

September 12, 2005

Ms. Beth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, KY 40602

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COMMISSION

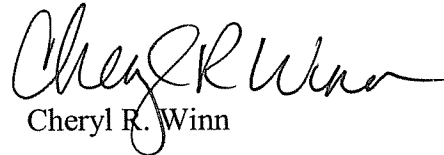
Re: Dialog Telecommunications, Inc., Complainant v. BellSouth
Telecommunications, Inc., Defendant
KPSC 2005-00095

Dear Ms. O'Donnell:

This is in reference to BellSouth's September 9 filing in this case in which it corrected its September 8 filing that included an attachment to the Sales and Use Tax Refund Application that it filed in this case on September 2. Unfortunately, there was yet another piece of information in the attachment that was not redacted. The original and ten (10) copies of the fully redacted attachment are enclosed. BellSouth respectfully requests that these copies be substituted for the ones filed on September 9 and that the copies filed September 9 be returned to BellSouth at the above address or that they be destroyed. If you have any questions, please contact Glenda Roby in my office at 502-582-8594.

Again, BellSouth regrets this error and apologizes for any inconvenience.

Very truly yours,


Cheryl R. Winn

Enclosures

cc: Parties of Record

601456

[REDACTED]

Statement of Reason for Refund Request

[REDACTED] seeks a refund of sales tax on its purchase of "CLEC services" from BellSouth Communications, Inc. for the period set forth on the attached refund application. [REDACTED] that the taxation of these purchases violate the letter and spirit of Section 253(a) of the Telecommunications Act of 1996 (the "Act").¹ Section 253(a) provides: "No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." Additionally, sales taxation of [REDACTED] purchase of CLEC services violates the equal protection provisions of both the United States and Kentucky Constitutions.

I.

[REDACTED] PROVISION OF LOCAL TELEPHONE SERVICE

The telecommunications ("telecom") industry has undergone significant change in the last 25 years. One of the primary catalyst of that change was the Act. The preamble of the Act succinctly states its purpose -- to promote competition in the telecom industry. The preamble states:

An Act to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new communications technologies.

The Act directed the Federal Communications Commission ("FCC") to take action to remove statutory, regulatory, economic, and operational barriers to local telephone services competition. In 1998, the FCC established a framework of national rules. These early rules focused on three entry points for local competition: (1) full facilities-based entry, (2) purchase of unbundled network elements from the incumbent local exchange carrier ("ILEC"), and (3) resale of the incumbent's retail services. With regard to entry point (3) -- "resale of the incumbent's retail services" -- the FCC prescribes a methodology for computing the wholesale price to be charged by the ILEC. The states are required to approve the rate set by the ILEC. Thus, companies like [REDACTED] are provided with a means of entry into the local telephone services market.

1. THE ECONOMICS OF LOCAL TELEPHONE SERVICE PROVIDED BY [REDACTED]

[REDACTED] provides local telephone service as an option for its customers. Of the three entry points for local competition listed above, [REDACTED] chose the third avenue, "resale of the incumbent's retail services." The transactions between the ILEC², [REDACTED] and the customers of [REDACTED] are simple wholesale and retail transactions. [REDACTED]

¹ 47 U.S.C. §201, et seq.

² In this case, the ILEC is the BellSouth Communications, Inc.

_____ pays a "wholesale price" to the ILEC for the provision of local telephone services. _____ then makes available and resells those local services to its customers at a "retail price" established by _____.

An example illustrating the transactions between the three parties follows. First, the ILEC receives approval from the Kentucky Public Service Commission for the rate that it will charge _____ (and others wanting to provide local telephone service)³ for local exchange services. In 2004, the Kentucky Public Service Commission required the ILEC to provide local exchange service to _____ at discount of 15.54% and 16.79% for business and residential subscribers, respectively. The discount is applied against the ILEC's retail local service rates. Therefore, if the ILEC charges its retail business customer \$10.00 for local telephone service, the ILEC must provide that same local service to _____ for \$8.45.

Next, _____, based on its operating costs and market conditions, determines the rate at which it can offer its customers local service. To compete with the ILEC (who as the incumbent provider is not only _____ supplier but is also its biggest competitor for local services), _____ must offer local service for \$10.00 or less. For purposes of this example, assume _____ prices its local service at \$9.80. Therefore, before sales tax, _____ gross profit is \$1.35. All expenses related to the resale of the local service, such as advertising, billing and administrative costs, etc. must be paid by _____ from this \$1.35.

2. THE COMPETITIVE DISADVANTAGE IMPOSED ON _____

Continuing with the example above, when the ILEC bills its customer the \$10.00 for local service, the ILEC also bills and collects 6% sales tax. Likewise, when _____ bills its customer \$9.80 for that same local service, it too bills and collects 6% sales tax. The issue herein is raised by the Department's imposition of sales or use tax on the payment from _____ to the ILEC on the wholesale service charge of \$8.45. While _____ certainly agrees it has an obligation to bill and remit tax on its retail services, the imposition of sales tax on the provision of the wholesale service creates a barrier to entry into the market which is prohibited by Section 253(a) of the Act. This is because double taxation of the local service is borne only by _____ and not by the ILEC.

