THE PROLIFERATION OF COMMUNICATIONS TAX

and what it means for your business
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If you operate under the assumption that communications taxes don’t apply to your company, it could be time to revisit that notion.

It can be easy to assume your business is liable only for sales and use tax, especially if that’s what you’ve always done. Plus, if you’re a traditional telecommunications company expanding your offerings, you need to be aware of the different ways communications services taxes and telecommunications tax apply.

Technology and communications change quickly, and tax legislation is constantly shifting to keep up, introducing new taxability rules and tax rates as fast as companies can introduce new offerings and features. Learn how you can stay compliant even in a dynamic industry.
Which businesses might be on the hook for communications services tax?

Gone are the days when state and local governments could rely on traditional wireline, wireless, and even VoIP providers as reliable sources of revenue. Traditional voice services are being replaced with new technologies like streaming and videoconferencing, or being embedded into other cloud services and SaaS platforms, and more companies than ever are using these types of technologies to conduct business.

New rules and regulations have been introduced to keep up, and existing obligations like the Federal Universal Service Fund surcharge and the Florida Communications Services Tax are casting a wider net to new forms of communications. As such, a broad range of companies once liable for sales tax alone are suddenly subject to more complex communications taxes, often without even realizing it. The services and products impacted range from smart devices and fitness equipment to customer relationship management platforms and entertainment streaming services – and the list goes on.

Another factor to consider

Communications services are increasingly cloud-based, virtualized, and embeddable, making them more pervasive and found often in products, services, or apps that were typically never considered to be a telco or communications offering. The boom in the adoption of communications-platform-as-a-service (CPaaS) solutions, which deliver communications services like voice, videoconferencing, SMS, and wireless connectivity through simple APIs, has allowed communications services to become easily embedded in a wide range of product categories. And that can make them unexpectedly subject to communications tax. For example, many B2B SaaS providers have incorporated voice calling, video chat, or messaging services into their CRM and marketing automation platforms as either add-on modules or part of their base offering. That one change can make them subject to a wide array of communications taxes.
How can you know if your company is responsible for communications tax?

First, there are a few quick questions to answer:

- Does your service include voice or conferencing?
- Does it include SMS or messaging?
- Do you offer any sort of streaming service?
- Does your manufactured product have a networked sensor?
- Do you offer a wireless or other data subscription service?
- Does your company provide a service in one or more of the key market segments below or include any of these as a feature in your core product?

- Audio/video/web conferencing
- Cable
- Cloud
- Cloud connectivity
- Collaboration
- Communications platform as a service (CPaaS)
- Data services (wireline or wireless)
- Hosting
- Instant messaging
- Internet of Things (IoT)

- Managed services
- Network sensors
- Software as a service (SaaS)
- Software-defined networking (SDN)
- Streaming
- Texting/short-message service (SMS)
- Unified communications as a service (UCaaS)
- Voice
- Voice over Internet Protocol (VoIP)

*If you answered yes to any of these questions, it’s time to understand how you might be responsible for communications tax.*
The term “communications tax” refers to a multitude of taxes, fees, and requirements levied at the federal, state, and local levels. These include taxes that were originally created for traditional voice and networking services but have continually been reinterpreted and adjusted over the years to account for emerging technologies.

For decades, communications tax applied to a very select set of industries. Telephone companies. Cable operators. Internet providers. But as communications technology advanced, the definition of telecommunications tax began to expand. Consumers abandoned traditional services for mobile and online options, and new tax laws followed.

However, with communications technologies evolving rapidly to include things like streaming, videoconferencing, collaboration tools, SD-WAN, and IoT, it’s become more difficult for tax authorities to keep up. When rates and rules change, it typically isn’t at a holistic, national level. As a result, communications tax today is a highly complex and varied web of local fees, state taxes, federal surcharges, and even special tax jurisdiction filing requirements, all of which can vary drastically from one location to another.

Unlike sales and use tax, which is often based on relatively straightforward calculations, communications tax can involve multiple calculations and considerations, each of which can be incredibly intricate. Compounding this, the jurisdictional boundaries for many communications differ from sales and use tax jurisdictional boundaries. With an industry in a state of constant transformation, simply monitoring changes and determining which rules and rates to apply is particularly daunting. And, these challenges continue across the compliance spectrum – there are unique returns for communications, with their own rules and filing schedules, and specific forms and rules for exemption management. Communications taxes often carry specific “truth-in-billing” requirements that govern how taxes must be presented and broken out on customer invoices.
Which product or service variables impact communications taxability?

Understanding your potential communications tax risk means first examining not only the technical nuances of your product or service but precisely how and where it’s being sold.

