Limiting a Taxpayer's Right to Recover Tax Costs Through Line-Item Surcharges

by James P. Kratochvill

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Two recent federal court of appeals decisions provide guidance for businesses generally, and telecommunications service providers (TSPs) in particular, regarding the restrictions imposed on states to prevent or limit vendors from recovering their gross receipts tax costs through the use of line-item surcharges on customer bills.

In *BellSouth Telecommunications, Inc. v. Farris*, the Sixth Circuit Court of Appeals held that a Kentucky statute prohibiting telecommunications and video service providers from recovering their costs for a gross receipts tax by stating the tax on customer bills violated the First Amendment of the U.S. Constitution.[1] However, in *Peck v. Cingular Wireless, LLC*, the Ninth Circuit Court of Appeals held that federal law did not preempt Washington state from limiting how and when wireless telecommunications service providers may apply line-item charges on customer bills to recover their Washington business and occupation (B&O) tax costs.[2] As a result, those wireless service providers appear to be subject to the same restrictions on their recovery of the Washington B&O tax costs from their customers as applicable to general business vendors under last year's decision by the Washington Supreme Court in *Nelson v. Appleway Chevrolet, Inc.*[3]

Cumulatively, those decisions appear to signify that states cannot prohibit or prevent vendors from disclosing or recovering tax costs from their customers by line-item charges, but the states do have leeway to prescribe when and how those line-item customer charges can be applied.

> ***Those decisions appear to signify that states cannot prohibit but may limit a vendor's disclosure or recovery of tax costs by means of line-item charges on customer bills.***

This article summarizes the history and development of line-item surcharges, particularly for TSPs, and examines the relevant case law affecting the use of line-item surcharges by vendors to recover tax costs from customers. The article also addresses several of the legal and practical questions facing taxpayers and states regarding the implementation and enforcement of possible government limitations on vendors seeking to recover their tax costs.

Background

Public utilities, including TSPs, have for decades borne the principal liability for state and local gross receipts taxes nationwide.[4] Since the 1980s TSPs

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[1] ___F.3d___, 2008 WL 4133382 (6th Cir. Ky. 2008).

[2] 535 F.3d 1053 (9th Cir. Wash. 2008).

[3] 157 P.3d 847 (Wash. 2007). (For the decision, see Doc 2007-10638 or *2007 STT 85-22*.)

[4] The historical rationale for those taxes was that they were levied in exchange for special rights and privileges the state granted to utilities, such as monopoly power, the power of eminent domain, and the right to use public rights of way. However, changes in competition, technology, and the regulatory environment, including deregulation, over the years eroded and removed the rationale for those utility taxes to the

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have included on their monthly billing statements to customers a separate line-item charge to recover those gross receipts taxes imposed on their revenue by state or local jurisdictions. Relying on authority granted by the Federal Communications Commission under federal law, TSPs have applied those charges to customers located in the state or local jurisdictions imposing the applicable taxes or fees.[5] The underlying FCC policy was that the burden of onerous state-levied taxes targeting interstate telephone service should be confined to the constituency (customers) of the jurisdiction imposing them and not be spread among (or exported to) all of the TSP's customers throughout the country.[6]

Thus, that line-item charge serves two important purposes. First, because gross receipts taxes are imposed generally on the vendor or service provider, vendors are not permitted to collect the tax directly from their customers (like a sales tax). Instead, providers that do not want to simply increase the base price of the service (or TSPs that do not want to raise their national rates) can recover their costs incurred for the tax from their customers by adding a separate surcharge for the tax recovery on customer invoices. Second, providers use line-item surcharges to inform customers about the existence and degree of a state's gross receipts tax and protect customers outside the taxing state from bearing the burden of an exported tax.[7] Use of the surcharge by TSPs contributed to the reduced number of states imposing telecommunications gross receipts taxes from almost 30 states in 1986 to only about 10 states by 2004.

But since then, several states have either expanded or enacted new gross receipts tax impositions on general businesses, as well as on TSPs and utilities.[8] Those include the adoption of new taxes in Ohio,[9] Texas,[10] and Michigan[11] and a proposed gross receipts tax measure in Illinois.[12] Also, Pennsylvania expanded the scope of its gross receipts tax upon telecommunications to include interstate services,[13] and Kentucky enacted a new gross receipts tax on communications and video service providers.[14] Like

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point that the original justifications for those taxes no longer existed, beginning as early as the mid-1980s. W. Hellerstein and H. Levine, "Utility Gross Receipts Taxes and Interexchange Telecommunications Carriers," *Tax Notes,* Aug. 1, 1988, p. 529. *See also* K. Case, "State Tax Policy and the Telecommunications Industry" in *The Telecommunications Revolution: Challenge for State Policymakers* 33 (J. Chaisson and B. Dyer eds., 2nd ed. 1993).

