ST 00-0154-GIL 07/26/2000 TELECOMMUNICATIONS EXCISE TAX

This letter discusses the taxability of “incentive credits” under the Telecommunications Excise Tax Act. 35 ILCS 630/1 et seq. (This is a GIL).

July 26, 2000

Dear Xxxxx:

This letter is in response to your letter dated May 23, 2000. We are unable to issue a Private Letter Ruling to you. This is because the matter you are inquiring about concerns another party who, in addition to you, would have to be bound in order to give effect to our ruling. This party has not made a similar request for, or commitment to be bound by, a letter ruling from the Department. Therefore, the nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found on the Department's Internet website at http://www.revenue.state.il.us/legalinformation/regs/part1200.

In your letter, you have stated and made inquiry as follows:

COMPANY (‘Company’) is headquartered in Illinois and utilizes BUSINESS for its telecommunications service. We hereby submit a request for a Private Letter Ruling, pursuant to 2 Ill. Admin. Code 1200.120. We appreciate this guidance on an issue related to the Illinois Telecommunications Excise Tax Act (‘Act’).

Company is not the subject of an audit by the Department, nor is litigation to which the Company is a party pending with the Department.

I. FACTS

Company utilizes BUSINESS’s long distance services pursuant to a contract in which it has committed to use BUSINESS’s services at a certain volume level for a period of three years. BUSINESS in turn has committed to deliver services at certain favorable rates for the same period. The rates are standard tariff rates that are discounted proportionate to the volume and term commitment agreed to by the Company.

In addition to the monthly discounts, the contract also includes a provision that the Company would receive certain discount credits (‘CREDITS’) at specified periods of time. CREDITS in this context are simply the additive inverse of the quoted per minute price of telecommunications, being derived entirely from a manipulation of per minute rates in the contract negotiations. It must be noted that the

carrier has a degree of flexibility in building CREDITS into a negotiated contractual price.

The first of the discount CREDITS (CREDIT #1) is referred to as a 'conversion credit'[1]. This discount credit was given to the Company, in the third month of the contract, in the form of a credit memo mailed separately from the bill. The Company was instructed to simply subtract the credit amount from its payment on that month's bill. In the month the credit memo was to be applied, the Illinois Telecommunications Excise Tax ('Tax') was computed on BUSINESS's invoice based on discounted service and usage charges but without regard to CREDIT #1.

The second, third, and fourth discount CREDITS (CREDITS #2, 3, 4) were received by the Company in subsequent months as specified in the contract. They were understood by the Company to be of the nature of signing bonuses.[2] CREDITS #2, 3, 4 appeared directly on the bills (as opposed to memos). They appeared on the bills below the tax line as a negative dollar value, the effect of which was to reduce the current amount due for that month. As in the case of the credit memo, the Illinois Telecommunications Excise Tax was applied on pre-credit charges.

The following illustration will serve to clarify the application of Tax by BUSINESS with respect to CREDITS:

Minutes used times tariff rates =		$100.00
Less, discounts	(30.00)	
Equals	$ 70.00	
Tax rate	7%	
Tax	$ 4.90	
Subtotal	$ 74.90	
Less, CREDIT		(50.00)

[1] The term 'conversion credit' is used in acknowledgement of the fact that it generally takes a large, multi-location customer several months to make the switch from one carrier to another. This can be costly to a customer, since on the date that the contractual commitment to the old carrier ends, the rates automatically revert back to standard tariff rates, without discounts. A significant expense is incurred in the months it takes a customer to achieve a full cutover to the new carrier. A conversion credit may be given by the new carrier to lessen the budget impact of that additional expense.

