



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #899

Tax Exemption for Air Carriers with Hub Terminal Facilities (DOT -- Transportation Finance)

[LFB 2001-03 Budget Summary: Page 651, #6 (part)]

CURRENT LAW

Commercial airlines are exempt from local property taxes and, instead, are taxed under the state's ad valorem tax authorized by Chapter 76 of the statutes. Proceeds from taxes paid by airlines are deposited in the state's transportation fund. The property of airlines is valued on a systemwide basis, and a portion of that value is allocated to Wisconsin based on a statutory formula intended to reflect the airline's activity in the state. The resulting value is taxed at the statewide average tax rate for property subject to local property taxes, net of state tax credits.

The formula used to apportion airline values to Wisconsin consists of three, equally weighted factors that include: (a) transport and transport-related revenues; (b) tons of revenue passengers and cargo; and (c) depreciated cost. For each factor, activity in Wisconsin is divided by activity in the system as a whole, and the result is multiplied by one-third. Each company's allocation percentage equals the sum of the three factors. In 2000, the total Wisconsin valuation of airline property was \$431,097,728 and the statewide average property rate was \$21.464 per \$1,000 of property. The ad valorem tax on airline property generated \$9,253,100 in transportation fund revenue in that year. Aircraft registration fees and general aviation fuel tax collections are also deposited in the transportation fund. Commercial air carriers are exempt from both aircraft registration fees and the aviation fuel tax.

GOVERNOR

Provide an exemption from Chapter 70 property taxes and from Chapter 76 state ad valorem taxes for all property owned by an air carrier company that operates a hub facility in

Wisconsin, if the property is used in the operation of the air carrier company, effective with property assessed as of January 1, 2002.

Define an air carrier company as any person engaged in the business of transporting persons or property in aircraft for hire on regularly scheduled flights. Define a hub facility as either one of the following: (a) a facility from which an air carrier company operated at least 45 common carrier departing flights each weekday in the prior year and from which it transported passengers to at least 15 nonstop destinations or transported cargo to nonstop destinations; or (b) an airport or any combination of airports in Wisconsin from which an air carrier company cumulatively operated at least 20 common carrier departing flights each weekday in the prior year, if the air carrier company's headquarters is in the state. Require the Department of Revenue to promulgate an administrative rule defining "nonstop destinations" and "company headquarters" for the purposes of this provision.

Reduce estimated transportation fund revenue by \$1,250,000 in 2001-02 and \$2,500,000 in 2002-03 to reflect the ad valorem tax exemption.

DISCUSSION POINTS

1. The Governor's recommendations summarized under the Fiscal Bureau summary item entitled "Tax Exemption for Air Carriers with Hub Terminal Facilities" involve both a tax exemption for certain commercial air carriers, which would take effect during the 2001-03 biennium, and changes to the funding for DOT's aeronautics assistance program, which would take effect during the 2003-05 biennium. This paper discusses the proposed ad valorem tax exemption, while LFB Paper #900 discusses the proposed changes to the funding for the aeronautics assistance program.

2. Proponents of the proposed tax exemption have cited the positive economic impact that a hub airline has on the region in which it is located. The airline hub may allow residents of the region to fly to more nonstop destinations than would be the case without an airline hub. This is important to many business travelers and, therefore, may help attract businesses to the region. In addition, the hub airline generates jobs, both directly and indirectly, that have an impact on economic growth in the state as well as on state and local tax collections.

3. The proposed ad valorem tax exemption for airlines operating a hub facility in Wisconsin would currently only apply to Midwest Express (including Skyway Airlines, the operating name of Astral, Inc., a wholly-owned subsidiary of Midwest Express) and Air Wisconsin Airlines (a United Express carrier). In calendar year 2000, Midwest Express paid \$1,953,300 under the ad valorem tax while Air Wisconsin Airlines paid \$577,100, for a total of \$2,530,400. These payments may go up or down depending upon the airlines' activity in the state and, because the assessment is based on market value, their profitability.

