STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
FRONTLINE COMMUNICATIONS CORPORATION	:	DETERMINATION DTA NO. 819786
for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period November 1, 1999 through November 30, 2002.	:	

Petitioner, Frontline Communications Corporation, c/o Vasam Thatham, One Blue Hill Plaza, 7th Floor, Pearl River, New York 10965, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period November 1, 1999 through November 30, 2002.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on June 2, 2004 at 2:30 P.M. with all briefs to be submitted by September 17, 2004, which date commenced the six-month period for the issuance of this determination. Petitioner appeared by Anderson, Gulotta and Hicks, P.C. (Michael A. Warnagiris, Esq., of counsel). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Lori P. Antolick, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly denied petitioner's claim for refund of sales and use taxes paid on its purchases of line access charges from the telecommunications providers Focal, Frontier, Intermedia, Network Access Solutions, Total Tel., and Citizen's Comm., on the

basis that such purchases were of intrastate telephone services subject to tax pursuant to Tax Law § 1105(b)(1)(B).

II. Whether, assuming such purchases were subject to tax as purchases of telephony or telegraphy, such services are nonetheless exempt from tax on the basis that they were used by petitioner to provide its customers with Internet access which, by its very nature, is an interstate activity exempt from taxation.

FINDINGS OF FACT

1. Petitioner, Frontline Communications Corporation ("Frontline"), which began doing business in 1995, and is headquartered in Pearl River, New York, is an Internet access service provider ("ISP") with customers located in New York as well as other states. Petitioner, via its connected network of circuits, enables its customers to access the Internet. The "Internet" has been defined as "many large computer networks joined together over high-speed backbone data links ranging (in speed) from 56 Kbps to T-1, T-3, OC-1 and OC-3."

2. The Internet works as a "packet switched network" based on a family of protocols known as "TCP/IP," that is Transmission Control Protocol/Internet Protocol, a system of networking protocols providing communication between computers with diverse hardware architectures and various operating systems across interconnected networks. Internet Protocol ("IP") defines how information is broken down into packets and routed. Transmission Control Protocol ("TCP") adds reliability to the IP packets, which helps the packets reach their destination in the proper fashion. A packet switched network allows the same computer to send and receive data packets to and from multiple sources simultaneously. It is not necessary for a direct connection to be established in order for two computers to communicate with one another

over the Internet. This network differs from circuit switched networks or traditional phone networks which require a continuous connection.

3. During the period in issue, November 1999 to November 2002, petitioner provided its New York customers with access to the Internet via dial-up lines, dedicated T-1 lines, satellite access and DSL access.[1] Petitioner did not provide voice communication services during the period in issue.

4. In order to function, an ISP must establish a network that spans from the point where the ISP's customer accesses the ISP to the point of presence ("POP"), a facility where local Internet traffic is aggregated, which is the gateway to the global Internet. To provide this network, and to carry out its business of providing Internet access (connectivity), petitioner had to purchase access to three kinds of circuitry, as follows:

> a) dial-access and dedicated access circuits which connected petitioner's customers to petitioner's facilities. These circuits were either dedicated T-1 circuits or PRI ("Primary Rate Interface") circuits connected to local telecommunications carriers' offices.[2]
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> b) an assembled network of circuitry, that connected all of petitioner's own facilities together.
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> c) circuitry connecting petitioner's facilities with the global Internet.

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[1] To further explain, a T-1 (Trunk Level 1) line is a digital transmission link with a total signaling speed of 1.544 megabits per second (1,544,000 bits per second which may be divided into up to 24 separate voice-quality channels which may be utilized as a single two-way high speed data stream). In turn, a T-3 connection is a digital transmission link with a total signaling speed of 44.736 megabits per second with a capacity equivalent to 28 T-1 lines. A DSL (Digital Subscriber Line) provides a faster technology for data transmission over telephone lines (compared for example to ordinary dial-up connections). A DSLAM, or DSL Access Multiplier, is a piece of equipment connecting DSL modems at a customer location to one or more high speed data circuits.

