INTERNAL REVENUE SERVICE
TE/GE TECHNICAL ADVICE MEMORANDUM

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Area Manager

Taxpayer's Name:
Taxpayer's Address

Taxpayer's Identification Number:

Year Involved:
Pre-Conference Held

Legend:

Taxpayer =
State =
X =
Y1 =
X$ =
X% =
Hearing =
Docket No. =
PURA =
PUC =
PURA §1 =
PURA §2 =

ISSUE:

Is revenue that Taxpayer receives from the Federal Universal Service Fund ("FUSF") and the State Universal Service Fund ("SUSF") income to the Taxpayer; and if it is income, is it excluded from the 85 percent member income test under section 501(c)(12)(B)(i) of the Internal Revenue Code ("Code") as income received or accrued from a nonmember telephone company for the performance of communication services that involve members of the Taxpayer?

Our position is that the revenue that Taxpayer received from the FUSF and the SUSF is income to the Taxpayer but is excluded from the 85 percent member income test pursuant to section 501(c)(12)(B)(i) of the Code.

FACTS:

Taxpayer is a telephone cooperative company organized under the laws of State, and is exempt from federal income tax under section 501(c)(12) of the Code.

Taxpayer is a local exchange carrier ("LEC") that provides regulated landline telecommunications services to rural, low population areas in State at per-subscriber costs that are significantly higher than the national average. Like all LECs, Taxpayer owns and operates the infrastructure that allows telephone users within its designated service area to call each other and to call subscribers of other telephone companies.

For its tax year ending December 31, Y1 ("Y1 tax year"), Taxpayer reported a total of X$ in gross receipts. About X% percent of this amount constituted FUSF and SUSF revenues. In order to maintain its status as an organization exempt under section 501(c)(12) during its Y1 tax year, Taxpayer had to receive at least 85 percent of its income from members for the sole purpose of meeting losses and expenses (hereinafter, the "85 percent member income test") during that year. I.R.C. Section 501(c)(12)(A).

In order to properly classify Taxpayer's FUSF and SUSF revenues for purposes of section 501(c)(12)(A), it is necessary to briefly review the history of the FUSF and SUSF's emergence. Many of the costs incurred in providing local service to an LEC's subscribers are "joint" or "common" with the provision of long distance services. Until the 1980s, the portion of joint and common costs of independent LECs like Taxpayer allocated to long distance were partially offset by contractual payments (called "settlements") from or one of its operating subsidiaries ( ), which at the time had a virtual monopoly on the long distance business in the United States. These settlement payments compensated an LEC for providing or customers with access to the LEC's subscribers through the LEC's facilities.

LECs such as Taxpayer are regulated on the federal, interstate level by the Federal Communications Commission ("FCC"), and on the state level by a state regulatory commission (in State, the State Public Utilities Commission ("PUC")). Since the 1940s, the FCC has, in conjunction with state commissions such as the PUC, been apportioning LECs' joint and common costs between the "interstate jurisdiction" regulated by the FCC and the "intrastate jurisdiction" regulated by state regulators such as the PUC. In order to make local service affordable to as many households as possible and thus foster the FCC's goal of achieving universal service, the FCC created implicit subsidies by apportioning an artificially high proportion of the joint and common costs to the interstate jurisdiction. These allocations permitted /to charge artificially high long-distance toll rates, and its interstate toll revenues were placed into an interstate "settlements" pool, from which LECs such as Taxpayer were allowed to recover the portion of their costs allocated to the interstate jurisdiction. The implicit subsidies achieved through this revenue sharing settlements process was an especially

significant source of support for small, rural LECs, which often could recover a large share of their costs from the interstate toll revenue pool. *See generally* In re High-Cost Universal Serv. Support, 24 FCC Rcd 6475, 6566-67, app. A, p. A-70-71, ¶ 162 & n.402.

Because many rural LECs were receiving such a large portion of their revenues in the form of settlement payments from and/or the , the Internal Revenue Service eventually had to address how cooperative telephone companies described in section 501(c)(12) should treat this settlement revenue under the 85 percent member income test. It did so in Rev. Rul. 74-362, 1974-2 C.B. 170, where it concluded that settlement amounts due to a cooperative for long distance calls made (or paid-for) by or customers constituted nonmember income for purposes of the 85 percent member income test. In 1978, as a direct response to Rev. Rul. 74-362, Congress enacted section 501(c)(12)(B)(i), which provided that for post-1974 taxable years, 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" would be excluded from the 85 percent member income test. Pub. L. 95-345, Section 1, 92 Stat 481 (1978); see also S. Rep. 95-762, at 1-3 (1978) (explaining that the new provision was a response to Rev. Rul. 74-362).

