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

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Two recent federal Court of Appeals decisions, *BellSouth Telecommunications, Inc. v. Farris* ("*BellSouth*")[1] and *Peck v. Cingular Wireless, LLC* ("*Peck*"),[2] provide guidance regarding the restrictions imposed upon states to prevent or limit vendors from recovering their gross receipts tax costs through the use of line item surcharges on customer bills. Cumulatively, these decisions appear to signify that states cannot prohibit vendors from disclosing or recovering tax costs from their customers by line item charges, but that states do have leeway to prescribe when and how such line item customer charges can be applied.

In addition to examining the above-referenced decisions, this article summarizes the history and development of line item surcharges and addresses several of the legal and practical questions facing taxpayers and states regarding the implementation and enforcement of possible government limitations upon vendors seeking to recover their tax costs.

**Background**

Public utilities, including telecommunications service providers ("TSPs"), have for decades borne the principal liability for state and local gross receipts taxes nationwide. Relying upon authority granted by the Federal Communications Commission ("FCC"), TSPs have included on their monthly billing statements a separate line item charge to recover these gross receipts taxes from customers located in the respective state or local jurisdictions imposing the applicable taxes or fees.[3] This line item charge serves two important purposes. First, because gross receipts taxes generally are imposed upon the vendor or service provider, vendors are not permitted to collect the tax directly from their customers (like a sales tax). Instead, providers who do not wish to simply increase the base price of the service (or TSPs that do not wish 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 to protect customers outside the taxing state from bearing the burden of an exported tax.

Employment of the surcharge by TSPs contributed to the reduced number of states imposing telecommunications gross receipts taxes, from almost thirty states in 1986 to only about ten 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.[4] These impositions have included the adoption of such taxes in Ohio,[5] Texas,[6] Michigan,[7] Pennsylvania,[8] and Kentucky.[9] Like TSPs, general business vendors naturally will seek to recover their tax expenses in some manner from their customers. However, a few of the states that have enacted such taxes have also sought to restrict or prohibit the recovery of such tax costs through the use of line item surcharges or similar entries on customer bills. *BellSouth* and *Peck* 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 by using line item charges.

***BellSouth Telecommunications, Inc. v. Farris***

In *BellSouth Telecommunications, Inc. v. Farris*, the United States Court of Appeals for the Sixth Circuit held that a Kentucky statutory provision that prohibited TSPs subject to a gross receipts tax from both collecting the tax directly from customers and stating the tax as a line item charge on customer bills violated the First Amendment of the United States Constitution.[10]

In 2005, Kentucky enacted a new gross revenues tax on communications and video service providers.[11] 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, Kentucky Revised Statues Annotated ("KRS") section 136.616(3) ("Section 3") stated:

> "The ***provider shall not*** collect the tax directly from the purchaser or ***separately state the tax on the bill to the purchaser***."[12]

The court first addressed the "not stating the tax" portion of the statute. Applying the constitutional test applicable to commercial speech, the court concluded that the statute regulates speech, not conduct, as it prohibits providers from stating the tax on the bill. While the court accepted that Kentucky has a substantial interest in avoiding potential consumer confusion about whether consumers, rather than providers, bear legal responsibility for the tax, the court concluded that the statute did not directly advance the Commonwealth's interest because the Commonwealth allowed providers to tell their customers anything about the tax, no matter how confusing, in all settings (e.g., in advertisements or on billing inserts) *except* on a customer invoice. Finally, the court concluded that the statutory prohibition was over-inclusive in that such a ban was more extensive than necessary to serve the Commonwealth's interest in preventing customer confusion over legal liability for the tax. The court stressed that regulating speech must be a last—not first—resort, and noted that Kentucky had a "full arsenal of options," short of restricting speech, to address such customer confusion. On this basis, the court held that the "not stating the tax" clause violated the First Amendment and must be struck.

