



## **VoIP Taxes: Your Guess Is As Good As...**

By John L. Guerra  
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VoIP providers trying to get straight answers about paying taxes can be forgiven if they feel like they've entered the Twilight Zone:

"Welcome to a world of VoIP taxation, a world where one must pay taxes, but no one seems to know who to pay. It's a world where VoIP providers can only guess which state, county or town will tax them; a place where you can't see if a call is local, long distance or international ..."

Even the nation's largest telecom providers, with their large staffs of tax lawyers and other revenue specialists, are often unsure of what's required from each state when it comes to VoIP taxes. Verizon, SBC, AOL and Comcast all have experience dealing with nearly every state—but can't tell you how they're supposed to pay taxes on their VoIP traffic in every state.

"VoIP providers have the difficulty of interpreting tax law that doesn't exist, is unclear and they're uncertain about it," says Jim Nasson, national tax partner for technology, media and telecommunications at Deloitte & Touche LLP. "Telecom carriers walk the tightrope; if they don't charge the tax to their customers on some service, they can be held accountable when the auditor comes in. If they are too aggressive in collecting taxes they have to go back to their customers and say, 'Oops, I shouldn't have charged you that tax.' And that's a customer-relations nightmare."

### **VoIP Awaits Regulatory Rulings**

The states can't be blamed for not knowing how to frame new laws to cover VoIP taxation and other regulatory fees. After all, the nature of the technology lacks regulatory definition. The telecom world is expecting a final ruling from the U.S. Supreme Court sometime in June on whether cable modem IP traffic is a telecommunications service or an information service. The FCC says it's an information service and thus not subject to the same regulation as regular telephone service. While it won't directly affect whether states can levy taxes on VoIP calls, a ruling by the high court that it's a telecom service would subject VoIP to traditional charges and fees such as USF and E-911.

The FCC traditionally has responsibility for interstate telecom; states for the most part have responsibility for intrastate traffic—activity within the state.

While the FCC has proclaimed it wants regulatory oversight over VoIP, states clearly want to maintain their traditional oversight roles—such as monitoring rates and contractual performance between providers and their customers. "The FCC regulatory regime for the most part leaves state and local governments with a lot of latitude in how to tax, and states say they have a lot of latitude in how they tax VoIP," says Jeff Friedman, partner at Sutherland, Asbill & Brennan LLP in Washington, D.C.

The normal equilibrium between the FCC and the states could be upset if the Supreme Court rules in favor of the information service camp. Watch for changes in what carriers can charge for termination and access, Nasson says.

"Because the regulatory guys also are fighting about whether VoIP is interstate or intrastate in nature," he says, "there could be changes in traditional access. Voice termination is charged at pennies per minute, but if they're terminating information services, that's charged at fractions of a penny per minute."

Whether the high court rules in the FCC's favor or not, Nasson says, the state-sponsored hunger for telecom tax revenue will continue with VoIP. "If the FCC classifies it as an information service, that's not necessarily how the taxing bodies will treat it, and if it's determined to be interstate in nature, that doesn't dictate tax treatment either," he says. "Only a handful of states tax information service, but all states have heavy levies on telecommunications service."

#### E-911 Can't Wait

Questions surrounding E-911 functionality on VoIP networks and charges related to its use (non-governmental fees) have been forced into the open already. Ahead of the Supreme Court ruling, at least two states have taken Vonage Holdings Inc. to court for failing to tell customers that they had to sign up for E-911 service by registering their addresses with a separate entity. Vonage also allegedly failed to tell customers that their VoIP emergency calls could be routed over lower-priority lines than those used by traditional 911 calls.

As a result of these rulings, Vonage and other VoIP providers that don't have their own facilities are signing agreements with LECs and mobile operators for access to equipment that nails down the address and location of the VoIP caller who dials 911.

"We need access to the wireline trunks that the LECs own and operate [for] their 911 systems, so we're negotiating with them directly for access to that equipment," says Brooke Schulz, senior vice president for corporate communications at Vonage.

Until the industry hears from the Supreme Court on the definition of high-speed Internet, VoIP providers will be without much guidance on E-911 fees—but they'll be paying LECs for use of their E-911 location equipment.

## Unbundling Local Calls from Long Distance

Providers say they can't, with much accuracy, unbundle voice traffic from the packets on their networks that carry other IP products such as ring tones and text messages. Nor can they break VoIP traffic down to separate buckets of local, long-distance or international traffic. While this may be partly true, until a VoIP provider can do so, it can't pay taxes on each type of call, which carries a different tax rate. Carriers have various ways to estimate the percentage of each call type, but none of them guarantee safe harbor from tax liabilities.

Though most VoIP providers charge a flat rate—for instance, \$29.99 a month for all VoIP call types—it's impractical in the long run. As traffic volume grows, they'll want to differentiate call types so they don't unknowingly overpay taxes in any call category, which results in lost revenue. Without understanding which calls are local and which are long distance, VoIP providers can't utilize QoS routing accurately, or better squeeze out revenue by, say, finding least-cost routing for long-distance calls.

