IN THE DISTRICT COURT OF THE VIRGIN ISLANDS
DIVISION OF ST. CROIX

RURAL TELEPHONE FINANCE COOPERATIVE, Petitioner, v. DIRECTOR, VIRGIN ISLANDS BUREAU OF INTERNAL REVENUE, Respondent.	Civ. No. 2015-_________

PETITION

The Rural Telephone Finance Cooperative ("RTFC") hereby petitions for a redetermination of the deficiency in income tax set forth by the Director of the Virgin Islands Bureau of Internal Revenue ("Respondent" or "BIR") in Respondent's Notice of Deficiency dated June 11, 2015 (the "Notice of Deficiency"). As the basis for this case, Petitioner states as follows:

1. Petitioner is a member-owned, not-for-profit cooperative association with its principal place of business and mailing address at 20701 Cooperative Way, Dulles, Virginia. It is incorporated in the District of Columbia.

JURISDICTION

2. The Notice of Deficiency, dated June 11, 2015, was mailed to the offices of Petitioner's attorney in the United States Virgin Islands ("USVI"). A copy of the Notice of Deficiency, including the statement and schedules accompanying the notice, is attached hereto as Exhibit A. The Court has subject matter jurisdiction over this matter pursuant to 48 U.S.C.

§ 1612(a), as this is a civil proceeding with respect to the income tax law of the USVI. This action is for the redetermination of income tax under Rule 71A.1 of the Local Rules of Civil Procedure of the District Court of the Virgin Islands.

TAXES IN CONTROVERSY

3. The deficiencies as determined by Respondent are in income taxes for the calendar years 1996, 1997, 1999, 2000, 2001, 2002, 2003, 2004, and 2005 (the "Years in Issue") in the following amounts:

Year	Amount of Claimed Deficiency
1996	$1,361,360
1997	$1,815,022
1999	$12,268,410
2000	$13,563,550
2001	$18,897,340
2002	$14,404,315
2003	$17,460,520
2004	$11,196,570
2005	$956,692

ASSIGNMENTS OF ERROR

4. The determination of the tax set forth in the Notice of Deficiency contains only the following two-sentence explanation as to the basis for the claimed deficiency:

> It is determined that income from [RFTC's] trade or business derived from sources within the United States Virgin Islands is reportable to the United States Virgin Islands Bureau of Internal Revenue on Form 1120-F and is subject to a 10% surcharge. Applied as per Internal Revenue Code § 61, § 937 and § 6020(b).

and it is based on the following errors:

RTFC Had No Income Effectively Connected with a USVI Trade or Business

(a) Respondent erred in determining that RTFC had income effectively connected with a trade or business in the USVI during the Years in Issue.

(i) Section 882[1] is not cited in the Notice of Deficiency, but it, rather than the sections cited in the Notice of Deficiency, provides the standard for determining whether a U.S. company owes taxes based on engagement in a trade or business in the USVI.

(ii) The provisions of the U.S. Internal Revenue Code serve as the income tax code of the USVI with the substitution of the term “Virgin Islands” for the term “United States” and vice versa except where manifestly inapplicable or incompatible with a separate territorial tax system. This tax system is called the “mirror” system of taxation.

(iii) Under Section 882, as mirrored in the USVI, “[a] foreign corporation engaged in trade or business within the [USVI] during the taxable year” is subject to taxation “on its taxable income which is effectively connected with the conduct of a trade or business within the [USVI].” I.R.C. § 882(a)(1). Therefore, in order to owe taxes in the USVI, RTFC must *both* (1) be engaged in trade or business within the USVI *and* (2) have income effectively connected with the conduct of that trade or business.

(iv) RTFC’s very limited activities in the USVI during the Years in Issue, which are described below, fall far short of what is required to constitute engagement in trade or business in the USVI. These activities were not considerable, continuous, or regular.

(v) Even if it were considered to have engaged in a USVI trade or business during the Years in Issue, RTFC’s interest income from USVI sources does not meet the second requirement of Section 882(a): that it be *effectively connected* with the conduct of a trade or business within the USVI.

(vi) Section 864(c)(2) provides the rules for determining whether interest income will be considered effectively connected with a trade or business. Treasury

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended and in effect for the Years in Issue.

