The Federal Government and the Utility User's Tax

Introduction

149 cities and four counties in California impose a utility user's tax. In the 03/04 fiscal year, these taxes generated $1.7 billion. Ten of the 149 cities collect 61% of the revenues from all UUT. The City of Los Angeles accounts for 36% of the total revenues collected. In the top ten most populous cities, rates range from 5% to 10%. In some of these cities, UUT revenues constitute approximately 25% of all general fund revenue. A utility user's tax is an "excise" or "privilege" tax imposed on a person using utility services. It is not imposed on the company providing those services. Typical language that might be found in an ordinance imposing the tax is: "There is hereby imposed a tax upon every person who uses any international, interstate and/or intrastate telephone communication services in the City, other than a telephone corporation."

The first challenge to the imposition of a UUT was considered in *Rivera v. City of Fresno.*[1] The City of Fresno imposed a tax "upon every person using intrastate telephone communication service" in the city, and "upon every person using gas in the city which is delivered through mains or pipes, and every person using electrical energy in the city." The tax was imposed at the rate of 5% of the total charges made for the utility service; was collected from the user by the utility company as part of its regular billing, and was paid over to the city by the utility company. Utility users argued that the UUT was actually a sales tax and that the Bradley-Burns Act[2] preempted the field of sales and use taxation. The City argued that the tax was substantially different from sales and use taxes covered by the Act and was expressly excepted by the Legislature by Revenue & Taxation Code § 7203.5(f) which provides that the Act should not be construed "as prohibiting the levy or collection by a city…of any other substantially different tax authorized by the California Constitution or by statute or by charter…." The Court upheld the tax noting that the sales and use tax was imposed on tangible personal property not utility services. However, UUT revenues will not continue to be the stable source of revenue cities have depended upon. This is because consumers are moving away from traditional "telephone" service and using "telephone" service that is not subject to local utility users' taxes. Pending federal legislation is intended to make sure that the new technology is not taxed. Both H.R. 436 (Bono, R-CA) and S. 166 (McCain, R-AZ) which were introduced in the House of Representatives and Senate, respectively, in January 2007, attempt to require that the taxation of utility service use be treated the same way as the taxation of personal property. In California, the result would be a UUT with a much lower rate.[3] It is not clear from language in the bill whether this legislation would apply only to taxation of the new technology or would apply equally to traditional telecommunications services.

[1] 6 Cal.3d 132 (1971).
[2] Revenue and Taxation Code §§ 7200 et seq.
[3] The locally imposed sales and use tax is 1%.

"Technological convergence" is "the modern presence of a vast array of different types of technology to perform very similar tasks…and is commonly used in reference to the synergistic combination of voice, data and video onto a single network." [4] Technological convergence means that communication is by packets of data that are transmitted in all directions by a vast array of means without geographical, political, or even technological boundaries. The means of communication are ethereal; they can't be touched or seen. It is difficult for regulatory and taxing authorities to accurately and timely determine what is being transmitted. Technological convergence plus the fact that approximately 21% of total UUT revenues are collected from wireless services has drawn the attention of the federal government. This paper will review some of the challenges facing cities that tax wireless communications.

The Federal Excise Tax

At first, cities imposed the UUT on intrastate telephone communications services only. At that time, there was a constitutional concern as to whether cities could tax charges for interstate calls. However in 1989, the United States Supreme Court decided *Goldberg v. Sweet,* [5] which removed the pre-existing constitutional doubt about whether a state could tax interstate telephone calls. Many cities' ordinances imposing the UUT on "telephone" or "telecommunications" services, exempts charges which were not taxable under the federal excise tax.

