

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

Accounting Treatment of
Payments Made by the
Puerto Rico Telephone Company
and the Puerto Rico Communications
Corporation to the Puerto Rico
Department of Treasury

AAD 95-119

MEMORANDUM OPINION AND ORDER

Adopted: January 29, 1996; Released: February 5, 1996

By the Deputy Chief, Common Carrier Bureau:

I. INTRODUCTION

1. On July 28, 1995, the Common Carrier Bureau ("Bureau") released a Public Notice seeking comments on a request by the Puerto Rico Telephone Company ("PRTC") and Puerto Rico Communications Corporation ("PRCC") that certain payments made to the Puerto Rico Department of Treasury be recognized as operating taxes and treated as such for purposes of calculating Universal Service Fund ("USF") assistance to which PRTC was entitled and its interstate access settlements.¹ In this order we address the issues raised by this request and conclude that a portion of the payments made to the Puerto Rico Department of Treasury by PRTC and PRCC can be recognized as operating taxes for USF assistance and interstate access settlements purposes.²

¹ Public Notice, AAD 95-119, DA 95-1633, Accounting Treatment of Payments Made by the Puerto Rico Telephone Company and the Puerto Rico Communications Corporation to the Puerto Rico Department of Treasury (July 28, 1995)(Public Notice).

² Operating taxes are those taxes properly recorded in Accounts 7200 through 7250 of Part 32, Uniform System of Accounts for Telecommunications Companies ("USOA"), including, for example, property taxes, gross receipts taxes, and federal, state and local income taxes. See 47 C.F.R. §§ 32.7200-7250.

³ Although PRCC and PRTC merged in 1994, we refer to them separately in this proceeding because during the year at issue (1992) they were separate corporations.

⁴ Under the Puerto Rico tax code, "gross income" for communications companies is specifically defined as the amount of fees collected for communications services. See *Puerto Rico, Special Local Taxes* Page 68,204-5, ¶68,255. "Gross income," as defined by the Puerto Rico tax code, is what most taxing jurisdictions refer to as "gross receipts." Gross income tax for the purposes of this proceeding is not the same as, nor should it be confused with, "corporate income tax." Corporate income tax is generally

II. BACKGROUND

2. PRTC and PRCC were separate local exchange telephone companies operating in Puerto Rico until they merged in 1994. During the entire period under review, these companies have been wholly owned by the Puerto Rico Telephone Authority ("PRTA"), a governmental instrumentality of the Commonwealth of Puerto Rico ("Commonwealth").³

3. PRTA, as a government entity, is exempt from taxation; the Commonwealth, however, requires PRTA to make payments to the Puerto Rico Department of Treasury as "payments in lieu of taxes." The Commonwealth requires two such payments. "Payment in Lieu of Taxes I" is similar to property taxes PRTA would pay to the Commonwealth's municipalities if it were not tax exempt. "Payment in Lieu of Taxes II" is essentially a surrogate for the gross income tax⁴ that PRTA would pay if it were a private company. Payment in Lieu of Taxes II, by Commonwealth law, must amount to at least \$20 million or 4% of PRTA's gross income although PRTA's Governing Board may approve a payment in excess of 4% of gross income if PRTA's financial condition allows.⁵

4. For the 1992 tax year, PRTA made Payments in Lieu of Taxes I and Payments in Lieu of Taxes II of \$22,260,639⁶ and \$101,696,702,⁷ respectively. PRTA made an initial Payment in Lieu of Taxes II of \$20 million (the minimum required payment) for the 1992 tax year on April 15, 1993. Meanwhile, on December 22, 1992, PRTA had completed the sale of Telefonica Larga Distancia de Puerto Rico (the Puerto Rico Long Distance company or "TLD") to Telefonica de Espana (Telephone Company of Spain) and realized proceeds of \$80 million. On March 25, 1993, PRTA's Governing Board authorized an \$80 million payment as an additional Payment in Lieu of Taxes II for the 1992 tax year to be paid on July 1, 1993. On June 24, 1993, PRTA's Governing Board raised the additional Payment in Lieu of Taxes II from \$80 million to \$81,696,702 (\$81.7 million), which equaled the combined earnings of PRTC and PRCC for 1992 before this additional "tax" was authorized.⁸

5. In 1993, the National Exchange Carrier Association ("NECA") raised questions regarding the Payment in Lieu

a tax on the "net income" (revenues less expenses) of a company.