[2] In the telecommunications industry a 'signing bonus' or 'promotional credit' is a tool often used by telecommunications carriers in competitive bidding situations. The use of such accomplishes several purposes. One use may be to help obscure from view the real bottom line per minute rate from the public. Such credits complicate the calculation of the real negotiated per-minute rate, and the less these negotiated rates are common knowledge, the better off carriers are in negotiations with other customers. Another purpose may be the psychological appeal of receiving a rebate of a large sum of money all at once, as compared to a less appealing percentage rate reduction over time. Obviously, most large companies such as ourselves are sophisticated enough to understand that the true price of service has to incorporate all such special credits into the equation. In the case of the contractual arrangement which is the subject of this letter, we were well aware during the negotiations that CREDITS were an integral component of pricing. In fact, we communicated our preference to dispense with the second, third and fourth CREDITS and simply pay a lower per minute rate consistent with the value of the credits. However, MCI conveyed its desire to utilize such credits in the pricing arrangement. We complied with their request since the true cost of service would be approximately the same either way.

Amount due and payable	$ 24.90

Company asserts that BUSINESS overcharged Tax with respect to the discount CREDITS and that a Tax refund is due. Company filed a refund claim with BUSINESS but it was denied. The following illustration shows our position with respect to how the CREDIT should be treated in the computation of tax:

Minutes used times tariff rates =	$100.00
Less discounts	(30.00)
Less, credit	(50.00)
Equals	$ 20.00
Tax rate	7%
Tax	$ 1.40
Amount due and payable	$ 21.40

In both cases, the credits are included in, i.e., factored into, the calculation of gross charges. The only distinction between the two scenarios is whether the credits serve to decrease the amount subject to Tax. As discussed below, the proper method of including those credits that are indeed discounts is as a negative number that decreases the amount subject to Tax.

II. DICUSSION: CREDITS EQUIVALENT TO A DISCOUNT MUST SERVE TO DECREASE THE AMOUNT SUBJECT TO TAX

The Telecommunications Excise Tax Act imposes a tax upon the act or privilege of originating or receiving intrastate or interstate telecommunications by a person in Illinois at a rate of 7% of the gross charge for such telecommunications purchased at retail and billed to a service address in Illinois. Under the Act, gross charges are defined as the amount paid for the act or privilege of originating or receiving telecommunications in Illinois, and for all services and equipment provided, valued in money, whether paid in money or otherwise, including cash, *credits,* services and property of every kind or nature.

In Section 630/2(a) of the Act, gross charge is defined as the ‘amount paid.’ In Section 630/2(b) of the Act, the ‘amount paid’ is defined as the amount charged to a taxpayer’s service address. These definitions are complimentary rather than contradictory. The ‘amount paid’ establishes the valuation of gross charges. The ‘amount charged’ to a taxpayer’s service address establishes the legal incidence of tax (timing as well as scope).

As discussed below, the ‘credits’ referred to in the Act are those for which the carriers expect to receive in full the amount billed, regardless of the nature of the payment. Secondly, there is a class

of ‘credits’ that is in essence, discounts, for which the carrier does not expect to receive payment. When the carrier has a legitimate expectation of receiving payment for the amount billed, the amount billed is taxable. However, when the credit is truly a discount, the carrier has no expectation of receiving payment for the discount amount. Therefore, the discount amount should be excluded from the taxable base for purposes of the Telecommunications Excise Tax.

A. Credits for which full payment is expected and is to be received by the carrier do not decrease the amount subject to Tax

1. Overpayment as a Form of Credit

The term credit may apply to those instances in which a customer has overpaid the carrier. For example, the current month’s gross charges are $75 and the customer pays $100. The amount of overpayment, $25, is considered a credit that will be applied to the following month’s bill. However, the fact of overpayment does not change the amount of money billed for either of the months nor the total amount of money expected to be received by the carrier. The carrier has simply received a portion of the amount in advance.

2. Extension of Credit

Another scenario in which the term ‘credit’ as described in the Act would apply is when the carrier itself extends credit to the customer. In such a scenario, the carrier and the customer have made arrangements for the customer to pay incrementally on the amount billed. Although the customer does not pay the full amount billed by the carrier at one time, the carrier still has a legitimate expectation of receiving over time the full amounts billed. Therefore, the full amount charged is subject to Tax under the Act as the carrier will receive the full amount charged.

