TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Telephone Excise Tax Refund Was Not Claimed on Business Tax Returns Primarily Because of the Perceived Work and Expense Involved to Do So

September 17, 2008

Reference Number: 2008-30-175

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 17, 2008

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Telephone Excise Tax Refund Was Not Claimed on Business Tax Returns Primarily Because of the Perceived Work and Expense Involved to Do So (Audit # 200830045)

This report presents the results of our review of business taxpayers who did not claim the Telephone Excise Tax Refund (TETR), although they appeared to qualify for it. The overall objective of this review was to determine why business taxpayers failed to claim the TETR on their Tax Year 2006 income tax returns. This review focused on business taxpayers filing a U.S. Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), or U.S. Return of Partnership Income (Form 1065). This audit was not included in our Fiscal Year 2008 Annual Audit Plan. It was initiated as a discretionary audit based on the results of our audits of the Internal Revenue Service's (IRS) administration of the TETR refunds for individual and business taxpayers.[1]

Impact on the Taxpayer

The IRS estimated that between 13.9 million and 15.9 million business taxpayers would be eligible to claim the TETR. Our prior report on the TETR business program concluded that 94.4 percent of business taxpayers filing for Tax Year 2006 did not claim any TETR, even though they most likely qualified for it. To help determine why so few businesses claimed the

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[1] *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded* (Reference Number 2007-30-178, dated September 26, 2007) and *The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed* (Reference Number 2008-30-091, date April 24, 2008).

TETR, we surveyed professional preparers of business tax returns.[2] This report provides information to the IRS regarding the effectiveness of its efforts to communicate the TETR program to a very broad audience of taxpayers for its use in improving similar efforts in the future.

Synopsis

The TETR was not claimed on business tax returns for a variety of reasons. Many of the preparers surveyed (35 percent) stated that their clients did not qualify for the TETR. Another 44 percent of the preparers did not claim the TETR because they believed that the amount of work and associated fees expended to compute the refund amount was ultimately not worth the refund that would be received. Still another 20 percent of the preparers either forgot to claim the TETR for their clients or were not aware that the refund was available to businesses.

Our survey also indicated that a surprisingly high percentage (27 percent) of the preparers who did not compute the TETR due to the cost involved were not aware that the IRS had offered a simplified (estimation) method of computing the amount. We provided specific details regarding the preparers' responses to our survey questions to IRS officials.

Response

We made no recommendations in this report. However, key IRS management officials reviewed it prior to issuance and agreed with the facts and conclusions presented.

Copies of this report are also being sent to IRS managers who are affected by the report issues. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.

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[2] See Appendix IV for our survey narrative and questions.

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Abbreviations

IRS	Internal Revenue Service
TY	Tax Year
TETR	Telephone Excise Tax Refund

Background

The telephone excise tax was first imposed in 1898 to fund the Spanish-American War. Originally, the tax applied to all telephone use. Later, it was revised to apply to long-distance calls on which call duration and distance were factored into the price. However, many telecommunications companies made changes to their billing models, factoring only call duration and not distance into their billing prices. As a result, these charges no longer met the requirements of the tax code and should not have been subject to tax.[1]

Several businesses litigated the taxability of these portions of the telephone excise tax and, after five circuit court losses, the Department of the Treasury announced on May 25, 2006, that it was conceding the legal dispute over the tax and that the Department of Justice would no longer pursue litigation. The Internal Revenue Service (IRS) also announced its decision to stop collecting the tax. The IRS then implemented a major program for both individual and business taxpayers to receive refunds for the portion of their telephone excise taxes paid on long-distance or bundled telephone service billed after February 28, 2003, and before August 1, 2006, that did not meet the statutory taxability requirements.

At that time, the Telephone Excise Tax Refund (TETR) was the most wide-reaching tax refund in the history of the IRS, which estimated that it would affect between 145 million and 165 million individual taxpayers and between 13.9 million and 15.9 million business taxpayers.[2] The IRS developed a process to refund these monies in a timely manner and made the request process relatively easy for most taxpayers. At the same time, the IRS wanted to minimize the number of refunds in excess of taxes collected and discourage requests for overstated refunds.

