



The Cost of Compliance: Providers Walk the Fine Line on the Tax Tightrope

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For providers, managing taxes is tough enough. But if you throw in fees and surcharges, things become even more of a challenge. Providers make business decisions about whether to place fees—not all of which are mandated by regulatory bodies—on their bills, and these decisions can have multiple impacts on their business. At the same time, customers face one of the highest percentages of taxes, fees and surcharges for telecom services, and there seems to be no end in sight.

The Tax Landscape

It is not uncommon to see the combined taxes, fees and surcharges on a bill reach one-fourth or one-third of a bill. "It's a pretty onerous level of taxation," says Eric Tresh, a partner at KPMG.

As some states, counties and municipalities face dramatic budget shortfalls, many are looking at telecom taxes as one way to generate revenue. The telecom industry has been an easy target of state and federal regulators to pass taxes through to customers, Tresh says. Diana DiBello, director of tax at Vertex, says as the states have had huge budget deficits, there have been rate increases. She does not speculate as to one being linked to the other; yet, she recognizes that the two have tended to coincide. According to Vertex's latest Sales Tax Rate Report, of 954 sales tax rate changes in 2003, 412 were increases.

"States need that revenue from those providers," says John Brind'Amour, Info Directions' product manager, tax planning and research. "A lot of states are trying to raise revenues, and they're looking for ways to do it. I think at least in the near term the tendency will be for taxes to go up." As one example, Pennsylvania recently added a tax on wireless telcos that previously had only applied to their wireline cohorts.

So with the tax landscape ripe for increases, what are providers' biggest pain points when it comes to taxes, fees and surcharges?

Provider Pain Points

1) Too Many Rate Changes, Too Many Jurisdictions

Determining the accounts to which taxes should be applied is no easy feat, and completing tax return filings for numerous jurisdictions makes compliance a headache for providers.

One KPMG customer with annual revenues of \$200 million files an average of 30,000-40,000 returns in one year alone.

"The larger your footprint... the more daunting the tax becomes," says BillSoft Founder Tim Lopatofsky. While many small providers may start out managing their taxes in-house, as they grow they soon seek out a specialized tax company to assist. "It doesn't take very long before it is more cost effective to outsource it," Lopatofsky says.

There is software today that seeks to simplify the task, but Bob Schwartz, vice president of Bill Correctors, says his company has found mistakes in tax software in the past. And, despite the fact that software is available, some providers still may use ZIP codes to associate taxes with an account.

“The ZIP code has no bearing as to whether the address is in a city,” Schwartz explains. If a provider is using ZIP codes, it can apply the tax to an account to whose address the tax should not be assessed. “This creates an over-collection of tax,” he says.

Schwartz says he has seen many providers that are out of touch with the most current tax for various jurisdictions. For example, the town of Fairfax, Calif., in Marin County dealt with a situation in which one provider was charging a higher rate than what was stipulated by the tax law. The municipality for which the provider had collected the taxes was burdened by having to refund the money. The issue actually went before the city council because determining how to refund this money was not easy—some people had moved, and there was a question about how the city would go about getting this money back to them. And, there is always the question of how far to go back to repay on over-collections.

“Telecom providers have been fighting this battle [over jurisdictions] forever and ever,” says Dave Bruns, chief of public information with the Florida Department of Revenue. “It’s not only a possible tax liability issue—it’s also a customer service issue.”

But, in fairness to providers, the changes are not easy to track. Companies like Vertex have entire research staffs assigned to cover particular jurisdictions. Some jurisdictions will rate on an annual basis; others may allow quarterly rate changes. Some states limit the number of times a tax can be changed in a year. Many states adhere to either a calendar year or a July 1 to June 30 fiscal year, which causes many rate changes to occur mainly in July or January, followed second by the months in which the start of a new quarter falls. According to Vertex’s sales tax rate report, in June 2003, there were 38 rates changes, while in July 2003, there were 2,561 changes in Texas alone. In December 2003, there were 56 rate changes while in January there were 454 rate changes.

