
When Taxpayers Have First Amendment Rights*

By Karen H. Currie

Karen H. Currie analyzes the Kentucky case of *AT&T v. Rudolph*, which held that a Kentucky statute prohibiting telecommunications service providers from collecting gross revenues tax directly from their customers by separately stating such tax on the bill to the customer violated the First Amendment right to free speech.

One of the more common challenges in the state tax area relates to the constitutionality of a particular tax or taxing statute. But challenges based on the First Amendment² right to free speech are fairly rare.

When considering constitutional challenges to state taxation, the Commerce Clause typically springs to mind. The dormant Commerce Clause has repeatedly been construed by the courts to prohibit state taxes that discriminate against interstate commerce. Other common constitutional challenges to state taxation include the Due Process Clause (requiring a minimum connection between the state and the item being taxed), the Equal Protection Clause (prohibiting nonuniform and unequal taxation), the Supremacy Clause (prohibiting taxes that discriminate against the federal government), the Privileges and Immunities Clause (barring taxes that discriminate against non-residents), and the Import-Export Clause (forbidding taxes that discriminate against interstate commerce). In *AT&T v. Rudolph*,³ the First Amendment, not the Commerce Clause, allowed the taxpayers to prevail against a Kentucky statute prohibiting the pass through of tax to the customer.

Earlier this year, the U.S. District Court Eastern District granted certain telecommunications service providers summary judgment on their claim that a Kentucky statute disallowing line item billing of gross revenue tax on telecommunications services

violated the First Amendment. At the same time, the court found that the companies lacked standing to challenge the statute on a Commerce Clause basis. The basis for the court's holding was that line item billing adopted by the telecommunications service providers is a type of speech, and the First Amendment prohibits any state tax or other restriction that discriminates or otherwise threatens the First Amendment right to free speech. The court concluded that the state could not adopt a statute that universally prohibited such line item billing.

Background

Effective January 1, 2006, the Kentucky Legislature enacted Ky. Rev. Stat. Ann. § 136.616(3) (hereinafter referred to as "Section 3"), prohibiting telecommunications service providers from collecting gross revenues tax directly from their customers by separately stating such tax on the bill to the customer. Several large telecommunications service providers challenged this provision arguing that because the provision forces them to increase the national rate for *all* customers, rather than just those customers in Kentucky, it violates the Commerce Clause and First Amendment of the U.S. Constitution.

The dispute stems from the interplay between Section 3 and the billing procedures adopted by the telecommunications service providers. The telecommunications service providers generally price their

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services by offering one or more national single-rate pricing plans, so that all customers pay the same base price. The invoice for a particular customer includes the base price plus a separate line item for each state and local tax applicable to that customer.

Kentucky's prohibition against including a separate line item for gross revenues tax forces the providers to either recover the cost from all customers across the nation by rolling the tax into the national rate or recover the cost from only Kentucky customers by changing their pricing model to provide for local rates. The second option is not a feasible alternative for the telecommunications service providers, as it would require the providers to effectively change their entire pricing model, including their billing and financial reporting systems, as well as requiring them to create specific advertising, marketing and customer services plans targeted at the Kentucky market. Thus, the providers felt that they were forced to increase the national rate for all customers, including those outside of Kentucky.

By rolling the gross revenues tax into the national rate for all customers, non-Kentucky residents are forced to bear the burden of a tax for which they receive no benefit from the tax revenues. Based on this inequity, the telecommunications service providers challenged Section 3, arguing that it violates the Commerce Clause of the U.S. Constitution because the prohibition discriminates against their out-of-state customers. They also argued that Section 3 was a violation of the First Amendment of the U.S. Constitution because the statute restricts the telecommunications service providers' right to speech (*i.e.*, their right to include a line item on the bill communicating the nature of the charge to the customer).

In an interesting opinion, U.S. District Court Eastern District rejected the providers' more common Commerce Clause challenge in favor of a unique First Amendment argument.

No Standing to Challenge Commerce Clause

The telecommunications service providers initially argued that Section 3 violated the Commerce

Clause of the U.S. Constitution by discriminating against their out-of-state customers because the service providers were forced to raise their rates nationwide. Non-Kentucky customers would be forced to pay Kentucky gross revenue tax without receiving any of the benefits of the tax revenues. Thus, the out-of-state customers were being unfairly discriminated against.

The court rejected this argument primarily on the grounds that the providers lack standing to assert a dormant Commerce Clause claim on their customers' behalf since the out-of-state customers lack standing to assert such a claim. The court further

stated that even if the providers had third-party standing to assert a dormant Commerce Clause claim on behalf of their non-Kentucky customers, the providers failed to state a claim upon which relief could be granted.

The court reasoned that the plaintiffs chose to recover the tax from the out-of-state customers by raising nationwide rates, but that nothing in the statute required the increased rate for out-of-state customers. Because the telecommunications service providers potentially could have recovered the tax indirectly from their Kentucky customers, the court found there was no discrimination against out-of-state interests.