The court then addressed the "no direct collection" clause. The court found that the terms of this clause referred to non-expressive conduct, not speech, and as a result lay beyond the protection of the First Amendment, and allowed it to survive. Arguably, this determination potentially diluted the effect of the court's First Amendment holding, as Kentucky could have taken the position that the surviving provision prevented not only the collection of the tax *as a tax* but also any collection of a tax reimbursement. Recognizing this potential result, the district court, on remand, issued a Modified Judgment confirming that the "no direct collection" clause of Section 3 did not violate the First Amendment, but that Kentucky was 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. As a condition, TSPs must not purport to shift the legal incidence of the tax by describing the line item as a direct tax on the customers themselves.[13]

The *BellSouth* decision would appear to prevent Kentucky, as well as other states 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 bills. It also affords a strong legal basis for all gross receipts taxpayers, not just telecommunications companies, to recover their tax costs in this manner. However, the *BellSouth* decision does not necessarily resolve the issue of whether states can legally limit howor when taxpayers may recover their tax costs through the use of these line item surcharges. To the contrary, the *BellSouth* decision strongly suggests that states have a legitimate interest in not misleading customers about their liability for gross receipts taxes imposed upon businesses. Thus, states arguably have the right to enact less-stringent measures that only protect consumers from misleading information and that limit the use of line item surcharges in ways that do not run afoul of the United States Constitution. Such a 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 the *Peck* decision.

***Peck v. Cingular Wireless***

In Washington State, Revised Code of Washington ("RCW") section 82.04.500 has been long considered a barrier to a direct recovery by vendors of the long-standing Washington business and occupation ("B&O") tax from their customers. This provision provides that:

[i]t 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.

In *Peck v. Cingular Wireless*, the Court of Appeals for the Ninth Circuit considered state law claims brought by wireless carrier customers alleging that the carriers had violated RCW § 82.04.500.[14]

The *Peck* court first addressed whether an FCC Order, which ruled that state laws prohibiting or restricting the use of line items to recover taxes constitute rate regulation preempted by the Federal Communications Act ("FCA"),[15] was entitled to deference. The Court of Appeals for the Eleventh Circuit previously had determined that the FCC Order was invalid in *National Ass'n of State Utility Consumer Advocates v. FCC* ("*NASUCA*"),[16] on the grounds that the FCC had exceeded its authority under Section 332(c)(3)(A) of the FCA when enacting the Order. The Ninth Circuit Court held that the district court was wrong not to follow the *NASUCA* decision, which the Ninth Circuit determined was binding both within and without the Eleventh Circuit.[17] In the absence of any valid FCC interpretation, the court agreed with the Eleventh Circuit's determination in *NASUCA* that the use of the term "rates" in FCA § 332(c)(3)(A) does not comprehend how line items are displayed or presented on wireless consumers' bills, but rather such practices constitute terms and conditions permitted by the FCA to be regulated by the states.

As to the Washington statute at issue, RCW § 82.04.500, the court concluded that, as interpreted by the Washington Supreme Court in *Nelson v. Appleway Chevrolet, Inc*.,[18] the statute simply structures the contract's negotiation and disclosure of the B&O tax recovery and therefore acts as a consumer protection statute. *Appleway* involved a situation where the customer and 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 held that the auto dealer's collection of the B&O tax from customers violated RCW § 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 the B&O tax was 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 an additional 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 upon a final purchase price.[19]

The *Peck* court thus concluded that the FCA does not preempt state claims brought pursuant to RCW § 82.04.500 because the statute regulates the disclosure, and not the reasonableness or propriety, of the underlying rates.[20] The court then remanded the case back to the federal district court to determine whether the court still had subject matter jurisdiction over these customer claims.

**Legal and Practical Issues Raised by the Decisions**

A recurrent theme throughout the decisions discussed above 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 the FCC's truth-in-billing rules) to limit the manner in which such line item charges are applied. The *BellSouth* court made it clear that Kentucky had several alternatives that it could have considered to regulate the use of such 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.

The *Appleway* decision by the Washington Supreme Court represents the highest state court precedent to date regarding the limits placed on vendors passing 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? If so, the *Appleway* court appears to indicate that the point in time at which 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 does not provide much guidance as to when a "final price" is actually set, particularly in the case of TSPs. For example, 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 why the "final price" was reached (presumably orally) outside of that written contract.