3. Bartering

Lastly, the term ‘credit’ may refer to what the customer might furnish the carrier in lieu of cash for the receipt of services, such as in a bartering situation. In this context the term credit addresses the possible payment arrangements (cash, credits, services, and property of any kind) that could be fashioned to satisfy a customer’s financial obligation to its telecommunications carrier. For example, in the event that a reciprocal business relationship exists between the carrier and the customer, the customer may want to issue a credit of its own to the carrier. It seems clear that this provision was incorporated into the Act so that bartering arrangements and the

like would not serve to reduce gross charges below the true value, in money, of the telecommunications services.

Under the contract, CREDITS were not issued in exchange for goods or services provided by the Company *to* BUSINESS. CREDITS were not purchased, traded for, or earned like barter currency stemming from a separate transaction. In the larger view, CREDITS have no monetary value of their own apart from this sale of telecommunications service.

4. Conclusion

In each of the above instances, the carrier expects to receive and is entitled to receive the full amount billed either in cash or in a corresponding value of credit, services, or property if in a bartering arrangement. Credits in the above contexts do not affect the gross charges, amount billed, or amount to be paid as the carrier does expect to receive the full fair market value of its services. The dollars represented by these credits are properly subject to Tax.

B. Credits for which no payment is expected and for which payment will not be received decrease the amount subject to Tax.

1. Credits for Bad Debts are Deducted from the Amount Subject to the Telecommunications Excise Tax

Once a carrier determines that an amount previously charged and billed to a customer is not going to be paid in full, they may, pursuant to statutory guidelines, apply for a bad debt credit with the Illinois Department of Revenue. Once the credit for the bad debt is approved, the carrier may then amend its Telecommunications Excise Tax return indicating that the amount expected to be realized was in fact NOT realized. Having so indicated, the carrier then takes a corresponding credit for the excise tax previously paid on the bad debt credit.

Therefore, the bad debt credit reinforces the fact that those amounts which the carrier does not expect to realize, such as discount credits, should be excluded from the taxable base for the assessment of the Telecommunications Excise Tax.

2. Credits that are Discounts are Deducted from the Amount Subject to the Telecommunications Excise Tax

As pointed out previously, promotional credits are generally viewed by all parties in a negotiation as a promotional tool, and they simply have to be factored into the whole equation when determining the true price that is ‘on the table’ in a bid process. Invariably, companies purchasing telecommunications on

term contracts are intent upon determining the actual, net per-minute rate being offered, in order to compare among a number of bidders vying for the business. One-time or periodic credits would be considered, just like discounts, as integral components of a contract when arriving at an 'apples to apples' cost comparison. This would be equally true whether the credit is labeled a 'conversion credit,' 'installation credit,' 'incentive credit,' 'signing bonus,' or any other sort of deduction from the eventual amount paid for telecommunications service.[3]

While many 'discounts' are computed using a percentage of actual usage, the discount in this scenario is in the form of CREDITS that are a negotiated fixed amount based upon Company's projected annual usage. (Note that both discounts and CREDITS are contingent upon the fulfillment of certain volume commitments over the term of the contract.) That the CREDITS in question are indeed discounts is reinforced by the fact that both Company and the carrier relied upon the CREDITS as a reduction in price when calculating the true rate per minute in the contract. Regardless of whether a deduction from tariff rates is calculated upon actual usage or negotiated at the inception of the contract as a flat amount, they are both in actuality discounts: they both decrease the amount of gross charges owed the carrier. Thus, CREDITS, which are in actuality discounts, are deducted from the taxable base for purposes of assessing the Telecommunications Excise Tax.

3. Conclusion

In the instance of both a bad debt and a discount CREDIT, the carrier does not have any expectation of realizing the discount CREDIT amounts as part of its gross income. Therefore, similar to the assessment of the Retailer's Occupation Tax, the discount CREDIT amounts in question should be excluded from the taxable base for purposes of assessing the Tax.

C. Taxation of Credits Pursuant to the Telecommunications Excise Tax Act should be similar to that of the Retailer's Occupation Tax Act.

