Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201123028**
Release Date: 6/10/2011

CC:PSI:B07:CJLangley
PRENO-105590-11

UILC: 4254.00-00

date: March 04, 2011

to: Holly McCann, Chief
(Specialty Programs, Excise Tax Program)

from: Stephanie Bland, Senior Technician Reviewer
(Passthroughs and Special Industries Division, Branch 7)

subject: Separately Stated Fees Includible in the Communications Excise Tax Base

This Chief Counsel Advice responds to your request for non-taxpayer specific assistance dated December 17, 2010. This advice may not be used or cited as precedent.

ISSUES

a. Whether the separately-stated fees and charges described herein are subject to the communications excise tax under § 4251 of the Internal Revenue Code (Code)?

b. Does the answer change depending upon whether the underlying service is for nontaxable services?

CONCLUSIONS

a. Extended area service fees, administrative charges, regulatory program charges, and interstate primary carrier fees are includible in the tax base for purposes of computing the § 4251 tax. Municipal charges/public right-of-way user fees are not includible in the tax base for purposes of computing the § 4251 tax.

b. Because the fees and charges are separately stated, they are not included as part of the underlying nontaxable services. Therefore, the result is the same, regardless of whether the underlying service is nontaxable.

FACTS

You have identified a number of fees and charges (Fees) that are associated with the provision of communications services. Some of the fees and charges in question are mandatorily-imposed by state or local governments. In these cases, the communications service provider (Provider) collects the fees and charges from the service subscriber (Customer) and remits them to the respective governmental body. Other fees and charges are not mandatorily-imposed by the government, but instead are imposed by the Providers as a means to recapture, or pass on, certain costs for which the Provider is responsible.

The Fees are summarized as follows:

Municipal Charges/Public Right-of-Way User Fees: Some municipalities impose mandatory fees for the use of rights-of-way. The fee provides the municipality with funds needed to recover the cost of administering the access to the right-of-way. The fee typically covers inspection, permit processing, engineering, traffic, and other such expenditures that the municipality incurs as utility companies work on the right-of-way. The Provider collects the fee and remits it to the appropriate governmental body. Depending on the state and/or municipality, the fee may be applicable to residential and business lines, ISDN, T-1, switched data, and one-way DSL lines. Some municipalities assess the fee as a franchise fee and a state public utilities commission then distributes the franchise revenue to the various municipalities. Others may assess it as a per telephone access line charge or percentage of revenue. Typically, this fee is imposed on the Provider and is not required to be passed on to the Customer. However, the Provider is allowed to recover these costs as a separately billed item.

Extended Area Service (EAS) Fee: State regulatory agencies sometimes authorize Providers to charge a fee in order to provide service to Customers that allows calls within one exchange to another exchange without a toll charge. In certain cases, the charge is optional. In other cases, the charge may be mandated by a local public service commission. An EAS fee is a fee for service. As such, it is retained by the Provider, and is not remitted to a government authority. It is a fee in lieu of toll charges and benefits the Customer by expanding the local service area.

Administrative Charge: This charge is applied per line, per month, by a Provider to help defray various costs imposed on the Provider by other telecommunications carriers, including, but not limited to, charges imposed by local telephone communication providers for delivery of calls from the Provider's Customers to the local telephone communication provider's landline customers, and for certain network facilities and services purchased from the local telephone communication providers. The administrative charge is not required by law to be collected from the Customer. The administrative charge and the components used to calculate it are subject to change.

Regulatory Programs Charge: This is a discretionary charge imposed by the Provider that is not directly associated with the provided communication service. The charge is not required to be collected by the Provider from the Customer. Instead, it is a fee collected and retained by the Provider to help cover costs related to funding and complying with various federal, state, and local government mandates, programs, and obligations.