<u>The IRS Notices.</u> The federal excise tax imposes a three percent tax on "communications services." "Communications services" is further defined as "(A) local telephone service; (B) toll telephone service; and (C) teletypewriter exchange service."[6] The definition of "toll telephone service" has remained the same since its adoption in 1965 but the interpretation of the phrase by the courts has changed over time. The first revenue ruling interpreting the meaning of "toll telephone service" was issued in 1979 (Revenue Ruling 79-404). That ruling addressed whether the federal excise tax applied to communications services between telephones in the United States and certain offshore facilities where the charge for the calls was based solely on the elapsed time of the call and not the distance between callers. The IRS acknowledged that the ruling did not fall within the definition of "toll service" but cited the rule "that a statute may be given an interpretation other than that which follows from its literal language where such interpretation is required to comport with the legislative intent."[7] This ruling was reiterated in 2005, when the IRS issued Notice 2005-79. Several taxpayers challenged the ruling and ultimately were successful as federal Court of Appeals in five circuits held that long distance charges based upon time, but not distance, are not "toll telephone service" within the meaning of the Federal Excise Tax law.[8]

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[4] http://en.wikipedia.org/wiki/Technological_convergence
[5] 488 U.S. 252 (1989).
[6] 26 U.S.C. § 4252(a).
[7] Rev. Rule 79-404, 1979-2 C.B. 382.
[8] *Fortis, Inc. v. United States* 447 F.3d 190 (2d Cir. 2006); *Office Max Inc. v. United States* 428 F.3d 583 (6th Cir. 2005); *Reese Bros. v. United States* 447 F.3d 229 (3rd Cir. 2006); *American Bankers Ins. Group v.*

In response to these cases, the IRS issued Notice 2006-50 which provided that, beginning August 1, 2006, the IRS would no longer assess and collect taxes on either long distance service or bundled service.[9] The F.E.T. will now apply only to "local-only service" provided under a plan that does not include long distance telephone service or that separately states the charge for local service on its bill to customers.[10] The Notice included a refund procedure whereby taxpayers can recover federal excise taxes paid after February 28, 2003 and before August 1, 2006.

On January 29, 2007, the IRS issued Internal Revenue Bulletin 2007-5 which "amplifies, clarifies, and modifies Notice 2006-50…." Of note is the following from Notice 2007-5:

- The method for sending or receiving a call, such as on a landline telephone, wireless (cellular) telephone or some other method, does not affect whether a service is local-only or bundled.
- If local and long distance service is billed to a customer on a single bill but the telecommunications company separately states the amount paid for local-only service and the amount paid for long distance service, the amount paid for local-only service is subject to the F.E.T.
- "Bundled service" is local and long distance service provided under a plan that does not separately state the charge for the local telephone service. Telecommunications companies provide bundled service for both landline and wireless (cellular) service. If VOIP service provides both local and long distance service, and the charges are not separately stated, such service is a bundled service.
- Neither Notice 2006-50 nor Notice 2007-5 *affect the ability of state or local governments to impose or collect telecommunications taxes under the respective statutes of those governments* (emphasis added).

<u>Local action in response to IRS Notices</u>. Prior to the IRS Notices, the F.E.T. was imposed on "bundled services" and "long distance" service that was not billed on the basis of both time and distance. If a city's UUT ordinance imposed the UUT on all services not exempt from the F.E.T. then that city's UUT has been imposed on "bundled services" and "long distance" service that was not billed on the basis of both time and distance. When these services became exempt from the F.E.T., a change was necessary to the UUT ordinance as well. The most straightforward way to make the necessary change is to adopt an ordinance which does the following:

(1) Severs the link between the definition of "telephone service" and the F.E.T. by deleting references to the F.E.T. and creating a new definition of "telephone service." The new definition would describe those telephone services upon which the UUT has

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United States 408 F.3d 1328 (11th Cir. 2005); and National R.R. Passenger Corp. v. United States 431 F.3d 374 (D.C. Cir. 2005).

[9] "Bundled service" is "local and long distance service provided under a plan that does not separately state the charge for the local service." IRS Notice § 3(a).