[2] Petitioner purchased PRI lines, representing an ISDN ("integrated services digital network") that carries digital data over the leased lines. A PRI is a configuration that is equivalent to a T-1 circuit, but faster, allowing the user to have access to 23 voice channels and one data channel. Petitioner also purchased "customer access lines" from "incumbent local exchange carriers" which allowed petitioner's customers to gain connection to petitioner's facilities.

5. Petitioner, a company which grew primarily by acquisitions of other companies, had network centers in New York, New Jersey and Virginia, and petitioner's system was a connected network of circuits to and from all of those locations. All of the circuits described above carried data to and from petitioner's customers' locations in New York State, and all of such data was routed through such locations regardless of the location of its intended destination. An ISP could ensure that its traffic is routed both inside and outside a particular state simply by locating servers or related equipment in at least two states.

6. For its dial-access customers, petitioner purchased PRI lines from various telecommunications providers. Petitioner's customers would use their modems and home telephone service to dial into the telecommunications providers' central office, at which point the provider would connect the customers' data calls to petitioner's PRI circuits in order to carry the data traffic to and from the Internet via petitioner's network and its routers and servers in the noted network center locations.

7. For its dedicated access customers, petitioner purchased point to point T-1 lines from various telecommunications providers. These circuits enabled petitioner's customers to have a constant connection directly to petitioner's network with a data transfer capability of 1.54 megabits per second. The data traffic from these customers was directed to and from the Internet in the same manner as with petitioner's dial-access customers, that is via petitioner's network and its routers and servers in the noted network center locations.

8. To connect petitioner's own network to the global Internet, petitioner purchased internet access service from AT&T, UU Net, Verio, Cable and Wireless, and Cogent.

9. On November 21, 2002, the Division received from petitioner an Application for Credit or Refund of Sales or Use Tax (Form AU-11) seeking a refund of sales and use tax paid by petitioner in the aggregate amount of $153,475.20. Such amount represented tax paid on petitioner's purchases of access and transport lines, on equipment (routers, modems, servers, etc.), and on other items including professional services, direct mailing and advertising.

10. By a letter dated April 21, 2003, the Division granted petitioner's claim to the extent of $12,688.53 (representing tax paid on certain equipment purchased after September 1, 2000, and other purchases including, presumably, petitioner's own Internet access purchases), but denied the $140,786.67 balance of petitioner's claim. Thereafter, further review and discussion between the parties resulted in petitioner's withdrawal of additional portions of its claim, including the portion pertaining to tax paid on equipment purchased prior to September 1, 2000, such that it is only the tax paid by petitioner on its purchases of line access which remains at issue, as described hereinafter.

11. During the period in issue, petitioner purchased (via lease) circuit connections (access lines) from the vendors Frontier, Focal, Intermedia, Network Access Solutions ("NAS"), Total Tel., and Citizen's Com. in order to connect its dial access and dedicated access customers to the Internet. Petitioner paid State and local sales tax on such line access purchases in the aggregate amount of $54,887.81. At hearing, petitioner agreed that its line access purchases from Intermedia and Total Tel. should be withdrawn from consideration for refund in this proceeding. Petitioner paid State and local sales tax on these purchases in the aggregate amount of $1,960.89 ($343.05 on its Intermedia purchases and $1,617.84, on its Total Tel. purchases), and elimination of such amount reduces the amount of tax with respect to line access purchases at issue and sought for refund in this proceeding to $52,926.92.

12. With its brief, petitioner submitted 16 proposed findings of fact. Each of such proposed findings have been included in the foregoing Findings of Fact.

CONCLUSIONS OF LAW

A. Tax Law § 1105(b)(1)(B) imposes sales tax upon the receipts from every sale, other than sales for resale, of "telephony and telegraphy and telephone and telegraph service of whatever nature except interstate and international telephony and telegraphy and telephone and telegraph service . . . ."

