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Broadband over Power Line: That Sometimes Complex Matter of Taxes

This last of three articles addresses the occasionally esoteric but important tax compliance and administration issues for broadband over power line. The authors provide a perspective on the origins of tax complexity in the area, followed by a survey of some of the significant domestic and international tax laws relevant to BPL. The article concludes with suggestions for administrative and contractual mechanisms for taming the tax beast and identifies some of the appropriate opportunities for incorporating tax analysis into business decisions.

Scott L. David, Martin L. Stern, and Holly K. Towle

I. Introduction

A. The challenge of taxes generally

In the early days of electrical experimentation, Michael Faraday, a pioneer in the study of electricity, was visited by Prime Minister Gladstone. Upon viewing the apparatus that resulted from Faraday’s work, Mr. Gladstone asked the scientist the value of his studies. Faraday answered, “Sir, I do not know, but some day you will tax it.” Subscribers of this Journal can affirm that Faraday was prescient in both the areas of electricity and taxation. If Faraday were alive today, he would probably not hesitate to restate his assertion, this time with respect to
broadband over power lines (BPL).

In this third, and final, installment in our series of articles providing an overview of legal issues associated with BPL, we turn our attention to taxes. As with the earlier installments, no short article can capture all of the tax issues that BPL businesses should consider. This very broad summary is intended, instead, to provide a context for electric power businesses to begin to evaluate the tax issues associated with BPL services in their business planning.

Part I of this article sets the stage with a general discussion of tax issues and technology businesses. Some of this discussion is unique to BPL businesses, while some is not. In Part II of this article, selected taxes and tax related legislation are surveyed, in an attempt to provide a flavor of the types of tax issues that will affect BPL business, many of which may be unfamiliar to electricity businesses. Finally, Part III of this article presents a discussion of various strategies for dealing with the uncertainties that were raised in the first two parts.

B. The challenge of taxes and changing technology

All businesses are affected by tax issues. Even companies operating in established industries (such as the electric power business) subject to well known tax rules must continually reevaluate their tax strategies to remain competitive.

Attention to tax issues is even more critical where both the technology supporting an industry and the tax laws are simultaneously changing. This is the situation with BPL, and telecommunications services generally. Telecommunications and related computer technologies continue to rapidly evolve. In addition, the tax laws affecting telecommunications and information technologies are currently in a state of flux. This situation requires that companies offering such services, including BPL and related services, pay particular attention to the direction of the changes and continually update their strategies for addressing the associated business risks.

C. Approaches to addressing the challenges

There are a variety of approaches that a company might take to address tax issues. For industry groups and the larger companies that will be significantly affected by tax law changes and that have the resources, it may be worthwhile to take an active role in lobbying and other policy work regarding federal and state tax legislation, drafting legislation, and related activities.

For such large companies, and for other companies with lesser resources, it is appropriate to consider other, more accessible, approaches to addressing tax risks. These include (1) consultation with legal, accounting, and financial advisers to identify effective tax strategies, (2) structuring business relationships and contracts to address federal, state, and international tax issues, and (3) implementing internal mechanisms to assure tax compliance.

Attention to these issues can yield significant benefits with a relatively modest expenditure of resources. For example, companies frequently enter into agreements while ignoring the tax provision as “boilerplate.” In many situations, however, consideration of tax issues in the structuring, negotiation, and preparation of agreements with company suppliers and customers can result in immediate tax savings and a lessening of tax risk. Such strategies are accessible to even the smallest companies, if they are aware of the relevant issues. These strategies are explored in greater depth in Part III, below.

D. The particular challenge for BPL providers

The particular legal and regulatory challenges facing current
and future providers of BPL services were outlined in the prior two articles of this series. Similar unique challenges face BPL providers in the area of taxation. In addition to the shifting landscape of taxation of telecom and information services, BPL services involve a combination of infrastructure and service profiles from the formerly separate electrical and telecommunications industries. These industries have traditionally been subject to separately established regulatory and tax regimes. Companies offering BPL services are forced to seek to integrate these systems, and to (1) structure their supplier and customer relationships to allocate and address tax risks arising in the separate businesses and (2) establish an administration and compliance program that can efficiently and accurately deal with all relevant taxes. Stated otherwise, electric power businesses offering BPL services have to deal with complex tax issues intrinsic in the separate power and telecommunications industries. 

