

# Rural Cooperative Coalition

May 4, 2004

***Filed Electronically***

Marlene H. Dortch, Secretary  
Office of the Secretary  
Federal Communications Commission  
445 12th Street, S.W.  
Washington, D.C. 20554

**Re: WT Docket No. 97-82  
EX PARTE NOTICE**

Dear Ms. Dortch:

The FCC staff has requested additional information from the Rural Cooperative Coalition (“Coalition”) with regard to their August 20, 2003 Petition for Partial Reconsideration (“Petition”)<sup>1</sup> in WT Doc. No. 97-82. The following provides further information about the Coalition’s concern that a telephone cooperative should not have to be tax-exempt to qualify as a *bona-fide* cooperative. Because tax-exempt status is irrelevant to *bona fides*, it is respectfully submitted that such a criterion for exemption from the rules attributing the revenues of affiliates of officers and directors to a cooperative for the purpose of determining eligibility for bidding credits, is misplaced. Specifically, the Coalition provides information below regarding the reasons many telephone cooperatives do not now or will not in the future qualify for exemption; the effect of tax law principles such as the ruling in *Puget Sound Plywood v. Commissioner*, 44 T.C. 305 (1965) (“*Puget Sound*”) on the structure of the telephone cooperatives; the interaction between IRC sections 501(c)(12) and 1381 et seq. (Subchapter T); whether a “three out of five year” exemption requirement would resolve the problems with the rule; and whether a showing of compliance with the *Puget Sound* principles complements or merely duplicates the current requirement of valid organization as a cooperative pursuant to state law.

**Rural Telephone Cooperatives’ Tax-exempt Status Under IRC Section 501(C)(12) Is Affected by Several Factors Unrelated To Their Status As *Bona Fide* Community Based Organizations**

The Coalition’s Petition (at p. 10) estimated that approximately fifty percent of rural telephone cooperatives can expect to fail the 85% member income requirement for tax

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<sup>1</sup> *Petition For Partial Reconsideration*, WT Docket No. 97-82 at 10 (filed by the Coalition August 20, 2003). See also, *Petition For Reconsideration*, WT Docket No. 97-82 (filed by Cable & Communications Corporation, Northeast Nebraska Telephone Company, and Poka Lambro)(June 9, 2003).

exemption. Since that time, the Coalition has conducted a study of NTCA's cooperative members which reinforces this estimate. Based upon a random survey, the Coalition asked the Internal Revenue Service (IRS) to review the tax returns of NTCA's Iowa member cooperatives for the tax period ending December 31, 2002. Of the 38 NTCA member cooperatives, 13 were determined by the IRS to be non-exempt, 4 were tax-exempt, 1 was tax-exempt but was not required to file (tax-exempt with less than \$25,000 in reportable revenues), and 20 had "unavailable" tax returns. According to the IRS, "unavailable" means that the tax return was not available for a variety of reasons, including that the cooperative may have submitted an extension of time to file. Because of the unavailability of the tax returns, it is not possible for the Coalition to precisely calculate the percentages for Iowa. However, it is clear that a growing number of cooperatives did not meet the 85% member income requirement in 2002.

The principle reasons for non-exempt status remain the provision of traditional services to non-members as the cooperative's market shifts, and the expansion of service to other forms of communication which are either not within the cooperative's certified exempt purpose, or are provided to non-members. A typical example is a cooperative which was required to enter into a partnership with other carriers in order to be able to obtain a license to provide mobile services to its own members. In other cases, the cooperative has extended its Internet Service to neighboring communities in response to demand for toll free dial-up access.<sup>2</sup> The Coalition is aware of no case in which an exemption was denied or revoked upon a finding that a telephone cooperative was a sham entity, nor is it aware of any instance in which the cooperative that failed to qualify for exemption was a newly created entity. The telephone cooperative industry continues to be composed entirely of cooperatives formed during the first 60 years of the twentieth century.

