

Part I

Section 118.--Contributions to the Capital of a Corporation

26 CFR 1.118-1: Contributions to the capital of a corporation.

Rev. Rul. 2007-31

ISSUE

Is universal service support received by a corporation under the universal service support mechanisms a nonshareholder contribution to capital under section 118(a) of the Internal Revenue Code?

FACTS

The federal universal service support mechanisms are required by 47 U.S.C. § 254. The Federal Communication Commission (Commission) is required to establish periodically the services to be supported by federal universal service support mechanisms. 47 U.S.C. § 254(c)(1). The Commission has established that the following services be supported by federal universal service support mechanisms: (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; and

(9) toll limitations for qualifying low-income consumers. 47 C.F.R. § 54.101(a). An eligible telecommunications carrier must offer each of the services in order to receive federal universal service support. 47 C.F.R. § 54.101(b).

The Universal Service Administrative Company (Administrator) administers the federal universal service support mechanisms. 47 C.F.R. § 54.701. The Administrator is responsible for administering the following federal universal support mechanisms: (1) the high cost support mechanisms described in 47 C.F.R. part 54, subpart D; (2) the low income support mechanisms described in 47 C.F.R. part 54, subpart E; (3) the schools and libraries support mechanism described in 47 C.F.R. part 54, subpart F; (4) the rural health care support mechanism described in 47 C.F.R. part 54, subpart G; (5) the interstate access universal support mechanism described in 47 C.F.R. part 54, subpart J; and (6) the interstate common line support mechanism described in 47 C.F.R. part 54, subpart K. 47 C.F.R. § 54.702(a). The Administrator is responsible for billing contributors, collecting contributions to the universal service support mechanisms, and disbursing universal service support funds. 47 C.F.R. § 54.702(b).

The federal universal service support mechanisms are funded by contributions from telecommunications carriers. Every telecommunications carrier that provides interstate telecommunications services must contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service. 47 U.S.C. § 254(d). Entities that provide interstate telecommunications services to the public, or

to such classes of users as to be effectively available to the public, for a fee will be considered telecommunications carriers providing interstate telecommunications services and must contribute to the universal service support mechanisms. 47 C.F.R. § 54.706(a). Federal universal service contribution costs may be recovered through interstate telecommunications-related charges to end users. 47 C.F.R. § 54.712(a).

In order to receive support, an eligible telecommunications carrier first must provide the supported services. The universal service support provided pursuant to 47 C.F.R. part 54, subparts D, J, and K (identified above) ensures that consumers in all regions of the nation have access to and pay rates for telecommunication services that are reasonably comparable to those in urban areas. The universal service support provided by 47 C.F.R. part 54, subparts E, F, and G (identified above) allows carriers to provide discounted, or reduced, rates to low income consumers, schools and libraries, and rural health care providers. The amount of federal universal service support received depends on either the discount offered to the targeted customers or the cost of providing service (the carrier's revenue requirement) in high cost areas. For financial accounting purposes, the Commission requires all carriers to record their federal universal service support receipts as revenue.

All carriers that receive universal service support must use that support only for the provision, maintenance, and upgrading of facilities and services for which the universal service support is intended. 47 U.S.C. § 254(e) and 47 C.F.R. § 54.7. This includes, for example, the ability to use the funds to reduce intrastate rates, to cover

operating expenses (billing and marketing expenses) associated with the supported services, and to upgrade the facilities for the supported services. Annual certifications are required to be filed with the Administrator and the Commission with respect to universal service support from certain universal service support mechanisms stating that all universal service support received from such mechanisms will be used only for the provision, maintenance, and upgrading of facilities and services for which the support is intended.

LAW AND ANALYSIS

Section 118(a) of the Code provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. The committee reports accompanying the enactment of what is now section 118(a) indicate that the provision was intended to codify the existing law that had developed through administrative and court decisions on the subject. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18 (1954).

Section 1.118-1 of the Income Tax Regulations includes within the meaning of a contribution to capital, a contribution by a nonshareholder and cites as examples of nonshareholder contributions to capital: the value of land and other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion from gross income does not apply to any money or property transferred to the

corporation in consideration for goods or services rendered.

In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), 1943 C.B. 1019, the Supreme Court held that payments by prospective customers to an electric power company that were used by the company to construct the facilities necessary to deliver electricity to the customers were not nonshareholder contributions to capital. The Court found that the motivation for the prospective customers' contributions was to obtain electric services from the power company and, therefore, the contributions were payment for services. 319 U.S. at 102, 1943 C.B. at 1021.

In contrast, Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), 1950-1 C.B. 38, held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. 339 U.S. at 591, 1950-1 C.B. at 41.

The Court again considered this issue in United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401 (1973), 1973-2 C.B. 428. In that case, the Court set forth the following five characteristics of a nonshareholder contribution to capital: (1) the contribution must become a permanent part of transferee's working capital structure; (2) the contribution may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) the contribution

must be bargained for; (4) the asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. 412 U.S. at 413, 1973-2 C.B. at 432.

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 413-14, 1973-2 C.B. at 432.

In Texas & Pacific Railway Co. v. United States, 286 U.S. 285 (1932), XI-1 C.B. 263, the Court held that payments received by a railroad company from the federal government did not constitute a contribution to capital and thus were includible in income. 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, XI-1 C.B. at 265.

In Deason v. Commissioner, 590 F.2d 1377 (5th Cir. 1979), the Fifth Circuit held that payments received from the Department of Labor for job training for unemployed individuals were not a contribution to capital under section 118. The court affirmed the opinion of the Tax Court, 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.

As provided in section 1.118-1 and stated by the Supreme Court in Detroit Edison and Chicago, Burlington & Quincy R.R., 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 the universal service support. There is a clear nexus between the universal service support and the provision of universal telecommunications services by the carriers. The motivation underlying the universal service support is to compensate the carriers for the shortfall in operating income for providing services at a discount to certain customers and/or providing services to customers in high cost areas at below cost rates. The universal service support is predicated on the carriers providing the mandated universal service and is an integral part of the government's mandate to insure that universal service is provided.

In addition, the universal service support does not satisfy the five characteristics of a nonshareholder contribution to capital set forth in Chicago, Burlington & Quincy R.R., because the universal service support: (1) does not necessarily become a permanent part of the carrier's working capital structure because the support is not limited to the acquisition of capital assets and can be used to pay current expenses; (2) is made for specific, quantifiable telecommunication services to telecommunication customers of the carrier; (3) is not bargained for because the universal service support mechanisms are a unilateral government program and the method of participation by carriers is mandated (despite any certification requirements); (4) does not benefit the carrier commensurate with the value of the support because the support payments merely maintain the carrier's viability; and (5) does not necessarily generate additional income for the carrier because the support is not limited to the acquisition of capital assets that will generate additional income for the carrier, but can be used to pay current expenses or to replace capital assets.

The holdings in Texas Pacific and Deason also are illustrative in this context. 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 payments did not warrant capital contribution treatment. 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 concluded that the payments were compensation for services

and therefore ineligible as a capital contribution. Similarly, although a public purpose is served by payment of the universal service support, and the payor is not the consumer of the universal telecommunications services, the universal service support is nonetheless compensation to the carriers for the provision of universal telecommunications services.

HOLDING

Universal service support received by a corporation under the universal service support mechanisms is not a nonshareholder contribution to capital under section 118(a) of the Code.

DRAFTING INFORMATION

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