STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION PETITION NO. C840627B

On June 27, 1984, a Petition for Advisory Opinion was received from New York Telephone Company, 1095 Avenue of the Americas, New York, New York 10036.

The issue raised is whether the receipts of New York Telephone Company (hereinafter "NY Tel") from providing access service in New York State to long distance (interexchange) telephone carriers are subject to the tax imposed by section 186-a of the Tax Law. The issue raised is a direct consequence of the divestiture of the American Telephone and Telegraph Corporation (hereinafter "A T & T"). As more fully described herein, the access service performed by NY Tel consists of originating or terminating telephone calls on behalf of long distance telephone carriers.

In the context of the postdivestiture environment, NY Tel argues that the access service now provided by it to the long distance carrier is, in turn, resold by the long distance carrier as part of the overall long distance service the long distance carrier provides to its customer, the person placing the long distance call. Accordingly, it is contended that receipts from access services provided to the long distance carrier, in connection with both intrastate and interstate (and foreign) telecommunications, are exempt from the section 186-a tax because NY Tel asserts that both the intrastate and interstate bases of the tax do not include these receipts. This is so, NY Tel asserts, because such bases contain only receipts derived from sales made to the ultimate consumer, and not those from sales for resale.

Accordingly, it must be decided (1) if both the intrastate base and interstate base for receipts from the sale of telephone service under section 186-a require that such receipts be only those derived from sales for ultimate consumption and, if so, (2) if the access service rendered by NY Tel is ultimately consumed by the customer of the long distance carrier within the intendment of section 186-a.

Section 186-a

Section 186-a imposes a tax on the furnishing of utility services including the selling of telephone service. In the case of a utility subject to supervision by this State, as is NY Tel, the tax is 3% of its gross income. Gross income is defined as "receipts received in or by reason of any sale...made or service rendered for ultimate consumption or use by the purchaser in this state .... " The tax, as added in 1937, was imposed only on receipts from intrastate activities and, as shown by the foregoing quotation, only on receipts from sales wherein the purchaser was the consumer.

From the language of the statute it is clear that if, in fact, the ultimate consumer of access services provided in connection with intrastate telecommunications is the customer of the long distance carrier, rather than the long distance carrier itself, receipts from such services would be excluded from NY Tel's intrastate base under section 186-a.

In 1983 the Legislature amended section 186-a by adding a new subdivision 2-a. The new subdivision added apportioned receipts from interstate and foreign telecommunications to the base of the tax. The relevant portion of such provision reads as follows:

"...a telephone or telegraph corporation shall include in its determination of gross income or gross operating income, in addition to receipts and profits described in subdivision two of this section, that portion of revenue from interstate and foreign transmissions service attributable to this state pursuant to provisions of paragraph (d) of subdivision four of section one hundred eighty-four of this article."

Accordingly, beginning in 1983 the section 186-a base consisted of an intrastate base of wholly New York telecommunications services and a new base of apportioned receipts from interstate and foreign telecommunications services.

While the new subdivision added a totally new base, it did not until 1985 specifically provide for an exclusion of receipts from sales to other than the ultimate consumer. In addition, the reference to section 184 in subdivision 2-a. is ambiguous. NY Tel argues that the Legislature intended that the rule excluding receipts from sales other than for ultimate consumption is to be applied to the formulation of the interstate base. As stated, there is no question that such rule applies to the formulation of the intrastate base.

As to the question of whether the sale for resale exclusion applies to the interstate base, it is determined that section 186-a was intended to be a conceptual whole and that, therefore, the exclusion is applicable. An examination of the legislative history of subdivision 2-a is ambiguous as to the formulation of the interstate base and, consequently, the application of the sale for ultimate consumption rule. However, it appears quite clear that, if such a rule were not applied to the interstate base, a serious constitutional question would arise -- receipts from services rendered for resale in connection with intrastate telecommunications services would be exempt whereas the receipts from the same services rendered for resale as part of interstate telecommunications services would be taxable. Such a divergent treatment would appear to violate the Commerce Clause prohibition that "No State, consistent with the commerce clause, may 'impose a tax which discriminates against interstate commerce'". Boston Stock Exchange v State Tax Commission, 429 US 318, 329 (1977).

