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PRIVATE TAXPAYER RULING LR06-002

March 7, 2006

The Department issues this private taxpayer ruling in response to your request of February 5, 2005, as supplemented by your letter of March 6, 2006, for a ruling on behalf of your company . . . ("Company"), regarding the applicability of Arizona transaction privilege tax to Company's gross income derived from sales of its digital subscriber line ("DSL") service.

Statement of Facts:

Your February 5 letter provides the following facts:

. . . .

Among the products provided to its business and residential customers, [Company] sells DSL. This is a product that allows the customer to simultaneously connect to the Internet . . . and the Public Switched Telephone Network . . . ("PSTN") over a single telephone line. This service removes the need for a "second telephone line" if an individual does not want to monopolize the primary telephone line while "on the Internet[.]" Further, the speed of information transfer is increased from the 56 Kps available by using a modem dial up transmitting over the traditional phone line

The ability to use a single telephone line for both data and voice transmission is accomplished by placing a "multiplexer" at the customer premise[s]. This devise [sic] increases the frequency of signals transmitted from the customer's computer to 30 KHz – 100 KHz. Since voice is transmitted at .3 KHz – 3.5 KHz, the two signals can occupy the same physical wire between the customer premises and the central office without interfering with each other. . . .

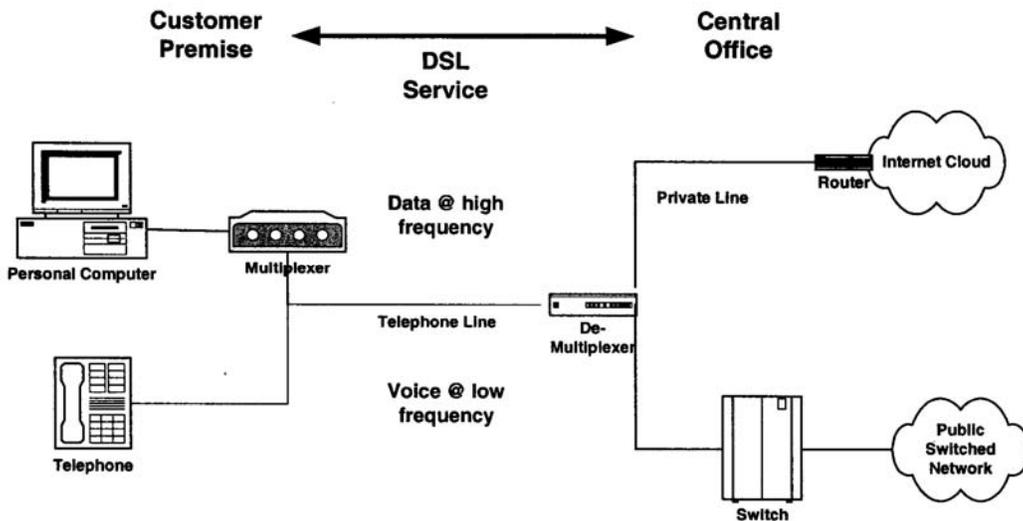
At the central office building, another piece of equipment called a "de-multiplexer" recognizes the two frequency transmissions, and diverts them to separate systems. The low frequency signal (voice) is sent to the PSTN network where it travels through the switch and is directed toward its destination based upon the telephone number entered by the originator. The high frequency signal (data) is routed to a private line (or similar transmission service) purchased by an Internet Service Provider . . . ("ISP"). The signals originating from the customers of a specific ISP are grouped and transmitted over the private line from the central office to the ISP's router that provides the physical connection to the Internet. However, the term "DSL" only refers to the transmission from the customer premise to the central office. The private line is purchased by the ISP for transporting the signals after consolidation of other customer's signals, and is not part of the DSL service sold to "end-users" (either through the ISP – described as situation #1 below, or directly to the customer – described as situations #2 and #3 below).

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The primary hardware utilized to deliver the DSL service consists of: (1) the multiplexer located at the customer premise, (2) the telephone wire traveling between the customer premises and the central office, and (3) the de-multiplexer located at the central office. This can be shown schematically as follows:



