

Interstate or Intrastate: Taxability Of Telecommunications

by Martin I. Eisenstein

Martin I. Eisenstein is a senior partner with the law firm of Brann & Isaacson, Lewiston, Maine. Eisenstein is chief counsel for AOL LLC in the case referred to in the article and is counsel on state and local tax matters for several other Internet service providers, telecommunications companies, and e-commerce merchants. He has written extensively on state and local tax issues.

The telecommunications industry is one of the most heavily state-taxed sectors in our economy.¹ In some states, for example, the combined state and local transaction taxes on telecommunications are well in the double digits. Although services are not subject to sales tax in most states, all but seven states impose sales taxes or other transactional taxes on telecommunications services.² Some states, such as Florida and New York, assess both a sales tax and another transaction-based tax.³ Also, there are myriad other special taxes and assessments — including 911 fees, the Universal Service Fund,

¹In a recent study titled "Total State and Local Taxes Paid by the Telecommunications Industry, Fiscal Year 2004" (July 18, 2005), Ernst & Young determined that the combined sales and excise tax rate for telecommunication services was almost twice that of the effective rate for the sale of tangible goods. See Figure 6. Ernst & Young found that the only sector of the U.S. economy taxed more heavily by state and local governments is the utility industry. The Ernst & Young study can be found at [http://www.ey.com/global/download.nsf.US/QUEST/_AT&T_Telecommunications_Study/\\$File/AT&TTaxTelecomStudy.pdf](http://www.ey.com/global/download.nsf.US/QUEST/_AT&T_Telecommunications_Study/$File/AT&TTaxTelecomStudy.pdf).

²Alaska, California, Idaho, Maryland (taxes only a limited number of services, such as cellular communications services), Nevada, Oregon, and Virginia do not impose a tax on telecommunications services at the state level. However, local jurisdictions in California are authorized under state law to impose the utility users tax on telecommunications (as well as other utilities). In some localities, the local utility users tax can be as high as 10 percent of revenue.

³Florida imposes a state tax at the rate of 6.8 percent of the sales price, West's F.S.A. section 202.12, and a gross receipts tax at the rate of 2.37 percent of gross receipts, West's F.S.A. section 203.01, for a combined state communications services

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Public Utilities Commission surcharges, and utility taxes — on providers of telecommunications.

Three recent state sales tax decisions, however, signify some relief for the heavily taxed telecommunications and related services sector. See *America Online, L.L.C. v. Iowa Department of Revenue*, Polk County District Court, State of Iowa, Case No. CV 6482 (Sept. 18, 2007) (*Doc 2007-23360* or *2007 STT 204-9*); *Qwest Corp. v. State of Wyoming*, 2006 WY 35, 130 P.3d 507 (2006) (*Doc 2006-5787* or *2006 STT 54-30*); and *Matter of Concentric Network Corp.*, 2006 WL 776279 (Tax Appeals Tribunal, Mar. 16, 2006) (*Doc 2006-6105* or *2006 STT 65-23*). In each of those decisions, the taxpayer was successful in its characterization of the service sold or purchased as an interstate service and therefore avoided the state's tax on intrastate telecommunications services. Those decisions are the subject of this article.

Characterization of a service as interstate may have a significant effect not only on a telecommunications company but also on related service providers.

Characterization of a service as interstate may have a significant effect not only on a telecommunications company but also on related service providers such as Internet service providers (ISPs). ISPs, for example, incur substantial expenses in procuring services such as T-1 circuits, primary rate interface circuits, asynchronous transfer mode lines, and digital subscriber line (DSL) circuits. Those expenses cannot be directly passed on to customers, as is the case for a sales tax. If the services purchased are characterized as interstate, rather than intrastate, that out-of-pocket tax liability may be limited. Similarly, providers of telecommunications

tax rate of 9.17 percent. Local taxing jurisdictions may levy their own tax on communications services, and the rate varies among jurisdictions.

