



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR District Director, Midwest District
Attn. Kay Maassen

FROM: Technical Assistant, (Health Care and E.O.)
Office of Associate Chief Counsel
(Employee Benefits and Exempt Organizations)

SUBJECT: Telephone Cooperative Refund Claims

This Field Service Advice responds to your memorandum dated September 15, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND: None

ISSUES:

- (1) Whether a telephone cooperative's receipts from the National Exchange Carrier Association (NECA) and payments for billing or collection services are member-source income, nonmember-source income or excluded income under section 501(c)(12)(A) and (B)?
- (2) Whether a telephone cooperative's receipts from NECA and payments for billing and collection are member or nonmember source income for purposes of computing the net margin attributable to members under section 4251?

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CONCLUSIONS:

- (1) A telephone cooperative's receipts from the NECA, and payments received for billing and collection services are excluded from computing the 85 percent member income test under section 501(c)(12)(B)(i).
- (2) A telephone cooperative's receipts from NECA and payments for billing and collection are member source income for purposes of computing the credit or refund under section 4251.

FACTS:

When members of a telephone cooperative converse with other callers on interstate or intrastate long distance telephone calls, they use the facilities of the cooperative, one or more interexchange carriers (ICs), and another local exchange carrier (LEC). Long distance charges paid by end users are divided among ICs and LECs. The cooperative submits monthly billings to the ICs and the National Exchange Carrier association (NECA). NECA divides the monthly interstate toll revenues among LEC's (including the cooperative) and ICs. NECA nets the amounts due to and from carriers and issues a bill or check to each carrier.

Telephone cooperatives are allowed to file a refund claim for the communications tax based on the profits generated by the cooperative. The question arises whether, for purposes of computing net margins attributable to providing telephone services to members, the NECA payments and payments for billing and collection services member-source income, nonmember-source income or excluded income.

LAW AND ANALYSIS

Section 501(c)(12)

Section 501(a) provides in part that an organization described in section 501(c) shall be exempt from taxation. . . .

Section 501(c)(12)(A) describes mutual or cooperative telephone companies ... but only if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Section 501(c)(12) (B) (i) provides that in the case of a mutual or cooperative telephone company section, 501(c)(12)(A) shall be applied without taking into account any income received or accrued from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company. In other words, section 501(c)(12)(B)(i) provides that

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income received from a nonmember telephone company for performance of "communication services" involving members of the cooperative is not taken into account in computing the 85 percent member income test of section 501(c)(12)(A).

Section 501(c)(12)(B)(i) was enacted in 1978 to change the result in Rev. Rul. 74-363, 1974-2 C.B. 170. Rev. Rul. 74-363 held that amounts due a telephone cooperative for services rendered to a nonmember long-distance telephone company must be treated as nonmember income for purposes of the 85 percent test.

The Senate Committee Report explained that "the sole effect of [section 501(c)(12)(B)(i)] is to exclude from the member-income computation any amounts which, under Rev. Rul. 74-362, would be considered as paid for performance by the telephone cooperative of telephone call-connection service for non-members." S. Rep. No. 762, 95th Cong., 2d Sess. 3 (1978), 1978-2 C.B. 358-359. See also, H. Rep. No. 742, 95th Cong., 1st Sess. 2-3 (1977).

Treas. Reg. § 1.501(c)(12)-1(c) further excludes from the 85 percent member-income test "credits under long distance interconnection agreements with other telephone companies for the performance of communications services involving the completion of long distance calls to, from, or between the cooperative's members (whether or not the credits may be offset, in whole or in part, by amounts due the other companies under the interconnection agreements). . . ."

Subchapter T (sections 1381-1388) of the Code sets forth the rules concerning the taxation of organizations operating on a cooperative basis. Section 1381(a)(2)(C) specifically excluded corporations engaged in furnishing electric energy, providing telephone service, to persons in rural areas from the provisions of subchapter T. Congress enacted subchapter T as part of the Revenue Act of 1962, 1962-3 C.B. 111. The underlying committee reports state that presently taxable organizations engaged in furnishing electric energy, or providing telephone service, to persons in rural areas do not come within the provisions of subchapter T and "will continue to be treated the same as under present law." See H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 483, and S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 819.

In Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. 674, 685 (1958), the Tax Court set forth the requirements for a patronage dividend:

First, the allocation must have been made pursuant to a preexisting legal obligation. . . . Second, the allocation must have been made out of profits or income realized from transactions with the particular patron for whose benefit the allocations were made, and not out of profits or income realized from transactions with other persons or organizations which were

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not entitled to participate in such allocations. . . And third, the allocations must have been made equitable.

