No. 13-1269

IN THE
Supreme Court of the United States

WORLDCOM, INC.,
Petitioner,
v.

INTERNAL REVENUE SERVICE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONER

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CORPORATE DISCLOSURE STATEMENT

Petitioner WorldCom, Inc.'s Rule 29.6 Statement was set forth at p. ii of the petition for a writ of certiorari, and there are no amendments to that Statement.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

ADMINISTRATIVE MATERIALS

OTHER MATERIALS

The IRS does not dispute that the decision below is the first — in the nearly 50 years since Congress last substantively amended § 4252 — to apply the excise tax on local telephone service to a data-only service. As *amici* representing both sellers and purchasers of data services, as well as businesses that depend on customers' access to data services, explain, that decision threatens enormous damage to a key segment of the Nation's economy. While the service at issue here is no longer in wide use, the IRS could apply the logic of the Second Circuit's opinion to a wide array of modern data services, which local telephone companies create using components that, when part of different services, could carry local voice calls. Although the IRS downplays those consequences, it offers no assurances that data services in widespread use today remain safe from the excise tax.

The IRS's effort to deny the clear conflict between the Second Circuit's decision and the earlier Federal Circuit decision (and, indeed, the IRS's own position before the Federal Circuit and in its prior rulings) is unavailing. The Federal Circuit's conclusion that a service used for data transmissions can be taxed as local telephone service only if that service could be used instead to complete telephone calls (which the IRS concedes is not the case here) squarely conflicts with the Second Circuit's conclusion that taxability turns instead on the equipment the telephone company uses to create the finished service.

The IRS encourages the Court to leave these concerns for another day. But that ignores the substantial costs of uncertainty, well established by *amici*, that the Second Circuit's decision has created in an area of fundamental importance to the Nation.

This Court's review is urgently needed.

ARGUMENT

A half century ago, Congress restricted the excise tax on "local telephone service" to services that, among other things, provide the purchaser with "the privilege of telephonic quality communication." 26 U.S.C. § 4252(a)(1).[1] In a series of rulings stretching back to 1979, the IRS consistently found that a local service, to be taxable, must offer a purchaser the right to "plug[] in a regular telephone set, if it so chooses," and complete a telephone call. Rev. Rul. 79-245, 1979-2 C.B. 380, 1979 WL 51191, at *2 (Jan. 1, 1979); *see* Pet. 8-9 (collecting rulings); Chamber *Amicus* Br. 7-8 (same).[2]

The Federal Circuit took the same view. In *USA Choice Internet Services, LLC v. United States*, 522 F.3d 1332 (Fed. Cir. 2008), it ruled that a service used to transmit only data is taxable as "local

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[1] The purchaser must also have "access to a local telephone system" and the ability to communicate with "substantially all persons" connected to that system. 26 U.S.C. § 4252(a)(1). Although petitioner disputes the Second Circuit's conclusion that COBRA service satisfied these additional requirements, *see*, *e.g.*, Pet. 13 & n.15, what makes this case worthy of this Court's review is the lower court's vast expansion of the term "telephonic quality" to include data-only services.

[2] The IRS contends (at 18 n.3) that the Court should ignore its private letter rulings ("PLRs") applying that same statutory interpretation. But when acting through PLRs, the IRS "cannot tax one and not tax another without some rational basis for the difference." *United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring in the result). Although not binding precedent, such rulings are therefore used by taxpayers to "predict[] how the [IRS] will view a particular issue." 13 *Mertens Law of Federal Income Taxation* § 47:154 (West 2014). The IRS encourages such reliance. *See Internal Revenue Manual* § 4.10.7.2.10(3) (Jan. 1, 2006) (PLRs "provide insight [into] the [IRS]'s position on the law and serve as a guide").

telephone service" if, and only if, the service *as purchased* could instead have been used to complete local telephone calls. *See id.* at 1341. Before the Federal Circuit, the IRS advocated for exactly that interpretation, arguing that the service was taxable because the taxpayer could "use the services in suit for voice, rather than modem, communication simply by" plugging in different equipment. Br. for Appellant at 47, *USA Choice*, *supra*, No. 2007-5077 (Fed. Cir. filed June 13, 2007), 2007 WL 1997157.