[1]Chapter 29 of the Laws of 1985 amended subd. 2-a of section 186-a by adding, "The requirement contained in subdivision two of this section regarding the inclusion of only those receipts which are received in or by reason of sales made or services rendered for ultimate consumption or use by the purchaser shall apply to this subdivision". Approved April 8, 1985, effective Jan. 1, 1985.

The fact that the overall level of taxation of the receipts from the interstate call is no greater than that of the receipts from the intrastate call does not appear to erase the Commerce Clause concern. The taxation of NY Tel's access receipts alone must be separately examined. In this instance, the Commerce Clause examination would focus on the taxation of NY Tel in its intrastate connected activities as compared to the taxation of NY Tel with respect to equivalent interstate connected activities. Armco v Hardesty, 104 S. Ct. 2620, 52 LW 4787 (1984), Boston Stock Exchange, supra.

It is therefore determined that in order to avoid a construction of section 186-a which would pose serious constitutional concerns, the sale for resale exclusion is viewed as applicable to the interstate base. Such exclusion is likewise applicable to receipts from foreign telecommunications since there is no indication that the Legislature intended different principles to apply to those receipts. With respect to both the intrastate base and interstate (and foreign) base, it now must be decided whether the access services are ultimately consumed by the long distance carrier or by its customer.

Telecommunications Before and After the Divestiture of AT&T

An understanding of the issue presented herein requires a brief description of the structure and operation of the telecommunications network before and after the divestiture of AT&T.

Predivestiture

Before divestiture, the effectuation of an intrastate long distance call, e.g., Albany to Buffalo, was accomplished solely by NY Tel which was then a wholly owned subsidiary of AT&T. NY Tel carried the call from the caller's residence in Albany to its terminus in Buffalo. Since its telecommunications activity with respect to the call was totally intrastate, NY Tel included 100% of the receipt from the call in its section 186-a intrastate base.

With respect to interstate telecommunications effectuated by the Bell system in pre-divestiture times, NY Tel and AT&T participated Jointly in the provision of interstate service, and they were both compensated pursuant to a business arrangement know as "division of revenues." The long distance call was billed and collected by NY Tel, and all revenues collected by NY Tel from interstate service were pooled. AT&T and NY Tel then shared such revenues, pro rata, based upon a formula contained in the division of revenues agreement between the two carriers. An interstate call from Albany to Chicago over the Bell system was effectuated as follows: first, the call was carried by NY Tel to its interface with the Long Lines system of AT&T in New York. Then AT&T carried the call from the New York interface to its interface with the local Bell company serving Chicago. The local company then took the call to the terminus. All three carriers divided the revenues pro rata, and NY Tel states that all three shared in the risk of nonpayment.

A further insight into the construction of section 186-a as applied to the pre-divestiture era is seen from the particulars of the way the base of section 186-a was constituted in pre-divestiture times. Under the division of revenues arrangement, approximately 100% of the share of the revenue received by NY Tel for its service in effectuating an interstate call was included in its interstate base under section 186-a since its activity with respect to such call took place solely in New York State. AT&T, the parent, long distance carrier, was required to include, on an apportioned basis, its share of the revenue it received from the call in its interstate base under section 186-a; if, for example, its allocation percentage was 10%, AT&T would have included 10% of its share of the division of revenue from the call in its section 186-a base.

Postdivestiture

The method of doing business changed as a result of divestiture. NY Tel became part of an independent entity; the manner of doing business with AT&T pursuant to the division of revenues arrangement ended, and NY Tel was required to offer any and all long distance carriers equal access to its lines on a tariff basis. See U.S. v AT&T, 552 F. Supp. 131 (1982). Accordingly, all long distance carriers would now pay NY Tel an access charge -- an independently approved charge for the provision of NY Tel's service in originating and/or terminating long distance telecommunications, whether intrastate or interstate, on behalf of the long distance carrier. The access charge is calculated on the long distance carrier's actual use of NY Tel's lines.