**Electric power businesses offering BPL services have to deal with complex tax issues intrinsic in the separate power and telecommunications industries.**

Businesses are motivated by trying to identify successful business models for products and services while minimizing tax and related risks and costs. Governments are motivated by the need to generate tax revenues to fund their respective operations, while providing for tax and other incentives to promote and support the growth of desirable industries. The result is a hodgepodge of conflicting rules and a “world-wide (tangled) web” of tax rules that, if ignored, can undermine economic models and catch the unwary. This is particularly relevant to the power and telecommunications industries where the margins are notoriously thin and where an unexpected tax liability could easily cause a service offering to be uneconomic.

The following is a review of some of the significant taxes and tax related legislative initiatives that will affect BPL and related product and service offerings. The discussion touches on issues associated with both BPL and other similar products and services. This broader coverage is motivated by the observation that most telecommunications and information services businesses are experiencing market pressures to expand and combine their service offerings to include related products and services, so it is possible that certain of the issues discussed, while not currently relevant, might soon become relevant. At the very least, the discussion will provide some insight into how various government entities might seek to tax BPL and related services.

**B. State tax issues**

States exercise significant independence in the manner in which they tax businesses within their respective borders. Many companies operate directly or through affiliates in multiple states, which requires consideration of the (sometimes conflicting) tax laws of various states.

Most states impose an income tax and a sales tax in addition to various other excise, property and other taxes. States generally have a well established structure for taxation of electric power companies and customers, although

**II. Overview of the Relevant Telecommunications and Internet Taxes**

**A. A time of change**

Telecommunications and information technologies are undergoing rapid change and the taxation of businesses offering and utilizing these services is developing. Developments in technologies and telecom products and services continue to challenge businesses and governments that are attempting to establish consistent and predictable rules and business strategies to address tax issues.

**Electric power businesses offering BPL services have to deal with complex tax issues intrinsic in the separate power and telecommunications industries.**

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there continue to be open issues as the Federal Energy Regulatory Commission and other regulatory changes are implemented (e.g., with respect to power marketing activity, independent power generators, etc.). The current trends in the taxation of businesses providing electrical generation, transmission, and related services, while interesting, are already familiar to readers of this Journal and are not the subject of this article, and will only be touched on as they relate to the discussion of BPL related rules.

In contrast to taxation of power businesses, states have just begun to struggle to identify the appropriate regimes for taxing newer telecommunications and information services. Some states impose additional or substitute taxes on telecommunications and/or information-related services, and some have passed legislation or issued guidance on certain limited elements of telecommunications and online business. Detailed guidance is, however, the exception rather than the rule. Even where guidance is available, the rules can vary greatly from state to state, making it impossible to generalize about the state tax profile of telecommunication and information services nationwide.

Notwithstanding the challenges arising from such variety, an attempt is made below to generally discuss selected state income and sales tax issues that will likely be relevant to providers of BPL services. Each particular transaction or company offering

must, however, be specifically evaluated under each relevant tax in each relevant jurisdiction, and no attempt is made here to provide a detailed overview of the taxes discussed.

1. *State income tax*

Most states that impose a net income tax generally follow the federal rules, with certain state adjustments. The myriad considerations associated with the federal and state income tax laws must be considered with attention to the facts associated with each situation. Many of these considerations will be the same for electricity and BPL businesses, since many income tax issues are not dependent on the type of business engaged in. Income tax considerations should be taken into account in planning both day-to-day operations and extraordinary transactions (such as mergers, significant business investments, joint ventures, etc.).

In addition to the income tax issues faced by businesses generally (such as employee and benefits tax issues, income and deduction timing, deduction and capitalization of facilities and operating costs, etc.) telecommunications and high-technology companies are currently grappling with a variety of income tax issues that have a particular impact on their businesses. These issues include, for example: (1) the deductibility and amortization of expenses associated with the business (particularly in light of relatively recent IRS cost capitalization regulations); (2) as companies seek to expand their service areas, they must consider the tax treatment of operations and income arising in other taxing jurisdictions; (3) as companies look to build their service offerings to subscribers, they must generally consider the tax implications of mergers, business combinations, joint ventures, and other transactions entered into with third parties; (4) as companies offer services to a broader base of subscribers, they must consider the timing, source, and character of both domestic- and foreign-sourced income; and (5) as companies add new products and services to increase or maintain market share, they must consider new issues associated with new lines of business. Businesses offering BPL services will be faced with these same issues.