### Problem 1: Does Your Company Have Nexus?

In the tax world, the term "nexus" has a thousand definitions, but in general it means a business presence or commercial connection. In the telecom industry, nexus is the jurisdiction in which a carrier must pay taxes. If a provider has nexus in Oklahoma, for instance, it must pay Oklahoma its taxes based on Oklahoma's tax statutes. Determining nexus (or more importantly, avoiding nexus) is a central issue in determining tax liability.

VoIP providers are having a tough time determining if they're liable for taxes—never mind which kinds of taxes the state wants them to pay. There are some 140 different kinds of taxes out there aimed at telecom providers.

"When it comes to nexus, some states are standing by what the FCC might dictate; other states don't understand what's going on or even know what VoIP is," says Tim Lopatofsky, founder of BillSoft. "These states haven't changed their tax laws to accommodate VoIP—they don't understand telecom revenue and how it's shifting [toward VoIP]."

But other states are waking up to the revenue they can gain from taxing VoIP. "States are realizing that VoIP is real," Lopatofsky says. "They're seeing revenue from traditional long distance going away. They realize they've lost revenue because they didn't see VoIP as what it is."

To be sure, states are coming to collect what's theirs.

"What the states have told the FCC is, 'You get the regulatory authority, but we're going to tax VoIP providers under our tax laws,'" says Diane DiBello, tax expert at Vertex Inc., which develops telecommunications software and related services.

### Nexus Test 1: Physical Presence in a State

Tax staffs at VoIP providers now must determine the states in which they have nexus. The first step is to determine whether the VoIP provider has a physical presence within a state. For the larger carriers—ILECs and largest cable broadband providers—that usually means most or all states. Physical presence is a bit tougher to nail down for smaller VoIP providers, but the answers may be surprising.

A provider can be deemed to have nexus even if it doesn't have headquarters, satellite offices, a sales kiosk or any "brick-and-mortar" property in a state, says Friedman, the partner at Sutherland, Asbill & Brennan.

"Nexus is defined differently in each state," he says. "Some say you have nexus if your company has any physical presence in that state; some expand that to include businesses within a state that do business with you."

### Nexus Test 2: Third-Party Liability

The third-party connection expands further. Suppose a VoIP provider based in Massachusetts (for example only) sends a single sales training manager to a Best Buy in Indiana, where she'll teach the Best Buy sales clerks how her company's IP phone works, including a sales pitch to use on shoppers. Not only do the IP phones on the store shelves indicate a presence, but to some states, relying on store employees in another state to sell one's product creates third-party nexus, and the VoIP provider may have to pay taxes in that state. "Some states would say any market-making activity of a third party is sufficient to create nexus," Friedman says.

How about an unsuccessful attempt to sign a contract with a third party in a state? Does exhibiting at a trade show, trying to sell one's software or services, indicate nexus? It depends on the state.

During debate over the future of Internet sales taxes, one school of thought held that the presence in Montana, for instance, of a Web server that processed orders for an online department store should be considered a "virtual warehouse," for purposes of nexus, as if the department store owned a real warehouse in the state.

### Nexus Test 3: The IP Cloud

Thankfully, no states are claiming Web sites as proof of nexus in the VoIP taxing rules.

"In regular telecom, if you have a customer in a state, that customer presence gives you nexus," says David Rubenstein, managing director of telecom at CCH Inc., which develops software and workflow tools for tax, accounting, legal and business professionals. "But if you're an Internet telephone carrier you're not going to have equipment in every state, or even a sales rep. The nexus argument becomes more appealing because there are loopholes in place for those companies. The Internet cloud doesn't have nexus to any particular state, it's an overhanging cloud."

Providers should determine how states handle VoIP equipment location, whether actual or virtual. Does the provider have to pay taxes in the states where it has VoIP equipment such as softswitches, fiber (leased or owned) over which the voice or IP packets travel, signaling gateways or portals? It's probably a good idea to understand where the VoIP provider's equipment is—just to make sure there's no tax liability left unanswered.

Vonage, for instance, doesn't own its own broadband network, aside from some servers and other minor equipment. It relies on Level 3 and others for its broadband capacity. "In all the 50 states we don't pay except in New Jersey, where we're headquartered," says Schulz at Vonage. "On top of that we pay the federal excise tax (3 percent), and we pay fees in Rhode Island, where we have access to E-911; we'll pay fees in states as we get access to more carriers' E-911 elements."

Once the provider has determined nexus, it should determine the kinds of taxes the state (or local jurisdiction) levies against providers. BillSoft's Lopatofsky gives a few examples of how states differ in their treatment of VoIP taxes. Each state asks itself two basic questions: is VoIP regulated, and is it taxable?

- Alabama levies a sales tax, but hasn't determined if VoIP is regulated.
- Alaska hasn't determined if VoIP is regulated or taxable.
- Florida doesn't consider VoIP a regulated service and has ruled that it's not taxable for gross receipts, sales, communications service tax, or telecom relay tax.
- Indiana and Kentucky say VoIP is taxable for sales and telecom relay, and both say VoIP is not regulated. Kentucky says it's taxable for Lifeline and telecom relay service.

