

Corporate Income Tax Issues for Telecom Entities

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Topics to discuss:

- What type of taxes are we talking about?
- Where do we have to file?
- Telecom specific state filings
- State apportionment trends
- Recent federal and state developments

Types of taxes

- Income taxes: imposed on apportionable income at state level with federal taxable income as starting point
- Privilege taxes: imposed on 'privilege' of doing business in the state (including license fees/taxes) (ex. AL, CA, OK, SC)
- Gross receipts taxes: imposed on taxable gross receipts (ex. OH, PA, RI, SC, VA)
- Margin tax in TX: imposed on lesser of 3 bases

State income taxes

Federal taxable income	\$XX
+/- state modifications	<u>XX</u>
State taxable income	\$XX
Times state apportionment factor	<u>XX%</u>
Income apportioned to state	XX
Times state tax rate	<u>XX%</u>
State tax	<u><u>\$XX</u></u>

The bottom two lines apply for C-corps, not PTEs.

PTE complexities of state income tax

- Income passed through to shareholders/ members/ partners or taxed same as C corp
 - File composite returns or not, if available?
 - Does the state tax the S-corp as a PTE or C corp?
 - Are taxes paid on behalf of the shareholder considered a tax expense or a distribution?
 - Some states require that the entity withhold on behalf of the shareholders
 - POAs and authorization forms from the shareholders are required to show they authorize participation in the filings

File Composite or Not?

Advantages

1. Shareholders relieved of filing requirement (i.e., lower tax prep fees)
2. Privacy for shareholder (no need to provide federal income tax return)

Disadvantages

1. Income often taxed at highest rate and exemptions/ deductions not allowed
2. Nonresident SOL issues

States that tax S-corps as C-corps

- Arkansas – must file S-election with state to be taxed as S-corp; otherwise taxed as C-corp
- District of Columbia – S-corps are treated as C-corps
- Georgia – must file S-election form with state for shareholders; otherwise taxed as C-corp
- Louisiana – S-corps are treated as C-corps (with reduction for income taxed at shareholder level)
- New Hampshire – S-corps are treated as C-corps
- New Jersey – must file S-election with state to be taxed as S-corp; otherwise taxed as C-corp
- Pennsylvania – can elect to be taxed as C-corp
- Tennessee – S-corps are treated as C-corps
- Texas – S-corps are treated as C-corps
- Wisconsin – can elect to be taxed as C-corp

Are composite taxes a distribution instead of a corporate tax deduction?

- Yes
- Make sure to make a true-up to make sure distributions are not disproportionate to ownership percentage to make sure you don't become ineligible to be an S-corp or violate partnership/operating agreements

Privilege taxes/minimum fee

- Alabama: applies to any foreign corporation qualified or registered under Alabama law and to any foreign corporation that is doing business in Alabama. A taxpayer is liable for the privilege tax for each year starting before the taxpayer has been dissolved or otherwise ceased to exist or has withdrawn or forfeited its qualification to do business in Alabama.
- CA: payment of the minimum franchise tax is not contingent upon the corporation conducting any business or engaging in profitable activities, but instead is imposed for the privilege of exercising the corporate franchise within the state.
- South Carolina: every corporation qualified to do business must file the annual return with license fee

Ohio Commercial Activity Tax (CAT)

- An out-of-state person is only required to register and pay the CAT if that person has bright-line presence in Ohio. A person has bright-line presence if any one (1) of the following applies at any time during the calendar year:
 - i. Property in this state is at least \$50,000; or
 - ii. Payroll in this state is at least \$50,000; or
 - iii. Taxable gross receipts sitused to Ohio are at least \$500,000; or
 - iv. 25% of total property or total payroll or total gross receipts is within this state; or
 - v. The person is domiciled in this state.
- Note: An out-of-state person meeting one of the above criteria must also have at least \$150,000 in taxable gross receipts sitused to Ohio during the calendar year to be subject to the CAT.