In the more than 30 years since Rev. Rul. 74-362 and the enactment of section 501(c)(12)(B)(i), telecommunications policy in the United States has slowly evolved from the provision of most telecommunications services by a government-sanctioned monopoly to the competitive provision of most telecommunications services. This evolution has gradually changed the way that LECs in rural or other high-cost areas recover their joint and common costs and, more generally, the methods that the FCC and state regulators employ to achieve universal service. These changes have occurred in several major steps. First, in order to facilitate competition between long distance companies associated with the court-ordered break-up of the FCC converted the settlements under contracts to tariffed "access charges," which would apply not only to (and BOCs) but also to emerging competitor long distance companies such as See, e.g., MTS and WATS Market Structure, Third Report and Order, 93 F.C.C. 2d 241, ¶ 112 (1983). As part of this change, the FCC created a new association of LECs, known as the National Exchange Carrier Association ("NECA"), to administer the access charges.

The PUC also required contractual payments for intrastate "long distance" to be converted to tariffed access charges. [Docket No.]

Around the same time, the FCC adopted a new formula under which it allocated a fixed 25 percent of LEC plant costs to the interstate jurisdiction, plus an additional allocation to the interstate jurisdiction for companies with higher than average costs-per-line, such as rural LECs. This additional allocation to the interstate jurisdiction was designated the "Universal Service Fund" and had the purpose of allowing carriers with high costs of local facilities to be able to maintain reasonable local rates. Amendment

of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Doc. No. 80-285, 96 FCC 2d 781 (1984).

The next major development in the evolution of subsidies to achieve universal service occurred in 1996, when Congress passed the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("the 1996 Act"). The primary purpose of the 1996 Act was to increase competition in telecommunications markets and to provide for an orderly transition from a regulated market with state-sanctioned monopolies to a competitive and deregulated market. The implicit subsidy mechanisms that had been achieving the FCC's goal of universal service before the 1996 Act were uniquely suited to a regulated market with state-sanctioned monopolies, and Congress believed that these mechanisms would need to be re-examined with the introduction of local competition. See Hearing. As a result, Congress directed the FCC to convene a Federal-State Joint Board to recommend new "specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service." 47 U.S.C. Sections 254(a)(1), (b)(5). The 1996 Act further provided that (1) "[e]very telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the [FCC] to preserve and advance universal service"; (2) that these mandatory contributions can be paid only to "eligible telecommunications carriers" ("ETCs") designated by the states; and (3) that the ETCs must use the universal service support only for the provision, maintenance, and upgrading of facilities and services for which the universal service support is intended. 47 U.S.C. Sections 254(d)-(e).

The FCC subsequently established that the federal universal service support mechanism will support, and that every ETC must offer, the following communication services and functionalities: (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. Sections 54.101(a)-(b). FCC regulations further provide that all entities providing interstate telecommunications services to the public (or to such classes of users as to be effectively available to the public) for a fee must contribute to the universal service support mechanisms in proportion to their share of end-user telecommunications revenues. See 47 C.F.R. Sections 54.706(a)-(b); In the Matter of Fed.-State Joint Bd. on Universal Serv., 12 F.C.C.R. 8776, ¶¶ 39-40 (1997). An independent subsidiary of NECA, the Universal Service Administrative Company ("USAC"), was established to administer the federal universal service support mechanisms, or Federal Universal Service Fund ("FUSF"), and is responsible for billing contributors, collecting contributions, and disbursing FUSF support to ETCs. 47 C.F.R. Section 54.701, 702(b).

FUSF support is provided to recipients under four programs, two of which are relevant here: the High Cost Support Program and the Low Income Support Program.

See 47 C.F.R. Sections 54.301-16, 54.400-418. The High Cost Support Program aims to enable carriers to provide service in high cost areas through a number of mechanisms, including interstate common line support ("ICLS"), local switching support ("LSS"), and high-cost loop support ("HCLS"). Both the ICLS (which recovers the portion of the cost of lines serving subscribers that is allocated to the interstate jurisdiction by the FCC) and the LSS (which provides support to LECs with 50,000 or fewer access lines, to help defray the higher switching costs of small LECs) are updated versions of programs that pre-date the 1996 Act and are intended to replace support that had been implicitly included in access charges prior to 1997. See Fed.-State Joint Bd. on Universal Serv., Universal Service Monitoring Report, CC Docket No. 96-45 pp. 3-7, 3-8 (2005) (hereinafter, "2005 Monitoring Report"). The HCLS, also a version of a program that pre-dates the 1996 Act, provides funding to ETCs with above-average "loop" costs (i.e., the costs of the physical wire that connects a caller to the ETC's central switching station) based on an allocation of above-average loop costs to the interstate jurisdiction. Id. at 3-2 to 3-4.