Regulations under Section 864 contain special rules for determining whether income from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business. Treas. Reg. § 1.864-4(c)(5). For purposes of this regulation, "securities" includes "any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items." Treas. Reg. § 1.864-4(c)(5)(v). A corporation is considered to be connected with the active conduct of a banking, financing, or similar business where it makes mortgage, industrial, or other loans. Treas. Reg. § 1.864-4(c)(5)(i)(b).

(vii) If a foreign corporation is considered to be engaged in the active conduct of a banking, financing, or similar business in the USVI, such as making loans, interest income within the USVI will be treated as effectively connected with the conduct *only if* "the . . . securities giving rise to such income . . . are attributable to the [USVI] office through which such business is carried on." Treas. Reg. § 1.864-4(c)(5)(ii). A security will be deemed to be attributable to a USVI office "only if such office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the . . . security." Treas. Reg. § 1.864-4(c)(5)(iii).

(viii) RTFC is engaged in the active conduct of a banking, financing, or similar business because it makes loans to unrelated rural telephone companies and their affiliates in the United States[2] and its territories and possessions, including the USVI.

(ix) However, RTFC does not now nor has it ever had a USVI office of any sort, much less one that "actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition" of the loans. Treas. Reg. § 1.864-

[2] As used herein, the term "United States" includes only the 50 States and the District of Columbia; it does not include any United States territory or possession, including the USVI.

4(c)(5)(ii), (iii). Accordingly, even if RTFC were considered to have been engaged in the conduct of a trade or business in the USVI during the Years in Issue, RTFC's interest income from the loans was not effectively connected with the conduct of such trade or business.

(x) Therefore, RTFC meets neither requirement of Section 882 during the Years in Issue: It was not engaged in a trade or business within the USVI and, even if it were so engaged, any income from RTFC's loans in the USVI was not effectively connected with the conduct of a trade or business in the USVI.

The Returns Prepared by Respondent Failed to Include Exclusions and Deductions and Were Not Prepared on the Basis of Petitioner's Fiscal Year

(b.) Even if RTFC did have income effectively connected with a trade or business in the USVI, Respondent erred in failing to include exclusions and deductions in the tax returns prepared by Respondent pursuant to Section 6020(b).

(i) Section 6020(b) states that if a corporation fails to file a return required by law, the Director "shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise." I.R.C. § 6020(b). Respondent included with the Notice of Deficiency Forms 1120-F for calendar years 1996-1997 and 1999-2005. The returns were prepared on the basis of the calendar year and not on the basis of Petitioner's fiscal year.

(ii) Respondent included interest income on those Forms 1120-F but did not include any deductions or exclusions.

(iii) RTFC is a not-for-profit cooperative taxed under Subchapter T of the Code, which files its U.S. federal income tax returns on the basis of a May 31 fiscal year. In determining the taxable income of a Subchapter T cooperative, there is excluded from taxable income amounts that the cooperative pays or allocates to its members as patronage dividends. During the Years in Issue, RTFC generally paid or allocated 99% of the net earnings that it made from interest on loans to its members back to its members as patronage dividends. In addition, RTFC generally contributed the remaining 1% of its net earnings to a cooperative educational fund. Consequently, RTFC typically had minimal (if any) federal income tax liability. In fact, for its fiscal years ended May 31, 1996, May 31, 1997, and May 31, 1999 through May 31, 2005 (years generally corresponding to the Years in Issue), RTFC paid in the aggregate a *total* of approximately $225,000 in U.S. federal income taxes with respect to the income it earned on *all* of its outstanding loans throughout the United States and its territories and possessions, including the loans giving rise to the interest income at issue here.

(iv) Even if RTFC had interest income effectively connected to the conduct of a trade or business in the USVI (which it did not), RTFC would have had little or no tax liability if deductions and exclusions had been properly included on the Forms 1120-F.

STATEMENT OF FACTS

5. Petitioner relies on the following statements of fact to sustain each assignment of error:

The Rural Telephone Finance Cooperative

(a.) RTFC is a member-owned, not-for-profit cooperative created in 1987 to serve the financial needs of the rural telecommunications industry by providing low-interest financing. RTFC makes loans to rural telecommunications companies and cooperatives and their affiliates for debt refinancing, construction or upgrades of infrastructure, acquisitions, and other corporate purposes.

(b.) RTFC helps ensure the continued viability of the rural telecommunications industry and helps maintain and improve telephone service across the United States and its territories. RTFC was the first source of private financing established solely for the rural telecommunications industry, and it continues to be the only private-sector lender owned and governed by its members in the industry.