We recently reported on the IRS' efforts to administer the refund program for individual and business taxpayers in two separate reports.[3] Our report on the business program concluded that 94.4 percent of business taxpayers did not claim any TETR–even though they most likely qualified for it–and that only a small portion of the tax collected from them will ever be refunded. The IRS made significant efforts to advise business taxpayers of the TETR program

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[1] Five circuit court cases held that a telephonic communication for which there is a toll charge that varies with elapsed transmission time and not distance (time-only service) is not taxable toll telephone service as defined in Internal Revenue Code Section 4252(b)(1).

[2] This estimate includes corporations, S corporations, partnerships, non-profit filers, Government entities, and businesses no longer in operation. Estates and trusts were not included in the estimate.

[3] *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded* (Reference Number 2007-30-178, dated September 26, 2007) and *The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed* (Reference Number 2008-30-091, date April 24, 2008).

and to simplify the claim process. However, a low percentage of taxpayers claimed the TETR, and a low percentage of the overall amount of tax collected was refunded.

To request the TETR, businesses were required to complete a Credit for Federal Telephone Excise Tax Paid (Form 8913) and file it with their tax returns. They were to complete Form 8913 by using the actual amount of refundable long-distance telephone excise taxes that they had paid between March 2003 and July 2006 (41 months) or by using an estimation method developed by the IRS.

The estimation method was designed by the IRS to simplify the refund calculation and to reduce the burden on taxpayers by helping them avoid having to recover their old telephone records. The estimation method required businesses to compare only two telephone bills from Tax Year (TY) 2006 (April and September) to determine the percentage of their telephone expenses attributable to the excise tax on long-distance service. They had to first calculate the telephone tax as a percentage of their April 2006 bill (which included the excise tax for both local and long-distance telephone service) and of their September 2006 telephone bill (which included only the tax on local telephone service). The difference between these percentages was to be multiplied by the total telephone expenses for the 41-month period. The refund was capped at 2 percent of telephone expenses for businesses with 250 or fewer employees and 1 percent for businesses with more than 250 employees.

During the closing conference of our prior audit to evaluate the TETR program for businesses, we discussed with IRS management the possibility of taking a survey to determine why such a large number of business taxpayers failed to claim the TETR. We and IRS management agreed that the results of such a survey could be beneficial to the IRS. Because we had received approval from the Office of Management and Budget to contact taxpayers for this purpose, we agreed to perform this survey.[4]

Our work was performed from the IRS Campus[5] in Ogden, Utah, during the period February through May 2008 and consisted of a survey of professional tax preparers who had completed business tax returns. Our review included a survey of preparers of returns filed and processed nationwide. We did not assess internal controls because doing so was not applicable within the context of our objective. We believe that the evidence we obtained provides a reasonable basis for our findings and conclusions based on our objective. Detailed information on our objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[4] Appendix IV contains the narrative and questions used during our survey. We provided specific details regarding preparers' responses to our survey questions to IRS officials.

[5] Campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Results of Review

The Telephone Excise Tax Refund Was Not Claimed on Business Tax Returns for a Variety of Reasons

We identified 5.3 million business tax returns [a U.S. Corporation Income Tax Return (Form 1120), a U.S. Income Tax Return for an S Corporation (Form 1120S), or a U.S. Return of Partnership Income (Form 1065)] that did not claim the TETR for TY 2006 and did include a designee telephone number.[6] We selected a statistically valid sample of 163 of these returns and made contact with the professional tax return preparers responsible for preparing them. We asked the preparers a series of questions that included why the TETR was not claimed, whether they were aware of the IRS' estimation method, and how they obtain tax information (see Appendix IV).