The Low Income Support Program is designed to ensure that quality telecommunications services are available to low-income customers at affordable rates. To receive funding from the Low Income Support Program relevant here – the Lifeline program -- recipient ETCs must offer specified universal services at reduced charges to qualifying low-income consumers. 47 CFR Section 54.401. ETCs receive universal service support reimbursement for each qualifying low-income consumer served. 47 CFR Section 54.407(b). The Lifeline program predates the 1996 Act, having first been established by the FCC at the end of 1984. 2005 Monitoring Report, at 2-1.

The passage of the 1996 Act caused the State Legislature, and in turn the PUC, to also shift from tariffed access charges to a State universal service fund mechanism, SUSF, similar to the FUSF. Like the FUSF, the SUSF "assists telecommunications providers in providing basic local telecommunications service at reasonable rates in high cost rural areas" and "reimburse[s] a telecommunications carrier providing lifeline services" described in the 1996 Act. [State] PURA. Similar to the FUSF, the SUSF is "funded by a statewide charge payable by each telecommunications provider that has access to the customer base." The new rules also reduced or eliminated the previous cost recovery mechanisms, such as access charges and various toll rates. To offset these reductions, the PUC authorized the establishment of a "make whole" mechanism referred to as Per Line per Month SUSF support. See PUC; PUC, Report to the 80th State Legislature, Review and Evaluation of the State Universal Service Fund Pursuant to PURA § 1. In addition, under the Lifeline Credit program, an ETC receives a credit from the SUSF for each of its qualifying low-income (Lifeline) customers receiving services required under the federal Lifeline program. PUC . Finally, the SUSF also provides reimbursements for reduced rates for intraLATA (Local Access and Transport Area) interexchange high capacity service for educational institutions, libraries, nonprofit telemedicine centers, and public or non-for-profit hospitals ("intra-LATA services support"). PURA § 2.

The SUSF administrator for State is X.

Taxpayer is an ETC serving a high cost, rural area of State. Thus, it is due a portion of the FUSF and SUSF fees paid by telecommunication providers to USAC and X, respectively. Most of this money represents amounts collected from telecommunications providers other than Taxpayer. USAC and X remit these FUSF and SUSF amounts to Taxpayer and other ETCs on a periodic basis. Taxpayer does not record these remittances from USAC and X as member income, since they do not represent amounts collected from its members for telephone and other telecommunications services.

Taxpayer follows the Uniform System of Accounts prescribed by the FCC, according to which it is required to account for FUSF receipts as access revenue under the same account number (Account 5082) that it recorded the access charge revenues before passage of the 1996 Act. See Responsible Accounting Officer Letter 27 (released June 10, 1998). In its Y1 tax year, Taxpayer accounted for all of its FUSF receipts in four categories under Account 5082, reflecting the four different FUSF mechanisms discussed above: ICLS, LSS, HCLS, and Lifeline. Taxpayer booked all SUSF receipts into one general ledger account; all SUSF receipts Taxpayer received in Y1 represent the SUSF categories described above (i.e., either Per Line per Month SUSF support, Lifeline credits, or Intra-LATA services support). As noted above, Taxpayer's FUSF and SUSF receipts accounted for 55 percent of Taxpayer's total receipts in its Y1 tax year.

LAW:

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 what is now section 118(a) indicate the provision was intended to codify existing law as it had developed through court and administrative decisions. See, e.g., H. Rep. No. 83-1337, at 17 (1954); S. Rep. No. 83-1622, at 18 (1954).

Section 501(c)(12)(A) of the Code provides for the exemption from federal income tax of benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Section 501(c)(12)(B)(i) of the Code states 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.

Section 1.501(c)(12)-1(a) of the Income Tax Regulations provides that an

organization described in section 501(c)(12) of the Code must receive at least 85 percent of its income from accounts collected from members for the sole purposes of meeting losses and expenses.

Section 1.501(c)(12)-1(c) of the regulations provides that for taxable years of a mutual or cooperative telephone company beginning after December 31, 1974, the 85 percent member income test described in section 1.501(c)(12)-1(a) is applied without taking into account income received or accrued from another telephone company for the performance of communication services involving the completion of long distance calls to, from, or between members of the mutual or cooperative telephone company.

Rev. Rul. 74-362, 1974-2 C.B. 170, applied section 501(c)(12)(A) to an agreement for the division of long distance toll revenues between a telephone cooperative and a nonmember telephone company. The Service held that the cooperative's share of the toll revenues collected by the telephone company (either for calls the company's customers made to cooperative members or collect calls received by the company's customers from cooperative members) was nonmember income for purposes of the 85 percent member income test. This ruling has been made obsolete by Pub. L. 95-345, § 1 (enacting section 501(c)(12)(B)(i)), as implemented by Rev. Rul. 81-291, 1981-2 C.B. 131.

