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Client Alert

IRS Concedes Defeat on Long-Distance Telephone Tax

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In a victory for common sense, the Internal Revenue Service announced in Notice 2006-50 (May 25, 2006) that it will no longer enforce the communications services tax on long-distance calling services and certain other telephone communications services. The Internal Revenue Service reached this decision after its position regarding the application of the communications services tax to modern long-distance calling services was rejected by five separate U.S. Courts of Appeals.

Impact on Taxpayers

- All long-distance calls are now exempt from the communications services tax (the "Telephone Tax").
- In addition, Notice 2006-50 (the "Notice") exempts "bundled services," which are certain kinds of combined local and long-distance services such as voice over internet protocol services, prepaid calling cards, and plans combining local and long-distance services that do not separately state the charge for local telephone service. For now, local-only services remain taxable, although legislation is currently pending in both houses of Congress to repeal the Telephone Tax entirely.
- The route for refund claims will be through the Internal Revenue Service ("IRS"), not through communications service providers ("Providers"). Taxpayers must submit refund or credit claims to the IRS on their 2006 federal income tax returns. These claims will be limited to tax amounts on services billed between March 1, 2003 and July 31, 2006. Refunds and credits will bear interest.
- Refunds and credits of Telephone Taxes that were previously treated as deductible business expenses will be generally includible in taxable income. Interest on refunds or credits will also be includible in taxable income.
- Individual taxpayers will have a safe harbor option, eliminating the need to document the actual amount of tax paid.

Impact on Communications Service Providers

- Providers are permitted, but not required, to refund Telephone Tax amounts billed on or before July 31, 2006.
- Providers are to cease billing and collecting the Telephone Tax on long-distance and bundled services ("Exempt Services") billed after July 31, 2006. Any tax amounts paid with respect to Exempt Services billed after July 31, 2006 are to be refunded to the customers.
- Providers will no longer be required to report any refusal by their customers to pay the Telephone Tax on any Exempt Services billed after May 25, 2006.
- Providers will be required to certify on Form 720 for the third quarter of 2006 that the tax reported does not include any Telephone Tax on Exempt Services billed after July 31, 2006.

Background

The Telephone Tax was enacted in 1898 as a luxury tax to help pay for the Spanish-American War. As telephones evolved from luxury item to mainstream household appliance, numerous attempts were made to repeal the tax. Despite these efforts, the Telephone Tax has survived, continuing today as sections 4251-4254 of the Internal Revenue Code of 1986, as amended (the "Code"). The Telephone Tax has been criticized as highly regressive and as a drag on innovation. Most recently, Congress repealed the tax in 2000, but the appropriations bill in which the repeal was included was vetoed.

In its current form, the Telephone Tax is a three-percent tax on amounts paid for "communications services." Code section 4251 defines "communications services" to include (a) local telephone service, (b) toll telephone service, and (c) teletypewriter exchange service. The statute defines "toll telephone service," in pertinent part, to mean "a telephonic quality communication for which … there is a toll charge which **varies in amount with the distance and elapsed transmission time of each individual communication**"[1] (emphasis added).

The Controversy

With the deregulation of the telecommunications industry, Providers dropped distance as a billing factor for most domestic long-distance calling services. This change opened a gap between the typical long-distance service and the definition of "toll telephone service" in the Telephone Tax statute. In recent years, taxpayers have relied on this gap to challenge the portion of the Telephone Tax imposed on their long-distance calls, arguing that such calls no longer fall within the definition of taxable communications services.

In the absence of Congressional action to modernize the definition of "toll telephone service," the IRS resisted taxpayer challenges to the Telephone Tax by arguing that modern "time only" long-distance services qualify as toll telephone service notwithstanding the lack of a distance billing component. The IRS based its position on the claim that the word "and" in the statutory reference to "distance and elapsed transmission time" should be read disjunctively to mean "or," so that a service billed based on time *or* distance would qualify as a toll telephone service. The gist of the IRS position was that because any contrary reading of the statute would eviscerate the Telephone Tax on long-distance services, and because Congress had not evinced an intent to eviscerate the Telephone Tax on long-distance services, Congress must have intended the word "and" to mean "or." The main authority cited for this position was the legislative history to section 302 of the Excise Tax Reduction Act of 1965, and the IRS's own Revenue Ruling 79-404 regarding ship-to-shore communications.

