

**APPEALS COORDINATED ISSUE PROGRAM  
COORDINATED ISSUE PAPER  
SETTLEMENT GUIDELINES**

<b>ISSUE:</b>	Taxation of Universal Service Fees
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TAXATION OF UNIVERSAL SERVICE FEES  
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STATEMENT OF ISSUE

Whether payments received by telecommunication service providers from Federal and state universal service programs constitute income under section 61 of the Internal Revenue Code or contributions to capital under section 118(a) of the Internal Revenue Code.

COMPLIANCE POSITION

The Federal Government asserts 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 may accrue from the payment.

INDUSTRY/TAXPAYER POSITION

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.

FACTS

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 sought to provide universal telecommunications services in all regions of the United States:

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. section 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. section 254(b)(4)).

Congress further provided in 47 U.S.C. section 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 the provision, maintenance, and upgrading of facilities and services for which the support is intended. Any such support should be explicit and sufficient to achieve the purpose of this section (emphasis added).

As a result of this legislation, 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”).

Every telecommunications carrier that provides interstate telecommunication services must contribute to the Federal USF a percentage (known as the contribution factor) of its interstate end-user revenues. 47 U.S.C. section 254(d). As a general rule, the telecommunications carriers collect this assessment from their customers through a specific USF monthly billing surcharge and then contribute these collections to the USF. The USF serves as a source of funds from which the telecommunications carriers may receive disbursements to defray the cost of delivering the universal telecommunication services. The disbursements are administered by the Universal Services Administrative Company (“Administrator”). USF support programs include the following Federal programs: Lifeline, Link Up, and high cost area support.

The “Lifeline” program provides low-income customers with reduced charges for the telecommunications services described in 47 CFR section 54.101(a). Eligible telecommunications may receive universal service support reimbursement for each qualifying low-income consumer receiving Lifeline service.

The “Link Up” program provides low-income customers with a reduction in the customary charge for commencing telecommunications service for a telecommunications connection at a consumer’s principal place of residence and a deferred schedule for payment of the charges assessed for commencing service, for which the consumer does not pay interest. A telecommunications company 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.

Similar to the payments in the Lifeline and Link Up programs, high-cost area support payments are provided to telecommunications companies to cover a financial shortfall resulting from the telecommunications company providing services under 47 CFR section 54.101(a) in areas where the average cost of such service is higher than the average rate they can charge. Historically, several Federal and state programs have provided explicit monetary payments to support the local loop and switching costs of telecommunications providers serving high cost areas. For example, the high cost loop support mechanism provides increasing amounts of explicit support based on the amount by which a telecommunication provider’s loop costs, as reflected in its books, exceed the national average.

Beginning January 1, 2000, telecommunication providers serving lines in high cost areas receive universal service support for the forward-looking economic costs of providing supported services in high-cost areas. In essence, in the case of providing service to a high cost area where population is sparse, the shortfall results because the average cost to the telecommunications companies to provide telecommunications services is higher than the average rates that they can charge. Under the Link Up and Lifeline programs, the exact shortfall resulting from providing service at a discount is calculated by determining the amount of the discount provided to each customer and the number of customers receiving the discount. In connection with the high-cost program, the methodology used to compute the shortfall is inherently more complicated. Because the FCC has determined that it is administratively infeasible to calculate the precise cost of providing service to each customer in a high cost area, the FCC provides support to carriers using the forward-looking cost methodology which uses an averaging of costs per line, taking into consideration the number of customers in a particular area.<sup>1</sup>

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<sup>1</sup> See In the Matter of Federal-State Joint Board on Universal Service, Tenth Report and Order, 14 F.C.C.R. 20, 156 paragraph 90 (rel. November 2, 1999). In the Order, the FCC concluded: “We find that using company specific data for federal universal service support purposes would be administratively unmanageable and inappropriate. Moreover, we find that averages, rather than company specific data, are better predictors of the forward-looking costs that should be supported by the federal high-cost mechanism. Furthermore, we note that we are not attempting to identify any particular company’s costs of providing the supported services. We are estimating the costs that an efficient provider would incur in providing the supported services.”

