

September 9, 2003

Mr. David A. Mador
Assistant Deputy Commissioner
Internal Revenue Service
Attn: CC: ITA: RU (REG-141097-02-Room 5226
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Excise Taxes; Communications Services, Distance Sensitivity (Proposed
Regulation 141097-02)
COMMENTS FOR THE RECORD

Dear Mr. Mador:

This letter supplements previous comments submitted by the Office of Advocacy in regard to the above referenced matter. It also is the basis for the Office of Advocacy's (Advocacy) statement at the hearing scheduled for September 10, 2003.

On April 1, 2003, the Internal Revenue Service (IRS) issued a notice of proposed rulemaking concerning the applicability of the communications excise tax on certain toll telephone calls.¹ The IRS determined that the Regulatory Flexibility Act (RFA)² was inapplicable to this proposed rule, and asserts it was not subject to notice and comment rulemaking, and it did not impose a new collection of information requirement on small businesses.³ Based on input from affected small entities, Advocacy disagrees with the IRS' determination, and we urge the IRS to perform an initial regulatory flexibility analysis of the rule's impacts in accordance with section 603 of the RFA.

The Office of Advocacy was established pursuant to Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. Advocacy is an independent office within the U.S. Small Business Administration (SBA), so the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The RFA, as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA), gives small entities a voice in the rulemaking process. The RFA requires Federal agencies, such as the IRS, to analyze the impact on small entities and consider alternatives to avoid overly burdensome regulation of small entities.⁴ Advocacy is required by section 612 of the RFA to monitor agency compliance with the RFA.⁵

¹ 58 Fed. Reg. 15,690 (Apr. 1, 2003).

² Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (1981) (codified as amended at 5 U.S.C. §§ 601-612).

³ 58 Fed. Reg. 15,690 (Apr. 1, 2003); at 15,691; see also 5 U.S.C. §603(a).

⁴ Pub. L. No. 96-354, 94 Stat. 1164 (1981) (codified as amended at 5 U.S.C. §§ 601-612).

⁵ 5 U.S.C. § 612.

On August 13, 2002, President George W. Bush signed Executive Order 13272, requiring Federal agencies to implement policies protecting small businesses when writing new rules and regulations.⁶ Executive Order 13272 instructs Advocacy to provide comment on draft rules to the agency that has proposed a rule, as well as to the Office of Information and Regulatory Affairs (OIRA) of the Office of Management and Budget.⁷ Executive Order 13272 also requires agencies to give every appropriate consideration to any comments provided by Advocacy. Under the Executive Order, the agency must include, in any explanation or discussion accompanying publication in the *Federal Register* of a final rule, the agency's response to any written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.⁸

Applicability of the Regulatory Flexibility Act

The RFA applies “whenever an agency is required by §553 of this title, or any other law, to publish general notice of proposed rulemaking....”⁹ If the IRS is required by the Administrative Procedure Act (APA) to conduct notice and comment rulemaking under section 553, it is our view that the IRS must prepare an initial regulatory flexibility analysis or certify, pursuant to section 605 of the RFA, that the rule will not have a significant economic impact on a substantial number of small entities. While the APA exempts certain IRS interpretative rules from notice and comment rulemaking, notice and comment is required for substantive, legislative rules. Advocacy believes the proposed rule constitutes substantive, legislative rulemaking that requires notice and comment.¹⁰

Current Law and Exemptions

Internal Revenue Code section 4251 imposes a federal excise tax of 3 percent on amounts paid for “communications services.”¹¹ The tax is currently included in each phone bill. After the bill is paid, the telephone company sends the tax to the IRS. Purchases of communications services can be a substantial cost for any business. Billing packages from service providers are widely varied and are an area for competition to attract business customers. In many cases, the method of phone service billing no longer matches the definition of a “toll telephone service” (one type of “communications service”) on which Congress imposed the tax in 1965.

Under the law, “communications services” subject to the excise tax include “toll telephone service,” which is defined as “(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...”¹² The proposed rule would affect this statutory definition by eliminating the distance calculation (the “distance” definition).

⁶ Exec. Order No. 13,272 § 1, 67 *Fed. Reg.* 53,461 (Aug. 13, 2002) (“E.O. 13272”).

⁷ E.O. 13272, at § 2(c), 67 *Fed. Reg.* at 53,461.

⁸ *Id.* at § 3(c), 67 *Fed. Reg.* at 53,461.

⁹ 5 U.S.C. §603(a).

