

WHITE PAPER: VoIP Service Provider Compliance with Communications Taxes and Regulatory Fees

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Words you have heard about your business probably include telecommunications, telecommunications services, VoIP telephony, I-VoIP and IP telephony, to name a few. In general, these are all “communications”; however, depending on whether you are before the FCC, a state utility commission, a taxing authority, a 911 administrator or local government, the precise words have special meanings and a variety of distinct legal consequences.

It is not just legal consequences with regard to government agencies that matter — legal consequences with suppliers and customers are important, too. In addition, participants in the communications industry can have different understandings about what constitutes “telecommunications” — which could affect whether taxes or fees are imposed or there is a tax exemption.

Issues that Affect Taxation and Regulation of VoIP Services

- Are the services subject to taxes?
- Are the services subject to Universal Service Fund fees?
- Are the services subject to 911?
- Are we exempt from pass-throughs?
- If we are exempt from pass-throughs, how can we prove it?

These questions and more are all too common today, particularly for companies that either sell retail VoIP services or provide wholesale services for retail VoIP providers. These questions are common to companies that make use of the Internet or IP in their wholesale supply chain.

Plain and simple, there is a great deal of confusion out there and, unfortunately, there are few simple, clear and generalized answers. The legal, regulatory and tax landscape applicable to VoIP communications services is highly uncertain, conflicted and changing rapidly. One thing is for certain, however, and that one certainty is the uncertainty.

At the end of the day, regardless of the questionable nature of a particular governmental agency’s legal authority to impose tax or regulatory burdens on certain providers, what all too many companies are finding out is that what REALLY matters is not what the law says – it is what their suppliers tell them they must do.

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Background

The history of figuring out the appropriate framework to govern, regulate and tax IP-based communications began in 1995, when America's Carriers Telecommunication Association ("ACTA"), an association of long distance resellers, became so concerned about the unfair competitive advantages a new breed of software-based "IP Telephony" providers might gain over its members simply by virtue of being unregulated, that they filed a petition asking the FCC either to (1) impose the existing regulatory obligations on VoIP as were being applied to functionally equivalent traditional telephone services; or (2) alleviate the traditional carriers from those burdens. The ACTA Petition sought regulatory parity, but evoked strong global opposition out of fears that parity would impede technological advancement. One specific consequence was that the ACTA Petition spawned the VON Coalition, the first Internet telephony association. The stir created by the very public bickering of ACTA and the VON Coalition ultimately led Congress to become involved.

In 1998, in a report to Congress requested by the then-powerful Sen. Ted Stevens (R-Alaska), the FCC stated its position on regulating various types of IP-based communications services. Proper emphasis must be placed on the term "position." It was in this report — aptly referred to as the "Stevens Report" — that the FCC first employed the terms phone-to-phone, computer-to-computer and computer-to-phone.

But the Stevens Report was not the law, nor was it a statement of actual FCC regulations — at most, it was a statement of the FCC's views on the topic. In other words, it was the FCC's position on VoIP in a hypothetical world in which the FCC regulated VoIP. Notably, the FCC never did anything to formally memorialize its views in actual regulations, and it never did rule on ACTA's petition. Instead, there was a long period of silence. Some would call it a gestational period, in which the FCC's silence and inaction was intentional and intended to allow VoIP to develop technologically and commercially in an incubated and insulated environment.

By 2001, a very Internet-friendly face showed up at the FCC in the form of Chairman Michael Powell. Under Powell, the VoIP gestational period continued. In 2004, the Commission took its first official action regarding VoIP when it halted the Minnesota Public Utilities Commission's efforts to regulate Vonage. Indeed, almost simultaneously, the FCC announced the establishment of its IP-Enabled Services Rulemaking proceeding which, at the time, Chairman Powell said was going to be the venue for making all future decisions on what, how and to what extent VoIP services would be regulated.

The 2004 Vonage Preemption Order was widely hailed at the time as the shield long sought by VoIP providers — the shield from being regulated by 50 different states and taxed by 50 states and

countless localities. The euphoria quickly wore off when Powell was followed by Kevin Martin, an FCC chairman who unabashedly demonstrated a very incumbent-friendly tilt. And, there is nothing the incumbents fear more than technological advancement. In its waning days as a stand-alone long distance provider, AT&T fired off a volley of FCC petitions aimed at separating VoIP from traditional telephone services. However, as AT&T's days were numbered, so too were the days of a supposedly regulation and tax-free VoIP industry.

As the Bell System re-monopolized, the lines between traditional circuit-switched telephony and IP-based telephony began to blur. No decision is more important in the evaporation of this line than the FCC's April 2004 AT&T Phone to Phone "IP-in-the-Middle" Order because the decision impacted not just retail service providers, but the entire supply chain that is involved in the delivery of VoIP telephony services. This may not have been the FCC's intent when it issued the its IP-in-the Middle Order, but it is funny how precedent can be expanded when there is a \$7 billion dollar fund to feed. Essentially, in the IP-in-the-Middle Order, the Commission found that "an interexchange service that: (1) uses ordinary customer premises equipment ("CPE") with no enhanced functionality; (2) originates and terminates on the public switched telephone network ("PSTN"); and (3) undergoes no net protocol conversion and provides no enhanced functionality to end users due to the provider's use of IP technology" is a telecommunications service. The impact of the FCC's decision was to ensure that Universal Service Fund obligations could and would be assessed on IP-in-the-middle communications services.