⁵ Although PRTA is liable for the Payments in Lieu of Taxes, the payments are assessed on the basis of the property values and operating results of its subsidiaries, PRTC and PRCC. In this order, to avoid confusion about the nature of the underlying transaction, we generally refer to PRTC and PRCC as making the payments. Under circumstances in which income taxes are determined on a consolidated basis by a carrier and its affiliates, Part 32 of the Commission's rules allows the income tax expense recorded by the carrier to be the same as the amount that would result if the carrier determined its taxes separately. See C.F.R. §32.27(e).

⁶ Payments in Lieu of Taxes I of \$ 19,207,445 for PRTC and \$3,053,194 for PRCC for a combined total of \$22,260,639. Letter from Joe D. Edge, Counsel for PRTC and PRCC, dated May 30, 1995 to Kenneth P. Moran, Chief, Accounting and Audits Division, Common Carrier Bureau, Attachment at 1.

⁷ Payments in Lieu of Taxes II of \$89,240,351 for PRTC and \$12,456,351 for PRCC for a combined total of \$101,696,702. *Id.*

⁸ Letter from Joe D. Edge, Counsel for PRTC and PRCC, dated November 30, 1993 to Kenneth P. Moran, Chief, Accounting and

of Taxes II in a series of letters to PRTC and PRCC.⁹ NECA stated that, for USF assistance and interstate access settlement purposes, NECA would only allow the Payment in Lieu of Taxes II made prior to the \$81.7 million payment.¹⁰ Based on NECA's estimates, exclusion of the disputed \$81.7 million from USF assistance and interstate access settlements reduced the combined USF assistance for PRTC and PRCC by \$6.4 million and reduced the combined interstate access settlements by almost \$16 million, for a total reduction in interstate payments to PRTC and PRCC of \$22.4 million. As a result of NECA's action, PRTC and PRCC requested that the Bureau recognize the payments made to the Puerto Rico Department of Treasury as operating taxes, to be treated as such for purposes of calculating USF assistance and interstate access settlements.¹¹

6. On April 28, 1995, the Bureau informed PRTC and PRCC that the Commission would permit their Payments in Lieu of Taxes to be treated as operating taxes for USF and interstate access settlement purposes to the extent that those amounts were calculated using tax rates no greater than rates normally applied to non-Commonwealth owned or affiliated companies operating in Puerto Rico.¹² The Bureau also requested that PRTC and PRCC provide, for the public record, an analysis that supports the amount of their payments in lieu of taxes that they claim should be considered as operating taxes for USF and interstate access settlement purposes.

7. On May 30, 1995, PRTC and PRCC filed their response to the Bureau's April 28, 1995 letter.¹³ In that letter, PRTC and PRCC state that if they were operating as private companies not affiliated with the Commonwealth of Puerto Rico, they would have paid \$51,884,669¹⁴ in property taxes, \$4,358,654¹⁵ in municipal license taxes, \$17,434,616¹⁶ in telecommunications gross receipts taxes, and \$54,873,280¹⁷ in Puerto Rico corporate income taxes. As a result, PRTC and PRCC claim that if they operated as private companies total hypothetical tax obligations would amount to \$128,551,219.¹⁸ They claim that the \$123,957,341¹⁹ paid as Payments in Lieu of Taxes I and

Payments in Lieu of Taxes II is less than the total hypothetical tax and therefore the entire amount paid should be allowed as operating taxes.²⁰ The Bureau reviewed the PRTC/PRCC submission and found a minor error in the calculation of the hypothetical municipal license tax. It was calculated using an incorrect tax rate. At our request PRTC and PRCC recalculated the hypothetical municipal license tax and revised its hypothetical municipal license tax estimate to \$2,955,328,²¹ a reduction of approximately \$1.4 million.

