Non-Traditional VoIP, UCaaS & Cloud Communications Service Distribution Models Proliferate in the Marketplace, but are they Risk Free?

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"Carrier of Record" VoIP/UCaaS Communications Service Distribution Model

Is it the Holy Grail? It can be, if it's done right.
Do it wrong and it can be a disaster!

M&D MARASHLIAN & DONAHUE, PLLC
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Agenda

INTRODUCTION:

- ❑ *Overview of U.S. Telecommunications Tax & Regulatory regime*

ISSUES AND ANALYSIS:

- ❑ *Market Conditions and Demand for non-traditional distribution models*
- ❑ *FCC Regulations*
- ❑ *Legal, Tax and Regulatory Risks associated with non-traditional distribution models (such as “Carrier of Record”)*

PRACTICAL SOLUTIONS:

- ❑ *Risk mitigation strategies for adoption of non-traditional distribution models*

INTRODUCTION: OVERVIEW OF U.S. REGULATORY AND TAX REGIME

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Overview of U.S. Tax and Regulatory Scheme

In the U.S., federal, state and local statutes, regulatory rules, and judicial precedent governing providers of regulated and taxed communications services recognize two types of entities:

1. **REGULATED/TAXED TELECOMMUNICATIONS PROVIDERS:** Wholesale or retail providers of telecommunications, including resellers of an underlying wholesale provider's services; and

2. **UNREGULATED/UNTAXED SALES OR MARKETING AGENTS:** Commission-based sellers of the services offered by a regulated and taxed provider of telecommunications.

Example 1: Regulated/Taxed Telecommunications Provider

Wholesaler

- Operates as a wholesale provider of telecommunications service inputs
- Sells services to Reseller at wholesale rates
- No relationship with End User
- Collects exemption certifications from Reseller (regulated and taxed on its services if sold directly to the public or to Reseller, unless Reseller provides the Wholesaler with proof of exemption)

Reseller

- Purchases services from Wholesaler at wholesale rates
- Combines the telecommunications inputs with software (e.g., cloud PBX) and then sells a bundle of software and telecommunications to the public as an I-VoIP/unified communications solution under its own brand name at retail rates
- Relationship with End User
- Pays no taxes/fees on services purchased from Wholesaler (with proof of exemption)
- Treated as a provider of I-VoIP services and is subject to direct regulation and taxation of said bundle of services at the federal, state and local levels
- Bills customer for services, inclusive of taxes and fees on retail price
- Collects and remits taxes/fees based on sales to End Users

End User

- No visibility to Wholesaler, Reseller seen as carrier
- Invoices include taxes/fees to be collected and remitted by Reseller

Example 2: Unregulated/Untaxed Sale Agent

Retail Provider

- Retailer of telecommunications services and contracts with independent sales agents to market and sell it services
- Retains control over the services provided to consumers, earns "top line" revenue, pays the sales agent a commission, and is responsible for regulatory and tax compliance with respect to its telecommunications services.

Agent

- Sells Retail provider-branded services on behalf of the provider and earns commissions from sales to consumers.

End User

- Contract for services with Retail Provider; sees Retail Provider as carrier
- Invoices include taxes/fees to be collected and remitted by Retail Provider

Various Distribution Models Operating in the Telecommunications Market

- There are a variety of service distribution models based on the different roles of regulated and unregulated business entities. For example:
  - *Private Label Distributor*
    - Uses own brand to market and sell a service and bears the regulatory and tax compliance burden (effectively a telecommunications Reseller model disguised as a "distribution" arrangement)
  - *Value-added Reseller/Channel Partner*
    - A form of private label distribution under a different name
  - *Systems Integrators*
    - Companies whose resale of telecommunications services comprise less than 5% of total revenue from "systems integration" service are exempt from direct contributions to the Universal Service Fund ("USF"), and not required to register with the Universal Service Administrative Company ("USAC") or file Forms 499 (currently N/A to Systems Integrators selling VoIP)

