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The Telephone Excise Tax: An Economic Analysis

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Steven Maguire
Analyst in Public Finance
Government and Finance Division

Brent W. Mast
Information Research Specialist
Knowledge Services Group

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Summary

The federal telephone excise tax generated $5.9 billion in revenue in fiscal year (FY) 2005. Since at least 2004, however, many taxpayers, individual and corporate, have challenged the legality of the telephone excise tax as it applies to toll (long distance) telephone services. The courts issued several rulings supporting the taxpayers' position that long distance toll services are not taxable and have ordered refunds. On May 25, 2006, the U.S. Treasury Department conceded defeat and announced that the Department of Justice "...will no longer pursue litigation and the Internal Revenue Service (IRS) will issue refunds of tax on long-distance service for the past three years." On August 31, 2006, the IRS announced individual taxpayers can file for a refund that varies from $30 to $60 based on family size. The refund request would be filed along with the individual income tax return for the 2006 tax year.

This decision will likely initiate further congressional review of the remaining tax on local telephone services. Options include repealing or significantly modifying the structure of the telephone excise tax. Complete repeal of the tax, both the local and long distance portions, has been estimated by the Congressional Budget Office (CBO) to cost $67.0 billion over the FY2006 to FY2015 budget window. The Joint Committee on Taxation estimated that repeal of the remaining excise tax on local telephone services would cost approximately $7 billion over the 2007 to 2016 budget window.

In the 109th Congress, S. 1321 and its companion, H.R. 1898, would repeal the telephone excise tax entirely. On June 28, 2006, S. 1321 was approved by the Senate Finance Committee. In the 110th Congress, S. 140 and S. 170 would repeal the remaining tax on local services. In addition to a review of current legislation, this report provides a brief history of the telephone excise tax, a discussion of the current legal issues, and an economic analysis of the telephone excise tax.

The telephone excise tax is relatively simple for the federal government to administer as third parties collect the tax and monitor compliance. The tax generates roughly $6 billion annually for the federal government. The tax, however, does not treat similarly situated taxpayers equally and is regressive. In addition, economic theory suggests the tax is inefficient, reducing overall economic welfare.

For a history of the telephone excise tax, see CRS Report RL30553, *The Federal Excise Tax on Telephone Service: A History*. This report will be updated as legislative events warrant.

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Brief History of the Telephone Excise Tax[1]

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*. The tax was repealed in 1902 but reenacted as America prepared to enter World War I, under the *Emergency Internal Revenue Tax Act of October 22, 1914*. In December 1915, the tax was set to expire, when Congress decided to keep it in force for another year. On January 1, 1916, the tax did expire, though for only a little more than nine months, at which time it was reenacted under the *War Revenue Act of October 3, 1917*. In 1924 the tax was repealed; it remained so until the passage of the *Revenue Bill of 1932*. The enactment of this 1932 law was justified by its proponents as a way to pay down the federal budget deficit which followed the decline in income tax receipts during the Great Depression. A few months before the United States' entrance into World War II, the tax was broadened by the *Revenue Act of 1941* to include local telephone services.

Since the enactment of the federal telephone excise tax in 1932, the tax has been continuously in effect — though in the 1960s, 1970s, and 1980s, the tax was repeatedly extended 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, or maintaining the rate and extending the scheduled date for proposed repeal.

Before 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 a 3% rate. The rationale for continuance was that budget deficits precluded allowing the tax to expire. Over the telephone tax's long history, exemptions from the tax have been provided to governmental customers, the American Red Cross, nonprofit educational organizations and nonprofit hospitals, common carriers, and radio and television broadcasting stations, among others.

The telephone excise tax may face further modification or possible complete repeal. This report describes the legal issues that have prompted scrutiny of the tax, analyzes the economics of the tax, and discusses legislative options for the 110th Congress.

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[1] For a legislative history of the telephone excise tax see CRS Report RL30553, *The Federal Excise Tax on Telephone Service: A History*, by Louis Alan Talley.

Legal Issues Surrounding the Telephone Excise Tax

The Internal Revenue Service (IRS) collects a 3% telephone excise tax on private charges for the following services: (1) local telephone service, (2) toll telephone service (i.e., long distance), and (3) teletypewriter exchange service.[2] The focus of the recent legal issue is the definition of toll telephone service. In particular, in the tax code, a toll telephone service means, in part,

> ...a telephonic quality communication for which ... there is a toll charge which varies in the amount with the distance **and** elapsed transmission time of each individual communication .... [3] [emphasis added].

