

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

In the Matter of)	
)	
Amendment of Part 1 of the Commission's)	
Rules - Competitive Bidding Procedures)	WT Docket No. 97-82
)	
)	
)	

PETITION FOR PARTIAL RECONSIDERATION

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SUMMARY

National Telecommunications Cooperative Association (“NTCA”), the Rural Telecommunications Group (“RTG”), Blooston, Mordkofsky, Dickens, Duffy & Prendergast (“BloostonLaw”), and Kraskin, Lesse & Cosson, LLC, (collectively the “Rural Cooperative Coalition” or “Coalition”) requests the elimination of the “tax-exempt” requirement for rural telephone companies seeking to exclude officer and director revenue from attributable revenues, for purposes of qualifying for bidding credits.

The legal requirements for structuring a rural telephone cooperative prevents applicants from improperly infusing capital or otherwise establishing sham cooperatives. These legal protections are independent of the tax status of the rural telephone cooperative.

The Commission’s tax-exempt requirement is unnecessary and undermines the very purpose of the exemption because many rural telephone cooperative applicants are not tax-exempt in a given year. The Commission should eliminate the tax-exempt requirement because the structure of a cooperative prevents sham operations; the 85 percent income test is not relevant to application of the attribution rule; it has no rational basis; and it contravenes Section 309(j).

To the extent that the Commission believes that an additional “gating” criterion is needed, the Coalition proposes that the Commission instead adopt one of the two alternative standards described herein. The first alternative would require that the rural cooperative seeking the attribution exemption must demonstrate that it satisfies the Internal Revenue Service’s three basic requirements for being recognized as a cooperative, as enunciated in the *Puget Sound* decision. The second alternative would require an applicant to demonstrate that it meets a “community commitment” standard before it would qualify for the attribution exemption. A rural

telephone cooperative would be required to have been continually operating since February 8, 1996 to demonstrate “community commitment.”

The Commission’s tax-exempt requirement has no rational connection to the objective of ensuring that the exemption would only be used by *bona fide* community-based cooperatives; instead, the requirement leaves many rural telephone cooperatives without the opportunity to participate in future auctions with the same level of bidding credits available to other similarly situated cooperatives.

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PETITION FOR PARTIAL RECONSIDERATION

Pursuant to Section 1.429 of the Commission's rules,¹ the National Telecommunications Cooperative Association ("NTCA"), the Rural Telecommunications Group ("RTG"), Blooston, Mordkofsky, Dickens, Duffy & Prendergast ("BloostonLaw"), and Kraskin, Lesse & Cosson, LLC, on behalf of their cooperative members and clients (collectively the "Rural Cooperative Coalition" or "Coalition") hereby respectfully submit this petition for reconsideration of certain aspects of the Commission's *Reconsideration Order* issued in the above captioned proceeding.² Specifically, the Coalition requests the elimination of the "tax-exempt" requirement for rural telephone companies seeking to exclude officer and director revenue from attributable revenues, for purposes of qualifying for bidding credits.

The Coalition applauds the Commission for exempting the affiliates of officers and directors of a rural telephone cooperative from attribution to the cooperative. The Commission

¹ 47 C.F.R. § 1.429.

² *Amendment of Part 1 of the Commission's Rules – Competitive Bidding Procedures*, WT Docket No. 97-82, Second Order on Reconsideration of the Third Report and Order and Order of Reconsideration of the Fifth Report and Order, rel. May 8, 2003; 68 FR 139 (2003) ("*Reconsideration Order*").

correctly identified that the unique business structure of rural telephone cooperatives justifies the exemption, recognizing that it is highly unlikely such entities would be able to participate in sham transactions that the Commission's attribution rule is designed to prevent.³ However, the Coalition respectfully submits that the Commission's adoption of a specific tax-exempt requirement as a condition of eligibility for the exemption should be rescinded, because it would have the unintended consequence of disqualifying many rural cooperatives from the benefits that the exemption was to have created. Moreover, under the tax-exempt requirement, a cooperative does not even know whether it meets the requirement at the time of filing its short-form application, because it will not know for some time after the close of its tax year whether it has met the test for exemption for that year. To the extent that the Commission believes that an additional "gating" criterion is needed, the Coalition proposes that the Commission instead adopt one of the alternative standards described below.