The Arrival of I-VoIP

The next round of FCC activity addressed services that did not neatly fall within the category described in IP-in-the-Middle Order. In its June 2005 VoIP 911 Order, the FCC created an entirely new category of regulated communications service — Interconnected Voice over Internet Protocol ("I-VoIP"). As a result of this decision, I-VoIP has become the poster child most communications legal practitioners rely on to differentiate between the type of IP telephony services the FCC seeks to regulate, as opposed to those it leaves untouched.

What Is I-VoIP?

The FCC defines "I-VoIP" as a service with the following characteristics:

- 1) enables real-time, two-way voice communications;
- 2) requires a broadband connection from the user's location;
- 3) requires IP-compatible customer premises equipment; and
- 4) permits users to receive calls from and terminate calls to the PSTN.

A service must possess *all four* characteristics or it is not I-VoIP.

There are several kinds of I-VoIP:

- IP-Enabled PBX
- IP PBX
- Hybrid TDM/IP PBX
- IP Call Centers

One common thread of all I-VoIP services is that they must include “off net” communications. “Off net” refers to the fourth prong of the definition; at least one end-point of a two-way communication must touch the PSTN.

Arguably, the FCC intended for its interconnected VoIP regulations to apply only to services which qualified as substantial substitutes for traditional telephony. There is one more important consideration that plays a significant role in determining whether, how, and the extent to which any particular retail “I-VoIP” service is regulated and taxed: the difference between being a fixed vs. nomadic VoIP service — which is sometimes referred to as “over the top” VoIP.

Common Indicia of a Retail VoIP Telephony Service

- Uses computers with multimedia hardware rather than hard-wired circuits and POTs lines to enable users to place calls;
- VoIP telephones and multimedia PCs convert analog voice signals into digital data streams;
- Telephone signals are routed over IP networks instead of over circuit-switched networks;
- A call path usually consists of contacting a target PC on the Internet or to connect to a standard telephone set via a gateway between the Internet and the PSTN;
- Original VoIP signaling standard: ISH H.323; today, most networks use Session Initiation Protocol (“SIP”) as a signaling standard;
- IP Telephones are intelligent terminals:
 - Hard phones (hardware-based) or
 - Soft phones (software-based, residing on desktops, laptops, tablets, handhelds or other computer platforms)

VoIP Toll

In addition to the newly created category of I-VoIP, there may exist yet another category of IP-enabled services: “VoIP Toll.” This category stems from the language included in the Universal Service Administrative Company’s (“USAC”) Instructions to Form 499-A. Specifically, the Instructions state that providers of toll service should classify their services as “VoIP Toll” on Form 499-A if those services: (1) use ordinary CPE with no enhanced functionality; (2) originate and terminate on the PSTN; and (3) undergo no net protocol conversion and provide no enhanced functionality to end-users due to the provider’s use of IP technology. In support of this instruction, USAC cites to the FCC’s IP-in-the-Middle Order. Pursuant to USAC’s instructions, VoIP Toll is a telecommunications service. However, the FCC neither uses the phrase “VoIP Toll” anywhere in its IP-in-the Middle Order, nor does the term appear in any FCC regulation. While the three-part test cited by USAC does appear in the IP-in-the Middle Order, the language of the Order suggests that the FCC’s intent in articulating the test was to simply clarify the scope of its holding in that proceeding, *i.e.*, services meeting the three-prong test are properly categorized as telecommunications services. The regulatory implication of USAC’s Form 499-A Instructions is unclear, as is whether USAC even has the authority to unilaterally create a new service category. With regard to VoIP Toll, there are regulatory differences depending on whether the retail service associated with the IP-in-the-Middle is phone-to-phone or computer-to-phone or computer-to-computer.

VoIP Is Not Black and White

Simply because the FCC has defined two categories of VoIP telephony services — I-VoIP and VoIP Toll — there are still different flavors of VoIP within these categories, such as the distinction between fixed vs. nomadic VoIP.

Fixed vs. Nomadic

What is the difference between fixed VoIP and nomadic VoIP?

Fixed VoIP — Only permits a subscriber to make calls from a fixed address. Fixed VoIP is ordinarily provided over a private communications network rather than the Internet. Because the origination or termination point of a fixed VoIP call can be readily identified, many of the regulatory and taxation pitfalls discussed in this presentation are minimized (or outright inapplicable to) fixed VoIP service.

Nomadic VoIP — Enables a subscriber to access the Internet to make a call from any broadband Internet connection. Because a call may originate from, or terminate to, any location, the FCC has held that it would be impractical, if not impossible, to separate the intrastate portion of VoIP service from the interstate portion and state regulation would conflict with federal rules and policies.

Regulatory implications

Each nuance carries significance not only at the federal level, with respect to FCC fees but there is even greater significance at the state level, primarily because, since the Vonage Preemption Order, the FCC has done very little to prevent states from creeping into the taxation and even regulation of VoIP.

Regulation of VoIP Service

The first question asked by many providers and new entrants is: “Are VoIP services regulated?” The quick and dirty answer is, “yes”, but there is very little about the regulatory classification or treatment of VoIP services, either retail or wholesale, that is clear or stable.

In contrast to the typical supply chain associated with circuit switched telephone services – which involves a facilities-based wholesaler and perhaps one or two resellers prior to the retail consumer - a voice-bearing IP packet can easily pass through a half dozen hands before being routed to its destination. The result is that there are (1) more companies in the VoIP supply chain and (2) more companies using a wider variety of routing technologies.