III. COMMENTS AND REPLY COMMENTS

8. AT&T Corp. ("AT&T"), MCI Telecommunications Corporation ("MCI"), Lambda Communications, Inc. ("Lambda") and NECA filed comments. Reply comments were filed by AT&T, NECA and the Puerto Rico Telephone Company.

9. AT&T states that no legitimate basis exists to allow PRTC and PRCC to classify the entire proceeds of the sale of their corporate affiliate, TLD, as an operating tax expense or to permit PRTC and PRCC to receive more USF assistance and interstate access settlements. AT&T asserts that the proceeds of the TLD sale are not operating in nature and should not be classified as income from operations.²² AT&T contends that Commonwealth's Local Law 33 provides that in computing PRTC's gross revenues, interest earned from any funds or other non-operational income shall be excluded. AT&T states, therefore, that because the TLD sale proceeds are non-operating in nature, they should not be included in the gross revenues for the computation of the Payments in Lieu of Taxes II.²³

10. MCI states that because the Payment in Lieu of Taxes I is intended to be equivalent to the property taxes PRTC and PRCC would pay as private corporations to the island's municipalities and that because PRTC and PRCC actually pay about \$29.6 million less property tax than they would if they were privately owned, the entire amount of Payments in Lieu of Taxes I should be counted as an operating tax. With respect to the Payments in Lieu of Taxes II,

Audits Division, Common Carrier Bureau, Federal Communications Commission.

⁹ Letters from Richard R. Snopkowski, Vice President Industry Relations, Eastern U.S., National Exchange Carrier Association, to Gladys Batista Torres, Group Director Corporate Planning, Puerto Rico Telephone Company, dated July 8, 1993, September 3, 1993, September 17, 1993, and November 3, 1993.

¹⁰ Pursuant to Part 69, Subpart G, NECA files tariffs on behalf of member companies and distributes access revenue settlements, and pursuant to Part 36, Subpart F, NECA administers the USF.

¹¹ Letter from Joe D. Edge, Counsel for PRTC and PRCC, dated November 30, 1993 to Kenneth P. Moran, Chief, Accounting and Audits Division, Common Carrier Bureau, Federal Communications Commission.

¹² Letter from Kenneth P. Moran, Chief, Accounting and Audits Division, Common Carrier Bureau, Federal Communications Commission, dated April 28, 1995, to Joe D. Edge, Counsel for PRTC and PRCC.

¹³ Letter from Joe D. Edge, Counsel for PRTC and PRCC, dated May 30, 1995 to Kenneth P. Moran, Chief, Accounting and Audits Division, Common Carrier Bureau, Federal Communications Commission.

¹⁴ Total property tax of \$44,790,414 for PRTC and \$7,094,255 for PRCC for a combined total of \$51,884,669. *Id.* Attachment, at 1.

¹⁵ Municipal license tax of \$3,826,154 for PRTC and \$532,000 for PRCC for a combined total of \$4,358,654. *Id.*

¹⁶ Telecommunications gross receipts tax of \$15,304,616 for PRTC and \$2,130,000 for PRCC for a combined total of \$17,434,616. *Id.*

¹⁷ Puerto Rico corporate income tax of \$46,203,537 for PRTC and \$8,669,743 for PRCC for a combined total of \$54,873,280. *Id.*

¹⁸ Total hypothetical tax obligation of \$110,124,721 for PRTC and \$18,426,498 for PRCC for a combined total of \$128,551,219. *Id.*

¹⁹ Total payments in lieu of taxes of \$108,447,796 for PRTC and \$15,509,545 for PRCC for a combined total of \$123,957,341. *Id.*

²⁰ PRTC and PRCC state that the hypothetical municipal license tax, telecommunications gross receipts tax and Puerto Rico income tax liability were based on 1992 pro forma tax filings as prepared by Deloitte & Touche, L.L.P. *Id.* Attachment, at 2.