B. Regulations of the Commissioner of Taxation at 20 NYCRR 527.2(a)(2) provide, in relevant part, that the words "of whatever nature" as contained in Tax Law § 1105(b) "indicate that a broad construction is to be given the terms describing the items taxed." Such regulations go on to provide as follows:

> The term *telephony and telegraphy* includes use or operation of any apparatus for transmission of sound, sound reproduction or coded or other signals.
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> * * *
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> Example 3: Message switching services, transmitted to a computer over lines leased from a communication carrier are telegraph services subject to the tax imposed under section 1105(b) of the Tax Law. (20 NYCRR 527.2[d][2].)
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> A service is not considered telegraphy or telephony if either of these services is merely an incidental element of a different or other service purchased by the customer.
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> Example 6: A company offers its customers a protective service using a central station alarm system, which transmits signals telegraphically. The customer is purchasing a protective service. (20 NYCRR 527.2[4].)

C. Chapter 615 of the Laws of 1998 added a new section 179 of the Tax Law, effective October 8, 1998, which provides as follows:

> 1. For purposes of this article, Internet access service shall not constitute a telecommunications service, nor shall the provision of Internet access service constitute the carrying on of a telephone, local telephone, telegraph, or transmission business.
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> 2. The term 'Internet access service' shall have the meaning ascribed thereto in subdivision (v) of section eleven hundred fifteen of this chapter.

Chapter 615 of the Laws of 1998 also added a new subdivision (v) to section 1115 of the Tax Law (as referred to in subdivision [2] above) which, effective October 8, 1998 and applying to sales and uses occurring on or after February 1, 1997, provides as follows:

> (v) Receipts from the sale of Internet access service, including start-up charges, and the use of such service, shall be exempt from the taxes imposed under this article. For purposes of this subdivision, the term 'Internet access service' shall mean the service of providing connection to the Internet, but only where such service entails the routing of Internet traffic by means of accepted Internet protocols. The provision of communication or navigation software, an e-mail address, e-mail software, news headlines, space for a website and website services, or other such services, in conjunction with the provision of such connection to the Internet, where such services are merely incidental to the provision of such connection, shall be considered to be part of the provision of Internet access service.

D. Prior to September 1, 2000, Tax Law § 1115(a)(12) provided, in relevant part, that receipts from the following shall be exempt from sales and use taxes:

> telephone central office equipment or station apparatus or comparable telegraph equipment *for use directly and predominantly in* receiving at destination or initiating and switching telephone or telegraph communication or in receiving, amplifying, processing, transmitting and retransmitting telephone or telegraph signals . . . . (Emphasis added.)

E. In 2000, chapter 63 of the Laws of 2000 removed the foregoing language from Tax Law § 1115(a)(12), and added a new paragraph (12-a) to such section which provided that, effective September 1, 2000, receipts from the following shall be exempt from sales and use taxes:

> Tangible personal property *for use or consumption directly and predominantly in* the receiving, initiating, amplifying, processing, transmitting, retransmitting, switching or monitoring of switching of telecommunications services for sale *or* internet access services for sale or any combination thereof. Such tangible personal property exempt under this subdivision shall include, but not be limited to, tangible personal property used or consumed to upgrade systems to allow for the receiving, initiating, amplifying, processing, transmitting, retransmitting, switching or monitoring of switching of telecommunications services for sale or internet access services for sale or any combination thereof. As used in this paragraph, the term 'telecommunications services' shall have the same meaning as defined in paragraph (g) of subdivision one of section one hundred eighty-six-e of this chapter. (Emphasis added.)

F. Tax Law § 186-e(1)(g), in turn, defines 'telecommunications services" as follows:

> 'Telecommunication services' means telephony or telegraphy, or telephone or telegraph service, including, but not limited to, any transmission of voice, image, data, information and paging, through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar media or any combination thereof and shall include services that are ancillary to the provision of telephone service (such as, but not limited to, dial tone, basic service, directory information, call forwarding, caller-identification, call-waiting and the like) and also include any equipment and services provided therewith. Provided, the definition of telecommunication services shall not apply to separately stated charges for any service which alters the substantive content of the message received by the recipient from that sent.[3]

G. The term "tangible personal property" means corporeal personal property of any nature having a material existence and perceptibility to the human senses (Tax Law § 1101[b][6]; 20 NYCRR 526.8[a]).