Before May 25, 2006, the IRS had taken the position that the toll charge may vary according to distance **or** elapsed transmission time. On May 25, 2006, however, the U.S. Treasury Department announced that the Department of Justice

> ...will no longer pursue litigation and the Internal Revenue Service (IRS) will issue refunds of tax on long-distance service for the past three years. Taxpayers will be able to apply for refunds on their 2006 tax forms, to be filed in 2007.[4]

A recent case argued before the 6th Circuit Court of Appeals on July 29, 2005, and decided on November 2, 2005, highlights the legal issues that surrounded the telephone excise tax that led to the announcement above terminating collection of the tax on long distance services.[5] OfficeMax challenged the legality of the excise tax in claims made on April 6, 2002, and February 13, 2003, and requested a full refund of excise taxes paid of $380,296.72. OfficeMax argued that its phone service provider, MCI, was not providing "a telephonic quality communication for which there is a toll charge which varies in amount with the *distance* and elapsed

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[2] 26 U.S.C. § 4251.

[3] 26 U.S.C. § 4252(b)(1). IRC § 4252(b) defines "toll telephone service" to mean:

> (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
>
> (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.

[4] IRS Notice 2006-50, to appear in the Internal Revenue Bulletin 2006-25, dated June 19, 2006.

[5] OfficeMax Inc. v. United States, 428 F.3d 583 (6th Cir. 2005). On March 30, 2006, the court denied the government's motion for the case to be reheard by the full court. OfficeMax Inc. v. United States, No. 04-4009, 2006 U.S. App. LEXIS 8294 (6th Cir. March 30, 2006).

transmission time of each individual communication . . ."[6] [emphasis in the original]. The OfficeMax toll telephone service charges (i.e., long distance) were based primarily on elapsed transmission time and not distance. Thus, OfficeMax argued, the phone service offered by MCI was not as defined in tax law and therefore not subject to the telephone excise tax. On November 2, 2005, the 6th Circuit Court of Appeals concluded that "a toll charge must vary by both distance and elapsed transmission time in order to be taxed. We thus hold for the taxpayer and affirm."[7]

The OfficeMax ruling was one of several IRS losses in court on this issue.[8] The volume of suits and the potential loss of revenue from the IRS losing these suits was reflected in federal revenue projections. The Congressional Budget Office (CBO) revenue projection for telephone excise taxes assumes that "...there is a significant likelihood — about 75 percent — that the IRS will acquiesce or lose those cases by 2007 and the tax on toll services will be terminated."[9,10]

Treasury Secretary Snow suggested during a congressional hearing on February 15, 2006, that the government could reconsider its position if the 6th Circuit Court of Appeals decided not to rehear the *OfficeMax* case.[11] The court denied the government's motion for rehearing on March 30, 2006.[12] The recent Treasury decision to discontinue collecting the tax and issue refunds conforms with the court rulings.

An important distinction to make is that the telephone excise tax is applied to both local and long distance telephone services. In addition, the excise tax is applied to wireless communication. Since it is the definition of "toll telephone service" that

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[6] *Id.* at 587.

[7] *Id*. at 584-85.

[8] *See* Am. Bankers Ins. Group v. United States, 408 F.3d 1328 (11th Cir. 2005), reversing 308 F. Supp. 2d 1360 (S.D. Fla. 2004); Am. Online, Inc. v. United States, 64 Fed. Cl. 571 (Ct. Cl. 2005); Honeywell Int'l, Inc. v. United States, 64 Fed. Cl. 188 (Ct. Cl. 2005); AMTRAK v. United States, 338 F. Supp. 2d 22 (D.D.C. 2004); Hewlett-Packard Co. v. United States, No. 04-03832, 2005 U.S. Dist. LEXIS 19972 (N.D. Cal. Aug. 5, 2005); Reese Bros. v. United States, No. 03-745, 2004 U.S. Dist. LEXIS 27507 (W.D. Pa. Oct. 20, 2004); Fortis, Inc. v. United States, No. 03 Civ. 5137, 2004 U.S. Dist. LEXIS 18686 (S.D.N.Y. Sept. 16, 2004). Additional refund suits are pending. *See* Warren Rojas, "Phone Tax Fix Could Put Refund Suits on Hold," *Tax Notes*, Jan. 24, 2005.

[9] U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*, Jan. 2006, p. 97.