4. Ad valorem tax payments are made in May and November of the year for which the assessments are made. Therefore, the tax collections associated with a single calendar year are

collected in two different fiscal years. The exemption would be effective with property assessed as of January 1, 2002, which would reduce revenues in 2001-02 by about half of what would otherwise be collected in calendar year 2002 (the May payment). In 2002-03, revenues would be reduced by an amount equal to about half of what would otherwise be collected in calendar year 2002 (the November payment) plus about half of what would otherwise be collected in calendar year 2003 (the May payment). Under the bill, estimated transportation fund revenues would be reduced by \$1,250,000 in 2001-02 and \$2,500,000 in 2002-03, implying combined, estimated tax collections from these two airlines of \$2,500,000 annually in calendar years 2002 and 2003.

5. Other legislation has been introduced during the current session (Assembly Substitute Amendment 1 to AB 100 and SB 158) that contains provisions that are substantially similar to the ad valorem tax exemption provision in the bill. However, in this other legislation the exemption would be effective with property assessed as of January 1, 2001, instead of January 1, 2002. One alternative would be to modify the bill to make the effective date consistent with the effective dates in the other legislation. In this case, instead of making a payment in November, 2001, for their 2001 taxes, the exempt airlines would not make this payment and would receive a refund of their May, 2001, payment. This would reduce transportation fund revenue by a total of \$2,500,000 in 2001-02, relative to the bill, or by \$3,750,000 in 2001-02 and \$2,500,000 in 2002-03, relative to the base.

6. The proposed exemption would currently apply to only two airlines. However, other airlines could qualify if they expand their operations in Wisconsin or move their headquarters to the state to meet the bill's definition of a hub facility. In this respect, the exemption could help to increase airline service in the state.

7. Although the proposed exemption may encourage other airlines to expand service in the state, the exemption may also apply to some airline industry reorganization that does not actually result in a benefit to the state. Such a reorganization could increase the proportion of airline property subject to the exemption, resulting in a larger reduction in transportation fund revenue. For instance, if another airline were to purchase Midwest Express and subsume its operations, all of the purchasing airline's Wisconsin value plus Midwest Express's value would be exempt from the ad valorem tax. Similarly, either Midwest Express or Air Wisconsin could acquire the operations of another airline, without actually affecting the Wisconsin service of that airline, thereby increasing the amount of Wisconsin value exempt from taxation. Another possibility is that either one of the exempt airlines could increase their market share at Wisconsin airports at the expense of another airline, which would also reduce ad valorem tax collections.

8. In addition to creating an incentive for other airlines to expand their operations in Wisconsin in order to meet the definition of a hub facility, the proposed exemption may create an incentive for the two airlines that would currently qualify for the exemption to expand their operations in Wisconsin as opposed to elsewhere. This would provide both service and employment benefits to the state.

9. Midwest Express (including Skyway) has recently purchased an additional 40

aircraft to be delivered over a five-year period between 2002 and 2006. Some of these aircraft will replace aircraft in the company's current fleet, but the company indicates that others will be used to expand service. The company has indicated that the new aircraft will be serviced in Milwaukee, but a determination has not yet been made on where additional service will be based.

10. In testimony before the Assembly Transportation Committee on a bill similar to the Governor's recommendations related to the hub exemption (AB 101), a representative of Midwest Express indicated that the proposed exemption may have an impact on how the company expands. The airline's current hub is Milwaukee, but it has two other bases of operations, in Omaha and Kansas City. According to the testimony, the company believes that there are unmet demands for the type of service that the company offers in both Kansas City and Milwaukee, and the airline will likely look to expand in both places. However, the company indicated that, while decisions on where to base flights are based on many factors including demand for the service and competition, the proposed tax exemption would increase the likelihood that the company would base particular flights in Milwaukee rather than in Kansas City.

11. Air Wisconsin has recently announced the purchase of 51 jets, to be delivered between 2001 and 2003. Some of the new jets will replace existing aircraft in the company's fleet, but they would also be used to expand service. Air Wisconsin, operating as a United Express regional carrier, feeds passengers into United Airlines' two major hubs, in Chicago and Denver. The company indicates that the additional planes would be used to expand service from the Denver and Chicago hubs, which may also affect service to Wisconsin airports. The proposed exemption may have an impact on where the company builds a maintenance facility to service the new aircraft. Madison and Milwaukee have been suggested as possible locations for a new Air Wisconsin maintenance facility, as well as cities in other midwestern states.