2. *State sales tax*

a. *Sales taxes generally*

About 45 states that impose a tax on telecommunications services do so through imposition of a sales tax or similar gross receipts tax. Unlike income taxes, whether
the states were previously prohibited from imposing tax on Internet access. The original ITFA exempted telecommunications services from the ban, and hence permitted states to tax telephone and other telecommunications services. The ITFA expired in November 2003, but was re-instituted (with certain changes) as the Internet Tax Non-Discrimination Act (ITNDA), which was signed into law in December 2004. The ITNDA carries forward the ITFA’s prohibition on state imposition of multiple and discriminatory taxes on Internet access.

Among the changes under the ITNDA, however, is a new provision that permits the states to tax VOIP services. Thus, companies that offer such services must attend to the distinction between VOIP services and other broadband offerings. This may be an issue, for example, when companies bundle VOIP with other broadband services and invoice subscribers for a single charge. Importantly, while the ITNDA permits states to impose such taxes, it is up to each state to decide upon the manner in which VOIP services will be treated within its taxing jurisdiction. Therefore, individual state laws must still be consulted by VOIP service providers.

c. Sales tax planning in a changing tax landscape

There are some sources of uniformity that can assist in tax planning for companies that offer telecommunications services in multiple states. For example, the
Telecommunications Act of 1996 and the Federal Communications Commission currently distinguish “telecommunications services” from “information services.” Many state sales tax laws are drafted to cover “telecommunications services.” By contrast, many states do not tax “information services.” Depending on the state, the FCC definitions can affect the manner in which the state taxes such businesses.

The definitions that are applied by the FCC are, however, currently in flux. It is anticipated that significant attention will be directed to these definitions when Congress next turns to the federal communications law. The FCC will also continue to release advice and rules that will affect the area. It is likely that, as technology continues to evolve, the FCC will need to continue to review and revise its definitions in which the state taxes such businesses.

The manner in which BPL and other broadband services are structured and made available to customers often requires attention to a broader range of tax considerations than are familiar to traditional businesses. For example, payments by a U.S. company to a non-U.S. entity for content or services that are provided by such foreign company may, in certain circumstances, be subject to U.S. tax withholding. This might be relevant, for example, where a BPL or other broadband provider arranges with a foreign entity for the provision of content (such as music, books, movies, etc.) or services that it offers to its subscribers. Simply put, under certain circumstances (where the income is sourced within the U.S.), the Internal Revenue Code requires that a U.S. party making a payment to a foreign person withhold income taxes (typically on passive types of income such as interest, royalties, etc.) due from the foreign party. If such taxes are not withheld, the U.S. party making the payment may be held liable for the full amount of the tax. The basic theory behind this withholding is that the IRS cannot ensure collection of tax from a foreign payee, so it must

These strategies are generally discussed in Part III of this article.

3. Other state taxes
Both the electric power industry and the telecommunications industry are subject to myriad laws in the different states and local jurisdictions. As such, it is not possible to generalize about how all such taxes will apply in every situation. One important method of analyzing taxes is to separate the two tax-related responsibilities of businesses; i.e., the payment of taxes imposed directly on the business (such as the business’s income tax) versus the responsibility to collect and remit to the state customer taxes (such as the customers’ sales tax).

As discussed below, these obligations are analytically distinct, and subject to differing administrative regimes that require different business approaches.

C. Federal tax issues

1. Federal income tax
As noted above, there are myriad federal tax considerations associated with both day-to-day operations and out-of-the-ordinary transactions that a business should take into account in its business planning. These include, among others, income and deduction issues, sourcing issues (with international payments), withholding issues and a host of others.
capture the tax prior to the time that the payments to the payee leave U.S. tax jurisdiction. In the situation where a company has suppliers (of content, services, etc.) outside of the U.S. and is making payments to such foreign suppliers, it is generally helpful to include a provision in its standard supplier agreements to clarify the responsibilities of the parties with respect to withholding, and to cause the business parties to consider this issue in negotiating prices and terms.

