

June 9, 2005

Courts Grant IRS Refunds of Federal Excise Taxes on Long-Distance Communications

On May 10, 2005, the United States Court of Appeals for the 11th Circuit became the latest and highest federal court to rule in favor of the taxpayer, granting a refund of Internal Revenue Service (IRS) excise taxes charged on certain long-distance telephone services. See *American Bankers Insurance Group v. United States*, 2005 WL 1083464 (11th Cir. 2005). The 11th Circuit joins four district courts and the United States Court of Federal Claims that have ruled in the past year that the Internal Revenue Code's excise tax provision does not apply to long-distance calls for which the rate does not vary based upon the distance of the call. The only district court to rule in favor of the IRS on this issue was overturned by the *American Bankers* decision.

Background

The Internal Revenue Code imposes a 3% federal excise tax on telecommunications services, which include "toll telephone service," as defined in Code Section 4252(b)(1). The statute, written decades ago when telephone services were provided for and billed differently, defines "toll telephone service" subject to excise taxes as toll service in which the charge "varies in amount with the distance and elapsed transmission time of each individual communication."

Today, most long-distance telephone providers bill their customers based on elapsed time (*i.e.*, businesses typically pay between a few and several cents per minute for long-distance telephone services no matter where they call in the United States). Long-distance providers today do not charge customers based on distance (*i.e.*, businesses do not pay more for calls of the same duration from Washington, D.C. to Los Angeles than from Washington, D.C. to Philadelphia).

Court Decisions

There has been a flurry of court activity since 2004 in which business customers have argued successfully that they are entitled to refunds from the excise tax applied to the long-distance portion of their telephone bill because their long-distance calls were not charged based on distance. The cases have run similar courses. In *American Bankers*, the company first sought a refund from the IRS, as required by the Internal Revenue Code. When the IRS did not respond to the refund claims, American Bankers brought suit in the Southern District of Florida seeking a refund of the excise taxes paid for long-distance services provided over four years, plus interest.

In all of the cases (except in the overturned *American Bankers* district court decision), the courts have interpreted the plain meaning of Section 4252(b)(1) to require that, in order for the IRS to collect an excise tax on long-distance service, the long-distance charges must vary by *both* distance and time. Because the long-distance services at issue in these cases involved nationwide per-minute charges (and therefore varied only by time), the courts held that the IRS is not authorized to collect the excise tax and that the taxpayers thus were entitled to the requested refunds.

Obtaining a Refund

Because of the way in which long-distance services are provided for and billed today, many businesses will have paid excise taxes on long-distance services similar to those at issue in the recent court decisions. The amounts of these taxes obviously vary substantially from customer to customer, but may be significant. For example, American Bankers sought and was granted a refund of \$361,763 plus interest for excise taxes incurred over four years.

At this juncture, the only way to obtain a refund of these taxes may be through litigation. The IRS continues to assess and collect the excise tax in spite of the court decisions. In its most recent public statement in response to inquiries precipitated by the recent litigation, issued August 30, 2004, the IRS stated that it will continue to collect the communications excise tax on long-distance telephone services "including those communications services similar to those at issue in the cases." It further instructed that "[p]ersons paying for taxable communications services are required to pay the tax to the collecting agent" but that "[t]axpayers may preserve any claims for overpayments by filing administrative claims for refund with the Service." The IRS stated that "failure to pay the tax to the collecting agent may result in the imposition of penalties, as well as interest." I.R.S. Notice 2004-57, 2004-35 I.R.B. Thus, the agency adheres to its position articulated in a 1979 Revenue Ruling that interprets the statute to impose excise taxes whether the charges are based on time *or* distance. Revenue Ruling 79-404.

Two of the district court cases are on appeal, and the 11th Circuit is the only court of appeals to have ruled on the issue. However, the 1979 Revenue Ruling continues to represent the IRS's interpretation of the excise tax statute unless and until the IRS "acquiesces" in the court decisions, at which time it may revoke the ruling or issue superseding guidance. In light of the near unanimity of the courts addressing this issue, the IRS may eventually acquiesce, but for the immediate future businesses should anticipate continuing to pay the tax. And although the legal landscape has changed significantly since the IRS issued its Notice, businesses should continue to view the public statement as the official position of the agency until it states otherwise.

The following general guidance should be considered by businesses in determining how to proceed further:

- ◆ The IRS has not changed its position as to the collection and payment of telephone excise taxes in circumstances such as those addressed by the recent cases and careful consideration should be given to any changes in your practices regarding such matters.
- ◆ Businesses that have paid large amounts of communications excise taxes on long-distance telephone service in the past few years may wish to consider filing for refunds with the IRS in order to preserve claims for overpayment of these taxes, and then seeking recourse in a district court or in the Federal Court of Claims. Businesses will have to consider whether the amounts of excise taxes potentially recoverable are significant enough to offset litigation costs. If you wish, our tax group can help you in filing and pursuing these claims.
- ◆ The courts' interpretation of Section 4252(b)(1)'s definition of "toll telephone service" pertains only to excise taxes imposed on certain long-distance services. Other Internal Revenue Code provisions impose excise taxes on local telephone service and on certain "periodic charge" long-distance services.

- ◆ The 11th Circuit decision is binding law in Florida, Georgia and Alabama, but it is only persuasive authority in other jurisdictions. District court and Federal Court of Claims decisions are not binding on other courts. As a result, although there is currently unanimity among courts, there is at this time no guarantee outside of these three states of a successful result in obtaining a refund.

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