[5]Sections 201(b) and 202(a) of the Federal Communications Act generally require telecommunications service rates, terms, and conditions to be just, reasonable, and nondiscriminatory. The FCC has since 1986 consistently sustained and sanctioned the practice by TSPs of recouping the costs of state gross receipts taxes imposed on their interstate receipts by adding line-item charges to the bills of customers in the jurisdictions imposing the taxes. For many years, this practice was accomplished through tariffs filed with the FCC. When challenged in 1988 by Connecticut, the FCC determined that the tariffs were a just and reasonable method for recovering state gross receipts taxes. *In the Matter of Connecticut Office of Consumer Counsel v. AT&T*, 4 F.C.C.R. 8130 (1989). Its decision was affirmed by the U.S. Court of Appeals for the Second Circuit, which concluded not only that allowing the surcharge was well within the FCC's broad authority, but also that the surcharge mechanism itself is a reasonable method of preventing states from singling out telecommunications for taxation in order to transfer a portion of their tax burden to nonresidents through rates for interstate telephone service. *Connecticut Office of Consumer Counsel v. Federal Communications Commission*, 915 F.2d 75 (2d Cir. 1990). The FCC's sanction of the surcharge practice continues today, without tariffs, under the Telecommunications Act of 1996. *See, e.g.*, Policy and Rules Concerning the Interstate, Interexchange Marketplace Implementation of Section 254(g) of the Communications Act of 1934, as amended, 11 F.C.C.R. 9564, *9571 (1996) at para. 12.

[6]Customers within the taxing states are more likely to benefit from the proceeds of such in-state taxes and to have the power — through their elected representatives — to reduce or eliminate those taxes. However, by increasing their national rates, the costs of a particular state's taxes would likely be borne disproportionately by customers outside of the taxing state, thereby imposing on the nontaxing state's customers most of the burden of the tax but almost none of the benefit enjoyed by the taxing state's customers.

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[7]One of the most significant deficiencies of the gross receipts tax is that it is a "stealth" tax with its true burden hidden from taxpayers. Even though the gross receipts tax is legally and visibly imposed on businesses, its burden is ultimately borne by consumers through higher prices and other separately stated charges. J. Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," Council On State Taxation (Jan. 2007); L. Wheeler and E. Sennoga, "Alternative State Business Tax Systems: A Comparison of State Income and Gross Receipts Taxes," *State Tax Notes*, Aug. 20, 2007, p. 487, *Doc 2007-16054*, or *2007 STT 162-2*.

[8]*See generally* J. Mikesell, *supra* note 7. *See also* L. Wheeler and E. Sennoga, *supra* note 7.

[9]Ohio commercial activity tax, Ohio Rev. Code Ann. section 5751.01 et seq.

[10]Texas margins tax, Tex. Tax Code Ann. section 171.0001 et seq. (2008).

[11]Michigan business tax, Mich. Comp. Laws Serv. section 208.1101 (2008).

[12]In March 2007 Illinois Gov. Rod Blagojevich (D) called on the General Assembly to replace the corporate income tax with a gross receipts tax. State of the State Address (Mar. 7, 2007).

[13]72 Pa. Stat. Ann. section 8101 (2008) et seq.

[14]Ky. Rev. Stat. Ann. section 136.600 (2008) et seq.

TSPs, general business vendors would naturally seek to recover their tax expenses in some manner from their customers.

Since 2004 several states have either expanded or enacted new gross receipts tax impositions on general businesses, as well as on TSPs and utilities.

However, a few of the states that have enacted gross receipts taxes have also sought to restrict or prohibit the recovery of those tax costs through the use of line-item surcharges or similar entries on customer bills. The *BellSouth* and *Peck* decisions each arose out of litigation initiated to test the limits of a state's power to control whether or how vendor taxpayers can recover their tax costs from customers using line-item charges.

The *BellSouth* Litigation

Kentucky had enacted in 2005 a new gross revenues tax on communications and video service providers.[15] Included in the measure was a provision that sought to prohibit the service providers from stating the tax charge on customer bills and effectively to prohibit recovery of the tax from customers through the use of separate line-item charges on customer invoices. The provision stated:

> The *provider shall not* collect the tax directly from the purchaser *or separately state the tax on the bill to the purchaser.* [Emphasis added.][16]

That attempt by Kentucky to restrict by statute the ability of TSPs to recover their gross receipts tax costs through a line-item surcharge on customer bills was not the only recent state effort to hinder recovery of a telecommunications tax.[17]

In *AT&T Corp. v. Rudolph*, the U.S. District Court, Eastern District of Kentucky, addressed a challenge by AT&T, Verizon, and BellSouth to restrain the Kentucky Department of Revenue from enforcing the above provision against those wire line long-distance TSPs.[18] Related litigation was initiated by a BellSouth local exchange carrier affiliate in *BellSouth Telecommunications, Inc. v. Farris*.[19] The TSPs in the *AT&T* litigation argued principally that KRS section 136.616(3) (section 3) was preempted by federal law because it regulated the rates charged by long-distance providers, in violation of the Federal Communications Act (FCA) and the authority granted by the FCC to TSPs to recover gross receipts taxes through a tax surcharge.

The TSPs also argued that the provision violated the free speech protections set forth in the First and 14th amendments because it prohibited the carriers from placing a written line item on the customer's bill that would notify customers of the origin and amount of the charge to recover the gross revenues tax and from otherwise communicating with their customers on their billing statements about the tax. In opposition, Kentucky argued that preemption didn't apply, and that Kentucky was not limiting free speech (in that carriers could communicate with their customers) and, if it were, the state had a compelling interest in maintaining section 3 because it was critical to the tax scheme not to mislead customers regarding who is the taxpayer.

