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**COORDINATED ISSUE**
**TELECOMMUNICATIONS INDUSTRY**
**UNIVERSAL SERVICE FUND REIMBURSEMENTS**
**UIL: 61.40-01**

## 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.

## 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 explicitly required the telecommunications providers to offer 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").

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. § 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 mandated universal services. To receive the funds, the carrier must submit a claim to the USF.

The disbursements are administered by the Universal Services Administrative Company ("Administrator") and are based on (1) the amount of discounted services provided, in the case of service to low-income customers,[1] schools and libraries,[2] and rural hospitals[3] and (2) an analysis of historic cost data in the case of payments made for extending services to high cost areas.[4]

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 USF and the state universal service funds.

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[1] 47 CFR Part 54, Subpart E.
[2] 47 CFR Part 54, Subpart F.
[3] 47 CFR Part 54, Subpart G.
[4] 47 CFR Part 54, Subpart D.

## LAW

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. I.R.C. § 61(a)(1).

Section 118(a) provides an exclusion from gross income for, in the case of a corporation, any contribution to the capital of the taxpayer. This section applies to capital contributions made by shareholders as well as to capital contributions made by persons other than shareholders. Treas. Reg. § 1.118-1. 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. In no event, however, shall the provision 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. See id.

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 utility. 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&O. 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.

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 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.

## ANALYSIS

As provided in Treasury Regulation section 1.118-1 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 the context of universal service payments, 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. Specifically, payments from the universal service funds are clearly predicated on the telecommunications service providers' actually providing the mandated universal service. Moreover, 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.

Despite assertions to the contrary, the mere accrual of a public benefit from a governmental payment for services does not transform that governmental payment into a capital contribution. Treasury Regulation section 1.118-1 clearly contemplates that not all government subsidies warrant capital contribution treatment, when it states that section 118(a) does not apply to subsidies paid to a producer to forbear from production.

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 not capital contributions.

## CONCLUSION

The payments received by telecommunications service providers in exchange for providing universal telecommunications services as defined under the operative federal and state programs do not constitute a capital contribution under section 118(a) and thus fall within the definition of gross income under section 61(a).