The first proposed alternative would require that the rural cooperative seeking the attribution exemption must demonstrate that it satisfies the Internal Revenue Service's three basic requirements for qualifying as a cooperative, as enunciated in the *Puget Sound* decision, discussed *infra*. This alternative test affords the Commission the benefit of its original "tax-exempt" criterion, namely, ensuring that the cooperative seeking an exemption has met Federally-recognized standards for treatment as a *bona fide* cooperative.

The second proposed alternative would require that the rural cooperative seeking the attribution exemption must demonstrate qualification under a "community commitment" standard. A rural telephone cooperative would be required to have been continually operating since February 8, 1996 (*i.e.*, the date that the definition of "rural telephone company" was

³ *Reconsideration Order*, para. 15.

enacted as part of the Telecommunications Act of 1996). This requirement would ensure that a cooperative has a demonstrated an established tie to the community that it serves. The requirement would also ensure that a sham cooperative could not quickly spring up in an attempt to circumvent the Commission's rule to garner a bidding credit.

I. INTERESTS OF THE COALITION

The Coalition's constituent members collectively represent several hundred rural telephone cooperatives. These cooperatives are interested parties that are significantly impacted by the outcome of this proceeding. Rural telephone cooperatives depend on bidding credits to help ensure that they can provide quality, affordable and advanced telecommunications services to rural America. Accordingly, the Coalition members have participated extensively in this rule making and other proceedings leading up to the Commission's *Reconsideration Order*.⁴

The constituent rural telephone cooperatives have been created to provide high quality telecommunications services to consumers of rural America. Many of these cooperatives have participated in previous FCC spectrum auctions, with varying degrees of success, and are contemplating participation in upcoming auctions. Several of these cooperatives have been forced to forego larger bidding credits when obtaining or attempting to obtain spectrum through participation in Commission auctions, in order to serve their rural communities. In some cases, rural cooperatives have officers and/or directors with outside business interests that have been attributed to the cooperative under the controlling interest rule, thereby artificially inflating the revenues of the cooperative, and reducing the amount of the bidding credit applied to any licenses won. In other cases, cooperatives concluded that it would be inappropriate to force their

⁴ See, e.g., *Reconsideration Order* at note 38; RTG Petition for Reconsideration, WT Docket No. 97-82 (filed Sept. 28, 2000).

officers and directors to provide their social security number and financial information for the sake of obtaining a bid credit. These experiences give the Coalition's members particular insight into this proceeding.

II. INTRODUCTION

In the *Fifth Report and Order*,⁵ the Commission adopted a “controlling interest” standard for determining whether to attribute to an applicant the gross revenues of its interest holders and their affiliates, in assessing whether such applicant qualifies for a bidding credit. Conceptually, under this standard, all parties that control an applicant or have the power to control an applicant, will have the gross revenues of their affiliates attributed to the applicant. To this end, the Commission adopted Rule Section 1.2110(c)(2)(ii)(F), which provides that “[o]fficers and directors of an entity shall be considered to have a controlling interest in the entity.” Pursuant to this Section, the FCC considered the officers and directors of a rural telephone cooperative to have a “controlling interest” in the cooperative, and accordingly, the revenue of any affiliates of the officers and directors were attributed to such cooperative.⁶ RTG filed a petition for reconsideration of this aspect of the controlling interest test, because of the adverse impact on rural cooperatives that must assemble their boards from the leaders of their local communities. During the ensuing months, the Coalition's members met with the Commission's staff to discuss this issue, and provided information concerning the structure of cooperatives. This information demonstrated that rural telephone cooperatives could not draw on the resources of their officers' and directors' outside business interests for purposes of funding an auction effort, and that

⁵ *Amendment to Part 1 of the Commission's Rules - Competitive Bidding Procedures*, Order on Reconsideration of the Third Report and Order, Fifth Report and Order, and Fourth Further Notice of Proposed Rulemaking, WT Docket No. 97-82, 15 FCC Rcd 15293 (FCC 00-274)(rel. August 14, 2000)(“*Fifth Report and Order*”).

cooperatives could not raise capital by selling equity interests, since the cooperative structure prevents such unequal equity holdings.⁷