However, before reaching the merits, the court first determined that the action was not barred by the federal Tax Injunction Act's proscription of federal courts from "enjoin[ing], suspend[ing] or restrain[ing] the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in courts of such State."[20] The court rejected Kentucky's claim that section 3 was critical in the tax scheme to identify

[15]KRS section 136.600 et seq.; 2005 Ky. Acts 168.

[16]KRS section 136.616(3). The General Assembly then amended KRS section 136.990 to include the following provision: "Any provider who violates the provisions of KRS 136.616(3) shall be subject to a penalty of twenty-five dollars ($25) per purchaser offense, not to exceed ten thousand dollars ($10,000) per month." 2006 Ky. Acts 6, section 11.

[17]The Pennsylvania legislature had in 2003 introduced legislation (HB 1428) to expand its gross receipts tax to interstate revenues and to similarly restrict the recovery of such tax through use of a line-item surcharge, but withdrew the surcharge restriction before the legislation was enacted. The New York gross receipts tax law contained a provision until 2000 (1995 for telecommunications service) prohibiting the tax from being added as a separate item to bills rendered by a utility to its customers. N.Y. Tax Law section 186-a(12).

[18]Civil Action 06-16, 2007 WL 647564 (E.D. Ky. 2007).

[19]Civil Action 3:06-39, 2007 WL 647561 (E.D. Ky. 2007). Also, a consortium of wireless carriers had filed suit earlier in the same federal court on November 18, 2005, for preliminary injunction against enforcement of KRS section 136.616(3). *Cingular Wireless LLC, et al. v. Rudolph*, Civil Action No. 05-81 (E.D. Ky. filed Nov. 18, 2005). Because an FCC order authorizing the use of line-item charges by wireless carriers (*see* note 51 and discussion, *infra* at 10) was subject to review before the U.S. Court of Appeals for the Eleventh Circuit in *National Association of State Utility Consumer Advocates (NASUCA) v. Federal Communications Commission*, 457 F.3d 1238 (11th Cir. 2006), *cert. den. Sprint Nextel Corp. v. NASUCA*, 128 S. Ct. 1119 (U.S. 2008) (*NASUCA*), the carriers and Kentucky stipulated to entry of an order granting preliminary injunctive relief and staying further proceedings pending outcome of *NASUCA*. *See* discussion of *NASUCA*, *infra*.

[20]28 U.S.C. section 1341. The federal court otherwise had jurisdiction in accordance with 28 U.S.C. section 1331 as both cases arose under the laws of the United States, specifically the FCA, and the commerce and supremacy clauses and First

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that the legal incidence of tax is on the provider and that the provider, not the customer, is the taxpayer. Because the TSPs did not seek to enjoin or refuse to pay the tax itself, the court concluded that enjoining section 3 provision would not disrupt the state's collection or receipt of taxes or interfere with the state's receipt of the tax from the parties responsible for paying it, and therefore does not invoke the injunction act proscription.[21]

On the merits, the court declined to address the preemption argument, because it determined instead that section 3 was unconstitutional on First Amendment grounds. Accordingly, the court held that Kentucky was enjoined from enforcing section 3 (and the accompanying penalty provision) because this provision violated the First Amendment right to free speech under the Constitution.[22] In reaching its holding, the court concluded that the provision neither served its alleged purpose nor had an effect consistent with that purpose.

First, the court determined that line items on customer bills that notify customers of the origin and amount of some taxes constitute speech within the meaning of the First Amendment. Second, without deciding whether those line items could be characterized as political or commercial speech, the court found that line items were not inherently misleading, and therefore satisfied the threshold test for protected speech under *Central Hudson Gas & Electric Corp. v. Public Service Commission*[23] that the commercial speech be neither unlawful nor misleading. Third, the court determined that the statute did not directly advance the state's interest in preventing the confusion or misleading of consumers regarding which party is responsible for paying the tax. The state's interest in avoiding confusion was advanced neither by prohibiting accurate (as well as misleading) information through line items or by allowing service providers to provide potentially misleading information to customers by any other form (that is, bill inserts or brochures) *except* line items on customer bills. Finally, the court concluded that the statute prohibits substantially more speech than necessary to prevent consumers from being misled by gross receipts tax line items, and that there was not a reasonable fit between the prohibition of speech and the state's asserted interest.

and 14th amendments of the Constitution. Therefore, that court has subject matter jurisdiction over that action.

[21]2007 WL 647564 at *4.

[22]2007 WL 647564 at *16, *quoting* the First Amendment of the U.S. Constitution, which provides that "Congress shall make no law . . . abridging the freedom of speech." U.S. Const., Amend. I.

[23]447 U.S. 557 (1980).

