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Business Law Client Alert

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FEDERAL EXCISE TAX ON LONG DISTANCE TELEPHONE SERVICE ELIMINATED

- ✓ *Check your telephone bill this month to be sure the 3% tax on long distance service does not appear.*
- ✓ *Collect your 2003–2006 telephone bills now and plan to apply for a refund in 2007.*

TAX ELIMINATED

The federal excise tax on long-distance telephone service has been eliminated, and the Internal Revenue Service has agreed to refund to millions of telephone customers the excise taxes they have paid over the last 41 months.

A CENTURY-OLD TAX

Since 1898, federal law has imposed an excise tax on telephone service. This tax, now at the rate of 3%, is familiar to most of us as the “FET” line item on our telephone bill. The FET was originally designed as a tax on wealthy Americans — those who could afford telephone service — and was intended to defray part of the cost of the Spanish-American War. Today, the tax is a mere annoyance for many, but for large long-distance users (including many small and mid-size businesses that have geographically diverse operations, large telemarketing, or significant telephone customer service functions) the tax has meant a major expense.

TAX ENDS THIS MONTH

Taxpayers should no longer see the FET on their long-distance telephone bills. The Internal Revenue Service has directed telephone companies to stop collecting the tax on long-distance services, effective August 1, 2006. If the tax does appear, taxpayers should hesitate to pay it, since any excise tax paid to a

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carrier for an invoice issued after July 31, 2006 must be recovered from the carrier, and will not be refunded by the Service.

Note that the FET is still in effect on local telephone service, and carriers must still collect the 3% tax on separately-stated local telephone service charges. However, services that do not separately state charges for local calls, such as cellular, "all-distance" landlines, VoIP and Internet-based offerings, are no longer subject to the tax. Note also that regulatory ("universal service") charges imposed by the FCC, as well as state and local taxes, still apply.

REFUNDS AVAILABLE

Telephone customers have a one-time opportunity to claim a refund of FET paid, retroactive to March 1, 2003, and may recover interest as well. The Treasury Department expects to issue refunds totaling about \$15 billion to taxpayers. Each refund should work out to approximately 130% of the taxpayer's average monthly long distance bill.

Refunds to Businesses: Entity taxpayers (including corporations, partnerships, limited liability companies and other non-individual taxpayers) must follow strict procedures and must claim the "actual amount" of FET paid in respect of long-distance services within the 41-month limitations period, March 1, 2003 through July 31, 2006. The determination of the correct amount involves some subtleties, and may require a careful review of historic telephone bills. The refund claim is made by filing it with the entity's tax return for the tax year 2006 (the tax period that includes December 31, 2006).

Now is the time to gather telephone bills and have them ready for review and calculation of the correct amount of FET paid. Carriers may or may not charge a fee for locating and duplicating historic telephone invoices. Many larger long distance users are billed electronically by their telephone company; such customers may need to request that their carrier provide a comma-delineated file

(e.g., an Excel spreadsheet) that breaks out their FET over the limitations period.

Refunds to Individuals: Individuals will have the option to avoid poring over historic telephone bills and instead claim as their refund a fixed "safe harbor" amount, yet to be determined by the Service. Individuals will be able to claim this refund as part of their Form 1040 return for 2006, generally due April 15, 2007.

WHY THE CHANGE?

The Government's acquiescence follows months of litigation. The Department of Justice and the IRS agreed to stop enforcing the FET only after losing five of six U.S. District Court cases brought by taxpayers in the last few years. The taxpayers' position upheld in these cases, is that the taxing statute, Internal Revenue Code Sec. 4252(b)(1), imposes the excise tax only when the toll charge "varies in amount with the distance and elapsed transmission time of each individual communication." Long distance tolls have historically been based on both "zones" and "minutes," but for the last several years virtually all long distance tolls have been based only on "minutes" and have not been distance-sensitive. The five district courts agreed that toll charges based only on time are not subject to tax under the plain language of the statute.

CONTACT

This client alert is courtesy of Avi M. Lev, a tax attorney who recently joined the firm. Avi practices in the Business Law Group and the Trusts and Estates Group and can be contacted at 617-589-3850 or by email at alev@davismalm.com. ♦

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