The supply chain associated with VoIP services creates added complexities in applying the Carrier’s Carrier Rule (“CCR”), or any supply chain enforcement mechanism, to VoIP services. At the federal level, under the CCR, wholesale carriers report revenue from contributing and reporting resellers as wholesale, thereby excluding such revenues from their own federal Universal Service Fund (“USF”) contribution bases. Through its “ancillary” Title I authority, the FCC generally requires providers of

I-VoIP and VoIP Toll to submit regulatory reports, including the FCC Form 499-A, and comply with other applicable rules.

Whereas a voice telephone call on the circuit-switched network is always a regulated telecommunications service, not all voice-bearing IP packets are regulated. The FCC has drawn distinctions between phone-to-phone, computer-to-computer, and computer-to-phone VoIP communications and applied differing regulatory obligations to each type of service. The distinctions between differing VoIP models make supply-chain enforcement of the CCR a difficult task.

Generally, state regulation of VoIP is limited to E-911, public safety, customer proprietary network information ("CPNI"), and consumer protection. A few states require a registration-like filing from VoIP providers for purposes of gathering information. Currently, state entry requirements (Certificate of Public Convenience and Necessity) and powers to assess state USF contributions are preempted with respect to *nomadic* VoIP service.

States also regulate VoIP through their Departments of Revenue, Comptrollers and other state taxing authorities. The telecommunications-related taxes they assess include:

- Sales and use tax
- Excise tax
- Utility tax
- Gross receipts tax
- Franchise tax
- State and/or local E-911 fees; and
- Select local government taxes

Finally, local governments can require VoIP providers to file E-911 periodic reports.

Federal Regulation

The FCC report that is the most critical filing an I-VoIP or any other provider of interstate or international telecommunications will ever file is the FCC Form 499-A. The form is due annually and must be filed by April 1st.

What Does the Form 499-A Provide?

On Form 499-A, I-VoIP providers report revenue data and other information which will be used to calculate contribution obligations to the following:

- Federal USF
- Federal Telecommunications Relay Services ("TRS") Fund
- North American Numbering Plan Administration ("NANP")
- Shared costs of Local Number Portability
- FCC Regulatory Fee

This form and its 55-page, single-spaced, 10-point-font instructional manual is the Holy Grail of FCC regulation. In addition to the funds identified above, revenue data from Form 499-A also serves as the basis for telecommunications annual federal regulatory fees.

For any wholesalers out there — including those that are merely transporting or routing IP packets in the middle of a transmission path — the Form 499-A instructions are also important because they establish the parameters of the CCR. Even though wholesale revenue is generally exempt from any and all regulatory fees, the failure to comply with the CCR can result in wholesale revenue (1) being reclassified as retail by USAC or the FCC; and (2) being subjected to all of the fees for which a wholesale provider's carrier customer would have been liable. This vicarious liability issue has caused tremendous disruption and confusion in the marketplace.

The CCR

The CCR is the most well-known of the "supply-chain" enforcement mechanisms affecting VoIP providers. In 2006, USAC, the USF administrator, created an extension of the FCC's CCR, which imposes vicarious liability on wholesalers who fail to verify their reseller customers' status. Wholesale carriers must now implement procedures to ensure they comply with the CCR, because any failure — no matter how slight — could result in the imposition of contribution obligations on revenue that really has no business being subjected to contributions. But, that is precisely how USAC and the FCC are getting carriers to engage in supply-chain enforcement. The teeth in the USF program is the fear of vicarious liability.

There is nothing terribly wrong with the FCC implementing a supply-chain enforcement mechanism. In fact, it is something that was lacking and that resulted in a great deal of imbalance in the retail marketplace because many retailers of telecommunications services simply ignored their duty to contribute. Indeed, the CCR is similar to the mechanisms that have worked fairly well at ensuring wholesalers and retailers are not paying duplicate sales taxes on consumer goods — including such things as traditional switched telephone services.

Both the state sales, use and excise tax reseller exemption process and the FCC's CCR work well when everyone in the supply chain is selling and reselling the same services and products, especially when the services and products have long histories of stable precedent. However, as stated previously, the regulatory classification of VoIP services and related legal precedent is rapidly evolving and is neither stable nor established.

While the CCR is only applicable at the federal level and at one government agency, it is one of the biggest regulatory concerns facing VoIP providers. Added to this are the difficulties imposed on VoIP providers by the supply chain enforcement system that is in place in nearly all of the fifty states with respect to sales, use, and excise taxes, as well as 911 fees. These difficulties stem from the fact that no two states define a taxable VoIP service the same way, and the only thing that matters to the states is THEIR state definition of telecommunications or telephony, irrespective of the FCC's definitions.

State Regulation

State regulation of VoIP services is confused and confusing, plain and simple. The states outlined following are just an example. Within each of these states, the application of these requirements can depend on a wide variety of factors, such as:

- (1) Is the service nomadic or is it fixed?
- (2) Is the service associated with a static IP address or is it over-the-top?
- (3) Do the fees apply based on the jurisdiction of the calls or the location of the billing address?

Examples of State Regulation of VoIP	
Alabama	No jurisdiction over VoIP, but E-911 charges do apply
Arkansas	E-911 and USF charges
Colorado	VoIP is unregulated, but E-911 charges and CPNI rules apply
Georgia	No state USF, TRS or Regulatory fees, but CPNI rules do apply
Louisiana	E-911 does not apply to VoIP, but state USF does
Missouri	Registration and Annual Report required, among other obligations
Montana	E-911 and TDD service fees apply
South Carolina	E-911 charge and CPNI rules apply
Wisconsin	CPNI rules apply

Since there are numerous differences in the way states regulate VoIP, to ensure compliance in this day and age, each company should conduct its own legal and regulatory risk analysis. Ignorance is no defense of the law, no matter how confusing and impossibly frustrating the law might be.

