

October 31, 2003

Mr. Robert H. Herz, Chairman  
Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

Dear Chairman Herz:

The National Telecommunication Cooperative Association (NTCA) has among its members 258 telephone companies that operate on a cooperative basis. The purpose of this submission is to provide comments on behalf of NTCA's cooperative members concerning why the provisions of Statement of Financial Accounting Standard (SFAS) 150 should not be applied to cooperatives' patronage capital allocations.

In the statement, the Financial Accounting Standards Board describes various instruments that are deemed either debt or equity. Of greatest concern to NTCA and its cooperative members is the pronouncement regarding "Mandatorily Redeemable Financial Instruments." According to SFAS 150, such instruments "shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity."

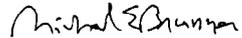
Patronage capital has been recognized as "equity" by both federal courts and federal agencies. The U.S. Bankruptcy Court, the U.S. Tax Court and various federal district courts all have held that patronage capital is equity. Also, the U.S. government, including the Department of Agriculture, the Internal Revenue Service and the Rural Utilities Service, has regarded patronage capital as equity.

Finally, application of SFAS 150 with respect to patronage capital of telephone cooperatives would have a cascading effect of destabilization for both the cooperatives and their lenders who have to access public debt markets. The application of the standard would cause the majority of telephone cooperatives to be in default on their current loan covenants, when nothing about the way the organizations do business has changed. Certainly the pernicious effects of this accounting policy would immediately change telephone cooperatives' access to and cost of capital.

With these considerations in mind, NTCA respectfully requests that the Financial Accounting Standards Board not apply the provisions of SFAS 150 to telephone cooperatives patronage capital. We therefore urge the board to act promptly to reconsider its decision.

Thank you for your consideration, and for providing the opportunity to submit this comment.

Sincerely,

A handwritten signature in black ink that reads "Michael E. Brunner". The signature is written in a cursive style with a large initial "M".

Michael E. Brunner  
Chief Executive Officer

MEB:tl

## **NTCA's Submission to the Financial Accounting Standard Board**

The National Telecommunications Cooperative Association ("NTCA") has among its members more than 300 telephone companies that operate on a cooperative basis. The purpose of this submission is to provide comments on behalf of NTCA's cooperative members concerning why the provisions of the Statement of Financial Accounting Standard ("SFAS") 150 should not be applied to cooperatives' patronage capital allocations.

### **I. BACKGROUND OF COOPERATIVES**

#### **General Definition of a Cooperative**

To define the term "cooperative" or "cooperative operation," consideration first must be given to the reason for the existence of such entities. Israel Packel, a noted cooperative scholar frequently cited by the federal courts, the Internal Revenue Service and others, explained cooperatives as simply being "economic associations for self-help." *The Organization and Operation of Cooperatives*, 4th ed., American Law Institute (1970), p. 2.

As a "self-help" association, a cooperative has no profit motive and no one other than its own members will provide it with equity capital. A cooperative is obligated to allocate to its member-patrons the excess over the cost of service to them. Such allocations are not derived from profit, but rather are deferred price adjustments.

In the treatise *Legal Phases of Farmer Cooperatives, Vol. II*, (FCS Information 100, Farmer Cooperative Service, U.S. Dept. Agr. (1976), p. 357, the U.S. Department of Agriculture added to the list of cooperative attributes the "obligation of members to finance the organization." It stated:

"While the obligation of members to finance is not listed first, it is of **prime importance**. A cooperative is organized for the benefit of its members as patrons and not as investors. Member-patrons are thus the persons primarily interested in the success of the enterprise and as they use its services, they **assume the basic responsibility of providing capital.**"

[Emphasis added.]

In other words, it is the members' responsibility to finance the organization which is satisfied by their initial equity contribution or by their contribution of capital through their patronage of the organization.

#### **Tax Law Definition of a Cooperative**

Turning to the federal income tax definition of a cooperative, perhaps the most concise definition was provided by the U.S. Tax Court in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), acq. 1966-1 CB 3. The Court said:

"Under the cooperative association form of organization, on the other hand, the worker-members of the association **supply their own capital at their own risk**; select their own

management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves receive the fruits of their cooperative endeavors, through allocations of the same among themselves as co-owners, in proportion to the amounts of their active participation in the cooperative undertaking.”

[Emphasis added.]

The Court went on to describe the three guiding principles at the core of economic cooperative theory as:

- “(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising there from;
- (2) Democratic control by the worker-members themselves; and,
- (3) The vesting in and allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members active participation in the cooperative endeavor.”

This definition is of great importance for purposes of interpreting SFAS No. 150. First, the court said that no return or a very limited return should be paid on capital provided by the members. This requirement squares with nearly all state statutes defining cooperative operation. Second, the definition reiterates the fact that margins in excess of cost are distributed based on member participation, not on capital investment.