The *Appleway* court offers even less guidance as to when a final price is set for businesses engaged in service transactions. In transactions such as the purchase of telecommunications service by consumers, where there is seemingly no "negotiation" regarding the price of the service, the point in time at which the final price is set appears more difficult to ascertain than in the sale of an article of tangible personal property. For example, in the case of most published contracts for telecommunications services, the general price of each service is listed along with the description of the corresponding service, while applicable additions to such prices are listed in a section of the contract usually labeled "Fees and Surcharges." 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% surcharge of a tax expense. Under *Appleway*, is the "final price" $29.95 or $31.75 ($29.95 + 6%)? 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?

The other major issue raised but left unanswered by the *Appleway* test concerns the manner of disclosing the tax surcharge. In the absence of judicial guidance, many questions abound. Would changing the advertising to note that "additional fees and surcharges" apply impact the determination of the *Appleway* negotiated price? Could a vendor eschew changing its advertising but make it clear (on its website?) before the customer actually signs up for the service that the price for the service includes a tax surcharge? Moreover, what level of specificity for the tax charge set forth in the advertising or published contract is sufficient for the change to become part of the final price? Must the actual amount of each tax surcharge be disclosed, or only the fact that some amount or percentage of a tax surcharge enters into the setting of the final price?

As can be seen, while 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.

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**Footnotes**

[1] 542 F.3d 499, (6th Cir. 2008).

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

[3] The FCC since 1986 has 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. The FCC's position 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 non-residents via rates for interstate telephone service. *Conn. Office of Consumer Counsel v. FCC*, 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 at ¶ 12 (1996).

[4] *See generally 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.

[5] Ohio Commercial Activity Tax ("CAT"), Ohio Rev. Code Ann. § 5751.01 *et seq*.

[6] Texas Margins Tax, Tex. Tax Code Ann. § 171.0001 (2008) *et seq*.

[7] Michigan Business Tax, Mich. Comp. Laws Serv. § 208.1101 (2008).

[8] 72 Pa. Stat. Ann. § 8101 (2008) *et seq*.

[9] Ky. Rev. Stat. Ann. ("KRS") § 136.600 (2008) *et seq*.

[10] *AT&T Corp. v. Rudolph*, Civil Action 06-16, 2007 WL 647564 (E.D. Ky. 2007); *BellSouth Telecommunications, Inc. v. Farris*, Civil Action 3:06-39, 2007 WL 647561 (E.D. Ky. 2007).

[11] KRS § 136.600 et seq.; 2005 Ky. Acts 168.

[12] The General Assembly then amended KRS § 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, § 11.

[13] *AT&T v. Rudolph*, Case 3:06-cv-00016-KKC (E.D. Ky. Oct. 22, 2008).

[14] *Peck v. Cingular Wireless LLC*, No. C06-343Z, Case 2:06-cv-00343-TSZ (W.D. Wash. Oct. 24, 2006).

[15] In 1993, Congress amended the FCA to create a new regulatory class called "commercial mobile radio service." 47 U.S.C. § 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. § 332(c)(3). On March 18, 2005, the FCC issued its Order that preempted the states from requiring or prohibiting the use of line items on monthly telephone bills by wireless service providers. *Nat'l Ass'n of State Utility Consumer Advocates' Petition for Declaratory Ruling Regarding Truth-in-Billing, In the Matter of Truth-in-Billing and Billing Format*, 20 F.C.C.R. 6448, 6449 at ¶ 1, 6461 at ¶ 27 (2005) (the "*FCC Wireless Order*").

[16] 457 F.3d 1238 (11th Cir. 2006), *cert. denied, Sprint Nextel Corp. v. NASUCA*, 128 S. Ct. 1119 (2008).

[17] The court explained that when federal agency rules are challenged in more than one court of appeals, as was the case in *NASUCA*, 28 U.S.C. § 2112 requires that the petitions be consolidated and assigned to a single Circuit, which thereby becomes and remains the sole forum for addressing the validity of such rules. In this instance, the challenges were consolidated and assigned to the Eleventh Circuit, which held that the FCC's Order was invalid.

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

[19] *Id*. at 851. 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. The statute was silent about disclosure, and the dealer was free to disclose and itemize any tax or cost prior to 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, the *Appleway* decision is not inconsistent with the *BellSouth* decision. 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.

[20] *Id*.