DSL is sold by [Company] in three different types of transactions: (1) An ISP can purchase the DSL service from [Company], and utilize it in the provision of high-speed Internet access to their customers. In this situation, the [Company's] transaction is with an ISP and not directly with the end user. For example, AOL can purchase DSL from [Company], combine it with its own browser (the software that resides on the customer's computer) and its access to the Internet. The finished product, consisting of these services, is sold for a single price to the end user as "high-speed Internet access[.]" (2) [Company] sells the DSL to customers to whom it also sells a telephone line. The customer is free to purchase the Internet access from an ISP of its choice. The two products (telephone line and DSL) are sold separately, separately identified and priced on the customer's bill. The telephone line is priced at the tariff rates established by the Arizona Corporation Commission, whether or not the DSL is purchased. The charges for the telephone line are not at issue in this ruling request. For example, an end-user can purchase the two communications services from [Company], and independently purchase the Internet access directly from any ISP it desires. (3) [Company] can sell the DSL separate from any other service . . . (such as a telephone line). In this situation, DSL is the only sale that occurs between [Company] and the end-user. For example, [customers] may not purchase a traditional telephone service, but utilize a wireless carrier for their voice communications. They may choose to purchase "naked" DSL (DSL service without the purchase of an underlying telephone line) from [Company], and separately contract with an ISP for the access portion of their connection to the Internet.

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The sole function of DSL is to allow the end-user to access the Internet. The signals that are sent and received over the Internet have their origin and destination both [within] the State of Arizona and throughout the world.

Your Issues:

You request a ruling on whether Company's gross income derived from sales of DSL to the following persons are subject to transaction privilege tax under the telecommunications classification:

1. An ISP for incorporation into its high-speed Internet access.
2. An "end-user customer" that also purchases a traditional phone line.
3. An "end-user customer" as "naked DSL."

Your Position:

Your position is that Company's gross income derived from any of the three categories of sales provided above are sales of interstate telecommunication services and, consequently, excluded from Arizona transaction privilege taxation under the telecommunications classification found at Arizona Revised Statutes ("A.R.S.") § 42-5064.

Conclusion and Ruling:

Telecommunications Classification Generally

A business that provides intrastate telecommunications services is subject to Arizona transaction privilege tax under the telecommunications classification. A.R.S. § 42-5064(E)(4) defines "intrastate telecommunications services" as "transmitting signs, signals, writings, images, sounds, messages, data or other information of any nature by wire, radio waves, light waves or other electromagnetic means if the information transmitted originates *and* terminates in this state" (emphasis added). The tax base for the telecommunications classification is the gross proceeds of sales or gross income derived from the business.

There are several tax exemptions and exclusions provided under A.R.S. § 42-5064. For instance, A.R.S. § 42-5064(A)(2) excludes a business's gross income derived from sales of "Internet access" services to its subscribers and customers. A.R.S. § 42-5064(E)(3) defines "Internet access" as "a service that enables users to access content, information, electronic mail or other services over the internet," but not "telecommunications services provided by a common carrier." Another example is A.R.S. § 42-5064(B)(1)(a), which exempts gross receipts derived from sales of intrastate telecommunications services to

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“[o]ther persons engaged in businesses classified under the telecommunications classification for use in such business.”

If any telecommunications services originate *and* terminate in Arizona, they are subject to transaction privilege tax under the telecommunications classification, unless otherwise exempted or excluded from tax under A.R.S. § 42-5064.

Bundled Transactions

Businesses subject to transaction privilege tax under the telecommunications classification may offer “bundled transactions” to their customers. A.R.S. § 42-5064(E)(1) defines a bundled transaction as “a sale of multiple services in which . . . (a) [t]he sale consists of both taxable and nontaxable services . . . [and] (b) [t]he telecommunications service provider charges a customer one sales price for all services that are sold instead of separately charging for each individual service.” Pursuant to A.R.S. § 42-5064(D), a business must be able to reasonably identify the portion of the sales price of a bundled transaction derived from charges for nontaxable services to overcome the Department's presumption of taxability for the entire gross income derived from the sale. The burden of proof is on the telecommunications service provider to establish that the gross proceeds of sales or gross income is derived from charges for nontaxable services. To meet its burden of reasonably identifying the nontaxable portion of gross income derived from bundled transactions, a telecommunications service provider may use allocation percentages, which are further addressed in A.R.S. § 42-5064(D)(1) and (D)(2).

Internet Tax Freedom Act Moratorium

In 1998, Congress enacted the Internet Tax Freedom Act (“ITFA”), imposing a temporary moratorium on certain state taxation of Internet access. It later amended ITFA in 2001 to extend the original moratorium to November 2003. On December 3, 2004, President George W. Bush signed the Internet Tax Nondiscrimination Act (P.L. 108-435) (“ITNA”) that put in place a similar moratorium of state taxation of Internet access, but that amended and clarified certain sections of ITFA by making clear that the definitions of “Internet access” and “Internet access service” under the act include telecommunications services purchased, used, or sold by a provider of Internet access to provide Internet access. ITNA provides grandfathering provisions that allow states to continue to impose taxes on services that are “Internet access” as newly defined up to either November 1, 2005 or November 1, 2007, based on certain requirements. One provision allows state enforcement of taxes that were generally imposed and actually enforced as of November 1, 2003, such as Arizona transaction privilege tax under the telecommunications classification imposed on intrastate telecommunications services purchased, used, or sold by Internet access providers, until November 1, 2005.