Third Option: Carrier of Record Model

- New, untested service delivery model
- Does not fit neatly within either the "Reseller" or "Agency" models recognized by the FCC
- Yet to be accepted by the FCC and/or state and local tax authorities
- However, there are no known absolute prohibitions on structuring commercial arrangements between a "Carrier of Record" and a "Retail Partner"
  - *The "Retail Partner" effectively operates as a Sales & Marketing Agent (and billing & collection agent to the Carrier of Record) even though it earns "top line" revenue, as opposed to a commission*

Carrier of Record Model

Carrier of Record

- Sells services at wholesale rates to “Agent” (Retail Partner); books wholesale price as revenue
- No direct relationship with End User, but listed as Carrier of Record (service provider) on invoices
- Calculates taxes/fees to be collected from End User by Retail Partner based on retail sales price
- Remits taxes/fees to relevant authority

Retail Partner

- Purchases services from Wholesaler at wholesale rates
- Sells services to End User at retail rates (wholesale + mark up)
- Records revenue based upon retail price for sales to End User
- Has relationship with End User
- Collects taxes/fees from End User (based upon Wholesaler’s calculations) and provides to Wholesaler to remit to relevant authority

End User

- Purchases services from Retail Partner
- Invoices include taxes/fees to be collected by Retail Partner
- Wholesaler is Carrier of Record, but services invoiced by Retail Partner

ISSUES AND ANALYSIS

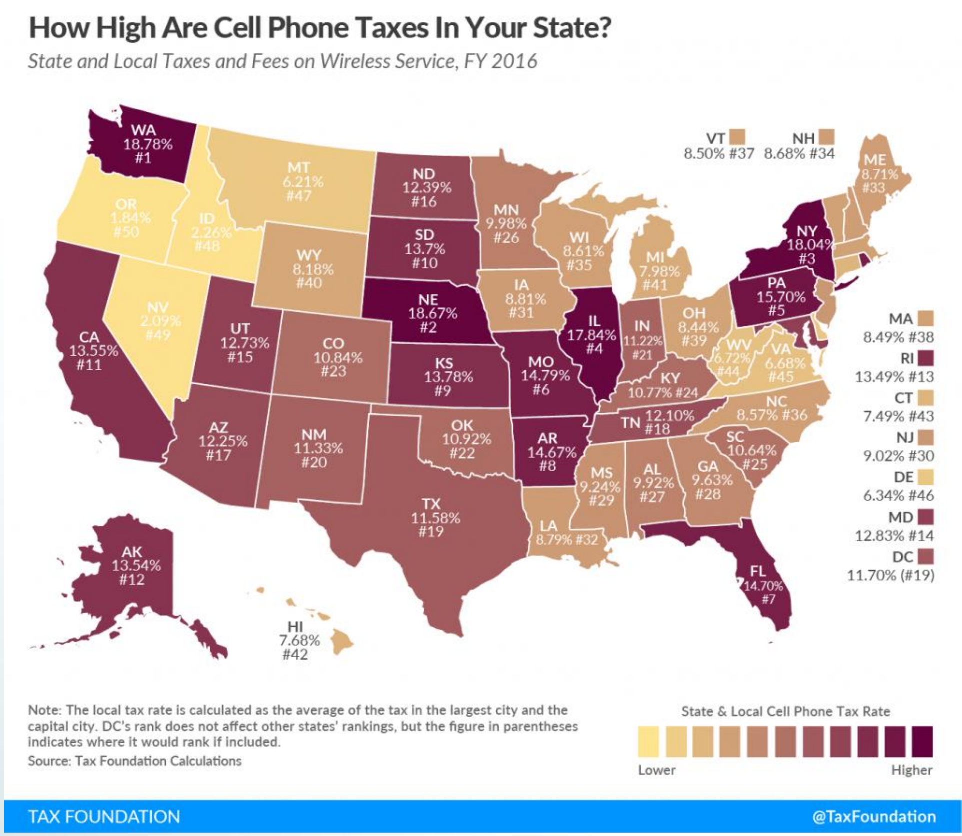
Market Conditions & Demand for Carrier of Record Model