¹⁰ For ease of reference, rules that require notice and comment rulemaking under 5 U.S.C. §553(b) are referred to as “legislative” rules.

¹¹ 26 U.S.C. §4251 et. seq. (All section numbers refer to the Internal Revenue Code unless specified.)

¹² 26 U.S.C. §4252(b)(1)(emphasis added.).

There is a second definition of toll telephone service (the “flat fee” definition) which reads:

(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 station in a specified area which is outside the local telephone system area in which the station provided with this service is located.¹³

Finally, certain categories of businesses are specifically exempt from the tax if they use the “flat fee” services described above. Section 4253(f) lists the industries (including news services, radio broadcasters, networks, common carriers, telephone or telegraph companies) that are exempt. These companies can file an exemption statement with their communications services provider and the tax will not appear on their bill.

Today, many of the new types of phone services and payment plans are based purely on time of use without any factor for distance. Thus, the statutory definitions do not cover as large a percentage of calls as they once did.

Amendment by Regulation

The IRS proposal adds section 49.4252-0(a) to the Code of Federal Regulations¹⁴ which cancels the statutory distance requirement: “for a communication 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 communication.”¹⁵ The language amounts to an amendment to the plain language of the statute. The new rule imposes a tax on certain “communications services” that are not specifically taxed under the statute (e.g. communications services that are not based on distance and sold to listed industries).

The IRS does not raise the legislative history behind section 4252 to support its proposal as a reinterpretation of the statute. The preamble to the IRS proposal instead focuses on the fact that the communications services marketplace has changed dramatically since 1965. While the market has changed, the statutory language has not. Absent amendment to the law or a clear expression of congressional intent, we believe that the IRS cannot ignore the plain language of the statute. Furthermore, the IRS’ proposal seems to conflict with congressional intent with regard to this section of the law. For example:

1. The distance requirement was specifically added to the definition by Congress. (see the Excise Tax Reduction Act of 1965);
2. Congress has often amended this subchapter (most recently in 1998) but did not change the distance requirement; and,

¹³ 26 U.S.C §4252(b)(2).

¹⁴ 26 C.F.R. Part 49.

¹⁵ 58 Fed. Reg. 15690 at 15692 (emphasis added.).

3. The IRS proposal removes an important distinction between the services described in section 4252 (b)(1) (distance) and (b)(2) (flat rate). Without the distance requirement, the application of the law to previously exempted groups is unclear. Both provisions could describe the same service, but those defined by the distance definition are always taxable while the flat rate definition can be exempt if used by an exempted group. The formerly exempted businesses could face audits and enforcement actions and higher taxes based on subjective judgments about their communications services agreements.

The IRS position on the status of these two provisions adds to the confusion. While the IRS proposes that section 4252(b)(1) must change to reflect the new marketplace, prior rulings on section 4252(b)(2) hold that the business must adhere to the letter of the language Congress used in 1965. The IRS issued Technical Advice Memoranda (TAM)¹⁶ recently explaining that bulk communications services purchased by listed (exempt) businesses must strictly follow the law or be disqualified from exemption. Taken together the proposed rule and these TAMs play both ends of the law against the taxpayer, resulting in maximum confusion (and perhaps maximum expense or tax exposure). One could just as plausibly assume that Congress intended to shield the listed industries from tax if they purchase any flat fee services and would have wanted to include new services that have developed over the last 40 years. In the absence of a statutory change amending the language of the law, the IRS is at best engaging in legislative rulemaking, and at worst amending the code by administrative rulemaking.

Changing the Plain Meaning of the Statute

In the preamble to the proposed rule, the IRS cites Revenue Ruling (Rev. Rul.) 79-404¹⁷ as authority for changing the meaning of the statute. Rev. Rul. 79-404 simply states the IRS' opinion that Ship-to-Shore radio call service which does not charge based on distance is subject to excise taxes if it connects to a toll call service for completion. The Rev. Rul. cites *United States v. American Trucking Associations*, 310 U.S. 534 (1940) and *Corn Products Refining Company vs. Commissioner*, 350 US 46 (1955) as judicial authority to overcome the general rule that the plain meaning of the language of the statute should be conclusive.¹⁸ Those cases allowed different judicial interpretations where the language of the statute made no sense or defeated the purpose of the statute. Other participants in this proceeding have provided arguments to distinguish those cases and assert that the IRS lacks the authority in this matter to change the statute by regulation. For the purposes of determining whether the RFA applies to the rule, however, we need only establish that the rule is more than interpretative. The IRS cites these cases to support the IRS' assertion that it can assume the authority to change the plain meaning of the statute in this proposal. In our view, the IRS is assuming the authority to change the meaning of the statute which makes this rulemaking legislative in nature. Therefore, this action is subject to the requirements of the APA¹⁹ and the RFA.

