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Digital Goods, Services and Fourth Wave Taxation: What Communications Service Providers Need to Know

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Introduction:

The rise of the digital economy is forever transforming how we work and live—and altering entire business models for communications service providers (CSPs). As game-changing technologies are introduced and adopted at a lightning-fast pace, one of the biggest potential ramifications continues to fly under the radar each year: taxation.

In jurisdictions across America, taxing authorities are working to determine how next-generation and over-the-top (OTT) content offerings should be categorized and how they differ from traditional communications services—and how to apply taxes accordingly. Just as the taxation of VoIP was uncertain a few years ago, the same is now true for these so-called "fourth-wave" digital services coming down the pipeline.

This whitepaper will serve as an introduction to how CSPs should prepare for tax compliance in this brave new world of cutting-edge services. It will specifically discuss:

- The importance of digital offerings to service provider business models
- The definition of digital goods versus digital services
- The current digital goods and services taxation landscape – what CSPs don't know
- How you should prepare for new technologies and unclear regulations

The New Face of Communications Revenue

It's a brave new digital world, as consumers seem to have an unstoppable appetite for over-the-top (OTT) video content and next-gen social, news and gaming apps. On the business front, cloud-based unified communications and software-as-a-service applications are overtaking the more traditional, premise-based phone systems and LANs. And amid all of this, mobile

services have become more immersive with integrated video and, increasingly, virtual reality.

"The trifecta of fast broadband networks, well-designed mobile computing devices and the insatiable supply of content, applications and services has unleashed… demand for more like never before," a 2015 Chetan Sharma Consulting report notes.

As CSPs face a continued decline in revenue from traditional voice and data services, this next wave of digital services—and the monetization opportunities that come with them—are the future focus.

"This new model of value-added services enables operators to capitalize on advanced technologies and capabilities, such as cloud, network functions virtualization and APIs, and establish a foundation to harvest new emerging digital services beyond previous communications offerings—extending services to new digital application areas such as the Internet of Things, analytics, e-commerce, mobile payments and e-health," explained Aashu Virmani, VP of products and go to market, digital services at Comverse, in a column.

But even as product development and technology innovation has marched on at an ever-quickening pace, the legal and regulatory frameworks have struggled to keep up. For the most part, consumer and business spending in the past was for services linked to some kind of tether—a copper line into a home, a fiber strand to a business, or the airspace between a cell tower and a phone. And the body of communications tax law we live and work with today is still based on that paradigm, reliant upon original statutes that focused exclusively on traditional phone and data communications services.

In order to embrace the taxation of digital goods and services which aren't wedded to an underlying physical infrastructure, the states must define what they are (and where they are), and eventually make some basic decisions on taxability—and service providers need to be ready to handle the changes.

A Brief Overview of Digital Goods and the Taxation Landscape

It should be noted first and foremost that there are digital goods, and then there are digital services.

Digital goods generally refer to digital audio files like music and podcasts; digital video files for television shows or movies; digital books, delivered electronically without physical media; and digital games. And generally speaking, because these have a tangible counterpart (downloaded music is analogous to a CD; an eBook is analogous to a physical book, and so on), these are mainly subject to sales and use taxes.

For more than 20 states, the streamlined sales tax project (SSTP) defines each of these categories and offers a blueprint for sales tax liability. But when it comes to the other states, and U.S. territories and the District of Columbia, the applicability of tax is all over the board.

Some look at digital goods and compare them to tangible ones—and decide whether to tax or not tax depending on how they compare to the tangible versions. Others don't define digital goods at all, but say if they're taxable or not depending on how useful they are—i.e., the value of the end item that the consumer received.

It's here, too, that the nuances of the term "over the top" (OTT) come into play. There's a difference between downloads versus streaming services, video on demand (VOD) and rented content. It boils down to this: One is a product that is

transferred to and retained by the consumer—while the others are services from which the consumer derives no content ownership.

Some states weigh this difference as being significant, and say that the product that's kept is taxable, while the subscription service is not. Some states will do the converse.

