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The Complex Tax Issues of Broadband over Power Line

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For some time utility companies in Europe have offered high-speed Internet service to consumers over their power lines, and American utilities are now beginning to provide broadband connections on their grid. There is a pervasive, national network of power lines which could be easily (and economically) used to provide broadband access. This function has become known as Broadband Over Power Line ("BPL"). But the taxation of such services, which combine utility and telecommunications issues, presents a real challenge both to the taxing authorities and to taxpayers. The following is a review of some of the significant taxes and tax related legislative initiatives that will affect BPL, and some insight into how various government entities might seek to tax BPL and related services. Taxes may be imposed by both the federal and state governments depending on the BPL services provided.

In the early days of electrical experimentation, Michael Faraday, a pioneer in the study of electricity, was visited by Prime Minister Gladstone. Upon viewing the apparatus that resulted from Faraday's work, Mr. Gladstone asked the scientist the value of his studies. Faraday answered, "Sir, I do not know, but some day you will tax it." Faraday was prescient in both the areas of electricity and taxation, and if alive today, he would probably not hesitate to restate his assertion, but this time with respect to Broadband over Power Lines ("BPL"). This article is intended to provide a context for electric power businesses to begin to evaluate the tax issues associated with BPL services in their business planning.

The Challenge of Taxes and Changing Technology

Even companies operating in established industries (such as the electric power business) subject to well-known tax rules must continually reevaluate their tax strategies to remain competitive. Attention to tax issues is even more critical where both the technology supporting an industry and the tax laws are simultaneously changing. This is the situation with BPL, and telecommunications services generally, as both continue to rapidly evolve. Further, the tax laws affecting telecommunications and information technologies are currently in a state of flux. This situation requires that companies offering such services, including BPL and related services, pay particular attention to the direction of the changes and continually update their strategies for addressing the associated business risks.

Approaches to Addressing the Challenges

There are a variety of approaches that a company might take to address tax issues. Depending on a particular company's resources it is appropriate to consider addressing these issues through some combination of legislative and lobbying activities, consultation with legal, accounting and financial advisers to identify effective tax strategies, structuring business relationships and contracts to address federal, state and international tax issues, and implementing internal mechanisms to assure tax compliance.

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Attention to these issues can yield significant benefits with a relatively modest expenditure of resources. For example, instead of ignoring the tax provision of a customer or supplier agreement as “boilerplate,” consideration of tax issues in the structuring, negotiation and preparation of agreements can result in immediate tax savings and a lessening of tax risk. Such strategies are accessible to even the smallest companies, if they are aware of the relevant issues. These strategies are explored in greater depth below.

The Particular Challenge for BPL Providers

In addition to the shifting landscape of taxation of telecom and information services, BPL services involve a combination of infrastructure and service profiles from the formerly distinct electrical and telecommunications industries, which have traditionally been subject to separately established regulatory and tax regimes. Companies offering BPL services are forced to seek to integrate these systems, and both to structure their supplier and customer relationships to allocate and address tax risks arising in the separate businesses and to establish an administration and compliance program that can efficiently and accurately deal with all relevant taxes.

The taxation of rapidly changing telecommunications and information technology service businesses is currently uncertain: governments at every level need to generate tax revenues and will continue to try to expand taxation. The resulting hodgepodge of conflicting rules (both domestic and international) presents a challenge to power and telecommunications industries, where profit margins are notoriously thin and where an unexpected tax liability could easily cause a service offering to be un-economic.

Federal Tax Issues: Income Tax, Telecommunications Excise Tax, And Other

The myriad federal income tax considerations associated with both day-to-day operations and out-of-the-ordinary transactions include, without limitation, income and deduction issues, sourcing issues (with international payments), withholding issues and a host of others.

