INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

a =

b =

c =

d =

e =

f =

g =

ISSUE: Do payments received by the Taxpayer's subsidiaries, regulated telecommunications service providers, from Federal and state low-income and high cost universal service programs constitute a contribution to capital under § 118(a) of the Internal Revenue Code?

CONCLUSION: Payments received by the Taxpayer from Federal and state universal service programs do not constitute a contribution to capital under § 118(a) of the Code.

FACTS: Taxpayer is a telecommunications holding company. Taxpayer's subsidiaries, are regulated public utility companies engaged principally in the business of providing telecommunication services. provides these services in , , , , and . provides telecommunications services in are accrual, calendar year taxpayers.

In a and b, received Federal and state funding for providing universal telecommunications services to low-income customers and those customers residing in rural, insular and high cost areas. In a, received a total of c for providing universal telecommunication services and d for b. In a, received a total of e for universal providing telecommunication services and f for b. In a and b, included in their Schedule M-1 adjustments certain direct operating expenses incurred through their participation in the The types of operating expenses include: 1) data processing expense; 2) customer notification expense; 3) legal expense; 4) service representative costs; 5) commercial and marketing costs, and 6) other.

As background, the concept of providing affordable basic local telephone services to all customers has been a part of the Federal Communications Commission's (FCC) and the state public utility commissions' public policy goals for many years. Prior to passage of the Telecommunications Act of 1996, Pub. L. 104-04, 110 Stat. 56 (codified as amended in sections of title 47, United States Code) ("TCA"),

this goal was accomplished through the use of mechanisms such as internal rate structures and access fees. These implicit mechanisms provided the necessary additional compensation for providing affordable basic telephone service to all customers including low-income customers and those customers located in high cost areas. Telephone companies consistently treated payments from these sources as taxable income, representing compensation for services performed for low-income customers and those customers residing in high cost areas.

Prior to the adoption of the TCA, there was only one primary provider of local telephone service for each geographic area in the United States. With the passage of the TCA and the opening of all geographic areas to competition for telecommunications services, Congress explicitly required that telecommunications providers provide universal telecommunications services in all regions of the United States. Specifically, Congress mandated in the TCA that:

> Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas. 47 U.S.C. § 254(b)(3).

Congress further required that "all providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service" (47 U.S.C. § 254(b)(4)).

Congress further provided in 47 U.S.C. § 254(e) that:

> After the date on which Commission regulations implementing this section take effect, only an eligible telecommunications carrier designated under section 214(e) of this title shall be eligible to receive specific Federal universal service support. A carrier that receives such support shall use that support only for <u>the provision, maintenance, and upgrading of facilities and services for which the support is intended</u>. Any such support should be explicit and sufficient to achieve the purpose of this section (emphasis added).

As a result of this explicit legislative mandate, the Federal Government and the various state governments have established specific universal service funds ("USF"). In order to receive disbursements from these USFs, a telecommunications provider has to be certified by the state utility commission as being an eligible telecommunications carrier (ETC). received ETC status and began receiving disbursements upon USF implementation in g. In addition, prior to and immediately after the passage of TCA,

The funding for the explicit federal and state USFs is provided by contributions made by all telecommunications companies in the United States. The USF fund is funded through revenue-based assessments, which are paid by the telecommunications providers. Their assessments are then, as a general rule, passed on to the consumer through a specific USF monthly billing surcharge. In order to defray the cost of delivering these supported universal service programs, the telecommunications companies receive disbursements directly from the USFs. These disbursements are administered by the Universal Services Administrative Company ("Administrator") and are based on the volume of discounted services provided for each of the universal service categories in the case of service to low-income customers. In the case of payments made for extending services to high cost areas, the payments are based on an analysis of historic data.

The revenue agents and Taxpayer have agreed that the Taxpayer has received the following Federal and or state government universal services reimbursement: 1) high cost areas support; 2) the Lifeline program; 3) the Link-Up program; and 4) reimbursement for direct operating expenses incurred in participation in

47 CFR § 54.101(a) defines the services or functionalities for rural, insular and high cost areas supported by federal universal service support mechanisms as: 1) voice grade access to the public switched network; 2) local usage; 3) dual tone multi-frequency signaling or its functional equivalent; 4) single-party service or its functional equivalent; 5) access to emergency services; 6) access to operator services; 7) access to interexchange service; 8) access to directory assistance; 9) toll limitation for qualifying low-income consumers.

