar to AT&T's Wide Area Telephone Service. Such a system would charge a user a set fee for unlimited telephone calls.

AT&T spokesman Pic Wagner said "ITT is following the same course as other companies in trying to increase long distance business. They are now increasing competition with other specialty companies as well as the Bell System."

Wagner said the ITT proposal leaves "still unanswered policy questions as to whether such an action is in the public interest."

The Federal Communications Commission has only recently begun to allow competition in the telephone business, which has long been dominated by AT&T under a government-sanctioned monopoly.

APPENDIX A