[10] Nevertheless, the IRS issued a notice on November 15, 2005, that the service would continue to assess and collect the tax under § 4521 on all taxable communication services, including communications services similar to those at issue in the cases. Internal Revenue Service, Notice 2005-79, *Communications Excise Tax; Section 4251*, Nov. 14, 2005. This ruling was revoked by IRS Notice 2006-50.

[11] Kurt Ritterpusch, "Snow Says Court Ruling Could Spell End to Enforcement of Telephone Excise Tax," BNA Daily Tax Report (Feb. 16, 2006).

[12] OfficeMax, Inc. v. United States, No. 04-4009, 2006 U.S. App.LEXIS 8294 (6th Cir. March 30, 2006).

was disputed, it is only the imposition of the excise taxes on certain long distance phone service arrangements, including wireless (cell phones), that has been legally challenged. The refunds for the past three years, to be issued in 2007, are estimated to approach $13 billion and includes taxes paid on long distance and wireless services.

On August 31, 2006, the IRS announced individual taxpayers can file for a standard refund that varies from $30 to $60 based on family size.[13] The refund request would be filed along with the individual income tax return for the 2006 tax year. Taxpayers also have the option of analyzing old telephone bills and submitting a claim for actual taxes paid since February 23, 2003. Some taxpayers have challenged the refund method arguing that taxpayers should be able to claim a refund for telephone excise taxes paid before February 28, 2003, as well.[14] The IRS established that only taxes paid from that date forward are eligible for refund.

Economic Analysis

As the debate surrounding the future of the remaining excise tax on local phone service continues, it is, perhaps, instructive to evaluate the tax from an economic perspective. Economists and public finance experts typically evaluate a tax using the following criteria. First, how simple is the tax to administer? Second, is the tax an equitable tax, or do taxpayers in similar economic situations encounter dissimilar tax liability? Equity could also be measured by the change in burden as income rises or the degree of progressivity. And, third, does the tax generate revenue efficiently?

Administrative Complexity

The 3% telephone excise tax is relatively easy to administer because a third party, telecommunications companies, collects the tax for the IRS. Enforcement is also relatively simple as service providers could stop providing service for nonpayment of taxes. Note, however, that collecting the telephone excise tax on behalf of the IRS does increase the complexity of tax compliance for telecommunications companies. The termination of the tax on long distance services could increase the complexity as telephone service providers will need to account separately for long distance and local services. Nevertheless, from the perspective of the federal government, the telephone excise tax is simple and almost costless to administer.

Equity Issues

Economists usually evaluate the equity of a tax in two directions, horizontal and vertical. Evaluating horizontal equity entails comparing the tax liability of similarly

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[13] Internal Revenue Service, Notice 2006-137, *IRS Announces Standard Amounts for Telephone Excise Tax Refunds*, Aug. 31, 2006.

[14] Stephen Joyce, "Five Class Actions Federal Cases Launched On Telephone Excise Taxes, Refund Method," BNA Daily Tax Report (July 14, 2006).

situated individuals. Evaluating vertical equity entails comparing the tax liability of tax units residing in different income levels. The degree of progressivity (or regressivity) of a tax is an often-used descriptor of vertical equity.

Horizontal equity. The telephone excise tax does not treat similarly situated individuals equally, thus deviating from the principle of horizontal equity. Two families of the same size and income level could pay significantly different federal taxes based on local telephone service charges. Horizontal equity in public finance means like individuals (or families), based on income or consumption, should encounter roughly the same tax liability. With the telephone excise tax, the family that pays more for local telephone services pays more federal taxes than the family with roughly the same total consumption or income. The recent Treasury announcement, ending the tax on long distance services, likely increased the horizontal equity of the tax as the variation in local telephone service costs do not vary as dramatically as long distance services.

Vertical equity. Assessing the vertical equity of the telephone excise tax requires examining the tax as it applies to two types of services: local telephone and long distance. Local telephone service is generally believed to be a normal good (a necessity) and long distance service more like a luxury.

A progressive tax regime is characterized by high income taxpayers paying a larger share of their income in taxes.[15] Typically, economists and political theorists posit that a vertically equitable tax regime is a progressive tax regime.[16] Excise taxes are almost always classified as regressive taxes, since they do not take into account the individual's ability to pay. The telephone excise tax on *local* telephone service, which does not vary by level of consumption or income, is a regressive tax. In contrast, the now eliminated telephone excise tax on *long distance* telephone service, a service which could be considered more akin to a luxury, was less regressive.[17]

The remaining telephone excise on only local telephone services is certainly a regressive tax. As noted above, a regressive tax is generally not considered vertically equitable.

