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memorandum

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subject: Accrual of Telephone Excise Tax Refund Income

This advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

When should a business entity that uses an accrual method of accounting report income from a telephone excise tax refund?

CONCLUSION

Such a business entity should report income from a telephone excise tax refund when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. In accordance with section 5(f) of Notice 2006-50, a business entity should report income on the date the return making the request is filed if it makes a properly substantiated request for refund of the actual amount on an original 2006 return. Otherwise, a business entity generally should report income from a telephone excise tax refund when it receives payment or notice that the request for refund has been approved, whichever is earlier.

BACKGROUND

In Notice 2006-50, 2006-1 C.B. 1141, amplified, clarified, and modified by Notice 2007-11, 2007-1 C.B. 405, the Internal Revenue Service announced that it will follow the holdings of Am. Bankers Ins. Group v. United States, 408 F.3d 1328 (11th Cir. 2005); OfficeMax, Inc. v. United States, 428 F.3d 583 (6th Cir. 2005); Nat'l R.R. Passenger Corp. v. United States, 431 F.3d 374 (D.C. Cir. 2005); Fortis, Inc. v. United States, 447 F.3d 190 (2d Cir. 2006); and Reese Bros. v. United States, 447 F.3d 229 (3d Cir. 2006). These cases hold 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 § 4252(b)(1) of the Internal Revenue Code. Accordingly, taxpayers were no longer required to pay tax under § 4251 for nontaxable service, which the notice defines as bundled service and long distance service. In addition, Notice 2006-50 notified taxpayers that they could request a refund of tax paid under § 4251 on nontaxable service that was billed to them during the period after February 28, 2003, and before August 1, 2006. Any taxpayer request for refund of tax on nontaxable service that was billed after July 31, 2006, would be denied by the IRS because any such request should be directed to the collector.

Section 5(a)(1) of Notice 2006-50 provides that the IRS agrees to credit or refund the amounts paid for nontaxable service if the taxpayer requests the credit or refund in the manner prescribed in the notice. Section 5(a)(2) provides that taxpayers may request a credit or refund of tax on nontaxable service that was billed after February 28, 2003, and before August 1, 2006, only on their 2006 federal income tax returns. Section 5(a)(3) provides that the instructions to the applicable federal income tax return forms will provide additional guidance. The forms and instructions will require taxpayers to certify that (1) the taxpayer has not received from the collector a credit or refund of the tax paid on nontaxable service billed during the relevant period and (2) the taxpayer will not ask the collector for a credit or refund of that tax and has withdrawn any such request that was previously submitted. The instructions will also require that taxpayers, except for those individuals using the safe harbor amount, retain records that substantiate the request.[1] These records should include bills from the collector that show the amount of tax charged for nontaxable service for each month during the relevant period and receipts, canceled checks, or other evidence that the amount requested was actually paid. Section 5(d)(2) provides that taxpayers other than individual taxpayers may request only the actual amount of tax paid on nontaxable service billed during the relevant period; no safe harbor amount is allowed for entities.

Section 5(d)(3) of Notice 2006-50 provides that any part of the credit or refund attributable to tax payments that were deducted as an ordinary and necessary business expense (including in the determination of unrelated business taxable income) must be included in income for the taxable year in which the refund is received or accrued to the

[1] Section 5(c)(1)(i) provides that no documentation will be required to be submitted or kept to support the safe harbor request. It also provides that the amount of this safe harbor is still under consideration and will be announced in later guidance.

extent that the tax payments reduced the amount of federal income tax (or unrelated business income tax) imposed.

Section 5(e) of Notice 2006-50 provides the following:

> Interest on the credit or refund included in income. If a taxpayer requests a credit or refund of the actual amount of tax paid, interest on the credit or refund of the tax paid for nontaxable service must be included as income on the taxpayer's income tax return for the taxable year in which the interest is received or accrued. Thus, individuals are generally required to report the interest on their 2007 income tax returns.

Section 5(f) of Notice 2006-50 provides the following:

> Estimated tax effects. Although the credit or refund allowed to a taxpayer under this notice will be requested on the taxpayer's income tax return, it is not a credit against tax for purposes of §§ 6654 and 6655. Accordingly, the taxpayer may not take the credit or refund into account in determining the amount of the required installments of estimated tax for 2006. In determining the amount of the required installments of estimated tax for 2007, the income attributable to the credit or refund is taken into account on the date the income is paid or credited in the case of a cash method taxpayer and on the date the return making the request is filed in the case of an accrual method taxpayer.

Section 12 of Notice 2007-11 provides rules for the Business and Nonprofit Estimation Method that eligible entities may use to determine the amount of their credit or refund for nontaxable service. Eligible entities may, but are not required to, use that method instead of the actual amount of federal communications excise tax they paid on nontaxable service to calculate the amount of their credit or refund.