H. Petitioner originally claimed that its purchases of line access were exempt from tax as sales for resale. This claim has not been further argued and appears to have been abandoned. In any event, it is undisputed that petitioner is an Internet access service provider and does not sell telephone or telegraph services to its customers, and thus its purchases would not be exempt as

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[3] This definition of 'telecommunication services' was added to the Tax Law by chapter 2 of the Laws of 1995, effective January 1, 1995.

purchases for resale. In ***Matter of Phone Programs, Inc.*** (Tax Appeals Tribunal, April 6, 2000), the Tribunal explained that "the resale exclusion for utility services demands that the services be resold as utility services, i.e., telephone services (20 NYCRR 526.6[c]; 527.2[e])."

I. In denying petitioner's claim for refund on line access charges, the Division maintains that petitioner purchased intrastate telephone service from the noted providers Focal, Frontier, and NAS. The Division asserts that petitioner's use of such lines thereafter has no impact on the taxability of such purchases at the time of purchase. In contrast, petitioner maintains that it purchases line access to provide its customers with Internet access via a packet switched network which is distinguishable from sound reproduction networks. Petitioner asserts that it did not use the lines to transmit signals, including voice traffic, and therefore did not use the lines to provide telephony or telephone service. In resolving this matter, it is important to note that the Tax Law draws a specific definitional distinction between the service petitioner sells to its customers, to wit, the sales tax exempt service of providing Internet access, from the service purchased by petitioner from the various telecommunications companies, to wit, the taxable provision of telecommunications services as defined.

J. Tax Law § 1105(b) imposes the tax "on receipts from intrastate communication by means of devices employing the principles of telephony and telegraphy." While petitioner did not use the lines to transmit traditional telephone signals, the lines admittedly could have been used for that purpose. 20 NYCRR 512.2(a)(2) clearly states that the words "of whatever nature" contained in the statute which imposes the tax indicate that "a broad construction is to be given the terms describing the items taxed." In addition, the sales tax is a "transaction tax," i.e., the liability for the tax occurs at the time of the transaction (***see*** 20 NYCRR 527.2[d][2]). The fact that petitioner, subsequent to its purchase of the lines, used such lines to provide its customers

with Internet access and did not utilize them for sound reproduction does not render the line access purchases nontaxable. In a memorandum of its Technical Services Bureau (TSB-M-97[1.1]C, TSB-M-97[1.1]S) dated November 15, 1999, the Division stated, in relevant part, as follows:

> Thus, the purchase of telephone service from telecommunications providers (such as local exchange companies or long-distance companies) to access the Internet does not fall within the scope of this exemption.[4] For example, the charge for the telephone call to an ISP to initiate access to the Internet is still subject to both sales tax and the telecommunication excise tax, as is the charge to an ISP for leasing telephone lines from a telecommunications provider.

As made clear from the definitions set forth in Tax Law § 179(1), (2); § 1115(v); and § 186-e(1)(g), petitioner was not selling telephone or telecommunications services to its customers, but was purchasing telecommunications service (subject to tax) to be used in the provision of its own (nontaxable) service of Internet access. Hence, the Division properly determined that petitioner's purchases of line access from the noted providers were purchases of telephony or telephone service properly subject to tax per Tax Law § 1105(b)(1)(B).

K. Petitioner has also argued that even if its line access purchases are held to be purchases of telephony or telephone services, the same are nonetheless exempt from tax because such lines are component parts of petitioner's interstate product known as Internet access. As noted, Tax Law § 1105(b)(1)(B) specifically excludes from tax interstate and international telephony and telegraphy and telephone and telegraph service. Petitioner asserts that in all cases, the Internet traffic on its network, while originating in and returning to New York, was routed through and beyond the borders of New York State. Petitioner cites to ***Matter of Southern***

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[4] The exemption referred to in the memorandum is that set forth in Tax Law § 1115(v) which exempted from sales tax the receipts from the sale of internet access service and the use of such service, as added by chapter 615 of the Laws of 1998.

