



TELECOM CHALLENGES IMPACTING TAXATION

FOR THE MODERN COMMUNICATIONS PROVIDER

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EXECUTIVE SUMMARY

The telecom service delivery environment continues to undergo seismic changes as Voice Over Internet Protocol (VoIP) goes mainstream, streamlined sales tax initiative remains uncertain, and competition between the new and more traditional breeds of service providers heats up. While the outlook for taxation remains uncertain, tax compliance and administration continues to be a heavy burden among wireline and wireless carriers; a burden that has been intensified by Sarbanes-Oxley reporting requirements.

From a taxation perspective, the telecom industry is currently as volatile as ever. Mergers and acquisitions continue to stir up the industry, while new product and service combinations emerge daily, often times, by non-traditional providers. Meanwhile, states are struggling to find a balance between the needs for tax simplification and tax revenues to fund necessary programs. Add to this mix the pressure of legislatures, lobbyists, and consumer advocates and the result is a very dynamic, evolving area of taxation that should challenge service providers' tax departments for years to come. Preparation will be the key for tax departments that wish to adapt readily to change and stay ahead of the curve.

Service providers should develop a resource toolkit covering the following:

- Worst-case scenario analysis
- Financial analysis
- A list of the right people to help, and
- Designating staff to stay on top of the proper channels for updates.

Indeed, the current tax and regulatory environment for new communications technologies is similar to seismic activity. However, while service providers in this industry cannot of course predict when the next "big one" will hit, implementing a kit as outlined will increase their ability to adapt to change in this unpredictable industry.

Regardless of the outcome of these regulatory and technology issues, carriers will need to have reliable systems, either developed in-house or provided by a reliable third-party provider, to assist in managing ever-changing rates and rules of taxes, fees and surcharges surrounding both traditional and newer communications technologies.

In this paper we will review the latest communications tax trends and policy direction for a range of dynamic topics that have far-reaching repercussions for communications providers, including VoIP, Broadband over Power Lines (BPL), Wireless Fidelity (WiFi), Internet Tax Freedom Act, Cell Phone Content, and Bundled Services. Finally we will review different tax collection approaches from service providers as well as highlight best practices for compliance with Sarbanes-Oxley.



VoIP BRINGS OPPORTUNITY, YET REGULATORY HURDLES ABOUND

Few technologies since the Internet itself have been shown to have the disruptive potential as VoIP. And few have raised so much controversy, particularly from a public policy standpoint. Some of the remaining regulatory hurdles include: tax treatment of VoIP, the role of intercarrier compensation in an IP-based call, the traditional utility regulatory issues such as non-discrimination and price regulation, and social policies such as access by persons with disabilities, universal service, Communications Assistance for Law Enforcement Act (CALEA), and 911.

VoIP defies easy categorization as a technology medium despite its rapid emergence and aggressive rollout plans by pure play VoIP providers, major telecoms and cable companies. Depending on which industry official or government regulator you speak to, VoIP could be considered a telecommunications service, an Internet service, data service, or something else entirely. The categorization issue has wide ranging implications for tax policy. If VOIP is not taxed as a traditional telecommunications service, the revenues of state and local governments could shrink drastically, as would the pool for Universal Service Fund (USF). Additional open issues abound, including does the VoIP provider owe access charges to the carrier completing the call over the Public Switched Telephone Network (PSTN), Will the revenue pool for 911 also be diminished if VOIP is not treated as a telecommunications service, can VoIP providers meet CALEA requirements?

On November 9, 2004 the FCC clarified that the FCC, and not the states, have the responsibility and obligation to decide which regulations apply to IP-enabled services. This position thwarts some states' attempt to require VoIP service provider such as Vonage to register as a telephone company. In a speech delivered in October 2004, former FCC Chairman Michael Powell stated that to allow the states to have regulatory authority over VoIP "is to dumb down the Internet back to the limited vision of government officials. That would be a tragedy."