In addition, the manner in which BPL and other broadband services are structured and made available to customers often requires attention to a broader range of tax considerations than are familiar to traditional businesses. For example, payments by a U.S. company to a non-U.S. entity for content or services that are provided by such foreign company may, in certain circumstances, be subject to U.S. tax withholding.¹ If such taxes are not withheld, the U.S. party making the payment may be held liable for the full amount of the tax. The basic theory

behind withholding is that the IRS cannot ensure collection of tax from a foreign payee, so it must capture the tax prior to the time that the payments to the payee leave U.S. tax jurisdiction. In the situation where a company has suppliers (of content, services, etc.) outside of the U.S., and is making payments to such foreign suppliers, it is generally helpful to include a provision in its standard supplier agreements to clarify the responsibilities of the parties with respect to withholding, and to cause the business parties to consider this issue in negotiating prices and terms.

In the opposite case (i.e., where the U.S. company is being paid for services rendered to a foreign person), and such payments might be subject to foreign withholding, the U.S. company should consider the inclusion of a withholding “gross up” provision. Such a provision generally requires that the foreign person’s payment obligation to the U.S. company be “grossed up” for any amount required to be withheld by the foreign country. Depending on the circumstances, this may be perceived as an aggressive position, since the U.S. company would, in effect, be asking the foreign company to pay its income tax due in another country. A “gross up” for withholding is, however, appropriate in circumstances where services were priced in anticipation of no tax being imposed in the foreign country, and certain other circumstances. The overall consideration of withholding issues must also take into account the U.S. company’s foreign tax credit situation (through which U.S. companies can take a credit against U.S. tax for certain amounts of income tax paid to foreign jurisdictions).

The foregoing discussion of tax withholding strategies is just one example of the variety of federal income tax issues that may be relevant to BPL businesses, and the importance of considering tax issues in structuring such businesses.

In addition to the federal income tax, the U.S. Government imposes a 3% Federal Telecommunications Tax on local and toll telephone services,² one of the many government extractions that burden a residential telephone bill. As technology has developed, the tax has been expanded to include innovations in the telecommunications space such as teletype service, WATS service and phone cards. The current explosion of technologies that can carry voice conversations has resulted in continued reexamination of the tax.

A recent proposal in Congress, if passed, would expand the telecommunications excise tax to subject VOIP services to the 3% tax. Another proposal would further expand the excise tax to cover all broadband services. These proposals would be relevant to electrical utilities that provide broadband services, particularly to the extent that the broadband offering included VOIP services. Depending on which proposal passes Congress, it is

possible that BPL and other broadband providers will have to figure out which services are subject to the tax and which are not. This exercise will be particularly difficult where taxable and non-taxable services are bundled.

Congress's two primary motivations in revising the telecommunications tax appear to be raising revenue and maintaining a level playing field among businesses offering telecom services. The first goal, raising revenue, has been the primary motivation for the imposition of the federal telecommunications tax since its inception as a luxury tax. It has also been the primary argument for the elimination of the tax, which has been observed to serve no other policy purpose.

The second motivation, the leveling of the playing field, has been put forth as an argument for broadening of the tax to cover the variety of broadband services. There are several arguments that can, however, be raised against this view, including (i) the suppression of innovation due to the fact that the tax will reduce revenue that could be available for financing R&D; (ii) the fact that the imposition of the tax will curtail budgets that could be available to expand service; (iii) the traditional argument that the telecom excise tax was originally passed as a luxury tax (to help finance the Spanish-American war) and that it should be repealed as serving no function other than revenue raising (and should certainly not be expanded); and (iv) the fact that the expansion of the definition of taxable services would not align with FCC regulatory definitions or state tax definitions, which would result in a substantial burden on companies that have to administer the various taxes and invoice and collect the various taxes from subscribers.

Other Tax Issues: The MTSA, Streamlined Sales Tax and Nexus

Tax laws will increasingly conflict as technologies continue to evolve. For example, under the Mobile Telecommunications Sourcing Act (the "MTSA"), which was passed by Congress to address income sourcing issues associated with cell phones, wireless calls and mobile telecommunications services are sourced to the "place of primary use" (i.e., a customer's residence or business address). Under the MTSA, cell phone services can only be taxed in those states and political subdivisions in which the "place of primary use" is located. As broadband and other related services are increasingly made available over mobile devices, these sourcing rules may be made applicable for charges associated with such services. Companies that offer services covered by the MTSA will need to consider MTSA requirements in their customer invoicing activities.

