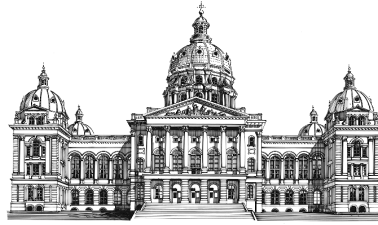

Iowa Legislative Fiscal Bureau

Dennis Prouty
(515) 281-5279
FAX 281-8451



State Capitol
Des Moines, IA 50319
September 26, 1994

Property Tax Treatment Of The Long-Distance Telecommunications Industry

ISSUE

The long-distance telecommunications industry is no longer a rate-regulated industry. However, the industry continues to have its property centrally assessed, reflecting a time when long-distance phone service was a rate-regulated monopoly.

AFFECTED AGENCIES

Department of Revenue and Finance (DRF)

CODE AUTHORITY

Chapter 433.4, Code of Iowa

BACKGROUND

Iowa is one of 13 states that provides disparate property tax treatment for the long-distance telecommunications industry. Specific tax treatment varies between these 13 states. The most common approach, utilized by 6 states, is the use of an interexchange listing percentage, such that property is assessed similarly across industries, but the taxable percentage is higher for long-distance carriers (and other utilities). The states of North and South Dakota have a tax treatment similar to Iowa's. As in Iowa, these states provide a commercial and industrial exemption for personal property, but do not extend the exemption to the long-distance telecommunications industry.

There are 9 classified industries whose property is subject to central assessment by the DRF. These classifications can be broken down into the following 4 groups: telephone, railroad, electric (including rural cooperatives), and gas (including pipelines). Most of the companies within these groups are rate-regulated.

The difference between local assessment and central assessment to these companies is significant. Personal property (tangible property not otherwise defined in Chapter 427A.1, Code of Iowa) is exempt from locally assessed taxable valuation but subject to centrally assessed taxable valuations. Personal real property, which includes machinery and equipment (M&E) and computers is locally assessed at 30.0% of acquisition value, but there is no exemption for centrally assessed properties.

I
S
S
U
E

R
E
V
I
E
W

The purpose of central assessment is two-fold. Initially, the companies subject to central assessment have property located throughout the State. The idea behind central assessment is that it is more efficient to have the State assess the property, assign the proportion of the property that falls into each county or subdivision, and have the companies pay each county based on the local levies. Central assessment also insures that the companies are not subject to local disputes over how property is distributed.

Secondly, since the affected companies are generally rate-regulated monopolies and have a guaranteed return on investment, the proponents of central assessment determined the companies should be subject to a broader property tax. Because of rate-regulation, it is more difficult to shift the tax to consumers or other classes of property, and there is no interstate competition. In short, the utility cannot relocate. Electricity will be provided to residents regardless of the property tax treatment imposed by that jurisdiction.

One exception can be found in the long-distance telecommunications industry. Since the breakup of AT&T, local telephone service continued to be provided by local monopolies. The economies of scale¹ are such that it was considered inefficient for companies to compete for local service. Long-distance providers were thrust into a competitive market, but are still subject to central assessment.

Central assessment of properties in Iowa is calculated by the DRF using a "unit value method." There is no distinction between the different classes of property (personal, personal real, building, and land). The unit value is then coupled with holdings in the State to determine the total Iowa assessment. In the case of the long-distance telecommunications industry, property is assessed according to a 3-factor formula. Through 1993, this formula was applied as follows: 70% stock and debt; 20% income; 10% cost. This resulted in companies having property assessed over 100% of the market value. The DRF changed the 3 factors to 50%, 40%, and 10% respectively in 1994, which brought the valuations closer to 100% of market value.

Once the "system" (world-wide) property value and State value are assessed, the assessment is allocated back to the counties based on cable-miles. For example, if a given county has 10.0% of the cable-miles of a long distance carrier, then the company is required to pay taxes to that county based on 10.0% of the unit value.

