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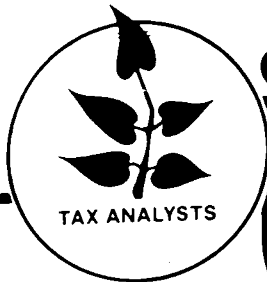

UTILITY GROSS RECEIPTS TAXES AND INTEREXCHANGE TELECOMMUNICATIONS CARRIERS

by Walter Hellerstein and Henry D. Levine

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In this article, Hellerstein and Levine consider the question whether there is any continuing justification for applying state utility gross receipts taxes to interexchange telecommunications carriers. They explore the historical basis for imposing special taxes on utilities, including telecommunications companies, observing that such levies were designed as a quid pro quo for the special rights and privileges the state granted to utilities. They then trace the evolution of the telecommunications industry and demonstrate that the historical rationale for imposing gross receipts taxes on the telecommunications industry no longer applies to the competitive segment of the industry in which interexchange carriers operate. They also point out that generally accepted criteria of sound tax policy militate against the imposition of a special gross receipts tax on interexchange carriers. Finally, they note other studies supporting their conclusion that there is no longer any justification for imposing utility gross receipts taxes on interexchange carriers. They recommend that states reconsider their telecommunications tax policy in light of these conclusions.

Table of Contents

A. Introduction 529
B. The Development and Rationale of Utility Gross Receipts Taxes 530
C. The Evolution of the Telecommunications Industry 531
1. The Development of the Bell System 531
2. Changes in Regulation of Telecommunications 532
3. Competition and Regulation in the Interexchange Market 533
D. The Eroding Justification for Imposing Utility Gross Receipts Taxes on Interexchange Carriers 533
E. Other Studies 534
1. The Florida Study 534
2. The Minnesota Study 535
3. The Pennsylvania Study 535
4. The Texas Study 535
5. The Case Study 535
6. The Wassall-Sullivan Study 535
F. Conclusion 536

A. Introduction

Thirty states impose selective gross receipts taxes on telecommunications companies,[1] usually as part of a tax imposed on utilities doing business in the state. The historical rationale for many of these levies was that they constituted a *quid pro quo* for the special rights and privileges that the state granted to utilities, such as monopoly power within a defined service area, the power of eminent domain, and the right to use public rights-of-way. For many years, this rationale justified the imposition of utility gross receipts taxes upon the telecommunications industry, which was essentially a regulated monopoly protected from competition by the states. With the dramatic changes that the telecommunications industry has undergone in recent years—including deregulation, the AT&T divestiture, and technological advances—the justification for applying utility gross receipts taxes to the competitive segment of the telecommunications industry has been brought into question. In this article, we examine the appropriateness of continuing to subject interexchange telecommunications carriers to state utility gross receipts taxes in light of the historical rationale for such

[1] Case, *State Tax Policy and the Telecommunications Industry*, in Council of State Policy and Planning Agencies, The Challenge of Telecommunications: State Regulatory and Tax Policies 63-65 (1986); Wassall & Sullivan, *State Taxation of Telecommunications Companies*, Proceedings of the Seventy-Ninth Annual Conference of the National Tax Association—Tax Institute of America 342 (1987).

taxes, the evolution of the telecommunications industry, and considerations of sound tax policy.

B. The Development of and Rationale for Utility Gross Receipts Taxes

There is no single or universally accepted definition of a public utility, but utilities generally possess some or all of a series of characteristics.[2] They provide services or commodities commonly viewed as necessities, such as electricity, gas, water, or transportation. They hold themselves out as ready and willing to serve "the public" upon demand in a nondiscriminatory manner, and are usually required to do so. They enjoy substantial freedom from competition either through the private acquisition of monopoly status or by the grant of a franchise or certificate from the state according them monopoly status. They enjoy additional special privileges granted by the state that are not granted to ordinary corporations, such as the right of eminent domain and access to rights-of-way on or over public property. And their rates and terms of service are regulated. In the "classic" American model, a utility must provide "adequate" service to all residents of its franchise territory and may charge only "just and reasonable" rates for the services that it provides. In return, it is (more or less) assured of recovering its prudently incurred expenses plus a "fair" return on its stockholders' equity.[3]

Probably, the first utility gross receipts tax was a special tax on the Washington branch of the Baltimore and Ohio Railroad imposed in 1833.

The special characteristics of public utilities led many states to develop special tax regimes applicable only to them. Most of these levies originated with railroads, which were not the first public utilities, but were the first to amass substantial assets and corporate power. The earliest special taxes took the form of charter taxes, which were prevalent while charters were still being granted by special acts of the legislature and before there were general incorporation laws.[4] These charter provisions included the first utility gross receipts taxes. Probably, the first utility gross receipts tax was a special tax on the Washington branch of the Baltimore and Ohio Railroad imposed in 1833.[5] In 1851, Illinois issued a charter to the Illinois Central Railroad that provided for a tax on its gross receipts.[6] Wisconsin adopted a gross receipts tax in 1854 as an alternative to the property tax.[7] Over time, utility gross receipts taxes were widely adopted and broadly applied.