As the Coalition previously noted, most rural telephone cooperatives have at some point been certified by the IRS as tax-exempt pursuant to Section 501(c)(12), which means the cooperative demonstrated both its operation under cooperative principles and that it met the 85% income test at that time. IRS practice does not require re-certification for tax years in which the cooperative does not meet the 85% test. Thus, non-exempt cooperatives do not lose their status as *bona fide* cooperatives operating pursuant to cooperative principles, as described in *Puget Sound*, simply because their member income is less than 85% in a given tax year or series of years. In non-tax-exempt years, the cooperative simply files a corporation income tax return and pays any taxes so required.

### **New Services / Service to "Non-Members"**

One important factor that does or will prevent many rural cooperatives from satisfying the 85 percent test on a long-term basis is their need to expand into new telecommunications services. Consumers today have a growing desire to receive their voice, Internet and video services from the same entity.<sup>3</sup> Rural telephone cooperatives must embrace this dynamic, or risk losing the critical mass of customers necessary to be a carrier of last resort. In some cases, if the rural telephone cooperative does not bring an advanced telecommunications service to its community, the community will have to do without this service. In other cases, the cooperative

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<sup>2</sup> See, e.g., *Weber v. Interbel Tel. Coop., Inc.*, slip. Op., MT Supreme Ct., Nov. 24, 2003

<sup>3</sup> The Great Shakeout: Winners and Losers in Telecom, Tim Owens, Cronin Communications, Presentation OPASTCO Winter 2002 Meeting.

may find its most viable customers have been “cherry-picked,” depriving the cooperative of the revenue stream need to serve its other rural subscribers. For these reasons, the public interest is served by encouraging rural cooperatives to embrace new technologies and services. Indeed, Congress has mandated this course by adopting Section 309(j) of the Communications Act of 1934, as amended. Many cooperatives have heeded this call by bidding for licenses in FCC spectrum auctions. While these licenses generally include the cooperative’s telephone service area, they also include geographic areas adjacent to, but outside of the service area.

As rural telephone cooperatives implement new services, it is often not possible or desirable to make the users of these new services “members” of the cooperative. The primary objective of each cooperative is still the provision of telephone service to its state-certificated rural area. The infusion of new cable or wi-fi customers into the cooperative’s membership, for example, may dilute the voting power of the certificated telephone area customers. If enough of the new customers reside outside of the certificated community, they could influence the affairs of the cooperative in a way that could interfere with its primary objective. Therefore, as cooperatives pursue the introduction of new advanced services, such services often create non-member income that is sufficient to push the cooperatives below the required 85 percent level. As these new services develop and hopefully succeed, they can keep a cooperative below the 85 percent level indefinitely.

The staff has inquired as to the nature of new services that may affect cooperative eligibility for the attribution exemption. While the Coalition has not been able to conduct a comprehensive, scientific survey, NTCA has recently informally surveyed its members.<sup>4</sup> The results of this survey, included as Attachment A hereto, show that respondents, about half of which are cooperatives, intend to offer a variety of new services over the next 12-18 month period.<sup>5</sup> The new services include: broadband, GSM/GPRS, fixed wireless, bundled voice, data and Internet, video over DSL, push-to-talk, paging, and text messaging.

Moreover, a full 76 percent of respondents have some form of agreement with a national wireless carrier to handle their roaming traffic. As previously discussed in the Coalition’s Petition (at p. 11), roaming revenues may not be member-sourced income. Certainly, roaming payments received from the non-member national carrier would not be member-sourced. Indeed, while the future looks brighter for rural cooperatives in their provision of advanced, diverse service offerings in rural areas, the brightness is tempered by the potential loss of their tax-exempt status.

## **Capital Gains**

Another reason for loss of exemption is the inclusion of a significant capital gain in a telephone cooperative’s income. Capital gains from the sale or conversion of rural telephone properties are not considered Section 501(c)(12) member income.<sup>6</sup> Accordingly, when a rural

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<sup>4</sup> *NTCA 2003 Wireless Survey Report*, December, 2003 (*Survey Report*).

<sup>5</sup> *Survey Report* at 10.