In the *Reconsideration Order*, the Commission agreed with the Coalition members' showing that a rural cooperative exemption from Rule Section 1.2110(c)(2)(ii)(F) for the purpose of attribution in rule Section 1.2110(b)(1) was appropriate. In particular, the Commission found that key differences between cooperatives and other business structures make it "highly unlikely that rural telephone cooperatives would be able to participate in the types of sham transactions the [controlling interest attribution] rule is designed to protect against."⁸ In doing so, the Commission recognized several factors that support the exclusion of the gross revenues of entities controlled by a rural telephone cooperative's officers and directors. Those factors are:⁹

1. The ownership and control of the cooperative remain in the hands of the patrons of the cooperative (i.e., telephone subscribers), rather than in non-patron equity investors;
2. The outside business interests of individual officers and directors of rural telephone cooperatives are not financial and management resources available to the cooperative;
3. The democratic structure of cooperatives requires the patrons to control the cooperative;
4. The cooperative members contribute equity to, and control, the capital of the cooperative, as opposed to outside investors.

As shown above, the Commission agrees with the Coalition's premise that the structure of a rural cooperative is such that the outside business interests of its individual officers and

⁶ See 47 C.F.R. §1.2110(b)(1).

⁷ See Ex Parte Letter of John A Prendergast, Esq. (on behalf of NTCA, RTG and BloostonLaw) submitted on November 26, 2002.

⁸ *Reconsideration Order* at para. 15.

⁹ *Id.*

directors are not financial resources available to the cooperative to raise capital or compete for FCC licenses, and that such interests should not be attributed when determining the cooperative's eligibility for bidding credits.¹⁰ The Commission created an exemption for rural telephone cooperatives, and adopted certain "gating" criteria to ensure that only *bona fide* rural cooperatives were eligible for the exemption. In particular, the applicant (or the controlling interest) must be validly organized as a cooperative pursuant to state law,¹¹ and the applicant (or the controlling interest) must be a "rural telephone company" as defined by the Communications Act. Unexpectedly, however, the Commission adopted a requirement that the applicant (or its controlling interest) must be eligible for tax-exempt status under the Internal Revenue Code ("I.R.C."), as part of its three-pronged test for determining whether an applicant's officers and directors are entitled to the exemption from the Commission's attribution requirement of 1.2110(c).¹² The Coalition respectfully submits that this requirement is unnecessary and undermines the very purpose of the exemption, because many rural telephone cooperative applicants are not tax-exempt in a given year.¹³ The legal requirements for structuring a rural telephone cooperative prevents applicants from improperly infusing capital or otherwise engaging in sham transactions. As discussed herein, these legal protections are independent of the tax status of the rural telephone cooperative.

¹⁰ *Reconsideration Order*, para. 12, noting that if an officer or director is considered a controlling interest of the applicant under another subsection of the controlling interest attribution rule, the exemption will not apply. Thus, the Commission has left itself yet another safeguard to apply to those situations in which there is a clear basis for attribution, beyond the mere fact that the person in question is an officer or director of a cooperative.

¹¹ *Reconsideration Order*, para. 16.

¹² *Id.*

¹³ See, *Applications to Participate in an FCC Auction (FCC 175) of Cable and Communications Corporation, Northeast Nebraska Telephone Company, and Poka Lambro Telecommunications, Ltd.* (initially filed May 8, 2002).

III. THE COMMISSION SHOULD ELIMINATE THE “TAX-EXEMPT” REQUIREMENT

The Coalition urges the Commission to eliminate the requirement that a rural telephone cooperative be tax-exempt in order to qualify for the attribution exemption. Whether a cooperative is or is not tax-exempt does not impact the ownership and control structure of the cooperative; does not impact the fact that the outside business interests of individual officers and directors of the cooperative are not financial and management resources available to the cooperative; does not impact the democratic structure of the cooperative; and does not impact the fact that members contribute equity to, and control, the capital of the cooperative, as opposed to outside investors.

None of the aforementioned factors, which are the foundations for the Commission’s decision that a rural cooperative would not have the incentive or ability to participate in the types of sham transactions the attribution rule was designed to prevent, require a cooperative to be tax-exempt. However, requiring a cooperative to be tax-exempt creates needless and dire consequences for the small carriers serving rural America that happen to be subject to federal income taxation.