And, help from regulatory bodies to keep pace with changes is handled differently by jurisdiction. “It tends to be kind of varied as to how people are notified,” says Info Directions’ Brind’Amour. Some states release advance notice of changes; some will put you on an email list. Some states actually require that you contact each local jurisdiction to find out about new tax rate changes.

2) Calls from Customers

In Florida, when the state enacted its new tax law in 2000 and 2001, satellite television customers experienced a sharp increase in rates. Prior to this, satellite customers only faced a state sales tax of about 6 percent, while cable providers faced local taxes on top of the state sales tax, which brought cable’s total tax burden to about 15 to 16 percent. The state did not believe taxes should amount to a competitive differentiator, so regulators sought to even the playing field between cable and satellite providers and ensure that there was not an unfair tax advantage toward one kind of provider versus the other.

The satellite taxes jumped from about 6 percent to about 13 percent, which made cable providers happier, but of course angered the satellite providers, who in turn publicized the Florida Department of the Revenue’s numbers and encouraged their customers to contact the DOR with any questions or complaints. Bruns vividly recalls the influx of calls to the DOR and says he was even fielding callers who had gone so far as to find his contact details online and page him at home.

The Florida DOR typically has 44 people in its call center, but with 1 million satellite customers in the state, the department had to expand its call center temporarily to manage the increase in calls. The department also had to put information on its Web site and in various publications.

New taxes or tax increases can cause such commotion among consumers that even Pennsylvania Secretary of Revenue Gregory C. Fajt published a press release in February to clarify that the state's new tax on wireless services were not assessed to consumers, rather they were a tax on the wireless providers. "Wireless service providers may choose to pass the tax along to their customers, but consumers should realize that the choice is entirely up to the providers," Fajt said in the release. "Some companies may decide to absorb the tax as a cost of doing business; others may pass a portion of the tax along to their customers; and some may require their customers to pay the entire tax, plus other 'costs.'"

"Most seemed to be passing some if not all of the tax through," says Pennsylvania Department of Revenue spokesperson Steve Kniley. "I guess what they would say is it is for the costs of collecting it."

Providers must be careful, warns Rene Sotola, chief technology officer of the communications, media and entertainment division at AMS, noting that whatever profit is made from a fee collected for a service can quickly evaporate when a customer calls in to inquire about the fee.

"In general what we find is the [providers] who put the most detail on the bill reduce the call center calls," Lopatofsky says.

If you call a Sprint PCS customer service representative (CSR) to ask tax questions, the CSR immediately directs you to the "tax experts." As it turns out, you are directed to an 800 number with an automated tax information recording. That may have just saved Sprint the 20 minutes you were going to consume of the CSR's time asking line-item by line-item what each tax meant and why it's on your bill.

The information regarding the number pooling and portability fee notes that this charge is designed to recover costs for the federally mandated pooling and porting services. Sprint PCS "will continue until costs are recovered." The recording is careful to point out on both the pooling and porting charge as well as the E-911 charge that "This surcharge is neither a tax nor a government imposed assessment."

3) To Charge or Not to Charge: That is a Business Decision

In his dealings with providers, Schwartz explains that most said they did not as a policy sell services with tax strategy. However, many Tier 3 providers are marketing that they do not add on surcharges like other providers do.

"Fees and surcharges are trickier than taxes," says Jeff Blackey, senior vice president of marketing at US LEC. US LEC tries to avoid fees because it minimizes billing complexity, and because the company is not trying to pass through fees and play them off as government-mandated fees. Blackey believes some providers have financial pressures, and they have tried to stretch the definitions to bring in revenue for themselves. Some companies will actually charge more in taxes just to make sure they get the right fees, he says.

AMS' Senior Principal Robert Balazs says the long distance carriers are the worst when it comes to passing through fees to customers.

But Lopatofsky notes, "If you can't pass it on, it's going to get buried in the cost."

4) Audits and Penalties

The cost of noncompliance is great. Steve Walden, vice president and general manager of Group 1's Centrus division, recalls one state fining a provider \$3 million for being out of compliance. Providers face the dreaded process and find that it is better to get it right the first time than to suffer an extensive audit.