[10] IRS Notice 2006-50 § 3(b).

been imposed historically. A city must continue to exclude services exempt from the F.E.T. either by setting forth the exemptions in the ordinance or by continuing to refer to Section 4253 of the F.E.T. law, in order to avoid "increasing" the tax by expanding the base. The better practice is to set forth the exemptions in the ordinance to that future changes or repeal of the F.E.T. will not affect the ordinance.[11]

(2) The ordinance should include findings that explain (1) the language linking the UUT to the F.E.T. was intended to adopt the definitions in the F.E.T. as they were commonly understood by the IRS in its Revenue Ruling 79-404; (2) the IRS has changed its understanding of the definitions of the F.E.T.; (3) the City Council does not wish to adopt the IRS' new understanding of the definitions of the F.E.T. but rather wishes to continue to impose the UUT as it has been historically imposed; and (4) the amendments do not constitute a change in the methodology of calculating the tax.

A city is required to notify the public utility or service supplier if it "repeals the tax, reduces an existing tax rate, changes the tax base, or makes any other changes to the tax that would affect the collection and remittance of the tax."[12] Although notification is not required for the changes suggested above, it may be advisable to notify those public utilities or service suppliers that collect the tax of the changes to the ordinance.

A cautionary note: It is important to distinguish between amending a city's UUT ordinance in response to the F.E.T. Notices and amending a city's UUT ordinance to respond to "technological convergence." Subsequent to the publication of the F.E.T. Notices, it was suggested to some cities that amendments to their UUT ordinance required voter approval. Voter approval is certainly required if the ordinance expands the base upon which the tax is imposed, as it would to respond to "technological convergence." However, voter approval is not required if the ordinance continues in effect the existing tax on the existing base. A careful review of your city's ordinance is required. There is not one correct response to this problem, nor is there one way of amending ordinances in the future to account for changing technology.

<u>The F.E.T. and Proposition 218.</u> Proposition 218 requires voter approval to "impose, extend, or increase" any tax unless and until that tax is submitted to the electorate for approval. Under the Proposition 218 Omnibus Implementation Act, a tax is "increased" if a city either "(1) increases any applicable rate used to calculate the tax; or (2) revises the methodology by which the tax is calculated if that revision results in an increased amount being levied on any person or parcel."[13] A tax is not "increased" if a city "implements or collects a previously approved tax…so long as the rate is not increased beyond the level previously approved by the agency, and the methodology previously approved by the agency is not revised *so as to result in an increase in the amount being levied on any person or parcel* (emphasis added).[14]

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[11] For example, S.170 (Ensign, R-NV) introduced on January 4, 2007, proposed to repeal the excise tax on telephone and other communications services.
[12] Public Utilities Code § 799(a)(5).
[13] Government Code § 53750(h)(1).
[14] Government Code § 53750(h)(2)(B).

A strong argument can be made that the amendment discussed above does not require voter approval and can be implemented by majority vote of the City Council since it neither "increases any applicable rate" nor "revises the methodology by which the tax is calculated" so as to increase "the amount being levied on any person." In fact, no change is being made to the way in which the UUT is imposed on telephone services. After the amendments, the same services will be taxed as before the amendments and before the IRS announcement. Unless there is legislative history to the contrary, cities generally linked the definition of "telephone service" to the F.E.T. definition for the administrative convenience of the tax collector. There was never an intent to bind the UUT to the F.E.T. such that a federal decision to reduce the base on which the F.E.T. was collected meant that the base on which a local tax was collected was likewise reduced.

Activity in the United States Congress

The Congress of the United States is the legislative forum of choice for those persons who are seeking to limit the authority of a state or local government to tax the new technology. In 1996, the Telecommunications Act adopted a federal ban on local taxation of direct broadcast satellite.[15] Satellite television now represents over 25% of the entire video market. AB 2987 (Nunez) (Chapter 700 of 2006 California Statutes) (The Digital Infrastructure and Video Competition Act of 2006) removed local franchising authority for CATV from local governments in California and replaced it with state-issued franchises to video service providers. The Act clearly states, however, that it does not "limit a local entity's ability to impose utility users taxes and other generally applicable taxes, fees, and charges under other applicable provisions of state law that are applied in a nondiscriminatory and competitively neutral manner."[16] This sets up a potentially unfair system in which consumers of satellite television pay less for their service than consumers of cable television who, in some jurisdictions, must also pay a utility users tax