services can limit the required collection of taxes on their revenue. Likewise, ISPs, before the expiration of the Internet Tax Nondiscrimination Act, 47 U.S.C. section 151, in so-called grandfather states and in other states after the expiration of that federal statute may be able to minimize taxation on services provided to their customers.⁴

There are 14 states that limit their sales tax to intrastate communications.⁵ Also, New York im-

⁴ISPs can also argue that a statute that taxes telecommunications does not apply to Internet access services. That was the successful argument of the taxpayer in *Prodigy Services Corp., Inc. v. Johnson*, 125 S.W. 3d 413 (Tenn. App. 2003).

⁵Ariz. Rev. Stat. Ann. section 42-5064(A) ("The telecommunications classification is comprised of the business of providing intrastate telecommunications services."); Colo. Rev. Stat. section 39-26-104(1)(c)(I) ("[A tax is imposed] upon telephone and telegraph services, whether furnished by public or private corporations or enterprises for all intrastate telephone and telegraph service."); 30 Del.C. section 5502(a) ("A tax is imposed on intrastate telephone commodities and services distributed within this State and on intrastate mobile telecommunications services at the rate of 4.25% of the charges for such services excluding any charges for Internet access as defined in section 5501(6) of this title."); Ga. Code Ann. section 48-8-2(4) ("Gross sales' means the: (B)(i) Charges, when applied to sales of telephone service, made for local exchange telephone service."); Ind. Code section 6-2.5-4-6(b)(1-2) ("A person is a retail merchant making a retail transaction when the person: (1) furnishes or sells an intrastate telecommunication service; and (2) receives gross retail income from billings or statements rendered to customers."); Iowa Admin. Code section 701-18.20 (422,423)(b) ("Communication service is provided 'in this state' only if both the points of origination and termination of the communication are within the borders of Iowa. Communication service between any other points is 'interstate' in nature and not subject to tax."); 36 M.R.S.A. 2551(20)(B)(1) ("Telecommunications services' does not include: (1) Except as otherwise provided by this subsection, service originating or terminating outside this State."); Mich. Comp. Laws section 205.93(a) ("The use or consumption of the following is taxed under this act in the same manner as tangible personal property is taxed under this act: (1) Except as provided in section 3b, intrastate telephone, telegraph, leased wire, and other similar communications, including local telephone exchange and long distance telephone service that both originates and terminates in this state."); Neb. Admin. R. & Regs. tit. 316, Ch. 1, section 065.01 ("Intrastate telephone and telegraph service, cellular telephone service, wireless paging service, and wireless radio service are taxable whether furnished by public or private corporations or enterprises."); N.H. Rev. Stat. section 82-A:3 ("A tax is imposed upon intrastate communications services furnished to a person in this state and purchased at retail from a retailer by such person, at the rate of 7 percent of the gross charge therefore."); North Dakota Admin. Code section 81-04.1-04-41.1 ("The gross receipts from the sale of all communication services, including telecommunications services and ancillary services, provided in the state are subject to sales tax provided the communication service originates and terminates within the state's borders, regardless of where the billing for the service is made."); S.C. Code Ann. section 12-36-110(k) ("sales of all local telecommunications services by local exchange companies"); Utah Code Ann.

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poses its state and local sales tax only on intrastate communications, although its gross receipts or utility tax is assessed on interstate as well as intrastate communication revenue.⁶ Other states provide exemptions from various taxes for specified interstate services. Arkansas and Kansas, for example, provide an exemption from their sales tax on telecommunications for both interstate private line service and interstate wide area service.⁷ Similarly, USF fees and other miscellaneous fees often are based only on intrastate revenue. A provider or user of telecommunications services and Internet access services should be aware of the recent cases finding that the services are interstate and, therefore, not subject to tax.⁸