PA Gross Receipts tax (RCT-111)

- applies to telegraph and telephone messages transmitted wholly within Pennsylvania; telegraph and telephone messages transmitted in interstate commerce that originate or terminate in Pennsylvania, provided the charges for these messages are billed to a service address in Pennsylvania; and mobile telecommunications service messages sourced to Pennsylvania (with the exception of sales of Internet access and sales for resale made to parties that are also subject to gross receipts tax) based on the place of primary use standard set forth in the Mobile Telecommunications Sourcing Act (4 USC §117).

PA Gross Receipts tax (RCT-111) cont'd

- Excludes the following revenues:
 - Internet access fees
 - Handset revenues
 - Resale sales made to parties already subject to tax (you must detail the name, EIN, and resale amount)
- May claim a credit for gross receipts tax paid to another state on messages or services that are taxable under the Pennsylvania gross receipts tax provisions.

PA Gross Receipts tax (RCT-111) cont'd

- Excludes the following revenues:
 - Internet access fees
 - Handset revenues
 - Resale sales made to parties already subject to tax (you must detail the name, EIN, and resale amount)
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PA Gross Receipts tax (RCT-111) cont'd

- Make sure to reconcile revenues per RCT-111 gross receipts return to the RCT-101 income tax return
- See the attachments necessary for the RCT-111 below (excerpted from the instructions)

Annual Report Checklist: Make sure you include the following to file your annual report properly and completely:

- Complete RCT-111, Gross Receipts Tax Report – Telecommunications Companies
- Copy of the FCC annual report and/or PUC annual report
- Copy of the federal income tax return as filed, or a pro-forma return if a report is not required to be filed with the IRS
- Monthly schedule of receipts if the taxpayer is a fiscal filer for federal purposes (this schedule must cover the two fiscal periods which include the 12 calendar months reflected on this report)
- Detail of reconciliation if total receipts do not equal the amount reported on the federal return
- Detail of reconciliation if PA receipts do not equal the amount used on the sales factor apportionment reported on the PA Corporate Tax Report, RCT-101/RCT-106 or Schedule H of the PA20S/PA65
- Detail of adjustments for PA bad debts
- Detail of PA non-taxable receipts

PA Notices: Inevitable?

- There are valid reasons why the revenues per the RCT-101 could differ from the taxable receipts on the RCT-111. Examples of non-taxable receipts include internet, tangible personal property sales (such as handsets), the inclusion of taxes within the revenue figure, and equipment rental. If you have these non-taxable receipts, you will need to provide the revenues for each respective non-taxable receipts category at both the PA and total company level (total company level receipts should typically tie-out to line 1 revenues on your federal income tax return).
- Note that sales for resale can also be carved out of the taxable receipts, but you must provide the name of the reseller, their sales tax number, EIN, and a breakout of intrastate, interstate, and mobile receipts in order to claim these sales as resale sales instead of taxable receipts.

RI Public Service Corporation Tax (T-72)

- “Telecommunications service” means the transmission of any interactive two way electromagnetic communications including voice, image, data, and other information, by means of wire, cable, including fiber optical cable, microwave, and radio wave, or any combinations of these media. This definition does not include value added nonvoice services in which computer processing applications are used to act on the form, content, code, and protocol of the information to be transmitted
- VOIP providers ARE considered telecom companies
- Imposed in lieu of business corporation and franchise taxes
- Expect RI personnel to still ask for the corporate return, but you can provide info that you are subject to this tax instead
- If principal business in RI is not telecom, then you are still subject to PSC tax and also subject to the corporate income tax

SC: SC1120 or SC1120U

- There are two statutes imposing corporate license fees.
 - SC1120 license fee is Section 12-20-50
 - SC1120U license fee is Section 12-20-100 (gross receipts)
- What are “telephone companies” under 12-20-100?
 - Cellular providers are NOT subject to Section 12-20-100
 - *Alltel Communications, Inc. v. South Carolina Dept of Revenue* (2012)
 - term "telephone company" was not defined term and its application to taxpayers was doubtful, and presence of ambiguity in tax assessment statute required doubt to be resolved in favor of taxpayer.
 - Case implies that ‘telephone company’ is landline company with property in the state with right to use public ROW