While BPL services are "non-mobile" to the extent that they are associated with electrical lines, many companies that offer "wired" services are discovering that competitive

pressures have forced them to consider offering bundled "wired" and wireless" services to consumers. The expansion of the service offerings to include "wireless" services requires that the MTSA requirements be addressed. This leads to potential conflicts to the extent that a single customer bill might be subject to different sourcing rules for different services to a single consumer.

Outsourcing and Multi-Sourcing Of Services

Where multiple companies are involved in the provision of a service to a customer (for example, where there are related agreements between a telecommunications service provider, a broadband company, a hosting service, an internet service provider and a content company that are all related to a service to deliver video clips to a cell phone), the respective tax responsibilities and liabilities must be worked out. Electrical utilities might experience a similar challenge, for example, where generation and transmission services are provided by different parties. In these situations, the various tax responsibilities of each party in the "supply chain" must be separately evaluated to confirm that the tax obligations, i.e., both tax payment and tax collection responsibilities, are properly discharged and will not result in an unanticipated obligation of another party in the transaction.

For example, where a BPL provider decides to offer a video or electronic book download service to its customers, and contracts with a third party provider to offer such service, the agreement should be drafted to assure that, if the relevant state imposes a sales tax on such service, the parties will make certain that the sales tax collection obligation is discharged and determine whether it is the BPL provider or the third party provider that has the collection responsibility. Frequently a BPL or other broadband service provider will want to maintain the direct customer relationship and to not expose their customers to multiple invoices (or potentially competitive offerings), so the BPL provider might take on the tax collection responsibility and prepare a single invoice for its customers. Discharging this responsibility may, however, be more complicated if the third party service provider's servers are accessed to provide the service and they (and not the BPL service provider) have the information on the identity and location of the customer that uses the third party service. The agreement between the parties should clearly address the elements that are necessary to assure compliance with relevant tax requirements.

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The Streamlined Sales Tax Project And Nexus

Other initiatives on the horizon include the states' "Streamlined Sales Tax Project" which continues to move toward implementation. SSTP may substantially affect the manner in which individual states administer their respective sales and use taxes, and the way in which multistate companies do business. The central concept of the SSTP is to make the respective state's laws more uniform to permit easier administration and to create a system through which remote sellers collect sales tax. Many states have already passed legislation to conform their local sales tax laws to the uniform definitions and administrative provisions of the SSTP.

Change will also occur with respect to the constantly evolving issues of sales tax nexus, the concept of "connection" that is necessary for a state to impose tax (in the case of income taxes) or a collection responsibility (in the case of sales and related taxes). Online businesses have already challenged traditional notions of nexus, laid down in the *Quill* case (which involved nexus issues in the mail order catalog context). The tax and nexus issues resulting from ever more elaborate combinations of telecommunications and online products and services will continue to require careful nexus analysis.

State Tax Issues

States exercise significant independence in the manner in which they tax businesses within their respective borders, and most states impose an income tax and a sales tax in addition to various other excise, property and other taxes. States generally have a well-established structure for taxation of electric power companies and customers.

In contrast, states have just begun to struggle to identify the appropriate regimes for taxing newer telecommunications and information services. Some states impose additional or substitute taxes on telecommunications and/or information related services, and some have passed legislation or issued guidance on certain limited elements of telecommunications and online business. Detailed guidance is, however, the exception rather than the rule. Even where guidance is available, the rules can vary greatly from state to state, making it impossible to generalize about the state tax profile of telecommunication and information services nationwide.

Most states that impose a net income tax generally follow the federal rules, with certain state adjustments. Income tax considerations should be taken into account in planning both day-to-day operations and extraordinary transactions (such as mergers, significant business investments, joint ventures, etc.).