Recognizing that patronage dividends are, in fact, a deferred price adjustment, the federal tax law allows an exclusion from gross receipts for all qualified “patronage allocations” to member-patrons of non-exempt telephone cooperatives. It is important to note that for non-exempt telephone and electric cooperatives, a “qualified” allocation is an exclusion from gross receipts as opposed to the tax law for virtually all other cooperatives which is a deduction from gross income. The significance of this for purposes of the discussion of SFAS No. 150 are two-fold: (1) that patronage allocations for telephone cooperatives are deferred price adjustments; and (2) the tax law requirement that to qualify for this preferential treatment the cooperative has to have a “pre-existing legal obligation” to allocate the excess collected over cost to member-patrons.

The specific requirements set forth in federal tax law to exclude patronage allocations are:

- (1) Allocations must be subject to a pre-existing legal obligation for the cooperative to do so;
- (2) They must be derived from patronage income; and,
- (3) They must be allocated equitably among member-patrons based on the participation of each.

See *Farmers Cooperative Co.*, 86 F. Supp. 201 (N.D. Iowa 1949); *Pomeroy Cooperative Grain Co.*, 31 T.C. 674 (1958), *Acq.*, 1959-2 C.B. 6.

While telephone cooperatives have the pre-existing obligation to allocate the margins collected over cost, their bylaws also provide their democratically elected board of directors substantial discretion in the return of this equity. There is **nothing in federal tax law** that specifies when allocated capital must be returned to member-patrons before **final liquidation or dissolution** of the organization. The practice of telephone cooperatives is to hold the member patronage allocations as equity over various periods depending on the financial integrity of the cooperatives and the judgment of the governing board of directors. Further, with the vagaries of the telecommunications industry today, past redemption practices by a board of directors cannot provide assurance for the future.

### **Federal Courts Recognition of Patronage Capital as Equity**

Federal bankruptcy courts have ruled that a cooperative's patronage capital is indeed equity for bankruptcy purposes and the holders of cooperative capital are subordinate to the debtors in bankruptcy. Similar conclusions have reached the federal courts considering tax law matters.

*In re Greensboro Lumber Company*, 157 Bankr. 921 (1993), the U.S. Bankruptcy Court held that patronage capital allocated by a rural electric cooperative to a patron were equity instruments, not debt. Where cooperative members have attempted to force cooperatives to offset capital credits against debts owed to the organizations, and where cooperatives have attempted to offset capital credits as debts against amounts owed from bankrupt members, the courts have held that such patronage instruments do not reflect an indebtedness, but rather equity instruments. *Clarke County Cooperative v. Reed*, 139 So.2d 639 (Miss. 1962); *In re Cosner*, 3 Bankruptcy Reporter 445 (1980).

For *Pasco Packing Association*, (DC) 57-2 USTC 9849, the federal district court found that patronage capital certificates issued by a cooperative corporation were not "debts", but rather represented contributions to the capital of the cooperative.

In *Atwood Grain and Supply Co. v. Commissioner*, 60 T.C. 412 (1973), the Tax Court found that revolving fund patronage dividends allocated by a cooperative were equity instruments, not debt.

### **Specific IRS Rulings**

The Internal Revenue Service ("IRS") has recognized patronage capital allocated from cooperative margins to members as equity in various private letter rulings and other determinations. For example, in IRS Letter Ruling 9224007-dated March 6, 1992 issued to a telephone cooperative, the government recognized patronage allocations as equity. In referring to the source of the cooperative's cash, the IRS said:

"The taxpayer believes that it has generated most of this cash from plant depreciation and **patron's equity capital**. Taxpayer has significant fixed assets for providing telephone service, and Taxpayer represents that the depreciation process generates certain levels of operating funds that are set aside for replacement of these assets. In addition, the **current patronage capital rotation is through t4, which provides a base of patrons' equity capital** that Taxpayer either invests in fixed assets or retains to meet operating needs."

[Emphasis added.]

## **II. ISSUANCE OF SFAS 150**

In May 2003 the Financial Accounting Standards Board issued SFAS 150 "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", which has significant implications for cooperatives in general, and specifically NTCA cooperative members. The Standard outlines new reporting requirements for financial instruments that have characteristics both of liabilities and equity. It defines a financial instrument as "evidence of an ownership interest in an entity...that imposes on one entity a contractual obligation to deliver cash to a second entity.... and conveys to that second entity a contractual right to receive cash from the first entity...."

In the statement, the FASB describes various instruments that are deemed either debt or equity. Of greatest concern to NTCA and its cooperative members is the pronouncement regarding "Mandatorily Redeemable Financial Instruments." According to SFAS 150, such instruments "shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity."