Here, the IRS abruptly reversed course and applied the tax to a service that WorldCom undisputedly could not use to complete a telephone call. As the *amici* confirm, the Second Circuit's erroneous acceptance of that unprecedented position has ramifications that go far beyond the particular data service at issue.

I. THE DECISION BELOW CREATES A SIGNIFICANT CIRCUIT CONFLICT

The Second Circuit's decision creates a circuit split with the Federal Circuit about the applicability of the telephone excise tax to data services that cannot be used to make or receive ordinary telephone calls. Such conflicts warrant this Court's intervention because they give taxpayers reason to forum-shop, "deriv[ing] an advantage" that taxpayers are "not supposed" to get. *Miller v. United States*, 38 F.3d 473, 476 (9th Cir. 1994), *abrogated on other grounds by Omohundro v. United States*, 300 F.3d 1065 (9th Cir. 2002) (per curiam); *see* Pet. 19-20.

The IRS does not deny that a conflict between the Federal Circuit and a key regional circuit about the reach of an excise tax presents serious forum-shopping concerns that warrant this Court's review. Rather, the IRS contends (at 12, 14) that there is no

circuit split, because the courts found two services that "worked in the same way" to be taxable, and the Second Circuit "relied on *USA Choice* in reaching its decision." Neither assertion withstands scrutiny.

A. The IRS's effort (at 13-14) to reconcile the circuit split mistakes outcomes for holdings. Although both *USA Choice* and the decision below found taxable a service *used* for data transmission, the courts' holdings cannot be harmonized.

The Federal Circuit considered the service USA Choice purchased and had the "right" and "legal freedom" to use: PRI lines supplied by local telephone companies. *USA Choice*, 522 F.3d at 1334-35, 1341 (internal quotations omitted). As USTelecom explains (at 8), "because a single PRI circuit could carry 23 simultaneous voice calls," PRI lines are commonly used for voice communications "by call centers and other customers with high inbound voice call volumes." Although USA Choice elected to plug the PRI lines into its own network access servers (which could receive only data transmissions), it could instead have connected those lines to equipment like that used by call centers, which could receive ordinary telephone calls. *USA Choice*, 522 F.3d at 1341.

Because USA Choice purchased a service that gave it the right to complete telephone calls, the Federal Circuit concluded that USA Choice obtained the privilege of "telephonic quality communication." *Id.* USA Choice's "own self-imposed limitations" on its use of that service — like a consumer's "choice to connect a facsimile machine rather than a telephone set to [her] telephone line" — did not "fundamentally alter the nature of the services that USA Choice had

the privilege to use." *Id.* (internal quotations and alterations omitted).

The Second Circuit, in contrast, ignored the service WorldCom purchased. Instead, it focused on the "theoretical[] capab[ilities]" of the *equipment* the local telephone companies used to provide that service, even though WorldCom had no right to access the underlying network equipment directly. *See* App. 5a, 29a; BTI *Amicus* Br. 12 (Second Circuit looked to "infrastructure the telephone companies used to create the COBRA service," rather than the service as "configured and sold"). As a result, the Second Circuit found the COBRA service taxable even though the *service* WorldCom purchased — unlike the one USA Choice purchased — had no voice capability regardless of how WorldCom chose to use it. App. 27a-28a.

The IRS seeks to minimize this difference between the two services, dismissing it (at 12) as the "only pertinent" one and suggesting (at 14) that the "critical fact [in] common" was instead the local telephone companies' use of voice-capable PRI lines as an "essential part of the COBRA service." But, contrary to the IRS's current position, the Federal Circuit did not deem relevant the characteristics of inputs to the service USA Choice bought. Instead, as the IRS itself argued to that court, what mattered was what *USA Choice could do* with the service it obtained.

B. That the Second Circuit "accepted" propositions set forth in *USA Choice* changes nothing. *See* Opp. 14-15. Statements in common hardly indicate holdings in harmony, and the two statements the IRS identifies only confirm the circuit split.

