

CRS Report for Congress

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Telephone Excise Tax

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Summary

The federal excise tax on local and long distance telephone service produces substantial revenues even at a tax rate of 3 percent. The Internal Revenue Service reports that the tax reached a new record in collections of \$4.9 billion in FY 1998. These taxes go into the general receipts of the U.S. Treasury and are not dedicated to a trust fund or any other special purpose. In the debate over whether the tax should be repealed, interested parties have attributed a number of advantages and disadvantages to the tax. Not only is the tax administratively easy for the federal government to collect, but it also continues to generate large and stable amounts of revenue. Those who favor the tax note that there is no serious evidence that the communications industry has been injured by the past imposition of this tax. Among those opposed to the tax there is broad consensus that this is a regressive tax. They stress that telephone usage should be distinguished from the sumptuary (“sin”) excise taxes imposed on items such as alcoholic beverages and tobacco. Opponents argue that the tax base is one which should be left to the states, that without this tax the communications industry would grow more rapidly, and that the economy would benefit from this expansion. This report will be updated as events warrant.

Brief History

The federal excise tax on telephone calls (also known as the communications tax) originated on long distance service under the *Spanish War Act of 1898*. This original tax attached when the call was valued at 15¢ or more. The tax was repealed in 1902 but reenacted as a tax on a per-message basis under the *Act of October 22, 1914*. Subsequently, the tax was repealed and reenacted several times. The federal tax on long distance calls has been levied on a continuous basis since passage of the *Revenue Bill of 1932*. That law was passed largely because of the federal budget deficit which occurred when income tax receipts declined because of the economic depression. The tax was

extended to local telephone services a few months prior to the U.S. entrance into World War II by the *Revenue Act of 1941*.

In the 1960s, 1970s, and 1980s, the federal telephone excise tax was repeatedly imposed on a temporary basis. In general, the laws under which the tax operated called for a gradual phase-down in the tax rate before total repeal of the tax. Often, revenue problems surfaced before the repeal date and Congress responded by either increasing the rate in effect, or continuing the rate but postponing repeal.

Prior to passage of the *Revenue Reconciliation Act of 1990*, the tax was scheduled to expire on December 31, 1990. The 1990 Act permanently extended the tax at the 3 percent rate. The rationale for continuance was that budget deficits precluded allowing the tax to expire.

Revenues

The revenue from the telephone excise tax goes into the general receipts of the United States Treasury. It is used for general government expenditures as they accrue. It is not earmarked for any particular government function or service. The tax produces substantial and stable amounts of revenue. A table that provides annual telephone excise tax collections since fiscal year 1980 appears on the final page of this report.

Assessment

In the continuing debate over whether the federal excise tax on telephone service should be repealed, interested parties have attributed a number of advantages and disadvantages to the tax. Following is a brief discussion of some of the issues associated with proposed repeal of the tax: the incidence, revenue needs, federal-state revenue competition, communication industry effects, and administrative collection ease.

Incidence

Excise taxes are labeled as regressive taxes to the extent that low-income people spend a higher fraction of their income on the taxed item than high-income people. Opponents of the telephone excise tax find regressivity to be an objectionable feature not only of the telephone tax borne directly by consumers, but also of the telephone excise taxes paid by businesses, to the extent that tax burdens are shifted forward to consumers. A 1987 study by the Congressional Budget Office, *The Distributional Effects of an Increase in Selected Federal Excise Taxes*, concluded that among excises, those on alcoholic beverages and tobacco products would have less of an impact upon low-income families than those on telephone service.¹ It was noted that the telephone excise tax would be accessed on nearly all low-income families (since 94 percent of households had telephone service in 1998), while taxes on alcoholic beverages and tobacco products show

¹U.S. Congressional Budget Office. *The Distributional Effects of an Increase in Selected Federal Excise Taxes*. Staff working paper. [Washington] January 1987.

that they impact only about a third of families with incomes less than \$10,000 (since not everyone drinks alcoholic beverages or smokes).

Those who oppose repeal of the telephone excise tax argue that the entire federal tax structure, rather than its individual parts, should be examined and that the system as a whole is not regressive. It is noted that the regressive telephone excise tax can be offset by progressive rates on federal personal income taxes. Additionally, proponents of the tax on telephone service argue that the tax on telephone service treats equally families who use the telephone equally.