(c.) RTFC was incorporated as a member-owned cooperative association in South Dakota in 1987 and reincorporated in the District of Columbia in 2005. RTFC is headquartered in Dulles, Virginia, where it also maintains its principal place of business.

(d.) RTFC makes loans to and provides guarantees for members, affiliates of members, certain industry trade associations, and other organizations that meet applicable financial and feasibility criteria, security requirements, and other conditions.

(e.) There are 486 owner-members of RTFC, representing 44 states and multiple territories. All of RTFC's members are engaged in furnishing telephone or telecommunications services, either directly or indirectly.

(f.) Members of RTFC are cooperative corporations, private corporations, public corporations, nonprofit corporations, utility districts, and other public bodies that are approved by the RTFC Board of Directors and are actively borrowing or are eligible to borrow from the Rural Utilities Service of the United States Department of Agriculture. Holding companies, subsidiaries, and other organizations that are related to members are eligible to borrow from RTFC as affiliates.

(g.) RTFC is taxable under Subchapter T of the Internal Revenue Code, and it is allowed to exclude from taxable income the amount of net earnings directly paid or allocated to its members, who are also borrowers and who are referred to as its patrons. RTFC therefore pays income tax based on its net income, excluding patronage-sourced net earnings directly paid or allocated to its patrons.

(h.) In accordance with its bylaws and board policies, RTFC allocates its net earnings to its patrons, a cooperative educational fund, and a general reserve, if necessary.

(i.) Generally, all net earnings, based on excess of revenues over operating costs and expenses (including the contributions to the cooperative educational fund described in the next subparagraph), are returned to owner-members who are borrowers through patronage allocations and direct payments and are excluded from taxable income pursuant to Subchapter T of the Internal Revenue Code.

(j.) RTFC is also required by the District of Columbia Cooperative Association Act (and previously by the South Dakota Cooperative Association Act) to allocate a portion of its net earnings to a cooperative educational fund. Funds from the cooperative educational fund are disbursed to fund the teaching of cooperative principles and for other cooperative education programs.

(k.) An allocation to the general reserve is made, if necessary, to maintain the balance of the general reserve at 50% of the membership fees collected.

(l.) RTFC is housed with the affiliated National Rural Utilities Cooperative Finance Corporation ("CFC") in Dulles, Virginia. CFC is a member-owned cooperative association for rural electric cooperatives incorporated under the laws of the District of Columbia in 1969. CFC's principal purpose is to provide its members with financing to supplement the loan programs of the Rural Utilities Service. CFC is tax-exempt under Section 501(c)(4).

(m.) RTFC is a member of CFC, and CFC is the sole lender to RTFC. CFC manages all business operations of RTFC from their shared Dulles, Virginia headquarters.

During the Years in Issue, RTFC had only one employee who was based in Virginia. All other RTFC staff members were employees of CFC, and no CFC employee is or has ever been based in the USVI.

(n.) RTFC's lending staff in Virginia receives applications for and underwrites term loans, lines of credit, bridge loans, and loan syndications. A potential RTFC borrower contacts the lending staff in Virginia to apply for financing. In turn, the lending staff evaluates the borrower's request to determine whether the credit represents an acceptable risk based on RTFC's loan origination and approval policies. If the lending staff determines that credit is acceptable, the staff works with the borrower from RTFC's Virginia offices to structure a loan and to draft a credit recommendation for review by management.

(o.) RTFC management reviews the credit recommendation and terms of the loan at RTFC headquarters in Virginia.

(p.) The RTFC Board of Directors makes the final decision as to whether to approve a loan.

(q.) RTFC's Board of Directors is comprised of citizens and residents of the United States. There has never been a Director from the USVI. All Board meetings are held in the United States; RTFC has never held a Board meeting in the USVI.

(r.) All loans to members and their affiliates are disbursed from RTFC's headquarters in Dulles, Virginia.

(s.) Member-borrowers are required to maintain good financial standing, repay their loans including interest and, for long-term loans, provide annual audited financial statements and documents confirming compliance with all loan covenants. Monitoring and servicing of loans is done from Virginia by RTFC staff. RTFC personnel do not regularly travel to the borrower's place of business. RTFC does not establish offices outside of Virginia or dispatch employees for an extended period of time to visit borrowers.

(t.) If a borrower fails to make payments, RTFC credit personnel will attempt to recover the funds, a process that sometimes requires in-person meetings between the borrower and RTFC personnel, generally at RTFC's Virginia offices.

