



## State Sales Tax Treatment of Bundled Transactions Involving the Purchase of Discounted Cellular Phones and Telecommunications Services

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### Background

The rapid expansion of information and telecommunications industries has spawned a breed of products that are being aggressively marketed to consumers. The overwhelming response to these types of products have escalated the marketing wars to fever pitch, creating a variety of products that can be further customized to match each consumer's personal preferences. For example, it is not uncommon these days to purchase a wireless cellular phone with a pricing plan for free air time, nationwide roaming privileges, internet access and voicemail notification. Such kinds of products in the telecommunications industry are referred to as a "bundled transaction or bundled product" because it combines the purchase of two separate types of property – the purchase of telecommunications equipment ("cellular phone") which is tangible personal property and telecommunications services which is an intangible. Bundled products are priced in a variety of ways. Some bundled products are sold based on a lump sum amount that represents a single value for both tangible and intangible components ("bundled sales price"). Other bundled products, though sold as a unit, have separately assigned prices for the tangible and intangible components. While the separate pricing purportedly represents each component's fair market value ("unbundled sales price"), there may be situations where the separately stated amount reflects a discounted value.

Although the integration of these bundled products into everyday life appear to be seamless, few states have managed to keep pace with the taxation of these items. Taxing agencies in jurisdictions that do not have specific guidance on the taxation of bundled products most likely resort to preexisting sales and use tax laws even if the existing tax scheme cannot effectively address their treatment. Because each jurisdiction's sales and use tax laws differ, bundled products may receive inconsistent sales tax treatment in several jurisdictions simultaneously. This article will discuss in particular the state tax treatment of bundled products that involve the purchase of discounted

cellular phones along with a pricing plan for telecommunications services.

### State Taxation of Bundled Transactions Involving Telecommunications Equipment and Services

As previously mentioned, there appears to be relatively few jurisdictions that have amended their sales and use tax statutes and regulations to directly address the taxation of bundled products.<sup>1</sup> The remaining jurisdictions apparently continue to employ a mixed transaction analysis to determine the taxability of a bundled product. Under a traditional mixed transaction analysis, a bundled product is broken down into its tangible and intangible components. To facilitate this determination, some taxing agencies may require vendors to separately state on the sales invoice that portion of the sales price applied to the tangible personal property, which is generally taxable, and that portion of the sales price charged to the intangible service, which is usually nontaxable<sup>2</sup> unless relevant statutes or regulations specify otherwise. However, not all taxing agencies resort to this method.<sup>3</sup> The remaining sections will discuss some common issues that may arise when a mixed transactions analysis is used to determine the taxability of a bundled product that represents the sale of discounted cellular phone and telecommunications services; and the difficulties that may arise in determining the sales tax base when both the cellular phone and telecommunications service are taxable in a particular jurisdiction.

### *Taxation of Discounted Telecommunications Equipment*

Under traditional sales and use tax principles, a mixed transaction that involves the sale of tangible personal property and intangible services will almost always be subject to tax for that portion of the sales price that

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represents that value of the tangible personal property, unless the particular taxing jurisdiction determines that the purchase of the tangible personal property was only incidental to the sale.<sup>4</sup> Therefore, a bundled product that involves the purchase of a discounted cellular phone and pricing plan service (in a state that does not tax telecommunications services) should be taxed only on that portion of the sales price that corresponds to the tangible personal property (*i.e.*, the cellular phone). However, determining the sales tax base of a bundled product that involves the purchase of a discounted cellular phone is not as clear cut, particularly when the stated retail price for the cell phone is almost the same as, or even below its original acquisition cost.