<sup>6</sup> Gain from the sale of an asset must be included as non-member income even if the sale is an involuntary or incidental one. *See, The Mountain Water Co. of La Crescenta v. Commissioner*, 35 T.C. 418 (1960); *Cate Ditch Co. v. U.S.*, 194 F.Supp. 688; 61-2 U.S. Tax Cas. (CCH) P9581

telephone cooperative sells its facilities, *e.g.*, sells a central office building when the cooperative moves to a larger location, or sells its dark fiber transmission lines and facilities, that income is non-member income for purposes of the 85% test even if the sale is to a member. For example, many telephone cooperatives recently recognized capital gains, and the corresponding loss of tax-exempt status a particular year, because of the sales of cellular and DBS systems. Therefore, the sale of a high value item of cooperative property in any given year may result in the cooperative exceeding the tax-exempt benchmark under Section 501(c)(12).<sup>7</sup>

### **Acquisition of New Exchanges**

Several rural telephone cooperatives have expanded their service territory through acquisition of nearby telephone exchanges from larger companies such as Qwest, thereby gaining economies of scale and providing improved service to areas historically neglected by the large carriers. Because the acquired exchanges often have substantially different financial operating characteristics, it may not be fair to the existing members to take the subscribers in the new exchanges immediately into membership. During the transition that may take several years, revenues from the new exchanges will all be considered non-member sourced income.

### **A “3 out of 5 year” Gating Requirement Is Not A Viable Option**

The staff posed the question of whether the use of a less-stringent tax-exempt criteria could be used as a gating criteria for purposes of its attribution rules. Specifically, instead of requiring a rural telephone cooperative to be deemed tax-exempt by the IRS every year in which the cooperative wants the opportunity to receive bid credits, the staff inquired about substituting a requirement that a rural telephone cooperative only need be IRS exempt for three out of the last five years prior to the filing of its auction application.

The Coalition agrees that a 3/5 could theoretically enable more cooperatives to become eligible to receive bid credits, and appreciates the flexible thinking that this approach represents. However, as pointed out in the Coalition *Petition*, the applicant would not know whether it would meet the 3/5 year requirement at the time of filing its short-form application, because of the lag in determining whether it will meet the IRS exemption threshold in that year.<sup>8</sup> If the 3/5 year period was to run from the period 5 years before the filing of the applicant’s short form, early-year auctions would still present a problem for cooperatives that were tax-exempt for two years, but have not yet received all of their revenue data to discern whether the exemption was met for the most recent tax period.<sup>9</sup>

Moreover, there are conceptual flaws with this approach. The Coalition has demonstrated that the tax-status of a rural telephone cooperative is independent from its

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(1961). *See also Tax Exempt Status for Your Organization* (Rev. May 2003)(IRS Publication 557) at page 53 (providing a numerical example of the negative tax implications associated with short-term capital gains (and losses) for cooperatives).

<sup>7</sup> *See also Ex Parte* filed by BloostonLaw, NTCA and RTG in WT Docket No. 97-82 (Dated June 3, 2003).

<sup>8</sup> *Petition* at 6.

<sup>9</sup> There is also a problem with tax audits that retroactively apply to prior tax years.

operation on cooperative principles and ideals. Therefore, the Commission's 85 percent gating requirement is not relevant as to the purpose of preventing sham entities from garnering bid credits. And as described above, many cooperatives will fail the 85 percent test for several years, because of revenues from new lines of business and advanced services that they are providing. A "3 out of 5" approach will not help many of these entities, especially once they have had their new revenue source in place for an extended period of time.