TX Margin (aka Franchise) tax

- Imposed on each taxable entity that does business in Texas or that is chartered or organized in Texas.
- Good news: Revenues from telephone calls that both originate and terminate in Texas are Texas receipts. Revenues from telephone calls that originate in Texas but terminate outside of Texas or that originate outside of Texas but terminate in Texas are excluded from Texas receipts.
- Bad news: Cost of goods sold for services is disallowed which largely eliminates the COGS base

VA Minimum tax in lieu of corp income tax

- Every telecommunications company, as defined by statute and certified by the State Corporation Commission, must complete Form 500T.
- “Public utilities” and “public service corporations” are all entities subject to regulation by the State Corporation Commission (SCC).
- A telecommunications company that is incorporated is subject to a minimum tax, instead of the corporate income tax, if the tax imposed by the corporate income tax is less than the minimum tax. A telecommunications company that is organized as a limited liability company, partnership, or other entity treated as a pass-through entity is subject to the minimum tax.
- *Telecommunications company defined Virginia Code* § 58.1-400.1: “Telecommunications company” means:
 - a telephone company or other person holding a certificate of convenience and necessity granted by the SCC authorizing telephone service;
 - a person authorized by the F.C.C. to provide commercial mobile service where such service includes cellular mobile radio communications services or broadband personal communications services;
 - a person holding a certificate authorizing domestic telephone service and belonging to an affiliated group including a person holding a certificate of convenience and necessity granted by the SCC authorizing telephone service; or
 - a telegraph company or other person operating the apparatus necessary to communicate by telegraph.
- Small business corporations electing to be treated as S corporations for federal income tax purposes under IRC §1362 are exempt from minimum tax imposed on telecommunications companies (Va. Code Ann. §58.1-400.1).

Ohio Municipal Income Tax

- Imposed on local exchange telephone companies having taxable nexus with Ohio and having property, payroll or sales in any Ohio municipality that has enacted a municipal income tax is subject to the Ohio Revised Code Chapter 5745 municipal income tax.
- Administered at the state level
- Sales are sitused based on costs of performance
- You are not subject to this and the city income taxes
- You have to fill out their excel template and upload it to their website

NY Article 9A or 9

- Article 9A of the NY tax law relates to general business corporations while Article 9 relates to telecom companies (among a select few other industries).
- The instructions for forms CT-183 and CT-184 give a good general definition of 'telephone businesses.' entities subject to taxation under Article 9 from also being taxed under Article 9A.
- Article 9: Franchise and excise tax returns (CT-183, CT-186-E, CT-184 (for entities principally engaged in local telephone business))
- Article 9A: Income tax returns (CT-3, CT-3-S, etc depending upon entity type)
- In general, NY will often request an income tax return for a time period that has not been filed, but the taxpayer is responsible for determining whether such a return is subject to the tax article for the company.

Where do I need to file?

- A state has jurisdiction to tax a corporation organized in another state only if the out-of-state corporation has nexus (sufficient contacts with the state)
- Quill Corp v. North Dakota
 - Supreme Court ruled that substantial nexus exists only if corporation has a nontrivial physical presence in the state
 - This related to sales taxes, NOT income tax
- Thus, many states have adopted 'economic nexus' standards that are based on the amount of income or sales derived from sources within a state.

Nexus safe harbor for state income taxes, right?

- P.L. 86-272 confers immunity from state income taxes if the only business activity in the state consists of “solicitation of orders” for interstate sales of tangible personal property ONLY.
- Thus, sale of services including telecom is NOT covered.
- Applies only to taxes imposed on net income but provides no protection against property taxes, gross receipts taxes, or corporate franchise taxes on net worth or capital

Basis for state income tax nexus

- In *Complete Auto Transit, Inc. v. Brady* ([430 US 274](#)), the U.S. Supreme Court announced the rule that states could impose a privilege tax on interstate business without violating the Commerce Clause if (1) there was sufficient nexus with the state to justify the tax; (2) the tax did not discriminate against interstate commerce; (3) the tax was fairly apportioned, and (4) the tax was fairly related to benefits received by taxpayer. The tax is on the portion of such corporation's income that is earned from business conducted within Alabama.
- Watch for 'minimum taxes' like in CA

What is the filing requirement take-away?