The principal rationale for special taxes on utilities was that they were a *quid pro quo* for the special rights and privileges that the state granted to utilities, such as monopoly power to operate within a defined service area, the power of eminent domain, and the right to use public rights-of-way.[8] A public service commissioner describing the origins of New York's special franchise tax on public service corporations called it "virtually a tax upon the right to use the streets, highways, and public places for special purposes."[9] In addition, special levies on utilities were viewed as a means of taxing the value of the right to operate, which was not captured by traditional property taxes on real and tangible personal property. As the New York City Corporation Counsel observed with regard to one of the state's special franchise taxes on public service corporations:

> We had always, or for many years, taxed railroad tracks, telegraph lines on poles, electric wires underground, etc., as real estate. The innovation in the law consisted in adding to the valuation of such property the value of the right to maintain, construct or operate those properties in, on, under, or over the public streets or highways of the city.[10]

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[2]The terms "public utility" and "utility" are employed interchangeably in this article, as they are in most materials dealing with public utilities.

[3]*See generally* A.J.G. Priest, Principles of Public Utility Regulation (1969).

[4]Public Service Tax Study Committee, Taxation of Public Service Corporations in Virginia 2 (1947).

[5]*Id.* at 3.

[6]*Id.* at 2.

[7]*Id.* at 3.

[8]As a matter of theory, one might distinguish in this regard between utility gross receipts taxes that are imposed in addition to the "ordinary" taxes imposed on other taxpayers and utility gross receipts taxes that are imposed in lieu of other taxes, particularly property taxes. In principle, "in lieu" taxes were often viewed not as special levies but rather as a means of taxing the value of utility property, which can be difficult to value under the traditional *ad valorem* property tax. *See* Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405, 420-22, 454 (1986). Insofar as they reflect a good faith effort to impose a tax that is equivalent to the property or other taxes paid by other taxpayers in the state, one does not need to make the case for imposing an additional tax burden on public utilities in order to justify in lieu taxes. As a practical matter, however, such "in lieu" taxes often bear no reasonable relation to the taxes that they are allegedly designed to replace and in fact amount to special, additional levies on utilities. *See*, e.g., *Railway Express Agency, Inc. v. Virginia*, 358 U.S. 434, 446-47 (1958) (Brennan, J., concurring) ("in lieu" tax of $139,739 alleged substitute for taxes aggregating $7,235). Of the 30 states that impose selective gross receipts taxes on telecommunications companies, 18 are in theory imposed in lieu of some other levy. Case, *supra*, note 1, at 63-65.

[9]Maltbie, *The Taxation of Public Service Corporations*, Proceedings of the Second International Conference of the International Tax Association 477 (1909); *see also* Plehn, *Taxation of Public Service Service Corporations*, Proceedings of the First National Conference of the National Tax Association 635 (1908); Foote, *Relation of Franchise Taxation to Service Rates*, Proceedings of the First National Conference of the National Tax Association at 655; E. Seligman, *Essays in Taxation* 181-82, 225-26 (9th ed. 1921).

New York has a long and complex history of imposing special taxes, including taxes measured by gross receipts, on public service corporations. *See* New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, *Transportation Taxes in New York State* 19 (1983); Laws of New York, 1880, section 6, 1880 N.Y. Laws 766 (imposing, in addition to other taxes, a levy on gross earnings of utilities including "every telegraph company or telephone company").

[10]Coleman, *Special Franchise Taxation in New York*, Proceedings of the First National Conference of the National Tax Association 649 (1908).

The history of gross receipts taxes on the telecommunications industry is part of the larger story, outlined above, of utility gross receipts taxes in general. Telegraph and telephone companies were first subjected to special taxes on their gross receipts soon after they began offering service on a commercial basis. Thus, Connecticut began taxing the gross receipts of telegraph companies in 1865 and of telephone companies in 1884;[11] New York imposed a gross receipts tax on telephone and telegraph companies in 1880;[12] Minnesota extended its gross earnings tax on railroads to telephone and telegraph companies in 1887;[13] and Texas imposed a 1.5 percent gross receipts tax on every person who owned or operated telephones or telephone lines in the state (and charged for their use) in 1905.[14]

Telegraph and telephone companies were... subjected to special taxes...soon after they began offering service....

The rationale for imposing utility gross receipts taxes upon the telecommunications industry (or for including the telecommunications industry within the scope of gross receipts taxes imposed on other entities) was essentially the same as the rationale for imposing gross receipts taxes upon utilities in general. The telecommunications industry rapidly developed into a regulated monopoly protected from competition by the state, and special taxes were viewed in part as payment for the public franchise.[15] Special taxation of the telecommunications industry also was justified as recompense for the use of public rights-of-way for telephone and telegraph poles and lines. Telephone companies were often granted the power of eminent domain to build their networks, which provided further justification for subjecting them to special taxes.