#### *Original Cost of Acquisition or Unbundled Sales Price*

Some states will impose the sales tax on the cellular phone's actual or unbundled sales price. For example, Nevada imposes the tax on the actual retail price paid to the supplier by the vendor for the cellular phone, even if the vendor only charged the customer a discounted price for the same equipment.<sup>5</sup> Moreover, failure to separately state on the customer's invoice the discounted or actual price paid to by the vendor to the supplier for the cellular phone will result in all charges (including nontaxable services) being subject to tax.<sup>6</sup> On the other hand, California and Texas will impose the tax on the unbundled price, unless the phone is discounted below a particular percentage level. If the discount exceeds that particular percentage level, both states will impose the tax on the original acquisition price charged by the manufacturer to the vendor. Thus, in California, if the bundled or unbundled sales price is less than 50 percent of the actual cost of the cellular phone, the vendor is required to pay tax based on the original retail price of the cellular phone.<sup>7</sup> Similarly in Texas, vendors of cellular phones that have been discounted to less than 25 percent of its original acquisition cost are liable for sales tax on the cost price of the cellular phone.<sup>8</sup> Apparently, the severely discounted price of the cellular phone indicates that the vendors are no longer making a taxable sale of tangible personal property – instead, the vendor is using the cellular phone as a promotional item to induce customers to purchase the telecommunications service being offered along with the cellular phone. Therefore, the original transaction between the manufacturer of the cellular phone and the vendor is recast as a taxable sale instead of an exempt sale for resale. Under both California and Texas authorities, the vendor ends up paying the sales tax on the original retail price of the telecommunications equipment, and cannot directly pass on the cost of the tax to the customer.

An issue may arise when the retailer cannot establish the unbundled sales price either because of inadequate documentation or because the cellular phone does not have an assigned unbundled retail price. Under such situations, California will impute a fair retail selling price to the equipment, based on the satisfaction of the Board. In the alternative, the fair retail selling price will be cost plus an eighteen percent mark up.<sup>9</sup>

#### *Reasonable Value*

Other jurisdictions tax bundled products based on the reasonable value of the bundled cellular phone and telecommunications service, without requiring vendors to separately charge for each component. For example, the New Mexico Department of Revenue has taken the position that a retailer of cellular phones could calculate the tax on the cellular phone based on the nominal consideration received for the cellular phone and related commissions.<sup>10</sup> In that matter, the agent sold the cellular phones for a nominal price as an inducement for customers to sign up with a specific telecommunications providers. In light of this ruling, the Department apparently is predisposed to accept the computation of sales tax based on the discounted price for the cellular phone as long as the price of the service plan is also included in the amount taxed, and the bundled price represents a reasonable value for both property and service purchased.<sup>11</sup>

#### *Actual Discounted Price*

Still, there are other jurisdictions that impose the tax based on the actual discounted sales price of the cellular phone, even if it is bundled with a telecommunication service. Arizona, for example, has taken such a position, albeit informally. However, vendors should still separately state the charge for the cellular phone and service on the customer's invoice for reporting purposes.<sup>12</sup> Hawaii, on the other hand, does not require separately stated charges as long as the tax is imposed on the actual consideration received for the bundled product, which consists of the discounted cellular phone price and the price of the pricing plan.<sup>13</sup>

#### *Taxation of Telecommunications Services at Point of Sale*

Unlike information and computer services, which are generally exempt from tax,<sup>14</sup> telecommunications services are not always exempt from the sales tax base. In fact, there is still considerable controversy in the application of the U.S. Supreme Court's decision in *Goldberg v. Sweet*,<sup>15</sup> which laid down the principle that

interstate telecommunications services may be taxable in jurisdictions where the calls either (1) originate or terminate within the state and that are charged to a service address within the state; or (2) originate or terminate within the state that is paid or billed within that state.<sup>16</sup> Therefore, separating the bundled transaction into its tangible and intangible services components does not generally resolve the issue of calculating the sales tax base for a bundled product since it does not always hold true that the intangible service component is nontaxable.

To determine whether the telecommunications service component of a bundled product is included in the sales tax base, vendors may have to take the additional step of inquiring whether the customer intends to use the cellular phone to make interstate or intrastate calls. For example, Arizona currently imposes tax on intrastate wireless telecommunications service, but does not consider interstate telecommunications services as taxable.<sup>17</sup> Therefore, the purchase of a cellular phone that includes a pricing plan for only intrastate calls would not be taxable.<sup>18</sup> On the other hand, New Mexico and Hawaii impose tax specifically on telecommunications services without any limiting language on whether the tax is imposed on interstate or intrastate calls.<sup>19</sup> Therefore, a vendor that has made a sale in Hawaii or New Mexico may have to make a further inquiry to determine whether the calls that will be made on the cellular phone will originate or terminate within the state and will be either charged to a service address, billed or paid within the state.<sup>20</sup> If these conditions are met, then the telecommunications service component of the bundled product may be taxable in these jurisdictions.

