

Phone Tax Fix Could Put Refund Suits on Hold

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With several favorable court decisions and almost \$1.6 million in excise tax refund claims under their belts, some tax attorneys expect they can keep fighting the IRS for years to come — unless the 109th Congress manages to rewrite the telephone tax.

Although the 3 percent communications surcharge — an often criticized provision that the United States Telecom Association (USTA) says affects roughly 94 percent of taxpayers — has been repeatedly tweaked throughout its 100-plus-year history, corporate telecom users insist the playing field changed after the Excise Tax Reduction Act of 1965 (P.L. 89-44) became law. As part of the excise tax cleanup bill, lawmakers transformed the excise tax on telephone service from the broad “toll telephone service” tax outlined in code section 4252(b) into a tax that applies to calls in which charges are levied based on “the distance and elapsed transmission time of each individual communication.”

The IRS, however, insists that distance “or” elapsed time should trigger the phone tax, regardless of how the statute reads today.

According to tax controversy lawyer and solo practitioner Brad S. Waterman, the generic-to-specific leap and the subsequent growth in flat-rate service packages have contributed to the mounting controversy over the excise tax.

“You have a situation in which the technology has passed by the statutory definition,” he told Tax Analysts, adding that after unsuccessfully trying to paper over the problem with a revenue ruling (Rev. Rul. 79-404, 1979-2 C.B. 382), the Service has now thrown its weight behind a congressional-intent position.

“The bottom line is that they’re trying to get past clear and unambiguous language,” Waterman said. “Our principal argument is: Look, the statute’s clear. End of story.”

According to the Justice Department, more than a dozen telecommunications excise tax refund suits have cropped up within the last 12 months. The IRS logged an early victory in the excise tax fight by persuading a Florida judge to deny a \$362,000 claim filed by American Bankers Insurance Group, but has since lost four times in district courts that have sided with taxpayers to the tune of approximately \$1.25 million. (For the district court opinion in *American Bankers Insurance Group v. U.S.*, 308 F. Supp.2d 1360 (S.D. Fla. 2004), see *Doc 2004-16370* or *2004 TNT 158-12*.)

Phone Tax Refund Suits					
Case Name	Decision Date	Holding	Firm	Refund Claim	Disposition
<i>American Bankers Insurance Group, Inc. v. United States</i> (Doc 2004-16370; 2004 TNT 158-12)	1/29/04	Court rules "distance and elapsed transmission time" could be read as and/or; IRS wins	Levine Blaszak Block & Boothby LLP ("LB3 group")	\$361,763.24	Taxpayer appeal pending in Eleventh Circuit Court of Appeals
<i>OfficeMax Inc. v. United States</i> (Doc 2004-3587, 2004 TNT 53-14)	2/13/04	Plaintiff wins summary judgment	LB3 group	\$383,990.38	IRS appeal pending in the Sixth Circuit Court of Appeals
<i>Fortis Inc. v. United States</i> (Doc 2004-19691, 2004 TNT 203-7)	9/16/04	Plaintiff wins summary judgment	LB3 group	\$439,384.84	Summary judgment on liability, pending stipulation of final refund and final briefing on section 4252(b)(2) sticking points
<i>National Railroad Passenger Corporation (Amtrak) v. United States</i> (Doc 2004-18894, 2004 TNT 188-17)	9/20/04	Plaintiff wins summary judgment	Miller & Chevalier	\$86,103.28	IRS appeal pending in U.S. Court of Appeals (District of Columbia)
<i>Reese Brothers Inc. v. United States</i> (Doc 2004-22155, 2004 TNT 225-19)	11/30/04	Plaintiff wins summary judgment	LB3 group	\$345,351.53	Summary judgment on liability, pending stipulation of exact damages
<i>Convergys v. United States</i> (Civil Action No. C-1-03-367)	Pending	To be determined	LB3 group	\$6,001,070.22	Pending in the Sixth Circuit; held in abeyance pending <i>OfficeMax</i> appeal
<i>Honeywell International, Inc. v. United States</i> (Case No. 03-1915T)	Oral arguments heard December 1, 2004; decision pending	TBD	LB3 group	\$2,357,637.56	Oral arguments heard in the U.S. Court of Claims on December 1; decision pending
<i>America Online, Inc. v. United States</i>	Pending	TBD	Baker & Mackenzie LLP	Unknown	Pending in the U.S. Court of Claims
<i>XO Communications Inc. v. United States</i>	Pending	TBD	Anderson, Gulotta & Hicks, PC	Unknown	TBD
<i>Roll International Corporation v. U.S.</i>	Pending	TBD	Unknown	Unknown	Pending in the Ninth Circuit
<i>Hewlett-Packard v. United States</i>	Pending	TBD	Unknown	Unknown	Pending in the Ninth Circuit
<i>PNC Bank, N.A. v. United States</i>	Pending	TBD	Unknown	Unknown	Pending in the Third Circuit
<i>JP Morgan Chase & Co. v. United States</i>	Pending	TBD	Unknown	Unknown	Pending in the Second Circuit
<i>Wal-Mart v. United States</i>	Pending	TBD	Unknown	Unknown	Pending in the Ninth Circuit
<i>Global Crest Communications v. United States</i>	Pending	TBD	Unknown	Unknown	Pending in the Fifth Circuit
<i>United Technologies v. United States</i>	Pending	TBD	Unknown	Unknown	Pending in the Second Circuit