The Second Circuit approvingly quoted the *USA Choice* court's statement that "telephonic quality

communication" must use "'a communication channel over which it is possible to have a two-way conversation with the use of telephones.'" App. 22a-23a (quoting *USA Choice*, 522 F.3d at 1341 n.2) (alteration omitted). But the Second Circuit disregarded the Federal Circuit's holding that the "channel" must afford the *service purchaser* the possibility of voice communication. *See USA Choice*, 522 F.3d at 1341 n.2 (relying on "uncontradicted testimony offered by the government" that the "provision of equipment by USA Choice would be the only configuration necessary" to allow USA Choice "to use its lines for voice communications").[3] Although the telephone companies used PRI lines among other network equipment to create the finished COBRA service that WorldCom purchased, the IRS concedes (at 4) that WorldCom had neither the ability to use the purchased service for voice calls nor any right of access to the underlying network equipment used to provide that service.

[3] Similarly, despite citing *USA Choice* for the proposition that the excise tax on "local telephone service" "applies to customers who use their phone lines, regardless" of how they use them, App. 28a, the Second Circuit ignored the Federal Circuit's reliance on the fact that the *service* USA Choice purchased gave it access to phone lines, which it chose to use exclusively for data transmissions. WorldCom had no such choice with COBRA service.

II. THE DECISION BELOW TRANSGRESSES THIS COURT'S TAX PRECEDENTS

The decision below deviated from this Court's teaching that a transaction must be taxed "in accord with what actually occurred and not in accord with what might have occurred." *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974). The Second Circuit also defied the long-recognized principle that a taxpayer may structure its transactions to "serve[] valid and substantial nontax purposes" that may have the effect of reducing its tax burden. *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 739 (1977).

A. The IRS wrongly argues (at 14) that WorldCom was taxed on what "actually occurred" because an underlying network component of the service it purchased could transmit voice calls if sold as part of a different service. The transaction that actually occurred was WorldCom's purchase from local telephone companies of a finished service that delivered only a "high-speed data stream," over which it was not "possible to transmit a traditional voice communication." App. 5a. Under *National Alfalfa*, the Second Circuit should have focused, as the Federal Circuit did, on the "inherent capabilities" of that finished service in determining its taxability. *USA Choice*, 522 F.3d at 1341. Instead, the Second Circuit incorrectly focused on the capabilities of PRI lines, access to which WorldCom could have chosen to buy but did not. *See* App. 5a (noting that a piece of the "COBRA *system*," not the COBRA *service*, "was theoretically capable of transmitting an ordinary telephone call").

B. The IRS's contention (at 15-16 & n.2) that the Second Circuit honored the form of the transaction

WorldCom had chosen is likewise erroneous. As petitioner explained, but the IRS entirely ignores, WorldCom chose to buy a service different from the one USA Choice bought, by design and for valid business reasons. WorldCom purchased an integrated, finished service that delivered a data stream because WorldCom concluded that it was more "efficien[t] and productiv[e]" to pay local telephone companies to aggregate dial-up ISP calls, process them, and convert them into packets of data that could be transmitted over the Internet. *In re WorldCom, Inc.*, 371 B.R. 19, 24 (Bankr. S.D.N.Y. 2007), *rev'd*, Nos. 02-13533 et al., 2009 WL 2432370 (S.D.N.Y. Aug. 7, 2009). USA Choice made a different business decision, buying PRI lines over which it could receive either voice calls or data communications. Taxing a service that permits voice communications — and is used for that purpose by call centers and others — but not a service with no voice capability does not produce the "strange result" the Second Circuit mistakenly perceived. App. 30a; *see* USTelecom *Amicus* Br. 10-11.

Nor is taxing PRI lines but not COBRA service "'at odds with the statute's intent.'" Opp. 15 (quoting App. 30a). In 1965, Congress "updated and modified" the statutory definitions to make clear that the excise tax applies to "the service" rather than the "equipment being supplied." *Trans-Lux Corp. v. United States*, 696 F.2d 963, 967 (Fed. Cir. 1982) (internal quotations omitted). Holding that the finished COBRA service WorldCom purchased is nontaxable furthers Congress's intent because taxability hinges on the nature of the service purchased — *i.e.*, whether the service can transmit voice calls — rather than the capabilities of equipment the telephone company

used to create that finished service. It is the Second Circuit that thwarts Congress's intent, by making taxability hinge on the local telephone company's underlying network equipment. *See* USTelecom *Amicus* Br. 10 n.3.