- ***Proliferation of UCaaS/VoIP***: Market demand for advanced communications, "ease of entry" (low regulatory burdens) and "ease of delivery" have spawned a proliferation of UCaaS/VoIP solution platform vendors who combine the telecommunications inputs from upstream telecommunications providers with software to create IP-based communications solutions.
- ***Transitioning of Large, Incumbent Providers***: At the same time, large incumbent providers of traditional telecommunications services are actively transitioning from retailer service providers to wholesalers of the telecommunications inputs used by platform providers to deliver retail solutions

<u>PROBLEM:</u> New retailers of communications services (via UCaaS/VoIP) are not equipped to cope with even the lighter touch regulatory burdens or tax obligations imposed on retailers of I-VoIP services.

The Compliance Challenge

- While the regulatory impositions are generally lighter on I-VoIP providers than they are on traditional telephone companies, the tax burdens are roughly equal.
- Communications services providers are among the most heavily taxed and regulated industries in the United States.
- In 2014:
  - *300 types of "Telecom Taxes" fees, charges, and surcharges*
  - *Imposed on potentially 685 different tax bases*
  - *Imposed by tens of thousands of jurisdictions at the federal, state, and local levels*
  - *Possible to have 48,000 different filings per legal entity nationwide*
- Tax burden on wireless as high as 18% in some states



Source: https://taxfoundation.org/cell-phone-tax-burdens-state-state/

Hobson's Choice Facing New VoIP/UCaaS Providers

- Hobson's choice: Either subject the company to all the costs, complexities and burdens of being the Regulated/Taxed Telecommunications Provider to obtain the customer relationship and revenue benefits, or opt against shouldering these regulatory and tax burdens, sacrificing these benefits and earning modest and dwindling commission-based revenue selling another carrier's services as a Sales/Marketing Agent.

Enter: Carrier of Record Model

- This Hobson's choice has led some companies to explore other options, including the Carrier of Record Model
- The Carrier of Record model seeks to achieve a balance where:
  - *(A) a single, larger and more financially and operationally equipped entity creates a retail UCaaS/VoIP solution;*
  - *(B) but where smaller, less financially and operationally capable entities with strong End User relationships can sell the solutions, retain their brand equity, enhance their customer relationship, derive "top line" revenue and achieve significant margins/profitability; and*
  - *(C) all while shifting the nationwide regulatory and tax compliance responsibilities to the UCaaS/VoIP solutions provider*

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Legal, regulatory and tax-related risks and operational obstacles to adoption of a Carrier of Record business model

- **FCC Precedent**
  - *Recognizes only dual model – Reseller or Agency*
    - (*Note – current precedent applies to traditional telecom services; not necessarily applicable to I-VoIP but likely to be applied to I-VoIP by the FCC)
  - *In distinguishing between the two, the FCC does not consider any single factor dispositive but examines all facts*
  - *Facts supporting "Agency"*
    - Agent does not purchase telecommunications services for incorporation into an offering sold to end users
    - Agent earns a commission on sales
    - Agent sells Service Provider-branded services on its behalf
    - Service provider responsible for customer service, pricing, terms of service
  - *Facts supporting "Reseller"*
    - Reseller purchases telecommunications services for incorporation into an offering sold to end users
    - Reseller buys, marks up and resells services under its own brand
    - Reseller has control over customer service, pricing, terms of service

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Legal, regulatory and tax-related risks and operational obstacles to adoption of a Carrier of Record business model (cont.)

- Primary Risk: ***UNTESTED***
  - *Retail Partner Risk – non-compliance with regulatory and tax responsibilities*
    - Auditor could determine that the Retail Partner is actually the provider and the entity that is responsible for reporting and remitting taxes and fees based on the top line revenue)
  - *Carrier of Record's Risk – over-collection of taxes and fees*
    - Due to delta between the revenue reflected in its accounting records and the tax/fee revenue basis, which is reflected in the Retail Partner's retail revenue
- GOAL - Demonstrate that, despite receiving top line revenue, the Retail Partner still qualifies as a mere Sales Agent rather than a "Reseller."
- KEY = Risk Mitigation.