In the opposite case (i.e., where the U.S. company is being paid for services rendered to a foreign person, and such payments might be subject to foreign withholding), the U.S. company should consider the inclusion of a withholding “gross up” provision. Such a provision generally requires that the foreign person’s payment obligation to the U.S. company be “grossed up” for any amount required to be withheld by the foreign country. Depending on the circumstances, this may be perceived as an aggressive position, since the U.S. company would, in effect, be asking the foreign company to pay its income tax due in another country. A “gross up” for withholding is, however, appropriate in circumstances where services were priced in anticipation of no tax being imposed in the foreign country, and in certain other circumstances. The overall consideration of withholding issues must also take into account the U.S. company’s foreign tax credit situation (through which U.S. companies can take a credit against U.S. tax for certain amounts of income tax paid to foreign jurisdictions).

The foregoing discussion of tax withholding strategies is just one example of the variety of federal income tax issues that may be relevant to BPL businesses, and the importance of considering tax issues in structuring such businesses.

2. Federal telecommunications excise tax

The U.S. imposes a 3 percent excise tax on local and toll telephone services. This tax is one of the many government extractions that are included on a residential telephone bill. The tax was originally passed in the late 1800s when it was clear what technology (the telephone) was being taxed. Over the years, as technology has developed, the tax has expanded to include innovations in the telecommunications space such as teletype service, WATS service, and phone cards. The current explosion of technologies that can carry voice conversations has resulted in continued reexamination of the tax.

A current proposal in Congress, if passed, would expand the telecommunications excise tax to subject VOIP services to the 3 percent tax. Another proposal would further expand the excise tax to cover all broadband services. These proposals would be relevant to electrical utilities that provide broadband services, particularly to the extent that the broadband offering included VOIP services. Depending on which proposal passes Congress, it is possible that BPL and other broadband providers will have to figure out which services are subject to the tax and which are not. This exercise will be particularly difficult where taxable and non-taxable services are bundled. A review of the many tax and other charges presented on a typical consumer phone bill provides a sense of how complicated a combined electrical/BPL bill might become when all of the relevant taxes are detailed on the bill. The complexity has implications both for customer relations and for internal tax administration, both of which are discussed in Part III below.

Congress’s two primary motivations in revising the telecommunications tax appear to be raising revenue and maintaining a level playing field among businesses offering telecom services. The first goal, raising revenue, has been the primary motivation for the imposition of the federal telecommunications tax since its inception as a luxury tax. It has
also been the primary argument for the elimination of the tax, which has been observed to serve no other policy purpose.

The second motivation, the leveling of the playing field, has been put forth as an argument for broadening of the tax to cover the variety of broadband services. There are several arguments that can, however, be raised against this view. Among the arguments that have been raised in opposition to broadening the tax are: (1) the suppression of innovation due to the fact that the tax will reduce revenue that could be available for financing R&D; (2) the fact that the imposition of the tax will curtail budgets that could be available to expand service; (3) the traditional argument that the telecom excise tax was originally passed as a luxury tax (to help finance the Spanish-American war) and that it should be repealed as serving no function other than revenue raising (and should certainly not be expanded); and (4) the fact that the expansion of the definition of taxable services would not align with FCC regulatory definitions or state tax definitions, which would result in a substantial burden on companies that have to administer the various taxes and invoice and collect the various taxes from subscribers.

D. International tax issues

As telecommunications and related technologies have become more sophisticated and robust, the world has gotten smaller. Companies that had previously dealt with only domestic suppliers and customers are increasingly able to engage in business worldwide. On the supply side, many business functions are provided to U.S. businesses by foreign entities (e.g., the outsourcing of back office functions, foreign phone banks for customer assistance, etc.). On the customer side, the Internet has enabled U.S. businesses to provide services to customers in every country. For example, U.S. companies can readily offer online services, downloads of music, software, books, and other content to customers around the globe. In the telecommunications space, customers of domestic telecommunications companies can use their cell phones in many foreign countries, and be billed by their domestic service providers. Each of these connections to a foreign jurisdiction results in a potential basis upon which a foreign jurisdiction might seek to impose tax.

The “globalization” of technology products and services has forced U.S. companies to deal with foreign tax laws, many of which are unfamiliar to U.S. companies. For example, under an European Union (EU) directive in 2003, a company that provides digital content downloads (such as music, books, software, movies, photographs, etc.) to a consumer in Europe is required to register in the European Union and collect and remit value-added tax (VAT) on such “download” sales, even if the U.S. company has no operations, employees, or other presence in Europe. There are strategies that companies providing content downloads can implement to lessen the administrative burden and tax risk associated with these operations.