The difficulty that arises in jurisdictions that tax telecommunications services is that it is almost impossible to predict the nature of the customers' future calls at the point of sale, when sales tax is usually determined. Therefore, determining exactly what portion of the telecommunications service purchased is used to make nontaxable/taxable intrastate calls or nontaxable/taxable interstate calls can turn out to be a vendor's compliance nightmare. Thus, in practice, taxability of interstate or intrastate telecommunications services is usually determined at a subsequent time when the customer has used up his or her free air time minutes and is now receiving or placing interstate calls under national roaming services.<sup>21</sup> The tax on the subsequent telecommunications service is imposed on a call by call basis, and then collected from the customer under routine billing procedures.

## Compliance and Representation Issues

In light of the varying treatment of bundled products that involve discounted telecommunications equipment, the more immediate concern often involves what representations the vendor should make to the customer at the point of sale. These representations appear relevant in states such as California, Nevada and Texas, where the vendor may end up paying sales tax based on the undiscounted retail price of the telecommunications product. It may also be advisable to separately state the price charged for the telecommunications equipment and service in these situations because the vendor runs the risk of being taxed on the entire reasonable value or fair retail value of the bundled product instead of just the telecommunications equipment. Lastly, it appears that telecommunications service providers should look into whether imposing tax on telecommunications service in states that tax such services can be done on a call by call basis.

## Notes

- 1 See for example, Nev.Admin.Code Ch. 372, § 485 (2001).
- 2 In states such as Georgia and Maryland, the consideration received for service performed in conjunction with a sale or included as part of a purchased tangible personal property may be excluded from the sales tax base if the portion of the sales price that reflects the consideration for the service is separately stated. Ga.Code Ann. § 48-8-2(9)(B)(ii)(2000); Md. Tax-Gen.Code Ann. § 11-101(j).
- 3 Generally, taxing jurisdictions do not require separate line items on invoices to show amounts charged for tangible personal property and services. For example, in Maine, it is not necessary to separately state the taxable and nontaxable amounts on the sales invoice. Any verifiable record that shows the amount charged is acceptable proof. *Scott Paper Co. v. Johnson*, 159 A.2d 319 (Me. 1960). On the other hand, Ohio will break down a product into its component taxable and nontaxable elements even if they are not separately stated on the invoice. The portion of the sales price that is attributable to the sale of tangible personal property is subject to tax, while the one attributable to the provision of services or intangibles is not taxed. See, *Accountant's Computer Svcs. Inc. v. Kosydar*, 298 N.E. 2d 519 (Ohio 1973); *Federated Dept. Stores Inc. v. Lindley*, 456 N.E.2d 1209 (Ohio 1983).
- 4 See for example, *MCI Airsignal Inc. v. State Board of Equalization*, 1 Cal. App. 4th 1527 (1991) (expressly holding that a taxpayer that transferred pager devices to its customers to provide telephone paging services was not subject to sales or use tax for the pager device transferred because the true object of the contract is the performance of a service). See also, 18 Cal.Admin.Code, § 1501.