Federal and state interaction

To the states, the FCC definitions merely serve as a guide, and states make their own laws based on their own definitions of communications services. To the extent these definitions do not result in a state regulatory regime that is inconsistent with or preempted by the federal structure, there is often a degree of overlap. For example, to the extent they remain consistent with federal CPNI rules, states are not preempted from enacting their own CPNI regulations. Thus, if an entity is in compliance with FCC CPNI rules (which are applicable to I-VoIP providers), it is likely in compliance with state CPNI rules as well. Likewise, there is a great deal of similarity in state public safety, consumer protection and unfair trade practices statutes.

However, providers should be mindful that there are often subtle, as well as not so subtle, differences between federal and state regulation. Thus, even when the state and federal regulations appear consistent, there are nuanced differences that providers must take into consideration. These subtle, nuanced differences between the federal and state regulatory schemes

are even felt with respect to "market entry" regulation, an area most would agree the FCC has clearly and unequivocally preempted.

For instance, even though state licensing requirements, such as Certificates of Public Convenience and Necessity, are preempted, a handful of state commissions (such as Montana and Nebraska) nevertheless require I-VoIP providers to register. In fact, as of June 30, 2009, the Indiana Utilities Regulatory Commission required all communications service providers, including providers of Internet protocol enabled services, to file an Application for a Communications Service Provider Certificate of Territorial Authority ("CTAs"). Even though Indiana routinely grants CTAs automatically after thirty days, the process of seeking a CTA is still much more substantial than a mere "registration" or notice filing. To date, no party has challenged Indiana's requirement as being preempted by the FCC, which technically means that Indiana's requirement remains the law of the land in Indiana and must be obeyed.

Yet, with as much encroachment as there apparently is, there are states which claim not to regulate VoIP at all. According to public pronouncements, these states reason that adherence to FCC "preemption" holdings requires them to refrain. While such public pronouncements should provide clear-cut guidance, even here, there is no "bright line" test, and these pronouncements are not fixed in stone.

The Vonage Preemption Order

Pursuant to 2004 amendments to the Internet Tax freedom Act (Internet Nondiscrimination Act, Pub. L. 108-535, Stat. 2615 (2004)), the federal prohibition against taxation of Internet services specifically excludes VoIP services. One of the gaping holes in the Vonage Preemption Order from 2004 is that it did not expressly preempt state commissions from applying taxation and generally applicable E-911, public safety, CPNI and consumer protection statutes to I-VoIP providers. A strict reading of the FCC's 2004 Vonage Preemption Order reveals that the FCC's explicit preemption is narrow in scope. State PUCs have seized on this in support of their argument that the FCC's decision cannot be interpreted to preempt the imposition of state USF contribution obligations on nomadic VoIP providers.

To date, Vonage has been relatively successful in fighting off attempts by states to impose state USF contribution requirements on its services, most recently winning a victory over the Nebraska Public Service Commission before the U.S. Eighth Circuit Court of Appeals. However, the states have not been deterred by adverse court decisions and continue to push for more authority over VoIP services. In a recent petition to the FCC, Kansas and Nebraska cite to the FCC's own statements, contained in an amicus brief filed before the Eighth Circuit, in support of their position that the FCC has not preempted their ability to impose state USF requirements on nomadic VoIP services.

While there remains some ambiguity as to the states' ability to impose state USF requirements on VoIP services, there is less doubt with regard to the states' ability to impose taxes and E-911 fees on such services. Seizing the opportunity to replenish depleting state revenues, several states published guidance on the application of their existing tax provisions to VoIP services. Many announced that VoIP qualifies, under state tax law, as a taxable telecommunications service. For example, Illinois and New Jersey both explicitly clarified that VoIP falls within those states' tax code

definitions of “telecommunications.” Likewise, Pennsylvania stated that VoIP did not come within the state’s sales tax exemption for enhanced telecommunications services. The import of those interpretive rulings is that the state codes at issue were always broad enough to include VoIP as a taxable service.

Absent any federal preemption whatsoever with regards to a state’s legal authority in these areas, states have been and, indeed, are free to apply their own statutory definitions of “communications” and “telecommunications services” when seeking to find sources of tax revenues or finding entities to remit fees that support E-911 services in their state. That is precisely what more and more states have done over the past several years. States are increasingly becoming vigilant in their enforcement of their “tax” and “911” regulations against providers of VoIP communications services. For all intents and purposes, with the exception of a small handful of states which have affirmatively decided not to “tax” VoIP, the vast majority of states now apply the same tax/911 requirements to VoIP services as have applied to traditional “telecommunications services” for decades.

911 Regulations

There is another unique, and uniquely important, type of regulation – 911 emergency services regulations. Virtually all states have generally applicable E-911 regulations. It is fully expected that in the months and years ahead, more and more of these regulations will be aggressively enforced against all types of VoIP providers, both fixed and nomadic.

Taxes and Fees Imposed on VoIP Service

It is not uncommon for many providers to mistakenly equate regulatory fees, like the FCC’s USF fee, to a tax. Much of the confusion arises because people talk about USF and Internet taxes interchangeably, as if the two are one and the same. However, there are important distinctions between regulatory fees and taxes. One of the most notable differences is that the vast majority of regulatory fees are owed by the regulated carrier, whereas taxes are owed by the ultimate retail consumer.