Golden Belt Telephone Cooperative v. Commissioner, 108 T.C. 498 (1997), acq. in result, 1998-18 I.R.B. 4, involved a rural telephone cooperative. In addition to local telephone service, it provided its members with long-distance service through connection with ICs. Golden Belt sent a single monthly telephone bill to each member that included charges for both local and long-distance calls. Upon collection of these charges, Golden Belt remitted to the ICs an appropriate portion of the amount for the long-distance calls and retained the remainder as compensation for providing billing and collection services.

At issue in Golden Belt was whether income received by the cooperative for billing and collection services performed on behalf of ICs qualifies as income received for the performance of "communication services." Based on our reading of the legislative history of section 501(c)(12), the Service contended that amounts received by a rural telephone cooperative for billing and collection services constituted nonmember income for purposes of the 85 percent income test. We concluded that "communication services" under section 501(c)(12)(B) is intended to apply only to amounts received for "call-completion services." Billing and collection services which could be performed by any entity and is not unique to telephone companies, are more like accounting services (i.e. financial and administrative) and not "call-completion services."

The Tax Court disagreed, relying heavily on the fact that in 1992 the Federal Communications Commission's (FCC) 1992 reversal of its previous position that billing and collection services are not "inherently a communications service under the Communications Act of 1934." The court accordingly held that billing and collection services are "properly considered a communication service." While our office disagreed with the Tax Court's reasoning, we issued an acquiescence in result. Accordingly, income received from ICs for billing and collection services constitutes income from "communication services" and is excluded in determining whether a rural telephone cooperative satisfies the 85 percent member income test of section 501(c)(12). In summarizing the Golden Belt opinion, your office's memorandum stated that this income "was from 'communications services' and was, therefore, member source income." This is incorrect.

Your memorandum notes that TAM 9224007 states that the income from communication services was patronage-sourced income. However, the determination that an amount of income is patronage-sourced for the computation of a cooperative's patronage dividend (whether under subchapter T or under the common law principles applicable to telephone cooperatives) does not control whether that same amount is collected from members for purposes of the 85 percent member income test of section 501(c)(12). An item of income may be non-member income and yet still be patronage-

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sourced income.¹ In addition to concluding that the billing and collection income of the cooperative was patronage sourced, your memorandum also notes that short-term interest income needed by the cooperative for its operations was patronage-sourced. This interest income is not an amount collected from members for purposes of the 85 percent member income test of section 501(c)(12).

Net margins attributable to members

Rev. Rul. 68-206 considered the circumstances under which a credit or refund of the communications excise tax paid under Code section 4251 is allowable to a cooperative when excess revenues are credited to the members' capital accounts. The tax credit is limited to the excess revenue attributable to amounts paid by the members for communication services, and excludes amounts attributable to noncommunication activities. Credit or refund of the tax paid on the overassessment may be allowed to the telephone company, provided it pays the amount of the tax to the members from whom the tax was collected, or obtains the consent of the members to the allowance of the credit or refund.²

The revenue ruling applies the principles utilized in allocating earnings for the determination of a patronage dividend in determining how to allocate earnings for purposes of determining the overpayment of the communications excise tax and the amount to be refunded or credited. Insofar as such income is patronage sourced, it is an amount allocable to member-sources for purposes of the revenue rulings.

We have coordinated consideration of your request with the Office of Assistant Chief Counsel (Passthroughs and Special Industries), who concur with our analysis. If

¹ For instance, I.R.C. § 1388(a) defines "patronage dividend" for purposes of subchapter T, in part, "as an amount paid to a patron" ... "(1) on the basis of the quantity or value of business done with or for such patron." (Emphasis added) While subchapter T does not apply to telephone cooperatives, section 1381(a)(2)(C), TAM 9224007, cited in your memorandum, is consistent with it.

² Rev. Rul. 70-13, 1970-1 C.B. 272, amplified this holding to include a situation where a cooperative is obligated by its bylaws to credit individual capital accounts of patrons with a proportionate part of any amount received during the year in excess of operating costs and expenses. The ruling held that the credits to the individual capital accounts include tax paid on amounts paid by patrons in excess of operating costs and expenses and, to the extent of such tax, constitute repayments of the communications tax.

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If you have any further questions, please contact _____ of this office at
(202) 622-4290.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

None

By: _____
ELIZABETH PURCELL
Technical Assistant