America Online, L.L.C. v. Iowa Department of Revenue

In this case, the Iowa Department of Revenue assessed the Iowa sales tax on the Internet access services and other online services provided by AOL LLC to Iowa residents. The DOR argued that those services constituted communication services provided within Iowa within the meaning of Iowa Code section 422.43. The pertinent rule, IAC section 18.20(5)(b), specifies that communication services provided in Iowa are only those services for which the points of origination and termination are in Iowa. Interstate communications service is exempt from taxation and defined in Rule 18.20(5)(b)

section 59-12-103(1)(A) (tax only on intrastate communications); Wyo. Stat. section 39-15-103(a)(i)(C) ("[t]he sales price paid for intrastate telephone and telegraph services including the consideration paid for the rental or leasing of any equipment or services incidental thereto").

⁶N.Y. Tax Law section 1105(b)(1)(B) ("On and after June first, nineteen hundred seventy-one, there is hereby imposed and there shall be paid a tax of four percent upon: (b)(1)(B) telephony and telegraphy and telephone and telegraph service of whatever nature except interstate and international telephony and telegraphy and telephone and telegraph service and except any telecommunications service the receipts from the sale of which are subject to tax under paragraph two of this subdivision." N.Y. Tax Law section 186-a "Notwithstanding any other provision of this chapter, or of any other law, (a) a tax equal to three and one-quarter percent through December thirty-first, nineteen hundred ninety-nine, and two and one-half percent on and after January first, two thousand of its gross income is hereby imposed upon every provider of telecommunication services doing business in this state which is subject to the supervision of the state department of public service which has a gross income for the year ending December thirty-first in excess of five hundred dollars.")

⁷Ark. Code Ann. section 26-52-301(3)(A)(iv); Kan. Stat. Ann. section 79-3603(b).

⁸Also, a telecommunications tax on interstate telecommunications requires the satisfaction of the two-part test set forth in *Goldberg v. Sweet*, 109 S.Ct. 582 (1989): (1) the service address or billing address is located in the state of taxation; and (2) the origination or termination of the telecommunications occurs in the state of taxation.



America Online (AOL) headquarters in Sterling, Va.

Manny Ceneta/Agence France Presse

as a service in which the origination point or termination point of the service is outside Iowa. The DOR argued that because AOL provided local, Iowa-based telephone numbers for its members to access the AOL service, its Internet service was an intrastate communication service.⁹ AOL leased modems associated with those local numbers, and a network service provider such as Sprint caused the conversion of the analog signal to a digital signal at the modem and carried the signal to the AOL data centers in Virginia.

In the administrative proceedings, an administrative law judge had ruled in favor of AOL and held that the position of the DOR that the AOL member made a local telephone call to connect with AOL for the service did not establish an intrastate service because a connection to Virginia, where AOL maintained its data centers, was necessary for the Iowa resident computer to receive the service. Thus, the ALJ focused on the origination point (the Iowa member's computer) and termination point (the Virginia data center) of the connection and therefore found that the AOL service, if a communication service, was an interstate service and not taxable.

⁹The assessment period was through June 30, 1999, because after that date the statute provided a specific exemption for the sale of Internet access.

In Iowa the DOR may appeal an ALJ's decision to the director of the DOR. On appeal, the director rejected the ALJ's decision and ruled that because customers have access to a local telephone number, the AOL service is an intrastate service and therefore taxable. The district court reversed holding that "even if the ultimate service provided has constituent parts, the relevant inquiry concerns the nature of the service the customer ultimately purchases and whether the complete 'end to end' communication occurs in the taxing state." The district court determined that the AOL service is an interstate communication, because a member could not obtain the service he or she purchased simply by calling the local number, but must be connected to the AOL data centers in Virginia. Therefore, the service purchased is inherently an interstate service.

The district court's determination that the service AOL provided was interstate, like the determination made by the ALJ, was based on the traditional analysis of the location of the origination point and termination point of the service being taxed, and not on the origination and termination point of a mere component of the connection between the AOL member and AOL. Thus, if a service involves separate components, as in the case of AOL Internet access, under the district court's analysis, the critical points of origination and termination are those for the overall service. That a component of the service provides for the origination and termination points

in one state for purposes of tariff filings does not mean that the actual service provided is entirely within the state. The determination of the relevant origination point and termination point, according to the court, is based on the service subject to the tax assessment.