Whatever the theoretical basis for the imposition of special gross receipts taxes on utilities (including telecommunications companies), their widespread adoption and durability may be attributable to less abstract considerations. The levies have been stable sources of revenue—even during times of economic distress—both because public utilities have generally maintained their financial health by comparison to other businesses and because gross receipts tax revenues do not vary directly with business profitability.[16] Because virtually all citizens purchase utility services, special levies on utilities also have been a practical way for elected officials to raise revenue without having to bear the political cost of imposing new (or increased) taxes directly on the voting public.

Finally, there was little resistance to the imposition of gross receipts taxes on utilities.[17] Utilities had little incentive to fight the levies because the taxes were considered a recoverable cost of providing their services. Under standard utility rate-making principles, they are recovered directly through the rates charged to a utility's customers and do not affect its return on investment or net profit.[18] Moreover, because it has generally been assumed that the demand for telecommunications and other public utility services is relatively inelastic,[19] it was thought that increases in the price of public utility services attributable to the taxes would not lead to significant decreases in consumer demand for those services.

C. The Evolution of the Telecommunications Industry

As indicated above, telecommunications has historically been viewed as a public utility function. Thus, telephone service is widely viewed as essential, and telephone companies have enjoyed freedom from competition and other special privileges. As a consequence, the industry operated for most of a century under Federal and state regulatory regimes that determined "just and reasonable" rates and guaranteed a fair return on provider investment.

By 1934, the Bell System was firmly established as a state-protected near-monopoly.

1. The Development of the Bell System. The monopoly position enjoyed by the Bell System during its formative years was attributable to its control of the patents issued to Alexander Graham Bell in 1876. After those patents expired in 1893, there was considerable competition in the industry, marked by the emergence of thousands of independent telephone companies. Over the next three decades, however, AT&T (under the leadership of the legendary Theodore Vail) consolidated its control over the industry through mergers, acquisitions, and regulatory and legislative action, which protected the Bell System from competition.[20] By 1934, the Bell System was firmly established as a state-protected near-monopoly.

The Communications Act of 1934[21] placed interstate communications under the authority of the Federal Communications Commission ("FCC" or the "Commission"). For the next 25 years, the industry represented a classic example of a regulated monopoly at both the state and Federal levels.[22] AT&T was the dominant firm in the

[11] Case, *supra*, note 1, at 37.

[12] *See* note 9 *supra*.

[13] Fisher & Martin, *Taxes and Telecommunications in an Era of Change*, in Final Report of the Minnesota Tax Study Commission 223, Vol. II (1986). Minnesota's gross earnings tax originated in a charter granted to the Pacific Railroad Company. *Id.*

[14] State of Texas, *Telecommunications Tax Options*, Report to the Joint Select Committee on Fiscal Policy 9 (1985).

[15] Touche Ross & Co., *Taxation of Telecommunications in Pennsylvania*, Report to the Department of Revenue 34 (1986).

[16] These factors may explain the timing of Florida's initial utility gross receipts. tax. *See* 1931 Fla. Laws 1160. The year 1931 was one in which an untapped source of stable revenue would have been particularly attractive.

[17] Case, *supra*, note 1, at 38.

[18] C. Phillips, *The Regulation of Public Utilities* 264 (1984).

[19] *Id.*; Case, *supra*, note 1, at 38. Demand is inelastic to the degree that an increase in price causes a proportionally smaller decrease in demand.

[20] *See generally* G.W. Brock, *The Telecommunications Industry* 89-125, 148-176 (1981).

[21] 48 Stat. 1064 (1934), 47 U.S.C.A. section 151 *et seq.* (West 1977 & Supp. 1987).

[22] *See generally* Brock, *supra*, note 20, at 177-97; Fisher & Martin, *supra*, note 13, at 227-28.

industry; it served approximately 80 percent of the telephone subscribers in the United States (including almost all major urban areas) and owned the only significant long distance telephone network. The remaining 20 percent of the population was served by a few sizable independents (notably General Telephone) and over a thousand small telephone companies, all of which were dependent on AT&T for long distance service and connections to other companies. Local companies operated as geographic monopolies under state regulatory control. For regulatory (and tax) purposes, the telecommunications industry was treated like other public utilities that enjoy special franchises, monopoly power, and an assured return within a framework of government regulation of rates and terms of service.

2. Changes in Regulation of Telecommunications. In a series of decisions that began in 1959 and accelerated in the 1970s, the Federal Communications Commission (supported—and occasionally pushed—by the courts) permitted competitive entry into segments of the telecommunications industry and loosened regulatory controls on those entrants that lacked market power.