Interstate Primary Carrier (IPC) Fee: IPC fees are discretionary charges allowed by the Federal Communications Commission (FCC) and imposed by Providers on multi-line business customers that do not have a primary or presubscribed interstate long distance carrier. The IPC fee is a monthly charge that covers the costs of local facilities that link the customer to the network to make or receive interstate long distance calls. It is a fee for service and is retained by the Provider.

LAW AND ANALYSIS

Section 4251(a) imposes a tax on amounts paid for communications services, defined in § 4251(b)(1) as local telephone service, toll telephone service, and teletypewriter exchange service. Section 4251(a)(2) provides that the tax is paid by the Customer.

Section 4291 provides that the tax is collected by the Provider.

In Notice 2006-50, 2006-1 C.B. 1141, the Internal Revenue Service (IRS) determined that Customers are only required to pay the § 4251 tax for "local-only" service. As relevant herein, § 4252(a) provides that local telephone service means (1) the access to a local telephone system, and the privilege of telephonic quality communication with substantially all persons having telephone stations constituting a part of such local telephone system, and (2) any facility or service provided in connection with a service described in (1) above.

Is the Fee an amount paid for local-only service?

To be an amount paid for communications service, a Fee must be paid for a taxable service. Generally speaking, the IRS considers amounts paid for local-only service to be subject to the § 4251 tax. Section 4(a) of Notice 2006-50 provides that taxpayers are no longer required to pay the § 4251 tax for nontaxable service. Section 3(d) of Notice 2006-50 defines the term "nontaxable service" as long distance and bundled service; that is, not local-only service. Section 4(b) of the Notice directs that the § 4251 tax is imposed on amounts paid for "local-only" service.

Section 3(b) of Notice 2006-50 defines local-only service as:

> [L]ocal telephone service, as defined in § 4252(a), provided under a plan that does not include long distance telephone service or that separately states the charge for local service on its bill to customers. The term also includes services

> and facilities provided in connection with service described in the preceding sentence even though these services and facilities may also be used with long distance service. See, for example, Rev. Rul. 72-537, 1972-2 C.B. 574 (telephone amplifier); Rev. Rul. 73-171, 1973-1 C.B. 445 (automatic call distributing equipment); and Rev. Rul. 73-269, 1973-1 C.B. 444 (special telephone).

As a result, if a Fee is characterized as local telephone service or provides a service in connection with local-only service -- even if also used with nontaxable long distance service -- it is subject to tax.

The IRS has provided guidance on two federally-mandated or authorized fees: the subscriber line charge (SLC) and the universal service fee (USF).

Section 8(b) of Notice 2007-11, 2007-1 C.B. 405, provides that the SLC, sometimes called the "Federal Access Charge," the "Customer or Subscriber Line Charge," or the "Interstate Access Charge," is an amount paid for local telephone service, and thus taxable. The Notice relies on Rev. Rul. 87-108, 1987-2 C.B. 260, which states that the SLC is a flat-rate, monthly charge authorized by the FCC and charged by local telephone companies for access to their local exchange facilities for interstate use by long-distance carriers and Customers. Because the SLC itself does not give Customers the right to make long distance calls, Rev. Rul. 87-108 reasons that the SLC is an amount paid in connection with local telephone service. Thus, the Notice holds that the SLC is subject to the § 4251(a) tax as an amount paid for local telephone service.

In contrast, § 8(c)(2) of Notice 2007-11 provides that the USF, sometimes called the "Federal Universal Service Fee" or the "Universal Connectivity Fee," is not an amount paid for local-only service, and thus is not taxable. The USF is a mandatory contribution made to the FCC by Providers that provide interstate and international telecommunications service to support various federal programs. The Notice reasons that the USF is charged to Customers in connection with long distance service because it is paid by Providers that offer long distance service.