47 CFR 54.101(b) provides that an eligible telecommunications carrier must offer each of the services set forth in paragraph (a) of this section in order to receive federal universal service support.

47 CFR Part 54, subpart D provides a variety of support mechanisms for telecommunications carriers in certain high cost areas including local switching cost support, support for acquiring telephone exchanges, and Long Term Support.
High cost areas encompass areas where the average cost to the telecommunications company to provide telephone service is higher than the average rates they can charge. The universal goal is to provide affordable basic local telephone service to anyone who desires it, even those in rural or isolated areas. In exchange for taking on the duty of providing telephone service to these high cost areas, the telephone companies in return receive additional funding through various Federal and state government programs.

47 CFR § 54.401 defines “Lifeline” as a retail local service offering:

(1) That is available only to qualifying low-income consumers,

(2) For which qualifying low-income consumers pay reduced charges as a result of application of the Lifeline support amount described in 47 CFR § 54.403; and

(3) That includes the services or functionalities enumerated in § 54.101 (a)(1) through (a)(9). The carriers shall offer toll limitation to all qualifying low-income consumers at the time such consumers subscribe to Lifeline service. If the consumer elects to receive toll limitation, that service shall become part of that consumer’s Lifeline service.

47 CFR § 54.405 provides that all eligible telecommunications carriers shall: (a) make available Lifeline service, as defined in § 54.401, to qualifying low-income consumers; and b) publicize the availability of Lifeline service in a manner reasonably designed to reach those likely to qualify for the services.

47 CFR § 54.407(a) provides that universal service support for providing Lifeline shall be available to the eligible telecommunications carrier, based on the number of qualifying low-income consumers it serves, under administrative procedures determined by the Administrator.

47 CFR § 54.407(b) provides that the eligible telecommunications carrier may receive universal service support reimbursement for each qualifying low-income consumer receiving Lifeline service, the reimbursement amount shall equal the federal support amount, including the support amount described in § 54.403(c). The eligible telecommunications carrier’s universal service support reimbursement shall not exceed the carrier’s standard, non-Lifeline rate.

47 CFR § 54.407(c) provides that in order to receive universal service support reimbursement, the eligible telecommunications carrier must keep accurate records of the revenues it forgoes in providing Lifeline in conformity with § 54.401. Such records shall be kept in the form directed by the Administrator and provided to the Administrator at intervals as directed by the Administrator or as provided in this Subpart.

47 CFR § 54.411 defines “Link Up” as the following assistance program for qualifying low-income consumers, which an eligible telecommunications carrier shall offer as part of its obligation set forth in 47 CFR §§ 54.101(a)(9) and 54.101(b):

(1) A reduction in the carrier’s customary charge for commencing tele-

communications service for a single telecommunications connection at a consumer's principal place of residence. The reduction shall be half of the customary charge or $30.00, whichever is less; and

(2) A deferred schedule for payment of the charges assessed for commencing service, for which the consumer does not pay interest. The interest charges shall be for connection charges of up to $200.00 that are deferred for a period not to exceed one year. Charges assessed for commencing service include any charges that the carrier customarily assessed to connect subscribers to the network. These charges do not include any permissible security deposit requirements.

(3) For an eligible resident of Tribal lands, a reduction of up to $70, in addition to the reduction in paragraph (a)(1) of this section, to cover 100 percent of the charges between $60 and $130 assessed for commencing telecommunications service at the principal place of residence of the eligible resident of Tribal lands. For purposes of this paragraph, charges assessed for commencing telecommunications services shall include any charges that the carrier customarily assesses to connect subscribers to the network, including facilities-based charges associated with the extension of lines or construction of facilities needed to initiate service. The reduction shall not apply to charges assessed for facilities or equipment that fall on the customer side of demarcation point, as defined in § 68.3 of this chapter.

(b) A qualifying low-income consumer may choose one or both of the programs set forth in paragraphs (a)(1) and (a)(2) of this section. An eligible resident of Tribal lands may participate in paragraphs (a)(1), (a)(2), and (a)(3) of this section.