As a result of the deregulation of the telephone system, costs for local telephone service have risen in many areas. In addition, there has been a proliferation of charges on telephone services.² Some have called for a revision of the federal excise tax as a means of helping lower-income persons retain their telephone service by subsidizing the telephone usage of the poor. That is, if this excise tax is to remain part of the tax structure, either low-income persons should be exempted from the tax or a trust fund be set up with revenues from the tax to help defray the cost of telephone service for the poor (See H.R. 727, 106th Congress, discussed in this report's section on **Legislation**).³

Revenue Needs

Perhaps the principal argument used in recent years for continuation of the tax was the need for revenues in order to reduce federal budget deficits. Proponents argued that the federal tax on telephone service cannot be evaluated in a vacuum, but needs to be considered in the overall federal budgetary situation. In addition, proponents noted that a reduction in exemptions for either types of services (such as installation charges) or types of organizations exempted (nonprofit hospitals, educational organizations, federal and foreign governments, etc.) from the communications excise tax could easily generate large additional amounts of revenue.⁴ While there are no longer annual federal budget deficits, some argue that tax cuts are not justified and that the surplus should be used to reduce the federal debt accumulated over many prior years of federal budget deficits.

Opponents of the tax concede that the elimination of the federal telephone tax would have an adverse effect on governmental receipts, but state that this objection does not begin to outweigh the many benefits that such a repeal would bring. Some opposed to the tax welcome the prospect of a modest tax cut; others state that the government could make up for this tax loss in many other ways--by tax reforms such as the elimination of "loopholes" or by reducing wasteful and nonessential government expenditures, to mention just two alternatives.

²These other charges are not covered by this report. For information on telephone charges see *Telephone Bills: Charges on Local Telephone Bills*. CRS Report RL30052, by James R. Riehl.

³As part of the federal universal service mandate, federal programs such as the Lifeline and Link-Up programs provide low-income consumers assistance to hook up to and remain on the telephone network.

⁴U.S. Department of Treasury. Office of Tax Analysis. *Report to the Congress on Communication Services Not Subject to Federal Excise Tax*. August 1987. p. 28.

Intergovernmental Relations

Those opposed to the federal telephone tax argue that this tax base could be left entirely to the states. Proponents of reserving this revenue opportunity for the states argue that this offers an excellent opportunity to reduce the trend toward centralization and bureaucracy in Washington and to “turn back” to the states revenue sources together with responsibilities for certain program areas.

Supporters of the federal tax say that there is no point in allowing this tax to be ceded to the states at a time when revenues are still needed to reduce the federal debt. If the federal excise tax is simply to be replaced by state levies, then this substitution negates the arguments advanced by proponents of repealing the tax. Supporters of the tax note that there is nothing preventing the states from levying the tax now and that many states already levy taxes on telephone service. Those that support retaining the federal tax point out that the arguments raised against the federal tax on such grounds as its regressiveness and its unjust burden on the telephone user would also apply to taxes at the state level.

Communications Industry Effects

Opponents of the tax argue that the elimination of the federal telephone tax would favorably affect the communications industry. While telephone companies do not bear this tax directly, through backward tax shifting they bear some of the economic burden of the tax. This burden is in the form of a reduction in both the number of subscribers and amount of services requested, caused by higher cost due to the federal excise tax. It has been additionally argued that placing an extra cost on telephone use discourages the expansion and improvement of telephone service. In the future, traditional telephone service may receive more competition from Internet telephony which is currently not subject to either the federal telephone excise tax or Federal Communications Commission (FCC) fees. Increased growth of the telephone industry, which elimination of the tax would presumably bring, should be considered in terms both of the many independent companies striving to make this industry more competitive and of the increased communication needs of this country.

Proponents of the federal telephone tax (particularly at its historically low 3 percent rate) argue that they have not seen an adverse effect on the growth of the communications industry. Supporters of the tax also note that federal programs to assist low income consumers gain access to and remain on the telephone network are in part supported indirectly (since telephone taxes go into the general fund) from the revenues this tax generates.