The tax treatment of federally-mandated or authorized fees depends on whether the fee is made in connection with local-only service. Like the SLC, the IPC fee appears to be an amount paid in connection with local telephone service that does not, by itself, give Customers the right to make long distance calls; thus, it is subject to the § 4251(a) tax as an amount paid for local telephone service. Similarly, the EAS fee appears to be an amount paid in connection with local telephone service (while it expands the local service area, it does not give Customers the right to make long distance calls); thus, is the EAS fee is subject to the § 4251(a) tax as an amount paid for local telephone service, unless another exception applies. We further note that none of the Fees at issue appear to be like the USF, because none are paid in connection with long distance service.

The facts provide that all of the Fees at issue (except the IPC fee) are mandated or authorized by state and local governments and are either based on an amount per telephone access line, a percentage of revenue, or a fee for service relating to local telephone service. Thus, all of the Fees are local in nature and are made in connection with local-only service. Thus, the Fees are amounts paid for local-only service, and are therefore subject to the § 4251 tax, unless a Fee is characterized as a state or local tax under § 4254(c). Accordingly, we must consider whether any of the Fees are properly characterized as taxes.

Is the Fee a tax under § 4254(c)?

For purposes of calculating the tax base, § 4254(c) provides that the tax base (that is, the amount paid for communications services) does not include the amount of any state or local tax imposed on the furnishing or sale of the communications services, but only if the amount of the tax is separately stated on the bill. Thus, if a Fee is a state or local tax within the meaning of § 4254(c) (Excluded Tax), and is separately stated on the bill, it is not subject to the tax under § 4251. In other words, an Excluded Tax is not an amount paid for communications services under § 4251(a).

To determine whether a Fee is an Excluded Tax, we must consider whether the Fee is a "fee" or a "tax."[1] The relevant inquiry is to assess whether the charge is for revenue raising purposes, making it a "tax", or for regulatory or punitive purposes, making it a "fee." Valero Terrestrial Corp. v. Caffrey, 205 F.3d 130, 134 (4th Cir. 2000) (citing Collins Holding Corp. v. Jasper County, 123 F.3d 797, 800 (4th Cir. 1997).. To aid this analysis, courts have developed a three part test that looks to different factors: (1) what entity imposes the charge; (2) what population is subject to the charge; and (3) what purposes are served by the use of the monies obtained by the charge.[2] Valero at 134. When the three-part inquiry yields an uncertain result, the most important factor becomes the purpose behind the statute, or regulation, that imposes the charge. In those circumstances, if the ultimate use of the revenue benefits the general public then

[1] Rev. Rul. 77-472, 1977-2 C.B. 379, as modified by Rev. Rul. 78-154, 1978-1 C.B. 361, holds that three categories of sales taxes are not subject to the § 4251 tax because they are Excluded Taxes. Because the Fees at issue have not been described as sales taxes, we assume that none of the Fees fall under the exemptions identified in Rev. Rul. 77-472.

[2] For examples of the application of the three-part test, see American Landfill, Inc. v. Stark/Tuscarawas/Wayne Joint Solid Waste Management District, 166 F.3d 835 (6th Cir. 1999) (American Landfill) (holding the charge at issue was a tax, even though it was levied by an administrative agency instead of the state legislature, and even though one purpose of the fee was to defray administrative costs, because it served a broad public purpose of benefiting the entire community); San Juan Cellular Telephone Co. v. Public Service Comm'n, 967 F.2d 683, 685 (1st Cir. 1992) (holding the charge at issue was a fee, not a tax, because it was assessed by a regulatory agency, placed in a special fund, and was used to defray the regulatory agency's costs, but did not provide a general benefit to the public); and Bidart Bros. v. California Apple Comm'n, 73 F.3d 925, 931 (9th Cir. 1996) (holding a charge at issue was a fee, not a tax, because it was not assessed by the legislature, paid by a small segment of the population to promote apple-growing in the state by promoting California apples, and provided only an incidental benefit to the general public).

the charge will qualify as a "tax," while if the benefits are more narrowly circumscribed then the charge will more likely qualify as a "fee." Id.