[1] Code section 4252(b)(1).

Not surprisingly, over the last year, five separate U.S. Courts of Appeals have rejected the IRS position. *American Bankers Insurance Group*[2] ("ABIG"), *OfficeMax, Inc.*,[3] *National R.R. Passenger Corp.*[4] ("Amtrak"), *Fortis*,[5] and *Reese Bros*.[6] all conclude that a long-distance plan in which calls are billed by time only is not a toll telephone service under Code section 4252. Furthermore, *ABIG*, *OfficeMax*, *Amtrak*, and *Reese Bros.* all hold that long-distance calls are not "local telephone service," even though such calls utilize the local telephone system.

The Notice

Following this string of defeats, the IRS finally threw in the towel, announcing in the Notice that it would follow all five Court of Appeals decisions and would no longer litigate the issue of whether modern long-distance calling services are subject to the Telephone Tax. In a news release issued along with the Notice, Treasury Secretary John Snow acknowledged that "the Federal Appeals courts have spoken across the board," adding that the Notice "marks the beginning of the end of an outdated, antiquated tax that has survived a century beyond its original purpose, and by now should have been ancient history."[7]

The Notice services three principal functions: (a) clarifying the scope of the communications services that will hereafter be regarded as nontaxable; (b) establishing the procedures for refunds or credits of taxes previously paid on nontaxable services; and (c) clarifying the obligations of Providers regarding refunds, tax returns, and taxes on local services. With respect to the scope of nontaxable services, the Notice arguably goes further than required by the recent court cases in exempting all long-distance services (not just long-distance services billed without a distance component) and in clarifying that no portion of bundled services will be treated as taxable local telephone services. Only "local telephone service," as defined in Code section 4252(a) remains taxable.

Regarding refund procedures, the Notice specifies that refund and credit claims will only be accepted on 2006 federal income tax returns. Other forms, such as Form 8849 Claim for Refund of Excise Taxes, as well as forms for later years, will not be processed. Taxpayers will be required to adhere to a number of detailed substantiation, recordkeeping, and certification requirements to be eligible for refunds or credits. The Notice also establishes a definite look back date (services billed after February 28, 2003) for the calculation of refunds or credits, implying that refund or credit claims with respect to earlier periods will be barred. Nevertheless, taxpayers with earlier open return years should be entitled to claim refunds with respect to amounts billed during such open years.

The principal impact of the Notice on Providers is to clarify when Providers should cease collecting the Telephone Tax, to relieve Providers of the obligation to participate in the refund process for amounts billed on or before July 31, 2006, and to specify that Providers, not the IRS, will have the responsibility to refund erroneous tax amounts paid for services billed after July 31, 2006. Moreover, because the cut off date for Providers to cease collecting the Telephone Tax falls within the middle of the third quarter of 2006, Providers will be required to certify to the IRS that their Form 720 filed for the third quarter does not report any Telephone Tax on Exempt Services billed after July 31, 2006. Providers will need to ensure that they have the proper systems in place to make that certification.

Conclusion

Notice 2006-50 is a victory for taxpayers and Providers, but it establishes some hurdles and obligations. For more information, or to discuss the impact of this development on your business, please contact an attorney with whom you work or one listed in the following section.

[2] 408 F.3d 1328 (11th Cir. 2005).

[3] 428 F.3d 583 (6th Cir. 2005).

[4] 431 F.3d 374 (D.C. Cir. 2005).

[5] 2006 U.S. App. LEXIS 10749 (2d Cir. Apr. 27, 2006).

[6] 2006 U.S. App. LEXIS 11468 (3d Cir. May 9, 2006).

[7] *Treasury Announces End to Long-Distance Telephone Excise Tax*, U.S. Treasury Department, Office of Public Affairs (May 25, 2006).

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