In addition to the state income tax issues faced by businesses generally (such as employee and benefits tax issues, income and deduction timing, deduction and

capitalization of facilities and operating costs, etc.) telecommunications and high technology companies are currently grappling with a variety of income tax issues that have a particular impact on their businesses. These issues include, for example, the deductibility and amortization of expenses associated with the business (particularly in light of relatively recent I.R.S. cost capitalization regulations), the tax treatment of operations and income arising in other taxing jurisdictions, and the tax implications of mergers, business combinations, joint ventures and other transactions entered into with third parties. They may have to consider the timing, source and character of both domestic and foreign sourced income and new issues associated with new lines of business.

State Sales Tax

About 45 states that impose a tax on telecommunications services do so through imposition of a sales tax or similar gross receipts tax. Unlike income taxes, whether sales tax is imposed or not can depend on how sales taxable activity is defined in the relevant jurisdiction. In many states, the sales tax is imposed on "telecommunications" services, but not on "information" services, and the definitions vary from state to state. Some states include only phone service, whereas others broaden the definition. As technologies have evolved, local tax authorities have been challenged to identify the boundaries of which telecommunications services are subject to tax. The law of each jurisdiction in which a company does business must be consulted to identify the services that are subject to tax. The lack of uniform definitions is a particular challenge to businesses that offer telecommunications and related information services in multiple states.

The expanded adoption of broadband services, including BPL services, will further challenge state tax authorities to draw distinctions between (and draft definitions categorizing) taxable and non-taxable services. For example, Voice over Internet Protocol ("VOIP") service, which provides telephonic quality voice communication over the Internet, is a broadband-based service that straddles the definitional divide between telecommunications and information services. Whatever the theoretical basis for asserting that VOIP services should not be subject to sales tax like traditional telephony, it is likely that, as VOIP technology displaces traditional telephony as the preferred alternative for voice communications, the states will seek to subject it to sales tax (Remember Faraday's quote).

Constitutional and Legislative Limits on State Sales Taxes

The states do not have unrestricted power to impose tax in the area of telecommunications and information

services. State taxation is subject to various constitutional and legislative limitations. Among the constitutional constraints is the “nexus” requirement which, stated very simply, requires that there be sufficient connection between the taxpayer and the jurisdiction that seeks to impose a tax.

Congress has also passed various legislative limitations on the states’ ability to impose tax. Among the important limitations in this area is the Internet Tax Freedom Act (the “ITFA”)³ and subsequent legislation, through which the states were previously prohibited from imposing tax on Internet access. The original ITFA exempted telecommunications services from the ban, and hence permitted states to tax telephone and other telecommunications services. The ITFA expired in November 2003, but was reinstated (with certain changes) as the Internet Tax Non-Discrimination Act (the “ITNDA”),⁴ which was signed into law in December, 2004. The ITNDA carries forward the ITFA’s prohibition on state imposition of multiple and discriminatory taxes on Internet access.

Among the changes under the ITNDA is a new provision that permits the states to tax VOIP services.⁵ Thus, companies that offer such services must attend to the distinction between VOIP services and other broadband offerings. This may be an issue, for example, when companies bundle VOIP with other broadband services and invoice subscribers for a single charge. Importantly, while the ITNDA permits states to impose such taxes, it is up to each state to decide upon the manner in which VOIP services will be treated within its taxing jurisdiction. Therefore, individual state laws must still be consulted by VOIP service providers.

Sales Tax Planning in a Changing Tax Landscape

There are some sources of uniformity that can assist in tax planning for companies that offer telecommunications services in multiple states. For example, the Telecommunications Act of 1996 and the Federal Communications Commission (the “FCC”) currently distinguish “telecommunications services” from “information services.”⁶ Many state sales tax laws are drafted to cover “telecommunications services.” By contrast, many states do not tax “information services.” FCC definitions often affect the manner in which the state taxes such businesses.

But the definitions applied by the FCC are in flux. Significant attention will be directed to these definitions when Congress next turns to the federal communications law. It is likely that, as technology continues to evolve, the FCC will need to continue to review and revise its definitions that are applied for regulatory purposes, and state taxation will follow those changes, continuing to

challenge businesses desiring greater certainty in structuring their product and service offerings.

Despite the unpredictability of the changes, businesses can take steps to reduce their exposure to tax risks through organizational structuring and the manner in which their agreements with suppliers and customers are negotiated and constructed. One important method of analyzing taxes is to separate the two tax-related responsibilities of businesses; i.e., the payment of taxes imposed directly on the business (such as the business’s income tax) versus the responsibility to collect and remit to the state customer taxes (such as the customers’ sales tax). As discussed below, these obligations are analytically distinct, and subject to differing administrative regimes that require different planning approaches.

When Should a Company Consider Tax Issues?

There are various discreet points at which a business should consider tax issues and consult with its tax advisors. These points offer appropriate settings for the consideration of tax issues as a result of a combination of one or more of the preparation of agreements and other documentation of existing or new customer and supplier relationships, situations where new products or services are being evaluated or developed, and situations where operational or structural changes are being considered for the business.

Preparation of Customer and Supplier Agreements: Where there are individual negotiations with customers, there are opportunities to individually address the tax treatment of such transactions. One goal of such analysis should be to try to cause the other party to share some of the tax burden or risk. Such individual negotiations are, however, uncommon in the case of agreements with telecommunications subscribers and electrical utility customers. As is the case with electrical utility customers, telecommunications and related businesses have a broad subscriber base, and there is typically not an individual negotiation of the subscriber contract with each subscriber. Instead, a standardized form of agreement is presented to potential customers, with their receipt of service generally conditioned on their agreement to the terms (including their agreement to accept later amendments!), prior to becoming a customer.

Internal Billing Processes: With regard to customer billing, three issues must be considered: the development and implementation of internal processes and administration associated with invoicing and collection of taxes, strategic and competitive considerations, and bundling.

Administration: Electric utilities and telecommunications companies must address numerous tax obligations in the preparation and administration of

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customer charges. These include taxes that are required to be collected from customers (those taxes, such as sales tax, for which the company may have a liability if it fails to collect), taxes that it is responsible to collect but for which it may not have a secondary liability (such as federal telecommunications tax), and those taxes that it may collect, but is not required to collect (which may include all others). Each of these types of taxes must be separately considered in the preparation of customer invoices. There are several companies that provide software and services that assist in elements of customer billing (such as sales tax rate calculation), but ultimately such products do not answer the difficult tax questions (such as nexus and definitional issues), which must still be addressed by the company and its advisers.

In addition to tax liability considerations, companies should consider administrative burdens associated with tax collection and remittance, whether internal accounting software can adequately track tax collection activity, and subscriber relations and competitive considerations associated with customer billings.

The issue of whether internal accounting software can adequately address tax administration is frequent challenge for public service businesses. Many accounting systems are a combination of computer and manual operations and “off the shelf” and “customized” (frequently internally created) software. As a result, many systems do not easily interoperate with commercially available tax administration software packages. In addition, the taxation of electricity sales to customers is typically subject to state and local tax under an entirely separate regime from that which is imposed on telecommunication and information services. As a result, internal billing systems of utilities, which are typically long-standing or “legacy” systems, often developed partially or entirely as custom systems, will need to be adapted to incorporate those elements needed to address the administration of the additional taxes.

The myriad rules that apply to such multiple service offerings and the efforts of such companies to gain a competitive edge (for instance through bundling services, providing alternative plans for billing based on various criteria, etc.), have resulted in a situation where customer bills for telecommunication services are among the most complex invoices received by today’s consumers. Such bills often reference several different service providers (such as long distance carriers, ISPs, content providers, SMS service providers, etc.) and set out numerous government taxes, fees and other extractions. The complexity of these invoices suggests the difficulty of administering all of such taxes. Electric companies and other parties that anticipate providing BPL services should anticipate similar issues in consumer billing and in the challenges of administering the various taxes when BPL

and related services are offered to their customers.