During an audit, an inspector may take a sample of the bills to determine whether a provider is taxing correctly. If a certain percentage is way off, the auditor may investigate this further. "The

more things they find incorrect, the deeper they're going to dig," Lopatofsky explains.

Some states may audit along a specific tax or fee line. Some audits are random while some are probably triggered by flags to revenue departments. If things look good with one provider, an auditor may never come back; however, if a state finds problems, it may communicate this with another local agency.

State audit cycles tend to run every three years, according to KPMG's Tresh, but he adds that some audits can drag on for months or years at a time. And, many providers are audited by multiple states at one time so providers must be able to support this.

For providers who make mistakes, jurisdictions typically invoke fines and charge interest that is above market price—anywhere from 7 to 13 percent. Penalties can run between 10 and 25 percent of the underlying tax liability.

In Florida, if a provider has not accurately captured taxes, a local government may assess a company a 2-year penalty plus interest, according to Bruns. And, Bruns calculates that the ability for a provider to recover any undercharges from a customer is next to zero. Likewise, he says that the competitive pressures are such that it is difficult to build the cost of this mistake into the bill.

In Florida alone there are 470 cities and 67 counties from which providers could have faced potential audits, not to mention the state. "That's a liability that [providers] have to manage," Bruns says. Under the state's streamlined system, providers now face only one audit performed by the Department of Revenue, which generally occurs once every three years.

According to industry experts, each auditor will have his or her own way to evaluate good-faith efforts to comply. There might be, for example, a nuance of a tax law that a company was not aware of. Ann Jurczyk, Group 1's vice president of marketing, says that many rural cooperatives often do not know what their liability is.

"When the law is vague, then you end up not charging the taxes and then you get whacked at audit," Bruns says.

"What the states are looking for isn't perfection," says Group 1's Walden. "What they are looking for is to see that you've made some attempt at getting it right." He notes that while many jurisdictions largely focused their audits on the bigger carriers in the past, some have now moved their attention to smaller telcos.

5) Class Action Lawsuits

The cost of compliance also includes any class action lawsuits that might occur.

A class action case against Qwest Communications alleges that the company placed surcharges on phone cards for calls completed from pay phones despite advertisements stating that there were "no connection fees." In a pending case against Sprint, customers allege the company charges unjustified fees, including 911 fees. And, Nextel Communications settled in a case that rippled through multiple states regarding its Federal Programs Cost Recovery Fee. The company is now required to make statements about the fee in its billing and advertising as well as when customers call in to query about the fee.

And, KPMG's Tresh points out, "There's been a fair amount of legal proceedings that you'll never hear about." Many cases do not get pushed through, and many settle. But, whether they get publicized or not, the act of litigating or settling on class action lawsuits is not without great cost to providers. While many customers may only receive pennies back from class action suits, these proceedings can cost providers millions of dollars.

7) Best Guess with New Technology

New technology forces providers to guess at taxing since tax law can often be antiquated and not fully define the taxability of new disruptive services, such as VoIP.

"A lot of companies do have that challenge [of what to do with new technology] and depending on how aggressive their tax department is will depend what they do," says DiBello. In the interim, a tax department of a company may decide not to tax a service in question, and it may get audited. While under audit, the company can decide whether to appeal it or take it to court. DiBello believes there is a need for telecommunications providers to make a strategic plan and to determine their roadmap when it comes to taxes.

"I hear from a lot of our customers that the tax department is the last to know," DiBello says. Marketing may roll out a product and a week before rollout, the tax department is alerted and must scramble to determine how to tax the new product.

Consumer Conundrums on Taxes, Fees and Surcharges

1) For Consumers, Tax Test too Tough to Pass

"I think the average customer does not understand [taxes]," says AMS' Sotola. But, are taxes enough to make a customer turn away from a provider? Most say no, because the taxes and fees largely will follow a customer from provider to provider. AMS' Balazs points out that even if a customer tries to perform a line-by-line comparison of taxes, it would be difficult because some providers will roll up fees into the state and local tax line item on the bill. Sotola does not believe that taxes and fees would be a primary reason why a customer would leave a carrier; however, if a customer is near churning anyway, an additional fee could be a tipping point.