Pacific Communication Co. (Tax Appeals Tribunal, May 14, 1991), wherein the Tribunal stated that in determining whether a taxpayer's activities are involved in interstate commerce, it is improper to isolate and individually examine the separate components of the overall activity being engaged in by such taxpayer. Petitioner argues that the access lines it leases are integrated with the other network components (servers, routers, modems, etc.) so as to form an interstate Internet network. Since the line access is just one component part of interstate Internet access, petitioner maintains that it cannot be subject to the tax.

L. For each of the purchases at issue herein, the line access service was delivered to and consumed by petitioner at various locations in New York State. The lines in question had terminal points in New York. Simply because the internet traffic on petitioner's network was routed or traveled out of state does not, in and of itself, lead to the conclusion that what petitioner purchased was interstate telephony or telephone service. Unlike the taxpayer in ***Southern Pacific (supra.)***, petitioner was not in the business of selling an interstate telephone service. Rather it sold no telephone service at all. Petitioner was the purchaser of line access, and it used the lines to provide an entirely separate service, Internet access service which, pursuant to Tax Law § 1115(v), was exempt from sales tax for the period at issue herein. While the lines may well have been used to provide Internet access service of an interstate nature to petitioner's customers, the taxes for which petitioner seeks a refund were not imposed upon the Internet access service, but upon the intrastate line access charges only. In sum, what petitioner's arguments overlook is the fact that the tax is not being imposed on the Internet access service, which is an interstate activity and which, pursuant to Tax Law § 1115(v), is exempt from tax. Rather, the purchase of the line access by petitioner from the various vendors was the act that triggered the imposition of the tax. The fact that petitioner subsequently used the

line access to provide a nontaxable interstate service to its customers does not affect the taxability of the preceding transactions, i.e., the purchase of the line access by petitioner from its vendors.[5]

M. Finally, support for the result reached herein may be found in ***Matter of Callanan Marine Corp. v. State Tax Commn.*** (98 AD2d 555, 471 NYS2d 906, ***lv denied*** 52 NY2d 606, 479 NYS2d 1026), where tax was imposed on scows traversing the Hudson River to deliver crushed stone to various locations in New York State (including New York City) from quarries located near Kingston, New York. For a portion of the trip (approximately 20 miles), the scows proceeded on the New Jersey side of the Hudson for navigational reasons, and the petitioner in that case argued that the scows were therefore engaged in interstate commerce because they crossed state lines. The Court disagreed, stating that the scows had a New York origin and a New York destination and that passage through New Jersey waters was merely incidental to what was clearly an intrastate journey. In ***Matter of Western Union Telegraph Company*** (State Tax Commission, February 4, 1983 [TSB-H-83(57)S]), the Commission held that telegraphic messages which originated and terminated in New York but which passed through a computer complex in New Jersey was intrastate telegraphy subject to sales tax under Tax Law § 1105(b).[6] Accordingly, petitioner's purchases of line access do not escape tax as purchases of interstate or international telephony and telegraphy or telephone or telegraph service.

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[5]In short, petitioner purchased a taxable service and the subsequent manner of its use is not determinative of its taxability when purchased. By way of contrast, the nature and manner of use of the tangible personal property (i.e., equipment) referred to in Tax Law § 1115(a)(former[12]) and Tax Law § 1115(a)(12-a) is specifically a requisite factor in determining eligibility for the exemption afforded under such sections.

[6] Decisions of the former State Tax Commission, while not binding on this forum, are entitled to respectful consideration (***see, Matter of The Racal Corporation***, Tax Appeals Tribunal, May 13, 1993).

N. The petition of Frontline Communications Corporation is hereby denied, and the Division's April 21, 2003 denial of petitioner's claim for refund, is sustained.

DATED: Troy, New York
March 10, 2005

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE