The Growing Controversy Over Federal Excise Tax on Long-Distance Calls

by Thomas D. Sykes

When I use a word . . . it means just what I choose it to mean – neither more nor less.

—Lewis Carroll's Humpty Dumpty,
in *Through the Looking Glass*

Section 4251 of the Internal Revenue Code imposes a federal excise tax of three percent on amounts paid for "communications services." The tax is embedded in a subscriber's monthly phone bill, which typically bears a vague reference to "federal taxes" or "taxes." After the subscriber pays the bill (including the embedded tax component), the carrier pays the tax over to the Internal Revenue Service pursuant to section 4291. Historically, the tax has had a low profile.

In recent years, many businesses using large amounts of long-distance services have been seeking refunds of the tax from the IRS, on the basis that these services do not come within the terms of the statute imposing the tax. The IRS is now moving to arm itself for litigation over the applicability of the tax to long-distance services. Thus, in April the IRS promulgated a proposed regulation on the statutory definition of "toll telephone service" for purposes of the tax. Prop. Reg. § 49.4252-0, 68 Fed. Reg. 15,690 (Apr. 1, 2003), would read out of the statutory definition the explicit requirement that the charge for the service vary with the distance of each individual communication — a requirement that is not met when long-distance services are billed, as they now often are, without regard to the distance spanned by the call.

This article reviews the arguments that the government has made in support of the position reflected in the proposed regulations. It concludes that the regulation is fundamentally flawed and, accordingly, should not be made final.

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Section 4252(b)

Under section 4251 of the Code, three types of "communications services" are subject to the tax: "local telephone service," "toll telephone service," and "teletypewriter exchange service." Subject to certain exceptions, whether tax is due on long-distance calls turns on whether those services are "toll telephone service" within the meaning of section 4252(b):

> **(b) Toll telephone service.**—For purposes of this subchapter, the term "toll telephone service" means—
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> **(1)** a telephonic quality communication for which (A) there is a *toll charge which varies in amount with the distance and elapsed transmission time of each individual communication* and (B) the charge is paid within the United States, and
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> **(2)** a service which entitles the subscriber, upon payment of a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), to the privilege of an unlimited number of telephonic communications to or from all or a substantial portion of the persons having telephone or radio telephone stations in a specified area which is outside the local telephone system area in which the station provided with this service is located. (Emphasis added.)

These provisions were enacted as part of the Excise Tax Reduction Act of 1965, Pub. L. No. 89-44, § 302, 79 Stat. 146 (1965 Act), and have not been amended.

The Growing Controversy

Controversy over the tax has grown in recent years because long-distance carriers, especially in the context of rate plans available to large business subscribers, have moved away from basing charges for long-distance calls upon the distance spanned by the call. Beginning in the first half of the 1990s, long-distance charges have been increasingly based upon the elapsed transmission time of the call, without regard to distance. Accordingly, amounts paid for long-distance service under many rate plans no longer come within the definition of "toll telephone service" set forth in section 4252(b). This development has led many large business subscribers, from every sector of the economy, to file administrative claims for tax refunds.[1]

On April 20, 2001, in response to the growing controversy, the IRS issued an Appeals Coordinated Issue Settlement Guideline (2001 TNT 226-12.). The Appeals Settlement Guideline, entitled "Excise Tax on Virtual Private Networks," acknowledges that long-distance service billed on the basis of elapsed time alone does not come within the language of section 4252(b).[2] Nonetheless, it concludes that "service for which a flat per-minute rate is charged should be taxed as toll telephone service," based upon "the purpose and intent of the statute."[3]

The IRS's Arguments

For this conclusion, the Appeals Settlement Guideline points to the legislative history to the 1965 Act. In pertinent part, that legislative history states:

> The definitions of local telephone service (previously general telephone service), toll telephone service, and teletypewriter exchange service have been updated and modified to make it clear that it is the service as such which is being taxed and not merely the equipment being supplied. Thus, in the case of local telephone service, the definition makes it clear that it is the right of access to a local telephone system and the privilege of telephonic quality communication which is taxed together with facilities or services provided with this service. *Toll telephone service is defined as being a telephonic quality communication for which a toll charge is made which varies in amount with the distance and lapsed [sic] transmission time of individual communications*, but only if the charge is paid within the United States. Also included in this definition of toll telephone service is WATS (wide area telephone service). This is a long-distance service whereby, for a flat charge, the subscriber is entitled to make unlimited calls within a defined area (sometimes limited as to the maximum number of hours). A teletype writer [*sic*] exchange service is defined as access from a teletypewriter or other data station to the teletypewriter exchange system of which such station is a part and the privilege of intercommunication by such station with substantially all persons having teletypewriter or other data stations in the same exchange system.

H. R. Rep. No. 433, 89th Cong., 1st Sess. 30 (1965) (emphasis added). The Senate Report contains an essentially identical paragraph. S. Rep. No. 324, 89th Cong., 1st Sess. 35 (1965). Before the amendment made by the 1965 Act, section 4252(b) of the Code defined "toll telephone service" simply as "a telephone or radio telephone message or conversation for which (1) there is a toll charge, and (2) the charge is paid within the United States."

The Appeals Settlement Guideline states that "there is no indication that the Congress [in enacting the 1965 Act] intended to make changes in the types of toll telephone service subject to tax," pointing to the first sentence of the quoted excerpt from the legislative history. The Appeals Settlement Guideline also asserts that "Congress historically taxed long distance telephone service in whatever form." It also contends that "where a new type of communications service is developed subsequent to the latest amendment of the communications tax Code provisions, the service will not be regarded as non-taxable but rather will be taxed under the Code provision which it most closely resembles."

The basis for these contentions is difficult to understand. Had the 1965 Congress wished to tax "long distance telephone service in whatever form," Congress easily could have defined "toll telephone service" in just that manner. Or if the 1965 Congress had wished to tax all long distance service "for which there is a toll charge," it did not need to make any change at all to the statute. Instead, Congress made elaborate changes to section 4252(b) to precisely define the manner in which the toll charge had to be determined for the service to be regarded as taxable "toll telephone service"— and the legislative history recites that definition verbatim. One interpreting a statute should be careful not to read words into, or out of, a provision that is *definitional*, as this one is. *See, e.g., Colautti v. Franklin*, 439 U.S. 379, 393 n.10 (1979) ("As a rule, '[a] definition which declares what a term "means" . . . excludes any meaning that is not stated'") (citation omitted).

The IRS's position suggests that the meaning of the statute is flexible and should evolve automatically to keep pace with changes in the marketplace. The Appeals Settlement Guideline cites no support for this view, aside from its own GCM 37273 (Sept. 27, 1977), which in turn cites no law on the point.[4] In fact, the IRS's view is undercut by the 1965 Act providing for complete elimination of the tax on communications services, after a three-year phase-out. Pub. L. No. 89-44, § 302, 79 Stat. 145 (1965). The cited House and Senate reports on the 1965 legislation each state (at pages 29 and 35, respectively) that the tax "is undesirable as a permanent feature of our excise tax system." Thus, an intent to tax all future long-distance services, in whatever form they may eventually appear, cannot properly be ascribed to the 1965 Act.

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The Appeals Settlement Guideline contends that "it is arguable that distance plays a role in rate determination," pointing to fact that the per-minute rates for long-distance calls from 1 of the 48 contiguous states to another are different from per-minute rates for intrastate calls, calls to Hawaii or Alaska, and calls abroad. This contention ignores that section 4252(b)(1) imposes a toll charge "which varies in amount with the distance and elapsed transmission time of each individual communication."

Finally, the Appeals Settlement Guideline asserts that amounts paid for prepaid telephone cards, which are typically billed on a flat per-minute rate but not on distance, were addressed in legislation enacted in 1997. But whatever Congress may have intended in 1997 simply cannot tell us anything about what Congress intended 32 years earlier.

Stated simply, each of the IRS's arguments is designed to show that section 4252(b)(1) does not mean what it says. But the meaning of that provision is plain: For long-distance service to be taxable as toll telephone service, the charge for the service must "var[y] in amount with the distance . . . of the individual communication." There is

nothing in related statutory text that makes this requirement ambiguous or uncertain. Under circumstances like these, "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'" *United States v. Ron Pair Enterprises*, 489 U.S. 235, 242 (1989). "Absent a clear showing of contrary legislative intent, the plain meaning analysis of the statutory language begins and ends the judicial inquiry." *Executive Jet Aviation v. United States*, 125 F.3d 1463, 1470 (Fed. Cir. 1997) (addressing transportation excise taxes).

Moreover, "if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer." *Hassett v. Welch*, 303 U.S. 303, 314 (1938) (footnote omitted). *See also Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1156 (Fed. Cir. 1993) ("In the case of doubt [about the meaning of statutes levying taxes], they are construed most strongly against the government, and in favor of the citizen"); *Tandy Leather Co. v. United States*, 347 F.2d 693, 695 (5th Cir. 1965) (stating, with respect to a federal excise tax statute, that "any doubts as to meaning are to be resolved against the taxing authority and in favor of the taxpayer"). The IRS seeks to create doubt where controlling rules of statutory construction permit none, and then resolves that "doubt" in favor of the wrong party.

For these reasons, the IRS's arguments for the taxability of long-distance calls that are billed on the basis of elapsed transmission time, without regard to distance,[5] are meritless.

The Proposed Regulation

Despite the plain meaning of the statute and the unambiguous nature of its legislative history, the IRS has issued Prop. Reg. § 49.4252-0(a), which would provide that "[f]or a communications service to constitute toll telephone service described in section 4252(b)(1), the charge for the service need not vary with the distance of each individual communication."[6] Why? Possibly because a lot of money is at stake and because an assessment undergirded by a regulation would be harder to overturn. Hence, if the regulation becomes final, a taxpayer suing to recover a tax refund respecting charges for long-distance service would have to demonstrate the regulation does not implement the statute in a reasonable manner. *Rowan Cos. v. United States*, 452 U.S. 247, 252 (1981); *Cottage Savings Assn. v. Commissioner*, 499 U.S. 554, 560-561 (1991).[7] That challenge seems easily surmountable given the statute and committee reports, but the courts often defer to the IRS's interpretation of the Code.

Conclusion

The Internal Revenue Service's hardening position that long-distance service billed on a basis that does not vary with the distance of the individual call is taxable seems wholly contrary to law. For this reason, the Treasury Department should not promulgate in final form the regulation proposed in April. In addition, the IRS should withdraw the position set forth in its Appeals Settlement Guideline and in Rev. Rul. 79-404, 1979-2 C.B. 382.

Taxpayers should not be deterred by the proposed regulation or the IRS's arguments from pursuing an appropriate tax refund. Indeed, a taxpayer with a mature administrative claim and a substantial amount of tax at stake (both currently and in future periods) should seriously consider whether bringing a prompt court challenge to the IRS's position would be advantageous.

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1 Long-distance carriers have continued to collect the excise tax on long-distance services, probably because the IRS could sue for the tax if the carrier failed to collect it. *See* I.R.C. § 4291 (requiring carriers to collect the tax imposed by section 4251). Courts have repeatedly held that a subscriber cannot recover the tax directly from a carrier; instead, the subscriber must pursue a tax refund suit against the United States. *See Du Pont Glore Forgan, Inc. v. American Tel. & Tel. Co.*, 428 F. Supp. 1297, __ n.21. (S.D.N.Y. 1977).

2 *See also* Rev. Rul. 79-404, 1979-2 C.B. 382 (stating that "[the service provided in this case] is not toll telephone service because the charge for such service does not vary with distance and therefore does not meet the requirement of section 4252(b)(1)," but nonetheless concluding that offshore satellite radio telephone service billed on the basis of elapsed time was "essentially" "toll telephone service").

3 Despite this conclusion, IRS Appeals has been settling these cases.

4 *Stichting Pensioenfonds Voor De Gezondheid v. United States*, 129 F.3d 195, 200 (D.C. Cir. 1997) (stating that GCMs "have no precedential value"); TAM 200252028 (Aug. 27, 2002) (stating that "General Counsel Memoranda were used as internal Service communications in the process of developing public guidance, and represent only the opinions of the individuals that drafted and reviewed the memoranda").

5 Several of the arguments set forth in the Appeals Settlement Guideline appeared earlier in Rev. Rul. 79-404, 1979-2 C.B. 382.

6 The proposed regulation states that it is effective with respect to amounts paid on or after the date of publication in the Federal Register of a final regulation.

7 The Notice of Proposed Rulemaking issued by the IRS, 68 Fed. Reg. 15690 (Apr. 1, 2003), identifies section 7805 as the authority for the regulation, so the regulation, if issued, would be classified as interpretative. In the tax field, interpretative regulations are issued under the authority of section 7805(a) (providing generally that the Secretary of the Treasury "shall prescribe all needful rules and regulations for the enforcement of this title [26 U.S.C.], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue"). By contrast, *legislative* regulations — which are more difficult to overturn — are issued under a specific statutory grant of rulemaking authority, such as section 1502 (authorizing the promulgation of regulations respecting consolidated returns). *See Boeing Co. v. United States*, 123 S.Ct. 1099, 1107 (2003) (recognizing the distinction between the two types of regulations).