In 1998, the Congress adopted the Internet Tax Freedom Act.[17] During the period beginning November 1, 2003, and ending November 1, 2007, no state or "political subdivision thereof" may impose taxes on internet access; or multiple or discriminatory taxes on electronic commerce. "Internet access service" means a "service that enables users to access content, information, electronic mail, or other services offered over the Internet…The term 'Internet access service" does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access."[18] The term "telecommunications" means the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received.[19] "Telecommunications service" means the offering of telecommunications for

[15] See Section 602 of the Act.
[16] Public Utilities Code § 5860(c).
[17] 47 U.S.C. 151, note 1.
[18] Section 1101(d)(3)(D) of the Internet Tax Freedom Act.
[19] 47 U.S.C. 153 (46).

a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used.[20]

S. 156 (Wyden, D-OR) was introduced on January 4, 2007 and would make the moratorium on Internet access taxes and multiple and discriminatory taxes on electronic commerce permanent. Similarly, H.R. 743 (Eshoo, D-CA) proposes to make the moratorium on Internet access taxes and multiple and discriminatory taxes on electronic commerce permanent.

S.166 (McCain, R-AZ) was introduced on January 4, 2007 and would prohibit states from imposing any new discriminatory tax on cell phones, cell phone service providers, or mobile services property for three years after the adoption of the measure. "New discriminatory tax" is generally defined as a "tax imposed on mobile services, providers, or property which is not generally imposed on other types of services or property or is generally imposed at a lower rate. Similarly, H.R. 436 (Bono, R-CA) prohibits states from imposing any new discriminatory tax on cell phones, cell phone providers, or mobile services after the adoption of the Act for three years.

A Possible Response to the Congress: The UUT and the Interstate Commerce Clause

The United States Constitution was adopted in 1787, and went into effect in 1789. Under the Constitution, the federal government only has those powers that are expressly or impliedly granted to it. Thus, the Tenth Amendment to the federal Constitution declares that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, or to the people." The federal Constitution gives Congress the power "to regulate commerce with foreign nations, and among the several States, and with the Indian tribes." (U.S. Const., Art. I, §8.) The regulation of the provision of telecommunications services and video services is the regulation of "commerce" under the Commerce Clause. This section will discuss whether Congress has authority under the Commerce Clause to prohibit all local taxation of services which have a connection to interstate commerce.[21]

In determining whether a tax imposes a prohibited burden on interstate commerce, the tax's practical effect rather than its label or appearance will be controlling.[22] A tax imposed on a local activity related to interstate commerce is valid if the local activity is not such an integral part of the interstate process, the flow of commerce, that it cannot realistically be separated from it. If a genuine separation of the taxed local activity from the interstate process is impossible, it is more likely that other states through which the

[20] 47 U.S.C. 153 (45).
[21] The structure of the U.S. Constitution requires Congress to cite to a defined Constitutional power to support its authority to legislate. Two of the most common of these powers are the commerce clause, and the authority under Section 5 of the 14th Amendment to enforce the rights to equal protection and due process of the law.
[22] *Nippert v. Richmond* 327 U.S. 416 (1946); *Railway Express Agency v. Virginia* 347 U.S. 359 (1954).

commerce passes or into which it flows can with equal right impose a similar tax, with the net effect of prejudicing or unduly burdening commerce.[23]

In *Goldberg v. Sweet*[24], the Court considered whether the Illinois Telecommunications Excise Tax Act was unconstitutional under the Commerce Clause. The case came to the Court "against a backdrop of massive technological and legal changes in the telecommunications industry."[25] The explosion in new telecommunications technologies and the breakup of the AT&T monopoly led a number of States to revise the taxes they impose on the telecommunications industry. The Illinois Act imposed a 5% tax on the gross charge of interstate telecommunications originated or terminated in Illinois; and charged to an Illinois service address. The Tax Act imposes an identical 5% tax on intrastate telecommunications. In order to prevent multi-state taxation, the Tax Act provides a credit to any taxpayer who can prove that the taxpayer had paid a tax in another State on the same telephone call which triggered the Illinois tax. Telecommunications suppliers are required to collect the tax from the consumer who charged the call to his service address. The Tax Act defined "telecommunications" broadly to include wide area telephone service; private line services; channel services; telegraph services; teletypewriter; cellular mobile telecommunications service…or "any other transmission of messages or information by electronic or similar means, between or among points by wire, cable, fiber-optics, laser, microwave, radio, satellite or similar facilities.