Loans to Innovative Communication Corporation and Vitelco

(u.) RTFC made loans to member Virgin Islands Telephone Corporation ("Vitelco"), its parent Innovative Communication Corporation ("ICC"), and the predecessor of ICC.

(v.) ICC was a diversified telecommunications company headquartered in the USVI that was owned during the Years in Issue by Jeffrey Prosser ("Prosser"). ICC provided wireline local telephone service, long-distance telephone services, cable television service, and/or wireless telephone service. ICC's immediate parent company was Emerging Communication, Inc., a Delaware corporation ("Emcom"), and Emcom's parent was Innovative Communication Company LLC, a Delaware limited liability company ("ICC-LLC") that was owned by Prosser.

(w.) Vitelco is an incumbent local exchange carrier and provides local fixed wireline telephone service in the USVI. It is engaged primarily in providing local telephone service and access to long-distance service.

(x.) RTFC's loans allowed ICC and its predecessor to acquire Vitelco and then to expand into other telecommunications-related sectors. Aided by RTFC loans, in 1998, ICC acquired cellular and cable television businesses in the Virgin Islands. RTFC's loans also enabled ICC and Vitelco to rebuild when hurricanes damaged the infrastructure of the USVI.

RTFC Activities Related to the Loans and Lack of Contacts with the USVI

(y.) Each of the loans at issue was negotiated and originated with RTFC staff at RTFC headquarters in Virginia. All credit decisions were similarly made at RTFC offices in Virginia. Communications between RTFC and ICC, Vitelco, ICC's predecessor, and/or related entities (the "ICC Entities") took place with very few exceptions over the phone, by fax, or at meetings in the United States.

(z.) As with all other loans it issues, RTFC completed the underwriting process in an effort to ensure that the ICC Entities had the ability to meet their obligations and RTFC's financial standards. Underwriting decisions and all day-to-day aspects of managing the loans took place in Virginia.

(aa.) RTFC did not ever have an office in the USVI.

(bb.) RTFC did not ever have any employees or agents based in the USVI prior to or during the Years in Issue, other than engaging local counsel for the purpose of seeking legal advice. All RTFC staff members, with one exception, were employees of CFC, which also did not have any employees or agents prior to or during the Years in Issue based in the USVI other than legal counsel. RTFC's only employee during the Years in Issue was based in Virginia.

(cc.) RTFC's directors were United States citizens residing in the United States, not the USVI. All Board meetings were held in the United States, never in the USVI.

(dd.) RTFC was not required to, and therefore did not and has not, applied for or obtained any licenses to do business in the USVI.

(ee.) RTFC's business activities took place in the United States, outside the USVI, during the Years in Issue. All management decisions and major policy decisions were made in RTFC's Virginia office.

(ff.) The underwriting and approval decisions for each loan took place in Virginia.

(gg.) The loans to the ICC Entities originated in Virginia.

(hh.) The terms of all loans were negotiated by RTFC from Virginia and the loans were executed by RTFC in Virginia.

(ii.) All of the loan documents at issue were governed by the laws of Virginia.

(jj.) Monitoring and maintenance of the loans was done from Virginia.

(kk.) During the Years in Issue, RTFC staff made only occasional brief trips to the USVI.

(ll.) During the Years in Issue, all of RTFC's assets and loans were held in the United States.

(mm.) RTFC did not own property outside of the United States.

(nn.) All RTFC tax returns were prepared and signed in the United States by independent accounting firms.

(oo.) All RTFC corporate records were maintained in Virginia.

(pp.) All disbursements from RTFC loans were made from locations in the United States.

(qq.) All interest payments from the ECC Entities were paid via check sent to RTFC in Virginia or were made directly to RTFC's accounts in the United States.

(rr.) During the Years in Issue, RTFC did not have any bank accounts in the USVI.

(ss.) During the Years in Issue, all records and data for loans made to the ICC Entities were held in Virginia.

(tt.) During the Years in Issue, RTFC did not solicit borrowers in the USVI.

(uu.) The only loans that RTFC made to USVI entities were to the ICC Entities.

(vv.) RTFC did not have letterhead or any other documents indicating a business or franchise in the USVI.