The distinction between fees and taxes can get blurry because the billing and collection processes for both are similar, if not identical; carriers “pass through” regulatory fees and they “collect” taxes, but the process for both is the same. Carriers are permitted to pass through regulatory charges to consumers, and carriers are legally obligated to act as the billing and collection agents for state taxes. Not only do regulatory fees and communications taxes share commonalities in billing, they also share a similar enforcement regime – which is referred to as “supply-chain enforcement.” The importance and implications of supply-chain enforcement are discussed below.

Historically, the Internet has been considered a “tax-free” zone. But as the Internet and Internet-facilitated commerce has developed during the past decade, the concept of a “tax-free” zone is becoming a historical relic. The Internet Tax Freedom Act, as amended, does still place a moratorium on the taxation of Internet access at the state and local level and protects e-commerce from sales tax for out-of-state transactions. The Internet Tax Freedom Act’s moratorium has been extended until 2014. As applied to VoIP communications services, at most, the moratorium would arguably prohibit the taxation of the *Internet Access component* of the VoIP service, but it does not

cover the communication service itself. Furthermore, the Internet Tax Freedom Act has not prevented the FCC from using its “ancillary” Title I jurisdiction to assess regulatory fee contribution requirements in support of federal programs on I-VoIP providers (claiming that the “public interest” so requires), nor has it stopped USAC and the FCC from imposing supply-chain enforcement on IP-in-the-Middle providers.

Taxes

There are no federal taxes on VoIP communications services. A number of states, however, do impose taxes on VoIP services, such as general sales, use and excise taxes. In addition, states have been increasingly interpreting their tax statutes to extend the application of tax obligations specific to the telecommunications industry to VoIP service providers (*i.e.*, state communications taxes).

In order for a business entity to be subject to taxation by a state or local government, the Due Process and Commerce Clause provisions of the U.S. Constitution require that a business maintain certain minimal contacts or a presence in the taxing jurisdiction. State and federal jurisprudence has helped to identify and clarify the many activities which can create the jurisdictional right to tax, referred to as “nexus.”

Different states have developed different interpretations of what types of business activities constitute sufficient nexus to impose their tax obligations on out-of-state businesses. The states’ determination of sufficient nexus is an extremely fact-driven analysis and, even within the same state, seemingly similar business activities can result in dramatically different tax obligations.

Although most states apply some sort of tax burden to VoIP services, there remains significant ambiguity because many state statutes and related regulatory provisions fail to spell out how VoIP services will be treated for tax purposes. Notable exceptions are Illinois and New Jersey, whose general tax statutes specifically encompass VoIP, and Louisiana and New York, whose tax laws have recently been interpreted by the state’s tax collection agencies to encompass VoIP.

The way state and local governments define “taxable telecommunications” is central to how they tax VoIP. These definitions can be broad and do not necessarily follow the definitions of “telecommunications” used by the FCC or state public utility commissions. For example, state and local tax definitions of telecommunications often include transmission of voice and data regardless of media or protocol.

Because many state taxation authorities are applying tax obligations to VoIP services by simply reinterpreting the existing language of their tax statutes and regulations to include VoIP services within their definition of telecommunications, some states, such as New York, are applying these additional tax burdens on VoIP providers retroactively, arguing that the applicable state statutory definitions have always encompassed VoIP services and providers should have been paying taxes on such services all along, even in the absence of any regulatory guidance or clarification on the issue.

New York State Definition of "Telecommunications Services"

For the purposes of the state telecommunications excise tax, New York's definition of taxable "telecommunications services" includes "ancillary" services that arguably are exempt from regulation under FCC precedent. Specifically, the inclusion of call forwarding within the definition could be used to impose taxation on IP PBX services that use auto attendant functionality to forward calls to the intended recipient.

The state's definition does not appear take into account intelligent information processing that may be part and parcel of a number of IP-enabled communications services. In addition, it is unclear, on the face of the definition, whether voice mail could be subject to the state excise tax as an ancillary service, despite clear statements from the FCC that such service is more appropriately characterized as an enhanced information service.

While the state's definition of taxable "telecommunications service" excludes services that alter the content of information, similar to the federal definition of information services, it is unclear whether, and the extent to which, the New York Department of Taxation and Finance will follow FCC precedent distinguishing telecommunications services from information services.

The states have not been reluctant to impose general fund and communications-related transaction taxes on I-VoIP providers. The ability of states and localities to impose such taxes usually turns upon:

- 1) the existence of a nexus between the I-VoIP provider and the state;
- 2) the precise definition of "telecommunications" or "telephone service" in the state's tax laws and regulations; and
- 3) whether taxable services are bundled with non-taxable services.

Complications in State Taxation

While general fund and telecommunications-related taxes may have been infrequently applied to VoIP services in their infancy, in light of increasing budget shortfalls resulting from the current recession, many states are increasingly resorting to vigorous enforcement of tax mandates against VoIP service providers as part of their efforts to find new sources of revenue. As traditional telecommunications industry services are already heavily taxed, state treasury departments must seek alternative means to refill their depleted coffers. This desperation, however, can lead, in some cases, to questionable application of existing statutes, as many of these interpretations derive from state departments of taxation, rather than directly from legislative mandates.