It is also noteworthy that the administrative judge relied on the Federal Communications Commission decision in *GTE Tel. Operating Cos.*, 13 FCC Rcd 22466 (1998). In *GTE*, the commission considered whether a DSL service provided by GTE, a network service provider (NSP), to ISPs to enable the ISPs to provide Internet access constituted an interstate service, even though the points of connection for the service by GTE were between the subscriber's home and a point of presence (POP) that was located in the subscriber's state. The FCC said that an interstate service, for which it may regulate, occurs "when a communication or transmission originates in any state, territory, possession of the United States or the District of Columbia and terminates in another state, territory, possession of the United States or the District of Columbia." *Id.* at 22474. The commission held that the DSL service "is an interstate service and is properly tariffed at the federal level." *Id.* at 22466. To make that determination, the FCC measured the traffic flowing across the GTE access service from one end of the network to the other, and not from the end user to the POP. Because the information brought back to subscribers from the Internet by ISPs comes from throughout the country, the FCC concluded that the only proper way to regulate the telecommunications services furnished by NSPs to an ISP is as an interstate service. *Id.* at 22481. Thus, the FCC concluded that DSL service is an interstate service even though such DSL service purchased by the ISP has an origination point and termination point in the same state.

The district court's and the ALJ's analysis in *America Online* is founded on two separate, but interrelated, tests. The first approach, used solely by the district court, is to consider the origination point and termination point of the service, the receipts of which are subject to the assessment. As the district court found in *America Online*, the assessed service provided by AOL required a connection from the member-subscriber's home computer to Virginia; therefore, the services purchased by the member were interstate. Simply connecting up to the modem located in the state of the member subscriber would not permit the member to obtain the services that were provided by AOL.

The ALJ's reference to *GTE* provided a separate basis for characterizing the AOL service as interstate. *GTE* stands for the proposition that anything that "touches the Internet," despite its point of origination or termination, constitutes an interstate service. Thus, on the basis of *GTE*, if an ISP were

purchasing service connecting between two points within a state, that service would be an interstate service because it was part of an overall Internet connection, even though the point of origination and termination of the service purchased are within one state.

Matter of Concentric Network Corp.

On March 16, 2006, in *Concentric Network Corp* and in companion cases decided on the same date, *Matter of Fastnet Corp.*, 2006 WL 776280 (Tax Appeals Tribunal, Mar. 16, 2006), and *Matter of Frontline Communications Corp.*, 2006 WL 776281 (Tax Appeals Tribunal, Mar. 16, 2006), the New York Tax Appeals Tribunal issued a far-reaching decision and held that any telecommunications services purchased by ISPs to provide Internet access constituted interstate services. The tribunal adopted in the tax area the FCC regulatory approach in *GTE*, although the tribunal did not cite *GTE*. The tribunal explained the basis for its decision:

In some circumstances, the lines at issue apparently carried communications between subscribers located in New York and petitioner's point of presence in New York. *It is artificial, however, to treat the point of presence as the destination of these communications in the sense that a voice call to a telephone number at a residence in Buffalo has a destination in Buffalo. If these lines were not in some way "connected to a circuit going to another state," and "as contemplated in Southern Pacific, the line access would be useless in accomplishing the purpose for which it was purchased by petitioner.* The data originating in the keystrokes on the subscriber's computer flow out to the internet through petitioner's point-of-presence facilities and data flows back in a continuous process that has no geographical reference that is perceptible to the subscriber or his interlocutors. Accordingly, the link in question seems is merely 'an intrastate strand of an interstate service.'" 2006 WL 776279 at 12 (emphasis added).