Group 1's Jurczyk explains that sometimes the description of a tax line item may be truncated because a jurisdiction's name is long, which can cause strange abbreviations that can confuse a customer. While Truth in Billing laws mandate that these taxes be spelled out, many billing systems typically do not carry a field that is long enough to accommodate the names of some taxes and fees.

"We put a lot of effort into ensuring that it [tax and fee explanations] was in customer-friendly terms," says Patrice Vogelman, Verizon's group manager for the consumer market. "We worked hard to get it down into language that is customer friendly."

While meeting with focus groups during Verizon's bill redesign process, customers indicated confusion about the way Verizon's taxes and fees sections appear on the bill. "We found that customers were confused that there were multiple tax sections." These sections were focused around local or toll or optional, to name a few.

In 2004, Verizon plans to aggregate all these taxes into one section with an add-on educational component to the monthly bill that describes the taxes, fees and surcharges.

According to Blackey, US LEC uses its sales force to educate consumers and explains taxes and fees in its proposals to customers. If a tax or fee is changing, the company will use bill messages to inform the customer. Sage Telecom sends out a welcome package explaining fees. Group 1's Jurczyk says a company would want to place a message on the bill if there is a significant tax or fee increase to explain why and minimize calls to the call center.

Some providers will actually design the bill to include information about the taxes and fees, but this can be expensive to do.

2) Advertised Rates: What They Say and What They Do

A commercial for a car will state clearly that taxes, tags and licenses are not included. When you see advertised telecom services, you won't see similar statements. For example, the Verizon Freedom plan may be advertised at \$50 a month, but with all the associated taxes and fees it may end up costing \$65 or more a month. "I've never seen rates quoted with taxes embedded," Schwartz says.

"In most cases, if you ask, they [providers] will give you an approximate number [for tax costs]," says AMS' Sotola. "The problem is you have to ask." Yet, in defense of telcos, Sotola points out that retail clothing stores do the exact same thing by advertising prices sans taxes. "They [retailers] are capitalizing on that mindset."

3) Providers: Just Passing Through

AT&T began charging a "Regulatory Assessment Fee" of 99 cents on each subscriber bill at the start of 2004. AT&T spokesperson Bob Nersesian says the fee is for the "cost of compliance with local and state regulations."

When asked if he thinks calling the fee a regulatory fee confuses consumers, Nersesian says, "It's made very clear by our explanation on our Web site, and I think it's been explained on the bill."

But others see room for customer confusion. "It's not clear from hearing the [name of the AT&T] fee that it is a fee that is going to a carrier," says US LEC's Blackey. Moreover, it sounds like it is being collected on behalf of a regulator. "Each carrier can call it different things so that it implies that the money is going to the federal government even if it is going to the carrier," Blackey says. We don't have a regulatory fuel surcharge that goes to gas stations, so why do providers get away with this.

The FCC has told providers not to misrepresent fees as mandated when they are not. "Obviously, that has no business there," Dr. Mark Cooper of the Consumer Federation of America says about the AT&T regulatory fee. "It's a practice that's bothersome."

"That's purely a pass-on [fee] that they made up," says AMS' Balazs about the AT&T charge.

At Verizon, the provider says it spells out its fees in language on the bill. "I think what we've put on the bill is that they are federal authorized as opposed to federally mandated," explains Vogelmann. This information will appear across from the taxes and fees portion of the bill as well as in the company's educational information.

Cooper maintains that while billing for telecom services is a mess, "there are different categories of abuse." In fairness to providers, Cooper notes that it is the FCC that allows providers to pass these fees through to the end customer.

Blackey says US LEC does not charge a similar regulatory assessment fee, believing that to comply with a regulation is a cost of doing business. "What it really amounts to is a rate increase. If it's a rate increase," he says, "call it a rate increase."