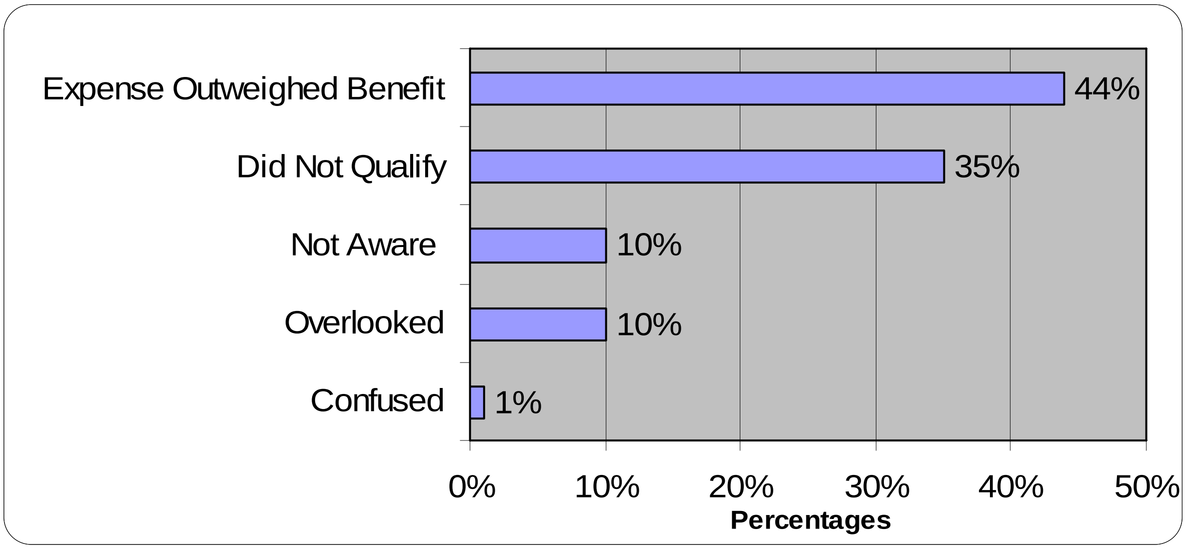
Primarily, the TETR was not claimed on business tax returns because the preparers believed that the amount of work and associated fees expended to compute the refund would not be worth the refund received.

We spoke directly to 163 professional tax return preparers. However, we did not receive specific responses from all 163 preparers on each question for various reasons. Some responders 1) concluded the survey midway because of time constraints or 2) chose not to provide answers to some of the questions. For others, some questions were not applicable based on their response to a prior question. For example, if a preparer did not claim the TETR because the business did not qualify for it, we did not ask the preparer if he or she would amend the business' tax return to claim the TETR. Therefore, throughout this report, our sample sizes change to reflect the numbers of preparers answering the questions.

Figure 1 provides an overview of why the TETR was not claimed on business tax returns. Each reason is discussed in more detail in this report. We provided a complete list of all preparers' responses to the IRS in a separate document.

[6] The 5.3 million business tax returns did not include taxpayers with other than a fiscal year ending December 31, 2006.

Figure 1: Overview – Why the TETR Was Not Claimed



Source: Our survey of professional preparers of business tax returns to determine why many businesses did not claim the TETR.

Some taxpayers simply did not qualify for the TETR

Preparers of 56 (35 percent) of 162 business returns in our sample indicated that their clients did not qualify for the TETR, mainly because they had no telephone and/or long-distance service. Of the 56 preparers who believed that their clients did not qualify, 35 indicated that their clients had no telephone and/or long-distance service. Others stated that their clients had claimed the TETR on another tax return (individual return or the parent corporation return).

Many preparers did not claim the TETR for their clients because they believed that the cost to compute it outweighed the benefit

The largest portion of businesses taxpayers–44 percent (71 of 162)–did not receive the TETR because preparers believed that the cost was higher than the benefit. That is, the perceived amount of work and associated fees that would have been expended to compute the refund amount were ultimately not worth the refund that would be received.

The significance of these numbers increases if the businesses that did not qualify for the TETR are eliminated from the sample. Considering only those business taxpayers that most likely qualified for the TETR, the percentage of those not claiming it due to the cost to compute it increases. Our survey showed that preparers for 67 percent (71 of 106) of the businesses that most likely qualified for the refund did not claim it because of the work and expense involved.

Many of the tax preparers were unaware of the estimation method. The IRS designed its estimation method in an attempt to simplify the refund calculation and to reduce the burden on business taxpayers by helping them avoid having to recover their old telephone records. Overall, the survey indicated that 30 percent (49 of 161) of the preparers responding were not aware of the estimation method. This percentage includes those who were not aware that the TETR was available for businesses (discussed later in this report).