1. The Structure of a Cooperative Prevents Sham Transactions

The Commission should eliminate the tax-exempt requirement because the structure of a cooperative prevents sham transactions. In *Puget Sound Plywood v. Commissioner*, 44 T.C. 305, 307-308 (1965)(“*Puget Sound*”) the Tax Court identified the three basic principles or requirements of a cooperative: (1) democratic control by the members, i.e., one member, one vote rather than voting rights proportional to equity contribution; (2) vesting in and allocating among the members all excess of operating revenues over operating expenses (i.e., operating at

cost); and (3) subordination of capital, i.e., margins are distributed in proportion to business done with the cooperative, and not in proportion to equity contributed.

The Internal Revenue Service (“IRS”) has been called upon at various times to explain the essential characteristics of a cooperative’s organization and functions, and to explain the subordination of capital principle listed above. For example, in Revenue Ruling 72-36, the Service shed light on this aspect of a cooperative’s function as follows:

“Question 1. Should the interest of members in the savings of an organization be determined in proportion to their business with the organization?

Answer: Yes. In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of the organization should be determined in proportion to their business with the organization....”¹⁴

Rural telephone cooperatives are not permitted to pay a dividend on capital investment. Moreover, if a cooperative, including a rural telephone cooperative, violates the aforementioned requirements, the cooperative not only loses its exemption from federal income tax under Section 501(c)(12), but more importantly, it is no longer entitled to exclude patronage-source revenue from income. Accordingly, subordination of capital serves as an automatic gate that prohibits a rural telephone cooperative from engaging in the types of sham transactions that the attribution rules were designed to prevent. The additional imposition of the Commission’s tax-exemption requirement does nothing except exclude many taxable rural telephone cooperatives from the benefits of a bidding credit, as discussed below.

¹⁴ Rev. Rul. 72-36, 1972-1 C.B. 151.

2. The 85 Percent Income Test Is Not Relevant to Application of the Attribution Rule

To qualify for and maintain a tax exemption in any given year, a rural telephone cooperative must receive 85% or more of its annual income from members. Member income is member-sourced and derived from the exempt activities conducted according to cooperative principles. In applying the member income test, the IRS classifies each item of income as member income, non-member income, or “excluded” income. For example, a telephone cooperative may provide telecommunications services to both members and non-members. The income from members is member-source income but the income from nonmember patrons is not. If nonmember income exceeds 15 percent in a tax year, the telephone cooperative will simply lose the tax exemption for that year, but does not need to reapply for exempt status if it passes the test in a subsequent year.

When a cooperative loses its exemption in a given year, it is then subject to federal income tax for that year. Accordingly, the difference between rural telephone cooperatives that are tax-exempt and those that are not, is that the earnings of the former related to their exempt purpose are not subject federal tax.¹⁵ For the purpose of the Commission’s rules the important point is that the structure of the cooperative, and the principles that govern the cooperative remain the same in both cases. Therefore, the inability of members or directors to infuse capital beyond their proportionate share of business with the cooperative, or to gain voting control or influence over the cooperative’s operation in proportion to their capital account is independent of the tax status of the cooperative.

¹⁵ Tax-exempt cooperatives remain subject to the unrelated business income tax.

IV. THE COMMISSION'S ATTRIBUTION RULES SHOULD NOT DISTINGUISH BETWEEN EXEMPT AND NON-TAX EXEMPT COOPERATIVES

Many rural telephone cooperatives are taxable cooperatives at some stage of their existence. Changes in demographics, financial markets and industry structure changes, including the recent branching-out of the rural telephone industry into new lines of communications business, have required cooperatives to classify proportionally more revenue as non-member income. The result is that these cooperatives become taxable.¹⁶ Once taxable, the Commission's tax-exempt requirement prevents those applicants from taking advantage of the attribution exemption, and thereby losing bidding credits that are used to level the playing field for acquisition of spectrum in rural areas.