¹⁶ TAM 200227008 (7/5/02); and TAM 199923002 (6/14/99).

¹⁷ Rev. Rul. 79-404 (1979-2 C.B. 382).

¹⁸ See *Helvering v City Bank Farmers Trust Co.*, 296 U.S. 85, 89.

¹⁹ 5 U.S.C. §553(b).

Significant Economic Impact on a Substantial Number of Small Businesses

Under the RFA, the IRS must determine if the proposed rule may have a significant economic impact on a substantial number of small businesses. If the IRS can certify that the rule will not have such an effect, the Secretary may so certify and provide the factual basis on which that finding is made. If it appears that there may be such an impact or the agency cannot certify otherwise, then the Agency must perform an initial regulatory flexibility analysis to provide notice to the regulated community of the impact of the proposed rule.

Again, based on input from affected small entities, Advocacy is of the view that the proposed rule will have a significant economic impact on a substantial number of small entities. In today's market place, bulk services (calling cards, cell phones, dedicated lines) are used by millions of small entities. The industries listed in section 4253(f) are particularly reliant on such services. Advocacy solicited input on the rule's potential impact from associations and businesses representing the telephone industry, railroads, trucking and radio and television broadcasters. The vast majority of businesses in each of these industries are small entities. For example:

- 10,280 telecommunications firms out of 10,483 (98%) are small businesses;
- 98,676 trucking firms out of 101,953 (96.8%) are small businesses;
- 6,042 out of 6,172 newspaper publishers (98%) are small businesses; and
- 6,086 radio & television broadcasters out of 6,670 (91.2%) are small businesses.²⁰

Since the proposed rule eliminates the important "distance" requirement that distinguishes section 4252(b)(1) and section 4252(b)(2), flat fee services could be classified by the IRS under either section. The companies exempt from paying tax by section 4253(f) are concerned that the IRS will categorize their services under section 4252(b)(1) and apply the tax to their communications services. The uncertainty created by the proposed regulations would cause them to incur significant expense to seek professional advice and review and renegotiate their contracts in addition to any extra taxes they might pay. Small businesses that do not hear of the change run the risk of audits and penalties.

Another example of confusion caused by the proposed rule involves the use of 800 numbers for marketing by exempt companies. Under the existing rules, small businesses believe the enormous costs of those lines would fall under the definition in section 4252(b)(2) and be exempt from the excise tax under section 4253(f). With the change in the definition proposed by the IRS to eliminate distance in section 4252(b)(1), the line could be construed as falling under that section and therefore not exempt from the 3% tax. This additional confusion will

²⁰ Office of Advocacy, U.S. Small Business Administration, based on NAICS codes and data provided by the U.S. Census Bureau, Statistics of U.S. Business. The figures for trucking firms and broadcasters are conservative, and were calculated using lower sales revenues thresholds than required by the SBA size standards because of the detail of the available data.

cause a costly review of all such agreements for businesses or increased tax liability if the IRS determines they are subject to tax.

The scenarios for confusion described above should be clarified by the IRS and the impact of the change in each instance addressed in a regulatory flexibility analysis. In addition, the IRS should identify and analyze significant alternatives that are less burdensome, with the opportunity for small entities to comment on both the regulatory approach chosen by the IRS and the significant alternatives considered. The RFA requires the IRS to inform the affected entities of what the proposal will require in the way of compliance so that they can comment meaningfully. Due to the complexity of the issues involved and the current ambiguity regarding the IRS' intent, the IRS is in the best position to clarify the proposal and identify alternatives, with the help of small entity outreach.

Conclusion

Advocacy urges the IRS to bring this rulemaking into compliance with the RFA by performing a regulatory flexibility analysis and reviewing alternatives that would minimize the burden on small businesses.

Thank you for your consideration in this matter. For additional information or to discuss Advocacy's comments, please do not hesitate to contact me or Russell Orban, (202) 205-6533 or russell.orban@sba.gov, of my staff.

Sincerely,

Thomas M. Sullivan
Chief Counsel for Advocacy

Russell Orban
Assistant Chief Counsel for Tax

Cc: Dr. John D. Graham, Administrator; Office of Information and Regulatory Affairs
Office of Management and Budget