## **III. RESPONSE OF NTCA ON BEHALF OF TELEPHONE COOPERATIVES**

### Unique Business Structure

As evident from the discussion above, cooperatives are substantially different from the ordinary business enterprise. As stated by cooperative scholar, Israel Packel, cooperatives are self-help organizations. They operate at cost with the members providing all of the risk capital. This has been the model for operation of a cooperative for over 100 years.

Further, the U.S. Department of Agriculture observed that the obligation of members to finance is of prime importance. Since no one else would be interested in furnishing a cooperative equity, the Department of Agriculture identified the member-patrons as being responsible for "providing capital" for the organization.

### No Fixed Redemption Period

Members of a telephone cooperative typically have a contractual right to receive their pro-rata share of the cooperative's net operating margins and by definition have an ownership interest in the entity. This is a requirement if the cooperative wants to exclude its patronage allocation from federal income taxation. However, the tax law requirement for a "pre-existing legal obligation" to allocate the patronage earning of the cooperative does not have a date certain for redemption of the members' patronage capital.

There are only two rules, which must be followed in terms of timing of patronage capital. First, the cooperative must allocate the margin on the basis of the members' participation at the time the margin is earned. Second, the cooperative is obligated to redeem the patronage capital of all members and former members at the time of dissolution or liquidation. From the time of initial patronage capital allocation until the final dissolution or liquidation, cash redemptions of patronage capital are entirely at the discretion of the cooperative's board of directors.

Cooperative boards' have the fiduciary duty to the members to manage the affairs of the organization, to direct management in the acquisition or construction of capital assets, and to ensure that the financial integrity of the organization is maintained. Opinions often change regarding the level of the debt that the cooperative should maintain as new directors replace

existing directors. The point is that there is not a fixed redemption period for redemption of patronage capital.

#### Federal Judicial Recognition as Equity

Also addressed in the first section of this submission is that fact that the federal judiciary has considered whether cooperative patronage capital is debt or equity for federal tax law and bankruptcy purposes.

In *Atwood Grain and Supply Co. v. Commissioner, Supra.*, the U.S. Tax Court determined that patronage capital of a cooperative was equity of the organization, not debt. See also *Pasco Packing Association, Supra.*

*In re Greensboro Lumber Company, Supra.*, the U.S. Bankruptcy Court held that patronage capital allocated by a rural electric cooperative to a patron were equity instruments, not debt. The Bankruptcy Court acknowledged that patronage capital had some different characteristics, but determined that it was nevertheless equity.

#### Disruptive Effect of Reclassification of Telephone Cooperatives' Patronage Capital as Debt

Like most other cooperative organizations, telephone cooperatives have very limited sources of capital. For equity capital their source is limited exclusively to their members. For debt capital, telephone cooperatives generally rely on debt from the Rural Utilities Services ("RUS") (a U.S. Department of Agriculture agency), the Rural Telephone Finance Cooperative ("RTFC"), or Co-Bank. All three lenders have stringent mortgage covenants associated with their loans.

If telephone cooperatives have to reclassify their patronage capital from equity to debt pursuant to SFAS 150, the first result will be that a majority of the industry will be in default of their debt covenants. Some have argued that the lenders will be accommodating since the resulting covenant defaults would be solely caused by the accounting change. That argument may be true with the RUS, but is untrue in the case of RTFC and Co-Bank. Both provide debt to cooperatives, and must package their loans to sell in public markets. Given the lack of knowledge regarding cooperative organizations, it seems likely that it will be more difficult and costly for RTFC and Co-Bank to re-market loans made to telephone cooperative that are financed with 100 percent debt.

#### **IV. CONCLUSION**

Telephone cooperatives have served rural America for over 90 years using the same fundamental operating principles. They truly have been self-help organizations in which the member-patrons have furnished their own equity capital. As discussed, while federal tax law requires that a telephone cooperative have a "pre-existing legal obligation" to allocate patronage capital to members, the law does not specify a time for redemption. Instead, that decision is left to the cooperative's board of directors.

Patronage capital has been recognized as "equity" by both federal courts and federal agencies. The U.S. Bankruptcy Court, the U.S. Tax Court and various federal district courts all have held that patronage capital is equity. Also, the U.S. Government including the Department of Agriculture, the Internal Revenue Service and the Rural Utility Service all have regarded patronage capital as equity.

Finally, application of SFAS 150 with respect to patronage capital of telephone cooperatives would have a cascading effect of destabilization for both the cooperatives themselves as well as their lenders who have to access public debt markets. The application of the standard would cause the majority of telephone cooperatives to be in default on their current loan covenants when nothing about the way the organizations do business has changed. Certainly the pernicious effects of this accounting policy would immediately change telephone cooperatives access to and cost of capital.

With these considerations in mind, NTCA respectfully requests that the Financial Accounting Standards Board not apply the provisions of SFAS 150 to telephone cooperatives patronage capital.