12. For a bill drafted during the 1999-01 session that would have provided an exemption that is similar to the exemption in the budget bill, the Legislative Reference Bureau (LRB) indicated that the proposed exemption may violate the Wisconsin Constitution's uniformity clause and the U.S. Constitution's commerce clause. The state uniformity clause requires that the taxation of all property within a particular class be uniform. That is, within a class, all property must be either completely exempt or assessed and taxed at 100% of its market value. A court may find that the distinction between property owned by an air carrier that operates a hub facility, as defined in the bill, and the property of any other airline creates an unreasonable classification. In this case, the exemption provided by the bill would not treat airline property uniformly and would, therefore, be unconstitutional.

13. The U.S. Constitution's commerce clause prohibits states from enacting laws that discriminate against interstate commerce. The LRB noted that a court could find that the proposed exemption violates this principal because it gives tax preferences to in-state businesses, but not to out-of-state businesses.

14. The bill's two distinct definitions of an airline hub facility may be treated separately by a court in any challenge of the constitutionality of the exemption. Under the first definition,

which applies to the operations of Midwest Express, a hub facility is determined by the number of nonstop flights and different destinations originating from a single airport. Under the second definition, which applies to the operations of Air Wisconsin, a hub facility is determined by the number of flights originating from any airport in the state, but only applies if the airline operating those flights has its headquarters in the state. While the first definition reflects a common understanding of an airline hub in the airline industry and among airline passengers, the second definition is not typical of a hub since it involves more than one airport. Therefore, a state court may be more likely to view the second definition as constituting an unreasonable classification of property for the purposes of property taxation. Furthermore, since this definition includes the requirement that the airport have its headquarters in the state, a court may be more likely to view this exemption as discriminatory against out-of-state businesses, and therefore, in violation of the commerce clause.

15. The LRB noted that it is unclear how a court would rule on these constitutional issues. In reviewing acts of the Legislature, the courts begin with a strong presumption that legislation is constitutional. A party challenging a law has to overcome this presumption.

16. A concern has been expressed that a court, if it rules that the proposed exemption is unconstitutional, could void the remaining airline ad valorem taxes. In this case, the total annualized loss to the transportation fund would be about \$9 million to \$10 million. If the Committee adopts the airline hub exemption, one alternative that may reduce the likelihood that the remaining airline ad valorem taxes are voided would be to include a provision that requires DOR to resume assessing and taxing the exempt property if a court rules the exemption unconstitutional. This would signal the Legislature's intention to the court that the tax shall remain if the exemption is disallowed.

17. Midwest Express has cited relatively high property taxes compared to other states as a reason that a hub exemption may be needed to induce an expansion of service in the state. However, property taxes are only part of the tax and fee environment that an airline must consider when deciding where to base flights. Corporate income taxes, excise or sales taxes on aviation fuel, aircraft registration fees, passenger facility charges (a ticket surcharge levied by the airport within federally-established limits) and other fees may affect an airline's costs. For instance, because of the manner in which Wisconsin assesses airline property and apportions that value to the state, property taxes in Wisconsin are higher than in some other states. However, taxes on fuel in Wisconsin are lower than many other states. Wisconsin exempts commercial airlines from the state's six cents per gallon excise tax on fuel and exempts fuel from the sales tax. Wisconsin does require commercial airlines to pay the three cents per gallon petroleum inspection fee on fuel, but airlines are eligible to receive a refund equal to two cents per gallon for every gallon in excess of 1,000,000 gallons purchased in a month. Since Midwest Express is currently purchasing about 3.5 million gallons per month in Wisconsin, the airline pays a net excise tax of one cent per gallon, after the refund, for each additional gallon purchased in the state. Midwest Express is the only airline currently receiving such a refund.

18. Missouri has a 4.225% sales tax on jet fuel in addition to a property tax on aircraft.

Commercial airlines operating in Illinois and Michigan are not subject to a personal property tax, but in Illinois there is a 6.25% sales tax on jet fuel and in Michigan there is a 6.0% sales tax on jet fuel plus a 1.5 cent-per-gallon excise tax. The tax on fuel for an additional gallon of fuel that Midwest Express would pay in Michigan, Missouri or Illinois will vary depending upon the price of fuel, but will be higher than in Wisconsin.