Alan Pearce, a telecom consultant working with the Justice Department in more than half the ongoing refund cases and president of Information Age

Economics, predicted the refund caseload would continue to increase unless either Congress or the Supreme Court weighs in on the underlying issue.

"This is something that's going to keep happening . . . until one of the decision-making entities, or both of them, make a final decision. And it is definitely careening in that direction," he said.

Sign of the Times

Paul B. Vasington, Analysis Group vice president and consultant for the Justice Department, blamed the court challenges on an "inartfully crafted" statute and myopic lawmakers.

"It's unfortunate that at the time that Congress tried to distinguish long-distance usage from other services . . . it was priced based on distance," Vasington said. "So I think it's a language issue more than an intent issue."

Vasington added that the Congressional Budget Office phone tax projections — which estimate that excise tax revenue is roughly \$6 billion — are dependent on sustaining the status quo. "You can't get to the numbers they're getting to if you were to consider it to no longer apply because of the changes in rate plans," he said.

Pearce said phone tax refund litigants would rather argue semantics than concede that "the time component . . . became essentially irrelevant because of developments — competitive and technological developments — that were not foreseen, not known, in the mid-1960s." While maintaining that many existing telecom providers still operate under the long-distance umbrella, Pearce pointed to a recent decision by the Federal Communications Commission barring state-by-state regulation of voice over Internet protocol (VOIP) services as a precursor for gauging emerging technologies.

The FCC effectively absolved VOIP providers from state regulation in a declaratory ruling issued last November in connection with a dispute between Vonage Holdings Corp. and the Minnesota Public Utilities Commission. As part of its findings, the FCC announced that "all VOIP services that integrate voice communications capabilities with enhanced features and entail the interstate routing of packets . . . will not be subject to state utility regulation."

The FCC opinion summed up the frustration FCC Commissioner Kathleen Q. Abernathy expressed in February 2004 about keeping laws up-to-date with VOIP technology:

People can use most VOIP services without regard to their physical location. In such a scenario, distance becomes irrelevant, and as a result our system of jurisdictional separations becomes an anachronism. When it comes to the regulatory framework, classifying VOIP services as interstate will allow policymakers to craft a unified federal strategy.

Pearce said the FCC ruling could ultimately push Congress to revisit the seemingly antiquated phone tax rules, although he stressed that any potential phone tax overhaul "should be a basement to attic rewrite" rather than a collection of piecemeal fixes that might require periodic fine-tuning.

Stephen J. Rosen, a telecom lawyer at Levine, Blaszak, Block & Boothby in Washington who has worked closely with Waterman on several refund suits, said the Big Five accounting firms had been pursuing phone tax settlement claims for years. He said frustrated clients eventually decided to take the fight to the courts instead.

Rosen downplayed the original American Bankers Group loss as a "fluke" and said, "We just caught a judge in Florida that does not have a modern view of the tax code."

Rosen said he believes many private phone carriers are quietly supporting the refund suits — particularly because those carriers serve merely as collection agents for the IRS, yet must report the phone tax revenue on their corporate returns.

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"They haven't been uncooperative," Rosen said. "[But] they're certainly not going to risk the wrath of the IRS to save their customers some money."