4) Paying for Services Not Yet Provided

Most consumers have no problem paying for 911 or E-911 service. But, how do customers feel about paying a fee for E-911 when it isn't even available?

While Sprint says it has installed E-911 equipment across its national network, its tax line states: "... the availability of this location service is very limited at this time." This is "beyond Sprint's control" in that local phone companies must also implement the technology to receive and process this location information. The Sprint line states: "Not all of these additional steps are complete." The E-911 deadline is Dec. 31, 2005, yet providers are already charging for the service. Whether that is Sprint's fault or the fault of the local providers who have not yet implemented E-911 technology, customers are left footing the bill.

5) Going Back To Collect: Some Providers Don't Make it Easy

When customers are overcharged, some providers will send customers to the taxing jurisdiction to recoup the over-collection. Schwartz says providers have special forms for adjustments and "it is not particularly difficult for them," however some will just not do it. But, he says there may be advantages for customers who go to the taxing jurisdiction to recoup over-payments in that often the provider will not give interest back on over-payments while a taxing jurisdiction typically will.

Schwartz, who works mainly with business customers, says that often a customer will contest a billing item and once found to be incorrect, a provider will reimburse the customer for the service, but not for the taxes and fees paid for that service. Schwartz says they probably figure that people will just forget about the tax.

Group 1's Jurczyk notes, however, that most billing software is not set up to do a reverse calculation for the taxes and fees, which is perhaps why providers are so likely to credit back monies for services not rendered, but why they hold out on returning the taxes and fees associated with that service.

6) Customers Give Telecom Taxes the Silent Treatment

"The bottom of the bill has gotten crowded with a variety of fees, surcharges and taxes," says the Consumer Federation of America's Cooper. While Truth-in-Billing mandates have forced providers to spell those fees out, Cooper says, "knowing that they're there doesn't do them [consumers] any good," especially if consumers do not understand what they are.

So why aren't consumers railing about the high taxes on telecom services?

Tresh says consumers will often lobby to knock down an income tax raise but don't often speak out against telecommunications taxes. As an example, try to get a penny tax in the D.C. metro area to help traffic congestion, and as a politician, you get stonewalled by voters, but put a \$1 tax on the telecom bill and nobody says a word.

Consumers often feel powerless when it comes to the tax portion on their telecom bill. If they can't even understand the taxes and fees, how do they ascertain if they are actually correct? And, what can be done about them anyway?

Schwartz says that many customers simply do not question the bill let alone the taxes. "When they think the bill comes from the heavens, they think the tax field must come from the archangels." Schwartz says, "There's a perception that billing is accurate and that taxes are always accurate."

But this is not always the case. Schwartz recalls a Pac Bell example wherein the company would apply a code to each jurisdiction when it would set up an account. By chance, it was discovered that if a tax code was not entered for a particular account, then Pac Bell's billing system automatically defaulted to the code "01" which corresponded to a tax for the city of Los Angeles. This amounted to a 10 percent municipality tax that was overcharged on affected customers' bills each month for more than five years. The ramifications of this rippled through not only the provider and its customers, but also through the Los Angeles city government. It hurt the city because the jurisdiction thought the revenue generated was correct and thus had allowed for this revenue in its budget. When the error was discovered, the city had to make adjustments in its own budget to make up for the shortfall.

Bills are not always perfect, so consumers and business customers alike would be remiss to think that the tax portion is never without fault.

For both providers and consumers keeping track of taxes, fees and surcharges is a tall order. As much as providers struggle to determine what to tax and what fees to levy, consumers struggle to understand what it all means.

Different carriers make different decisions about what to pass through to the end customer. But this decision must be based on a few critical questions:

- 1) What can the provider do within the bounds of the law?
- 2) What is the elasticity of demand on a service?
- 3) What is the impact on the billing system?
- 4) How will the customers react?
- 5) What is the financial impact if the provider does not pass the fee through?
- 6) What are the call center costs to deal with customer questions?