- There are at least 18 states that have laws that remove a business from the protection of P.L 86-272 simply by qualifying to do business in a state.
- Nearly all the states have economic presence standards in which an out-of-state business has income tax nexus if the business directs economic activity in the state OR derives income from a state by making sales to customers in the state
- Thus, don't rush to the conclusion that the lack of physical presence in a state relieves you of filing requirements there.

Apportionment for service revenues

- Once the determination is made that your multi-state business has a filing requirement in a state ('nexus in the state'), the business must apportion the revenue, property, and payroll.
- Three main revenue sourcing categories: (1) Cost of Performance, (2) Market Based Methods, and (3) Other methods based on where the services are performed or the ultimate customer's location or based on telecom specific sourcing rules.
- The cost of performance method attributes the sale to the state in which a greater proportion of the income producing activity is performed than in any other state based on the relative direct costs to provide the service.
- The market based method attributes revenue to a state based on where the service recipient is located. Additionally, many states weight the sales factor higher than the property and payroll factor for the same reason.

Why does apportionment matter?

- You can pay taxes on the same revenue twice
 - Here is an example: Business is based in COP state (A) with 100% of property and payroll there but 1/3 of its sales are in MB state (B); income of \$100 & 5% tax rate
 - If B was COP as well, you would only have 1/9th of income apportioned ($1/3$ sales times $1/3$ factor since no payroll or property) in B and $8/9^{\text{th}}$ of income apportioned to A ($2/3$ sales + $3/3$ property + $3/3$ payroll)
 - However, B is a market-based state so they disregard the property and payroll factors so $1/3$ (or $3/9$) is apportionment factor. COP state law does not change so you are now at $11/9^{\text{th}}$ of income

Example tax impact

Both COP states

- A taxes = \$4, B taxes=\$1
- A: \$100 times $8/9^{\text{th}}$ times 5%
- B: \$100 times $1/9^{\text{th}}$ times 5%

A is COP and B is MB

- A taxes=\$4, B taxes=\$2
- A: \$100 times $8/9^{\text{th}}$ times 5%
- B: \$100 times $3/9^{\text{th}}$ times 5%

A is MB and B is COP

A taxes = \$3, B taxes=\$0
A: \$100 times $2/3$ times 5%
B: \$100 times $0/9^{\text{th}}$ times 5%

Both MB states

A taxes = \$3, B taxes=\$2
A: \$100 times $2/3$ times 5%
B: \$100 times $1/3$ times 5%

Oregon apportionment tax case

- A 2012 case in Oregon outlines the importance of determining the applicable costs for determination of the cost of performance (COP).
- The Oregon Tax Court rejected AT&T's method of sourcing its telecommunications receipts to Oregon. AT&T had prepared an amended return in which all receipts from interstate and international telecommunications were excluded from Oregon gross receipts on the basis that the majority of the costs of performance to earn those receipts were incurred in New Jersey. The Oregon Department of Revenue (OR DOR) argued that rather than looking at all costs of performance for all telecommunication services, AT&T was required to look at the direct costs for each telecommunications transaction separately and those direct costs were primarily the fees paid to local exchange carriers, e.g., Qwest, Verizon. The OR DOR also argued and the Oregon Tax Court agreed that the OR DOR's simplified method of sourcing interstate telecommunications charges based on origin, termination and service address, more accurately reflected AT&T's Oregon receipts based on cost of performance than AT&T's method did. (AT&T Corp. v. Dept. of Rev., Or. Tax Ct., Dkt. No. TC4814, 01/12/2012.)
- Does this mean that telecom businesses' revenue sourcing in COP states can approximate market sourcing because the payment of access charges for local customers is such a prevalent direct cost in the determination of the costs of performance while home state administrative costs are not considered includible.

