



**Senate Fiscal Agency**  
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BILL



ANALYSIS

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House Bill 4834 (Substitute S-2 as reported)  
House Bill 4835 (Substitute S-2 as reported)  
Sponsor: Representative Deborah Whyman  
House Committee: Tax Policy  
Senate Committee: Finance

Date Completed: 7-1-96

### **RATIONALE**

Currently, under both the General Sales Tax Act and the Use Tax Act, an exemption is provided for the purchase of machinery and equipment for the use or consumption in the rendition of a service that is taxable under Section 3a(a) of the Use Tax Act. (Section 3a(a) provides for the taxation of the use or consumption of *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.) The exemption is limited to the tangible personal property located on the premises of the subscriber and the "necessary exchange equipment".

The application of this exemption has resulted in disagreements between telecommunications companies and the Department of Treasury. In *MCI Equipment Corporation, et al. v Michigan Department of Treasury* (Michigan Tax Tribunal, April 4, 1995, Docket Nos. 113032, 113033, and 113034), the Department contended that to achieve the exemption a multilevel set of criteria had to be met: the property had to be machinery or equipment; it had to be used in the rendition of a taxable service; and it could include only that tangible personal property that was located on the premises and was the "necessary exchange equipment". The case involved an audit of MCI by the Department, in which the auditor concluded that none of MCI's machinery and equipment

should be qualified for the exemption because MCI did not engage in providing local telephone service and thus owned no property that could be considered "necessary exchange equipment". The Tribunal rejected the Department's argument, saying that the exemption was not specifically granted for local exchange services, but addressed "the rendition of a service"; further, it agreed with the arguments of MCI concerning what constituted exchange equipment. The decision has been appealed by the Department.

It is the contention of some that disagreements between the Department and the telecommunications industry over the application of the exemption will continue, or increase, because the major advances in technology in recent years have resulted in the rapid development, and replacement, of telecommunications equipment. This, they argue, in combination with the deregulation of the industry, has resulted in not only a blurring of what constituted exchange equipment but also a blurring of the distinction between local and long distance telephone service. It has been suggested that the Use Tax Act and the General Sales Tax Act be amended to clarify the exemption.

### **CONTENT**

House Bill 4834 (S-2) would amend the Use Tax Act and House Bill 4835 (S-2) would amend the General Sales Tax Act to exempt from the use tax and the sales tax the purchase of certain telecommunication equipment. The bills would provide an exemption for the purchase of machinery and equipment for use or consumption in the rendition of *any combination of services*

(rather than the rendition of a service, as currently provided), taxable under Section 3a(a) of the Use Tax Act (pertaining to intrastate communications, as described above) or under Section 3a(c) of that Act, which refers to the following: interstate telephone communications that either originate or terminate in Michigan 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 this State including calls between Michigan and any place within or without the United States outside of Michigan. The exemption would be limited to the 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, not including distribution equipment including cable or wire facilities. The bill would delete reference to “necessary exchange” equipment.

MCL 205.94 (H.B. 4834)  
205.54a (H.B. 4835)

## **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

### **Supporting Argument**

The General Sales Tax Act and the Use Tax Act both allow an exemption to telecommunication companies for tangible personal property located on the premises of the subscriber and the “necessary exchange equipment”. The exemption is provided to those engaged in the use or consumption of a service that is taxable under Section 3a(a) of the Use Tax Act. In a disagreement involving MCI and the Department of Treasury over the application of the exemption (argued before the Michigan Tax Tribunal), the issue was the definition of “necessary exchange equipment” and whether that term, and the tax exemption, applied to certain disputed categories of equipment. 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 granted only for local telephone exchange services. The Department also had 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 bills essentially would codify the decision of the Tribunal, by extending the exemption to long distance services and further defining the equipment to which the exemption would apply. 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. The bills recognize that tax statutes cannot remain stagnant when the world they apply to is changing rapidly. The legislation also would provide additional incentives for companies to invest in telecommunication services in the State and would foster economic development. By eliminating potentially disparate and inconsistent treatment among telecommunications companies that provide services in Michigan, and providing a fair application of the exemption to equipment used by all providers of intrastate and interstate services, the bills would make Michigan a more attractive place for telecommunications companies to invest.

### **Opposing Argument**

The Tax Tribunal decision in *MCI v Department of Treasury* has been appealed by the Department. If passed, the bills would negate the arguments of the Department and render its case moot. While there has been, with technological advances and increasing competition among phone companies, a blurring of the distinction between equipment used for interstate calls and equipment used for intrastate calls, that does not mean that the solution to the disputed application of the use tax exemption is to exempt all machinery or equipment purchased for use or consumption in *any combination of services*, and all of the equipment specified in the bills. The bills would expand the exemption far beyond what is necessary. 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. If a service is not subject to the use tax, the property should not be exempt. Because there have been changes in the telecommunications industry, the Department has been engaged in discussions with the industry, and there is not yet agreement over the tax treatment of certain kinds of equipment. The bills would end any discussion of tax treatment of the equipment in question and simply place in statute language favored by telecommunications companies.

Legislative Analyst: G. Towne

## **FISCAL IMPACT**

In FY 1996-97, on a full-year basis, it is estimated that House Bills 4834 (S-2) and 4835 (S-2) would reduce sales and use tax revenue by a combined \$3.1 million. The loss in revenue would have an impact on several budget areas in the following estimated amounts: General Fund/General Purpose revenue would be down \$1.6 million, School Aid Fund revenue would be down \$1.4 million, and revenue sharing would be reduced \$100,000. These estimates are based in part on information from the Department of Treasury.

Fiscal Analyst: J. Wortley

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.