Requiring VoIP service providers to register as a telephone company adds additional complexity to the business model of those non-traditional telecommunications companies. However, many states are concerned over the potential tax revenue loss as VoIP becomes more popular. The question remains as to how the states will reconcile the need to maintain revenue in light of the FCC's classification of VoIP service providers. While FCC policy dictates that VoIP remain off-limits from a federal regulatory viewpoint, this stance does not exclude state and local jurisdictions from levying taxes, fees and surcharges for VoIP calls. In fact, several states, including Pennsylvania, Tennessee and Wisconsin have legally defined VoIP as a telephony service, making it subject to taxation as any other voice service. We expect this state-level trend to continue in light of the tight budget environments at the state and local levels.

BROADBAND OVER POWER LINES – FOLLOWING SAME ISSUES AS VoIP?

Broadband Over Power Lines (BPL) involves offering broadband service over the unused higher frequencies of power lines. Currently, utilities are deploying BPL primarily to track basic network-maintenance data across their lines, but more and more energy companies and pure-play ISPs, using varying business models, are turning to BPL to serve up broadband services. With significant investment and successful market trials the application could open up as a true threat to Cable and RBOC's dominance of broadband service. The chief benefit of BPL is extending even further the convenience of broadband access through an established, widespread network. Legions of



telecommuters could potentially “power in” to the office to access their networks. Plugging into the Internet would be possible via any outlet and a specialized modem. Data speeds of 3 megabits per second would rival that of cable broadband.

Though BPL is in use now by the utilities for applications such as remote meter reading, consumption measurement and network management, and despite some entries into this segment by power companies and ISPs, widespread acceptance as a consumer broadband application is probably still at least a year away. The rollout of broadband services would require significant investment in basic infrastructure such as substations and transmission lines. Power companies are confident that the quality of BPL transmission will be available with minimum interference from other frequencies, such as those frequencies used by emergency personnel.

Turning to a public policy and regulatory perspective, BPL as a method of access to the Internet has great appeal to the FCC as the Internet can be accessed anywhere there is an outlet and would require less investment than broadband alternatives currently available to consumers. From a competitive standpoint it remains to be seen whether the potential entry of utilities into the broadband marketplace would end up leveling or “un-leveling” the playing field.

As with VoIP, a slew of regulatory issues crop up. For example, will power companies need to deal with the bundling debate much like telecoms have in the past? Time will tell whether the states consider this offering from a public utility subject to the standard utility regulatory fees, not to mention whether a BPL provider would qualify for special public utility exemptions.

These new technologies offer challenges to the communications industry and regulatory authorities. Will classification by states lead to various degrees of tax treatment? Will states define VoIP as telecommunications service and if so will all the various telecommunications taxes apply? How will the FCC and the states manage the disparity between a traditional telecom and a VoIP provider selling the same service? How will electrical utility companies, another regulated industry, entering the broadband market impact the levelness of the playing field? The regulatory framework for utilities is currently not structured to effectively and impartially handle these rapidly evolving service offerings. While the intent of the 1996 Telecommunications Act was to foster competition, the industry has evolved into a hybrid of regulated and unregulated companies providing the same types of service under differing regulatory oversight.

WIFI, WISPs, AND CELL PHONE CONTENT

WIFI, also known as 802.11b, is a mainstream broadband service provided in many public locales such as airports, hotels, coffee shops and now by metropolitan governments over major city footprints. Wireless Internet service providers (WISPs), make use of licensed and unlicensed spectrum to provide the “last 30-50 mile connectivity”, as opposed to the last mile connectivity offered by traditional broadband providers. As with VoIP, WISP has become the darling of former Chairman Powell, who stated, “You are among my broadband heroes – spinning wheat into gold – turning the spectrum ‘junk’ bands into venues for...services to businesses and consumers.”¹ The FCC’s policy position on licensed wireless broadband services has facilitated spectrum leasing for licensees and has streamlined the process for license assignments and transfers.