The EU initiative is an example of how the Internet can cause a “domestic” business to have “international” tax liabilities.

E. Other tax issues

1. The MTSA

Tax laws will increasingly conflict as technologies continue to evolve. For example, under the Mobile Telecommunications Sourcing Act, which was passed by Congress to address income sourcing issues associated with cell phones, wireless calls and mobile telecommunications services are sourced to the “place of primary use” (i.e., a customer’s residence or business address). Under the MTSA, cell phone services can only be taxed in those states and political subdivisions in which the “place of primary use” is located. As broadband and other related services are
increasingly made available over mobile devices, these sourcing rules may be made applicable for charges associated with such services. Companies that offer services covered by the MTSA will need to consider MTSA requirements in their customer invoicing activities.

While BPL services are “non-mobile” to the extent that they are associated with electrical lines, many companies that offer “wired” services are discovering that competitive pressures have forced them to consider offering bundled “wired” and “wireless” services to consumers. The expansion of the service offerings to include “wireless” services requires that the MTSA requirements be addressed. This leads to potential conflicts to the extent that a single customer bill might be subject to different sourcing rules for different services to a single consumer.

2. Outsourcing and multisourcing of services

Where multiple companies are involved in the provision of a service to a customer (for example, where there are related agreements between a telecommunications service provider, a broadband company, a hosting service, an Internet service provider, and a content company that are all related to a service to deliver video clips to a cell phone), the respective tax responsibilities and liabilities must be worked out. Electrical utilities might experience a similar challenge, for example, where generation and transmission services are provided by different parties. In these situations, the various tax responsibilities of each party in the “supply chain” must be separately evaluated to confirm that the tax obligations, i.e., both tax payment and tax collection responsibilities, are properly discharged and will not result in an unanticipated obligation of another party in the transaction.

For example, where a BPL provider decides to offer a video or electronic book download service to its customers, and contracts with a third-party provider to offer such service, the agreement should be drafted to assure that, if the relevant state imposes a sales tax on such service, the parties will: (1) make certain that the sales tax collection obligation is discharged and (2) determine whether it is the BPL provider or the third-party provider that has the collection responsibility. Frequently a BPL or other broadband service provider will want to maintain the direct customer relationship and to not expose their customers to multiple invoices (or potentially competitive offerings), so the BPL provider might take on the tax collection responsibility and prepare a single invoice for its customers. Discharging this responsibility may, however, may be more complicated if the third-party service provider’s servers are accessed to provide the service and they (and not the BPL service provider) have the information on the identity and location of the customer that uses the third-party service. The agreement between the parties should clearly address the elements that are necessary to assure compliance with relevant tax requirements.

3. The Streamlined Sales Tax Project

Other initiatives on the horizon include the states’ “Streamlined Sales Tax Project” which may, if it is implemented, substantially affect the manner in which individual states administer their respective sales and use taxes, and the way in which multistate companies do business. The central concept of the SSTP is to make the respective state’s laws more uniform to permit easier administration and to create a system through which remote sellers collect sales tax. While many states have already passed legislation to conform their local sales tax laws to the uniform definitions and administrative provisions of the SSTP, the project still has challenges to overcome.
4. The evolving “nexus” concept
Change will also occur with respect to the constantly evolving issues of sales tax nexus, which is affected by a combination of legislation and federal and state court cases interpreting the U.S. Constitutional requirements. Simply put, nexus is the concept of “connection” that is necessary for a state to impose tax (in the case of income taxes) or a collection responsibility (in the case of sales and related taxes). Online businesses have already challenged traditional notions of nexus. The tax and nexus issues resulting from ever more elaborate combinations of telecommunications and online products and services will continue to require careful nexus analysis.

III. When Should a Company Consider Tax Issues?
Even for settled and established industry sectors, such as electrical generation, transmission, and public utility businesses, tax issues can play an important role in business strategy and modeling. Tax planning is even more critical where the technology, tax laws, and product and service offerings are changing daily, as is the case in the telecommunications and information services market, which includes BPL services. There are various discreet points at which a business should consider tax issues and consult with its tax advisors. These points offer appropriate settings for the consideration of tax issues as a result of a combination of one or more of: (1) the preparation of agreements and other documentation of existing or new customer and supplier relationships, (2) situations where new products or services are being evaluated or developed, and (3) situations where operational or structural changes are being considered for the business. These are each briefly discussed below.

