



Federal Communications Commission
Washington, D.C. 20554

May 2, 2014

DA 14-611

Richard A. Belden
Chief Operating Officer, Interim Chief Executive Officer
Universal Service Administrative Company
2000 L St., NW, Suite 200
Washington, DC 20036

Re: WC Docket Nos. 10-90, 05-337 and 06-122; CC Docket No. 96-45

Dear Mr. Belden:

On August 19, 2009, the Universal Service Administrative Company (USAC) requested guidance on various policy questions related to the federal universal service fund (Fund or USF).¹ By this letter, the Wireline Competition Bureau (Bureau) provides guidance on USAC's outstanding policy questions related to the universal service high-cost support mechanism.²

Documentation Retention Requirements

The Commission adopted rules establishing documentation retention requirements for recipients of the high-cost universal service support program in the 2007 *Comprehensive Review Order*.³ In particular, section 54.202(e) of the Commission's rules required that recipients of high-cost support shall retain, for at least five years, all records required to demonstrate to auditors that the support received was consistent

¹ Letter from Richard A. Belden, Chief Operating Officer, USAC, to Julie Veach, Acting Chief, Wireline Competition Bureau, FCC, WC Docket Nos. 05-337, 06-122 (Aug. 19, 2009) (August 19 Letter). The Wireline Competition Bureau sought comment on USAC's request for USF policy guidance. *See Comment Sought on Request for Universal Service Fund Policy Guidance Requested by the Universal Service Administrative Company*, WC Docket Nos. 05-337, 06-122, CC Docket No. 96-45, Public Notice, 24 FCC Rcd 12093 (Wireline Comp. Bur. 2009).

² The August 19 Letter requested guidance on three issues related to the universal service high-cost support mechanism. The Bureau previously addressed USAC's guidance request regarding applicability of the competitive eligible telecommunications carrier industry-wide interim cap to company-specific caps established in the *Alltel-Atlantis Order* and *AT&T-Dobson Order*. *See* August 19 Letter at 7-8; Letter from Sharon E. Gillett, Chief, Wireline Competition Bureau, FCC, to Richard A. Belden, Chief Operating Officer, USAC, 26 FCC Rcd 5034 (Wireline Comp. Bur. 2011). *See also High-Cost Universal Service Support et al.*, WC Docket No. 05-337 et al., Order, 23 FCC Rcd 8834 (2008) (interim cap order); *Applications of ALLTEL Corporation, Transferor, and Atlantis Holdings LLC, Transferee for Consent to Transfer Control of Licenses, Leases and Authorizations*, WT Docket No. 07-128, Memorandum Opinion and Order, 22 FCC Rcd 19517 (2007) (*Alltel-Atlantis Order*); *Applications of AT&T Inc. and Dobson Communications Corporation for Consent to Transfer Control of Licenses and Authorizations*, WT Docket No. 07-153, Memorandum Opinion and Order, 22 FCC Rcd. 20295 (2007) (*AT&T-Dobson Order*).

³ *See Comprehensive Review of the Universal Service Fund Management, Administration, and Oversight*, WC Docket No. 05-195, Report and Order, 22 FCC Rcd 16372, 16383-84, para. 24 (2007) (*Comprehensive Review Order*).

with the high-cost program rules.⁴ This rule became effective on January 23, 2008.⁵ USAC's August 19, 2009 letter sought guidance on "what, if any, remedial action should be initiated against carriers that did not maintain documentation for periods [audited] prior to the establishment of the High-Cost Program documentation rules."⁶

Consistent with general principles of administrative law and the framework adopted by the Commission in the *Comprehensive Review Order*, we clarify that, absent evidence of waste, fraud and abuse, USAC should not take any further action against carriers for document retention inadequacies during time periods when there was no document retention rule in effect. As a general rule, in the absence of statutory authority, rules adopted pursuant to a rulemaking proceeding may only be applied prospectively.⁷ In adopting section 54.202(e), the Commission did not express an intention to implement the high-cost documentation rule retroactively or cite any statutory authority that would permit retroactive application of the rule. The Commission did, however, express an overarching goal to deter misconduct and inappropriate uses of universal service funds.⁸ Accordingly, consistent with existing Commission rules and procedures, where document retention inadequacies predating the effective date of section 54.202(e), combined with other factors, suggest the presence of waste, fraud, and abuse, USAC should take further action to ensure the integrity of the Fund. Such other factors could include, but are not limited to: (1) evidence of non-compliance with other statutorily- or regulatory-mandated document retention requirements (e.g., document retention requirements to support the account balances in the Part 32 Uniform System of Accounts, continuing property records, pole attachment calculations, plant equipment age, cost, or useful life, depreciation rates);⁹ (2) fraudulent representations; (3) corrupt