On appeal, the U.S. Court of Appeals for the Sixth Circuit in *BellSouth Telecommunications, Inc. v. Farris* affirmed in part the district court's decision.[24] First, the court agreed with the district court that the Tax Injunction Act did not bar this lawsuit, finding that these taxpayers did not seek to avoid paying taxes or to limit the amount of their taxes due, but merely sought relief to end a ban on what the taxpayer may do to recover the tax from, and to say about the tax to, its customers.[25] The court also agreed that the "no stating the tax" clause in section 3 violated the First Amendment.[26]

> ***The court questioned why telecommunications customers are any more likely to be confused by tax line items on bills than are consumers of other services.***

Like the district court, the court of appeals concluded that the section 3 clause restricted speech, but it was uncertain whether that speech was commercial or political in nature — types of speech held to different constitutional standards. The court explained its difficulty by reasoning that line items were a hybrid implicating both commercial and political speech. In one sense, stating the tax on customer bills promotes the economic interests of the parties and provides the means to describe a commercial transaction. But in another sense, that statement announces who bears the political responsibility for the price increase occasioned by the new tax, the provider or the legislator, using a vehicle (invoices) most likely to capture voters' attention.[27]

However, the court ultimately determined that it was unnecessary to reach that characterization because Kentucky's statute does not survive even the less stringent level of scrutiny applicable to commercial speech under *Central Hudson*. *Central Hudson* adopted a four-part test to gauge the validity of commercial speech regulations:

- does the challenged law regulate speech, does the proposed speech concern lawful activity, and is it nonmisleading;

[24]___ F.3d ___, 2008 WL 4133382 (6th Cir. Ky. 2008). The court of appeals consolidated the *AT&T* and *BellSouth* cases for purposes of that appeal.

[25]2008 WL 4133382 at *4.

[26]However, the court distinguished the "no direct collection" clause, stating that the terms of the clause refer to nonexpressive conduct, not speech, and as a result lie beyond the protection of the First Amendment. Accordingly, the court determined that the district court erred to the extent that it meant to strike all, rather than just part, of the section 3 provision. *See* discussion, *infra*.

[27]2008 WL 4133382 at *5-6.

- is the governmental interest substantial;
- does the regulation directly advance the governmental interest; and
- is the regulation more extensive than necessary to serve that interest?

Applying that test, the court concluded that section 3 regulates speech, not conduct, because it prohibits providers from stating the tax on the bill, and the debate concerns what the provider may say (saying why it has raised prices), not what it may do (raise prices to account for the new tax).[28] Second, the court concluded that the providers' speech does not concern unlawful activity because, as Kentucky does not oppose the providers' efforts to raise prices to account for the new tax, speech about the reasons for those price increases does not advance an illegal transaction. Nor did the court find the speech to be inherently misleading, but truthful and verifiable. The providers in fact increased prices to absorb the tax imposed on their gross revenues and intended to accurately show on invoices the amount by which the new tax increases prices.[29]

Third, although the court accepted that Kentucky has a substantial interest in avoiding potential consumer confusion about whether consumers, rather than the providers, bear legal responsibility for the tax, the court concluded that section 3 does not directly advance the state's interest. In part, the court was troubled because the state allows providers to tell their customers anything about the tax, no matter how confusing, in all settings (for example, in advertisements or on billing inserts) *except* on a customer invoice. The court was also concerned by the state's decision to prohibit just one type of line-item statement — those about this tax — and no other. The court questioned why telecommunications customers are any more likely to be confused by tax line items on bills than are consumers of other services, and could not think of a good reason on its own for that distinction.[30]

Finally, the court concluded that the section 3 prohibition was overinclusive because that ban was more extensive than necessary to serve the state's interest in preventing customer confusion over legal liability for the tax. The court stressed that before a government may resort to suppressing speech to address a policy problem, it must show that regulating conduct has not sufficed or that as a matter of common sense it could not suffice — in short, that regulating speech must be a last, not first, resort.[31]

The court found that that was not the case in *BellSouth*, and expounded on the "full arsenal of options" Kentucky had, short of restricting speech, to address customer confusion. Those included:

- enforcing the existing Kentucky Consumer Protection Act, which prohibits "unfair, false, misleading, [and] deceptive acts or practices in the conduct of any trade or commerce";[32]
- enforcing federal regulations such as the FCC's truth-in-billing requirements;[33]
- requiring a disclaimer about the gross revenues tax any time a provider chooses to mention the tax on a bill; and
- allowing an award of costs and fees to litigants who successfully challenge a misleading line item.

Also, because the state had offered no evidence or studies to suggest the premise that consumers would in fact be confused about the incidence of the tax, the court viewed the state's concern about the possibility of deception in hypothetical cases as insufficient to justify section 3's regulation of speech. On this record, said the court, there is considerable reason to doubt whether the state's speech ban corrects a problem of its own making or indeed was meant to respond to another problem — political accountability for the tax.[34]

> **BellSouth *would appear to prevent Kentucky, and likely any state imposing a gross receipts tax, from enacting or enforcing laws to prohibit its recovery by taxpayers through line-item surcharges on customer bills.***

Those conclusions suggest that *BellSouth* would appear to prevent Kentucky, and likely any state imposing a gross receipts tax, from enacting or enforcing laws to prohibit its recovery by taxpayers through the use of line-item surcharges on customer

[28] *Id.* at *6.
[29] *Id.* at *7.
[30] *Id.* at *8.
[31] *Id.* at *9.