More important, however, is the fact that 27 percent of those who believed that the amount of work and associated fees outweighed the amount of refund their clients would receive were unaware that the estimation method was available. Of the 71 preparers who did not claim the TETR because of the related cost, 19 were unaware of the estimation method.

Some preparers were not aware of the TETR

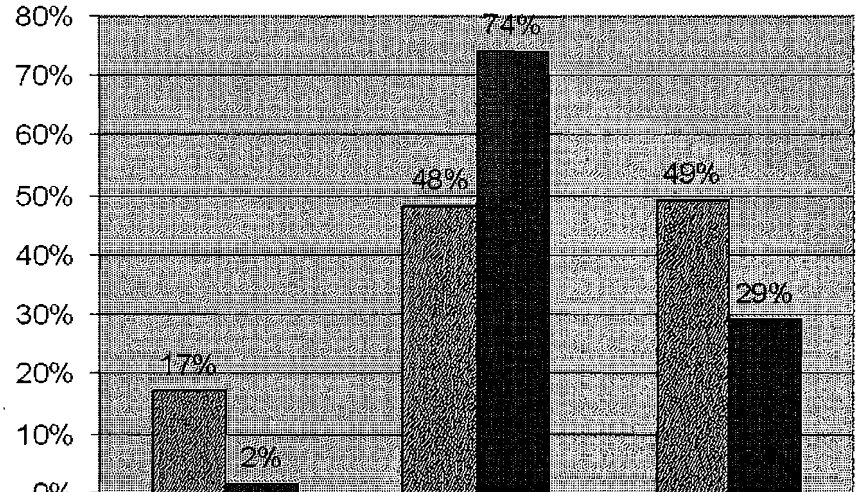
Our survey revealed that more than 10 percent (17 of 162) of the preparers were not aware that the TETR was available to businesses. To further develop this issue, we tried to gather data on the relative sizes of the preparer firms that were not aware of the TETR as well as the sources of information they used to obtain information needed to prepare tax returns.

Small tax return preparation firms appeared less likely to have a clear understanding of the TETR program. Our survey indicated the possibility that the smaller the firm, the less likely preparers might be aware of tax law changes or new tax programs. As mentioned above, 17 of 162 preparers were not aware that the TETR was available for businesses. Fifteen (88 percent) of the 17 preparers worked for a firm with 5 or fewer tax professionals.

Overall, 59 percent (90 of 152) of those preparers who would disclose the size of their firm were practicing in an office with 5 or fewer professionals. Considering this situation, 17 percent (15 of 90) of those working in the small firms were not aware that businesses could claim the TETR. By contrast, only 1 (1.6 percent) of the 62 preparers from the large firms (those with more than 5 professionals) who would disclose the size of the firm was unaware of the TETR.

At the same time, we found a correlation between the size of the firm and how it obtains information needed to prepare tax returns. Commercial tax research services and the IRS web site (IRS.gov) were the most common means for tax preparers to obtain tax information. As shown in Figure 2, 74 percent (46 of 62) of the preparers from the large firms subscribed to and used commercial tax research services, while 48 percent (43 of 90) of the preparers from small firms subscribed to such services. Preparers from the small firms tended to rely more heavily on information located at IRS.gov. Our survey showed that 49 percent (44 of 90) of the preparers from small firms relied on the IRS web site for their tax information, while only 29 percent (18 of 62) of the preparers from the large firms used it for tax research.

Figure 2: A Comparison of Small and Large Firms



	Not Aware of the TETR for Businesses	Relied on Commercial Research Services	Relied on IRS.Gov
Small Firms (<6 professionals)	17%	48%	49%
Large Firms (>5 professionals)	2%	74%	29%

Source: Our survey of professional preparers of business tax returns to determine why many businesses did not claim the TETR.

Some preparers forgot to claim the TETR for their clients, and a small number were confused as to how to claim it in their situation

Our survey revealed that 10 percent (16 of 162) of the preparers were aware of the TETR and believed that their clients qualified for the refund. However, they overlooked the refund when filing their client's tax return.