⁴ See 47 C.F.R. § 54.202(e) (2008). See also *Comprehensive Review Order*, 22 FCC Rcd at 16385, para. 24, noting preexisting document retention obligations and the requirement to make such documentation available to USAC: "To the extent other rules or any other law require or necessitate documents be kept for longer periods of time (e.g., to support the account balances in the Part 32 Uniform System of Accounts, continuing property records, pole attachment calculations, plant equipment age, cost, or useful life, depreciation rates), we do not alter, amend, or supplant such rule or law. High-cost program recipients must keep documents for longer periods of time as required or necessary under such other rules or law and make such documents available to the Commission and USAC." In 2011, the Commission adopted a ten year record retention requirement for all recipients of high-cost and Connect America support, that supersedes the five year requirement. The ten year requirement became effective on May 8, 2012. See 47 C.F.R. § 54.320(b); *Connect America Fund et al.*; WC Docket No. 10-90 et al., Report and Order and Further Notice of Proposed Rulemaking, 26 FCC 17663, 17864, paras. 619-21 (2011), *pets. for review pending sub nom. In re: FCC 11-161*, No. 11-9900 (10th Cir. argued Nov. 19, 2013); *Connect America Fund et al.*, 77 Fed. Reg. 26987-01 (May 8, 2012).

⁵ OMB approved the information collection requirements contained in the *Comprehensive Review Order* effective as of January 23, 2008. *Comprehensive Review of the Universal Service Fund*, 73 Fed. Reg. 11837-01 (Mar. 5, 2008).

⁶ August 19 Letter at 3.

⁷ See *Georgetown University Hospital v. Bowen*, 821 F.2d 750, 757 (D.C. Cir. 1987), *aff'd* 488 U.S. 204, 208 (1988). Commenters agree that the documentation retention rule cannot be applied retroactively. See, e.g., Comments of the Independent Telephone and Telecommunications Alliance, WC Docket No. 05-337 et al., at 2-10 (filed Oct. 28, 2009); Comments of the Nebraska Rural Independent Companies, WC Docket No. 05-337 et al., at 5-7 (filed Oct. 28, 2009); Comments of the USA Coalition, WC Docket No. 05-337 et al., at 3-5 (filed Oct. 28, 2009).

⁸ *Comprehensive Review Order*, 22 FCC Rcd at 16374, para. 6; Memorandum of Understanding between the Federal Communications Commission and the Universal Service Administrative Company at 11, *available at* <http://transition.fcc.gov/omd/usac-mou.pdf> (USAC MOU).

⁹ See, e.g., 47 C.F.R. § 32.2000.

administrative processes; or (4) any other suggestion or indication of waste, fraud or abuse. In such instances, pursuant to the existing Memorandum of Understanding, USAC should work in consultation with appropriate Commission staff in the Wireline Competition Bureau, Office of Managing Director, Enforcement Bureau, and Office of Inspector General to take appropriate action, including, but not limited to, further review of relevant funding requests and recovery of funds disbursed in violation of a Commission rule that implements the Communications Act of 1934, as amended, or a substantive program goal.¹⁰

Income Taxes Attributable to S corporations

USAC also asked whether income taxes attributable to S corporations, that result from the S corporation shareholder's ownership of the entity's equity, should be included in a rate-of-return carrier's revenue requirement and, therefore, recoverable from the Fund.¹¹ In response, we clarify that USAC should allow rate-of-return carriers structured as S corporations to include in their revenue requirement the income taxes paid by their shareholders that result from their ownership of the corporation's equity. Because these carriers receive high-cost support based on their revenue requirement, the inclusion of these taxes will result in these carriers receiving an income tax allowance from high-cost support.

Commission precedent on a related issue supports permitting inclusion of the taxes in a carrier's interstate revenue requirement for high-cost support purposes. When the Commission regulated the rates of cable systems that were not subject to effective competition, it permitted individual owners, partners, and S corporations to recover income taxes attributable to the provision of regulated cable services through their rates.¹² In so doing, the Commission acknowledged that "[r]egulators have generally permitted rate-

¹⁰ USAC MOU at 2-5.