- <sup>5</sup> Nev.Admin.Code Ch. 372, § 485.
- <sup>6</sup> *Id.*
- <sup>7</sup> See 18 Cal.Admin.Code, § 1585. In essence, California will recharacterize the original sale transaction between the telecommunications equipment manufacturer and the vendor as if the vendor had purchased the equipment for its own taxable use, instead of as a sale for resale.
- <sup>8</sup> See Tex.Tax Bull. (July 1, 1993). See also, Decision No. 38,270 (May 15, 2000), No. 31,474 (Feb. 23, 1994), No. 28,267 (Mar. 30, 1992). The theory behind this treatment is that the grossly discounted sales price of the telecommunications equipment indicates that the vendor is not making a taxable sale but using the severely discounted telecommunications equipment as an inducement for customers to sign up for the service. This means that the telecommunications equipment is actually being used by the vendor as a promotional item. See, 34 Tex.Admin.Code § 3.301(c)(1). For purposes of determining the taxable and nontaxable components, the sales invoice should separately state the sale price of the equipment, the amount of discount applied, and the amount charge for the service plan. *Id.*
- <sup>9</sup> See 18 Cal.Admin.Code, § 1585 (a)(4).
- <sup>10</sup> N.M.Dept. of Revenue Ruling 401-953 (June 26, 1995).
- <sup>11</sup> See N.M.Stat. Ann. § 7-9-3(F); 3 N.M.Admin.Code, § 2.1.29.5.
- <sup>12</sup> Based on a telephone inquiry on a no-name basis to the Ariz.Dept. of Revenue, Feb. 12, 2001. See also, Ariz.Rev.Stat. § 42-5061(H); Ariz.Admin.Code r. 15-5-104(D).
- <sup>13</sup> See Hawaii Rev.Stat. § 237-3(a).
- <sup>14</sup> Information and computer services are generally nontaxable unless it is treated as a sale or transfer of tangible personal property. See 18 Cal.Admin.Code, § 1501; Fla.Admin.Code Ann. r. 12A-1.032, r. 12A-1001(16). In situations where the provision of information services also involved the receipt of tangible personal property, taxpayers have prevailed under the theory that that the true object of the transaction was the performance of the service or that the tangible end product was merely incidental to the performance of services. See, *Dun & Bradstreet, Inc. v. City of New York*, 11 N.E. 2d 728 (N.Y. 1937) (credit bureau reports); *Credit Bureau of Miami County v. Collins*, 364 N.E.2d 27 (Ohio 1977) (credit bureau reports); *Community Telecasting Service d.b.a. WABI Television v. Johnson*, 220 A.2d 500 (Me. 1966) (market research reports).
- <sup>15</sup> See 488 U.S. 252 (1989).
- <sup>16</sup> The degree of difficulty in sourcing telecommunications services for sales tax purposes will be somewhat considerably lessened when H.R. 4391 goes into effect after August 1, 2002.
- The new law provides that all charges for mobile telecommunications services provided by a customer's "home service provider" will only be subject to sales and use tax in the taxing jurisdiction of the customer's "place of primary use", regardless of where the mobile telecommunications services originate, terminate or pass through. A "home service provider" is defined as "the facilities based carrier or reseller with which the customer contracts for the provision of mobile telecommunications services". The term "place of primary use" is the applicable residential or business street address supplied by the customer that is within the licensed service area of the home service provider. The new law does not apply to prepaid telephone calling services or resellers of telecommunications services.
- <sup>17</sup> See Ariz.Rev.Stat. § 42-5064.
- <sup>18</sup> However, it seems unlikely that a bundled product that is the subject of a marketing promotional would offer only intrastate telecommunications services.
- <sup>19</sup> See N.M.Stat. Ann. § 7-9-3(F)(1)(d); Hawaii Rev.Stat. § 237-3(a).
- <sup>20</sup> The U.S. Supreme Court recognized that its holding in *Goldberg v. Sweet* could subject a taxpayer who splits its billing and service addresses between two different states to multiple taxation. The Court's example of this situation can be found in its footnote 13:
- "For example, if a company's Arkansas headquarters paid the telephone bills of its Illinois subsidiary, two state taxes would be paid on telephone calls made by the Illinois subsidiary to the head office or any other Arkansas location. Such calls would terminate and be billed or paid in Arkansas, and they would also originate and be charged to an Illinois service address. Likewise, a collect call from the Arkansas headquarters to the Illinois subsidiary could be taxed in both States. The collect call would originate and be billed or paid in Arkansas, and it would also terminate and be charged to an Illinois service address. Non-collect calls from the Arkansas headquarters to the Illinois subsidiary would not, however, be captured by the Illinois Tax Act. Likewise, the Arkansas statute would not tax interstate calls made by the Illinois subsidiary to States other than Arkansas."
- The widespread implications of the Court's holding in *Goldberg v. Sweet* are beyond the scope of this article.
- <sup>21</sup> Some state taxing agencies are of the opinion that telecommunications service providers should have little difficulty in determining which calls are taxable and which are not taxable by reviewing each customer's monthly billing statements, and conceivably impose the tax on a call by call basis. This, of course, presents another set of new compliance issues which are beyond the scope of this article.