¹ WISPCON, 10/27/04



What is the regulatory future for wireless broadband? It should closely resemble other broadband deployments such as BPL, but the states' ultimate part in the equation is a great unknown.

Once a limited outlet for a few applications such as checking stock quotes, cell phones have emerged as a multibillion-dollar content platform that has burgeoned in the last few years to include ring tones, text messaging, photography, streaming content, and a host of personalized services. The personal ring tone market alone generates over \$3B in revenue annually. From a taxation perspective, cell phone content has straddled the nebulous line between being a product and a telecommunications service.

However, in October 2004 the Streamlined Sales Tax Project members decided that ring tones would specifically be excluded from the definition of telecommunications services. This exclusion was requested by the wireless industry to safeguard its independence from the telecom realm despite the fact the content is delivered by a telecom provider. The SSTP Digital Products workgroup continues to monitor states' ability to tax ring tones under the definition of a digital product.

Passage of the Mobile Telecom Sourcing Act (MTSA) on the one hand, which simplified the determination of taxation for a mobile call by eliminating the two out of three methodology, and on the other hand existing tax exemptions for specific wireless services such as ring tones and games, have tilted taxation policy slightly in favor of the wireless service providers. Given the prevalence of service bundling in the telecom industry, we expect to see the eventual packaging of wireless telephony service by pure-play WIFI providers, and with it the potential for complex tax and regulatory burden.

INTERNET TAX FREEDOM ACT (ITFA)

President Bush signed into law the ITFA in December 2004 to extend the moratorium on multiple and discriminatory taxes on Internet Access and Internet Commerce. The ITFA prohibits, beginning November 1, 2003, and ending November 1, 2007, state and local taxes on Internet access, and multiple or discriminatory state and local taxes on electronic commerce (this provision reinstates the ITFA moratorium originally enacted in 1998). However, the grandfather clause for the Wisconsin telecommunications service tax is extended only until November 1, 2006. The Act expands the definition of exempt Internet access to include telecommunications services "to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access." This provision narrows the moratorium exception for taxes on telecommunications services that had been used by some states to tax digital subscriber line (DSL) service, and it presumably exempts telecommunications services used by Internet service providers over the so-called Internet backbone (i.e. the "middle mile" of access).

The Act enacts a new grandfather clause to permit, until November 1, 2005, other Internet access taxes that were generally imposed and actually enforced as of November 1, 2003. This provision permits, for instance, states and localities that have been taxing DSL service to continue to do so for another two years, despite the narrowed exception for taxes on telecommunications services. The Act also allows the taxation of otherwise exempt Internet access service that is bundled with taxable services, unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business.



One may question the need for the ITFA as the technologies related to the Internet continue to develop and proliferate, r. However, Internet access is but one of the many new technologies providing a vehicle for new and emerging technologies and electronic commerce. The ITFA may just be providing another potential source for disparity in an already complex and inequitable tax and regulatory landscape.

BUNDLED SERVICES

The marketing departments of the major telecoms have popularized bundling multiple services together on a customer's bill as a method to offer one-stop shopping, and in turn increase customer loyalty. From a taxation perspective however, the tax treatment of taxable and non-taxable components within the bundle creates a thorny issue for service providers.

SSTP's approach to defining the sales price emphasizes that sellers may not exclude exempt charges from the sales price of a bundle unless that charge is separately stated and documented on the invoice. However, some states have begun to add provisions for bundling of telecom services to mirror the language of the MTSA. For example, Alabama has recently amended its Utility Privilege Tax Regulation to include the following: "Beginning with bills dated after May 5, 2004, charges for nontaxable services combined or bundled with and not separately stated from taxable charges for telephone or telegraph services are subject to taxation, unless the exempt charges can be reasonably identified in the books and records kept in the regular course of business by the utility provider" Rule 810-6-5-.26(3)(c)11(d). This provision is almost identical to the provision contained in Alabama's Mobile Communications Services Tax regulation.