Coupled with the independence of NY Tel, all telephone users were given the opportunity, in both intrastate and interstate telecommunications, to select the long distance carrier that is to carry the call, and such long distance carrier bills directly, on behalf of itself, for the total charge of the long distance call. The charge received by the long distance carrier is not shared with NY Tel. NY Tel charges the long distance carrier an access charge which is a part of the long distance carrier's overall cost in the provision of the long distance call.

With respect to effectuating intrastate long distance telecommunications, NY Tel no longer functions as the long distance carrier. Its telecommunications service is now limited to service which is local in scope. The Albany to Buffalo call is now carried by NY Tel to its interface with the long distance carrier which then takes the call to Buffalo, and there the call is carried to its terminus by NY Tel. NY Tel charges an origination-associated access service and termination-associated access service to the long distance carrier. The access charge is subject to the terms and conditions of tariffs authorized by the New York State Public Service Commission.

Concerning the particulars of the formulation of the section 186-a intrastate base after divestiture, even if it is found that the access service provided by NY Tel is resold by the intrastate carrier, the intrastate base would not appear greatly affected. Since the service the long distance carrier is providing is, generally, still 100% in New York, the long distance carrier would include 100% of its total receipt in its intrastate base. The carrier would include 100% of its charges to customers without deducting the cost of the access service provided by NY Tel.

Concerning the particulars of the interstate base, if NY Tel's argument is adopted, in the post-divestiture era the entire amount received by the long distance carrier for the interstate call would be taxed on an allocated basis. As a result, the amount representing NY Tel's share, which was formerly included by NY Tel at 100%, would now be included in the section 186-a base of the interstate carrier, but on an apportioned basis. Therefore, while not influenced by the manner in which the section 186-a base will be constituted, this decision will have an impact on the section 186-a interstate base in the post-divestiture era.

It should also be noted that, with respect to interstate telecommunications, the activity that NY Tel now performs in relation to the long distance carrier is generally the same activity that it performed pre-divestiture. The activity is the same; however, it is clear that the business arrangement under which the activity is performed is different. We will now discuss the application of the law to the facts herein.

The Application of the Law

The economic philosophy of section 186-a in taxing only receipts from sales for ultimate consumption is congruent with that of the sales and compensating use tax (Tax Law, § 1105). Specifically, the regulations under section 186-a state that "Receipts from sales or services for ultimate consumption or use by the purchaser in this State are taxable, but receipts from sales for resale, as distinguished from sales for consumption, are not taxable" [20 NYCRR 501.9(a)]. As a result, it is appropriate to obtain guidance in reaching a decision herein by examining court decisions concerned with sales for resale for purposes of the sales tax.

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[1] For example, let's examine the tax revenue from a call from Albany to Chicago. The charge is $5.00 both before and after divestiture. Before divestiture the call was divided by a division of revenues agreement as follows: $1.00 to NY Tel, $3.00 to the long distance carrier and $1.00 to Ill. Bell. The section 186-a base pre-divestiture would have picked up 100% (wholly New York activity) of NY Tel's $1.00 and the apportioned part of the interstate carrier's receipt, which for the purposes of this example will be 30¢ ($3.00 x a hypothetical 10% New York allocation), total - $1.30. After divestiture, if NY Tel prevails, the $5.00 receipt of the interstate carrier is subjected to tax, and the total § 186-a base would, accordingly, be 50¢ ($5.00 x 10%). In effect 10% of NY Tel's receipt is picked up (10¢) and, in addition, 10% of the amount going to Ill. Bell is also picked up (10¢). It should be noted that by taxing the entire charge made by the interstate carrier, and thereby including the amount representing Ill. Bell's receipt, the total diminution of the section 186-a base in this illustration is actually something less than 90%. Based upon the actual NY allocation of the particular interstate carrier, the revenue impact would increase or decrease as compared to this illustration.