(c) A carrier's Link Up program shall allow a consumer to receive the benefit of the Link Up program for a second or subsequent time only for a principal place of residence with an address different from the residence address at which the Link Up assistance was provided previously.

(d) An eligible telecommunications carrier shall publicize the availability of Link Up support in a manner reasonably designed to reach those likely to qualify for the support.

47 CFR § 54.413(a) provides that eligible telecommunications carriers may receive universal service support reimbursement for the revenue they forgo in reducing their customary charge for commencing telecommunications service and for providing a deferred schedule for payment of the charges assessed for commencing service for which the consumer does not pay interest, in conformity with § 54.411.

47 CFR § 54.413(b) provides that in order to receive universal support reimbursement for providing Link Up, eligible telecommunications carriers must keep accurate records of the revenues they forgo in reducing their customary charge for commencing telecommunications service and for providing a deferred schedule for payment of the charges assessed for commencing service for which the consumer does not pay interest, in conformity with 47 CFR § 54.411. Such records shall be kept in the form directed by the Administrator and provided to the Administrator at intervals as directed by the Administrator or as provided in this subpart. The foregone revenues for
which the eligible telecommunications carrier may receive reimbursement shall include only the difference between the carrier's customary connection or interest charges and the charges actually assessed to the participating low-income consumer.

Concerning the state universal service programs, the states permit the Taxpayer to obtain reimbursement based upon the Taxpayer's submission of a claim for lost revenues in providing universal telecommunications services to low-income customers and for extending service to customers residing in high cost areas.

In the request for technical advice, Taxpayer asserts that because the motive of the contributors (Federal and state governments) was to benefit the greater public good by providing enhanced telecommunications services throughout the United States and since the contributor government agencies are not the consumer of the services provided, the funding for the universal services should be treated as a contribution to capital. In response, the revenue agents assert that the payments are contingent on the provision of services by the payee telecommunications company, and thus represent compensation for services which do not qualify for capital contribution treatment, notwithstanding that a government entity made the payment and that some public benefit accrues because of the payment.

LAW AND ANALYSIS:

Section 61(a) and section 1.61-1 of the Income Tax Regulations provide that gross income means all income from whatever source derived, unless excluded by law.

Section 118(a) provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Section 1.118-1 of the Income Tax Regulation provides, in part, that section 118 applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a government unit or by a civic group for the purpose of enabling the corporation to expand its operating facilities. However, <u>the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid to induce the taxpayer to limit production</u> (emphasis added).

The Supreme Court has also provided guidance concerning the dichotomy between capital contributions and income in exchange for the performance of services. In Detroit Edison v. Commissioner, 319 U.S. 98 (1943), the Court considered whether payments by customers to an electric utility company for extending the utility's services to customers' homes constituted capital contributions rather than taxable income. In concluding that the payments were taxable income and not capital contributions, the Court stated: "It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transaction neither in form nor in substance bore such a semblance. The payments were to the customer the price of the service" 319 U.S. at 102-103.

Later, the Court held that payments to a corporation by community groups to induce the location of a factory in their community represented a contribution to capital. Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). The Court concluded that the contributions made by the citizens were made without anticipation of any direct service or recompense, but rather with the expectation that the contribution would prove advantageous to the community at large. 339 U.S. at 591. The Court reasoned:

> Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups. The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under these circumstance the transfers manifested a definite purpose to enlarge the working capital of the community. 339 U.S. at 591.

Finally, in United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401 (1973), the Court considered whether a taxpayer was entitled to depreciate the cost of certain improvements including highway undercrossings and overcrossings, crossing signals, signs, and floodlights, that had been funded by the federal government. The Court held that the government subsidies were not contributions to the taxpayer's capital. In considering the precedent of Brown Shoe and Detroit Edison, the Court identified from these cases the salient characteristics of a nonshareholder contribution to capital under the Internal Revenue Codes of 1939 and 1954:

1. It must become a permanent part of the transferee's working capital structure;

2. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee;

3. It must be bargained for;

4. The asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and

5. The assets ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

In reaching its conclusion that the improvements at issue did not qualify as contributions to capital, the Court reasoned: “Although the assets were not payments for specific, quantifiable services performed by CB&Q for the Government as a customer, other characteristics of the transaction lead us to the conclusion that, despite this, the assets did not qualify as contributions to capital. The facilities were not in any real sense bargained for by CB&Q. Indeed, except for the orders by state commissions and the government subsidies, the facilities would not have been constructed at all” 412 U.S. at 413-414.