As SSTP and other initiatives progress, states may opt to address similar provisions as MTSA. However, the states must reconcile revenue impact and law changes against taxpayer needs. As seen in a number of states adopting SSTP conforming legislation, what appears to lawmakers as a simple law change, often creates politically charged angst for taxpayers and results in legislative retraction and/or delay.

TO TAX OR NOT – DIFFERENT APPROACHES FROM SERVICE PROVIDERS

Communications providers may take a conservative or aggressive approach to tax liability and collection. The conservative approach dictates taxing a service, which limits exposure from tax not collected and any resulting penalties and interest. No questionable reserves need to be forecasted for this exposure. On the other hand, an aggressive approach of not taxing a particular service puts the provider at a competitive advantage versus providers that do tax the same service, but increases exposure to collection costs, penalties and interest and customer churn.

In *AT&T Corp. and AT&T Communications of Texas LP, v. Public Utility Commission of Texas, et al.*, the U.S. Court of Appeals determined that the Federal Telecommunications Act of 1996 (TA96) preempted a Texas regulatory fee on intrastate, interstate, and international calls originating in Texas. The fee in question is the Texas Universal Service Fund (TUSF). As a result of TA96, the FCC was allowed to assess interstate service providers to fund the Federal Universal Service programs. Alternatively, states are allowed to assess intrastate providers to fund the state universal service programs. There is no treatment prescribed for multi-jurisdictional carriers



providing both intrastate and interstate service. Texas' fee on all revenue for calls originating in Texas resulted in a double assessment and put multi-jurisdictional carriers at a distinct competitive disadvantage compared with the pure interstate carriers. In the end AT&T's position on the TUSF was justified.

When faced with a situation like AT&T in the case above, the choice to collect or not collect is never easy. A provider that collects taxes/fees and then is later awarded refunds must jump through a myriad of hoops to get the money back to the customers. Some options include reducing the fee rate, charging a negative rate, issuing credits, taking ads out in papers to identify customers no longer with the company and writing checks. Issuing checks to consumers is the most costly of options and usually the refund method of last resort. On the other hand if a tax is not collected and determined to be due, back billing can be even more of a nightmare and the service provider stands to lose money when attempting to collect the tax or fee from their customer. Some customers will just not pay the tax or fee when charged at a later time. Also, some providers' contracts limit the period of time the company can go back to for back billing. Both scenarios lead to additional costs and consume valuable resource time.

To minimize the cost of compliance today, telecom carriers need to base their decisions on their business model and tolerance for risk. The exposure to a smaller provider could put it out of business if states later determine that the service falls under definition of the existing tax base (e.g. VoIP). On the other hand the risk may financially outweigh the costs associated with complying today, even if the company is later required to collect and remit the taxes. There are no guarantees that states will be prospective in application of law. States may retroactively impose taxes that could result in significant liability for a service provider. Additionally, the amount of time it can take to resolve a tax/fee related issue through the appeals process may take years.

MANUFACTURING EXCLUSIONS FOR TELECOMS

The debate persists between states and service providers over the manufacturing exemption. The basis for this exemption is the conversion of sound waves to signals. States' positions vary widely in the designation of voice conversion as the creation of tangible personal property.

Taking a pro-industry stance, the Missouri Supreme Court in 2002 overruled a lower court decision denying manufacturing exemption to Southwestern Bell's equipment used to convert voice to data for transmission. The Supreme Court sided with the Regional Bell Operating Company (RBOC) in stating, "Although the human voice may not be unsuitable for common use, it is unsuitable for communication that must occur over any appreciable distance... The listener requires that the voice be 'manufactured' into electronic impulses that can be transmitted and reproduced into an understandable replica." (Southwestern Bell Telephone Co. v. Director of Revenue, Missouri Supreme Court, No. SC83859, June 11, 2002)

However, in Bell Atlantic Mobile Systems, Inc. v. Commonwealth of Pennsylvania, March 2004, the Pennsylvania Supreme Court confirmed the Commonwealth Court's decision that only tangible personal property can be deemed 'manufactured.' The inclusion of telecommunications services in the state's definition of TPP is only intended to identify that service as taxable.