²¹ Revised hypothetical municipal license tax of \$2,590,648 for PRTC and \$364,680 for PRCC for a combined total of \$2,955,328. Letter from Donald E. Parrish dated September 25, 1995, to Gary Seigel, Accounting and Audits Division, Common Carrier Bureau, Federal Communications Commission.

²² AT&T Comments at 1-2.

²³ *Id.* at 4-5.

however, MCI states that, while PRTC and PRCC characterize these payments as a replacement for the gross receipts taxes they would pay as a private company, PRTC's and PRCC's estimates regarding the taxes they would pay as a private company incorrectly include Puerto Rico corporate income tax, which PRTC and PRCC are exempt from paying. MCI states that if the companies have been exempted from paying income taxes, ratepayers should receive the benefit of that exemption.²⁴ MCI contends, therefore, that the only relevant comparison is with the gross receipts tax PRTC and PRCC would have paid as private companies.

11. Lambda argues that PRTC and PRCC's \$81,696,702 Payment in Lieu of Taxes II should be disallowed because it was a discretionary payment in excess of the 4 percent of gross income threshold that PRTA is required to pay under Commonwealth law. Lambda also claims that because Commonwealth law provides PRTA with authority to approve discretionary payments in excess of the 4 percent threshold it is unlike any operating tax.

12. NECA requests that the Commission clarify this issue promptly so that it can accurately administer both the Commission's USF program and NECA's interstate access settlements process. NECA also requests that if the Commission rules in Puerto Rico's favor, that the Commission make its order effective retroactive to the date of the payments so it can reimburse PRTC and PRCC the amounts that have been withheld. NECA further requests that the Commission clarify whether its decision in this matter also applies to other municipally-owned utilities.²⁵

13. In its reply comments, PRTC states that no party disputes the amount paid as Payments in Lieu of Taxes I nor the initial \$20 million paid as Payments in Lieu of Taxes II. According to PRTC, the only dispute concerns whether the second amount of \$81.7 million paid as Payments in Lieu of Taxes II should be allowed for interstate access settlement and USF payment purposes.²⁶ PRTC claims that the Puerto Rico Legislature's determination on the recovery of payments in lieu of taxes did not result in an unreasonable 1992 tax burden on PRTC and PRCC. PRTC further states that the amounts paid by PRTC and PRCC are "not disproportionate in view of the companies' size, revenues or scale of access services" and that the payments are not disproportionate in comparison with the tax payments that the companies would have to make if they were operating as private entities in Puerto Rico.²⁷ PRTC urges that the amounts originally claimed as operating taxes by PRTC and PRCC be allowed in the determination of 1992 access and universal service amounts due to PRTC and PRCC.²⁸

IV. DISCUSSION

14. The issue before us is whether amounts paid by PRTC and PRCC to the Commonwealth of Puerto Rico through PRTA, an agency of the Commonwealth, can be claimed as operating tax expenses for USF and interstate access settlement purposes. Because the "taxed" entities and the Commonwealth are effectively one and the same, these transactions are not at arm's length. The commenters have

expressed concern about the discretionary nature of amounts paid by PRTA, the relationship of PRTA's payments to the proceeds from the sale of TLD, and the lack of a relationship of some of the payments to the taxes that would be paid by private companies.

15. Parties also expressed concern that if the Commission permits these payments to be recorded as operating tax expenses, it would significantly affect the USF distributions and interstate access settlements of other entities unaffiliated with PRTC or PRCC, namely other local exchange carriers ("LECs"). USF distributions to other carriers would be reduced because the Commission has capped 1994 USF payments at a fixed amount; therefore, increases in payments to PRTC and PRCC would reduce payments to all other USF recipients by a like amount. Likewise, interstate access settlements to other carriers would be reduced because in the NECA pooling process the total revenues in the pool are distributed among the participating carriers. Therefore, increases in payments to PRTC and PRCC would reduce payments to other LECs participating in pool settlements by a like amount. Allowing the full amount of Payments in Lieu of Taxes as operating taxes, as PRTC and PRCC request, would increase their interstate receipts from NECA by \$22.4 million²⁹ while simultaneously reducing interstate receipts of other LECs by \$22.4 million.