It’s increasingly typical for companies within the broad telecommunications, streaming, technology, and many other nontechnical industries to sell bundled services within the key market segments outlined earlier – and sometimes beyond. Companies may merge or partner, particularly to remain competitive, or they may develop and launch new products. This, often unknowingly, expands the potential communications tax risk.

As more companies face the possibility of costly communications tax audits, it’s highly important to understand if, when, and how your business is responsible for communications tax. Often, all it takes is one new feature to quickly render a company subject to a highly complex web of rules, regulations, and fees. In general, if your product has any ability for voice, video, SMS, or data connectivity, you may have a communications tax responsibility. When your product or service is bundled with any one of these, you may immediately trigger this obligation, in different ways, across different jurisdictions.
Here are a few common scenarios:

**Voice and video**
SaaS and collaboration platforms commonly have the ability to connect with the world outside their internal network. If you can only talk to your coworkers on the same platform, your service may not be interconnected and only subject to some of the communications taxes. However, if you can connect with phone numbers on the public switched network, your service is more likely interconnected and subject to communications tax.

**Streaming**
As in video, music, and gaming. This includes typical entertainment subscriptions and purchases, but could also include nontypical streaming services for things like live events, professional education, and faith-based practices. Another common scenario is for tangible products bundled with streaming services, like fitness equipment.

**Connectivity**
Smart devices by definition come with an array of sensors, but they may or may not come with their own wireless connectivity subscription service. If they do, they may likely be communications taxable. For example, your smart thermostat uses your home Wi-Fi so it’s probably not communications taxable. But a drone or a crop or oil pipeline sensor likely has its own onboard connectivity. Similarly, a “smart” security camera could come with its own built-in wireless data plan. These connections are potentially communications taxable.

**SMS**
When sharing either promotions or real-time product or service updates, many companies are turning to text messaging. SMS can be a powerful business strategy, but it also has the potential to subject your company to communications taxes.

**Understanding how your product should be classified for tax purposes is critical. Is it an information service? Is it a communications service? Or is it a hybrid of both? The tax implications can be dramatic.**
Which business model variables impact communications taxability?

Just like your product or service mix, how you merchandise and price your products and services can greatly affect your tax scenario. Understanding the nuances of each of these, and how to track and manage the requirements in more than 60,000 jurisdictions in North America, can be overwhelming.

Bundling requires careful consideration

Bundling services has become common practice, for good reason: Bundled packages offer customers greater value and are often easy to sell. But as varying services are bundled together, the likelihood of communications tax complexity increases. Services like calling, SMS, videoconferencing, and click-to-call could each be subject to their own separate set of communications taxes, and how these are handled can vary greatly from jurisdiction to jurisdiction. In fact, in some states, including just one communications taxable item can make the entire bundle subject to communications tax.

Geographic expansions widen tax scope

Each time your business expands to a new market, the likelihood of communications tax complexity increases. At a time when cloud-based and virtualized, “over-the-top” environments make it possible to readily scale services for hundreds or thousands of different ZIP codes or even around the globe, this is an especially important consideration. Each new service area opens the door to new collection and filing requirements or e-invoicing requirements for global markets. That means virtually any fast-growing communications or technology business could soon find itself newly exposed to a wide range of state, county, and local communications taxes.
Mergers and acquisitions often create new obligations (and catch auditors’ attention)

Across the communications and technology industries, new offerings are being introduced at astonishing speed. Emerging trends are opening the door to new packages and portfolios, while mergers and acquisitions are broadening the volume of services companies are able to provide – all of which can trigger a new communications tax obligation. In a recent survey of executives, 92% of companies expect M&A deal volume to increase or stay the same over the next year. As relationships like these continue to grow, communications tax auditors are watching announcements closely.

Online selling increases complexity

For many companies, selling services on an ecommerce website is an essential part of the plan to remain competitive. Because online payments are instant, unlike traditional billing cycles, it’s imperative to quote and calculate communications tax in real time – and to ensure your tax platform is hardened to mitigate downtimes. That “always-on,” frictionless customer buying experience is critical not only to decrease shopping cart abandonment but also to help minimize communications tax risks.

Reselling creates additional demands

Whether it’s part of managed services or channel partnerships, reselling activity is highly likely to involve additional communications tax complexities. The communications tax treatment of any services you resell will need to align with the tax treatments of your partner, including mission-critical exemption certificates. As communications services become more intertwined, managed service providers find it necessary to expand their scope of offerings and, in doing so, dramatically increase their tax complexity.
Six best practices for communications tax compliance

Although the complexities of communications taxation aren’t likely to ease up any time soon, it is possible to be prepared. Several best practices can go a long way toward ensuring your business remains compliant.