[32] KRS section 367.170.
[33] The FCC has said that "it is a misleading practice for carriers to state or imply that a charge is required by the government when it is the carriers' business decision as to whether and how much of such costs they choose to recover directly from consumers through a separate line-item charge." *In the Matter of Truth-in-Billing and Billing Format*, 20 F.C.C.R. 6448, *6461 (2005) at para. 27. Carriers are therefore prohibited from using "misleading statements or descriptions" and from placing charges on a bill "in such a way as to lead a reasonable consumer to believe that the charge has been mandated by the government." *Id.* Thus, for example, carriers are prohibited from placing a discretionary charge in a section or subsection of the bill that otherwise contains only government required charges or taxes because that may lead a reasonable consumer into believing that the discretionary charge is also required. *Id.*
[34] 2008 WL 4133382 at *10.

bills. *BellSouth* also appears to afford a strong legal basis for all gross receipts taxpayers, not just telecommunications companies, to recover their tax costs in that manner. However, the court may have diluted the effect of its holding in Kentucky and elsewhere by its determination not to strike the entire section 3 statute, but to separate what it called the "no direct collection" clause (that is, that "the provider shall not collect the tax directly from the purchaser") from the invalidated "no stating the tax" clause, and allow the former clause to survive.

Ostensibly, the court's legal reason for not striking the clause was that, according to the court, the terms of the clause refer to nonexpressive conduct, not speech, and as a result lie beyond the protection of the First Amendment.[35] However, the court went on to say that it is unclear precisely what the no direct collection clause does, and that it remains to be seen what purpose the clause will serve in the future. In a somewhat rambling discussion, the court mused on several possible ways that the conduct related to each clause could differ, but concluded only that because the two clauses *may* bar different things, the no direct collection clause was not unconstitutional on its face because it appeared to regulate only conduct and not speech.[36]

Although the *BellSouth* court does not provide clear guidance as to what purpose the no direct collection clause would serve in the future, in all probability, that clause, standing alone, would have the limited effect of preventing taxpayer vendors from attempting to collect the Kentucky gross revenues tax (as a tax) from its customers as they would a sales tax. That would be consistent with the plain language of the clause and the legislative intent of the gross revenues tax law generally to impose the incidence of and the liability for the tax directly on the vendor, not the customer.[37]

More importantly, *BellSouth* does not necessarily resolve the issue of whether states can legally limit how or when taxpayers recover their tax costs through the use of those line-item surcharges. To the contrary, the *BellSouth* court suggests strongly the premise that states have a legitimate interest in not misleading customers about their liability for gross receipts taxes imposed on businesses and can enact less stringent measures that only protect consumers from misleading information, or limit the use of line-item surcharges in ways that do not run afoul of the Constitution. A similar proper limitation of that use has been sanctioned in Washington regarding its B&O tax and confirmed by the Ninth Circuit Court of Appeals in *Peck*.

The *Peck* Litigation

Washington has imposed for more than 70 years a B&O tax on the privilege of engaging in almost any business in the state, measured by the gross receipts of the taxed business activity conducted in the state.[38] RCW section 82.04.500 has been long considered a barrier to a direct recovery by vendors of the Washington B&O tax from their customers. That section provides:

> It is not the intention of this chapter that the taxes herein levied upon persons engaging in business be construed as taxes upon the purchasers or customers, but that such taxes shall be levied upon, and collectible from, the person engaging in the business activities herein designated and that such taxes shall constitute a part of the operating overhead of such persons.

To comprehend *Peck*'s effect, some background is useful regarding how that provision has been enforced and interpreted by the Washington Department of Revenue and the Washington courts.

In 2000 the Department of Revenue issued guidance saying that, although the statute did intend that the B&O tax be part of the seller's overhead, it did not prevent a seller from itemizing and showing the effect of the tax on a customer's bill.[39] In effect, the DOR determined that a seller's decision whether to recover the tax from its customers was a business decision by the seller.

However, in *Nelson v. Appleway Chevrolet, Inc.*, the Washington Court of Appeals refused to defer to the DOR and held that an auto dealer's passing onto and collection from customers of the Washington B&O tax violated RCW section 82.04.500.[40] The case involved a situation in which the customer and the automobile dealer agreed to the price for a vehicle and entered into a written agreement that also listed several other fees and taxes, including a charge for the Washington B&O tax. The court concluded that although the economic burden of a

[35]*Id.* at *11.

[36]*Id.* at *12. Having allowed the no direct collection clause to survive, the court also allowed the related penalty provision to survive, but limited its application by saying that the penalty provision may not be applied to enforce the invalidated no stating the tax clause.

[37]On October 22, 2008, the federal district court (Eastern District of Kentucky) entered a Modified Judgement in *AT&T Corp., et al. v. Rudolph* that confirms that the "no direct collection" clause of section 3 does not violate the U.S. Constitution's First Amendment, but that Kentucky is enjoined from enforcing section 3 and from applying the related penalty to prohibit TSPs from using line items in customer bills to recover their costs for the gross revenues tax, so long as the TSPs do not purport to shift the legal incidence of the tax by describing the line item as a direct tax on the customers. Case 3:06-cv-00016-KKC (Oct. 22, 2008).

[38]RCW section 82.04 et seq.

[39]State of Washington Department of Revenue, special notice (Sept. 5, 2000).