In a significant 1932 Supreme Court opinion, the Court considered the issue of whether payments received by a railroad company from the Federal Government constituted a contribution to capital and thus not included in income. Texas & Pacific Railway Co. v. United States, 286 U.S. 285 (1932). The Court noted the Transportation Act of 1920 provided for payments representing a guarantee of minimum operating income to compensate the railroad during the transition from federal control to private ownership. The Court reasoned that the payments did not represent capital contributions: “Here they were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose...The Government’s payments were not in their nature bounties, but an addition to a depleted operating revenue consequent upon a federal activity” 286 U.S. at 290.

In a 1979 United States Court of Appeals decision, the court considered a taxpayer’s argument that payments received from the Department of Labor for job training for hardcore unemployed individuals represented a contribution to capital under § 118 of the Code. Deason v. Commissioner, 590 F.2d 1377 (5th Cir. 1979). The court of appeals deferred to the lower Tax Court decision which concluded that irrespective of the public benefit of reduced unemployment that occurred as a result of the payments, the payments constituted direct compensation for training services and thus could not be considered a contribution to capital.

Initially, we rule that the Taxpayer cannot use § 118(a) to exclude payments for the recovery of expenses incurred by in the course of participating in the Section 1.118-1 of the Regulations specifically provides that the capital contribution exclusion “does not apply to any money or property transferred to the corporation in consideration for goods or services rendered.” Thus, the reimbursement to for direct operating expenses incurred in the provision of services constitutes income under § 61.

Concerning the reimbursements for the provision of universal telecommunications services in compliance with the Federal and state programs,we note that § 1.118-1 of the Regulations not only precludes compensation for service from qualifying as a capital contribution, but the regulation contemplates that governmental subsidies paid to a producer to forbear from production does not warrant capital contribution treatment. Thus, contrary to the Taxpayer's view, the fact that a governmental entity makes a payment for service and some public benefit accrues as a result of the compensation, does not transform governmental payments into capital contributions under § 118.

As provided in § 1.118-1 and stated by the Supreme Court in Detroit Edison and Chicago Burlington, compensation in exchange for a specific quantifiable service constitutes taxable income, not a capital contribution. Indeed, the Court in Brown Shoe premised its decision that inducement payments by community groups to a private corporation for relocating and building a factory constituted a capital contribution, based on the specific absence of customers and payment for services. Conversely, these are precisely the factors that are present in this request for technical advice. There is a clear nexus between the government payments to the Taxpayer and the Taxpayer providing universal telecommunications services. The motivation underlying the payments is to compensate the Taxpayer for the shortfall in operating income from having to provide service at a discount to low-income customers and extending service to customers in high cost areas. It is clear that the payments are predicated on the Taxpayer providing the mandated universal service. The payments are an integral part of the government's mandate to insure that universal service is provided.

The precedent of Texas Pacific and Deason are also analogous to the present case. In Texas Pacific, the Federal Government provided payments to fulfill a statutory public purpose and yet because of the inherent nature of the transaction as reimbursement for deficiencies in operating income, the payment did not warrant capital contribution treatment. Similarly, in Deason, the Federal Government made payments that served the public goal of reducing unemployment. Despite the existence of a public benefit derived from the payment, the court focused its analysis on whether the payments were compensation for services performed, and concluded that the payments were compensation for services and therefore ineligible as a capital contribution. These cases do not support Taxpayer's claim that a public purpose is an overriding factor mandating characterization of a payment as a capital contribution; neither do they support Taxpayer's claim that the payor must be the consumer of the services provided to treat the payment as compensation.

Based solely on the foregoing analysis, we conclude that the payments received by the Taxpayer in exchange for providing universal telecommunications services as defined under the operative Federal and state programs do not constitute a capital contribution under § 118(a) of the Code.

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

-END-