Companies should consider the manner in which various tax charges are presented on customer invoices. Some jurisdictions require that certain taxes be separately stated in invoices. Beyond these legal requirements, however, the central consideration is whether the company will be at a competitive disadvantage if it charges and/or separately invoices its customers for certain taxes. Generally thin margins in both the electric utility and telecommunications industries put pressure on companies to consider the approaches that competitors are taking with respect to billing for taxes.

Many companies combine (or “bundle”) different services and the manner in which services are bundled and invoiced can affect the tax treatment of such services. It is not possible to generalize about the tax effect of bundling, since there are many possible “bundles” of services. The administration of taxes for bundled offerings can be complex in situations where two or more services that are taxed under different tax regimes are bundled and offered for a single price.

There are various tax rules that address bundling, and they will frequently tax the bundled offering based on the “predominant” or “primary” object of the offering if the charges are not separately invoiced. The applicable local law should be reviewed. The tax issues associated with bundling, and possible opportunities to achieve tax savings, should be carefully considered in the establishment of BPL service offerings. The balancing of the tax considerations with business strategic considerations is critical to implementing a successful BPL program.

Supplier Agreements: Very few, if any, telecommunication service providers are able (due to human resources and infrastructure constraints), or find it economical, to provide services to customers on a fully vertically-integrated basis, i.e., to supply every element of customer service without resort to outside suppliers. This may be in contrast to many traditional suppliers of electricity which may own and operate generation, transmission and distribution assets. Nearly all companies providing BPL and related telecommunications and information services will work with some suppliers of content, telecommunications services, maintenance and help services, computer related services, web site design, web site hosting, payroll function, and a variety of other services.

Each interaction with a third party supplier presents an opportunity for tax planning. In the context of negotiating third party agreements, consideration should be given to the tax issues associated with the specific supplies and to whether there are opportunities to shift (or at least share) tax risk or tax burdens to the other party. This shift may be achieved directly through the contractual

allocation of such burdens or indirectly through the manner in which the agreement is structured and the supplies characterized.

More specifically, a company should generally consider whether it is appropriate through the provisions of the contract itself to cause the counterparty to be responsible for taxes. A contract might provide that a company's business customer is responsible for reimbursing the company for a tax that is normally levied on the company. The "passing through" of taxes may be done explicitly (and documented in the agreement), or implicitly (as an item of overhead that is taken into account in pricing models developed by the supplier).

In addition to the contract terms, a company should consider the overall structure of the agreement, and the characterization of the products and services offered under the contract to identify strategies that will achieve the most favorable tax treatment. For example, where a supplier is providing software development services and a license to certain software to a company, the company should consider the tax ramifications associated with treating its payments as royalties versus payments for services and identify any possible planning opportunities associated with such characterization.

It is not possible to generalize about the most favorable structure and form of agreement for every transaction, as each agreement is established in a unique context. Awareness and consideration of the local, state, federal and in some cases international, taxes involved is necessary in order to properly evaluate the economic impact of such taxes. A company that does not take such considerations into account will be at a substantial disadvantage in negotiations, and will potentially miss opportunities and fall into traps that can significantly alter the economic results of a transaction.

Another important aspect of a supplier agreement is the exit strategy. Long-term agreements can bind companies to business arrangements that have become uneconomical as a result of changes in the market, so attention should be paid to termination provisions, change in law provisions and the manner in which the tax section is drafted. While these provisions may often be dismissed

as "boilerplate" in agreements, when properly crafted they can provide additional comfort that the company will not have to live with a failed strategy or a situation where a once-great and innovative service offering becomes a "bad deal" due to changes in the technology and business landscape.

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- ¹ Internal Revenue Code of 1986, as amended, section 1441.
- ² Internal Revenue Code of 1986, as amended, section 4251.
- ³ The Internet Tax Freedom Act comprises Titles XI and XII of Division C of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999, P.L. 105-277, §§ 1100 et seq. (1998).
- ⁴ Internet Tax Nondiscrimination Act, P.L. 108-435 (2003) (the "ITNDA").
- ⁵ ITNDA., Section 1108.
- ⁶ Telecommunications Act of 1996.

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