[40]121 P.3d 95 (Wash. Ct. App. 2005).

tax is usually passed on to the customer, that does not mean that the Legislature cannot design a statute to set forth the manner in which the passthrough must take place. Although the statute did not expressly address itemization on customer bills, the court interpreted it to mean that the tax could not be separately passed on to the customer, but that the seller had to consider the tax as an operating expense. Therefore, the court held that the B&O tax could be added to operating overhead but could not be passed on to the customer as a tax.[41]

On appeal, the Washington Supreme Court sought to clarify the appeals court's decision by taking a similar but arguably less stringent view of the statute.[42] The supreme court held that the auto dealer's collection of the B&O tax from customers violated RCW section 82.04.500 because the charge for the tax was disclosed *after* the final price had been set. The court interpreted the statute to unambiguously state that the B&O tax is not imposed on customers and is a cost of doing business for the taxpayer vendor. Accordingly, as an overhead cost, the statute required vendors to include the cost of the B&O tax as part of the price of the product sold, not as a charge on top of the price, as in the case of a governmentally imposed sales tax. The court determined that the dealer could disclose or itemize costs associated with the purchased item during the negotiation of or before setting the final purchase price, but it could not add a B&O tax to the final purchase price as one of several fees and taxes after agreement on a final purchase price.[43]

Of particular interest to this article, the court rejected the auto dealer's claim that its First Amendment right to free speech was violated because neither its decision nor the statute *prevented* disclosure or itemization of the B&O tax recovery.[44] The statute was silent about disclosure, and the dealer was free to disclose and itemize any tax or cost before setting a final price. Accordingly, because the Washington statute, unlike the Kentucky statute, did not prohibit but only limited the use of line-item surcharges, *Appleway* is not inconsistent with the federal court decision in *BellSouth* on its face.

The last section of this article discusses the practical and legal questions raised by the requirements for recovering the B&O tax set forth in the *Appleway* decision.

The litigation that would actually lead to the Ninth Circuit Court of Appeals decision in *Peck* proceeded in federal court. While the *Appleway* appeal to the Washington Supreme Court was pending, the federal district court for the Western District of Washington held in three separate but consistent decisions — *Peck v. Cingular Wireless LLC*,[45] *Hesse v. Sprint Spectrum L.P.*,[46] and *Riensche v. Cingular Wireless LLC*[47] — that the language in RCW section 82.04.500 interpreted by the *Appleway* court to restrict the pass-on of the Washington B&O tax in effect constituted a line-item regulation preempted by section 332(c)(3)(A) of the FCA.[48] In those cases, the district court dismissed state law claims

[41]Id. at 104.

[42]*Nelson v. Appleway Chevrolet, Inc.*, 157 P.3d 847 (Wash. 2007).

[43]*Id.* at 851.

[44]*Id.* at 852.

[45]No. C06-343Z, Case 2:06-cv-00343-TSZ (W.D. Wash. Oct. 24, 2006).

[46]No. C06-0592-JCC, 2007 U.S. Dist. LEXIS 3885 (W.D. Wash. Jan. 18, 2007). That case also involved claims by customers for breach of contract and Washington Consumer Act violations by Cingular for allegedly charging a surcharge in addition to the agreed rate and failing to disclose the surcharge before it appeared on customer bills. Those claims were later dismissed by the federal court in *Olsen & Hesse v. Sprint Spectrum LP*, No. C06-0592-JCC, 2008 WL 474063 (W.D. Wash. Feb. 20, 2008). *See also Miller v. Sprint Spectrum LP*, No. C07-59JLR, 2007 WL 4358313 (W.D. Wash. Dec. 6, 2007) (similar customer suit dismissed).

[47]No. C06-1325Z, 2007 WL 906149 (W.D. Wash. March 22, 2007). This case also involved claims by customers for breach of contract and Washington Consumer Act violations by Cingular for allegedly charging a surcharge in addition to the agreed rate and failing to disclose the surcharge before it appeared on customer bills. Those claims were later dismissed by the federal court in *Riensche v. Cingular Wireless LLC*, No. C06-1325Z, 2007 WL 3407137 (W.D. Wash. Nov. 9, 2007).

[48]In 1993 Congress amended the FCA to create a new regulatory class called commercial mobile radio service. 47 U.S.C. section 332(d)(1). That provision states that "no State or local government shall have any authority to regulate the entry of or the rates charged by any commercial mobile service or any private mobile service, except that this paragraph shall not prohibit a State from regulating the other terms and conditions of commercial mobile services." 47 U.S.C. section 332 (c)(3). The amendment granted the federal government exclusive authority to regulate the "rates charged" and "entry" of wireless carriers. But though the states were prohibited from regulating rates or entry, the amendment provided that the states could continue to regulate "other terms and conditions" of wireless service. On March 18, 2005, the FCC issued its order that denied the petition filed by the state consumer advocates and preempted the states from requiring or prohibiting the use of line items on monthly telephone bills by wireless service providers. *In the Matter of Truth-in-Billing and Billing Format; Nat'l Ass'n of State Utility Consumer Advocates' Petition for Declaratory Ruling Regarding Truth-in-Billing*, 20 F.C.C.R. 6448, *6449 (2005) at para. 1. The FCC concluded in its order that "state regulations requiring or prohibiting the use of line items . . . constitute rate regulation and . . . are preempted under Section 332(c)(3)(A) of the Act." After describing line items as a "rate element," the FCC reasoned that the prohibition or requirement of line items "directly affect[s] the manner in which the [wireless service provider] structures its rates." The FCC distinguished the ability of the states to mandate or prohibit line items from the ability to impose taxes, state universal service support charges, and other disclosure laws, which the FCC left undisturbed.

by Cingular's and Sprint's Washington customers that the wireless carriers unlawfully violated RCW section 82.04.500 by passing on the B&O tax as a separate line-item charge on their bills.