Therefore, it was the nature of the data traffic carried over the lines and the use the ISPs made of the services purchased, and not the origination point and termination points of the service purchased, that were the critical factors for the tribunal in determining whether the service was interstate. The tribunal's decisions represent the adoption of the principle that the characterization of the telecommunications as interstate or intrastate rests on "the nature of the data traffic carried over the provided lines and the destination of those communications" rather than on the actual service separately purchased and taxed. *Id.* at 11-12.

Qwest Corp v. State of Wyoming

The Wyoming Supreme Court's opinion in *Qwest Corp v. State of Wyoming* blends the approach in the *America Online* Iowa case and the *Concentric* line of cases in New York. Qwest imposed a flat fee access charge on its residential customers for connection to the local network to permit those customers to have the ability to make or receive an interstate telephone call. The Wyoming Department of Revenue argued that because that access was between two points in Wyoming, the fee was subject to the Wyoming sales and use tax on intrastate telecommunications. The Wyoming Supreme Court explained that the local access fee permitted Qwest's customers access to the local loop in order to link to a long-distance call and that the local loop was vital to completion of an interstate call. *Qwest*, 130 P.3d 507, 513. The court held that the way to determine whether communication service is interstate or intrastate is to identify the points of origination and termination of the ultimate communication service purchased by the consumer. *Id.* at 515. Adopting an analysis similar to that used by the district court in *America Online*, the court said that the access taxed by the DOR could not itself provide the customer service. *Id.* The court then, however, seemed to base its decision on an approach that resembles the New York Tax Appeals Tribunal's *Concentric* decision, saying that "[t]he access service provides a two-way transmission only when it is connected to the interstate network at which point the connection is not 'from one point to another within Wyoming.'" *Id.*

The most far-reaching and favorable principle for taxpayers is that in the *Concentric* line of decisions.

The Wyoming court based its decision, in part, on the Michigan Court of Appeals decision in *GTE Sprint Com. v. Dept. of Treasury*, 179 Mich. App. 276, 445 N.W. 2d 476, 477 (Mich. App. 1989). It is noteworthy, however, that the Wyoming court rejected the analysis in *AT&T Com. v. Dept. of Revenue*, 778 P.2d 677, 678 (Colo. 1989), which found that access service was taxable. The court said that the Colorado decision was based on a decision that was later overruled, as well as on a different definition of a taxable telecommunications service. Most importantly, the service in *AT&T Com* was sold by the local exchange carrier to AT&T, an interstate carrier. That was a discrete service sold by one carrier to another and was comparable to the service sold by the telecommunications carriers to the ISPs in *Concentric*. In contrast, the access fee in *Qwest* was imposed on the consumer, who made an inter-

state call, so that the access fee was only one component of the interstate service purchased by the consumer.

Summary

In the future, purchasers and sellers of telecommunications services should point to various aspects of the three decisions discussed in this article to characterize the services at issue as nontaxable. The Iowa District Court's decision in *America Online*, the New York Tax Appeals Tribunal decisions in *Concentric* and companion cases, and the Wyoming Supreme Court decision in *Qwest Corp.* represent characterizations of various telecommunications-related services as interstate in nature. The analysis employed in those decisions is similar but is founded on different principles. The most far-reaching and favorable principle for taxpayers is in the *Concentric* line of decisions. In those cases, even though the tax was on the purchase of a distinct service that was provided within two points within the state and that was separately tariffed by the state utilities commission, the tribunal found that services purchased were interstate because the service purchased was merely a component of an overall interstate service provided by the purchaser to its customers. Although the *Qwest* court addressed a component of an interstate service, the purchaser of the component was also the purchaser of the interstate service. In *Concentric*, however, the purchaser of the component taxed was not the purchaser of the interstate service. Rather, the purchasers of the interstate service were the customers of the purchaser. In *America Online*, the service that the DOR sought to tax was the interstate service offered to AOL's members. Although there was a local component to that service, the purchaser separately paid a separate provider of that service (its local exchange carrier). ☆