The Court reviewed the four-pronged test used to determine whether the tax violated the Commerce Clause: the tax is applied to an activity with a substantial nexus with the taxing State; is fairly apportioned; does not discriminate against interstate commerce; and is fairly related to services provided in the State.[26] Prior to the four-pronged test, the cases supported the view that interstate commerce enjoyed a "free trade" immunity from state taxation.

The Court assumed the first prong: Illinois has a substantial nexus with the interstate telecommunications reached by the Tax Act. The Court described the purpose of the second prong, the apportionment requirement: to ensure that each State taxes only its fair share of an interstate transaction. A tax is determined to fairly apportioned by examining whether it is internally and externally consistent. To be internally consistent, a tax must be structured so that if every State were to impose an identical tax, multiple taxation would not occur.[27] The Court concluded that the Illinois tax was internally consistent because if every State taxed only those interstate phone calls which are charged to an in-state address, only one State would tax each interstate call. The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being tax. The

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[23] *Michigan-Wisconsin Pipe Line Co. v. Calvert* 347 U.S. 157 (1954)
[24] 488 U.S. 252 (1989)
[25] 488 U.S. supra at 253.
[26] *Complete Auto Transit, Inc. v. Brady* 430 U.S. 275 (1977).
[27] *Container Corp. of America v. Franchise Tax Board* 463 U.S. 149 (1983) cited in *Goldberg v. Sweet*, infra, at page 261.

Court concluded that the tax was externally consistent for the following reasons: (1) the tax has many of the characteristics of a sales tax. Even though the "retail purchase" of telephone services is not purely a local event, the Tax Act reasonably reflects the way that consumers purchase interstate telephone calls. (2) The tax is imposed only on those calls which are originated or terminated in Illinois; and charged to an Illinois service address. It is difficult to devise an external consistency test based upon miles traveled, for example or some other indicator of the connection to the State. This case "involves the more intangible movement of electronic impulses through computerized networks. An apportionment formula based on mileage or some other geographic division of individual telephone calls would produce insurmountable administrative and technological barriers.[28]

The third prong of the test prohibits a State from imposing a discriminatory tax on interstate commerce. The economic burden of the Illinois tax falls on the telecommunications consumer. It is not the purpose of the Commerce Clause to protect state residents from their own states.

The fourth prong of the test asks whether the Illinois tax is fairly related to the presence and activities of the taxpayer within the State. The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State. The Court concluded that the Tax Act is fairly related to the benefits received by Illinois telephone consumers.[29]

The Court concluded that the Illinois Tax did not violate the Commerce Clause because it is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services which the State of Illinois provides to the taxpayer.

If a gross receipts tax on telecommunications services can be structured so that it does not interfere with interstate commerce in violation of the Commerce Clause, then how is the federal government able to on the Commerce Clause to prohibit all taxes on telecommunications services (or on Internet Access, etc.)? The federal government prohibits states and local governments from imposing an income tax on the income derived within that state from interstate commerce if the only business activities within the State were those of a salesperson soliciting orders for approval or rejection out of state and, if approved, that are shipped from out of state.[30] The authority for the regulation is the Commerce Clause.[31] Such an income tax would fail the first prong of the *Goldberg v. Sweet* test: there is not a substantial nexus between the activity of the sales person and the state imposing the income tax. Can the federal government use that

[28] *Goldberg v. Sweet*, Id. at page 264. Many years ago, the Court considered and rejected certain state taxes on interstate telecommunications. See e.g., *Cooney v. Mountain States Tel. & Tel. Co.* 294 U.S. 384 (1935); *Western Union Tel. Co. v. Pennsylvania* 128 U.S. 39 (1988); *Ratterman v. Western Union Tel. Co.* 127 U.S. 411 (1988). These cases were decided in the era when the Court held the view that interstate commerce itself could not be taxed.
[29] *Goldberg v. Sweet*, supra, at page 267.
[30] 15 U.S.C. 381.
[31] *Cal-Roof Wholesale, Inc. v. State Tax Commission* 410 P.2d. 233 (1966).