The cost paid by _____ is fixed by the wholesale rate charged to the company by the ILEC. The price _____ may charge to its own customers is fixed by the retail rate charged by its competitor, the ILEC. Therefore, _____ has no way of passing on the additional tax to its customers. In other words, it must simply absorb the tax. As a result, _____ 13.5 percent gross profit is instantly reduced to 7.5 percent. This required absorption "prohibit[s] or [will] have the effect of prohibiting the ability of [_____] to provide ... intrastate telecommunications service."

³ These companies are referred to as "CLEC's," that is, "competitive local exchange carriers."

Thus, the assessment of sales tax on the wholesale purchases of [REDACTED] runs afoul of Section 253(a) of the Act. Stated otherwise, Section 253(a) of the Act pre-empts the assessment of this tax on [REDACTED].

II.

SALES TAXATION OF THE WHOLESALE CHARGES PAID BY [REDACTED] IS PROHIBITED BY FEDERAL AND STATE LAW

Kentucky's sales taxation of [REDACTED] CLEC purchases begins with Kentucky's statutory sales tax scheme. Pursuant to that scheme, KRS 139.200 imposes a six percent tax on "retail sales" made within the Commonwealth and the furnishing of "[c]ommunications service to a service address in this state, other than mobile telecommunications services as defined in KRS 139.195, regardless of where those services are billed or paid, when the communications service: 1. Originates and terminates in this state; 2. Originates in this state; or 3. Terminates in this state." KRS 139.195 defines "communications services" to include "Local and long-distance telephone services.. It is thus clear that [REDACTED] is responsible for collection of sales tax when [REDACTED] sells local telephone services to end users.

The question presented by the Department's application of the statutes is whether [REDACTED] purchases of local exchange services from the ILEC for resale are subject to sales tax. Intuitively, the answer to this question must be a resounding "no" because [REDACTED] purchases these services from the ILEC for the purpose of reselling the services to end users. However, KRS 139.100(1)(a)(1) exempts sales for resale only when tangible personal property is being purchased. KRS 139.160 defines "tangible personal property" as follows:

"Tangible personal property" means personal property which may be seen, weighed, measured, felt or touched, or which is in any other manner perceptible to the senses, regardless of the method of delivery, and includes natural, artificial and mixed gas, electricity, water, steam, and prewritten computer software.

This expansive definition of "tangible personal property" includes virtually everything imaginable except communications services. The absence of communications services from the definition of "tangible personal property," along with the fact that no other statutory provision expressly exempts sales for resale of communications services, appears to form the statutory basis of the Department's position that [REDACTED] purchases of local exchange services for resale are subject to sales tax.

The Department's position is set forth in the following administrative regulation:

Section 1. Communications service providers are the consumers of all tangible personal property and services, including access services, used to provide communications services to their own customers. Purchasers of access services shall not claim the access services purchased are exempt as being for resale.

Section 2. Communications service providers that purchase communications services from facilities-based carriers to resell to their own customer base shall not claim the communications services purchased are exempt as being transactions for resale.

Section 3. All receipts from the sale of communications services are subject to Kentucky tax unless otherwise exempted by the sales tax law. The sale of communications services is not eligible for the resale exemption.

103 KAR 28:140. Therefore, Kentucky law, as interpreted and applied by the Department, requires [REDACTED] to pay sales tax when it purchases local exchange services for the purpose of reselling the services to its customers.

A. **APPLICATION OF THE SALES TAX STATUTES TO [REDACTED] WHOLESALE PURCHASES VIOLATES SECTION 253 OF THE ACT**

As stated above, in providing customers with local telephone services, [REDACTED] competes not only with other CLECs but also with ILECs. It is beyond dispute that the Kentucky sales tax statutes, as applied by the Department, discriminate against [REDACTED] and other CLECs in favor of the ILECs. [REDACTED] has little control over its ability to profitably provide local telephone service to end users. [REDACTED] purchases the service from the ILEC at a price largely fixed by the ILEC. To compete with the ILEC, [REDACTED] must charge end users a price less than or equal to the price charged by the ILEC. [REDACTED] would be able to compete with the ILEC if these were the only limitations on its profitability.

The problem lies in the imposition of sales tax liability on [REDACTED] purchases from the ILEC for resale. This imposition of tax significantly reduces [REDACTED] gross profit on local telephone service transactions and, once all of the expenses related to the resale of the local telephone service are factored into the equation, causes [REDACTED] to operate at a net loss. The ILECs, on the other hand, because they are incumbent local exchange carriers, provide local telephone service directly to end users, and therefore they incur no sales tax liability because there is no "wholesale purchase" on which they must pay tax.

