

Taxation of Voice Over Internet Protocol Impact on Service Providers and Business Users

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In last month's issue of *Practical Strategies*, we looked at the growth in state and local taxation of telecommunications services. Here, we look at the federal, state, and local taxation of a particular innovation within that industry. This article will be of interest to all businesses considering using this new technology, as well as the providers of the services themselves.

The popularity of voice over internet protocol or "VOIP" telephone service is the result of its very low cost. By utilizing the infrastructure of the Internet to deliver voice quality telephone service all over the world, VOIP service providers can deliver telephone service at a very competitive price.

One additional advantage is the potential tax savings that can be available to VOIP consumers. Telephone service has been subject to excise tax since the United States imposed a three-percent tax on telephone service to fund the Spanish American War in 1899, and state and local governments were soon to follow.

Although the guns of the Spanish American War have long fallen silent, the federal excise tax continues to soldier on. When the three-percent federal excise tax is combined with state and local taxes, the total tax rate on telephone service can exceed 20 percent. If a VOIP provider can avoid these excise taxes, it would give them an even bigger competitive advantage over traditional long distance carriers.

Unfortunately, the tax status of VOIP service leaves many unanswered questions.

The Federal Excise Tax

The federal excise tax is imposed on voice quality long distance telephone service. Amazingly, the Internal Revenue Service has not issued any guidance on whether VOIP service should be subject to this excise tax.

It appears that the IRS is reluctant to take any position for fear of political reprisals from stakeholders claiming that the IRS is "trying to tax the Internet." Further, the Federal Communications Commission (FCC) has taken the

position that VOIP service is not subject to regulation as a telephone service.

Complicating the issue is the fact that the federal tax code says that the tax only applies where time *and* distance of the call are factors in determining the rate. If this is read literally, then the federal tax would hardly be applicable to any long distance telephone arrangements, because few, if any, factor in the distance covered for calls originating and terminating inside the US.

Several large corporate customers have won refund litigation in federal courts. The US Court of Appeals for the Eleventh Circuit recently confirmed that the federal tax is not due where the distance of the call is not a factor. Many companies are now filing refund claims.

Notwithstanding these cases, the IRS is digging in its heels and maintaining that long distance arrangements in which the distance covered is not a factor in the rate are nevertheless subject to tax.

So where does this leave VOIP service as far as the federal excise tax is concerned?

First, the IRS has not yet announced a position on this issue. Second, the FCC has said that VOIP is not a telephone service, but rather a data transmission service for regulatory purposes. Third, VOIP might not be subject to the federal tax in any event (even if it is considered a telephone service for tax purposes) because of the current cases holding that the tax is not due on long distance calling arrangements where distance is not a factor in the amount charged. The federal excise tax would not be due for VOIP services because VOIP providers do not consider the distance covered in calculating the amount of the charge.

Some VOIP providers might want to take the risk that the federal tax is not due on their service. However, the more cautious companies might request a ruling from the IRS, and force the IRS into taking a position on this issue. It is also possible that Congress might weigh-in on the issue and say that the VOIP either is, or is not, subject to the federal tax.

State and Local Taxation

For several years VOIP providers have argued that their service is not subject to state and local taxation because of the federal legislation known as the Internet Tax Freedom Act (ITFA). ITFA was enacted by Congress in 1998 to prevent state and local governments from imposing tax on Internet access.

[Practical Strategies provided extensive coverage of the ITFA and its subsequent renewals. See our November 2004 issue (Vol. 4, No. 11), for example.]

VOIP providers have maintained the position that this federally mandated moratorium prevented state taxation of VOIP service -- even though that VOIP service was not itself Internet access -- and, in fact, VOIP service required the customer to have Internet access to be eligible for the service.

Congress extended the ITFA by passing the Internet Non-Discrimination Act of 2005. The new legislation specifically states that states are free to impose tax on VOIP service, putting this argument against state taxation to rest.

Some states have adopted specific rules stating that VOIP service is subject to their telecommunications taxes (Illinois, North Carolina, and Minnesota). Others are likely to follow. Most states that impose a tax on telecommunications services define the service subject to such tax broadly enough so to cover VOIP service.

However, this does not mean that VOIP providers are automatically required to collect a state's telecommunication taxes. For any company to come under the tax jurisdiction of a state, it must have "nexus" there. The Supreme Court

has held that to have nexus for transaction tax purposes, a company must have a substantial presence in that state.

A VOIP provider can avoid a state's tax jurisdiction by avoiding nexus. Although this is nearly impossible for a traditional long distance carrier -- because they must lease lines in the states where they provide service -- it is feasible for a VOIP provider to avoid nexus. This can be done by making certain that the VOIP provider does not have any employees or assets in the state.

For example, the router that a customer must use should *not* remain the property of the VOIP provider. If it retains ownership of the equipment, it will have assets in the state, which would be enough presence to establish nexus.

The VOIP provider should also avoid the use of a server in any state in which they intend to avoid nexus. The company should avoid sending employees to trade shows, as well, because a state might argue that the regular presence of employees at a trade show triggers nexus.

A survey of all activities in a state should be undertaken to determine whether any activities could lead to nexus, and a resulting tax obligation. By careful planning, a VOIP provider can take steps to minimize its risk that it should be collecting state telecommunications taxes. □

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