A. Preparation of customer and supplier agreements

1. Customer agreements
Where there are individual negotiations with customers (for example where a business enterprise purchases bulk services from a company, or where company services are purchased for resale or for inclusion in a third-party service offering) there are opportunities to individually address the tax treatment of such transactions. One goal of such analysis should be to try to cause the other party to share some of the tax burden or risk. At the very least, there should be attention to making sure that the business/economic model of the transaction has properly taken tax issues into account.

Such individual negotiations are, however, uncommon in the case of agreements with telecommunications subscribers and electrical utility customers. As is the case with electrical utility customers, telecommunications and related businesses have a broad subscriber base, and there is typically not an individual negotiation of the subscriber contract with each subscriber. Instead, a standardized form of agreement is presented to potential customers, with their receipt of service generally conditioned on their agreement to the terms (including their agreement to accept later amendments!), prior to becoming a customer.

There are at least three general contexts in which taxes should be taken into account in consideration of customer billings issues. These include: (1) the development and implementation of internal processes and administration associated with invoicing and collection of taxes; (2) strategic and competitive considerations; and (3) bundling.

a. Internal billing processes and administration
Electric utilities and telecommunications companies must address numerous tax obligations in the preparation and administration of customer charges. These
include taxes that are required to be collected from customers (those taxes, such as sales tax, for which the company may have a liability if it fails to collect), taxes that it is responsible to collect but for which it may not have a secondary liability (such as federal telecommunications tax), and those taxes that it may collect but is not required to collect (which may include all others). Each of these types of taxes must be separately considered in the preparation of customer invoices.

There are several companies that provide software and services that assist in elements of customer billing (such as sales tax rate calculation), but ultimately such products do not answer the difficult tax questions (such as nexus and definitional issues) which must still be addressed by the company and its advisers. Also, most companies offer services with unique elements, which prevents outsourcing the entire customer billing effort. This is particularly true in the case of BPL services, since the tax regimes of the electricity industry and the telecom industry are historically distinct and therefore not yet captured in any “off the shelf” tax administration software programs.

In addition to tax liability considerations, companies should consider administrative burdens associated with tax collection and remittance, whether internal accounting software can adequately track tax collection activity, and subscriber relations and competitive considerations associated with customer billings. These are addressed below.

The administrative burdens might be increased, for example, as a result of the BPL service provider desiring to be perceived by its customers as the sole provider of the services, even though a variety of service providers are involved in the “supply chain” for the service. This would require that the billing system incorporate tax elements associated with all of the aggregated services. In some situations, however, electrical utilities may choose to have the Internet service provider (ISP), content provider or other third party provide its services directly to customers, and merely permit such third parties to carry their services over its electrical system. To the extent that the third party has a direct customer relationship, including billing the customer directly, the BPL provider will not have the administrative burden associated with third-party related taxes.

The issue of whether internal accounting software can adequately address tax administration is another challenge to most public service businesses. Many accounting systems are a combination of computer and manual operations and “off the shelf” and “customized” (frequently internally created) software. As a result, many systems do not easily interoperate with commercially available tax administration software packages. In addition, the taxation of electricity sales to customers is typically subject to state and local tax under an entirely separate regime from that which is imposed on telecommunications and information services. As a result, internal billing systems of utilities, which are typically longstanding or “legacy” systems, often developed partially or entirely as custom systems, will need to be adapted to incorporate those elements needed to address the administration of the additional taxes. There are often complexities associated with these adjustments and, even with the use of commercially available tax administration products, it is important to provide sufficient lead time to allow the systems to be developed and tested. Companies considering offering BPL services should be certain to involve their billing and accounting representatives early in the planning process to assure a smooth transition to the new systems.

In the first article of this series, we noted that the current market penetration of broadband services offered over cable or phone lines was enabled by infrastructure (i.e., cable systems and phone lines) that preexisted the
availability of broadband services. The same is true for BPL, which utilizes existing electrical transmission lines (with the appropriate addition of equipment to generate and receive the signal). With the addition of broadband services, phone and cable companies offering such services have struggled to identify the appropriate tax regime for broadband services and strategies to assure compliance with applicable law.