In applying these rules to the Fees in question, it appears that the municipal charges/ public right-of-way user fees are taxes because they are imposed by a municipality and provide a benefit to the general public. These Fees contain a public safety component (promoting safety on public roads when the communications right-of-way is under repair) that makes the Fees more like taxes. This is regardless of their actual allocation (to the general fund or a specific fund) and regardless of any actual use to defray administrative expenses. Cf. American Landfill, Inc. v. Stark/Tuscarawas/Wayne Joint Solid Waste Management District, 166 F.3d 835 (6th Cir. 1999). Thus, the municipal charges/public right-of-way user fees are Excluded Taxes and are not part of the tax base for purposes of computing the § 4251 tax.

In contrast, the EAS fee appears to be a fee rather than a tax because it is retained by the Provider. Although the EAS fee arguably benefits the general public, it is not revenue raised by the government to benefit the public or to defray an agency's regulation-related expenses. Rather, it is a fee for service retained by the Provider to defray the Provider's costs of providing local-only service to the Customer. It appears to be indistinguishable from the Provider's other costs of providing local-only service. Thus, the EAS fee is not an Excluded Tax and is subject to the § 4251 tax because it is an amount paid in connection with local telephone service.

With regard to the administrative fees and the regulatory programs charges, we note that these Fees are discretionary and, as their names suggest, correlate to regulation-related expenses. In addition, these Fees are not paid to the state or local government, but are retained by the Provider to defray the Provider's costs of complying with various regulations. Thus, the administrative fees and the regulatory programs charges are not Excluded Taxes and are subject to the § 4251 tax because they are amounts paid in connection with local telephone service.

Does is matter if the underlying service is a nontaxable service?

As described above, § 3(d) of Notice 2006-50 defines "nontaxable service" as long distance and bundled service. Long distance service is defined in § 3(c) of Notice 2006-50 as telephonic quality communication with persons whose telephones are outside the local telephone system of the caller. Bundled service, as revised by § 5(c) of Notice 2007-11, is defined as:

> [L]ocal and long distance service provided under a plan that does not separately state the charge for the local telephone service. Bundled service includes plans that provide both local and long distance service for either a flat monthly fee or a charge that varies with the elapsed transmission time for which the service is used. Telecommunications companies provide bundled service for both landline and wireless (cellular) service. If Voice over Internet Protocol service provides

> both local and long distance service and the charges are not separately stated, such service is bundled service.

You are concerned about a situation in which the Provider bills the Customer for bundled local and long distance service that does not separately state the charge for local telephone service but does separately state a Fee, such as the taxable SLC, on the bill. In other words, the underlying charges are for nontaxable services, but the Fee is for a taxable service. If the Fee is separately stated, it is not part of the nontaxable bundled service. Thus, if the separately stated Fee itself is for a taxable service, such as the SLC, the IPC fee, and the EAS fee, then the Fee is subject to tax. If the Fee is for a nontaxable service, such as the USF, or is an Excluded Tax, such as the municipal charge, then such Fee is not subject to tax, regardless of whether the underlying service is taxable or nontaxable.

This conclusion is further supported by the definition of local-only service in § 3(b) of Notice 2006-50, which provides that the term "also includes services and facilities provided in connection with service described in the preceding sentence even though these services and facilities may also be used with long distance service" (emphasis added). Thus, a Fee for a service or facility used in connection with nontaxable service, such as long distance, may be subject to tax if it is also used in connection with local telephone service, such as the SLC in Rev. Rul. 87-108, 1987-2 C.B. 260, discussed above. See also § 8(b) of Notice 2007-11, 2007-1 C.B. 405.

In addition, since at least 1987, Providers have known that some Fees are taxable, (because Rev. Rul. 87-108 holds that the SLC is taxable). Therefore, an argument that Providers generally do not calculate tax on a Fee is unpersuasive. Further, § 4254(c) would not be necessary to exclude state and local taxes from the tax base if all taxes and fees were automatically excluded.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3130 if you have any further questions.