Rev. Rul. 81-291, 1981-2 C.B. 131, states that for taxable years of a mutual or cooperative telephone company beginning after 1974, the 85 percent member income test for exemption under section 501(c)(12)(A) of the Code is applied without taking into account income received or accrued from another telephone company for the performance of communications services involving the completion of long distance calls to, from, or between members of the mutual or cooperative telephone company.

Rev. Rul. 2007-31, 2007-1 C.B. 1275, provides that FUSF payments received by a corporation do not represent nonshareholder contributions to capital under section 118(a) of the Code and are income to the receiving corporation because the "motivation underlying the [FUSF] 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."

In United States v. Coastal Utilities, Inc., 483 F. Supp.2d 1232 (S.D.Ga., 2007), aff'd 514 F.3d 1184 (11th Cir. 2008), the court held that FUSF payments and similar payments from the Georgia SUSF are not non-shareholder contributions to capital under section 118(a) of the Code, and thus are income to the corporation.

ANALYSIS:

A. Whether the revenue Taxpayer received from FUSF and SUSF is income.

Under Coastal Utilities, 483 F. Supp.2d at 1248-51, the court determined that

FUSF payments and similar payments from the SUSF were not non-shareholder contributions to capital under section 118(a) and were thus income to the corporation. Similarly, the IRS determined in Rev. Rul. 2007-31, that FUSF payments received by a corporation are not non-shareholder contributions to capital under section 118(a) of the Code. Rev. Rul. 2007-31 states that the payments are instead income to the receiving corporation and all carriers are required by the FCC to record their FUSF receipts as revenue for financial accounting purposes.

Therefore, pursuant to Coastal Utilities and Rev. Rul. 2007- 31, the revenues received by the Taxpayer from FUSF and SUSF constitute income to the Taxpayer.

B. Whether the income the taxpayer received from FUSF and SUSF should be excluded from the calculation of the 85 percent member income test under section 501(c)(12)(A) of the Code.

In order for FUSF and SUSF payments received by a cooperative telephone company to be excluded from the 85 percent membership income test under section 501(c)(12)(B)(i) of the Code, they must be (1) from a nonmember telephone company; and (2) for the performance of communication services that involve members of the cooperative telephone company.

All telecommunications carriers are required to contribute to the FUSF in proportion to their interstate retail revenue. After collecting the revenue, USAC, acting as the FCC-designated collection and disbursement agent, disburses the revenue to LECs such as Taxpayer in accordance with the amount the LEC is due. The SUSF operates in a similar manner, through X. Thus, Taxpayer's net FUSF and SUSF revenues are all coming from nonmember telephone companies, with USAC and X, respectively, acting as intermediaries. Therefore, the Taxpayer's FUSF and SUSF revenue constitutes income received or accrued from nonmember telephone companies.

In addition, Taxpayer's FUSF and SUSF revenue represents compensation for the performance of specified communication services that involve Taxpayer's members. See, e.g., Rev. Rul. 2007-31 (concluding that FUSF payments compensate carriers for the provision of universal telecommunications services). Taxpayer must use FUSF support, for example, "only for the provision, maintenance, and upgrading of facilities and services for which the support is intended," 47 U.S.C. 254(e), and the FCC regulations specify that the support is intended only for communication services, 47 C.F.R. 54.101(a) (listing the communications services to be supported by FUSF). The services or functionalities supported by FUSF payments that all ETCs must provide to their members/subscribers include access to long distance carriers, so that Taxpayer's members/subscribers can call and be called by any subscriber of the nonmember telephone companies that contribute to FUSF. See, e.g., 47 C.F.R. 54.101(a)(1), (7). By providing their members/subscribers with access to long distance carriers, ETC like

Taxpayer also benefits each contributing nonmember telephone company by increasing the total number of subscribers that can connect to their networks and thereby increasing the value of such networks. The FUSF also benefits contributing nonmember, interexchange carriers by lowering access charges and, therefore, long distance charges.

Finally, FUSF and SUSF revenues represent the functional equivalent of the portion of the AT&T/BOC settlements in effect during the 1970s that implicitly subsidized universal service and that Congress intended section 501(c)(12)(B)(i) to exclude from the 85 percent member income test. Therefore, we conclude that the FUSF and SUSF revenue received by Taxpayer is properly categorized as excluded income under section 501(c)(12)(B)(i) of the Code.

CONCLUSION

For the reasons set forth above, we conclude that non-member revenue that the Taxpayer receives from the FUSF and SUSF is excluded from the 85 percent member income test under section 501(c)(12)(B)(i) of the Code because it is income received or accrued from a nonmember telephone company for the performance of communication services which involve the members of the Taxpayer.

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 -