16. Because PRTC and PRCC are owned by the Commonwealth of Puerto Rico, the Commonwealth is effectively "taxing" itself through the transfer of funds from its LECs while simultaneously charging the interstate revenue pool for an interstate contribution to support its levy. We do not question the Commonwealth's statutory right to transfer funds from its LECs, as permitted under Puerto Rico law, even if such payments are highly discretionary. Whether or not the carriers can claim these payments as taxes for reimbursement under USF and interstate access settlement programs, however, depends on whether such payments can be properly recorded as operating taxes in Accounts 7200 through 7250 of the USOA.³⁰ Because the USOA does not specifically address the recording of payments made in lieu of taxes, we must interpret the provisions of the USOA with respect to such payments.

17. In our view, payments in lieu of taxes by a government owned corporation can be recorded in Accounts 7200 through 7250 only if they meet the standard set forth in our letter of April 28, 1995, *i.e.*, the payments must be calculated using rates that do not exceed tax rates applicable to private enterprises operating in the jurisdiction. We believe that a payment in excess of an amount calculated in accordance with this standard is in most cases a dividend paid by a government owned corporation to its owner, which should be charged to retained earnings if it represents a dividend paid out of earnings or to other capital accounts if it is a liquidating dividend. There may be cases where such an excess payment would be considered a contribution, and under those circumstances such a payment would be charged to Account 7370, Special Charges.

²⁴ MCI Comments at 3.

²⁵ NECA Comments at 1-2.

²⁶ PRTC Reply Comments at 2.

²⁷ *Id.* at 3-4.

²⁸ *Id.* at 4-5.

²⁹ See *supra*, ¶ 5.

³⁰ See *supra*, fn.2

18. In their letter of May 30, 1995, PRTC and PRCC describe three hypothetical taxes that they would pay as private enterprises -- property taxes, gross receipts taxes (including municipal license taxes that are assessed on gross receipts), and Puerto Rico corporate income taxes. Our analysis of payments in lieu of taxes for 1992, the relationship of these payments to the hypothetical tax obligations, and the amounts allowable for each category are discussed below.

19. *Property Taxes.* Because Payments in Lieu of Taxes I is calculated based on property values, it is comparable to the property taxes paid by private entities. Applying the standard set forth in the April 28 letter to Payments in Lieu of Taxes I paid by PRTC and PRCC reveals that the amount actually paid in 1992 (\$22,260,639)³¹ is less than the amount that PRTC and PRCC would have paid as private entities (\$51,884,669).³² Moreover, we received no comments that objected to allowing PRTC and PRCC to recover the amounts paid as Payments in Lieu of Taxes I. Accordingly, we find that the entire amount of Payments in Lieu of Taxes I paid in 1992 by PRTC and PRCC should be recorded in Account 7240, Operating Other Taxes, and treated as operating taxes for USF and interstate settlement purposes.

20. *Gross Receipts Taxes.* The taxes on private entities in Puerto Rico that are similar to the Payment in Lieu of Taxes II are the telecommunications gross receipts tax and the municipal license tax that is also assessed on gross receipts. Applying the standard set forth in the April 28 letter to Payments in Lieu of Taxes II reveals that the amount paid by PRTC and PRCC (\$101,696,702)³³ is substantially greater than the amount they would have paid as private entities (\$20,389,944).³⁴ Therefore, the amount of gross receipts taxes that should be recorded in Account 7240 and allowed as operating taxes for USF and access settlement purposes is \$20,389,944. The remaining amount of \$81,306,758 should, in our view, be charged to Account 4550, Retained Earnings.

21. We conclude that the additional \$81,306,758 paid as Payments in Lieu of Taxes II should not be recorded as an operating tax because that would result in gross receipts taxes for these government owned corporations that greatly exceed gross receipts taxes that would be paid by private enterprises. Moreover, this additional payment does not resemble a tax in any way. It was not based on any tax rate applied to a taxable base. It was declared by the taxpayer rather than required by the taxing authority. It was a one-time payment rather than a recurring tax assessment.