Legal and Operational Challenges of COR Model

- CHALLENGE: Timing of Tax & Fee calculation, invoicing and recoupment.
  - *<u>Operational Challenge</u>: Challenge for Carrier of Record and Retail Partner to implement a solution that engages in "real-time" or "same month" calculation and invoicing of taxes and fees on end-user invoices.*
  - *<u>Legal Risk</u>: Any billing gap may create a compliance issue (unpaid or late paid taxes and fees); however, the risk is modest and largely manageable. Indeed, it is not unusual for companies lacking in sufficient billing software automation of multi-jurisdictional taxes to report and remit with built-in lags.*

Legal and Operational Challenges of COR Model

- CHALLENGE: Management of retailer credits, refunds, etc.

  – *Operational Challenge:* It can be very difficult to manage credits and refunds, and ensure that these are properly translated into billing data that is properly calculated. The Carrier of Record will need to ensure that its billing and tax calculation engines have the ability to manage credits and refunds and ensure that data is updated as close to "real-time" as possible.

  – *Legal Risk*: This is best addressed through contract. Because the Retail Partner lacks direct access to the Carrier of Record's billing platform, everything must be done through the Carrier of Record. Contracts should address appropriate protections for the Carrier as well as the Partner.

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Legal and Operational Challenges of COR Model

- CHALLENGE: Management of End User tax exemptions.
  - Operational Challenge: *It is the Retail Partner's responsibility to solicit, obtain and provide proof of exemption for end users. They must have a rigorous process for ensuring timely collection of all appropriate exemptions, including review to ensure that they are fully and accurately completed.*
  - Legal Risk: *If proof of exemption is not provided or provided late, this creates legal risk and exposure for the Carrier of Record and Retail Partner. If an end user is exempt and provided necessary proof, but the proof was not implemented, there is financial exposure to the end user that may not be recoverable/refundable.*

Legal and Operational Challenges of COR Model

- CHALLENGE: Implementation of 911 Rules.
  - *<u>Operational Challenge</u>: The Carrier of Record will be tasked with compliance with 911 rules – which mandate 911 services for end users. Operationally, the Retail Partner would need to be advised of the requirements for the Net911 Act, and any associated risks.*
  - *<u>Legal Challenge</u>: 911 liability must be discussed in clear contract language allocating duties between the Carrier of Record and the Retail Partner.*

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Legal and Operational Challenges of COR Model

- CHALLENGE: Accounting Complexities.
  - *<u>Operational Issues</u>: The Carrier of Record books revenue at the wholesale sales price (discounted price as sold to the Retail Partner). The Retail Partner books revenue from sale to end user (at retail price).*
  - *<u>Legal Risk</u>: The Carrier of Record's general ledger needs to tie to taxes/fees it is reporting in the event of a USAC (USF) or state (tax) audit. Because of the difference between what is being charged to end users by the Retail Partner and the revenue recognized by the Carrier of Record, its general ledger will not tie to its tax/fee reporting. As discussed above, USAC or a state tax auditor could determine:*

    (1) Carrier of Record over collected taxes/fee from end users;

    (2) End users are owed a refund of all over collected taxes/fees; and

    (3) Retail Partner is the entity that should have reported and remitted based on end user revenue

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Carrier of Record Model Risk Mitigation Strategies

- Defenses
  - *Primary defense: Correct Amounts of Taxes/Fees Paid*
  - *Secondary defense: Lack of Jurisdictional Authority*
- Risk Mitigation
  - *Structure the relationship to mirror "Sales Agent" model, but operationally and contractually shift duties and responsibilities consistent with legal precedent*
  - *Strive for Operational Perfection*
  - *Contracts, Contracts, Contracts!*

Questions?

HERE'S HOW TO REACH ME:

Jonathan S. Marashlian

jsm@commlawgroup.com — 703-714-1313

www.commlawgroup.com

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