The revolution began with the *Above 890* decision in 1959, which opened the private line market to competition from private microwave systems by allocating spectrum for their use.[23] *Above 890* was followed by *Carterfone*, in which the Commission first authorized competition in the provision of electronic equipment used in connection with the public switched network;[24] the *First Computer Inquiry*, in which the Commission took steps to renounce regulation of data processing and associated communications services;[25] *Specialized Common Carrier Services*, which opened the private line market to competition;[26] and the *Domsat* case, which approved competitive entry into the domestic satellite market.[27]

When the FCC hesitated, the courts pushed ahead. In the mid-1970s, the D.C. Circuit blocked the Commission's efforts to prevent MCI from offering general long distance service, known in the industry as message toll services (MTS),[28] and then ordered the Commission (and AT&T) to facilitate MCI's provision of MTS by making local access facilities available to it.[29]

Perhaps most importantly, the Modification of Final Judgment (MFJ) that settled *United States v. Western Electric Co.* was midwifed by a Federal court. In the MFJ, AT&T agreed to settle an antitrust suit brought by the Department of Justice in the early 1970s by divesting the 19 local Bell Operating Companies (BOCs). It retained the Long Lines Division, its manufacturing arm (Western Electric) and most of Bell Labs, and was given freedom to enter into any line of business, including the unregulated data processing markets from which it had been barred by a consent decree executed in 1956. The BOCs, organized into seven regional holding companies (RBOCs), were to provide local exchange service and local access to long distance service. They were required to provide "equal access" to their facilities to all interexchange carriers and were prohibited from manufacturing equipment or offering long distance and information services.[30]

MCI and U.S. Sprint are the second and third largest players. . . .

Under the MFJ, the territories within which the BOCs are permitted to carry calls from end to end are called Local Access and Transport Areas (LATAs).[31] With minor exceptions, the 192 LATAs specified in the order implementing the MFJ do not cross state lines.[32] Although there are intraLATA toll calls, the BOCs carry over 95 percent of them even in those states that allow competitors to provide intraLATA switched services. While states allow some competition in the intraLATA market, most still prohibit (or limit) intraLATA competition.[33] By contrast, virtually all multi-LATA states allow more-or-less open competition in the provision of intraLATA service,[34] as does the FCC in the interstate market.

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[23] *Allocation of Frequencies in the Bands Above 890Mz*, Report & Order, 27 F.C.C. 359 (1959) ("*Above 890*"). *Above 890* was followed (and expanded) in *Microwave Communications, Inc.*, Decision, 18 F.C.C.2d 953 (1969), which authorized a "specialized carrier" to provide private line service between St. Louis and Chicago.

[24] *Use of the Carterfone Device in Message Toll Tel. Service*, Decision, 13 F.C.C.2d 420 (1968) ("*Carterfone*").

[25] *Regulatory & Policy Problems Presented by the Interdependence of Computer Communications Services & Facilities*, Tentative Decision, 28 F.C.C.2d 291 (1970). The general deregulation of customer premises equipment and enhanced services (services that combine elements of data processing and communications) was completed in the *Second Computer Inquiry. See Amendment of Section 64.702 of the Commission's Rules & Regulations (Second Computer Inquiry)*, Final Decision, 77 F.C.C.2d 384 (1980).

[26] *Establishment of Policies & Procedures for Consideration of Application to Provide Specialized Common Carrier Services in the Domestic Public Point-to-Point Microwave Radio Service & Proposed Amendments to Parts 21, 43, & 61 of the Commission's Rules*, First Report & Order, 29 F.C.C.2d 870 (1971) ("*Specialized Common Carrier Services*").

[27] *Establishment of Domestic Communications-Satellite Facilities by Non-governmental Entities*, Second Report & Order, 35 F.C.C.2d 844 (1972) ("*Domsat*").

[28] *MCI Telecommunications Corp. v. FCC*, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978).

[29] *MCI Telecommunications Corp. v. FCC*, 580 F.2d 590 (D.C. Cir.), *cert. denied*, 439 U.S. 980 (1978).

[30] *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 990, D.C. 1982).

[31] *United States v. American Tel. & Tel. Co.*, 569 F. Supp. 990, 993-95 (D. D.C. 1983).

[32] Nine states consist of a single LATA. At the other extreme, Texas includes 17 LATAs.

[33] As of September 1987, 40 states permitted intraLATA reseller competition, but only 19 permitted facilities-based intraLATA competition by interexchange carriers. Five other states permitted partial facilities-based intraLATA competition, and the issue was pending in 10 more states. *See IntraLATA Competition Picture May See Many Changes Over Next 12 Months*, State Telephone Regulation Report, Sept. 24, 1987, revised and updated in Nov. 5, 1987, at 6 (hereinafter "State Telephone Regulation Report"). Through cost efficiencies and/or access pricing, the BOCs have succeeded in retaining a *de facto* monopoly in the market for intraLATA switched services even where competition is legally permitted. In intraLATA private line markets (including special access), competition is beginning to emerge, but at this time, it is confined to a few major urban centers.

[34] State Telephone Regulation Report, *supra*, note 33, at 6.