¹¹ August 19 Letter at 4; Chapter 1, Subchapter S, of the Internal Revenue Code allows corporations with 100 shareholders or less, among other requirements, to elect to be taxed as a partnership. 26 U.S.C. §§ 1361-1379.

¹² *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service*, MM Docket No. 93-215, CS Docket No. 94-28, Report and Order and Further Notice of Proposed Rulemaking, 9 FCC Rcd 4527, 4604, paras. 135-40 (1994) (*Cable Order*). In a Notice of Proposed Rulemaking, the Commission initially concluded that taxes payable by individual owners, partners, or S corporations on income from cable operations would not be recoverable in rates for regulated cable service. *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992*, MM Docket No. 93-215, Notice of Proposed Rulemaking, FCC 93-353, at para. 30 n.32 (1993); see also *Cable Television Act of 1992*, 58 Fed. Reg. 40762-01, 40766 (July 30, 1993). The Commission reversed its initial conclusion after reviewing comments and conducting further analysis. *Cable Order*, 9 FCC Rcd at 4604-07, paras. 135-38. Commenters in the *Cable Order* proceeding provided various legal precedents that supported the treatment of income taxes as an allowable expense for S corporations, such as *Suburban Utility Corp. v. The Public Utility Comm'n of Texas*, 652 S.W.2d 358 (Texas 1983) (*Suburban*); *Moyston v. New Mexico Public Services Comm'n*, 76 N.M. 146, 412 P.2d 840 (N.M. 1966) (*Moyston*); *Greeley Gas Co. v. State Corp. Comm'n.*, 15 Kan. App. 2d 285, 807 P.2d 167 (Kan. App. 1991) (*Greeley*). In *Suburban*, the Supreme Court of Texas held that a water utility organized as a Subchapter S corporation was entitled to a reasonable cost of service allowance for federal income taxes actually paid by shareholders or for the taxes the utility would be required to pay as a conventional corporation, whichever was less. 652 S.W.2d at 364. In *Moyston*, the Supreme Court of New Mexico found that rates which fail entirely to take federal and state income taxes into account as operating expenses of a sole proprietorship utility are unfair, unjust, unreasonable, and discriminatory; the Court held that an amount equal to the tax the utility would pay if incorporated is a reasonable and realistic amount to deduct from the utility's taxable income for ratemaking purposes. 76 N.M. at 161, 412 P.2d at 851. In *Greeley*, the Court of Appeals of Kansas, while apparently agreeing with the holdings in *Suburban* and *Moyston*, affirmed the

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regulated companies to recover income taxes in order to compensate the utility for taxes imposed directly on the utility”¹³ Noting that cable operators “operate under diverse ownership forms,” the Commission reasoned that it “should design an income tax treatment that permits recovery of income taxes regardless of the form of ownership of the regulated cable service enterprise.”¹⁴ We find that this rationale applies equally in the context of high-cost support service, as there is no basis for ignoring the diversity of corporate ownership forms while making high-cost support determinations.¹⁵

Allowing S corporation shareholders to recover an income tax allowance is also consistent with industry practice. As noted in the record, the National Exchange Carrier Association (NECA) allows S corporations to receive income tax reimbursement from NECA pools and from high-cost support. In NECA’s Separation Cost Issue 3.1, NECA states that telephone companies have historically been permitted to recover taxes calculated on regulated operating income.¹⁶ To determine the level of income taxes that S corporations will be reimbursed from the NECA pools, NECA requires S corporations to calculate an effective tax rate based on a composite of the shareholders’ tax rates. NECA Cost Issue 3.1 provides S corporations with the instructions for calculating the allowable portion of these taxes for both pooling and high-cost support purposes.¹⁷ This means that S corporation rural local exchange carriers that rely on guidance from NECA are already operating under the assumption that they are permitted to recover an allowance from high-cost support for the income taxes paid by their shareholders.¹⁸

Our interpretation is further informed by treatment of this issue by other regulatory agencies. As noted in the record, the Federal Energy Regulatory Commission (FERC) permits an income tax allowance for all entities or individuals, including S corporations, owning an interest in regulated public utility assets, provided that the entity or individual has an actual or potential income tax liability to be paid on the income from those assets.¹⁹ FERC and various state public utility commissions take the position that a S

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Kansas Corporation Commission's disallowance of the recovery of state and federal income taxes by a Subchapter S utility, because it failed to provide competent evidence of the income taxes paid. 15 Kan. App. 2d at 287-88, 807 P.2d at 169-70. *See Cable Order*, 9 FCC Rcd at 4605, n.289.