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[15] Some economists use the term "equal sacrifice." Equal sacrifice relies on the tenet that the last dollar of income is worth less to a high-income taxpayer than to a low-income taxpayer.

[16] The *degree* of progressivity is not as well settled. For purposes here, it is assumed that even a mildly progressive tax regime would achieve vertical equity.

[17] Jerry Hausman, *Taxation by Telecommunications Regulation*, National Bureau of Economic Research, Working Paper no. 6260, Nov. 1997, p. 12. An income elasticity of greater than one means, for example, that a 1% increase in income generates a greater than 1% increase in demand for a good. Hausman states that "...the income elasticity of demand of long distance demand is about 1.0." This implies that long distance service could be a luxury good.

Efficiency

Economic theory and public finance experts posit that a tax should not change the consumption decisions of taxpayers. Changing the consumption patterns of taxpayers results in the skewed allocation of resources away from the taxed good to other goods. The loss in economic efficiency can sometimes exceed the revenue generated by the tax if consumption patterns change significantly.

On the other hand, optimal tax theory suggests that goods with very inelastic demand (i.e., demand that does not change much with a change in prices) should face relatively higher taxes. The logic behind this theory is that if individuals do not change behavior significantly in response to a price increase driven by taxes, then the change in behavior will be minimized. With a smaller change in behavior, the economic efficiency loss is minimized. Though compelling in theory, for equity and fairness reasons, applying optimal tax theory would seem misplaced for telecommunications services generally and local telephone services specifically.

Excise taxes are sometimes justified either to correct for a market failure or to discourage consumption of a good or service to ultimately benefit society. Economic efficiency is improved in both scenarios with some type of selective tax. The telephone excise tax, however, is unlike the other prominent selective excise taxes. For example, the gasoline excise tax is often identified as a tax designed to correct a market failure. In this case, the market failure is the inability of the competitive market system to fully account for the cost to society of burning fossil fuels. The gasoline excise tax, it is argued, helps correct this market failure through internalizing this cost and is therefore an efficiency improving tax.[18]

Excise taxes on tobacco and alcohol, on the other hand, are not correcting for an explicit market failure. Supporters of these so called "sin taxes" argue that the negative impact on society of alcohol and tobacco consumption merit taxing these goods to discourage their consumption.

Economic theory suggests that if an excise tax does not correct for some market failure or does not intend to achieve some societal goal, such as discouraging tobacco or alcohol consumption, then the tax almost certainly reduces overall economic efficiency. The telephone excise tax does not meet either criterion.[19]

Nevertheless, the remaining tax on local telephone services, which some view as a necessity and thus demand is very inelastic, is very efficient in that taxpayers cannot easily change behavior to avoid the tax.

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[18] In addition, the gas tax is sometimes viewed as a "user fee" for the use of federally financed roads. This is another argument for using a selective excise tax: it can be used as a benefit tax.

[19] For more, see U.S. Department of the Treasury, Office of Tax Analysis, *Report to Congress on Communications Services Not Subject to Federal Excise Tax*, Aug. 1987.

Telephone Excise Tax Revenue

Although the telephone excise tax generated $5.9 billion in revenue in FY2005 this revenue represents just 0.27% of total federal revenue. **Table 1** reports the revenue generated by the telephone, tobacco, and alcohol excise taxes since FY1998. These excise taxes individually represent a relatively small portion of total excise revenue collected. **Table 1** also reports the projected revenue generated by the taxes in FY2016 and the percentage of total federal revenue generated by the telephone excise tax.

The Congressional Budget Office (CBO) estimates that telephone excise tax revenue will comprise just 0.13% of total federal revenue in 2016, about half the percentage of today. This sharp relative decline reflects the CBO belief that the IRS will lose the revenue generated by excise tax on long distance toll service. This belief has been realized. The announcement that the refunds for taxes paid on long distance services will be approximately $13 billion implies that about 75% of the excise tax revenue over the last three years was from the tax on long distance services.