3. Competition and Regulation in the Interexchange Market. The term "interexchange carrier" is most commonly applied to providers of "basic" communications services that the BOCs are not permitted to provide—calling across state and/or LATA lines. The AT&T divestiture essentially created a separate market for interexchange services. That market now includes several hundred companies, of which the largest (by far) is AT&T with some 70-75 percent of the carrier portion of the market.[35] MCI and U.S. Sprint are the second and third largest players—their combined market share is generally said to range from 15-20 percent. Beyond these three, there are other significant entrants such as ALC, Western Union, and ITT, hundreds of resellers (large and small) and an indeterminate number of private (or enhanced) networks that use microwave facilities, satellites, or fiber leased from other entities to transport messages around the country.

There is considerable disagreement among carriers, state and Federal regulators, and outside analysts about the degree of competition in the interexchange market, though virtually all agree that it is growing. The plurality view is that AT&T continues to retain some power to raise prices and/or restrict output, but that this power varies by product line and territory and has been eroding since "equal access" was introduced and the company's market share began to drop. Some important submarkets—e.g., MTS service in urban areas—are quite competitive. Even in them, AT&T is the strongest and (possibly) lowest-cost provider and is said to function as a price leader in the manner of U.S. Steel and General Motors in years past. In other submarkets—e.g., "900" services and "Dial 0"—AT&T's market share is very high and it is hard to escape the conclusion that it retains significant market power.

The interexchange market is at least somewhat competitive and is becoming more so with time.

To the extent that regulation tracks developments in the "real world," it confirms these conclusions. Neither the FCC,[36] nor any major state regulatory body,[37] imposes traditional public utility regulation on interexchange carriers other than AT&T. Indeed, a substantial number of regulatory bodies (including the FCC) have taken steps to streamline their oversight of AT&T.[38]

The bottom line is that, unlike the market for local or intraLATA telephone service, the interexchange market is at least somewhat competitive and is becoming more so with time.

The same can be said of virtually all of the new communications services introduced in the last decade, whether or not limited to interexchange service. Since the *Domsat* decision, the FCC has consistently sought to create open entry policies for new services such as Digital Electronic Message Service and Multipoint Distribution Service. When spectrum or other limitations made open entry infeasible—as in the case of cellular radio—the Commission sought to use "structured competition" as a substitute for close economic regulation. With important exceptions, the states have followed suit.

The result is a growing array of public and private telecommunciation services that are fiercely competitive and largely unregulated. Many of them use no rights-of-way, or even wires. They do not resemble "utilities" of the type that most state legislatures undoubtedly had in mind when they first enacted gross receipts taxes on telephone and telegraph companies.

Interexchange carriers are no longer protected from competition by the state....

D. The Eroding Justification for Imposing Utility Gross Receipts Taxes on Interexchange Carriers

Changes in the regulatory and technological environment of the telecommunications industry have eroded the historical rationale for including interexchange carriers within a utility gross receipts tax to the point where none of the original justifications for imposing utility gross receipts taxes on telephone companies today supports subjecting interexchange carriers to such taxes.

Interexchange carriers are no longer protected from competition by the state, so the argument that they should be subjected to special taxes in exchange for the grant of a monopoly franchise no longer applies. Other special privileges, such as eminent domain and the uncompensated or subsidized use of public rights-of-way, are today largely confined to the local operating companies and thus provide no continuing justification for subjecting interexchange carriers to a special tax regime. Nor (with the exception of AT&T in approximately half of the states) do interexchange carriers conduct their business within the framework of pervasive economic regulation designed to ensure the delivery of telecommunication service to all of a state's residents at reasonable cost in return for a reasonable return on investment. In short, interexchange carriers no longer have the essential

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[35] Industry Analysis Div., Common Carrier Bureau, FCC, *AT&T's Share of the Interstate Switched Market, Third Quarter 1987* 3 (released Dec 28, 1987).

[36] *See Policy & Rules Concerning Rates for Competitive Common Carrier Services & Facilities Authorizations Thereof*, Second Report & Order, 91 F.C.C.2d 59 (1982). All interexchange carriers other than AT&T were subjected to "streamlined" regulation in 1980 and "foreborne" regulation in 1982. At one point the FCC even tried to force AT&T's rivals to withdraw their tariffs, but that effort was turned back by the courts. *MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186 (D.C. Cir. 1985).

[37] As of November 1, 1987, only three states purported to regulate the rates-of-return of facilities-based interexchange carriers other than AT&T; only one (Iowa) claimed to regulate reseller returns. None of the regulating states was large. State Telephone Regulation Report, *supra*, note 33, at 6.

[38] *See Policy & Rules Concerning Rates for Dominant Carriers*, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987). According to State Telephone Regulation Report, by last fall 26 states allowed AT&T some degree of pricing flexibility, and nearly a score of those had abandoned (or significantly modified) the application of traditional rate of return on rate base regulation to AT&T. State Telephone Regulation Report, *supra*, note 33, at 6-7.

characteristics of public utilities, and there is therefore no warrant for continuing to tax them under a scheme designed for public utilities.