Recent federal & state developments

- Tennessee Service Revenue Apportionment Case
- CA Franchise Tax Exposure
- Federal tangible property regulations
- Property tax ramifications

TN Service Revenue Apport. Case

- Vodafone Americas Holdings, Inc & Subsidiaries v. Roberts
- Taxpayer originally filed its returns apportioning receipts based upon customers' billing address
- Amended returns using cost of performance method resulting in much of revenues not being taxed
- TN Court of Appeals ruled that COP did not fairly represent the company's business in TN
- Governor is expected to sign into law that sources service revenue based on market-based sourcing

Do you have to file in CA?

- "Doing business" means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. For taxable years beginning on or after January 1, 2011, a taxpayer is doing business in this state for a taxable year if any of the following conditions has been satisfied:
 - The taxpayer is organized or commercially domiciled in this state.
 - Sales of the taxpayer in California exceed the lesser of five hundred thousand dollars (\$500,000) or 25 percent of the taxpayer's total sales.
 - The real property and tangible personal property of the taxpayer in this state exceed the lesser of fifty thousand dollars (\$50,000) or 25 percent of the taxpayer's total real property and tangible personal property.
 - The amount paid in this state by the taxpayer for compensation exceeds the lesser of
 - Fifty thousand dollars (\$50,000) or 25 percent of the total compensation paid by the taxpayer.
- The dollar amounts above are indexed annually with the values for the 2014 being as follows:
 - Sales \$529,562
 - Property \$52,956
 - Payroll \$52,956

Federal Tangible Property Regs

- Also called repair regulations
- Guidance issued in late Sept 2013 with clarifying guidance issued during 2014 and into 2015 tax season
- Effective for tax years beginning on or after 1/1/14
- Defines materials and supplies
- Examples of repairs versus asset capitalization
- Routine maintenance expensed: maintenance performed more than once during class life of asset
- Capital Improvements and dispositions guidance

* AICPA Quick Summary of Final Tangible Property Regulations

What is a UOP (Unit of Property)?

- You are required to capitalize amounts paid to acquire, produce, or improve tangible property.
- For improvements, you are required to capitalize costs that:
 - Result in betterment of the UOP
 - Result in the restoration of the UOP
 - Adapt the UOP to a new or different use
- Definition is all components of a piece of property that are functionally interdependent make up a single UOP
- See the regulations as they include MANY examples
- Assess each item on an invoice, NOT an invoice total

De Minimis Safe Harbor

- Provides safe harbor election for capitalization policy
 - If you have an ‘applicable financial statement’, (AFS) then the capitalization policy can be assets > \$5,000
 - If you don’t have an AFS, then the capitalization policy can be assets > \$500
- Recommend having a policy whether you have AFS or not (written policy **MUST** be in place at beginning of year for AFS filers while written not required if no AFS)
- The safe-harbor policy **MUST** be used for book and tax purposes (no book to tax difference for assets capitalized)
- **MUST** attach statement to your return for election

Accounting Method Changes?

- A method of accounting for tax purposes is the consistent treatment of a material item in computing taxable income
- Examples: UOP decision, depreciation method & capital expenditures vs. repair/maintenance decision
- Must use Form 3115 to notify the IRS that the taxpayer is changing an accounting method.
 - Item being changed
 - Present method for the item(s) being changed
 - Proposed method for the item(s) being changed
 - Cite the regulation supporting the proposed method

Small Business Relief

- On February 13, 2015, the IRS released Rev. Proc. 2015-20 which allows small businesses to comply with the new repair regulations prospectively and without filing a Form 3115
 - NO prior year changes can be made under relief
 - NO prior year positions are covered in audit under relief
- Small business is each separate trade or business that has (1) assets totaling less than \$10 million on the first day of the year the business first applies the regulations (i.e., 1/1/14 for a calendar year filer) or (2) average annual gross receipts of \$10 million or less for the prior three years

Property tax ramifications?

- On September 3, 2014, South Carolina issued an information letter stating they would follow (i.e., conform to) these IRS regulations for the applicable years, which represents one of the first state comments to the recently issued guidance.
- General note: Don't ignore your locations including equipment located in data centers as penalties are stiff for property tax and often exemptions are available for timely filed declarations

Open forum for comments