We found two other preparers did not claim the TETR for their clients because they were confused as to how to claim it in a "flowthrough" situation. [redacted]

Additional Survey Results

Most preparers had no plans to file amended returns to claim the TETR

The IRS does not allow the TETR to be claimed on TY 2007 tax returns but will allow a taxpayer to file an amended return for TY 2006. As expected, most preparers who knew about the estimation method, but still considered that the cost to claim the TETR outweighed the benefit, were not planning to file amended returns. In addition, we found that most of the other applicable preparers responding to our survey were not planning to amend their clients' returns to claim the TETR.

Figure 3 presents details of the preparers' responses to our question regarding amending their clients' tax returns.

Figure 3: Plans to File Amended Tax Returns to Claim the TETR

Reason for Not Claiming the TETR	Number of Preparers	No Plans to Amend	Would Amend	Would Consider Amending	No Response
Cost Outweighed the Benefit (**preparer not aware of the estimation method**)	19	13	1	2	3
Not Aware of the TETR	17	9	1	4	3
Overlooked the TETR	16	7	2	4	3
Confused About Claiming the TETR for a Business	2	1	0	1	0
Totals	**54**	**30**	**4**	**11**	**9**

Source: Our survey of professional preparers of business tax returns to determine why many businesses did not claim the TETR.

Preparers would have preferred a standard TETR amount for businesses, similar to that provided to/for individual taxpayers

Rather than use of an estimation method, the IRS allowed individual taxpayers to claim a standard amount based on the number of exemptions claimed on their individual returns (see Figure 4). No records were needed to support the individual taxpayers' requests, and individuals did not have to assemble 41 months of telephone bills to determine their TETR amount. Requesting a standard amount required the completion of only one additional line on the U.S. Individual Income Tax Return (Form 1040).

Figure 4: TETR Standard Amounts for Individuals

Exemptions	Standard Amount
1	$30
2	$40
3	$50
4 or more	$60

Source: 2006 Form 1040 Instructions (page 60).

During the planning stages for our survey, IRS management suggested that we ask the contacted preparers the following question: "if a standard amount had been offered for business taxpayers, would you have claimed it even if it was less than what you considered to be the actual amount of TETR owed to your clients?" We included such a question in our survey and found that almost all of the preparers responding (130 of 138) would have taken advantage of a standard TETR amount for their business taxpayers if the IRS had provided one.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine why business taxpayers failed to claim the TETR on their TY 2006 returns. This review focused on business taxpayers filing a U.S. Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), or U.S. Return of Partnership Income (Form 1065). To accomplish the objective, we:

I. Identified business taxpayers who had not claimed the TETR on their TY 2006 returns.

   A. Performed queries of the IRS Business Return Transaction File[1] using the Treasury Inspector General for Tax Administration Data Center Warehouse[2] to identify taxpayer accounts on which the TETR was not claimed (included businesses filing Forms 1120, 1120S, or 1065). We selected a statistically valid sample of 163 returns from a population of 5,324,957 business returns that had not claimed the TETR and did include a designee telephone number. We selected the sample using a 90 percent confidence level, 50 percent expected error rate, and ±6.5 percent precision.

   B. Validated, verified, and assessed the reliability of computer-processed data by matching 20 records meeting the sample criteria against data contained on IRS databases to ensure that the computer selection criteria were accurate.

II. Contacted business tax return preparers identified in the sample selected and determined why they had not claimed the TETR.

   A. Obtained authorization from Office of Management and Budget to contact preparers.

   B. Developed a written discussion narrative with specific questions that could be used to obtain the required information from preparers.

   C. Using the discussion narrative, contacted preparers identified in Step I.A. and obtained specific information.

III. Summarized and evaluated information obtained from business tax return preparers contacted to determine why they had not claimed the TETR.

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[1] The Business Return Transaction File contains data transcribed from the initial input of the original business tax returns during return processing. Subsequent or amended return data are not contained in this File.

[2] The Data Center Warehouse is a collection of IRS databases containing various types of taxpayer account information that is maintained by the Treasury Inspector General for Tax Administration to analyze data for ongoing audits.

A. Summarized the information obtained from the preparers. For each reason or explanation given, we determined the overall number of preparers who provided that reason and determined the percentage of the whole.