Subjecting interexchange carriers to utility gross receipts tax is inconsistent not only with the historical justification for levying such taxes on the telecommunications industry, but also with generally accepted principles of sound tax policy. The three most widely employed criteria for evaluating taxes are equity, neutrality, and administrability. The application of utility gross receipts taxes to interexchange carriers receives low marks under each of these standards.

Subjecting interexchange carriers to utility gross receipts tax is inconsistent...with generally accepted principles of sound tax policy.

It is universally agreed that taxes should be equitable, i.e., that the tax burden should be distributed fairly. Despite disagreements over just what consitutes a fair distribution, horizontal tax equity (taxpayers in similar positions should bear similar tax burdens) is broadly accepted. That principle is violated by application of a utility gross receipts tax to interexchange carriers, which can no longer rationally be distinguished from other service providers.[39] There is no warrant for taxing such carriers under a utility gross receipts levy while companies offering services in related industries (e.g., data processing or the media) go untaxed. Even under a broad-based tax on "telecommunication services," some competing services inevitably escape taxation.[40] In the end, there is simply no justification from a tax equity perspective for saddling the competitive segment of the telecommunications industry with special tax burdens when taxpayers operating in other competitive sectors of the economy escape taxation.

Neutrality is another widely accepted desideratum of modern tax policy. A tax is neutral when it does not induce taxpayers to alter their behavior in response to the tax. A broad-based profits tax, for example, is generally regarded as neutral because a firm will make the same profit-maximizing decisions it would have made in the absence of the levy. The same cannot be said, however, for the application of a gross receipts tax to interexchange carriers. Wholly apart from criticisms that may be leveled against gross receipts taxes in general on neutrality grounds,[41] subjecting interexchange carriers to a utility gross receipts tax will distort economic decision making and produce suboptimal resource allocations by increasing the cost of interexchange services relative to the cost of other, untaxed services. Investment in interexchange technologies that would have occurred in the absence of the levy may be diverted to untaxed technologies, even though the former are more efficient, and purchases of interexchange services that would have occurred in the absence of the tax may be foregone.[42]

Taxes also should be easy to administer and to collect. Utility gross receipts taxes, particularly as applied to telegraph and telephone companies, have historically been a model of administrative simplicity. The delineation of the industry, and hence the firms and receipts subject to tax, was clear, and the tax applied to only a handful of telecommunications providers in the state. With deregulation, divestiture, and evolving telecommunications technology, all of this has changed. As Professor Karl Case has noted, "[n]ow hundreds of firms provide complex products and services in a competitive environment," and "[d]etermining which firms and which services should be subject to special telecommunications tax provisions has become enormously complex."[43] With reference to Florida's effort to extend its utility gross receipts tax to all "telecommunication services,"[44] Professor Case points out that,

> even the carefully worded Florida statute is unclear about potential future developments. What happens when a single fiber optic cable brings television and radio programs, reads meters, connects home security systems to central dispatch boards, and provides two-way voice communications at the same time? These products and services are far removed from the vision of a public utility providing basic communications.[45]

In sum, the continuing application of a utility gross receipts tax to interexchange carriers cannot be justified by the historical rationale for applying such taxes to the telecommunications industry or by widely accepted norms of sound tax policy.

E. Other Studies

The conclusion reached above that interexchange carriers should not be subjected to utility gross receipts taxes is reinforced by other studies that have considered the issue.

1. The Florida Study. In 1985, the Florida Telecommunications Task Force submitted its Final Report to Governor Graham in response to his charge that the Task Force examine "the telecommunications industry from the perspective of recent technological and regulatory changes for the purpose of recommending rational public policy for equitable taxation."[46] The Florida Task Force explicitly "acknowledged that the traditional *quid pro quo* for the state subjecting an industry to gross receipts taxation is some form of state protection for that industry

[39] Case, *supra*, note 1, at 58.

[40] Overnight air courier services, for example, compete with telecopy (i.e., "Fax") services, yet only the latter must bear the burden of a special tax on telecommunication services. The same is true for batch processing at regional centers followed by shipment of tapes to central locale versus on-line, real time reporting of data from the regional centers via telephone lines.

[41] *See Case, supra*, note 1, at 55.

[42] *See Id.* at 46. To the extent that industries that make heavy use of interexchange communications—such as financial services—are viewed as desirable by a state, taxes that impose disproportionate burdens on telecommunications are counterproductive and discourage economic development.

[43] *Id.* at 45.

[44] Act of June 17, 1985, ch. 85-174, 1985 Fla. Laws 1172.

[45] Case, *supra*, note 1, at 46.