The applicability of a state telecommunications tax to VoIP services is further complicated by the broad range of specific services offered within the VoIP category. VoIP includes a wide variety of IP-based services, such as peer-to-peer voice communication, private intra-company voice communication, calls originating or terminating on the PSTN but incorporating IP-based transmission, and calls between an IP-based telephone and a PSTN user. Traditionally, regulators

have limited basic telephony to services connected to the PSTN. Thus, the extent to which an IP-based service is integrated with the PSTN may play a role in the classification of the service for tax purposes.

Likewise, service providers often bundle the basic telephony component of VoIP with Internet Access and enhanced features, such as directory assistance, call forwarding and voice-to-email or fax messaging functionality, making classification of the service for tax purposes even more complicated. It is unclear, under many existing state laws, whether a bundled VoIP-based service is, or should qualify, as a taxable telecommunications service. Further, treatment of taxable and non-taxable goods and services bundled together itself can be a challenge because states do not have a uniform policy regarding the taxation of bundled goods and services.

The various standards used by states to deal with bundled products include “true object” tests, *de minimis* tests, “primary object” tests and “essence of the transaction” tests. As a result, the same bundled service offering can result in vastly different tax obligations depending on the taxing jurisdiction.

One mechanism states are using to collect taxes on VoIP services is to pressure those providers at the top of the supply chain, the “Tier One Providers,” to either pay state taxes on VoIP and other IP-enabled services or to require that their customers provide sufficient proof that they, themselves, are both registered with the states and are paying applicable taxes. As a result, this pressure is now trickling down from the Tier One Providers to the IP-in-the-Middle/platform providers and down the line to the ultimate retailer. However, in contrast to the federal USF requirements, where providers are only faced with reporting and contribution requirements from one entity, supply-chain enforcement of state taxation involves navigating and complying with the requirements and tax schemes of potentially fifty-one different jurisdictions, which share little to no uniformity amongst their applicable tax laws.

In order to better position themselves for tax purposes, many Tier One Providers now offer separate and distinct packages for origination and termination services. To avoid exposure to audits and adverse findings from state taxation authorities, many Tier One Providers are taking the initiative and classifying certain aspects of their services, namely enhanced origination services, as enhanced intrastate service for tax purposes. Most of these providers are already registered in every state and have nexus with such states, so their willingness to classify aspects of their service offerings as intrastate poses no real adverse compliance obligations on them – particularly since these providers pass state and local taxes onto their customers.

In determining how to classify their own services, wholesale provider customers of Tier One Providers (IP in the Middle/Platform Providers) have little choice but to follow the dictates of their underlying carriers. In other words, these wholesale Platform Providers are increasingly unable to structure and classify their services to best suit their needs or the needs of their customers because the Tier One Providers have already dictated the path that must be followed. Thus, the Tier One Providers are often dictating the business models and product offerings of their downstream wholesale customers.

This evolving landscape is not without consequences for the downstream customers. First, should the FCC disagree with a Tier One Provider's determination that its enhanced origination services are intrastate and not subject to federal USF obligations, downstream providers are likely to feel the effect of such adverse finding in the form of pass-throughs. In addition, to the extent that platform and retail providers' federal USF reporting obligations likewise are impacted by the practices of Tier One Providers and by resulting FCC and USAC findings, these providers could face adverse action for past reporting deficiencies.

Second, these downstream providers, particularly the Platform Providers, face a Hobson's choice of either agreeing to the pass-throughs imposed by the Tier One Providers or facing potentially astronomical costs related to supply-side enforcement. For strict application, the supply-side enforcement mechanisms would require companies that have no nexus with the states to potentially register and create nexus, for the sole purpose of providing exemption certifications to their underlying carriers. Because of the ubiquitous nature of IP-enabled communications, for many providers, this could involve registration in almost every state.

Finally, under this scenario, downstream providers are exposed to the risk of double taxation in jurisdictions that do not recognize or allow for deductions for amounts such providers have paid in the form of pass-throughs to their upstream carriers. Moreover, this scheme permits the indirect taxation of providers, through pass-throughs, whose ultimate service may not actually be taxable.

Federal Regulatory Fees

While the federal government does not impose taxes on VoIP services, it does impose an alphabet soup of regulatory fees on providers, including USF, TRS, NANP and LNP support, and annual fees. Each of these support mechanisms are FCC creations that are administered by USAC. To collect federal regulatory fees, the government also turns to a variety of billing and collection agents, such as the [National Exchange Carrier Association](#) ("NECA") and Neustar.

State Regulatory Fees

In addition to the federal regulatory regime, some states also apply regulatory fees on VoIP services — particularly on companies that provide "fixed VoIP" services, like those typically offered by the facilities-based broadband providers such as cable companies and Verizon FIOS. In addition, there are quite a few states that are seeking to impose regulatory fees on nomadic, over-the-top VoIP, though their road has been much tougher in light of FCC and court pronouncements questioning whether states' regulatory authority can be extended to such services. Note, however, that a state's authority to *tax* such services, as distinct from imposing regulatory requirements and obligations, has faced little challenge.