### **The Principles Established In *Puget Sound Plywood V. Commissioner* Do Not Duplicate the Cooperative's "State Law" Gating Criterion**

For the purpose of the Commission's objectives in exempting *bona fide* telephone cooperative from the attribution rules, the important point is that the legal structure and financial operation of telephone cooperatives are the same for tax-exempt and non-tax-exempt cooperatives. *The validity of a cooperative as a legal business entity is independent of whether it is exempt from income taxes.* This means that independent of its tax status, the telephone cooperative, consistent with its organizing state statute, its articles and bylaws, is democratically controlled by its members, allocates among its member all excess of operating revenues over expenses in proportion to their patronage, and does not pay interest or dividends on equity.<sup>10</sup>

The Commission's first gating requirement requires the applicant (or the controlling interest) to be validly organized as a cooperative pursuant to state law. The staff has asked the Coalition whether this gating requirement encompassed the Coalition's *Puget Sound* principles proposed as an alternative to the Commission's 85% gating rule. The Coalition does not believe that the *Puget Sound* principles are duplicative of the first gating requirement. Instead, the *Puget Sound* principles go further and are therefore complements to the Commission's first gating requirement.

The first gating requirement is distinguishable from the *Puget Sound* principles. Most, if not all rural telephone cooperatives were created more than fifty years ago. Accordingly, these cooperatives were organized under state cooperative laws in existence at that time. Our review of a random sampling of cooperative-related state codes show that not every state uniformly incorporates all of the *Puget Sound* principles. Therefore, it is respectfully submitted that the *Puget Sound* principles could best serve as a complement to the Commission's requirement that a cooperative be validly organized pursuant to state law.

On this point, the Coalition previously demonstrated how the structure (governance and financing) of a rural telephone cooperative insulates it from participating in the FCC-identified harmful bid financing activities that necessitated its "controlling interest" rules.<sup>11</sup> Indeed, in the *Reconsideration Order*, the Commission recognized the four key structural factors that make it "highly unlikely that rural telephone cooperatives would be able to participate in the types of sham transactions the [controlling interest] rule is designed to protect against."<sup>12</sup>

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<sup>10</sup> See *2002 Ex Parte* at 8 (Section 8.2 of the NTCA Model Bylaws) and 16 (Article VIII of the PVT Bylaws).

<sup>11</sup> *2002 Ex Parte* at 7-17.

<sup>12</sup> *Reconsideration Order* at para. 15. Those factors are: 1)The ownership and control of the (continues on next page)

Accordingly, the legal structure of the cooperative prevents the members or directors of the cooperative from infusing capital into the cooperative beyond their proportionate share of business with the cooperative, or gaining voting control or undue influence over the cooperative's operations.<sup>13</sup> Therefore, the Commission's tax-exempt gating requirement is not necessary to prevent sham entities from garnering bidding credits. However, because many rural telephone cooperatives do not meet the IRS 85 percent threshold for tax purposes in a given year, the Commission's rule could unnecessarily exclude them from its attribution exemption.

Assuming *arguendo* that a rural telephone cooperative could create a sham organization (or be a sham itself) for purposes of garnering bidding credits, the Commission has already created an automatic safeguard unrelated to the tax status of the cooperative. Rule Section 1.2110(b)(3)(iii)(a) states:

The applicant will not be exempt from § 1.2110(c)(2)(ii)(F) for the purpose of attribution in § 1.2110(b)(1) if the gross revenues or other financial and management resources of the affiliates of the applicant's officers and directors (or the controlling interest's officers and directors) are available to the applicant.<sup>14</sup>

The Commission stated that this requirement in and of itself limits passage through the exemption door "to those cooperatives, or their subsidiaries, that do not benefit from the financial and management resources of the outside businesses affiliated with the cooperatives' officers and directors, or the subsidiary's officers and directors."<sup>15</sup> Accordingly, the 85 percent gating requirement is not necessary.

### **The Puget Sound Principles Apply Equally to Exempt and Non-Exempt Rural Telephone Cooperatives, Exempt Farmer Cooperatives, and Non-Exempt Cooperatives Subject to Subchapter T of the Internal Revenue Code**

The staff also requested more information regarding the effect of tax laws, including the *Puget Sound* principles, Subchapter T of the IRC and Section 501(c)(12), on the legal structure of a rural telephone cooperative, as applied to the issue of bidding credits. Rural telephone cooperatives, whether exempt pursuant to Section 501(c)(12), or non-exempt but taxed according to pre-1962 (i.e., pre Subchapter T) law,<sup>16</sup> farmers' cooperatives exempt under IRC Section 521, and non-exempt cooperatives subject to Subchapter T must operate in accordance with

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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; and 4) The cooperative members contribute equity to, and control, the capital of the cooperative, as opposed to outside investors.