The Telecommunications Excise Tax should be applied similar to the Retailers' Occupation Tax Act. In Saxon-Western Corporation v. Mahin, 81 Ill.2d 559 (1980), the Illinois Supreme Court held that only the amounts actually realized by the seller are taxable. If the seller has an expectation of being reimbursed

[3] One of the primary requirements of tariffs is to make public disclosure of all terms of carrier-customer contracts, the key element of which is price. The contract referred to in this letter was a specialized tariff filed with the Federal Communications Commission. A tariff filing insures that there are no other terms, understandings, or arrangements apart from this contract. CREDITS then, being an integral component of this contract tariff, cannot be separated from the *price* charged for the telecommunications service. CREDITS have no value or effect on their own apart from the contract, notwithstanding BUSINESS suggestions to the contrary.

the value of the coupon by a manufacturer, the coupon amount is included in the taxable base for purposes of assessing the Retailer's Occupation Tax. If, however, the seller does not have any expectation of realizing the coupon's value, the coupon amount is excluded from the taxable base for purposes of assessing the Retailer's Occupation Tax. Similar to the seller, BUSINESS does not realize nor has any expectation of realizing the face value amount of the discount credit coupon or the discount credits. Therefore, these amounts should be excluded from the taxable base for purposes of calculating the Telecommunications Excise Tax.

D. Logic Supports the Conclusion that Discount Credits Serve to Reduce the Amount Subject to Tax

1. The Tax which corresponds to the discount credits is itself a negative number.

To argue that discount credits should be included in the gross charge, then to fail to acknowledge that *tax* on a credit would have to itself be a credit (i.e., a negative number) is to contradict mathematical principles, not to mention common logic.

The Act defines gross charges as the *amount paid* for telecommunications, valued in money. The amount that is paid for a service is the true measure of the value of the service. The amount the Company paid, valued in money, was the billed amount charged, less discounts, less CREDITS.

2. Reference to all billing documents required in determining the amount charged.

The discount CREDITS issued by the carrier to Company involve both a discount credit in the form of a memorandum and discount credits that appeared on the regular monthly billing invoice. Regardless of how each credit was effectuated, they all decreased the amount of money realized by the carrier and should be excluded from the taxable base for purposes of assessing the Tax.

Therefore, in figuring the amount charged for telecommunication services, reference must be made to not only that which appears on the regular monthly bill, but also to any form of written payment notification, such as a supplementary invoice, corrected bill, statement of past due account, credit memorandum, debit memo, and any other medium of communicating an amount due that would have any effect on the amount to be received by the carrier. An obligation is legally binding whether or not the amount appears on the statement that is normally mailed out the same day each month.

If 'amounts charged' are narrowly construed, as only those amounts appearing on the regular bill, then the following situations would be problematic for purposes of deciding what constitutes gross charges:

- A billing problem or mistake might necessitate an auxiliary billing that is 'off' the regular billing platform. This could take the form of a business letter sent out describing an additional amount due. It would be difficult to argue that the additional amount due should be excluded from taxation.

- When an account has been closed and a billing overcharge is discovered to have occurred, a refund must be provided by the carrier in the form of a check made payable to the customer. In such a case, the refund would be barred from including a corresponding refund of tax.

While the above scenarios, occur in real-life situations, the following two are hypothetical. They are only presented to illustrate the difficulties with the holding that 'amounts charged' are only those amounts that appear on a regular monthly bill.

- An arrangement could be concocted whereby a carrier sends no periodic billing and the customer meters its own minutes, sending payment at a prearranged rate. Under a narrow construction of 'amounts charged,' none of the amounts paid would be included in gross charges.

- Another type of arrangement might be utilized where a customer writes a check up front as an advance payment for a year's worth of telephone service. At the end of the year, the account is settled and the carrier then sends a bill for any shortfall. Only the shortfall (the amount billed) would be included in gross charges.