CURRENT SITUATION

In Iowa, there are at least 5 long-distance companies competing for long-distance customers: AT&T, MCI, U.S. Sprint, Wiltel, and Iowa Network Services. All of these companies are centrally assessed. The following table compares the central assessments of these companies and those of all centrally assessed properties.

1992-1993 Valuations of Centrally Assessed Property in Iowa
(Millions of Dollars)

	<u>1992</u>	<u>1993</u>	<u>Percent Change</u>
All Property	\$ 7,818.5	\$ 7,269.0	-7.0%
Long-distance Phone Companies	375.5	323.8	-13.8%

¹Economies of scale refers to the optimal size of a producer within an industry. Optimal size is determined by examining the size at which the product can be produced at the least cost. In the case of local phone service, a local monopoly (1 producer) is generally considered the optimal (most efficient) producer size.

Long-distance Phone Companies Percent of Total 4.8% 4.5%

Assuming an average tax rate of \$30.80 per \$1,000 of valuation, long-distance phone companies paid approximately \$11.6 million in property taxes based on the 1992 valuations and \$10.0 million based on the 1993 valuations. This does not include the taxes paid for telemarketing services provided by these companies. Telemarketing services are currently locally assessed, so personal property is not taxed, and personal real property is valued at 30.0% of acquisition value.

There are 2 concerns that have been raised regarding the tax treatment of the long-distance telecommunications industry. The first concern is a constitutional question. Three of the companies (AT&T, MCI, and U.S. Sprint) filed appeals based on the constitutionality of treating them differently from locally assessed companies. The cases rest on the supposition that similar property must be taxed similarly. (The appeals were settled when the DRF established the new 3-factor formula.)

The second concern is one of interindustry and interstate competition. For example, a company like IBM could sell excess capacity from its private line networks and be taxed at locally assessed rates, but long-distance phone companies would pay considerably more. There is also a concern of interstate competition. For example, MCI was looking for a site for a data center. The company claimed that a Nebraska location, compared to an Iowa location, would save them approximately \$5.0 million in property taxes each year, due to the disparate tax treatment imposed by Iowa.

ALTERNATIVES

Local assessment of properties owned by the long-distance telecommunications industry is an option that could be initiated by the General Assembly. This would require the elimination of the central assessment references to the long-distance telecommunications industry (Chapter 433.4, Code of Iowa). Currently there is no distinction between local and long-distance carriers in the Code of Iowa.

Economic development efforts by companies in the long-distance telecommunications industry could be enhanced if local assessments were utilized. The single-factor corporate income tax is already appealing to these companies because a large percentage of the industry's sales are outside the State. The extent to which economic activity would increase with local assessment is not known.

There would be a shift in property tax burden from the affected companies to other classes of property. This assumes that the State would not replace the lost revenue. Based on appeals from the 3 largest firms, between 63.0% and 96.0% of the centrally assessed long-distance telecommunications property would be considered personal property if locally assessed. This implies that the lost revenue to local governments (tax shift) would be between \$6.1 million and \$9.6 million each year, based on 1993 assessments.

The DRF has formed an intradepartmental working group to discuss the specific implications for the telecommunications industry as well as the general concept of central assessment. The Department is expected to issue recommendations prior to the commencement of the 1995 Legislative Session.

BUDGET IMPACT

Locally assessing long-distance carriers would have an impact on local governments as described in the previous section. There would also be an impact on the State budget through the State school aid formula. The loss in property tax valuation represents a reduction in the tax base. Due to the formula, the State would make up \$5.40 per \$1,000 of lost taxable valuation. This would result in a cost to the State of an amount between \$1.1 million and \$1.7 million each year beginning in FY 1997, based on 1993 valuations.

In future years, the cost would be lessened by 2 factors:

1. Property valuations from long-distance carriers are expected to decline as a result of a change in the unit value formula.
2. The impact to the State and local governments would be lessened to the degree that enhanced economic activity would generate additional revenues.

Currently the impact of these effects can not be estimated.

STAFF CONTACT: Jon Muller (Ext. 14611)