22. Based on the facts and circumstances contained in the record, it appears that most of PRTC and PRCC's additional Payment in Lieu of Taxes II, *i.e.*, at least \$80 million of the \$81.7 million, resulted from the sale of the TLD subsidiary. The record also shows that, under PRTA's normal accounting practice, profits from PRTC and PRCC are placed in the construction fund.³⁵ Therefore, in the absence of the sale of TLD, we conclude that this \$81.7

million additional "tax payment" would not have been made. We find treating this discretionary payment as an "operating tax" for USF and interstate access settlement purposes would be inconsistent with our interpretation of the USOA. In our view, this additional payment is akin to a dividend paid out of earnings.

23. *Income Taxes.* PRTC and PRCC state that they would have paid \$54,837,280 in corporate income taxes to Puerto Rico in 1992 if they were private corporations.³⁶ Applying the standard set forth in our April 28th letter, PRTC and PRCC can not claim this hypothetical tax for USF and access settlement purposes because they made no Payments in Lieu of Taxes based on net income in 1992, and they have no amounts that could be properly recorded in Account 7230, Operating State and Local Income Taxes.

V. CONCLUSION

24. After considering the record in this proceeding, we conclude that the position taken in our April 28th letter was correct. We will only permit PRTC and PRCC to claim an "operating tax" for payments in lieu of taxes to the extent that the amounts paid are calculated using tax rates no greater than those that apply to non-Commonwealth owned or affiliated companies operating in Puerto Rico because in our view these are the only amounts that can be properly recorded as operating taxes under the USOA. Thus for 1992, PRTC and PRCC should be allowed \$22,260,639 for Payments in Lieu of Taxes I and \$20,389,944 for Payments in Lieu of Taxes II.

25. Our decision in this matter, of course, applies to all future amounts claimed by PRTC and PRCC as operating taxes for USF and interstate access settlement purposes, *i.e.*, PRTC and PRCC may not claim for USF and interstate access settlement purposes payments in lieu of taxes in excess of those amounts that they would have paid if they were operating as private, non-Commonwealth owned LECs. Our interpretation as to the amounts that may be recorded as operating taxes in Accounts 7200 through 7250 extends to other government owned corporations as well. We encourage parties that may have any doubt as to the applicability of this interpretation to their specific circumstances to a file a request for an interpretation pursuant to §32.17, Interpretation of Accounts.³⁷

VI. ORDERING CLAUSES

26. Accordingly, IT IS ORDERED, pursuant to Sections 4(i) and 5(c) of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 155(c) and Sections 0.91 and 0.291 of the Commission's Rules, 47 C.F.R. §§ 0.91, 0.291, that PRTC's and PRCC's request to consider certain payments made to the Puerto Rico Department of Treasury be treated as operating taxes for purposes of determining their

³¹ See *supra*, ¶ 4.

³² See *supra*, ¶ 7.

³³ See *supra*, ¶ 4.

³⁴ Total municipal license tax of \$2,955,328 (See *supra*, fn. 21) and total telecommunications gross receipts tax of \$17,434,616 (See *supra*, fn. 16) for a combined total of \$20,389,944.

³⁵ PRTC, in n.4 of its Reply Comments, stated that PRTC's and PRCC's net income is not paid out in dividends but is

reinvested in extensions to, and improvement of, the Commonwealth's network.

³⁶ Letter from Joe D. Edge, Counsel for PRTC and PRCC, dated May 30, 1995 to Kenneth P. Moran, Chief, Accounting and Audits Division, Common Carrier Bureau, Federal Communications Commission.

³⁷ 47 C. F. R. §32.17.

draw from the interstate access revenue pools and the USF administered by NECA IS GRANTED to the extent set forth herein, and is otherwise, in all respects, DENIED.

27. IT IS FURTHER ORDERED that the National Exchange Carrier Association, Inc. shall reimburse PRTC and PRCC retroactive to 1992 only to the extent provided herein.

FEDERAL COMMUNICATIONS COMMISSION

Kathleen B. Levitz
Deputy Chief,
Common Carrier Bureau