Since a customer's purchase of a digital service is intangible, sales tax law has been slow to follow the shift. It's true that some states routinely apply sales taxes to services, yet they are using a body of sales tax laws originally drafted with tangible goods in mind—and these are not uniformly applied to intangible services. In some states, if something doesn't have a tangible form counterpart, sales tax doesn't apply.

Digital Services and Communications Tax

Thanks to the rise of cloud-based services, mobile-everything, virtualization and streaming, a significant portion of consumer and business spending has shifted to services where the value elements are intangible. This would include all of the consumer apps and cloud services and streaming/OTT offerings out there, along with VoIP, SaaS, conferencing, managed services and co-location on the business side.

They may not have tangible equivalents like eBooks do, but these services have counterparts in something else: traditional communications services. And communications tax has accordingly become an evolving arena that is increasingly accommodating to digital transformation.

This is where much of the uncertainty and complexity comes into play for CSPs, because the adaptation and application of communications tax laws to digital services has not occurred uniformly across the states.

You May Not Know What You Don't Know

As they foray farther into the next-gen realm, CSPs will find a multiplicity of laws in different states and unsettled regulation to deal with. And thanks to a fuzzy line between traditional and next-gen taxation requirements, there is a raft of misunderstanding and a lack of awareness when it comes to how handling digital services requires different approaches from existing taxation processes.

The "Netflix" Tax

Cloud services are increasingly a target for many jurisdictions for sales tax, too. Last year, Chicago decided that its 9 percent "amusement tax" should cover Netflix, Spotify, Hulu, Amazon Prime, and other streaming services, to help make up for sales tax revenue lost to falling DVD and CD sales.

Annual U.S. sales of DVDs and Blu-ray discs has fallen from a high of $20.2 billion a decade ago to around $10 billion, according to data from the Digital Entertainment Group, while the Recording Industry Association of America reports shipments of CDs fell from $13.2 billion in 2000, to $1.9 billion last year.

Similarly, traditional software sales—subject to traditional sales tax, be it for physical media or downloads—are starting to suffer as SaaS adoption takes off—leaving a hole in the local coffers that many municipalities want to fill.

So, in Chicago's mind, it should be able to collect local taxes on cloud SaaS services and streaming music and video. Other state governments like Tennessee and Idaho are experimenting with new taxes as well.

Some states have guidance and regulations defining these things clearly, saying that if a provider of this service does so in a specific way, then it's taxable. For instance, in some states, cloud-based video conferencing qualifies as a taxable telecommunications service with certain taxes applied based on the location of the originating user. But many states simply don't address digital services at all.

"And that's a dangerous thing, because ignorance is not an exception," explained Sandra Thomas, senior tax solution consultant at Avalara. "A state might not provide any guidance and then suddenly, the Department of Revenue will issue a ruling that says, 'This is taxable and it always has been'—and then you're retroactively liable for a large sum of unpaid tax. You shouldn't go on the assumption that a state doesn't tax something because they didn't say anything about it."

Where there are existing definitions and specific regulations, there is a great deal of divergence amongst the states in determining how and when services are taxed: The definitions and terms are not universal; and the treatment of particular services varies.

“As an example: Missouri doesn’t define digital at all, and the state doesn’t tax them,” explained Thomas. “Alabama also doesn’t define it, but says that any property that is perceptible to the senses is taxable—and that could be most digital services, like a streaming video feed or a conference call. One product in one state may be taxable, and it may not be in the other, but the reasoning may be totally different. CSPs need to make sure they understand how states handle these things specifically, and why.”

This becomes a special kind of issue when it comes to the sheer portability of cloud services. For instance, as a service, streaming is taxed where it’s used. But what happens when the user streams a podcast during a work commute across state lines? How will it be taxed when fees are charged per use instead of a monthly subscription? These are questions that we do not yet have answers to, so calculating risk must become part of a CSP’s next-gen tax strategy.

Taxation can also come down to the type of company that’s selling the service, so it’s also important to always make one’s case with auditors when other types of companies aren’t being taxed for the same kind of service.

“We’ve seen for instance in California where they have a utility users’ tax that only applies to ‘communications’; so if a communications provider sells something like a SaaS product, the jurisdiction will try to tax it. But if another type of company, like a managed IT provider, tries to sell the same thing, they won’t tax them. So, competitors aren’t being taxed but CSPs are, making for a competitive advantage.”