¹³ *Cable Order*, 9 FCC Rcd at 4607, para. 138.

¹⁴ *Id.*

¹⁵ Commenters agree that state and federal income taxes should be recoverable regardless of their corporate form. *See, e.g.*, National Telecommunications Cooperative Association Initial Comments, WC Docket No. 05-337 et al., at 2 (filed Oct. 27, 2009); Comments of the Organization for the Promotion and Advancement of Small Telecommunications Companies and the Western Telecommunications Alliance, WC Docket No. 05-337 et al., at 9-10 (filed Oct. 28, 2009) (OPASTCO Oct. 28, 2009 Comments); Reply Comments of GVNW Consulting, Inc., WC Docket No. 05-337 et al., at 2 (filed Nov. 12, 2009).

¹⁶ NECA Cost Issue 3.1.

¹⁷ *See id.* at Schedule A.

¹⁸ *See* Comments of TCA, WC Docket Nos. 05-337 et al., at 3 (filed Oct. 28, 2009); OPASTCO Oct. 28, 2009 Comments at 11.

¹⁹ Aug. 19 Letter at 6; Comments of the National Exchange Carrier Association, Inc., WC Docket No. 05-337 et al., at 6-7 (filed Oct. 28, 2009) (NECA Oct. 28, 2009 Comments); OPASTCO Oct. 28, 2009 Comments at 11; Reply Comments of the Minnesota Independent Coalition, WC Docket No. 05-337 et al., at 6-7 (filed Nov. 12, 2009) (MIC Nov. 12, 2009 Reply Comments). *See also* Federal Energy Regulatory Commission, *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139, para. 32 (2005) (*FERC Statement*). FERC’s current policy arose out of a court decision concluding that FERC had not justified a policy permitting a limited partnership to include an income

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corporation is merely a pass-through device that permits shareholders to avoid double corporate taxation by passing the income tax to the S corporation's shareholders.²⁰ FERC has determined that the income taxes that S corporation shareholders pay are "just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation," and that the income taxes paid by S corporation shareholders are a cost of doing the S corporation's business, regardless of whether the utility itself or the shareholders actually pay the taxes.²¹

Accordingly, based on our review of prior Commission actions, industry practice and comparable treatment on this issue by other regulatory agency decisions, we clarify that income taxes attributable to S corporation shareholders as a result of their ownership of the corporation's equity are includable in a carrier's revenue requirement and therefore recoverable through high-cost support.

If you have any questions regarding this letter, please do not hesitate to contact me at 202-418-1500.

Sincerely,

Carol E. Matthey
Deputy Chief
Wireline Competition Bureau

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tax allowance in its rates equal to the proportion of its partnership interests owned by corporate partners, but disallowing a tax allowance for partnership interests not owned by corporations. *Id.* at para. 2.

²⁰ A number of state public utility commissions have permitted corporations to impute the income tax paid by their shareholders that result from their ownership of the corporation's equity for ratemaking purposes. *See, e.g., The Commission's Generic Evaluation of the Regulatory Impacts from the Use of Non-Traditional Financing Arrangements by Water Utilities and Their Affiliates*, Docket No. W-00000C-06-0149, Decision No. 73739, 2013 WL 750288, Ariz. Corp. Comm'n (2013); *Petition of Hamilton Southeastern Utils., Inc. for Approval of a New Schedule of Rates and Charges for Sewer Service*, Cause No. 43761, 2010 WL 3378024, Ind. Util. Reg. Comm'n (2010); *Re Rural Tel. Co.*, Docket No. 03-10004, Compliance Order, 2005 WL 389184, Nev. Pub. Util. Co. (2005); *Madera Utils., Inc.*, Docket No. 2003-368-S, Order No. 2004-526, 2004 WL 2781833, S.C. Pub. Serv. Comm'n (2004).

²¹ *FERC Statement*, at para. 33. *See also* NECA Oct. 28, 2009 Comments at 7; MIC Nov. 12, 2009 Reply Comments at 7 (quoting *FERC Statement* at para. 33).