Support is distributed to telecommunication companies in the high cost areas based in part, on the difference between the average cost per line in that high cost area and a national benchmark and the number of lines served. Payments are provided to the telecommunications companies based upon the submission of information to the Administrator, in the case of low-income support, specifying the number of low-income customers served and the amount of discount provided, and in the case of high cost support, the number of lines served.

47 CFR section 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 operator services; 7) access to interexchange service; 8) access to directory assistance; and 9) toll limitation for qualifying low-income consumers.

47 CFR section 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 (emphasis added).

States have established similar but separate universal service funds. Generally, the states will permit the telecommunications carriers to obtain reimbursement based upon the 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.

The amounts at issue in this paper are those amounts received from the Federal USF and the state universal service funds.

## LAW AND ANALYSIS

As defined in section 61(a), gross income means all income from whatever source derived, unless otherwise excluded by law. Specifically, the term includes, among others, compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 118(a) provides an exclusion from gross income for, in the case of a corporation, any contribution to the capital of the taxpayer.

Section 1.118-1 of the Income Tax Regulations 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 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 does

not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production (emphasis added).

The statutory term “contribution to capital” is not expressly defined in the Internal Revenue Code, the regulations, or the legislative history of section 118(a). The rather brief legislative history of section 118(a) indicates that the exclusion was intended to be a codification of the existing law that had developed through administration and court decisions. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17, A-38 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18 (1954).

The Supreme Court has provided guidance concerning the dichotomy between capital contributions and income received in exchange for the performance of services. In Detroit Edison v. Commissioner, 319 U.S. 98 (1943), the Court held that payments made by prospective customers to an electric utility to cover the cost of extending the utility’s facilities to the customers’ homes were part of the price of service and not contributions to capital. The Court found that the customers did not intend to make contributions to the taxpayer’s capital and regarded the payments as the price of services, stating, “it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company.” Id. at 103.

In Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), 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. 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. Id. 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 circumstances the transfers manifested a definite purpose to enlarge the working capital of the community. Id. at 591.

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." Id. at 413-414.

Furthermore, the Supreme Court and lower courts have addressed the proper treatment of payments received by taxpayers from the Federal Government as subsidies for performing services in the ordinary course of their businesses. In Texas & Pacific Railway Co. v. United States, 286 U.S. 285 (1932), the Supreme Court considered whether payments received by a railroad company from the Federal Government as guarantee of minimum operating income constituted capital contributions. 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, therefore, 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" (Id. at 290, emphasis added).

Similarly, in Deason v. Commissioner, 590 F.2d 1377 (5th Cir. 1979), the Fifth Circuit Court of Appeals considered whether payments received by the taxpayer from the Department of Labor for job training for hardcore unemployed individuals represented capital contributions. The court deferred to the reasoning of the 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.

In the case of USFs, the taxpayers contend that universal service payments are contributions to capital and make the following arguments: 1) the motive of the payments is to benefit the public good by providing enhanced telecommunications services throughout the United States; and 2) the FCC is not the actual consumer of the universal telecommunication services provided, therefore section 118 capital contribution treatment is appropriate.

As provided in section 1.118-1 of the Regulations and stated by the Supreme Court in Detroit Edison and Chicago Burlington, compensation received in exchange for a specific quantifiable service constitutes taxable income, not a capital contribution. Indeed, the Court in Brown Shoe premised its decision (i.e., inducement payments by community groups to a private corporation for relocating and building a factory constituted a capital contribution) on the specific absence of customers and payment for services.

In contrast, these are precisely the factors that are present in the case of universal service reimbursements. There is a clear nexus between the payments from the Federal and state universal service funds to the telecommunications service providers and the provision of universal telecommunications services. In other words, payments from the universal service funds are clearly predicated on the telecommunication service providers' actually providing the universal telecommunications services. Thus, the motivation underlying the payments is compensation 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.

In addition, section 1.118-1 of the Regulations not only precludes compensation for service from qualifying as a capital contribution, but the regulation provides that governmental subsidies paid to a producer to limit production does not warrant capital contribution treatment. Such payments provided are clearly given to producers to compensate for the shortfall in income that would thereby result. In the case of universal service payments, the payments are also given to compensate for the shortfall in income.

