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A Look Back at Telephone Excise Tax Refunds: After the Gold Rush

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The Tax Man Turns Santa Claus

Over the last five years the Internal Revenue Service—the agency charged with collecting tax revenues—has, in one case, refunded moer than $4 billion to taxpayers. The catalyst for this reaction was a group of enterprise users that was willing to step up and challenge the IRS when it insisted on taxing a long distance service that no longer fit within the plain language of the tax code. Although this particular gold rush is over, it is an encouraging tale for any enterprise user who believes that a federal, state, or local taxation authority is being driven more by revenue maximization than adherence to the legislatively created tax code, and is willing to confront that authority in court.

At the end of the day, this story demonstrates that courts will reward taxpayers' adherence to principle with substantial refunds, provided the taxpayers are persistent in shedding judicial light on the misdeeds of revenue collectors. Because taxes and fees constitute a large and ever growing portion of telecommunications invoices, there is an increasing incentive for end users to scrutinize, and, when appropriate, challenge the collection of these taxes and fees.

This particular opportunity was created by a collision of industry structure and §§ 4251 and 4252 of the Internal Revenue Code (the "Code"). In those sections Congress chose to subject a very specific flavor of long distance service to federal excise tax, but in the interest of maximizing revenue the Service chose to interpret those sections broadly. After the federal courts got through educating the Service on the plain meaning rule, it regurgitated much (but not all) of the unlawfully collected taxes to millions of very surprised taxpayers. Now that this gold rush has come to an end, it is a good time to ask (and answer) the core question: "What happened here and can it happen again?"

Way Back in '65

The story begins in 1965, when Congress amended § 4252(b)(1) of the Code to define 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." As some older readers will recall, back in the day, if you lived in New York City it cost more to call California than it did to call New Jersey. Coupled with a separate section describing WATS, Congress had described all of the commercial long distance services offered in 1965 by AT&T, which at the time had a monopoly on long distance services.

Fast forward to the mid-90's, when AT&T and other long distance service providers began to offer long distance service on a "postalized" (non-distance sensitive) basis. Suddenly, there was only one per minute price for long distance calls in the United States. And just as suddenly the service being provided no longer fit the § 4252(b)(1) definition of service subject to the tax.

The Refund Game Begins

The mismatch between the plain language of the Code and the service being provided to real world customers did not escape the notice some enterprising lawyers and accountants, who began to file refund claims on behalf of their clients. The IRS denied these claims at the examination level, relying on a 1979 Revenue Ruling in which it admitted that non-distance sensitive long distance service fell outside the literal language of the Code, but nevertheless decreed that, "a statute may be given an interpretation other than that which follows from its literal language where such interpretation is required in order to comport with the legislative intent." The Service was not, however, completely confident in its bold rejection of the plain meaning rule, as evidenced by the fact that if a taxpayer took its case to IRS Appeals, the Service would settle for 33 cents on the dollar, plus interest. The gold rush was on.

Just as the Service was less than confident that the courts would uphold its theory of statutory interpretation, taxpayers were less than confident that the courts would apply the plain meaning rule. As a result, for approximately eight years the refund game was played as one in which taxpayers that brought refund claims to IRS Appeals were rewarded with a refund of 33.3% of the amount remitted. Meanwhile the Service got to keep 66.7% of the amount remitted on protested claims—plus 100% of the amounts remitted by taxpayers without the knowledge or wherewithal to play the refund game.

Enter the Federal Courts

In 2003 a number of enterprise users tired of the game and filed lawsuits in the Court of Claims and various federal district courts seeking full refunds of the amounts they had paid. At the heart of each of these cases was the plain meaning rule. If § 4252(b)(1) taxed only long distance service for which the charges varied by distance

and elapsed transmission time, could the IRS tax long distance service for which charges varied only by elapsed transmission time? The answer—which seems pretty obvious in retrospect—was a resounding "No." Ten cases were tried. Only one court held for the Government, stating that in this particular case "and" could mean "or;"a theory not even the Government had pressed with any vigor. The rest of the trial courts had no difficulty affirming the conjunctive meaning of "and," and held for the taxpayer. How bad was it? At oral argument in the Honeywell case, Court of Claims Judge Miller asked the IRS's counsel "How many of these cases does the Government intend to lose before it acquiesces?"

The courts of appeals were no kinder to the Government's theories—its lone victory was reversed and all of the taxpayer victories were affirmed on appeal. On May 31, 2006, the IRS answered Judge Miller's question by issuing Notice 2006-50, in which it capitulated and announced that effective August 1, 2006, modern, postalized long distance service would not be subject to the federal excise tax. In this Notice, and the companion Notice 2007-11, the Service went further than the courts and stated that wireless service and prepaid telephone cards were also non-taxable. And the Service established a refund procedure pursuant to which taxpayers could either claim a safe harbor amount ($30 to $60 for individuals and households) or calculate the actual amount of tax paid, the option chosen by most enterprises. The refund period was March 31, 2003 through July 31, 2006; refund claims were to be filed in conjunction with a taxpayer's original or amended tax return for 2006. (Ultimately, the Service chose July 25, 2012 as the filing deadline for all refund claims).

The Payoff is Huge

Now the gold rush was in full swing. All of a sudden, the Service was paying refunds of 100 cents on the dollar, plus interest, for long distance services purchased over a 41 month period. For enterprises that were heavily dependent on long distance service (e.g., hospitality, consumer products, financial services), many of the refunds were in the seven figure range. And paradoxically, distributors of prepaid telephone cards fared extremely well in the refund process. Unbeknownst to most prepaid card distributors, the carriers selling them the cards were required to collect, report, and remit tax based on 3% of the face value of the cards sold—but the actual "customers" paying the tax were the distributors. For large distributors, six and seven figure refunds were not unheard of.

But What About the Little Guy?

Although the Service refunded billions in mis-collected excise taxes to sophisticated businesses who learned of the refund from their tax advisors, the IRS retained a large portion of its ill-gotten taxes. The Service chose to give refunds through the federal income tax process, but millions of poor and elderly individuals who have phones do not file income tax returns, and virtually none of them got the refunds to which they were legally entitled. The IRS's failure to reach out to the little guys spawned two class action suits.

The first was filed in the Federal District Court for the District of Columbia and alleged that the IRS had violated the Administrative Procedure Act by failing to promulgate simple and fair refund procedures and put them out for public comment prior to implementing them. Reversing a trial court finding in favor of the IRS, the D.C. Circuit held that "[t]he litigation position of the IRS throughout the history of the excise tax has been startling … After conceding the excise tax was collected illegally, the Service set up a virtual obstacle course for taxpayers to get their money back." As of today, however, the Service has yet to revise its refund program in response to the court order. The second class action suit was filed in the Federal District Court for the Middle District of Pennsylvania and alleged that people who paid the tax through their telephone providers but were not required to file tax returns were not given sufficient notice of the availability of refunds. While that court has been unenthusiastic about the plaintiff's proposal to involve the carriers (which know from whom they collected the tax) in the refund process, the court has not granted the Government's motion to dismiss.

Lessons Learned: Let's Do It Again!

As the gold rush winds down we ponder its impact and its lessons. First, enterprise users that were willing to expend the resources necessary to prepare, file, and substantiate refund claims with the IRS received significant cash refunds. Second, on a going forward basis, the cost of an enterprise's long distance and wireless service fell by 3% overnight, a significant savings.

Finally, and perhaps most importantly, taxpayers learned that they should not be shy about holding the IRS to the same standard of compliance with the plain language of the tax code as is required of taxpayers. In the words of the Sixth Circuit in the Officemax appeal, when confronted with "an agency that frequently insists that its citizens 'turn square corners,'" courts are increasingly willing to insist that the IRS do the same.

Currently, state, federal, and local taxes and fees constitutes up to 20% of an enterprise user's monthly bill. Behind each of these taxes and fees is a very specific statute or rule authorizing the collection thereof. The rewards for taxpayers who remember the Sixth Circuit's teachings when comparing the taxation practices of the government and its collection agents (i.e., wireless and wireline carriers) to the language authorizing the collection of these taxes and fees can be substantial.