In Burger King v. State Tax Commission, 51NY2d 614 (1980), the court held that materials used to package food sold by the fast food chain, including wrappers for hamburgers, cups for beverages and sleeves for french fries, were purchased by Burger King for resale because that packaging "is such a critical element of the final product sold to customers" Id., at 622. It must be asked whether this same characterization can be applied to the access service supplied to the long distance carrier.

It is clear that after the divestiture the origination or termination service afforded by NY Tel to AT&T is sold to AT&T. It is also clear that the long distance carrier then resells, on behalf of itself, such service as a component of the long distance service afforded by AT&T to its customer. The access service provided by NY Tel does not appear to be consumed by the long distance carrier.

The PSC now regulates the intrastate-associated access charges made by NY Tel to the intrastate long distance carrier. On the interstate level, the charges to interstate long distance carriers are under the supervision of the Federal Communications Commission (FCC). Up to June, 1984, charges to interstate long distance carriers, other then AT&T, were pursuant to the ENFIA (Exchange Network Facilities for Interstate Access) tariff; AT&T and its subsidiaries, pending tariff approval by the FCC, paid an access charge set out in an interim agreement with NY Tel. From June 1984 to present, a generally applicable FCC tariff governs access charges to all interstate carriers.

In conclusion, it appears that the long distance carrier's sale to its customer is of a service which includes the local access service provided to it by NY Tel . As such, the access service provided to the long distance carrier constitutes a "critical element of the final product sold to customers." Granted, the sale of the access service by NY Tel is not a sale for resale as such, but a resale as a component part of the service sold by the long distance carrier. This is a transaction of a type envisaged by the sales tax regulation which states that the (sales tax) resale exclusion is applicable "where a person, in the course of his business operations, purchases. . .services which he intends to sell . . . as a component part of other. . .services " [20 NYCRR 526.6(c) (1)].

Accordingly, it is decided that commencing with the divestiture of AT&T, January 1, 1984, (1) access charges made by NY Tel to intrastate long distance carriers pursuant to PSC tariffs in connection with their provision of intrastate long distance service to their customers (2) up to and including May 1984, access charges made by NY Tel to interstate long distance carriers, other than AT&T, pursuant to the ENFIA tariff in connection with their provision of interstate long distance service to their customers (3) up to and including May 1984, access charges made by NY Tel to AT&T pursuant to interim agreement in connection with AT&T's provision of interstate long distance service to its customers and (4) subsequent to May 1984, access charges made by NY Tel to interstate long distance carriers pursuant to generally applicable FCC tariffs in connection with their provision of interstate long distance service to their customers are not included in NY Tel's base under section 186-a of the Tax Law.

As a concomitant of this decision, it is seen that the long distance carriers are making a sale of a long distance service which includes local components, and that such sale is made to the ultimate consumer so that its entire receipt from its customers for the long distance call, without deduction of NY Tel's access charge, is subject to tax under section 186-a.

The result reached herein, and its consequential revenue effect, is one which flows not directly from legislative design but rather directly from the divestiture of AT&T; the tax result is different after divestiture because of the different structure of the telephone system resulting therefrom.

This opinion deals with only the access service described herein which NY Tel provides to long distance carriers for resale by such carriers. Moreover, it in no way deals with access services to telephone users. It is hoped that, in spite of the adverse effects on section 186-a revenues that may flow from divestiture, one effect of this opinion will be a prospective rate reduction of intrastate-associated and interstate-associated access charges made by NY Tel to long distance carriers and that such rate reduction will find its way to the consumer. With respect to the period that has intervened since divestiture, it is hoped that this decision will serve as a foundation for a refund to consumers of the section 186-a tax liability which is the subject of this opinion where such tax liability was used by NY Tel to support current rates.

DATED: September 20, 1985

s/FRANK J. PUCCIA
Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth herein.