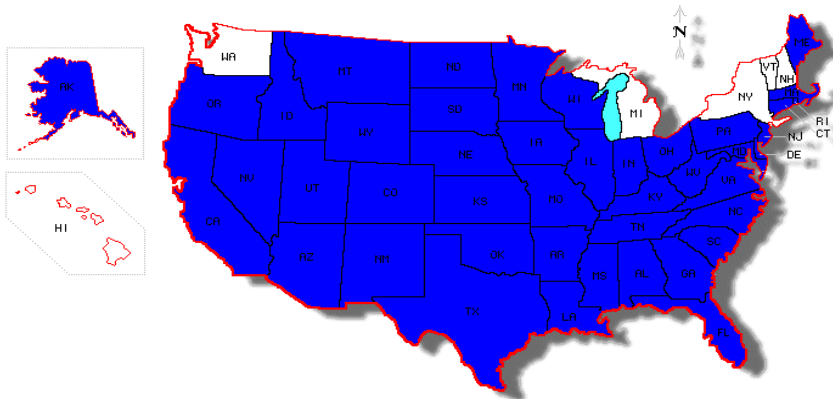
911 Fees

One area in which states have not had much difficulty extending their regulatory reach is 911 fees. But the way in which the states exercise such authority is not cut and dry.

- Some states impose 911 fees the same way taxes apply. And like taxes, 911 fees are payable to each city, county and municipality within the state.
- Some states impose 911 as a regulatory fee.
- In one state, Vermont, 911 support is funded by the same pool of carrier contributions earmarked for state universal service.

States with 911 Surcharges Applicable to VoIP

The states that have the ability to impose 911 surcharges and other obligations on VoIP providers are shaded. "Ability" means that it is within their existing statutory and regulatory authority to impose 911 surcharges; however, this doesn't mean that these states currently are doing so.



States often delegate the right to collect 911 to the local authorities that collect the surcharges and administer local 911 funds.

Some states roll their 911 fund obligations into other fees such as state USF. Determining whether 911 charges will apply to a particular VoIP service provider requires a detailed state-by-state analysis.

Because many jurisdictions do not consistently enforce their regulatory obligations, a company that handles compliance in-house may not be aware of compliance obligations that are not being

currently enforced. These companies can be in for a nasty surprise when a jurisdiction begins to enforce its obligations, especially if it is in the context of a notice asking whether the company has or has not been paying 911 support fees in the past.

There is every reason to expect that VoIP service offerings and VoIP service providers will continue to proliferate. Indeed, VoIP is a highly fertile area for continued growth and innovation. This is because:

- there are new technical applications for VoIP-based services developing every day;
- legacy networks are more and more frequently turning to VoIP solutions (there is really no choice as the more efficient VoIP functionalities make legacy solutions less and less maintainable, supportable or profitable); and
- VoIP-based service revenue continues to skyrocket.

VoIP is clearly the technology of the future. However, along with its continued proliferation and growth in popularity, VoIP may encounter closer scrutiny from both federal and state regulators, leading to more — rather than less — regulation and taxation of VoIP-related offerings, especially given the potentially large revenue base at stake. In the already complex area of telecommunications law, the regulation and taxation of VoIP on the federal and state/local levels is certainly no less murky — and is probably even harder to get your arms around — than any other area.

FCC Action

As discussed previously in this series, the FCC largely treats I-VoIP as a traditional switched telephone service for regulatory purposes — subjecting I-VoIP providers to almost all of the same Title II regulations which have applied to traditional telecommunications carriers for many years. In addition, pursuant to its 2004 *AT&T Phone-to-Phone IP-in-the-Middle Order* (“*IP-in-the-Middle Order*”), the FCC extended its regulatory authority over another category of VoIP services — IP-in-the-Middle services, or what has come to be described by USAC as “VoIP Toll” services. While the long-term effects of the FCC’s expansion of its regulatory authority continues to evolve, one pending proceeding — the Compass Global Notice of Apparent Liability (“NAL”) — may shed light on how the FCC’s and USAC’s expanding authority over IP services can and will impact VoIP providers, specifically, and the telecommunications industry, in general.

IP-in-the-Middle and Compass Global NAL

In 2004 the FCC released its *IP-in-the-Middle Order*. In the Order, the FCC did not attempt to justify the expansion of its authority over IP-in-the-Middle services as part of its ancillary jurisdiction. Rather, the FCC relied exclusively on its Title II authority and declared that “an interexchange service that: (1) uses ordinary customer premises equipment (“CPE”) with no enhanced functionality; (2) originates and terminates on the public switched telephone network (“PSTN”); and (3) undergoes no net protocol conversion and provides no enhanced functionality to end users due to the provider’s use of IP technology” is a “telecommunications service.”

The FCC reached this decision in the context of AT&T’s phone-to-phone VoIP service. This particular service was basically a dial-around service that used existing telephones to dial a platform where calls were then routed over the Internet for termination. Initially, the FCC’s release of the *IP-in-the-Middle Order* created little reaction in the greater communications industry, namely because the decision was supposedly limited to the specific service offered by AT&T. Thus, at the time, there was little indication that the decision could and would impact the entire supply chain associated with the delivery of VoIP-enabled services.

However, the *IP-in-the-Middle Order* has been transformed and expanded in recent years by both USAC and the FCC’s Enforcement Bureau. Relying on the language in the Order, USAC has seemingly created, through its Instructions to the Form 499-A, an entirely new category of regulated VoIP services – “VoIP Toll.” Without even questioning USAC’s authority to create a new category of regulated services, the FCC’s Enforcement Bureau has looked to USAC’s Instructions to justify what is becoming a perversely expansive and complex view of what constitutes a regulated IP-in-the-Middle service.

This perversion is reflected in the language of the FCC’s NAL against Compass Global. Among its offerings, Compass provides a peer-to-peer, “IP in-IP out” voice-bearing data packet routing service, its Enhanced Wholesale Service (“EWS”). Compass’ EWS service is limited to the least cost routing of voice-bearing IP packets from one carrier to another. It does no business with retail consumers. Yet the FCC, through its NAL, is seeking to impose the same Form 499, USF, TRS, and Carrier’s Carrier obligations on Compass as it would on a retail provider of traditional telephone service.