It seems clear that 'amounts charged' should include all bona fide, recorded payment obligations, whatever the document type used, including all forms of credit/debit postings, and that officially-constituted memoranda (memos) are inherent to the computation of the obligation.[4]

---

[4] A principle's logic can be tested by applying extreme circumstances and then weighing the outcome. Assuming BUSINESSS's position is correct, consider Hypothetical Situation #1: A carrier offers to provide telecommunications service under an arrangement where the carrier will bill client for $100,000, and will concurrently provide a credit of $95,000 which the customer will apply against the invoice. The customer would pay more for tax than for service! (The customer's payment check would be for approximately $12,000, which is the sum of $5,000 for telecommunications service and approximately $7,000 tax.) Hypothetical Situation #2: Suppose a customer, desiring to procure the services of a highly sought after carrier, agrees to make a one time payment of $200,000 in exchange for a three year commitment from the carrier to provide telecommunications services, with rates capped for the duration

III. CONCLUSION

As mentioned above, there are two basic classes of credits: (1) those for which the carriers expect to receive the amount billed in full, such as credit extended, credit for overpayment, and credit in a bartering arrangement; and (2) those credits which are in actuality discounts and for which the carrier does not expect to receive payment of the discount amounts. Similar to the application of the Retailer's Occupation Tax, the amount of dollars represented by the credits for which the carrier has an expectation of realizing the money are included in the taxable base while the credits which are not expected to be realized decrease the amount subject to Tax. In both cases, credits ultimately are factored into, or included in, the calculation of gross charges. Not only does this conclusion correspond with the apparent intent of the Act as written, but it also follows logical mathematical principles. Furthermore, such a reading of the Act provides for a clear and unenforceable method of applying the Telecommunications Excise Tax.

Please advise us whether, in your opinion, the Company is due a refund of Illinois Telecommunications Excise Tax from BUSINESS.

If you have any questions or need additional information regarding this issue, please call me. My telephone number is ####. Thank you in advance for your guidance on this issue.

The Telecommunications Excise Tax Act imposes a tax upon the act or privilege of originating or receiving intrastate or interstate telecommunications by a person in this State at the rate of 7% of the gross charges for such telecommunications purchased at retail from a retailer by such person. 35 ILCS 630/3 and 35 ILCS 630/4. "Gross charges" means the amount paid for the act or privilege of originating or receiving telecommunications in this State and for all services and equipment provided in connection therewith by a retailer, valued in money whether paid in money or otherwise, including cash, credits, services and property of every kind or nature, and shall be determined without any deduction on account of the cost of such telecommunications, the cost of materials used, labor or service costs or any other expense whatsoever. 35 ILCS 620/2(a). "Amount paid" is defined as the amount charged to the taxpayer's service address in this State regardless of where such amount is billed or paid. 35 ILCS 630/2(b).

It is our understanding that BUSINESS charges COMPANY a tariff rate for each minute of service provided, less an incentive discount. This results in the gross charges to COMPANY. BUSINESS collects tax from COMPANY based on the amount

---

of the term. The one time payment also served to increase the monthly discount level beyond what it would have been under ordinary circumstances. Note that this is the inverse of the arrangement that is the subject of this ruling request. Logic would demand that if the one time $200,000 payment is deemed to be included in (added to) the amount charged/paid for purposes of determining gross charges, then CREDITS would also have to be included in (effecting a deduction from) the amount charged/paid.

of gross charges. In addition to the incentive discount, BUSINESS also provides COMPANY incentive credits. These credits, rather than reducing the amount of gross charges, may be applied as payments against gross charges. COMPANY applies these credits to its gross charges and remits the remaining amounts due, in order to satisfy its gross charges from BUSINESS.

Since the tax is imposed as a percentage of gross charges, tax must be collected based upon the amount of charges from BUSINESS. The credits, rather than reducing the amount of gross charges, appear to be used to pay the charges. Credits are consideration subject to tax. Therefore, these credits are subject to the Telecommunications Excise Tax.

Section 10 of the Telecommunications Excise Tax Act governs claims for credit or refund. Under Section 10, if it appears that the retailer has paid an amount of tax or penalty or interest in error, the retailer may file a claim for credit or refund. However, no credit or refund will be allowed for any amount paid by the retailer unless it is shown that the retailer bore the burden of such amount and did not shift the burden to anyone else. This means the retailer would have to show that he has unconditionally repaid the tax to the customer from whom he collected such tax. Please note that the Department has no authority to compel a retailer to file a claim for credit. Whether or not a retailer refunds to a customer the taxes paid and files a claim for credit with the Department is a private matter between the retailer and the customer.

I hope this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Martha P. Mote
Associate Counsel

MPM:msk