B. Evaluated whether the IRS' efforts to inform taxpayers about the TETR were effective. We also determined whether additional methods of communicating tax information to taxpayers are available to the IRS and whether those methods could be beneficial to the IRS in the future.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Survey Narrative and Questions

1. *Hello, I'm calling from the Treasury Inspector General for Tax Administration, a Federal agency that has oversight of the Internal Revenue Service. We are currently conducting a survey to help assess the IRS' ability to effectively communicate important tax issues to taxpayers and preparers. Do you have a few minutes to speak with me?*

2. *This is not a review of your client's tax return. The information you provide will be compiled, and your client's identity will not be disclosed.*

   The time required for this telephone call will vary depending on your responses. However, it should not take longer than 5 minutes. Your response is voluntary and will remain completely confidential. There are no penalties for not replying. We are prohibited by law from providing information concerning your client's tax account to third parties without his or her permission. We are contacting you, in part, because your client might not have received the full tax benefit or refund that it was entitled to.

3. *We selected a sample of tax returns filed for Tax Year 2006 that did not claim the Telephone Excise Tax Refund. This refund is available to almost all businesses that use long-distance telephone service. IRS records show that your client's company did not claim this refund on its Tax Year 2006 return. In regard to this, would you mind if I ask you a few questions?*

   Q1: *Which of the following reasons best describe(s) why you (or the company you prepared the taxes for) did not claim the refund?*

   A. You were not aware of it.
   B. You were aware of it but forgot to claim it.
   C. You were aware of it but believed that you did not qualify for it (A-C, assess whether the taxpayer qualified[1] then skip to ***Q3***).
   D. The prior records were not available.
   E. The prior records were available, but the amount of work and associated fees outweighed the amount of refund you would receive.

[1] In general, any taxpayer (individual or business) who paid the telephone excise tax as part of its long-distance or bundled service during the refund period (after February 28, 2003, and before August 1, 2006) is eligible to request the refund on its Tax Year 2006 Federal income tax return. This includes individuals, businesses, and non-profit or tax-exempt organizations. Taxpayers can base their refund requests on the actual amount of tax paid. To do this, a taxpayer must fill out a Credit for Federal Telephone Excise Tax Paid (Form 8913) and attach the Form to the regular Tax Year 2006 income tax return. However, many taxpayers do not want to look through up to 41 months of old telephone bills or lack records they need to calculate the actual amount of tax paid. For that reason, the Federal Government developed an estimation method to calculate the TETR.

F. (If other, have them explain).
G. No telephone service or long-distance service.

Q2: *Were you aware that there is a relatively simple method available for estimating the refund amount?*[2] *(Y/N)*

Q3: *Which of the following do you normally use to obtain the tax information needed to prepare the return?*

A. Tax forms and instructions.
B. IRS publications (how are they obtained?).
C. IRS outreach programs.
D. IRS.gov.
E. Internet – other tax-related sites.
F. Commercial tax research software (RIA, CCH, BNA) or tax service.
G. Other.

Q4: *Which of the following methods would be the best way that the IRS could inform you of a new tax law change?*

A. Tax forms and instructions ("WHAT'S NEW").
B. IRS publications.
C. IRS outreach programs.
D. IRS.gov.
E. Internet – other tax-related sites.
F. Television.
G. Radio.
H. Newspapers.
I. IRS email.
J. Mail.
K. Other.

Q5: *Are you aware that you can still claim the TETR by filing an amended return? (Y/N)*

Q6: *Will you amend the return to receive this refund? (Y/N)*

Q7: *If the IRS had offered a standard amount, would you have claimed it, or do you believe that it would have benefited your client? (Y/N)*

[2] The estimation method requires businesses to compare only two telephone bills from Tax Year 2006 (April and September) to determine the percentage of their telephone expenses attributable to the excise tax on long-distance service. They must first figure the telephone tax as a percentage of their April 2006 bill (which included the excise tax for both local and long-distance service) and of their September 2006 telephone bill (which included only the tax on local service). The difference between these two percentages should then be multiplied by the total telephone expenses for the 41-month period. The refund is capped at 2 percent of telephone expenses for businesses with 250 or fewer employees and 1 percent for businesses with more than 250 employees.

Q8: *How many accounting professionals work for your firm?*

Q9: *How many business returns did you prepare last year (estimate) and what percentage claimed the TETR?*