1. The Commission Should Eliminate The Tax-Exempt Requirement Because It Has No Rational Basis

While most, rural telephone cooperatives have qualified for tax exemption in the past,¹⁷ currently it is estimated that only approximately fifty percent of rural cooperatives can expect to pass the 85% member income test.¹⁸

Rural telephone cooperatives have responded to their members' requests to provide a broad range of communications and information services. Today many rural telephone cooperatives provide cable television or other video services, dial-up or broadband Internet access or ISP service, cellular (or other wireless) services, home security monitoring, and

¹⁶ Taxable rural telephone cooperatives, however, are still permitted to exclude patronage-sourced revenue from income as long as they are operating consistent with the principles established in *Puget Sound*.

¹⁷ The exemption from federal income taxes for cooperative telephone companies was enacted in the Revenue Act of 1916, Pub. L. No. 64-271, ch. 462 §11(a)(10), 39 Stat. 756, 767 (1916). The Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253 (1924) added the 85% member income test, which was then reenacted in successive revenue acts and codes. *See also Reconsideration Order* at note 57.

¹⁸ Estimate based on informal surveys of NTCA member cooperatives.

medical alert services.¹⁹ This branching out is in the public interest, because the telephone cooperative is often the only entity positioned to bring such advanced services to its rural community and surrounding areas. For a variety of reasons, revenues from these services may not meet the IRS requirements for member-sourced income.²⁰ Accordingly, because the revenues from such services may not be member-sourced, the cooperatives may no longer qualify for the tax exemption.

An example of the various factors affecting a cooperative's percentage of member income is the Commission decision requiring separate long-distance and local corporations.²¹ This regulation is unrelated to the Commission's rules for auction bidding credits, and yet has impacted whether certain rural cooperatives qualify for tax-exempt status because revenues from subscribers to a cooperative's long distance affiliate may be classified as non-member sourced income.

¹⁹ Roaming revenues may also be classified as non-member income, even though the Commission's rules require wireless carriers to carry such traffic.

²⁰ Beginning in 1974 a series of IRS rulings caused many telephone cooperatives to lose tax-exempt status. These rulings have in many respects now been reversed either by legislation, judicial review or reconsideration by the IRS. The relevance of this history for the present proceeding is that during the period between the IRS rulings and their subsequent reversal, the cooperatives would have been excluded from the cooperative exemption from the attribution rules for no reason having any relevance to those rules. *See, e.g.*, Rev. Rul. 74-362, 1974-2 C.B. 170; Notice 92-33, 1992-30 I.R.B. 15 (1992); PLR 9722006 (1997); Rev. Rul. 2002-55, I.R.B. 2002-37.

²¹ *See, Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Market Place*, CC Docket Nos. 96-149, 96-61, Second Report in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-6; 62 FR 36017 (1997); 47 C.F.R. §§ 64.1901-1903. If a cooperative finds it desirable to enter the long distance business using even a portion of its own long distance facilities the current rules force it to create a subsidiary, the customers of which will not be members. Accordingly, the gross revenue from those subscribers will not be included in the denominator of the percent member income fraction, thus making it harder for the cooperative to meet the 85 percent test. On the other hand, if the cooperative operates the long distance business as a pure reseller, the long distance revenues received from members are member income in both the numerator and denominator.

2. The Commission Should Eliminate the Tax-Exempt Requirement Because It Is Contrary To Section 309(j)

The Commission’s decision to require every rural telephone cooperative to be tax-exempt before its officers and directors are exempted from attribution²² will have the unintended effect of diluting the Commission’s mandate, under Section 309(j) of the Act.²³ Section 309(j) directs the Commission to promote the development and rapid deployment of new technologies, products, and services for the benefit of the public, *including those residing in rural areas*, and to promote economic opportunity and competition by avoiding excessive concentration of licenses and by disseminating licenses among a wide variety of applicants, including rural telephone cooperatives.²⁴ As demonstrated herein, because many of today’s rural telephone cooperatives are not tax-exempt, the the tax exemption criterion will hinder rather than enhance the opportunities of such applicants to obtain spectrum. To avoid this result, the Commission should eliminate the tax-exempt requirement.