19. Whether higher fuel costs in other states, or higher costs associated with other taxes and fees in those states, will outweigh higher property taxes in Wisconsin for a particular flight will depend on many factors that are particular to the route in question. In order to get a sense of the magnitude of the total cost to the airline of a sales tax on fuel, it may be useful to compare what Midwest Express would have paid in other states had the company purchased as much fuel in those states as it does in Wisconsin. If, for instance, Midwest Express had purchased as much fuel in Missouri as the company purchased in Wisconsin in 1999-00, the company would have paid about \$1.5 million in sales tax on that fuel. Similarly, the company would have paid about \$2.5 million in Michigan and \$2.2 million in Illinois if it bought the same amount of fuel in those states. By comparison, Midwest Express paid \$655,000 in petroleum inspection fees in Wisconsin in 1999-00, net of the refund. These estimates assume a fuel price of 85 cents per gallon, which was the average cost of jet fuel in January, 2001, according to the U.S. Department of Transportation. The sales tax figures would increase or decrease depending upon the price of fuel.

20. The course of action the Committee decides to take on the proposed exemption may depend upon whether the goal is to provide the maximum inducement possible within the confines of the ad valorem tax or whether the goal is to create incentives to approximately equalize the tax burden in Wisconsin relative to other states, such as Missouri. If the goal is to provide the maximum inducement possible, then the proposed exemption may be appropriate. If the goal is to equalize the tax environment, considering both fuel taxes and property taxes, providing a benefit for hub airlines that is smaller than the revenue loss associated with the exemption may be sufficient. It is possible, however, that even with the full ad valorem tax exemption, market factors would override tax considerations and the airlines would base flights or maintenance facilities in other states.

21. If the Committee determines that a benefit should be provided to airlines with hubs in the state in an attempt to equalize the tax environment between Wisconsin and other states, but that the revenue loss associated with the proposed exemption is too great to justify providing the exemption, one alternative would be to provide the assistance to hub airlines in the form of a grant made by DOT. The amount that would be needed to "equalize" the fuel and property tax environment is difficult to determine since it depends upon many variable factors, such as the price of fuel, an airline's transport-related revenue and the particular flights that are offered. Therefore, the grant level may be based on an assessment of what is affordable, while still trying to create a reasonable benefit to the participating airlines.

22. Instead of the ad valorem tax exemption, a grant could be made to airlines that operate a hub facility in the state, using the definitions in the bill, based on the number of passengers that the airline carries that enplane or deplane in the state. The following formula assumptions

would produce a grant to each qualifying airline that would equal about one-half of the amount that each airline paid in ad valorem taxes in 2000: (a) \$0.42 would be paid for every passenger enplaned or deplaned in the state by an airline that operates a hub facility in the state using the first definition of a hub facility (traditional understanding of a hub); and (b) \$0.28 would be paid for every passenger enplaned or deplaned in the state by an airline that operates a hub facility in the state using the second definition of a hub facility (requiring headquarters in Wisconsin). Using this formula, the grant would be apportioned to the two companies in about the same proportion as their 2000 ad valorem tax payments. Under this alternative, \$1,250,000 SEG could be provided for making the grant in 2002-03.

23. If the Committee determines that providing a benefit to the two airlines equal to the airlines' current ad valorem tax payment is important, an alternative to the tax exemption would be to provide a grant that approximates the amount that the airlines paid in taxes in 2000. The formula outlined in the previous point could be modified to provide \$0.84 for every passenger carried by an airline that operates a hub facility in the state using the first definition of a hub facility and \$0.56 for every passenger carried by an airline that operates a hub facility in the state using the second definition of a hub facility. Under this alternative, \$2,500,000 SEG could be provided for making the grant in 2002-03. Since a grant would not involve modifications to the tax code, concerns about the constitutionality of the hub airline exemption may be avoided.

24. The appropriation for providing the grants under either of these grant alternatives could be a sum sufficient appropriation, which would allow the grant amount to increase or decrease if the number of passengers carried by the airlines increases or decreases. This may increase the incentive for the qualifying airlines to increase service in Wisconsin. The fiscal impact estimates are based on the number of passengers carried by the qualifying airlines in calendar year 2000.