Ultimately, documentation is always important to help define the bright line of what’s taxable and what isn’t, Thomas said. “States are trying to figure out how to tax even when they’re recognized as communications-related things,” she noted. “Many times they’ve still only applied sales and use tax. In some states, VoIP for instance doesn’t get hit with USF and PUC fees because the state doesn’t regulate that.”

She also pointed out the case of Florida, where digital services meet the communications definition and are taxed by the Communications Services Tax.

The Battle of the Bundle

As complex as this arena already is, digital products also are often bundled with other services, which adds an entirely new layer of compliance concerns.

For instance, a popular bundle for wireless operators is the zero-rated or “freemium” bundle, which offers a data plan along with access to specific streaming services, where that traffic doesn’t count against a consumer data cap and the service itself may be bundled at no charge. The streaming traffic is technically “free,” although the service provider would be paying the originator of the content a percentage.

Or, cable operators have recently started rolling out broadband-only packages that can be paired with a limited OTT version of its TV programming, usually at a significantly reduced cost from a triple-play subscription. The streaming service is a next-gen offering without clear taxation parameters in many states; the broadband piece is universally understood.

On the business side, desktop-in-a-box services often combine business broadband with a range of SaaS services, plus VoIP and IP conferencing. Some of those elements are subject to settled tax regulation, and some aren't.

Also, if one item in a bundle is taxable and the other isn't, some states will permit CSPs to only pay tax on the taxable items—something that requires the CSP to keep good records of how the bundle was created and what it consists of. Other states however will say that taxability is an all or nothing proposition—if there's one part of the bundle that's taxable, then the entire package would be as well. This seems straightforward enough, but in the realm of digital offerings, where taxability is murky anyway, there's a risk in how CSPs define those services.

"Any time that you bundle something with something else, you have to look at the taxability for both items," explained Thomas. "But with digital goods, this is something that is not yet well-defined, so if a CSP does business in states where the law isn't clear, and doesn't charge tax, they could build a large liability that they might not be able to get back from their customers later—and, they'll pay if they are assessed in an audit."

Conclusion

Key Implications for CSPs

- The tax laws are in flux regarding digital "fourth-wave" goods and services.
    - Governing bodies are asking questions, and so should communications service providers.
        - How are states responding to this year's innovations?
        - What will federal agencies regulate next?
        - Which taxes and fees will be applied, and when?
- If you don't have the internal resources to track these changes in every taxing jurisdiction (most don't), find a trusted partner who can.
- CSPs will need to prepare for these coming changes by expanding their billing capabilities, implementing a communications tax engine for automation.
- Not preparing for the nuances and complexities that come with the sale of digital products could open CSPs up to audit.

Define & Question Everything

The bottom line? Define everything and question everything.

"If CSPs are doing business in a lot of states, they want a partner to help them define their product, and then determine what's taxable and what isn't," Thomas said. "A lot of that involves coming up with good documentation about what you're selling and how it's treated in different states. Having someone who can really talk through exactly what you're selling is an invaluable aid in avoiding issues in an audit."

She added, "and above all, work with the sales and marketing department to ensure that all new offerings—even a bundle of existing offerings—are not sold without reviewing the tax implications."

This is especially important considering that fresh service categories are looming on the horizon, that have yet to be defined from a tax perspective. For one, the Internet of Things (IoT) is quickly emerging as a significant agent of transformation as it blends the physical and digital worlds.

In the latest Ericsson Mobility Report, 28 billion connected devices are forecasted by the year 2021, more than half of which will be machine to machine (M2M) and IoT connections. How these connections will be taxed has yet to be addressed, but CSPs would do well to start probing their state tax authorities on the questions now.

About Avalara

Avalara helps businesses of all sizes achieve compliance with sales and use, communications, VAT, excise and other transactional tax requirements by delivering comprehensive, automated, cloud-based solutions that are fast, accurate, and easy to use. Avalara's SaaS-based solution is designed to effectively manage complicated and burdensome tax compliance obligations imposed by federal, state, local, and other taxing authorities in the United States and internationally.