Contrary to the IRS's assertion (at 15-16), Congress's exemption of "private communication service" from the telephone excise tax does not suggest otherwise. When Congress added that exemption in 1965, businesses that bought both internal communication ("intercom") systems and local telephone service from a telephone company paid excise tax on both services. But businesses could buy intercom systems from third-party sellers excise-tax-free. *See Trans-Lux*, 696 F.2d at 967. Congress added the exemption to allow telephone companies to compete with the third-party sellers on an equal playing field. *See id.* The Second Circuit's decision creates an *unequal* field. USA Choice bought network access servers and other equipment to route the data transmissions it received over the PRI lines to the Internet excise-tax free. But the Second Circuit holds that, when local telephone companies sell access to that same equipment as part of a finished service, the telephone excise tax applies.

In all events, it was not the court's role to try to correct perceived inequities in the statute where — unlike in the context of private communications services — Congress had not seen fit to act. *See Lamie v. United States Trustee*, 540 U.S. 526, 538 (2004) (courts should not read "absent word[s] into . . . statute[s]" or "rewrit[e] rules that Congress has affirmatively and specifically enacted") (internal quotations omitted); USTelecom *Amicus* Br. 10-12; Chamber *Amicus* Br. 3-4, 14.

III. THIS CASE PRESENTS AN ISSUE OF NATIONAL IMPORTANCE

The Second Circuit's decision not only invites taxpayer forum-shopping, but also "opens the door" for the IRS to tax "Internet access and related broadband data services of all shapes and sizes." Chamber *Amicus* Br. 9-10. *Amici* representing the interests of numerous buyers and sellers of data services, and businesses that sell products that consumers access through data services, have expressed their alarm at the Second Circuit's decision and the prospect that the IRS will use that decision to rejuvenate an outdated excise tax. *See* Chamber *Amicus* Br. 9-15; USTelecom *Amicus* Br. 7-12; BTI *Amicus* Br. 6-11; Tax Foundation *Amicus* Br. 10.

As *amici* explain, the potential for an additional three-percent tax on data services threatens significant damage to a key segment of the United States economy. *See* BTI *Amicus* Br. 4-6. Broadband access to the Internet and the data services enabling it play a vital role in today's marketplace. *See* Chamber *Amicus* Br. 10-14. Taxing those services more heavily makes them "less attractive to invest in and develop," jeopardizing the "advancement of Internet technology" and the "corresponding economic and social benefits" that technology creates. *Id.* at 13, 14; BTI *Amicus* Br. 4-6. If anyone is to impose additional taxes on these services despite the clear costs, it should be Congress, not the courts or the IRS repurposing nearly 50-year-old statutory language. *See* Chamber *Amicus* Br. 14.

At a minimum, the Second Circuit's decision increases the "uncertainty surrounding the taxability of different kinds of services," which in turn "distorts purchasing and investment decisions," and makes the tax costlier to "administ[er]." USTelecom *Amicus*

Br. 2, 5; Chamber *Amicus* Br. 15. Although COBRA service is no longer "a widely used service for connecting to the Internet" (Opp. 19), the decision below puts today's data services at risk of the same tax treatment. The Second Circuit's reasoning rests not on characteristics specific to COBRA service or other services that enable dial-up Internet access, but instead on a characteristic — the use of underlying network equipment over which voice communication could travel, if used as an input to a different service — common in today's broadband data services. *See* Chamber *Amicus* Br. 14-15; Tax Foundation *Amicus* Br. 10.

The IRS does not deny this, and it offers no assurances that it will read the Second Circuit's decision narrowly and not extend it to these new — and, for the government's coffers, lucrative — contexts. The most the IRS can muster (at 19) is to assert that we and the *amici* do not explain how the Second Circuit's test "would apply to broadband." But we did just that: if what matters is not what the service sold actually does, but only whether some of the underlying network equipment (to which the service purchaser has no access) could carry voice communications when part of an entirely different service, the IRS could claim that virtually every data service is a taxable local telephone service.

The IRS's shifting views of the tax only validate these concerns. After arguing to the Federal Circuit that a service is taxable *because* the purchaser could have used it to complete a voice call, the IRS has now endorsed the Second Circuit's immensely more expansive view. The IRS's apparent willingness to apply the telephone excise tax to data-only services widely used today has generated costly uncertainty that only this Court can resolve.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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