#### Problem 2: Call Type and Sourcing Rules

The next big question mark in the twilight realm of VoIP taxation deals with the call type, and how in the world VoIP providers are supposed to avoid paying too much or too little tax on the revenue from calls when they supposedly can't determine which are local and which are long distance. They are faced with the choice of whether to assign tax sourcing based on the Goldberg Rule (still relying on shaky origination and termination data) and whether to unbundle local and long-distance traffic based on a universally accepted formula or a best estimate—neither of which promises safe harbor when the state tax auditors come knocking.

The nature of VoIP networks—the caller's location is based on an IP address mapped to a phone number, rather than directly to a house address—complicates nailing down where VoIP calls begin and end. To increase the confusion, VoIP providers offer subscribers an area code of their choice, for reasons of convenience or marketing.

#### Unbundling the Bucket

So how does a VoIP provider figure out how to pay tax on that a bucket of 10 million minutes? In a perfect world, the provider must be able to determine which state gets the tax, and how much each call type should be taxed.

A lot of tax experts suggest that VoIP providers use the Goldberg Rule—the two-out-of-three rule—supported by the Mobile Telecom Sourcing Act and upheld by the Supreme Court. The rule says that a state or other jurisdiction is the taxing authority for a wireless call if it satisfies two out of three elements identifying the call: origination, termination, or billing and service address. So if a VoIP call originates in Maryland and the caller is billed in Maryland, that state would get the tax from that call. "The Goldberg Rule is typically used as a beginning point," says Friedman. "That could get tricky in VoIP, though, when origination or termination is unknowable."

According to Mike Basch, tax research and product specialist at Vertex, the designation of call type is important, because states apply different tax rates for inter- and intrastate traffic. But because they cannot separate call types, VoIP providers may find the most practical approach is the FCC ruling allowing wireless providers that charge subscribers a flat monthly fee to unbundle their traffic into 28.5 percent interstate and 71.5 percent intrastate. Some states, most notably Nebraska, have begun to charge VoIP providers a USF fee based on that same split, so it's probably the most painless way to separate call types.

However, figuring tax liability this way won't be sufficient in the long run. The pre-subscribed breakout doesn't take into account non-voice IP traffic. Providers may be unwittingly paying the greater tax rate for voice on its data traffic, too, which is taxed at a much lower rate or not at all. For instance, products like ring tones may only carry a sales tax and not a telecom relay tax or other tax applied only to voice. Providers won't want to pay more taxes than they have to simply for convenience.

#### Managed Networks Versus Traffic Studies

Oddly though, determining which traffic is data and which is packetized voice shouldn't be that difficult, especially on managed networks, says Lopatofsky at BillSoft. "On managed networks the VoIP packet is much smaller than a normal data packet. Managed networks have software that says, 'That's a VoIP packet, hold the other kinds of traffic and let that one go on.'"

The wireless formula has a major drawback: it's too broad. The 28.5/71.5 breakout may be way off the mark for some VoIP providers. They could end up paying far too much tax on local traffic—the most highly taxed traffic—because the formula greatly overestimates the amount of local traffic on a provider's network.

Some telecom tax experts suggest performing a traffic study to determine the local/long distance mix and compare it to the FCC formula. This not only lets the provider see how close the formula is to its situation, it can choose which model serves it best.

"That's an important thing for a carrier to look at," CCH's Rubenstein says. "If you can't do any call tracking, you have to configure a worst case, as far as taxing liability goes. Some providers apply tax as if it's all local basic service, which is the most heavily taxed service."

## Do the Best You Can

"Right now the advice is to do the best you can with the information you have that's available," says Nasson at Deloitte & Touche. "Even though this is your first time through and your data will be limited, you at least have something to show the auditors. Periodically evaluate what you've done to document what you've got—to show you weren't trying to be abusive with the available data."

With all the uncertainty and confusion among the states on what they'll tax and how they'll tax it, telecom tax professionals offer some sage advice:

1. Define what you're selling. Separate what you're selling in your mind. If it's VoIP, treat it like telecommunications for now. If it's data, such as e-mail or ring tones, see if there's a way to determine each type of service by packet.
2. In which states does the VoIP provider have nexus, according to their revenue offices? Contact each state if you can spare the staff. Follow the directions supplied by the states themselves—the best form of safe harbor.
3. If you're selling a communications service and data services, determine if each IP transaction is interstate or intrastate as best as you can. 4. Ask yourself for which taxes each of your services is liable. States tax each data transaction differently.

The various telecom tax experts seemed to agree on one thing: If a VoIP provider hasn't done so already, it should hire a tax lawyer to help guide it through the confusing and evolving tax rules surrounding this new technology.

"All of these questions should go through a tax counsel," Rubenstein says. "The laws differ from state to state; it has to be dealt with on a case-by-case basis. The question of where a softswitch is located—all this is really something for expert counsel who knows this area best."

Otherwise, providers should call each state's department of revenue or taxation and ask for guidance. Some departments of revenue may provide related information on their Web sites. Among the details you'll want to know are the factors that determine nexus, the kinds of taxes you're required to pay, and the rates.