In a joint letter to the IRS last fall, the USTA and the United States Communications Association said the best way to streamline future telecom tax issues was to stop rewriting the past. "The resolution of whether data transmission should be taxed, or not taxed, should be left to the political process and a congressional vote," the telecom groups wrote. "Past federal excise tax decisions made by the Service, that are now found to be inconsistent with the law, need to be reviewed and repealed or withdrawn to provide clarity going forward."

One telecom industry source told Tax Analysts that most long-distance phone providers would rather see the tax be eliminated than have their online competitors fall prey to the outdated provision.

"We're not saying that this tax should be expanded to cover everybody, but at a bare minimum we'd love to see it repealed in its entirety," the source said. "What I don't know at the beginning of 2005 is whether or not there is any political will in Congress to go in and patch up the holes in the federal excise tax."

Calling in the Cavalry

Vasington said he's heard little talk on Capitol Hill about abolishing the phone tax but noted that there has been talk about retooling the provision to provide funding for struggling rural communications projects.

"There's been some discussion of using the federal excise tax revenues as a source of funding for universal service programs," Vasington said. "I wouldn't be surprised to see something like that happen."

'We would love to see this speed through the courts and have the taxpayers win and have it just become obsolete that way,' one industry insider told Tax Analysts.

A source familiar with the telecom industry said repeal advocates might face an uphill climb this year, particularly since the projected revenue gains make it tough to shut off the spigot with Social Security reform on the horizon. "There probably will be a place marker put out there for repeal . . . [but] we're probably not going to do any heavy lifting on it," the source said.

The source said that member education on some of the excise tax options is ongoing and that the emphasis is more on repeal than on the idea of "dressing up" the tax to help capture alternative telecom providers like Vonage or Comcast. "If Congress does go down that road — and they may — I think that there will be a big division within the Congress over the merits of doing so," the source said, adding that any major overhaul would likely spark an industrywide backlash from telecom, cable, and other communications providers.

An aide to the Senate Finance Committee said committee leaders are ready to help iron things out.

"The sense we've gotten [from the IRS] is that they're still comfortable about it, but perhaps the administration in the budget will request new clarifying language," the Finance staffer said. "So I think we'll look to the Service and Treasury to see if they believe they need additional clarifying language . . . and if that's the case, that's just fine."

A Republican aide to the House Ways and Means Committee said House taxwriters would also take their cues from the White House, pointing to tax reform, permanence of tax cuts enacted in 2001 and 2003, and pension reform as priorities in the new Congress.

The Finance Committee aide said that guidance (Notice 2004-57) reiterating the Service's position about continuing communications tax collections "seems to have satisfied the phone companies" for

now. (For Notice 2004-57, 2004-35 IRB 376 see *Doc 2004-17324* or *2004 TNT 154-15*.)

The telecom industry source, however, said that once an appellate court upholds one of the pending refund suits, some service providers might drop the self-collection responsibility. "We would love to see this speed through the courts and have the taxpayers win and have it just become obsolete that way," the source said.

According to Waterman, the plain language stance taken by the Supreme Court in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), ensures that modern courts will continue to shoot holes in the IRS's congressional-intent argument. "The interesting point is that the courts these days are, generally speaking, very reluctant to interpret statutes in a way that is inconsistent with the clear language of the statute," he said. (For the text of the Supreme Court's opinion in *Gitlitz*, see *Doc 2001-1085* or *2001 TNT 7-13*.)

Rosen added that the IRS hopes a split in the circuit courts will strengthen its hand, but added that perhaps the pending caseload could be enough to eliminate the phone tax.

"There might be enough here to set the precedent," Rosen said.

Jean A. Pawlow, a member at Miller & Chevalier who advanced a refund claim by Amtrak, added that focusing on the common carrier clause in section 4253(f) — a provision that exempts from the phone tax information providers ranging from phone and telegraph companies to radio stations — could allow everyone from the airline industry to distributors like FedEx and UPS to pursue their own phone tax refunds.

Waterman added that as the litigation costs dwindle, smaller businesses might soon be able to take advantage of the refunds as well.

"All the work's been done: The briefs have been written by both the government and the private lawyers, and the courts have issued decisions . . . and it's all in the public domain," Waterman said. Rosen said, however, that the 3 percent refund checks are unlikely to produce a windfall for anyone with nominal phone charges.

Rosen said his firm would continue notifying clients about their phone tax liability.

"Far be it from us to stop Congress from updating a statute," Rosen said. "Until that happens, we'll continue to file refund suits." ■