The myriad rules that apply to such multiple service offerings and the efforts of such companies to gain a competitive edge (for instance through bundling services, providing alternative plans for billing based on various criteria, etc.), have resulted in a situation where customer bills for telecommunication services are among the most complex invoices received by today’s consumers. Such bills often reference several different service providers (such as long-distance carriers, ISPs, content providers, SMS service providers, etc.) and set out numerous government taxes, fees, and other extractions. The complexity of these invoices is not only a customer relations issue, but it suggests the difficulty of administering all of such taxes. Electric companies and other parties that anticipate providing BPL services should anticipate that they will encounter similar issues in consumer billing and in the challenges of administering the various taxes when BPL and related services are offered to their customers.

In the case of charges for electrical services, many states will permit the company to pass through taxes that are imposed on the company, and some provide that such taxes be separately invoiced or noted on the customer bill. These rules might not apply to non-electricity services (such as BPL services). Companies will need to consider how to address such billing issues taking into account the applicable rules, customer relations issues, administration, and other factors.

b. Competitive and strategic considerations

Competitive considerations are important in the customer billing relationship. In addition to the business considerations of competitive pricing of the underlying products and services, companies should consider the manner in which various tax charges are presented on customer invoices. Some jurisdictions require that certain taxes be separately stated in invoices. Beyond these legal requirements, however, the central consideration is whether the company will be at a competitive disadvantage if it charges and/or separately invoices its customers for certain taxes.

Thus, for example, for those taxes that are required to be collected and are separately invoiced by all companies providing similar services (for example with respect to sales tax on telephone service), a company will not be at a competitive disadvantage in collecting and invoicing for such taxes, since all companies that sell service to the same or similar customers will invoice for such taxes in the same way. By contrast, if a particular company seeks to recover reimbursement of taxes (whether or not separately invoiced) it can affect its ultimate charge to customers and therefore affect the company’s competitive position if other companies are not seeking reimbursement for such tax (or do so in a manner that is not obvious to the customer). Generally thin margins in both the electric utility and telecommunications industries put pressure on companies to consider the approaches that competitors are taking with respect to billing for taxes.

c. Bundling

Many companies combine (or “bundle”) different services in order to encourage consumers to purchase additional services from the company, to introduce or promote new or less popular services by pricing them in an advantageous way as a combined offering, and to differentiate their service offerings from other
companies. The manner in which services are bundled and invoiced can affect the tax treatment of such services. It is not possible to generalize about the tax effect of bundling, since there are many possible “bundles” of services. The administration of taxes for bundled offerings can be complex in situations where two or more services that are taxed under different tax regimes are bundled and offered for a single price.

There are various tax rules that address bundling, and they will frequently tax the bundled offering based on the “predominant” or “primary” object of the offering if the charges are not separately invoiced. Thus, for example, if telephone services (subject to sales tax) are bundled with non-taxable information services, with a single charge made for the bundled service, the company providing that bundled service may be required to collect sales tax with respect to the entire charge. In some cases, the company may be permitted to separate the charges for tax purposes, if their books and records offer sufficient support for how such charges should be divided. The applicable local law should be reviewed.

The tax issues associated with bundling, and possible opportunities to achieve tax savings, should be carefully considered in the establishment of BPL service offerings. The balancing of the tax considerations with business strategic considerations is critical to implementing a successful BPL program.

2. Supplier agreements

Very few, if any, telecommunication service providers are able (due to human resources and infrastructure constraints), or find it economical, to provide services to customers on a fully vertically integrated basis, i.e., to supply every element of customer service without resort to outside suppliers. This may be in contrast to many traditional suppliers of electricity which may own and operate generation, transmission, and distribution assets. Nearly all companies providing BPL and related telecommunications and information services will work with some suppliers of content, telecommunications services, maintenance and help services, computer related services, Web site design, Web site hosting, payroll function, and a variety of other services.

Each interaction with a third-party supplier presents an opportunity for tax planning. In the context of negotiating third-party agreements, consideration should be given to the tax issues associated with the specific supplies and to whether there are opportunities to shift (or at least share) tax risk or tax burdens to the other party. This shift may be achieved directly through the contractual allocation of such burdens or indirectly through the manner in which the agreement is structured and the supplies characterized.

