

Getting Refunds Of Illegally Collected Federal Excise Taxes

Editor's note: LB3 partner Steve Rosen helped lead the firm's work on this case, and contributed much of the content of this column.

In marathons, the last couple of miles are the hardest. The same seems to apply to getting the Federal Excise Tax ("FET") refunds that the government agreed to provide almost a year ago. Levine, Blaszak, Block & Boothby brought the cases that forced the government to give back the money. This month, we're going to provide an FAQ (without the Q) on collecting what your company is owed.

Background—The Tax And Its Demise

Much to the detriment of those making phone calls (i.e., just about everyone), the federal excise tax on communications was misapplied for many years. The Internal Revenue Code defines taxable "toll telephone service" as "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." After 1990, long distance rates became non-distance sensitive, or "postalized," which means that under the statute as written, long distance service has not been properly taxable for well over a decade.

The IRS insisted, however, that non-distance-sensitive services were taxable. From the late 1980s through 2004, that zany view spawned a cottage industry. A few savvy law and accounting firms would repeatedly file tax refund claims with the IRS on behalf of corporate clients. The IRS would disallow the claims, but on review the IRS Appeals Division would settle the claims for 30 to 40 cents on the dollar. No lawsuits—but only those who participated in this refund "game" got

refunds, and those refunds were only a fraction of their tax payments.

Beginning in 2002, we brought a series of cases challenging the government's interpretation as contrary to the plain language of the statute.

The government made a lot of arguments, which ultimately boiled down to the claim that the word "and" as used in the statute should be read as if it were synonymous with "or" because Congress really wanted to tax all long distance service (even if it didn't say so).

The argument sounds like a loser, and it was. Eventually five federal appeals courts held for the taxpayer, and none ruled for the government. Certain to face more rebukes from the courts, on May 25, 2006, the IRS agreed to stop collecting FET on interexchange services, and to

refund 41 months' worth of previously collected taxes.

In the press release that accompanied the announcement, then-Treasury Secretary John Snow said, "Today is a good day for American taxpayers; it 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." It was a great Washington moment—the agency that fought tooth and nail to keep the illegal tax in place took credit for its repeal.

What Gets Refunded

In Notice 2006-50, which announced the refunds, the IRS declared that long distance service would no longer be taxed. Long distance service was defined as inbound and outbound; intrastate, interstate and international; bundled local and long distance services (e.g., freedom plans, VOIP) if local service is not charged for separately; and



**If you want the fairest deal,
you'll likely have to comb
through old records**

mobile/cell service. The Notice also announced that refunds would be made through a credit on 2006 income tax filings.

That was not such a great idea, but you have to understand that the IRS consulted with the telcos (not the users who actually paid the tax) when it was coming up with the refund process, and using the income tax system met the telephone companies' principal goal, which was to keep themselves out of the refund process.

Purely local service remains taxable until Congress amends the law. The President has proposed eliminating the tax on local service, and a bill to do so has been introduced in the House, but until these proposals are enacted, local services will be subject to FET.

It Ain't Over Until The IRS Sings

Unfortunately, the IRS did not "surrender" on terms that are particularly helpful to enterprise users. Specifically, Notice 2006-50 created problems in two areas:

- 1.) which services are non-taxable/refundable; and
- 2.) the refund process.

To address these areas, the IRS issued a supplementary notice (Notice 2007-11) last December. It established a methodology that businesses and non-profits could use to estimate

the refunds due them; it also clarified the service definitions and reversed a silly provision in the May notice that would have forced companies that had already filed for refunds to file again.

The estimation method was an important breakthrough because, let's face it, a lot of companies don't keep (or can't find) 40 months' worth of phone bills. The methodology for estimating sounds complicated, but to use it you only need telephone bills for the two months of April and September of 2006, and your "total telephone expenses" (but not itemized bills) for March 2003 through August 2006.

You estimate the amount of tax remitted, and thus the refund due, by subtracting the post-repeal tax percentage (which includes only tax on local) from the pre-repeal tax percentage (which includes local and long distance). After thus deriving the tax percentage applicable to long distance service, you multiply this percentage by the total monthly telephone expenses for the 41 months to calculate the refund you are due.

But, there's a big catch. For small and mid-sized businesses—those with fewer than 250 employees—the tax percentage under the estimation method is capped at 2 percent. Except for businesses with huge long distance bills (most of whom keep records), that should work.

But for businesses with more than 250 employees, the tax percentage is capped at 1 percent of total telephone spend, and that almost surely

understates the actual refund due. In other words, for large businesses, it is probably worth the time to calculate the actual refund due—if you have or can retrieve your phone bills.

Can you get those bills from your long distance and wireless providers? Probably. Will it cost you? Maybe.

By the way, because the IRS's approved estimation methodology isn't in a regulation, as a legal matter it's of questionable authority. Other estimates might well be accepted by a court—but it is hard to imagine that it would be worth the cost of litigating the issue for any customer that is not in the Fortune 100.

A couple of other issues are worth mentioning as we go forward, while purely-local calls are still taxable. First, the technology used to transmit a call (wireless, wireline POTS, wireline VOIP) is irrelevant to the call's tax status. Second, bundled local and long distance service (e.g., wireless, VOIP) is non-taxable, provided the plan does not separately state the amount paid for local-only service. Third, the IRS has been claiming that intraLATA toll calls are local (therefore still taxable) and that some USF (Universal Service Fund) charges remain taxable—but it's just wrong on both points.

Finally, the housekeeping. The FET refund credit is claimed on a line on your 2006 income taxes. Because the credit is part of an income tax filing, you'll need to retain records in case your calculations are audited. Ideally, you should keep spreadsheets identifying the amount of refund due by month and quarter, telephone bills (paper/CD-ROM) in as detailed a form as practicable, the A/P feeds or pages used to calculate "telephone expenses," and proof of payment (either through the bills themselves or cancelled checks).

Good luck□

**Purely-local
calls are
still taxable**

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