same Commerce Clause authority to prohibit all local taxes on Internet Access? Wouldn't a tax on *access* to the Internet make the UUT on "telephone" service less discriminatory and isn't such access the same as picking up a traditional telephone to make a call? Does a substantial nexus exist between the activity of the person using DSL or a cable modem or a phone line to access the Internet and the local government imposing the tax?[32]

Pending Litigation

There are five pending cases involving the utility user's tax. In the first three cases, the plaintiffs are being represented by the same attorneys.

- *Granados v. County of Los Angeles* is a class action requesting a refund under the County's utility user's tax. The request for refund is based upon the IRS's F.E.T. ruling. The plaintiffs contend that the County owes them a refund of taxes paid for the prior two years based upon the assumption that the IRS has been enforcing the F.E.T. incorrectly for two years. The County filed a demurrer challenging the propriety of the class action. On the merits, the County argues that its UUT has its own broader definition of taxable telephone services which is not dependent upon the IRS's interpretation of the F.E.T. The demurrer will be heard April 13, 2007. An update of the status of the case will be presented at the Spring Conference.

- *Ardon v. City of Los Angeles* is a class action requesting a refund of the City's UUT and an injunction against the continuing collection of the tax. The plaintiffs contend that the City owes them a refund of taxes paid for the prior two years based upon the assumption that the IRS has been enforcing the F.E.T. incorrectly for two years. The City filed a demurrer challenging the propriety of the class action. The demurrer will be heard April 13, 2007. An update of the status of the case will be presented at the Spring Conference.

- *McWilliams v. City of Long Beach* is a class action requesting a refund of the City's UUT and an injunction against the continuing collection of the tax. The plaintiffs contend that the City owes them a refund of taxes paid for the prior two years based upon the assumption that the IRS has been enforcing the F.E.T. incorrectly for two years. In addition, plaintiffs contend that the City's amendment of its ordinance to remove reference to the F.E.T. violated Proposition 218 by creating a new tax without voter approval. The City filed a demurrer challenging the propriety of the class action. The demurrer will be heard April 13, 2007. An update of the status of the case will be presented at the Spring Conference.

[32] "Mobile telecommunications services provided in a taxing jurisdiction to a customer, the charges for which are billed by or for the customer's home service provider, shall be deemed to be provided by the customer's home service provider" 4 U.S.C. 117 (Mobile Telecommunications Sourcing Act).

- *TracFone Wireless, Inc. v. City of Los Angeles* is an action asking for a refund of the City's UUT because TracFone's sales are exempt from the tax because they are not subject to the F.E.T. The City has filed a demurrer, which will be heard on April 4, 2007, arguing that TracFone does not have standing to sue since TracFone is not a taxpayer but simply a tax collector. An update of the status of the case will be presented at the Spring Conference.

- *TracFone Wireless, Inc. v. County of Los Angeles* is an action asking for a refund of the City's UUT because TracFone's sales are exempt from the tax because they are not subject to the F.E.T. The City has filed a demurrer, which will be heard on April 4, 2007, arguing that TracFone does not have standing to sue since TracFone is not a taxpayer but simply a tax collector. An update of the status of the case will be presented at the Spring Conference.

Conclusion

There are two significant obstacles to expanding the base on which the utility user's tax is imposed to include those telecommunications advances which are part of the technology convergence. The first is the requirement to receive voter approval when a tax is "increased." The UUT would be increased by this expansion in the base. The second is the federal government's threats to prohibit taxes on certain telecommunications services which have heretofore not been included within a city's definition of "telephone services" in its UUT ordinance. This threat should be analyzed carefully to determine whether it is a proper exercise of the federal government's commerce clause power. The failure to be able to tax the expanded base will necessarily reduce UUT revenues as the migration of the taxpayer from traditional "telephone" service to technologically-advanced "telephone" service continues.