[46] Letter from Co-Chairman Joseph P. Cresse and Randy Miller to Governor Bob Graham, Feb. 1, 1985, reproduced in Florida Telecommunications Task Force, Final Report to Governor Bob Graham and the Florida Legislature (1985).

from market competition."[47] It went on to observe that "[r]ecent technological change has served to increase substantially the competitive market forces in the telecommunications industry during the same time that regulatory agencies have realized a reduced role in industry protection."[48] Although the Florida Task Force recommended retention of the gross receipts tax on interexchange carriers, it did so *not* because this represented sound tax policy but rather because revenue concerns overrode other considerations.[49]

2. The Minnesota Study. In 1986, the Minnesota Tax Study Commission issued a final report in which it considered all aspects of the state's tax structure.[50] With respect to taxation of the telecommunications industry, which has long been subject to a gross receipts tax in Minnesota, the report recommended that the legislature "[m]aintain the gross receipts tax on telephone and telegraph companies for one or two years to permit planning for replacement of the tax with a property tax that treats telecommunications business as other commercial industrial activities are treated."[51]

3. The Pennsylvania Study. In 1986, Touche Ross & Company prepared a Report on Taxation of Telecommunications in Pennsylvania for the Pennsylvania Department of Revenue.[52] The report considered various alternatives to Pennsylvania's existing system of taxing the telecommunications industry, which includes a utilities gross receipts tax. The report recognized the general inappropriateness of applying a utility gross receipts tax to competitive segments of the telecommunications industry, and three of the four proposed alternatives eliminated the gross receipts tax on interexchange carriers.[53]

4. The Texas Study. In 1985, the staff of the Texas Lieutenant Governor and the Comptroller of Public Accounts prepared a Report on Telecommunications Tax Options.[54] The report considered four options relating to the state's then-existing gross receipts tax on the telecommunications industry. In evaluating the advantages and disadvantages of each option, the report recognized that substituting a sales tax for the gross receipts tax on interexchange carriers would treat competing services more uniformly.[55] The advantages of retaining the gross receipts tax on the telecommunications industry included familiarity, simplicity (because no legislative action would be required), uncertainty over the impact of changing the existing system, because the telecommunications industry is still in a state of flux.[56]

Substituting a sales tax for the gross receipts tax on interexchange carriers would treat competing services more uniformly.

5. The Case Study. In 1986, Professor Karl Case completed a study on State Tax Policy and the Telecommunications Industry for the Council of State Policy & Planning Agencies.[57] Professor Case observed that the historical justification for imposing gross receipts taxes on the telecommunications industry had "eroded."[58] He noted that "differential taxes on telecommunications firms are not neutral with respect to economic choices; they distort both consumption and investment decisions leading to a misallocation of society's valuable resources."[59] And he concluded that the justification for special tax treatment of the telecommunications industry has ended and that "the time has come for states to treat telecommunications firms like other businesses."[60]

6. The Wassall-Sullivan Study. In 1986, Professors Gregory Wassall and John J. Sullivan authored a paper on state taxation of telecommunications companies.[61] It surveyed the current status and recent trends of state taxation of telecommunications and considered the appropriate tax policy toward telecommunications firms. The paper concluded that "the present system of state telecommunications taxation could be improved upon with respect to equity, efficiency, and ease and cost of administration if the gross receipts tax on telecommunications were eliminated."[62]

In support of this conclusion, the authors note that the arguments against the gross receipts tax are clearest when the tax is imposed on both the competitive and regulated sector of the telecommunications industry.

> In the competitive sector, consisting primarily of interstate telecommunciations, it represents an additional tax that firms in other competitive industries do not have to pay. *Ceteris paribus*, the return to competitive firms in the telecommunications industry will be reduced, thus restricting output. Further, the largest firms in the competitive industry are multiproduct firms; higher taxes on one product

[47] Florida Telecommunications Task Force, *supra*, note 46, at 33.

[48] *Id.*

[49] The Florida Task Force interpreted the Governor's charge as including the "[m]aintenance of revenue committee to the PECO (Public Education Capitol Outlay) Trust Fund at a viable and stable level." *Id.* at 11. As a practical matter, this precluded the Task Force from acting on the implications of its own findings that changes in the regulatory and technological structure of the telecommunications industry undermined the rationale for continuing to subject the competitive segments of the industry to the utility gross receipts tax. Even so, the Task Force *did* recommend that the industry be allowed to credit its gross receipts tax payments against its state corporate income tax liabilities, which would (if adopted) have mitigated the inequities of the gross receipts tax.

[50] Minnesota Tax Study Commission, Final Report of the Minnesota Tax Study Commission (1986). A staff paper included in the report was devoted to taxes on the telecommunications industry. *See* Fisher & Martin, *supra*, note 13, at 223.

[51] Minnesota Tax Study Commission, *supra*, note 50, at 23. Although Minnesota's gross receipts tax is "in lieu" of property taxes, *see* note 8 *supra*, the Commission's conclusion that telecommunications companies should be treated like other businesses for tax purposes is equally germane to utility gross receipts taxes imposed in addition to other taxes.