<sup>13</sup> See *Petition* at 9.

<sup>14</sup> 47 C.F.R. § 1.2110(b)(3)(iii)(a). See *Reconsideration Order* at para 17.

<sup>15</sup> *Reconsideration Order* at note 71.

<sup>16</sup> Subchapter T of the Tax Code (26 USC §§ 1381- 1390) provides tax regulations for entities other than rural telephone cooperatives. The corresponding tax provisions for non-exempt rural telephone cooperates are at 26 CFR §§ 1.1381-1 – 1.400L(b)-1T.

cooperative principles. There is no general definition of a cooperative in the Internal Revenue Code. Instead, a common law definition is applied by the IRS and the courts in such cases as *Puget Sound* and in rulings and publications such as Revenue Ruling 72-36, both of which are cited in the *Petition*.

Further explanation is offered in *IRS Publication 557*. *IRS Publication 557* explains that in order to qualify for exemption under Section 501(c)(12), mutual or cooperative organizations:

...must be organized and operated on a mutual or cooperative basis. They are associations of persons...banded together to provide themselves a mutually desirable service approximately at cost and on a mutual basis. To maintain the mutual characteristic of democratic ownership and control, they must be so organized and operated that their members have the right to choose the management, to receive services substantially at cost, to receive a return of any excess of payments over losses and expenses, and to share in any assets on dissolution.

...must use their income to cover losses and expenses, with any excess being returned to members or retained for future losses and expenses.

The rights and interests of members in the annual savings of the organization must be determined in proportion to their business with the organization.

...a mutual or cooperative association whose shares carry the right to dividends will not qualify for exemption.<sup>17</sup>

These essential characteristics of a cooperative are fully consistent with the three criteria cited in *Puget Sound* and discussed in the *Petition*: democratic control by the members; operating at cost; and subordination of capital. Although the cooperative in that case happened to be subject to Subchapter T, and rural telephone cooperatives are not, the consistency of the IRS explanation shows that the same basic criteria apply to all types of cooperatives, irrespective of the governing tax code section.<sup>18</sup> The last point cited from *Publication 557* is an example of an application of the subordination of capital principle from *Puget Sound* to a telephone cooperative.<sup>19</sup>

The correctness of applying *Puget Sound* principles to rural telephone cooperatives is also shown by relevant portions of the IRS Internal Revenue Manual. The Internal Revenue

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<sup>17</sup> *Id.* at p. 52.

<sup>18</sup> For example, Section 521 provides exemption for farmers' cooperatives organized and operated on a cooperative basis. Section 1381(a)(2) refers to any corporation operating on a cooperative basis.

<sup>19</sup> See also, *Wabash Valley Power Ass'n*, Case No. 85-2238-RWV-11, 1991 Bankr. LEXIS 2213 at para. 122 (Randall Snowling, an expert in the field of taxation, citing *Puget Sound* as representative of the necessary characteristics of a tax-exempt cooperative under Section 501(c)(12) of the Internal Revenue Code).

Manual sets forth the policies and guidelines of the Internal Revenue Service.<sup>20</sup> Courts often refer to the language of the Manual in the development of rationales for resolving tax-related disputes.<sup>21</sup> The Manual demonstrates that Subchapter T cooperatives and rural telephone cooperatives are both subject to the principles set forth in *Puget Sound*.