Similar to Arizona's statutory provisions on bundled transactions under A.R.S. § 42-5064(D), ITNA provides that Internet access charges that are aggregated with and not

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separately stated from charges that are subject to tax can be taxable, unless an Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business. ITNA also provides that its provisions on Internet access should not be construed to affect a state's taxation of Voice over Internet Protocol ("VoIP") or successor protocols.

Ruling

Based on the above-described scope of transaction privilege tax imposed under the A.R.S. § 42-5064 telecommunications classification, and using the term "DSL" as meaning the transmission of signals within the high frequency 30 kHz – 100 kHz range from an Arizona customer's premise to Company's central office in Arizona, the Department rules as follows:

1. Before November 1, 2005, Company's gross income derived from the sale of DSL service to an ISP that the ISP utilizes in its provision of Internet access to its customers was subject to tax under A.R.S. § 42-5064, unless the ISP constituted a business that was subject to tax under the telecommunications classification and was consequently "classified under" the classification, pursuant to A.R.S. § 42-5064(B)(1). DSL constitutes a telecommunications service that originates within Arizona at the Arizona customer's location and terminates within Arizona at the central office, and is consequently intrastate in nature. An ISP that was not otherwise subject to tax under the telecommunications classification would not be subject to tax on its gross income derived from providing Internet access, whereas an ISP that was subject to tax under A.R.S. § 42-5064 and used DSL service in its business was taxable on gross receipts derived from the sale of DSL service to its users. Concurrently, Company's gross income derived from sales of DSL would be subject to tax in the former case and exempt from tax under A.R.S. § 42-5064(B)(1) in the latter case.

After November 1, 2005, Company's gross income derived from the sale of DSL service to an ISP that the ISP utilizes in providing Internet access to its customers is exempt from tax under A.R.S. § 42-5064, pursuant to ITNA's proscription of state taxes on telecommunications services purchased by an Internet access provider to provide Internet access.

2. Before November 1, 2005, Company's gross income derived from the sale of DSL service to an end-user customer that also purchases a traditional telephone line, wherein the customer purchases Internet access separately from an ISP of its choice, was subject to tax under A.R.S. § 42-5064. After November 1, 2005, Company's gross income derived from the sale of DSL service to an end-user customer that also purchases a traditional telephone line is excluded from tax under ITNA as a telecommunications service that is used by an Internet access provider to provide Internet access, assuming that: (a) the end-user customer is utilizing DSL

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service solely for the purpose of obtaining Internet access and (b) Company is separately stating charges for DSL service and the traditional telephone line. If Company charges an end-user customer a single fee for both DSL service and the traditional telephone line, the sale constitutes a bundled transaction under A.R.S. § 42-5064(E)(1), and gross income derived from the sale of DSL service wholly used for Internet access is nontaxable insofar as Company is able to reasonably identify those gross receipts derived from the nontaxable service in its books and records kept in the regular course of business.

If Company's DSL service is not utilized by an end-user customer solely for purposes of Internet access (e.g., customer uses low-pass filters to enable voice transmissions with Company's DSL service), however, Company's gross income derived from DSL service is not excluded from taxation by A.R.S. § 42-5064 or ITNA, and will be subject to transaction privilege tax under the telecommunications classification unless Company reasonably identifies the portion of nontaxable gross income associated with DSL service used for Internet access. Company may use allocation percentages as provided in A.R.S. § 42-5064(D) to reasonably identify such nontaxable gross income.

3. Before November 1, 2005, Company's gross income derived from the sale of DSL service to an end-user customer independent of any other services was subject to tax under A.R.S. § 42-5064. After November 1, 2005, gross income derived the sale of DSL service to the end-user customer independent of any other services is excluded from tax under ITNA as a telecommunications service that is used by an Internet access provider to provide Internet access if, as explained in the second part of this ruling above, either: (a) the end-user customer is utilizing DSL service solely for the purpose of obtaining Internet access or (b) Company reasonably identifies the portion of nontaxable gross income associated with DSL service used for Internet access.

The Department clarifies that, in the three parts of the ruling provided above, the use of the term "Internet access" does not include VoIP services.

This private taxpayer ruling does not extend beyond the facts presented in your letters of February 5, 2005 and March 6, 2006.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law, or notification of a different Department position.

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The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited, nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.