EDUCATIONAL PRIMER: Management of Wholesaler-Retailer Tax Exemptions for Providers of Communications and VoIP Services

INTRODUCTION

Recent estimates indicate that the total number of taxes imposed on telecommunications and VoIP services is almost three times greater than the number of taxes imposed on other businesses. Given the number and variability of these taxes, it is critical for telecommunications companies to implement policies and procedures that accurately manage their state and local tax obligations. Management of wholesale/supply chain issues – including state and local tax exemptions – is a critical component of such tax compliance policies and procedures.

In most states and local jurisdictions, taxes apply to retail service offerings only. To comply with state and local tax requirements, all retailers of taxable telecommunications services must register with the appropriate taxing authority, assess taxes on their taxable services, and remit the collected taxes to the appropriate taxing authority.

To avoid the double taxation that would occur if a retailer paid taxes on the underlying communications services purchased from its wholesale provider, a retailer may be exempt from supplier taxes by registering with the applicable taxing jurisdiction and, thereafter, properly completing and submitting appropriate tax exemption certificates to its suppliers.

A retailer's (including reseller's) failure to provide adequate proof of exemption to its wholesaler(s) will likely result in the wholesaler(s) passing through transaction taxes to the retailer, thus increasing the risk of double taxation of the wholesale inputs.

This Educational Primer provides both Wholesalers and Retailers of communications services with a high-level overview of the state and local transaction tax exemption process and requirements to mitigate the risk of double taxation.

I. Tax Compliance Obligations of Wholesale Providers

Wholesalers are responsible for their own tax compliance. Under state and local tax laws and regulations, wholesalers cannot rely on their reseller customers or their underlying suppliers (in the event a wholesaler is not the ultimate wholesaler) to comply with state and local tax requirements on their behalf. A wholesale transaction is not automatically treated by state and local taxing authorities as a tax exempt transaction. Instead, wholesalers are required to treat any sale as a retail sale, absent adequate and jurisdictionally appropriate proof of exemption.

IMPORTANT NOTE: ***Not all wholesalers are the same; determining the necessary requirements applicable to each upstream entity is highly fact dependent, as explained in Section III – Situsing Issues and the associated Chart below.***

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Retail providers must register, collect and remit applicable taxes to state and local taxing authorities. Wholesale providers must likewise register to the extent they: (1) sell any retail services; (2) cannot secure a valid exemption certificate from any reseller customer; or (3) must register in order to prove exemption to an ultimate wholesale provider. Wholesale providers must treat any transaction not supported by a resale exemption certificate as subject to applicable taxes. A wholesaler that can demonstrate (through the collection of tax exemption certificates) that each of its customers pays taxes directly to the governing tax authority, may not need to register in a given jurisdiction.

The following section discusses registration, collection, remittance, and exemption certificate obligations as applied to "ultimate" and "in the middle" wholesalers. To ensure compliance, wholesalers must register with the appropriate taxing authorities and assess and remit all applicable taxes on their taxable services, unless a reseller customer submits to the wholesaler a validly executed tax exemption certificate.

A. Tax Registration Requirements for Wholesalers

Tax registration presents a challenge for wholesalers, as registration obligations often depend on whether the wholesaler is the ultimate underlying facilities-based provider or reselling the services of another wholesale provider.

1. In the Middle Wholesalers

When a wholesaler resells the services of another provider, it may be required to register with tax authorities in three circumstances: (1) if it sells any services at retail; (2) when any reseller customer fails to provide a validly executed exemption certificate, and the wholesaler is required to assess and remit taxes on the taxable services sold to that customer; and/or (3) in order to prove exemption from pass-through taxes from its underlying provider.

2. Ultimate Wholesalers

When a wholesaler is the ultimate, underlying facilities-based service provider, meaning it does not resell the service of another provider, the wholesaler will also be required to register with taxing authorities if: (1) it sells any services at retail; and/or (2) its reseller customers fail to provide validly executed tax exemption certificates, and, as a result, the wholesaler is required to assess and remit taxes on taxable services sold to such reseller customers. However, a facilities-based wholesaler may be exempt from tax registration obligations if all of its reseller customers provide validly executed tax exemption certificates.