1. Ensure tax preparation anticipates the pace of innovation

For many businesses today, a company’s greatest advantage is its pace of innovation. From a communications tax perspective, however, rapid innovation has the potential to increase compliance risks. As new offerings are introduced at an impressive rate, a company’s tax obligation could be growing too.

For this reason, it’s imperative that a member of your tax department has a seat at the table with product and marketing, and when it comes to planning for any mergers or acquisitions. That way, all team members can get a clear understanding of how pricing models, bundled pricing, and new communications features and offerings can impact tax treatment.

When these departments understand the potential tax treatments of each new service or feature, billing becomes much more predictable and risks are much lower. In contrast, when divisions work in silos, the business could eventually find itself in a difficult situation where a new product has been selling for months before anyone is aware that collection and remittance need to take place.
2. **Adopt a comprehensive, automated tax solution**

Among communications and technology companies that perform well and have low audit risk, an astounding 70% report using **end-to-end communications tax solutions**. Nearly 70% automate tax returns and filing, and most use ERPs alongside comprehensive tax solutions.

These high performers understand the fundamental need for a comprehensive, complete platform. While most businesses have sales and use tax engines in place, these systems aren’t able to handle the complexities of communications taxes on their own. Moving forward, tax automation systems that unify the abilities to calculate tax, file returns, and manage exemptions for not only sales and use tax, but also specialized communications taxes, will be crucial.

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3. **Consider best-in-class, cloud-based SaaS technology**

When it comes to adopting a reliable tax platform, flexibility is key. Communications tax rates and requirements change all the time, which means any system you use should be updated frequently. Integrations with other business-critical software are crucial, as is the ability to scale quickly as you build new products and promotions.

For this reason, many communications and technology companies are turning to cloud-based platforms. **Among best-in-class performers surveyed by research firm Aberdeen**, 76% turn to SaaS for communications tax calculation, and 72% use it for returns and filling. As companies innovate and open themselves up to new communications tax obligations, SaaS solutions can make it much easier to stay ahead of the latest fees, rates, and filing requirements. Because they’re continually updated, they remove much of the risk associated with an ever-changing communications tax landscape. Cloud solutions also provide the ability to easily scale to accommodate growth – both expected and unexpected.
As innovation and adoption of new communications technologies continue to accelerate, changes to the communications tax landscape are likely to follow suit. That means tax compliance will continue to be a moving target – and the only way to stay ahead is to constantly adapt processes, tools, technologies, and integrations. Based on the latest surveys, best-in-class companies are more likely to be able to quickly pivot to support changes.

A key, but often overlooked consideration, is the ease of integrations. Enabling new sales channels, mergers and acquisitions, or new technology initiatives often entails utilizing new ERP, billing, or subscription management systems that often require integration with tax technology. It’s important for tax technology partners to offer a wide and proven ecosystem of out-of-the-box integrations and to be sure those integrations are built to support multi-tax scenarios, not just sales and use.

Tax compliance will continue to be a moving target – and the only way to stay ahead is to constantly adapt processes, tools, technologies, and integrations. Based on the latest surveys, best-in-class companies are more likely to be able to quickly pivot to support changes.
5. Don’t gamble on your tax risk

If you don’t understand your potential for communications tax risk, find out! Seek legal advice to help you make sense of your current situation, your future business goals, and how the future state of the industry and the tax and regulatory environment might affect your business. Make an educated decision — you may discover it’s very clear whether you’re required to collect and remit communications tax or if you can continue with only sales and use tax. Or you may find yourself in the common gray area of emerging technologies. From there, you can decide how to proceed.

6. Optimize for the customer experience

It may not be the first consideration on your list, but the tax solutions you use can have a big impact on the customer experience. From real-time ecommerce transactions to accurate invoicing, there are countless areas where having the right software in place can make a big difference in sales and revenue. Do your research when selecting vendors to be sure any software you use will become a point of success — rather than failure — in your customer’s journey with your company.
Be ready for today, future-proof for tomorrow

Whether you participate directly in the communications space or plan to incorporate communications features or streaming into your existing product, staying ahead of communications taxes will remain important. The pace at which a growing array of businesses will face complicated communications taxes at the federal, state, county, and local levels will continue to increase. The sooner your organization can prepare for the complexities, the more likely you are to remain compliant and profitable.

The team at Avalara for Communications stays on top of the ever-changing communications tax ecosystem. Our SaaS-based solutions, industry knowledge, extensive tax experience, and exceptional service can help you successfully maximize tax efficiency and minimize tax risk, no matter how the industry changes.

Contact Avalara today.

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