Administration

Those in favor of the tax note that the federal excise tax on telephone service has administrative advantages. Because the telephone companies collect the tax from the customers, the federal government is spared this expense. The administration of the tax by the federal government is therefore much simplified. In addition, it is difficult for the telephone user to evade payment of this tax. Those persons refusing to pay this tax are easily identified and action can be taken against them.

Opponents of the tax note that it is not the function of the telephone company to act as the collection agent for largely "invisible" federal taxes. Further administrative costs associated with collection are most likely passed forward and are borne by consumers through higher charges for service.

Legislation

In the 105th Congress, Representatives Jennifer Dunn and Billy Tauzin introduced H.R. 3648 as the "Tax on Talking Repeal Act of 1998" which called for the repeal of the federal telephone tax. Representative Dunn serves on the House Ways and Means Committee while Representative Tauzin serves on the Committee on Commerce as Chair of the Subcommittee on Telecommunications, Trade and Consumer Protection. On the Senate side, Commerce Committee Chairman John McCain announced at a meeting of the Cellular Telecommunications Industry Association (February 23, 1998) that he promised to seek repeal of the telephone excise tax. In introducing his bill, S. 1909, he noted that implementation of the *Telecommunications Act of 1996* (P.L. 104-104) created new charges on consumers' telephone bills and called for the repeal of the telephone excise tax as an outdated and unnecessary old charge.

Other bills in the 105th Congress called for the telephone tax revenues to be used for other phone related purposes. Representative Klink's bill, H.R. 4474, would establish a Telecommunications Trust Fund to receive telephone tax revenues to support federal universal service. Two other bills (Senator Burns' bill S. 2348, Representative Tauzin's bill H.R. 4324) would use one third of the revenues for the E-rate program⁵ with the remainder of the tax repealed.

In the 106th Congress, Senator McCain reintroduced his bill (S. 94) to repeal the telephone excise tax. That bill has been referred to the Senate Finance Committee. In contrast, H.R. 727 introduced by Representative Klink would retain the telephone tax and dedicate all of its revenue to a telecommunications trust fund to support universal telecommunications services. That bill was referred to the House Committee on Commerce and the Committee on Ways and Means.

⁵For additional information see CRS Issue Brief 98040, *Telecommunications Discounts for Schools and Libraries: The "E-Rate" Program and Controversies*, by Angele A. Gilroy.

| TABLE 1. Telephone Excise Tax Collections | | |
|--|----------------------------------|---|
| Fiscal Year | Rate of Tax (percent) | Collections from Telephone and Teletype Service (\$ thousands) |
| 1980 | 2% | \$1,117,834 |
| 1981 | 2 | 998,503 |
| 1982 | 1 | 919,749 |
| 1983 | 3 | 1,048,317 |
| 1984 | 3 | 2,034,965 |
| 1985 | 3 | 2,307,607 |
| 1986 | 3 | 2,339,153 |
| 1987 | 3 | 2,522,062 |
| 1988 | 3 | 2,555,082 |
| 1989 | 3 | 2,266,000 |
| 1990 | 3 | 3,075,209 |
| 1991 | 3 | 2,952,522 |
| 1992 | 3 | 3,173,000 |
| 1993 | 3 | 3,351,600 |
| 1994 | 3 | 3,774,000 |
| 1995 | 3 | 3,825,700 |
| 1996 | 3 | 4,243,400 |
| 1997 | 3 | 4,706,800 |
| 1998 | 3 | 4,910,000 |

Note: During the 1960s and 1970s, the tax rate was as high as 10 percent.

Sources: For fiscal years 1980 to 1989 collection figures have been taken from appropriate *Annual Reports of the Commissioner of Internal Revenue* published by the Department of the Treasury, Internal Revenue Service, Publication 55.

For fiscal years 1990 and 1991 collection figures have been taken from appropriate information releases entitled *Internal Revenue Report of Excise Taxes*.

For fiscal years 1992 to 1997 collection figures have been taken from the *Statistics of Income Bulletin*, issued in Fall 1998 (Vol. 18, No. 2) published by the Internal Revenue Service.

For fiscal year 1998 the collection figure came from the U.S. Office of Management and Budget. *Budget of the United States Government, FY2000*, Analytical Perspectives. February 1999. p. 90.