25. If either an exemption or a grant is approved, the Committee could choose to create a six-year sunset for these provisions in order to require a future Legislature to review the extent to which they are effective or necessary for inducing airlines to expand their service or locate their operations in the state.

ALTERNATIVES TO BILL

1. Approve the Governor's recommendation to provide an exemption from Chapter 70 property taxes and from Chapter 76 state ad valorem taxes for all property owned by an air carrier company that operates a hub facility in Wisconsin, if the property is used in the operation of the air carrier company, effective with property assessed as of January 1, 2002. Reduce estimated transportation fund revenues by \$1,250,000 in 2001-02 and \$2,500,000 in 2002-03.

2. Modify the Governor's recommendation to provide an ad valorem tax exemption by changing the effective date from property assessed as of January 1, 2002, to property assessed as of January 1, 2001. Reduce estimated transportation fund revenue by an additional \$2,500,000 in 2001-02.

<u>Alternative 2</u>	<u>SEG</u>
2001-03 REVENUE (Change to Bill)	- \$2,500,000

3. Modify the Governor's recommendation by specifying that DOR is required to assess the property exempted by the proposed exemption and collect taxes for that property, if a court determines that the proposed ad valorem tax exemption is unconstitutional.

4. Delete the Governor's recommendation to provide an ad valorem tax exemption for airlines operating a hub facility in Wisconsin and instead adopt one of the following:

a. Provide \$1,250,000 SEG in 2002-03 in a sum sufficient appropriation for making grants to air carrier companies that operate a hub facility in Wisconsin. Require DOT to make grants on or before July 31 of each fiscal year starting with 2002-03 for all qualifying airlines as follows: (a) \$0.42 for every passenger enplaned or deplaned in the state during the prior calendar year by an airline that operates a hub facility in the state, defined as a facility from which the air carrier company operated at least 45 common carrier departing flights each weekday in the prior year and from which it transported passengers to at least 15 nonstop destinations or transported cargo to nonstop destinations; and (b) \$0.28 for every passenger enplaned or deplaned in the state during the prior calendar year by an airline that operates a hub facility in the state, defined as an airport or any combination of airports in Wisconsin from which the air carrier company cumulatively operated at least 20 common carrier departing flights each weekday in the prior year, if the air carrier company's headquarters is in the state. Require DOT to promulgate rules to administer the grant program, including a definition of the terms "nonstop destinations" and "company headquarters."

<u>Alternative 4a</u>	<u>SEG</u>
2001-03 REVENUE (Change to Bill)	\$3,750,000
2002-03 FUNDING (Change to Bill)	\$1,250,000

b. Provide \$2,500,000 SEG in 2002-03 in a sum sufficient appropriation for making grants to air carrier companies that operate a hub facility in Wisconsin. Require DOT to make grants on or before July 31 of each fiscal year starting with 2002-03 to all qualifying airlines as follows: (a) \$0.84 for every passenger enplaned or deplaned in the state in the prior calendar year by an airline that operates a hub facility in the state, defined as a facility from which the air carrier company operated at least 45 common carrier departing flights each weekday in the prior year and from which it transported passengers to at least 15 nonstop destinations or transported cargo to nonstop destinations; and (b) \$0.56 for every passenger enplaned or deplaned in the state in the prior calendar year by an airline that operates a hub facility in the state, defined as an airport or any combination of airports in Wisconsin from which the air carrier company cumulatively operated at least 20 common carrier departing flights each weekday in the prior year, if the air carrier company's headquarters is in the state. Require DOT to promulgate rules to administer the grant program, including a definition of the terms "nonstop destinations" and "company headquarters."

Alternative 4b	SEG
2001-03 REVENUE (Change to Bill)	\$3,750,000
2002-03 FUNDING (Change to Bill)	\$2,500,000

5. Specify that the provisions adopted under this paper do not apply after December 31, 2007. [This alternative may be adopted in addition to any of the previous alternatives.]

6. Maintain current law.

Alternative 6	SEG
2001-03 REVENUE (Change to Bill)	\$3,750,000

Prepared by: Jon Dyck