Table 1. Selected Excise Tax Revenue, 1998 to 2005, and 2016

($ in billions)

Year	Total Revenue	Excise Tax Receipts				
		Total	Telephone		Tobacco	Alcohol
			Amount	Percent of Total Revenue		
1998	1,722	59.2	4.7	0.27%	5.7	7.6
1999	1,828	72.1	5.2	0.28%	5.3	7.9
2000	2,026	70.6	5.6	0.28%	7.2	8.1
2001	1,991	68.2	5.7	0.29%	7.4	8.1
2002	1,853	69.2	5.8	0.31%	8.3	8.4
2003	1,783	69.5	5.8	0.33%	7.9	8.5
2004	1,880	71.8	5.8	0.31%	7.9	8.7
2005	2,154	73.0	5.9	0.27%	8.7	8.6
2016(p)	4,113	97.1	5.5	0.13%	7.9	11.2

Notes: (p) Indicates projected revenue.

Sources: Excise tax receipts for 1998 through 2004 are from the IRS. Total revenue through 2005 are from the Office of Management and Budget, *Economic Report of the President*, February 2006, Table B-78, p. 375. Data for 2016 and 2005 excise tax receipts are from the Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*, Table 4-8, p. 97.

Legislation in the 109th Congress

In the 109th Congress, S. 1321 and its companion, H.R. 1898, would repeal the telephone excise tax entirely.[20] The Senate legislation is sponsored by Senator Rick Santorum, and it has 17 cosponsors (as of September 7, 2006). On June 28, 2006, S. 1321 was approved by the Senate Finance Committee by voice vote. The House version is sponsored by Representative Gary Miller, and it has bipartisan support with 220 cosponsors (as of September 7, 2006). The Congressional Budget Office estimated in 2005 that eliminating the tax would cost $67 billion over the 2006 to 2015 budget window.[21] However, the CBO baseline includes the tax on long distance services which is no longer collected. The Joint Committee on Taxation estimated that repealing the remaining tax on local telephone services would cost just over $7 billion over the 2007 to 2016 budget window.[22] In the 110th Congress, S. 140 and S. 170 would repeal the remaining tax on local services. Supporters of the repeal legislation cite the efficiency losses associated with the tax as well as the regressive characteristics of the tax described earlier in this report.

Opponents of outright repeal cite the revenue loss of approximately $6 billion annually if the tax were completely repealed. Bolstering this argument is the size of the current budget deficit and the prospect for continued deficits well into the future. The budget issues become particularly more acute if proposals to make the recent tax cuts permanent become law.[23] The estimated revenue cost over the 2007 to 2016 budget window of making permanent (1) estate tax repeal ($357.9 billion), (2) the expanded 10% individual income tax bracket ($261.8 billion), and (3) the lower individual income tax rates ($384.8 billion) are cited by opponents of further tax cuts such as telephone excise tax repeal.[24] Opponents of repeal also note the administrative simplicity of the tax and its high compliance rate.

One intermediate option that would improve the economic efficiency of the tax would be to amend existing law so that all communications services are taxed at the same rate. Without credits or transfers to lower-income taxpayers, however, the tax would still fail the test of vertical equity. Horizontal equity would also suffer, as different consumption choices could change the burden of taxes across equally situated individuals.

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[20] Another bill, S. 758, would prohibit the extension of the federal telephone excise tax to Internet access services.

[21] Congressional Budget Office, Budget Options, February 2005, p. 333.

[22] Joint Committee on Taxation, *Estimated Revenue Effects of the Chairman's Mark of S. 1321, the "Telephone Excise Tax Repeal Act of 2005," and S. 832, the "Taxpayer Protection and Assistance Act of 2005," Scheduled for Markup by the Committee on Finance on June 28, 2006*, JCX-26-06, 109th Congress, June 26, 2006.

[23] See CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg A. Esenwein and Marc Labonte.

[24] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*, Jan. 2006, Table 4-10.

The repeal of the excise tax on toll services and wireless services has increased the regressivity of the telephone excise tax but marginally improved its economic efficiency. Economic efficiency has been improved because local services are, practically speaking, a necessity; and, as such, individuals would not change behavior in response to the tax (at least in the near term). Vertical equity suffers for the same reason efficiency is increased. Local services are typically levied at a fixed rate, thus lower-income taxpayers will encounter the same tax liability as high-income taxpayers. Horizontal equity maybe be marginally improved, as tax liability would not depend on consumption of long distance services, and charges for local services would not vary across taxpayers. How telecommunications companies respond to changes in the tax law will likely have a significant effect on the overall efficiency and equity of a retooled telephone excise tax regime.