COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C010612B

On June 12, 2001, a Petition for Advisory Opinion was received from PricewaterhouseCoopers LLP, 1301 Avenue of the Americas, 7th Floor, New York, New York 10019. Petitioner, PricewaterhouseCoopers LLP, submitted additional information with respect to the Petition on November 30, 2001.

The issues raised by Petitioner are:

1. Whether receipts received by X Company under its reciprocal compensation arrangements with competitive local exchange carriers ("CLEC") qualify for a sale-for-resale exclusion under section 186-e of the Tax Law.

2. Whether X Company's receipts from its reciprocal compensation arrangements are receipts from telecommunication services subject to the tax imposed under section 184 of the Tax Law.

Petitioner submits the following facts as the basis for this Advisory Opinion.

X Company ("X") is a non-facilities-based CLEC that is registered with the New York State Public Service Commission ("PSC"). Petitioner states that X is a reseller of local and enhanced telecommunication services primarily to enhanced service providers ("Customers"), including Internet service providers ("ISP") and Voice Information Providers ("IP") located in selected markets in the United States.

X's receipts at issue are from reciprocal compensation arrangements for the provision of (1) dedicated access lines between CLECs' switches and X's Customers' equipment (audiotex programs and servers) and (2) collocation services that allow X's Customers to collocate their equipment on racks at a CLEC's office.

Petitioner states that "reciprocal compensation" refers to an arrangement between two local exchange carriers where the first carrier (typically an incumbent local exchange carrier or "ILEC") compensates the second carrier (typically a CLEC) for the transport and termination, on the CLEC's network facilities, of calls originating on the ILEC's facilities. In other words, when a user on one carrier's network makes a local call to a user on a second carrier's network, the first carrier must pay the second carrier for terminating that call. Typically, such compensation is based on minutes of use per call. These arrangements are of relatively recent origin, originating under the Federal Telecommunications Act of 1996. (See, 47 USC §252(d)(2). Also see, PSC Opinion No. 99-10, Case 99-C-0529 - Proceeding On Motion of the Commission to Reexamine Reciprocal Compensation (issued August 26, 1999), pp. 3-10.)

Petitioner states that the PSC requires that when an ILEC's customer initiates a call that terminates on a CLEC's network, the originating ILEC must compensate the terminating CLEC for the transport and termination of the call pursuant to an interconnection agreement (i.e., reciprocal compensation arrangement.) Due to the regulatory nature of reciprocal compensation, the ILEC must compensate the CLEC or X for terminating a call based on the rates established by the PSC. The ILEC compensates the CLEC or X automatically (i.e., an invoice is not issued for services).

Petitioner has set forth the mechanics of a reciprocal compensation sharing arrangement in the following example:

1. An ISP's subscriber (i.e., the end-user) dials a local number to connect to the ISP's server. This call originates with the ILEC.

2. The ILEC then routes the call to the ISP in one of three ways:

    (a) through X's switches and dedicated access lines connected to the ISP's server;

    (b) through a CLEC's switch and then through X's dedicated access lines to the ISP's server; or

    (c) through a CLEC's switch terminating at the ISP's server collocated at the CLEC offices pursuant to an agreement with X.

It should be noted that under scenario 2(a) the ILEC pays reciprocal compensation directly to X, whereas under scenarios 2(b) and(c) X and CLEC share the reciprocal compensation paid by the ILEC.

X has exclusive reseller agent agreements for its services with three other CLEC's. Under these agreements, the CLECs allow X to collocate certain electronic and computer equipment at the CLECs' offices. CLECs place a long distance block on all lines assigned to X's Customers. Accordingly, X and its Customers are liable for basic local access line or trunk charges only. CLECs appoint X as their exclusive sales/reseller agent for services provided for X's Customers (ESP services). In return, X agrees to provide CLECs exclusive rights to handle X's traffic in a given market. All traffic generated by X's equipment or X's Customers' equipment occurs within the same Local Access Transport Area ("LATA").

These agreements provide that X shares in the CLECs' reciprocal compensation received from ILECs for traffic terminated by CLECs to either X's equipment or X's Customers' equipment.

CLECs pay X reciprocal compensation based on usage by ISPs and IPs at rates determined by the agreements. X's products generate very large volumes of inbound traffic and no outbound traffic. Accordingly, the CLECs, and consequently X, receive much more in reciprocal compensation than they pay out. X's receipt of the reciprocal compensation is contingent upon the other CLECs receiving the reciprocal compensation payments from ILECs. CLECs usually pay X on an installment basis, dependent upon how much reciprocal compensation the CLECs collect from ILECs. X also enters into some agreements directly with originating ILECs. X's share of reciprocal compensation represents approximately 80 percent of X's total revenues in each year since 1997.

Petitioner states that absent the reciprocal compensation requirement, X would simply bill the CLEC or ILEC, as the case may be, for connecting calls to an ISP's server that are initiated by ISP's subscribers. X would receive a resale certificate from the CLEC or ILEC since the services X provides are telecommunication services that are subsequently resold as telecommunication services.

Discussion

Issue 1

Section 186-e.2(a) of the Tax Law imposes an excise tax on "the sale of telecommunication services by any person which is a provider of telecommunication services ...." The tax is imposed on gross receipts from: (1) any intrastate telecommunication services; (2) any interstate and international telecommunication services (other than interstate and international private telecommunication services) which originate or terminate in New York State and which telecommunication services are charged to a service address in New York State, regardless of where the amounts charged for such services are billed or ultimately paid; and (3) interstate and international private telecommunication services, the gross receipts of which are apportioned as prescribed in section 186-e.3 of the Tax Law.

Section 186-e.1(g) of the Tax Law defines "telecommunication services"as "telephony or telegraphy, or telephone or telegraph service, including, but not limited to, any transmission of voice, image, data, information and paging, through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar media or any combination thereof and shall include services that are ancillary to the provision of telephone service ...."

Section 186-e.1(e) of the Tax Law defines "provider of telecommunication services" as "any person who furnishes or sells telecommunications services regardless of whether such activities are the main business of such person or are only incidental thereto...."

Section 186-e.2(b)(1) of the Tax Law provides that there shall be excluded from the tax imposed by section 186-e of the Tax Law the sale of telecommunication services to a provider of telecommunication services which is an interexchange carrier or a local carrier where such services are purchased by such provider for resale as telecommunication services to its purchasers. In order to qualify for this exclusion, the purchaser must sell the purchased telecommunication services as telecommunication services. Moreover, the purchaser must be an interexchange carrier or local carrier. Pursuant to Technical Services Memorandum TSB-M-95(3)C, December 13, 1995, a provider may accept a *Certificate of Public Convenience and Necessity* issued by the PSC as evidence that a carrier is eligible for the resale exclusion. Also, see New York State Department of Taxation and Finance Publication 41(12/95) *Treatment of Sales-for-Resale Under Section 186-e of the Tax Law* for a list of local carriers, interexchange carriers, and facilities-based cellular common carriers eligible for the sale-for-resale exclusion as of November 1995.

Section 186-e.1(b)(1) of the Tax Law defines "interexchange carrier" as "any provider of telecommunication services between two or more exchanges that qualifies as a common carrier. Common carrier means any person engaged as a common carrier for hire in intrastate, interstate or foreign telecommunication services."

Section 186-e.1(b)(2) of the Tax Law provides that a "local carrier" means any provider of telecommunication services for hire to the public, which is subject to the supervision of the PSC and is engaged in providing carrier access service to a switched network. For the sole purpose of the application of the sale for resale exclusion under section 186-e.2(b) of the Tax Law, a reference to an "interexchange carrier" or "local carrier" shall include a cellular common carrier which is a facilities-based cellular common carrier without regard to a determination of whether such carrier is providing local or interexchange service as such.

In this case, X is a CLEC and registered with the PSC. The receipts X derives from the reciprocal compensation arrangements are similar to traditional sales of telecommunications services for resale. Pursuant to section 186-e.1(g) of the Tax Law, X provides telecommunication services for an ILEC consisting of the transport and termination of calls originating on the ILEC's facilities. The ILEC charges its customers for the entire call, that is, for originating, transporting and terminating the call, and X receives a portion of the ILEC's receipts as compensation for X's transport and termination of the call. The sharing of reciprocal compensation between X and another CLEC does not change the underlying characteristics of the transactions which are the provision of telecommunications services for resale pursuant to section 186-e.2(b)(1) of the Tax Law.

Accordingly, pursuant to section 186-e.2(b)(1) of the Tax Law, the receipts received by X under its reciprocal compensation arrangements with CLECs and ILECs qualify for the sale-for-resale exclusion and are not subject to the tax imposed under section 186-e of the Tax Law.

<u>Issue 2</u>

Section 184.1 of the Tax Law provides that a corporation is subject to the additional franchise tax under section 184 for the privilege of exercising its corporate franchise, doing business, employing capital, owning or leasing property in a corporate or organized capacity or maintaining

an office, in New York State, if it is formed for or principally engaged in the conduct of local telephone business.

Section 184.1 of Article 9 of the Tax Law, provides that the term "local telephone business" means the provision or furnishing of telecommunication services for hire wherein the service furnished by the provider thereof consists of carrier access service or the service originates and terminates within the same LATA. It also provides that the term "telecommunication services" has the same meaning for purposes of section 184 as for section 186-e of the Tax Law.

In this case, X provides telecommunication services as described in section 186-e.1(g) of the Tax Law. Petitioner states that all traffic generated by X's equipment or X's Customers' equipment occurs within the same LATA. Accordingly, X's receipts from reciprocal compensation arrangements with CLECs and ILECs are receipts from the provision of a local telephone business under section 184.1 of the Tax Law. Since approximately 80 percent of X's receipts each year, since 1997, are from such local telephone business, such receipts are subject to the tax imposed under section 184 of the Tax Law.

DATED: July 8, 2002

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