In practice, there is little uniformity in how wholesalers treat their tax registration obligations. Because each wholesaler is responsible for its own tax compliance, all providers in the supply chain must carefully evaluate their registration obligations to determine the best course of action for ensuring tax compliance and avoiding double taxation on the wholesale inputs.

B. Tax Exemption Certificates

As stated, wholesalers can only accept validly executed tax exemption certificates. To be validly executed, the certificate must include the reseller's tax registration number, and must certify that the reseller is (1) registered with the appropriate tax authority; (2) purchasing the service for resale; and (3) properly collecting and remitting taxes, or is selling the service to other resellers who have demonstrated exemption from taxation. Most taxing jurisdictions require resellers to complete a specific form. If a reseller submits a tax exemption certificate that is not properly executed (for example, it omits the reseller's tax registration number), or fails to provide an exemption certificate altogether, the wholesaler must assess taxes on the taxable services sold to the reseller and remit the collected taxes to the appropriate taxing authority. As noted above, in order to collect and remit such taxes, the wholesaler must be registered with the appropriate taxing authority.

C. Avoiding Double Taxation

When a wholesaler resells the services of an ultimate wholesaler, the in the middle wholesaler must manage its direct remittance obligations and the exemptions of its customers as well as its own exemption from state and local taxes.

First, the in the middle wholesaler must assess all applicable taxes on its own resold services, in the event that its reseller customers fail to provide validly executed exemption certificates. Second, the ultimate wholesaler will collect applicable state and local taxes from the in the middle wholesale (reseller) customer, unless the in the middle wholesaler submits validly executed tax exemption certificates for the applicable jurisdictions. As a result, it is imperative that wholesalers implement policies and procedures to ensure that all tax exemption certificates submitted to their underlying wholesalers are validly executed, in order to avoid potential double taxation.

As detailed in Section III and the chart following, situsing issues directly impact providers' state and local tax obligations. Situsing can be especially impactful for in the middle wholesalers. Where an ultimate wholesaler is registered in all states, and determines the tax situs for sales to its reseller customers based upon end-user customer usage patterns, the reseller would be required to register in every jurisdiction where the customer uses the service (likely throughout the U.S.) to secure exemption from the ultimate wholesaler, even if the reseller does not sell services at retail directly to end-user customers in these jurisdictions.

Alternatively, an ultimate wholesaler might determine the tax situs based upon the point of sale to the reseller. Such reseller may not be required to register in all states, but only a limited number of states in which: (1) it cannot collect tax exemption certificates from all customers; (2) it sells at retail; or (3) it must register in order to avoid pass-through taxes.

As discussed further below, wholesaler providers have not shown a great deal of uniformity in their approach to tax situsing (outside of the Tier I service providers such as AT&T and Verizon). Because each company will determine its own tax compliance policies, it may be necessary to evaluate the specific facts of a specific wholesaler-reseller transaction / relationship to determine the best course of action for the downstream provider to avoid double taxation on the wholesale inputs.

II. Tax Exemption Obligations of Retail Providers

Like wholesalers, retailers are responsible for their own compliance with state and local tax requirements. A retailer cannot rely on its wholesale supplier to assess and remit taxes on its behalf. Therefore, even if an underlying wholesaler assesses and remits taxes on the services purchased by the retailer (if the retailer does not provide the wholesaler with a properly executed tax exemption certificate), the retailer must assess taxes and remit the collected taxes to the proper taxing authorities based on retail revenue. The following describes at a high level the tax exemption obligations of retail providers.

First, retailers must register with the proper taxing authorities where they provide services.[1] Retailers should also register with all taxing authorities where their underlying service provider seeks to collect taxes, in order to ensure exemption from taxes in those jurisdictions. The retailer must assess all applicable taxes on its retail services and remit all collected taxes to the proper taxing authorities. To be exempt from taxation by its underlying wholesaler, the retailer must complete and submit a validly executed tax exemption certificate. As described above, if the tax exemption certificate is not validly executed, the wholesaler will collect taxes from the retailer.