Line Item Is Protected Speech

The court found Section 3 was unconstitutional based on its impact on the telecommunications service providers' right to free speech. The court determined that a written line item placed on a customer's bill to convey the origin and amount of a charge is "speech," protected by the First Amendment of the U.S. Constitution. As "speech," any regulation or restriction must be constitutionally permissible.

The test for whether a type of restriction is permissible will vary based on whether the speech that is restricted is considered political or commercial speech. The court chose not to weigh in on whether Section 3 restricts commercial or political speech, but instead summarily concluded that because the provision could not withstand even the more restrictive scrutiny applied to commercial speech, it could not be upheld.

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Line item billing is not inherently misleading

The first query in determining whether a particular commercial speech regulation is constitutionally permissible is whether the commercial speech concerns an unlawful activity or is misleading such that it would not be protected by the First Amendment. The government argued that a line item charge would be misleading, non-protected commercial speech because it would imply that the tax is one that the customer, rather than the telecommunications service provider, is responsible for paying. The court rejected this argument and concluded that the government offered no evidence that the line item was inherently misleading. Thus, the line items are protected by the First Amendment.

Line item prohibition does not advance a substantial government interest

To the extent the line item is protected by the First Amendment, the government must assert a substantial interest for the restriction set forth in Section 3. Section 3 must directly advance this governmental interest and cannot be more extensive than necessary to serve the interest.

The court seemed to accept the state's assertion that the government has a substantial interest in preventing confusion regarding the party responsible for the payment of a particular tax, but concluded that Section 3 does not advance this interest. The court reasoned that because Section 3 prohibited *any* line item, whether accurate or not, Section 3 could not advance the government's interest in prohibiting confusion. Further, the court found that the prohibition of *any* line item was an excessive restriction of more speech than necessary to advance the government's interest in preventing Kentucky customers from being misled.

The government's interest in preventing misleading information could have been furthered by a prohibition against only misleading information. Instead, the government chose to broadly prohibit any line item associated with the tax, which amounted to an unconstitutional violation of free speech.

What Other Statutes May Violate The First Amendment?

This case is of particular relevance in today's era of state tax reform. Historically, taxes that were passed through to customers as a separate line item on invoices were typically sales taxes or other similar transaction taxes. Corporate income taxes were recovered indirectly, as they were built into the cost of the item or service sold.

The current trend is for states to shift from income-based taxes to gross-receipts based taxes that are often a hybrid tax, with both income tax and sales tax characteristics. These new gross receipts taxes have created a multitude of new issues, including whether a company should be allowed to pass such taxes through to their customers or include these in the bottom line cost.

The Ohio Department of Taxation has weighed in on the issue on its website discussing its Commercial Activity Tax:

The CAT is not a transaction tax like the sales/use tax. Instead, the CAT is a tax that is considered a cost of doing business in this state, and you may include it like other overhead costs (e.g., employee wages) in the part of the total price you charge your customers. Because the CAT is not a transactional tax imposed on your customers, the CAT is part of the sales/use tax base. In addition, the law does not permit the CAT to be separately billed or invoiced to another person.⁴

It will be interesting to see if the Ohio's prohibition against separately billing the CAT will face a First Amendment challenge in light of the holding in *AT&T v. Rudolph*.

Texas similarly considered adopting a provision prohibiting the direct pass-through of the Texas margin tax, but the provision was excluded from the final technical corrections bill. Many believed the proposed prohibition was a response to Sprint's issuance of a notification to its customers that Sprint would begin charging a 1 percent "Texas Margin Fee Reimbursement" as a separate line item on the bill for each of its Texas customers. The Texas Legislature reacted by proposing several iterations of a line item disallowance, which varied from a blanket pro-

hibition of any type of line item billing to a more limited prohibition against only those taxes not yet paid (with a statement disclosing the tax is not required to be passed through to the customer). None of the iterations made the final legislation; however, the Comptroller and Texas attorney general have publicly condemned Sprint's actions, going so far as to issue a press release and letter ruling prohibiting such a pass-through of tax,⁵ and ultimately filing a petition for an injunction in district court to prevent the reimbursement.⁶ There is little doubt that we will be hearing more from Texas on this issue in the future.

We are just beginning to see the impact of constitutional challenges in this area. Expect to see an

increase in constitutional First Amendment challenges as we move into the next generation of state tax.

ENDNOTES

- ¹ This article was originally published in Jones Day's STATE TAX RETURN newsletter and is reprinted with permission.
- ² The First Amendment provides that "Congress shall make no law ... abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances." U.S. CONST., AMEND. I.
- ³ *AT&T v. Rudolph*, 2007 U.S. Dist. LEXIS 13692 (Feb. 7, 2007).
- ⁴ Ohio Department of Taxation, *Commercial Activity Tax Frequently Asked Questions*, tax.ohio.gov/faqs/content/commercial_activities/qa.asp.
- ⁵ See Tex. Atty. Gen., *News Release* (Feb. 5, 2007); TEX. COMP. PUB. ACCTS., No. 200701867L (Jan. 29, 2007).
- ⁶ See *Texas v. Sprint Spectrum L.P.*, No. GV4-02057 (Tex. Dist. Ct. filed Feb. 5, 2007).

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