



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE ENROLLED BILL ANALYSIS**

Date Amended:	Enrolled	Bill No:	SB 1040
Tax:	Emergency Telephone Users Surcharge	Author:	Kehoe
Related Bills:	SB 1024 (Kehoe) AB 231 (Eng)	Position:	Support

BILL SUMMARY

Among other things, this bill would make the following changes to the Emergency Telephone Users (911) Surcharge Act:¹

- Clarify the definition of “toll telephone service.”
- Impose the 911 surcharge on amounts paid by every person in the state for Voice over Internet Protocol (VoIP) service.

ANALYSIS

“Toll Telephone Service” Definition
Revenue and Taxation Code Section 41016

CURRENT LAW

Emergency Telephone Users (911) Surcharge Act

Under existing law, Section 41020 of the Revenue and Taxation Code imposes a surcharge on amounts paid by every person in the state for intrastate telephone communication services. The current surcharge rate is 0.50 percent of the amounts paid for intrastate telephone services in this state. The surcharge is paid to the Board of Equalization (Board) and deposited in the State Treasury to the credit of the State Emergency Telephone Number Account in the General Fund. The funds in this account are used to pay for the costs of administration of the 911 emergency telephone number system.

Section 41010 defines intrastate telephone communication services to mean all local or toll telephone services where the point or points of origin and the point or points of destination of the service are all located in this state.

Section 41015 defines “local telephone service” to mean both of the following:

- (a) The access to a local telephone system, and the privilege of telephonic quality communication with substantially all persons having telephone or radiotelephone stations constituting a part of the local telephone system.
- (b) Any facility or service provided in connection with a service described in subdivision (a).

The term "local telephone service" does not include any service which is a "toll telephone service" or a "private communication service."

¹ Part 20 (commencing with Section 41001) of Division 2 of the Revenue and Taxation Code.

Section 41016 defines “toll telephone service” to mean:

- (a) A telephonic quality communication for which (1) there is a toll charge which varies in amount with the distance and elapsed transmission time of each individual communication and (2) the charge is paid within the United States, and
- (b) A service which entitles the subscriber, upon payment of a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), to the privilege of an unlimited number of telephonic communications to or from all or a substantial portion of the persons having telephone or radiotelephone stations in a specified area which is outside the local telephone system area in which the station provided with this service is located.

Section 41021 requires every service supplier to collect the surcharge from each service user at the time it collects its billing from the service user. A service provider is defined in Section 41007 to mean any person supplying intrastate telephone communication services pursuant to California intrastate tariffs to any service user in this state. The term also includes any person supplying intrastate telephone communications services for whom the California Public Utilities Commission (CPUC), by rule or order, modifies or eliminates the requirement for that person to prepare and file California intrastate tariffs.

Federal Law

Under existing federal law, an excise tax is imposed on amounts paid for communications services. The term “communication services” is defined to mean, in part, local telephone service and toll telephone service. “Toll telephone service” is defined in Section 4252(b) of Title 26 of the United States Code to mean:

1. A telephonic quality communication for which (A) there is a toll charge which varies in amount with the distance **and** elapsed transmission time of each individual communication and (B) the charge is paid within the United States, and
2. A service which entitles the subscriber, upon payment of a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), to the privilege of an unlimited number of telephonic communications to or from all or a substantial portion of the persons having telephone or radio telephone stations in a specified area which is outside the local telephone system area in which the station provided with this service is located.

The federal excise tax on telephone services is administered and collected by the Internal Revenue Service (IRS).

PROPOSED LAW

This bill would amend Section 41016 to revise the definition of “toll telephone service” to clarify that (1) either of the services described in subdivisions (a) and (b) constitutes a “toll telephone service,” (2) toll charges may vary in amount with either the distance or elapsed transmission time, or the distance and elapsed transmission time, of each individual communication, and (3) subdivision (b) includes flat rate service plans with a fixed number of minutes.

As an urgency measure, these provisions would become effective immediately.

IN GENERAL

According to the Department of General Services (DGS) staff, there are 475 official public safety answering points (PSAPs) that are funded by the 911 surcharge. PSAPs include primarily law enforcement agencies, such as local police and sheriff departments, and fire departments. The 911 surcharge revenues pay for all of the network and infrastructure that support 911 services, and ongoing support for refreshing equipment, the network, and database information that appears at each site when someone calls “911.” The 911 surcharge rate is currently set at 0.50 percent, the lowest rate allowed by statute, which is expected to produce approximately \$100 million for the 2007/08 fiscal year.

Toll telephone service. With the advent of telephone services where the charges vary based only on the elapsed time, and not on the distance between the caller and the recipient of the call, questions arose as to whether such services constituted “toll” services under the federal definition. A number of cases were brought to challenge the imposition of the federal excise tax on these services. Five federal appellate courts agreed with the claimants that the tax could not be imposed on the charges for these services because, since the charges for the services did not vary with the distance of the call, the services did not come within the federal definition of toll telephone services, nor did they constitute local telephone services. (*American Bankers Insurance Group v. United States* (11th Cir. 2005) 408 F.3d 1328; *OfficeMax, Inc. v. United States* (6th Cir. 2005) 428 F.3d 583; *National Railroad Passenger Corp. v. United States* (D.C.Cir. 2005) 431 F.3d 374; *Fortis, Inc. v. United States* (2d Cir. 2006) 447 F.3d 190; and *Reese Brothers, Inc. v. United States* (3d Cir. 2006) 447 F.3d 229.)

The courts held that, with respect to the definition of “toll telephone service” as provided in Section 4252(b)(1)(A) of the United States Code, the word “and” (emphasized above) is used “conjunctively” and could not be construed to be used “disjunctively” to mean “or.” Neither the Ninth Circuit nor the U.S. Supreme Court has issued an opinion on this legal issue.

On May 25, 2006, the IRS announced that it would stop collecting the federal excise tax imposed on long-distance telephone service. In addition, the IRS published IRS Notice 2006-50 (see http://www.irs.gov/irb/2006-25_IRB/ar09.html), which provided the background and basis for its decision and the rules for obtaining refunds of federal excise tax paid during the period March 1, 2003, through July 31, 2006.

BACKGROUND

In 2001, Assembly Bill 1458 (Kelley) would have revised the Emergency Telephone Users Surcharge Law to instead impose a surcharge upon service users for each access line for each month a service user subscribes or contracts with the service

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

supplier. This Board-sponsored measure was intended to simplify the application of the surcharge for service suppliers by eliminating the complicated calculations and interpretations of what charges are subject to the 911 surcharge. That bill was amended to remove these provisions before the bill was heard in its first policy committee.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the DGS and is intended to change the definition of “toll telephone service” to include time or distance in addition to time and distance, in response to the IRS ruling which announced that, under the current federal definition, toll charges are not subject to the federal excise tax.
2. **Has the state’s definition of “toll telephone service” been challenged?** As of the date of this analysis, neither the federal Ninth Circuit Court of Appeals nor any California state court of appeals has addressed the subject of the state’s definition of “toll telephone service.” It is reasonable to expect that a California state court will be asked to consider the definition, and it is possible that the court could decide that the 911 surcharge may not be imposed on charges for toll telephone service that do not vary by both elapsed time and distance, as “toll telephone service” is presently defined.
3. **Suggested amendment.** It is recommended that declaratory language be included in the legislation for purposes of Section 41016, which defines “toll telephone service,” stating that the Legislature meant “and” to also mean “or” when it enacted the program in 1976. This recommended language would strengthen the state’s litigation position and help avoid the potentially devastating effect that a refund of three years’ worth of 911 Surcharge paid on long distance charges that varied only by elapsed time would have, should this come before a court for an interpretation. An unfavorable ruling would have a major impact on the 475 local public safety agencies whose 911 services are supported by the 911 Surcharge revenues.
4. **Related legislation.** Assembly Bill 231 (Eng) would amend Section 41016 of the Revenue and Taxation Code to clarify that “toll telephone service” means, in part, toll charges that vary in amount with either the distance or elapsed time, or both the distance and elapsed transmission time, to be consistent with existing billing practices and advances in technology. In addition, that bill would remove the reference to “and” at the end of subdivision (a) to clarify that subdivision (a) and (b) describe separate types of toll telephone services and clarify that subdivision (b) includes flat rate service plans with a fixed number of minutes. As of the date of this analysis, that bill is inactive.

Expansion of 911 Surcharge to VoIP Service

Revenue and Taxation Code Sections 41007, 41009, 41011, 41016.5, 41019.5, 41020, 41025, 41030, 41031, 41046, 41050, and 41152

CURRENT LAW

Under existing law, Section 41020 of the Revenue and Taxation Code imposes a surcharge on amounts paid by every person in the state for intrastate telephone communication services.

Section 41021 requires every service supplier to collect the surcharge from each service user at the time it collects its billing from the service user. A service provider is defined in Section 41007 to mean any person supplying intrastate telephone communication services pursuant to California intrastate tariffs to any service user in this state. The term also includes any person supplying intrastate telephone communications services for whom the California Public Utilities Commission (CPUC), by rule or order, modifies or eliminates the requirement for that person to prepare and file California intrastate tariffs.

Section 41020 provides, in accordance with the federal Mobile Telecommunications Sourcing Act (P.L. 106-252), that the surcharge does not apply to any charges for mobile telecommunications services billed to a customer where those services are provided, or deemed provided, to a customer whose place of primary use is outside this state.

"Charges for mobile telecommunications services" is defined to mean any charge for, or associated with, the provision of commercial mobile radio service, as defined in Section 20.3 of Title 47 of the Code of Federal Regulations, as in effect on June 1, 1999, or any charge for, or associated with, a service provided as an adjunct to a commercial mobile radio service that is billed to the customer by or for the customer's home service provider, regardless of whether individual transmissions originate or terminate within the licensed service area of the home service provider.

"Mobile telecommunications service" is defined to mean commercial mobile radio service, as defined in Section 20.3 of Title 47 of the Code of Federal Regulations, as in effect on June 1, 1999.

The Board is required, pursuant to Section 41128, to enforce the provisions of the 911 Surcharge Act and is authorized to prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of the 911 Surcharge Act.

PROPOSED LAW

This bill would amend Section 41020 to impose the 911 surcharge on amounts paid by every person in the state for (1) intrastate telephone communication services in this state, and (2) VoIP service that provides access to the "911" emergency system by utilizing the digits 9-1-1 by any service user in this state. With respect to VoIP service, the bill specifically provides that the surcharge would not apply to charges for VoIP service where any point of origin or destination is outside this state.

This bill would clarify that books and records kept in the regular course of business may be used to calculate charges not subject to the surcharge despite a service supplier's billing practices. In addition, a service supplier may choose a reasonable and verifiable method to calculate the interstate revenue portion not subject to the surcharge. Any

method chosen by a service supplier would be required to remain in effect for at least one calendar year. The methods are as follows:

- Books and records kept in the regular course of business.
- Traffic or call pattern studies representative of the service supplier's business within California.
- For VoIP service only, the VoIP safe harbor factor established by the Federal Communications Commission (FCC) to be used to calculate the service supplier's contribution to the federal Universal Service Fund (USF).

The FCC safe harbor factor in effect for VoIP service on September 1 each year would apply for the period of January 1 through December 31 of the next succeeding calendar year for purposes of this method.

The VoIP safe harbor method would become void and of no effect at such time as the FCC establishes a safe harbor factor for the federal USF for VoIP service that is greater than seventy-five percent for interstate revenue or abolishes the safe harbor factor applicable. In such case, a VoIP service supplier may use an alternative method approved in advance by the Board, which would be available to all VoIP service suppliers.

The FCC safe harbor factor applicable to VoIP service would be used solely as a mechanism to calculate the charges not subject to the surcharge for VoIP service and is not necessarily reflective of the intrastate portion of VoIP service. Furthermore, the bill would state that the use of the FCC safe harbor factor shall not be interpreted to permit application of any intrastate requirement, other than the application of the 911 surcharge, upon VoIP service suppliers.

If a service supplier reasonably relies upon books and records kept in the regular course of business or any documentation that satisfies such "reasonable and verifiable method," then such service supplier's determination of the portion of the billed amount attributable to services not subject to the surcharge would be rebuttably presumed to be correct. The service supplier's choice of books and records or other method and surcharge billing practice would also be rebuttably presumed to be fair and legal business practices.

The bill also contains Legislative intent language stating that the provisions of the VoIP safe harbor method would not be considered to be a precedent for the application of the surcharge or any other tax or fee where a person is required to collect a tax or fee imposed upon another.

This bill would also make conforming changes to Section 41020 for purposes of the Federal Mobile Telecommunications Sourcing Act to include VoIP service with respect to the taxation of mobile telecommunications services, which can also be nomadic. Specifically it would provide that the surcharge does not apply to any charges for VoIP service billed to a customer where those services are provided, or deemed provided, to a customer whose place of primary use is outside this state.

This bill would also amend Section 41007 to revise the definition of "service supplier" to include any person supplying intrastate telephone communication services to any service user in this state pursuant to California intrastate tariffs and providing access to the "911" emergency system by utilizing the digits 9-1-1 and any person supplying VoIP service to any service user in this state and providing access to the "911" emergency

system by utilizing the digits 9-1-1. The definition would continue to include any person supplying intrastate telephone communications services for whom the Public Utilities Commission, by rule or order, modifies or eliminates the requirement for that person to prepare and file California intrastate tariffs.

This bill would also add Section 41016.5 to define “VoIP service” to mean any service that satisfies the following two requirements:

- Does all of the following:
 - Enables real-time, two-way voice communication that originates from and terminates to the user's location using Internet Protocol (IP) or any successor protocol;
 - Requires a broadband connection from the user's location;
 - Permits users generally to receive calls that originate on the public switched telephone network and to terminate calls to the public switched telephone network; and
- Does at least one of the following:
 - Requires Internet protocol-compatible customer premises equipment (CPE);
 - When necessary is converted to or from transmission control protocol (TCP)/IP by the service user's service supplier before or after being switched by the public switched telephone network;
 - Is a service that the FCC has affirmatively required to provide 911 or E911 service.

Section 41019.5 would be added to the 911 Surcharge Act to provide that it is the intent of the Legislature that any voice quality communication utilizing VoIP would not be regulated by the enactment of this bill, and to clarify that the bill's sole purpose is to ensure that all forms of voice quality communication that connect to the “911” emergency system contribute to the State Emergency Telephone Number Account.

This bill would also add Section 41152 to incorporate the Legislature's findings and declarations, which are as follows:

- Access to emergency telephone service has been a longstanding goal of the state.
- The Act remains an important means for making emergency telephone service available to every person in this state.
- Every reasonable means should be employed by telephone corporations and every provider of telephonic quality communication to ensure that every person using their service is informed of, and is afforded the opportunity to use, emergency telephone service, regardless of the means by which emergency telephone calls are placed.
- The furnishing of emergency telephone service is in the public interest and should be supported fairly and equitably by every telephone corporation and every provider of telephonic quality communication in a way that is equitable, nondiscriminatory, and competitively neutral.

And lastly, this bill would make conforming references to “VoIP service” throughout the 911 surcharge law.

As an urgency measure, these provisions would become effective immediately; however the provisions expanding the imposition of the 911 surcharge on amounts paid by every person in the state for VoIP service and a service supplier's choice to use a reasonable and verifiable method, as described, for purposes of calculating the interstate revenue portion not subject to the surcharge, would become operative January 1, 2009.

COMMENTS

1. **Purpose.** This provision is intended to address the growth of VoIP services that will further reduce the 911 base, citing Montana as a jurisdiction that recently expanded their 911 surcharge base to include VoIP services. The shrinking of the base upon which the 911 surcharge is levied potentially jeopardizes the ability of the state to fully fund the 911 program. Moreover, it creates a competitive inequity where charges for some telecommunications services are assessed to pay for the state's 911 program while other equivalent services are not.
2. **What is VoIP?** According to the FCC, VoIP "is a technology that allows you to make voice calls using a broadband Internet connection instead of a regular (or analog) phone line. Some VoIP services may only allow you to call other people using the same service, but others may allow you to call anyone who has a telephone number - including local, long distance, mobile, and international numbers. Also, while some VoIP services only work over your computer or a special VoIP phone, other services allow you to use a traditional phone connected to a VoIP adapter."

In June 2005, the FCC imposed Enhanced 911² (E911) obligations on providers of "interconnected" VoIP services. Interconnected VoIP service allows you to make and receive calls to and from traditional phone numbers, usually using an Internet connection, possibly a high-speed (broadband) Internet connection, such as Digital Subscriber Line (DSL), cable modem, or wireless broadband.

While interconnected VoIP service may be used from a single location, like a residence, some interconnected VoIP services can be used wherever you travel, as long as a broadband Internet connection is available. Interconnected VoIP service is offered to consumers under a number of different brand names, but for purposes of this analysis, such services are referred to as "nomadic."

3. **How would the imposition of the 911 surcharge differ for VoIP service?** This measure would expand the imposition of the 911 surcharge to include amounts paid by every person in the state for VoIP service. Currently, the surcharge is imposed only upon "intrastate telephone communication service," which includes all local or toll telephone service where the point or points of origin and the point or points of destination of the service are all located in this state.

According to industry, current technology does not allow VoIP service suppliers to differentiate between intrastate and interstate communications (where the point of origin is located in this state and the point of destination of the service is located outside this state). To address this technological disadvantage, this bill would allow VoIP service suppliers to calculate the interstate revenue portion, based on a

² E911 systems automatically provide to emergency service personnel a 911 caller's call back number and, in most cases, location information.

reasonable and verifiable method, so that amount can be excluded from the basis upon which the 911 surcharge is imposed. The reasonable and verifiable methods would include books and records, traffic or call pattern studies, and the VoIP safe harbor established by the FCC for contributions to the federal USF.

This bill would also allow other service suppliers (landline and wireless) the option of using traffic and call pattern studies, in addition to standard books and records, to calculate the interstate revenue portion not subject to the surcharge. Currently, the surcharge applies to a charge that includes interstate, long distance services when bundled with intrastate telephone services if the service supplier cannot clearly breakdown the interstate, long distance service charges. The “safe harbor” factor would be available for VoIP service only.

4. **What is the VoIP “safe harbor”?** In 1997, the FCC created the USF to meet the goals of Universal Service authorized by the Telecommunications Act of 1996. The goals of Universal Service are to promote the availability of quality services at just, reasonable, and affordable rates; increase access to advanced telecommunications services throughout the nation; advance the availability of such services to all consumers, including those in low income, rural, insular, and high cost areas at rates that are reasonably comparable to those charged in urban areas.

In addition, the 1996 Act states that all providers of telecommunications services should contribute to federal universal service in some equitable and nondiscriminatory manner. This contribution provides support to the high cost, low income, rural health care and school and libraries programs.

The USF contributions are assessed only on revenues generated from interstate or international calls. Due to the difficulty for VoIP providers to determine the percentage of interstate and international traffic, the FCC established a VoIP “safe harbor” that approximates the percentage of VoIP revenues generated from interstate and international calls. The VoIP safe harbor, which is used to estimate interstate revenue, is currently set at 64.9 percent of total VoIP service revenue. VoIP service providers may also utilize traffic studies or the actual percentage of interstate calls to determine their federal USF contributions.

5. **Bundling of services.** Many service suppliers have begun to offer bundled pricing when two or more services are purchased (e.g. phone, cable and Internet services for a single package price). The surcharge would apply only to the portion of the bundled price representing charges for intrastate telephone communication or VoIP services. This bill clarifies that a service supplier may use books and records to determine the charges not subject to the 911 surcharge.

Under existing law, Section 41056 requires a service supplier to maintain such records as may be necessary to determine the amount of the surcharge collected under the provisions of the 911 Surcharge Act, and Section 41129 requires every service supplier to keep such records in such form as the Board may require. Furthermore, Regulation 2431, *Records*, requires a surcharge-payer to maintain all records necessary to determine the correct surcharge liability under the 911 Surcharge Act and all records necessary for the proper completion of the required surcharge return. Additional specific record keeping requirements generally include totals for intrastate telephone communication billed, exemptions allowed by law, and amounts of the 911 surcharge collected.

6. **Related legislation.** Senate Bill 1024 (Kehoe) would, among other things, impose the 911 surcharge on amounts paid by every person in the state for VoIP service and clarify the definition of “toll telephone service.” The provisions of SB 1024 were developed and refined throughout 2007 by the DGS staff, Board staff, and industry and consumer tax groups, and it is this consensus language that has been amended into Senate Bill 1040.

COST ESTIMATE

The Board would incur non-absorbable costs related to expanding the imposition of the 911 surcharge to VoIP service. These costs would include identifying and registering additional surcharge payers, revising Board publications, training Board staff, mailing and processing additional returns and surcharge payments, increasing compliance and audit efforts, and increasing legal services related, in part, to advice, opinions and appeals, due to the increase in the number of surcharge payers. These costs are estimated to be \$505,000 for fiscal year 2008-09 and \$649,000 for fiscal year 2009-10, and each fiscal year thereafter.

REVENUE ESTIMATE

This measure would not affect the state’s revenues. The 911 surcharge is set at a rate necessary to fully fund the 911 program.

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