Cingular and Sprint argued that the prohibition of a line-item B&O tax recovery by RCW section 82.04.500 constituted rate regulation, which is preempted by the FCA, while the customers argued such prohibition constituted other terms of service, which are within the purview of state regulation under the FCA. The court found the FCA to be unclear and ambiguous as to whether regulation of rates encompasses regulation of line items. But the court determined that the FCC's interpretation of rates in the FCC wireless order — that is, that state regulations requiring or prohibiting the use of line items constitute rate regulation — was entitled to deference under the U.S. Supreme Court's standard for deference set forth in *Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*[49] The court said that it did not matter that the B&O tax is a tax of general applicability rather than a tax imposed specifically on wireless service carriers, because the FCC's edict preempted even a generally applicable law that seeks to regulate line items.

The district court in those decisions also recognized but disagreed with the Eleventh Circuit Court of Appeals decision in *National Ass'n of State Utility Consumer Advocates v. FCC* (*NASUCA*).[50] The *NASUCA* court held that the FCC exceeded its authority under section 332(c)(3)(A) of the FCA when it issued the FCC wireless order preempting states from regulating the use of line items in customer billing for cellular wireless services. Specifically, the court found that the language of section 332(c)(3)(A) unambiguously preserved the ability of the states to regulate the use of line items in cellular wireless bills.[51] The Washington district court in *Peck* pointedly disagreed with that finding, saying that a line item is one of the charges a wireless customer pays in order to receive service, and that a "rate" could refer to the total amount a customer pays for service.[52]

[49]467 U.S. 837 (1984).

[50]457 F.3d 1238 (11th Cir. 2006), *cert. den., Sprint Nextel Corp. v. NASUCA*, 128 S. Ct. 1119 (U.S. 2008).

[51]457 F.3d at 1254 (citations omitted). According to the *NASUCA* court, the prohibition or requirement of a line item affects the presentation of the charge on the user's bill, but it does not affect the amount that a user is charged for service. State regulations of line items regulate the billing practices of cellular wireless providers, not the charges that are imposed on the consumer. Because the presentation of line items on a bill is not a "charge or payment" for service, the court concluded that it is an "other term or condition" regulable by the states.

[52]No. C06-343Z, Case 2:06-cv-00343-TSZ (W.D. Wash. Oct. 24, 2006).

On appeal, the Ninth Circuit Court of Appeals in *Peck v. Cingular Wireless, LLC*, vacated the district court's decision.[53] First, the court determined that the district court was wrong not to follow the Eleventh Circuit Court of Appeals decision in *NASUCA*, which the Ninth Circuit concluded was binding both within and outside the Eleventh Circuit regarding the validity of the FCC wireless order.

The Ninth Circuit said that when federal agency rules are challenged in more than one court of appeals, 28 U.S.C. section 2112 requires that the petitions be consolidated and assigned to a single circuit, which becomes and remains the sole forum for addressing the validity of those rules. In this instance, because the FCC's order was initially challenged in both the Second and Eleventh Circuits, the challenges were consolidated and assigned to the Eleventh Circuit, which held that the order was invalid. As a result, the Ninth Circuit ruled that "there is no FCC ruling on the issue of whether 'rates' include line-item charges" to which the district court could have deferred.[54]

In the absence of any FCC interpretation of FCA section 332(c)(3)(A), the Ninth Circuit agreed with the Eleventh Circuit's determination in *NASUCA* that the statute's use of the term "rates" does not comprehend how line items are displayed or presented on wireless consumers' bills.[55] As to the Washington statute at issue, the court noted that RCW section 82.04.500 does not purport to dictate how much businesses may charge for their goods or services, but that Cingular remains free to charge its customers as much, or as little, as the market will bear.

Rather, as interpreted by the Washington Supreme Court in *Appleway*, the statute, according to the Ninth Circuit, simply structures the contract's negotiation and disclosure of the B&O tax recovery, and therefore acts as a consumer protection statute — that is, regulating the method of disclosure, rather than the reasonableness or propriety of the underlying rate.[56] Consequently, the Ninth Circuit found that RCW 82.04.500 is a measure within the state's purview to regulate other terms and conditions rather than rates under the FCA, and held that the FCA does not preempt state claims brought under RCW 82.04.500.[57] The court remanded the case back to the federal district court to determine whether the court still had subject matter jurisdiction over these customer claims.

[53]535 F.3d 1053 (9th Cir. Wash. 2008).

[54]*Id.* at 1057.

[55]*Id.*

[56]*Id.* at 1058.

[57]*Id.*

Legal and Practical Issues Raised by the Decisions

Despite the various holdings of the courts discussed in this article, a recurrent theme throughout those decisions appears to be that, short of actually prohibiting the use of line-item charges to recover gross receipts taxes, states may enact or enforce state laws (such as consumer protection statutes) or employ federal rules or laws (such as truth in billing) to limit the manner in which those line-item charges are applied. The *BellSouth* court made clear that Kentucky had several alternatives that it could have considered to regulate the use of those line-item charges, and the *Peck* court endorsed the *Appleway* rationale in Washington to similarly limit how and when line-item charges could be used to recover taxes.