V. IN THE ALTERNATIVE, THE COMMISSION SHOULD ADOPT A MODIFIED ATTRIBUTION EXEMPTION REQUIREMENT

As discussed above, the Coalition believes that the Commission can simply eliminate the “tax-exempt” criterion, and that its remaining safeguards are adequate to preclude any sham arrangements. However, if the Commission believes that an additional gating criterion is needed, the Coalition proposes that the Commission adopt one of two substitute safeguards. The first proposed alternative would require that the rural cooperative seeking the attribution exemption must demonstrate that it satisfies the IRS guidelines for the three basic principles or

²² 47 C.F.R. § 1.2110(c)(2)(ii)(F).

²³ 47 U.S.C. § 309(j).

²⁴ 47 U.S.C. § 309(j)(3).

requirements of a cooperative, as enunciated in the *Puget Sound* decision, *supra*: (1) democratic control by the members, i.e., one member, one vote; (2) operating at cost; and (3) subordination of capital. The cooperative could demonstrate that it satisfies this criterion by showing that it has been issued an IRS certification that it qualified for tax-exempt treatment under Section 501(c)(12), even if the cooperative is not tax-exempt under the 85%/15% rule in a given year; or the cooperative could show based on its charter and by-laws that it observes the three *Puget Sound* principles listed above, again without regard to whether it is currently tax-exempt under the 85%/15% rule. This alternative test affords the Commission the benefit of its original “tax-exempt” criterion, namely, ensuring that the cooperative seeking an exemption has met Federally-recognized standards for treatment as a *bona fide* cooperative. At the same time, it would not have the effect of punishing those cooperatives that have lost tax-exempt status because of a one-time sale of assets, or because they have aggressively pursued bringing other types of advanced services to rural America.

The second proposed alternative would require an applicant to demonstrate that it meets a “community commitment” standard before it would qualify for the attribution exemption. A rural telephone cooperative would be required to have been continually operating since February 8, 1996 (*i.e.*, the date that the definition of “rural telephone company” was enacted as part of the Telecommunications Act of 1996). A carrier that has continually served a rural community for several years has a demonstrated commitment to provide rural customers with quality, innovative and cost-effective telecommunications service and should give the Commission assurance that such entity is not a “sham.” The requirement is also administratively simple.

Either of these alternative requirements would help ensure that the attribution exemption would only be used “by bona fide community-based cooperatives, not sham entities.”²⁵ The requirements are objective and easily verifiable. The requirements also avoid one of the problems with the tax-exempt requirement. As demonstrated in the *ex parte* letter submitted by Coalition members and as discussed above, the tax status of a rural telephone cooperative may change from year to year because of the sale of certain assets or the success of secondary lines of business that may cause more than 15% of revenues to derive from non-member sources.²⁶ Because of the time lag associated with annual tax accounting, and IRS review, neither the Commission nor a rural telephone cooperative can accurately predict whether the cooperative will be tax-exempt at the time of a Commission auction. Therefore, the Commission’s tax-exempt requirement is unworkable as a result of untimely verification. The current requirement also creates unwarranted uncertainty, further deterring cooperatives from participation in the Commission’s auctions.

The better approach is to simply eliminate the tax-exempt requirement, or substitute one of the alternative requirements described above. In combination with the other two exemption factors, either alternative requirement would help to provide a meaningful opportunity for small cooperatives to acquire spectrum in order to serve rural America. It would also guard against the use of sham transactions by unscrupulous companies trying to gain a competitive edge.

VI. CONCLUSION

For the foregoing reasons, the Coalition respectfully submits that the Commission should eliminate the requirement that an applicant (or the controlling interest) must be eligible for tax-

²⁵ *Reconsideration Order* at para. 17.

²⁶ *Ex Parte* filed by Blooston, NTCA and RTG in WT Docket No. 97-82 (Dated June 3, 2003).

exempt status under the I.R.C. in order for the income of affiliates of a rural telephone cooperatives' officers and directors to not be attributed to the applicant. The requirement does not effect whether the attribution exemption would only be used by *bona fide* community-based cooperatives. However, the requirement does leave many rural telephone cooperatives without the opportunity to participate in future auctions.

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I, Douglas W. Everette, hereby certify that I am an attorney with the law firm of Blooston, Mordkofsky, Dickens, Duffy & Prendergast, and that copies of the foregoing Petition For Partial Reconsideration were served by hand delivery on this 20th day of August, 2003 to the persons listed below:

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