For Subchapter T organizations, the Manual states that an objective of auditing a cooperative is to determine whether the organization is operating on a cooperative basis within the scope of IRC Sections 1381-1388.<sup>22</sup> The Manual also provides that “an organization is operated on a cooperative basis within the meaning of IRC section 521 if it allocates net profits to patrons on the basis of business done with or for such patrons.”<sup>23</sup> The Manual also defines a Member of a cooperative as “any person...who shares in the profits of a cooperative and is entitled to participate in the management of such cooperative.”<sup>24</sup>

Similarly, the operation of a non-profit 501(c)(12) exempt rural telephone cooperative is described in the Manual.<sup>25</sup> Specifically, Part 4.76.20.4 of the Manual titled “Organizational and Operational Test – Basic Cooperative Principles” cites to *Puget Sound* and enunciates the principles set forth in that case<sup>26</sup> as the elements that the IRS reviewers are to utilize when evaluating whether a rural telephone cooperative meets the requisite structural standards of a *bona fide* cooperative. Accordingly, the IRS applies the principles of *Puget Sound* to rural telephone cooperatives.

As demonstrated by *IRS Publication 557*, the above cited cases, and the Manual, although *Puget Sound* involved a Subchapter T cooperative, the *Puget Sound* principles apply equally to rural telephone cooperatives. Accordingly, it appears that the Commission could apply those principles to rural telephone cooperatives, as advocated by the Coalition in their Petition.

The Manual also describes how specific types of revenue flows are to be classified for purposes of calculating whether a cooperative will be deemed tax-exempt. For example, each year, the excess of operating revenues over operating expenses is considered to be capital furnished by the members-patrons. At 7.25.12.3.1 the Manual notes that the “rights and interests of members in the annual savings of the organization should be determined in proportion to their business with the organization. Funds in excess those needed to meet current losses and operating expenses may be retained to meet the organization’s reasonable needs for normal business purposes....”

These attributes of a cooperative illustrate that it is not possible for an officer or director to utilize the resources of his or her personal business to either gain control of a cooperative, or

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<sup>20</sup> Internal Revenue Manual (Manual) available at <<http://www.irs.gov/irm/>>.

<sup>21</sup> See, e.g., *United We Stand Am. v. IRS*, 359 F.3d 595, 601-602 (March 5, 2004).

<sup>22</sup> Internal Revenue Manual, at 4.44.1.1.1 (01/01/02). The cited sections specifically apply to Subchapter T exempt farmers’ cooperatives.

<sup>23</sup> Manual at 4.44.1.2.2.

<sup>24</sup> *Id.* at 4.44.1.2.3.

<sup>25</sup> Manual at 4.76.20 *et seq.*

<sup>26</sup> Those basic principles or requirements are 1) Democratic control by the members; 2) Operating at cost; and 3) Subordination of capital. See Manual at 4.76.20.4.3 (04/01/2003).

to make those resources available to the cooperative. The officer or director must be a member of the cooperative and contribute capital *only* in proportion to his or her business with the cooperative, and is entitled to only one vote regardless of the proportion of the total equity he or she has contributed through patronage. These requirements apply *regardless of whether or not* the cooperative is tax-exempt under Section 501(c)(12). Accordingly, the Commission's 85 percent gating requirement is superfluous and should therefore be eliminated from its rules.

## **Conclusion**

In response to the FCC staff request for additional information, the Coalition has provided this ex parte presentation. It is respectfully submitted that the information herein further demonstrates that the Commission should eliminate the requirement that a rural telephone cooperative be eligible for tax-exempt status under the IRC. First, whether a rural telephone cooperative is required to pay taxes on patronage-based member income has no bearing on its status as a *bona-fide* cooperative. Second, the Coalition has demonstrated, on a going forward basis, the tax-exempt status of rural telephone cooperatives continues to be placed in jeopardy. Third, the Coalition has provided evidence that the *Puget Sound* principles apply to rural telephone cooperatives. Fourth, the Coalition explained the inappropriateness of using a 3/5-year tax-exempt qualification period to replace the strict yearly gating element announced in the *Reconsideration Order*. Finally, the Coalition has demonstrated that its proposed *Puget Sound* gating requirement is complementary to, and not duplicative of the Commission's criteria that the applicant (or controlling interest) is validly organized as a cooperative pursuant to state law. Therefore, the Commission should grant the Coalition's Petition and eliminate the requirement that a rural telephone cooperative be tax-exempt to qualify as a *bona-fide* cooperative for purposes of bid credit qualification.

Respectfully submitted,

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