[52] Touche Ross & Co., *supra*, note 15, at 35.

[53] *Id.* at 69-87.

[54] State of Texas, *supra*, note 14.

[55] *Id.* at 22 and 25.

[56] *Id.* at 20. The report made no recommedations.

[57] Case, *supra*, note 1 at 37.

[58] *Id.* at 58.

[59] *Id.*

[60] *Id.*

[61] Wassall & Sullivan, *supra*, *note 1*.

[62] *Id.* at 345.

may put them at a disadvantage in competing in other industries. In addition, firms in competitive industries are not necessarily profitable, but a gross receipts tax is payable nevertheless. Currently, some interstate telecommunications firms are losing money on their operations.[63]

With respect to considerations of efficiency, i.e., the burden that a gross receipts tax imposes on the market, Wassall and Sullivan noted that the excess burden on telecommunications firms can be substantial, especially in states that impose a gross receipts tax in addition to a sales tax on telecommunication services. They further pointed out that the problem is exacerbated by the fact that the most price-elastic communications services are generally sold in the competitive sector. Finally, the authors observed that the costs of administering and complying with a gross receipts tax on telecommunications, while minimal when the industry was comprised of the Bell System and a handful of independent telephone companies, had become much more significant.

[63] *Id.*

In the competitive sector today, the tax is collectible from an increasing number of vendors, many of whom have primary interests in other industries. The more broadly telecommunications is defined, the greater will be the costs of identifying taxpayers, administering the tax, and enforcing compliance.[64]

F. Conclusion

We conclude that there is no tax policy justification for including interexchange services within the scope of a utility gross receipts tax base. Our conclusion is supported by the erosion of the historical rationale for applying a utility gross receipts tax to the contemporary telecommunications industry; widely accepted principles of tax policy, which militate against subjecting interexchange carriers to a special tax on their gross receipts; and the similar conclusions reached by other studies that have examined these questions. We recommend that state legislators reconsider their telecommunications tax policies in light of these conclusions.

[64] *Id.*

WASHINGTON ROUNDUP

ERIC CHAIRMAN URGES ACTION AGAINST MORATORIUM ON PENSION REVERSIONS. "A moratorium on reversions is the precursor to a new pension mandate," warned ERISA Industry Committee (ERIC) Chairman Robert Stone in a July 21 speech before the ERIC Quarterly Membership meeting. Stone asserted that a mandate providing unearned benefits is an untenable precedent that would substantially increase employers' liability on plant closings, layoffs, early retirement, and even normal termination, according to an ERIC news release.

Stone noted that the recent Eleventh Circuit Court of Appeals reversal of *Blessitt v. Dixie Engine Co.* (CA 11, No. 86-8123) rejected any right to "payment of retirement benefits based on future years of service not actually worked." According to the news release, the decision overturns an earlier ruling in the case that limited an employer's recovery of surplus assets on terminating a defined pension plan.

However, Stone cautioned against a premature celebration. "Hard fought victories in court can be overturned in the dead of night by an election year Congress," he said, noting that the Senate Appropriations Committee has already agreed to a 15-month moratorium on reversions of plan assets. Stone informed members that the full Senate will take up the moratorium issue this week and that the House-Senate conference is expected to deal with the issue before the August 12 recess.

The ERIC news release has been placed in the August 1, 1988 *Tax Notes Microfiche Database* as *Doc 88-6383.*

CORETECH APPLAUDS FINANCE HEARING WHERE RESTRUCTURED R&D CREDIT WAS WIDELY PRAISED. Legislation recently introduced by Senate Finance Committee members John C. Danforth, R-Mo., and Max Baucus, D-Mont., to reform the R&D tax credit received universal praise at a hearing held by the Senate Finance Subcommittee on Taxation and Debt Management on July 12, 1988, according to a news release from CORETECH, the Council on Research and Technology. Senate bill 2484, which would restructure the "base" period of the R&D tax credit, expand its coverage, and make the R&D credit permanent, was supported in testimony by the Treasury Department, the Small Business Administration, and several leading economists.

CORETECH Chairman Joseph Saloom, testifying in support of the Danforth/Baucus proposal, pointed out that Japan offers 19 different tax incentive systems to encourage technological innovation and that the U.S. must adapt its policies to changing conditions in order to remain abreast of its major trading partners during this era of intense international competition. "As an organization representing many companies that are technological leaders, we are extremely concerned that U.S. public policy actively stimulate innovation," Dr. Saloom said.

The CORETECH news release includes testimony by other witnesses at the hearing. Treasury support for S. 2484 was based on the claim that the incentive effect of the credit's fixed-base structure would result in a five-fold increase per dollar of revenue cost. Treasury also noted that by allowing companies two ways to compute the credit against this fixed base, S. 2484 would significantly expand the number of firms eligible for the credit.

The CORETECH news release has been placed in the July 25, 1988 *Tax Notes Microfiche Database* as *Doc 88-6192.*