Other examples include a Connecticut law requiring that all telecommunications service bills "only label a charge as a tax if such tax is directly assessed by the taxing entity on the customer through the telecommunications company, which tax shall appear as a separate charge on such bill."[58] Similarly, pending in Congress is a bill, S. 2033 (introduced September 27, 2007), that would require wireless carriers to set forth all taxes and fees required by a federal, state, or local statute or regulation, and no other charges or fees, in a separate section of each bill sent to a subscriber, and itemized separately.[59]

> ***Neither the state court in* Appleway *nor the federal court in* Peck *provides much guidance regarding when a final price is actually set, particularly in the case of TSPs.***

But the Washington Supreme Court's decision in *Appleway* represents the highest state court precedent to date regarding the limits placed on vendors to pass through a gross receipts tax expense to customers. Can the example of the Washington statute and the *Appleway* decision and rationale be exported to other jurisdictions as a means to limit (without prohibiting) the recovery of other gross receipts taxes by a line-item charge on customer bills? The *Peck* court, at least regarding the Washington B&O tax, was skeptical about Cingular's arguments that requiring businesses to quote prices on a tax-inclusive basis would necessarily mislead consumers or conceal the effect of the state's tax on their rates. The court was satisfied that Cingular remains free to disclose, during negotiation or on customers' bills before a final purchase price is set, how much of that final purchase price is attributable to the B&O tax under *Appleway*.[60]

However, neither the state court in *Appleway* nor the federal court in *Peck* provides much guidance regarding when a final price is actually set, particularly in the case of TSPs. In fact, in a strong dissent in *Appleway*, a minority of the court criticized the majority for turning a fairly simple statute into a complex and ultimately unworkable decision barring sellers from passing on overhead tax costs to their customers unless they expressly negotiate the particular part of overhead as part of the price.[61]

The *Appleway* court appears to indicate that the point when an "agreement on a final purchase price" is reached constitutes the point after which no surcharge can legitimately be added to the final price. However, the court noted that the vendor's written contract disclosed at four places, and the purchaser acknowledged, that the B&O tax was being passed through. But the court does not explain how those facts do or do not enter into the determination when the final price is set, nor does the court explain why the final price was reached (presumably orally) outside the written contract.[62] Perhaps the court viewed the language in the contract as confirming that the B&O tax charge was added to the final sales price that had already been set and agreed to in a legally binding oral contract.

The *Appleway* court offers even less guidance as to when a final price is set for businesses engaged in service transactions. For example, in transactions such as the purchase of telecommunications service by consumers, in which there is seemingly no negotiation regarding the price of the service, the point when the final price is set appears more difficult to ascertain than in the sale of an article of tangible personal property. Historically, for most consumer telecommunications purchases, the consumer was deemed to be bound by tariffs filed with regulatory agencies that listed the carrier's terms, conditions, and prices.[63] In recent years, with the deregulation of TSPs, the legal requirement of filing a tariff has been largely eliminated for most services, though many states continue to follow the doctrine of constructive notice, whereby customers of service providers are deemed to be provided with at least notice

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[58]Conn. Gen. Stat. section 16-256j (2008).

[59]S. 2033, 110th Cong. section 5.

[60]535 F.3d at 1058, n. 2.

[61]157 P.3d at 856-857.

[62]Under section 2-305 of the Uniform Commercial Code, parties can conclude a binding contract for the sale of goods even without having agreed on price. *See, e.g.*, RCW section 62A.2-305.

[63]*New York, New Haven & Hartford Railroad Co. v. Interstate Commerce Comm'n*, 200 U.S. 361 (1906).

of the terms and conditions contained in published contracts of the service provider.[64]

In the case of most tariffs and published contracts, the general price of each service is listed along with the description of the corresponding service, while applicable additions to that price are listed in a section of the contract usually labeled "fees and surcharges." The fees and surcharges section of the contract, in many cases, says that the fees and surcharges listed are a part of the price of the service purchased. Suppose that the price of the service (in the TSP's advertising and the terms and conditions section of its published contract) is identified as $29.95 per month, and the fees and surcharges section of the contract provides that there is an additional 6 percent surcharge of a tax expense. Under *Appleway*, is the final price $29.95 or $31.75 ($29.95 + 6 percent)? In other words, does the advertised price of $29.95 trump the contract language including the surcharge for purposes of determining the *Appleway* negotiated price?

What level of specificity of the tax charge set forth in the advertising or published contract is sufficient to make the tax charge part of the final price?

In the absence of judicial guidance, many other questions abound regarding the *Appleway* test. Would changing the advertising to note that additional fees and surcharges apply affect the determination of the *Appleway* negotiated price? Could a vendor forgo changing its advertising but make it clear (on its Web site?) before the customer actually signs up for the service that the price for the service includes a tax surcharge? Moreover, what level of specificity of the tax charge set forth in the advertising or published contract is sufficient to make the tax charge part of the final price? Must there be disclosure of the actual amount of each tax surcharge or only that some amount or percentage of a tax surcharge enters into the setting of the final price?

Although states may have the legal right to limit when and how vendors can apply line-item charges to recover taxes, states and taxpayers alike need to consider and address more carefully the many practical and business issues, such as those raised above, before proceeding in that direction. ✰

[64]C.H. Helein, J. Marashlian, and L. Haddad, "Detariffing and the Death of the Filed Tariff Doctrine: Deregulating in the 'Self' Interest," 54 *Fed. Comm. L.J.* 281 (2002).