Accordingly, the ILECs are able to profitably provide local telephone service to end users while [REDACTED] and other CLECs can only do so at a loss. There can be no question that this is discrimination and that it arises directly from the Department's decision to subject [REDACTED] and other CLECs to sales tax liability for their wholesale purchases. The application of Kentucky's statutes in this manner violates the Act by precluding [REDACTED] and other CLECs from competing in the local telephone services market with ILECs. Additionally, the discrimination that results from the Department's interpretation and application violates the equal protection provisions of the United States and Kentucky Constitutions.

**B. REVENUE'S APPLICATION OF SALES TAX TO [REDACTED]
WHOLESALE CLEC PURCHASES VIOLATES THE FEDERAL AND STATE
CONSTITUTIONS**

The Fourteenth Amendment to the United States Constitution prohibits states from denying anyone "the equal protection of the laws." U.S. Constitution, Amendment XIV, Section 1. This provision prohibits states from employing classifications that treat similarly situated people dissimilarly. Sections 1, 2 and 3 of the Kentucky Constitution embrace the federal equal protection clause, *Commonwealth v. Smith*, Ky., 875 S.W.2d 873, 878 (1994), and the same legal standards govern claims brought under both federal and state law. *Delta Air Lines, Inc. v. Commonwealth*, *Revenue Cabinet*, Ky., 689 S.W.2d 14, 18-19 (1985). State laws that do not "adversely affect a fundamental interest or contain a classification based upon a suspect criterion" are evaluated under the rational basis standard. The Kentucky Supreme Court has described rational basis review as follows:

Under that standard, a statute will be sustained if the legislature could have reasonably concluded that the challenged classification would promote a legitimate state purpose. Legislation will be upheld under equal protection principles of the federal and state constitutions if the law is rationally related to a legitimate objective. The constitutionality of a statute will be upheld if its classification is not arbitrary, or if it is founded upon any substantial distinction suggesting the necessity, or propriety, of such legislation.

Yeoman v. Commonwealth, Ky., 983 S.W.2d 459, 469-470 (1998).

In this case, [REDACTED] does not argue that Kentucky's sales tax statutes adversely affect any fundamental interests or that any legislative classification is based upon a suspect criterion. Instead, [REDACTED] maintains that no "substantial distinction" exists for treating the wholesale purchase of communications services different from the wholesale purchase of "tangible personal property," as that phrase is defined in KRS 139.160. Accordingly, the rational basis standard applies.

The absence of a rational basis for discriminating against [REDACTED] and other CLECs in favor of the ILECs is apparent from the fact that the discrimination violates the letter and spirit of the Act. As stated above, the preamble to the Act declares its purpose "to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers . . ." To effectuate this purpose, Section 253(a) provides that "[n]o state or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." Simply stated, the federal government has determined that competition should be promoted in the telecommunications industry and has prohibited the States from limiting that competition. In the present case, the Kentucky sales tax statutes have the effect of prohibiting [REDACTED] and other CLECs from providing local telephone services to end users because the statutes preclude the possibility of them profitably providing these services. The General Assembly cannot contend that it had a rational basis for enacting an

anti-competitive statutory scheme that violates federal telecommunications legislation, nor can the Department defend its anti-competitive interpretation and application of the statutes.

Furthermore, no other wholesale transactions—including wholesale transactions involving all other utility services—are subject to sales tax. The General Assembly's decision to exempt all other wholesale transactions from taxation reflects a sound economic policy, i.e., taxes must not be allowed to accumulate on intermediate market transactions. There simply is no rational explanation for the Department's decision to abandon this well-reasoned approach and treat wholesale communications transactions differently than all other wholesale transactions.

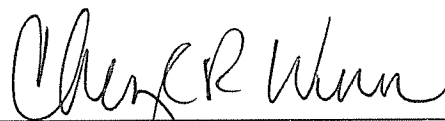
Accordingly, the Department's application and interpretation of the taxing statutes violates the equal protection provisions of the United States and Kentucky Constitutions. [REDACTED] is due a refund for amounts it paid pursuant to the Department's unlawful tax policy.

CERTIFICATE OF SERVICE

It is hereby certified that a true and correct copy of the foregoing was served on the following individuals by mailing a copy thereof, this 12th day of September, 2005.

Hon. Douglas F. Brent
Stoll, Keenon & Park, LLP
2650 AEGON Center
400 West Market Street
Louisville, KY 40202

Jim Belina
President & CEO
Dialog Telecommunications, Inc.
756 Tyvola Road
Suite 100
Charlotte, NC 28217

A handwritten signature in black ink, appearing to read "Cheryl R. Winn", written over a horizontal line.

Cheryl R. Winn