Taxpayers who did not use the safe harbor amount were required to file Form 8913, Credit for Federal Telephone Excise Tax Paid, with their income tax return for the tax year that includes December 31, 2006. The Instructions for Form 8913 state that there are two methods to calculate the credit or refund on Form 8913. One method is the actual amount, which requires information from the phone bills for the 41-month refund period. The other method, for eligible entities, is the Business and Nonprofit Estimation Method.

The Instructions for Form 8913 provide the following:

> You must report as interest income in the year received or accrued the part of your credit or refund attributable to interest, from line 15, column (e). If you deducted any telephone excise tax paid, you also must include in gross income in the year received or accrued the smaller of the amount deducted or the rest of

your credit or refund, from line 15, column (d), except to the extent the deduction did not reduce federal income tax.

Announcement 2012-16, 2012-18 I.R.B. 876, states that taxpayers have until July 27, 2012, to request refunds of the telephone excise tax. It also states that the IRS will not process refund requests submitted after July 27, 2012.

There has been litigation challenging the validity of Notice 2006-50, and a district court recently addressed this matter in In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, Misc. Action No. 07-014 (RMU) (D.D.C. Apr. 10, 2012), 2012 WL 1179063, 2012 U.S. Dist. LEXIS 49716. In that opinion, the court held that the government violated the procedural requirements of the Administrative Procedure Act and that the appropriate remedy was to prospectively vacate Notice 2006-50 and remand the matter to the IRS.

ANALYSIS

Section 451(a) of the Code provides the general rule that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides, in part, that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer, unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. See also Kollsman Instrument Corp. v. Commissioner, T.C. Memo 1986-66, aff'd, 870 F.2d 89 (2d Cir. 1989).

If a requirement that documentation be submitted is ministerial, the requirement does not affect the determination of whether all events that fix the right to receive income (or that establish the fact of liability) have occurred. See Rev. Rul. 2003-3, 2003-1 C.B. 252, and the cases cited therein. Rev. Rul. 2003-3 holds that an accrual method taxpayer should include the amount allowed as a state income or franchise tax refund when the taxpayer receives payment or notice that the refund claim has been approved, whichever is earlier. The revenue ruling states that approval by state authorities of state income and franchise tax refund claims is not ministerial but involves substantive review. Cf. Rev. Rul. 62-160, 1962-2 C.B. 139 (accrual method taxpayer should accrue interest on a credit or refund of federal tax as of the date the right to receive the credit or refund is determined).

As described above, section 5(f) of Notice 2006-50 provides that, in determining the amount of the required installments of estimated tax for 2007, the income attributable to the credit or refund is taken into account on the date the return making the request is filed in the case of an accrual method taxpayer. Section 5(f) effectively treats the IRS approval of a request for refund made on an original 2006 return as a ministerial act if the request was properly substantiated and was for the actual amount of telephone excise tax charged and paid for the 41-month refund period.

It appears to us that the determination in section 5(f) of Notice 2006-50 is limited to the particular factual situation described in the notice, prior to its amplification, clarification, and modification by Notice 2007-11. As contemplated in Notice 2006-50, entities, on the original 2006 return, would be making claims for the actual amount of tax on nontaxable service. Notice 2006-50 states that these taxpayers will be required to retain records that substantiate the request, and these records should include phone bills that show the amount of tax charged for nontaxable service for each month during the relevant period as well as evidence that the amount charged was actually paid. There was no indication in the notice that the term "actual amount" meant anything other than the exact amount shown on the records that substantiate the request. In other words, there was no indication that the actual amount could be established through any other means, such as by statistical sampling. See Cohen v. United States, 650 F.3d 717, 720 n.3 (D.C. Cir. 2011) ("Entities could use the 'Business and Nonprofit Estimation Method' formula to calculate their refund, or gather all their phone records during the refund period instead."); cf. section 2 of Rev. Proc. 2011-42, 2011-2 C.B. 318 (describes various published guidance permitting the use of statistical sampling).[2] Notice 2006-50 effectively assumed that in these circumstances approval of the request for refund would generally be ministerial. This assumption would not apply outside the specific context addressed in that notice.

Accordingly, consistent with section 5(f) of Notice 2006-50, a business entity that uses an accrual method of accounting should report income on the date the return making the request is filed if it makes a properly substantiated request for refund of the actual amount on an original 2006 return. Otherwise, a business entity that uses an accrual method of accounting generally should report income from a telephone excise tax refund when it receives payment or notice that the request for refund has been approved, whichever is earlier. See Rev. Rul. 2003-3.

Please call (202) 622-4950 if you have any questions.

[2] After Notice 2006-50 was issued, the IRS made a business decision to allow, in appropriate circumstances, the use of statistical sampling to prove a claim for the actual amount of tax on nontaxable service.