According to the NAL, Compass is providing a VoIP Toll “telecommunications service” unless Compass can prove that the voice packets it is routing are 100 percent, exclusively from computer-to-computer retail services and not from any phone-to-phone or phone-to-computer VoIP services. This is perhaps the most troubling, yet least publicized and least understood, expansion of federal regulatory jurisdiction over IP services to date. If the NAL becomes binding precedent, it will effectively impose Title II regulatory duties on purely private service providers who are engaged in the transporting, transmission or routing of voice-bearing IP packets on a purely private, wholesale only basis.

The Compass Global NAL enforcement proceeding is evidence that the FCC now considers the entire VoIP supply chain potentially subject to its jurisdiction — at least with respect to the Universal Service Fund program, including the Carrier’s Carrier Rule. If the Compass Global NAL becomes binding precedent, it would impose obligations on companies engaged in peer-to-peer wholesale IP

routing. In other words, it would mean the FCC could extend its regulatory hooks into every aspect of Internet-based communications and transport.

Additional Pending Proceedings

In addition to the pending Compass Global enforcement action, there are a variety of other petitions, appeals and rulemaking proceedings which remain pending at the FCC; some for several years. Actions on these matters may impact the scope and nature of the FCC's (and USAC's) authority to regulate VoIP services.

Important pending matters to watch are the assortment of appeals of USAC audit decisions related to enforceability of USAC's Instructions and the impacts of USAC's actions on the Carrier's Carrier Rule. Given the current ambiguity in the marketplace, getting some clarity on these issues would serve the industry well and could help guide new entrants that are currently struggling to develop workable business models.

Another mechanism through which the FCC could affect VoIP providers is the resolution of long-pending proceedings, such as its IP-Enabled Service rulemaking proceeding. The "IP-Enabled Services" Proceeding, opened by the FCC in 2004, was intended to be the primary means of addressing the complex legal and regulatory classifications associated with advanced IP-based communications services. To date, the FCC has not taken any action to settle any of the broad policy issues raised therein. Instead, the FCC has simply used this proceeding as a cover for its efforts to extend Title II regulations to I-VoIP providers on an increasingly ad hoc, piecemeal basis.

It is possible the current FCC, seated by a president who espoused an "open and more honest government," will be more out front when a change in regulation is contemplated. But with the recent extension of Section 214 discontinuance regulations coming under the new Commission's watch, the first opportunity to demonstrate openness appears to have been missed.

Other pending FCC rulemakings which are likely to impact VoIP provider rights and obligations include the Intercarrier Compensation reform and USF reform proceedings, all of which may be consumed by FCC proceedings on developing a National Broadband Policy.

What's on the Horizon at the FCC?

The FCC will continue to affect VoIP providers as it addresses pending proceedings:

- "IP-Enabled Services" Proceeding;
- "Developing a Unified Intercarrier Compensation Regime" (CC Docket 01-92);
- "Universal Service Contribution Methodology" (WC Docket 06-122);
- "Role of the Universal Service Fund and Intercarrier Compensation in the National Broadband Plan" (GN Docket Nos. 09-47, 09-51, 09-137)

State and Local Regulations & Taxes

Given the present economy, state and local taxing authorities will likely continue to look more and more frequently to VoIP service providers to replace lost tax revenues.

The Nebraska Public Service Commission and the Kansas Corporation Commission Joint Petition is unlikely to be the final volley from the states. We expect continuing efforts from state commissions looking to beef up local revenues by imposing more and more taxes and regulatory payment obligations on I-VoIP providers. For example, the continued expansion of state sales and use, transaction-type, taxes to encompass I-VoIP providers is likely.

Further, it is possible that there could be an expansion of E-911 surcharges for I-VoIP providers in jurisdictions which have not yet enacted such measures. It is also possible that there could be a proliferation of local tax assessments similar to the \$3.50 monthly telecommunications tax assessment imposed by the City of Baltimore on nomadic VoIP providers. Despite a challenge by Vonage and concerns regarding nexus and the risk of double taxation, the tax was upheld on appeal. For example, currently, the City of San Francisco imposes a 7.5% tax on telecommunications, and the City of Los Angeles imposes a 9% use tax on communications. In addition, localities in Illinois, New York and Florida are also authorized to impose telecommunications-related taxes.

Where Do We Go From Here?

Whether you already provide VoIP services or are thinking about entering the market, the future holds great promise. But the reality of both the present day and tomorrow is that success in the VoIP communications industry does not come without paying the price of regulatory and tax compliance. VoIP is no longer viewed by lawmakers, policymakers, regulators, or the "tax man" as a nascent technology in an infantile market that somehow requires continued incubation and protection. Success in the VoIP services industry will be achieved by those who understand the regulatory and tax environment and develop and maintain strategies to minimize the cost and complexity of those environments.

The best approach for existing and new entrants alike is to first obtain an understanding of the *current* regulatory and tax obligations and to establish an effective program to stay abreast of changes that will undoubtedly occur. Having experts available that are familiar with the regulations and the taxes involved, as well as the applicable regulatory bodies, who follow developing trends in such regulation and taxation, and proactively provide timely updates as developments occur is an option that should be given serious consideration. Being forewarned is being forearmed and will help minimize unnecessary costs, regulatory/tax entanglements and permit management to focus on its core competency and its company's bottom line.

ABOUT US

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