More specifically, a company should generally consider whether it is appropriate and/or desired, through the provisions of the contract itself, to cause the counterparty to be responsible for taxes. For example, a contract might provide that a company’s business customer is responsible for reimbursing the company for a tax that is normally levied on the company. The “passing through” of taxes may be done explicitly (and documented in the agreement), or implicitly (as an item of overhead that is taken into account in pricing models developed by the supplier).

In addition to the contract terms, a company should consider the overall structure of the agreement, and the characterization of the products and services offered under the contract to identify strategies that will achieve the most favorable tax treatment. For example, where a supplier is providing software development services and a license to certain software to a company, the company should consider the tax ramifications associated with treating its payments as royalties versus payments for services and identify any possible planning.
opportunities associated with such characterization. It is not possible to generalize about the most favorable structure and form of agreement for every transaction, as each agreement is established in a unique context. In any case, awareness and consideration of the local, state, federal, and in some cases international, taxes involved is necessary in order to properly evaluate the economic impact of such taxes. A company that does not take such considerations into account will be at a substantial disadvantage in negotiations, and will potentially miss opportunities and fall into traps that can significantly alter the economic results of a transaction.

Many companies will, over time, seek to enter into similar agreements with a similar group of third parties, in some cases developing a standardized form of agreement to use in such situations. Having a single form of agreement has many benefits including reduced administration, increased predictability, decreased risk-management burden, facilitation of interpretation, planning and enforcement, and other benefits. For example, subscriber agreements will typically be uniform, and third-party content provider agreements may be based on a single form. Where such uniform agreements are used by the company, attention should be paid to including a tax provision that is tailored to such agreements, but is broad enough to cover anticipated variations in such agreements.

For example, where a BPL company is entering into agreements with content providers (to secure content for the company to provide to its subscribers) it would be useful to include a provision that covers the company’s responsibility to withhold taxes on certain payments made to any non-U.S. content providers, even if not all of the content providers will be outside of the U.S. The provision would be irrelevant in cases where content providers are located in the U.S., but will cover situations where payments are made to foreign companies. If such a provision is not included in the standard form of agreement, its inclusion might be overlooked in the situation where the counterparty is foreign.

Another important aspect of a supplier agreement is the exit strategy. In the fast-moving world of digital services (which combines the twin factors of fast-paced technological innovation with perennially fickle consumer preferences), product offerings and business models change quickly. Long-term agreements can bind companies to business arrangements that have become uneconomical as a result of changes in the market. Attention should be paid to termination provisions, change in law provisions and the manner in which the tax section is drafted. While these provisions may often be dismissed as “boilerplate” in agreements, when properly crafted, they can provide additional comfort that the company will not have to live with a failed strategy or a situation where a once-great and innovative service offering becomes a “bad deal” due to changes in the technology and business landscape.

B. New product/service development

In addition to the analytical challenges resulting from changes in technology and the changing regulatory and tax landscape, electric power, telecommunications, and related companies operate in a very competitive market that requires constant innovation and the introduction of products and services that can continue to compete with a host of competitors. This is a primary driver in the push to provide BPL services. While tax considerations are certainly not the primary issue in product introduction, the development of new products and services offers an opportunity to review the tax ramifications of how such initiatives can best be addressed.
For example, if a company is considering offering a service to download software to subscribers, it might choose to test market that service in a jurisdiction where there is authority that such downloads are not subject to sales tax, rather than a jurisdiction where such software downloads are taxable.

C. Business combinations and joint ventures

As noted above in the discussion of supplier agreements, companies increasingly turn to third parties to provide support or elements of company services. Such arrangements range from one-time or relatively minor suppliers to arrangements with third parties that are more strategic and are critical to the company’s success. In the latter case, significantly more attention is generally paid to the terms of the joint venture or other business combination, including the tax issues involved. The possible variations of business combinations, joint ventures, acquisitions, etc., does not permit easy generalization about how to approach tax issues. Consultation with legal and accounting advisors on the tax ramifications of the transaction and the post transaction operations is critical to a full understanding of the strategic implications of a transaction. ■

Endnotes:

3. ITNDA, Section 1108.
5. Internal Revenue Code of 1986, as amended, Section 1441.