Further, the precedent established in Texas Pacific and Deason support this conclusion. 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 indeed compensation for services and therefore not capital contributions. Indeed, a close review of these cases indicates that a crucial factor is the motivation of the transferor in making the payment; and, this motivation must be deduced from a review of all of the

facts surrounding the payment. These cases do not support the contention that a public purpose is an overriding factor mandating characterization of a payment as a capital contribution. Payments based on compensation for services do not qualify as contributions to capital even if the payments serve a public benefit.

Next, taxpayers argue that the contributor government agencies must be the actual consumer of the services performed by the telephone providers in order for the funding to be deemed compensation for services, and thus not a capital contribution. Section 1.118-1 of the Regulations provides that a nonshareholder contribution to the capital of a corporation does not apply to money or property transferred to the corporation in consideration for goods or services rendered. The regulations do not limit the prohibition to the case where the contributor is the recipient of the services rendered. The prohibition is equally applicable in the case where the contributor's payments are given to the corporation to provide services to a third party. This was the conclusion in Deason, where the court held that a payment by the government to a taxpayer to provide job training for unemployed individuals constituted compensation for training services and thus ineligible for capital contribution treatment.

### SETTLEMENT GUIDELINES

Judging from the authorities reviewed above, the key factor that ties the case law, statutes, and regulations together is the motive of the transferor in making the payments. In the present case, that motive must be deduced from the stated motive of the involved parties, as well as the nature of the payments, and any other relevant facts surrounding the payments. The facts are these: (1) The telephone carriers must offer specific services as set forth in 47 CFR section 54.101(a) in order to receive Federal universal service support; (2) in order to provide universal telephone service, the Federal Government is making the payments to the telephone carriers to provide service for low-income customers and customers residing in certain high cost geographic areas; (3) the amount of the payment reflects the unrecouped expenses or revenue lost in serving these customers.

The crucial question that must be answered in determining whether a transfer constitutes a non-shareholder contribution to capital is the motive of the transferor. To fulfill the statutory goal of providing universal telecommunications services, the Federal Government's and state governments' motives in making the USF payments is to compensate taxpayers for the shortfall incurred in providing services at a discount to low-income customers and in high cost areas where the average cost to the telecommunications companies to provide the telecommunications services is higher than the average rates that they can charge. Clearly, the payments are contingent on the taxpayer providing the services specified in 47 CFR section 54.101(a) to low-income customers and customers in high cost areas. As such, the payments are compensation for services under section 1.118-1 of the Regulations and therefore do not qualify as contributions to capital.

The taxpayer may argue that the transferor's motivation in making the payments to the transferee telecommunications provider is simply to enable them to expand their operating facilities and any additional services provided are merely a byproduct of this capital expansion. In response, we point out that in the present case the facts clearly support characterizing the transferor's payment as compensation for services. The clear purpose of the enabling legislation is to provide universal telecommunications services. The TCA and implementing regulations enumerate specific types of telecommunications services to be provided to targeted segments of the population and geographic areas. The amount of payment received by the telecommunication providers from the Federal and state governments is directly tied to the amount of subsidized services provided. Indeed, this is not a case where the transferor's motivation for making the contribution is merely to assist the transferee in expanding its facilities for which additional telecommunications services are just an outgrowth of these facilities. Rather, the Government transferor's motivation for making the payment is to provide telephone services to low-income individuals and those individuals residing in high cost areas. In essence, the payments to the telecommunications providers represent rate subsidies, inextricably linked to the services the telecommunications providers are required to provide in order to receive reimbursement.

In addition, we believe taxpayers will likely advance the argument that the transferor's public benefit motivation is controlling even if the payments are compensation for services based on previous Service administrative decisions. We refute taxpayers' argument regarding public benefit motivation by asserting that in situations where the transferor has dual motivation (i.e., obtaining services as well as providing a public benefit), such a transfer is not a contribution to capital, citing the Supreme Court's opinion in CB&Q which states: "transfers...made with the purpose, not of receiving direct service or recompense, but **only** of obtaining advantage for the general community, as in Brown Shoe, the result was a contribution to capital" 412 U.S. at 411 (emphasis added).

Due to the factual nature of these issues, there is always a possibility that a court will accept the taxpayer's arguments. Despite this hazard to the Government, we believe that the litigation hazards to the taxpayer on the USF issue are substantial.