Similarly, in a Kansas Supreme Court decision upholding an earlier Kansas Board of Tax Appeals (BOTA) ruling, sales tax refunds were denied on telecommunications equipment claimed to qualify for manufacturing exemption. Five telecommunications companies on the claim were not entitled



to a refund of the tax. Delivering the Court's opinion, Justice Marla Luckert echoed the assertions previously made by both the DOR and the BOTA that the plain and unambiguous language of the Kansas Retailers' Sales Tax Act defines telecommunications as a service and not tangible personal property. The companies' machinery purchases were therefore not eligible for the exemption.

In the years ahead we expect to see increased lobbying and litigation activity in the telecom industry as large, consolidated telecom service providers attempt to exert even greater muscle in their effort to pressure DORs to allow such exemptions for their industry.

SARBANES OXLEY – BEST PRACTICES

Sections 302 and 404 of the Sarbanes Oxley have wide reaching impact on the tax policy and practices of communications carriers. Section 302 mandates that CEOs and CFOs formally attest to the accuracy and fairness of the organization's audited financial statements and disclosures.

Section 404 requires that company annual reports contain "Internal Control Reports" that detail management responsibility for establishing and maintaining internal structures and procedures to financial reporting and assess the effectiveness of those controls.

Sarbanes Oxley offers a broad set of challenges to the communications industry. Specifically, the Internal Control audits require assessing and evaluating controls for data that is difficult to acquire and manage. For a pure telecom under Sarbanes, the tax department needs to know how and what controls are in place to ensure that financial data is accurately reported and accounted for.

As the telecommunications industry has become a magnet for the microscopes of state and federal regulators and watchdogs in the wake of the WorldCom accounting scandal, getting a handle on enterprise financial processes and controls is essential. Though not all-inclusive, we offer the following best practices for communications service providers:

Engage a consulting firm that understands your industry processes and limitations,

- Document, document, document – maintain up to date and accurate documentation for policies and procedures,
- Have appropriate sign offs without bringing the organization to its knees,
- Understand weaknesses and identify ways to either correct or compensate, and
- Use Sarbanes Oxley to your advantage!

Here is a chance to get additional funding for the tax department. Many programs that tax departments would like to improve upon or put in place may now fall neatly under the SOX umbrella.



About Diana DiBello

Diana DiBello has frequently spoken for numerous groups and organizations including Telestrategies, the Institute for Professionals in Taxation (IPT), the National Association of Credit Managers and the Vertex Exchange Customer Conference. Over the years her topics have included discussions on Tax Strategy, Telecommunications Taxes, and Electronic Commerce.

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At Vertex, Dan serves as a specialist for emerging trends in telecommunications and the application of taxation to new communications technologies. Dan is also responsible for managing Vertex® Communications Tax *L Series*® and Vertex Communications Tax *Q Series*™ products.

About Vertex Inc.

Vertex Inc. is the leading provider of tax technology solutions, serving more than 10,000 customers worldwide. Vertex solutions automate processes and enhance decision information across every major line of business tax including income, sales, consumer use, value added, communications, and payroll. To serve its customers, Vertex works in partnership with leading software and service providers, including SAP, Oracle, Microsoft, J.D. Edwards, IBM and PeopleSoft. Founded in 1978, Vertex is headquartered in Berwyn, PA and has offices in Atlanta, Chicago, Dallas, Sarasota and Washington, DC.

To learn more about Vertex's solutions, call a Vertex representative at 800-355-3500 or visit us at **vertexinc.com**.