III. Situsing Issues

Wholesalers and retailers must be mindful of tax situsing issues when implementing tax exemption policies and procedures. The tax situs is the location that determines what taxes and fees should be assessed on a particular sale of goods or services. Taxes are “sourced” to a particular jurisdiction, when that jurisdiction’s taxes apply based upon the nature of the sale.

Wholesalers take varied approaches in how they determine the tax situs. Some wholesalers treat the customer’s billing address as the tax situs, regardless of (1) the type of tax; or (2) the points of origination or termination of end-user communications traffic. Other wholesale service providers choose to determine the situs based upon the points of origination and termination of the end-user communications traffic. Others take a hybrid approach, and vary their determination of tax situs based on the type of tax. For example, for communications services taxes, these wholesalers rely on the end points of the call, but for sales taxes they treat the situs as the customer’s billing address.

How a wholesale service provider determines the tax situs can have important consequences for its retailer customers. Retailers must keep in mind that wholesalers control their own tax liability; they assess and remit taxes based on their own determination of responsibility. Thus, some wholesalers may take a more expansive or conservative approach regarding tax collection than the retailer would. Regardless of the approach used by the wholesaler, retailers must ensure that they comply with their own tax obligations, while minimizing their pass-through liabilities from suppliers. Implementing policies and procedures to ensure direct compliance and to minimize pass-through liabilities could require the retailers to register for taxes in nearly all 50 states, as well as numerous local jurisdictions.

[1] Registration with State Tax authorities (typically a Department of Revenue) will frequently, but not universally, require concurrent registration with the applicable state’s Secretary of State, as either a foreign Corp. or LLC.

The following chart highlights the practical implications of the Tax Policies of different types of wholesalers, principally arising from the decisions each wholesaler must make regarding situsing of revenue for tax purposes:

ULTIMATE WHOLESALER: Basing Taxes by Sourcing Wholesale Revenue to Ultimate End User Location	**ULTIMATE WHOLESALER:** Basing Taxes by Sourcing Wholesale Revenue based on Point of Sale with Reseller	**MIDSTREAM WHOLESALER:** Tax Sourcing and, therefore, Tax Exemption Dependent on Tax Policies & Practices of Ultimate Wholesaler
Here, the ultimate wholesaler ignores a customer's billing address, and sources taxes based on ultimate end-user traffic patterns. For example, an ultimate wholesaler bills services to a New Jersey address. The wholesaler relies on call detail information, and assesses taxes and fees based upon customer usage patterns, with origination and termination points in all 50 states. Instead of applying New Jersey taxes only, the ultimate wholesaler will collect applicable taxes in all 50 states (and potentially a number of local jurisdictions) from the reseller customer, unless the reseller provides valid proof of exemption. This is a more burdensome and conservative approach for the ultimate wholesaler, but it ensures strict tax compliance. This approach exposes midstream wholesalers and retailers to a greater volume of taxes and fees.	Here, the ultimate wholesaler sources taxes based on a customer's billing address, not end-user traffic patterns. For example, an ultimate wholesaler bills services to a New Jersey address. The wholesaler relies on the customer billing address, and assesses New Jersey taxes only. This is a less burdensome approach for the ultimate wholesaler, and is more predicable for midstream wholesalers and retailers.	Midstream wholesalers are dependent on the sourcing policy implemented by their upstream wholesaler. For example, if the upstream wholesaler sources revenue based on call detail information, the midstream wholesaler cannot predict with certainty what taxes and fees will be assessed, and in turn, in which states it must register and procure tax exemption certificates. This could include registration obligations in all 50 states, and a multitude of local jurisdictions. If the upstream wholesaler sources revenue based on the customer's billing address, the midstream wholesaler can more predictably manage its tax compliance and tax exemption obligations.

IV. Tax Compliance Advice and Solutions

The *Comm*Law Group and its affiliated consulting firm, The *Comm*pliance Group, offer a variety of solutions to assist both wholesale and retail telecommunications service providers with the evaluation of their tax obligations, development of tax compliance policies and procedures, and the outsourcing of tax compliance obligations, including the exemption process.

For more information on how organization can help you comply with your tax and regulatory compliance responsibilities, please contact us.

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