(ww.) During the Years in Issue, after taking into account deductions for expenses and excluding patronage dividends, RTFC had very little net income from the interest it earned on loans to the ICC Entities. In fact, for its fiscal years ended May 31, 1996, May 31, 1997 and May 31, 1999 through May 31, 2005 (years generally corresponding to the Years in Issue), RTFC paid in the aggregate a *total* of approximately $225,000 in U.S. federal income taxes with respect to the net income earned on all of its outstanding loans throughout the United States and its territories and possessions, including the loans at issue in this case.

(xx.) During the Years in Issue, RTFC engaged independent accounting firms to review and audit RTFC's financial statements in the United States. In each year, RTFC had no uncertain tax positions, and these auditors issued unqualified opinions to the effect that the financial statements of RTFC presented fairly, in all material respects, the financial position of RTFC in conformity with accounting principles generally accepted in the United States of America. RTFC exercised reasonable diligence in ensuring an understanding of its tax obligations and acted in good faith in complying with those obligations.

(yy.) RTFC stopped lending money to the ICC Entities more than a decade ago, after ICC defaulted on its loans and declared bankruptcy.

ICC Default and Bankruptcy

(zz.) By late 2002, there were signs that ICC and Vitelco were experiencing financial problems.

(aaa.) In the spring of 2004, RTFC learned that Vitelco had raised capital by issuing $85 million in preferred stock to private equity funds. Contrary to the requirement in RTFC's loan documents that any capital funds raised first be applied to RTFC's outstanding loans, ICC used funds raised by Vitelco to attempt to purchase the national phone company of Belize. When ICC and Vitelco failed to remit the proceeds of the equity sale as payment on account of RTFC's loans, RTFC declared a default, alleging this and several other violations of the loan agreements.

(bbb.) In late 2004 and in 2005, RTFC engaged in discussions with ICC and Vitelco in an effort to resolve the defaults. These discussions took place both via telephone and face-to-face meetings in Virginia. ICC and RTFC were unable to come to an agreement.

(ccc.) ICC made its last loan payment in June 2005.

(ddd.) RTFC's collateral for the ICC loans it extended to ICC included (i) a series of mortgages of real estate located in the USVI and elsewhere, security agreements, financing statements, pledges, and guaranties creating liens in favor of RTFC on substantially all of the assets and voting stock of ICC, (ii) a direct pledge of 100% of the voting stock of Vitelco, (iii) secured guaranties, mortgages and direct and indirect stock pledges encumbering the assets and ownership interests in substantially all of ICC's other operating subsidiaries, and (iv) a personal guaranty of the loans from Prosser, ICC's indirect majority shareholder and chairman.

(eee.) RTFC filed a lawsuit against ICC for failure to comply with the terms of its loan agreements. Subsequently, the parties reached a settlement on this lawsuit and others at issue between RTFC, ICC, and other related entities in which RTFC obtained entry of judgments against ICC for $524 million, with Prosser jointly and severally liable for up to $100 million, and dismissals with prejudice of all claims and counterclaims asserted by Prosser and his companies.

(fff.) Despite having the option to discharge the judgments for discounted payment, ICC and Prosser failed to satisfy the judgments, and in 2006, ICC, some of its related entities, and Prosser filed for bankruptcy. The bankruptcy court appointed a trustee to assume ownership and control of ICC.

(ggg.) In 2009, RTFC and ICC's bankruptcy trustee entered into a Purchase Agreement for certain ICC assets and stock in ICC subsidiaries operating in the USVI, the British Virgin Islands, and other jurisdictions. In connection with that transaction, RTFC wrote off $354 million of the loans that it had made to ICC.

(hhh.) As part of the Purchase Agreement transactions, RTFC assigned its claims against ICC and the subsidiaries, including its liens and credit bid rights against the ICC entities and assets, to CFC.

(iii.) CFC has since taken steps to ensure that the business formerly operated by ICC could continue to operate as a utilities provider servicing the needs of the public in the USVI.

<u>Issuance of the Notice of Deficiency</u>

(jjj.) In 2004, according to local USVI news sources, Senator Luther Renee requested that the BIR investigate whether RTFC owed taxes based on loans issued to ICC.

(kkk.) RTFC is not aware that the BIR took any actions in response to Senator Renee's inquiry.

(lll.) Almost a decade later, in 2014, the BIR, through outside consultant Ruth B. Jackson, contacted RTFC regarding the tax issues alleged herein.

(mmm.) Following limited dialogue, the Notice of Deficiency was issued to RTFC's counsel on June 11, 2015.

(nnn.) In issuing the Notice of Deficiency, Respondent incorrectly addressed the Notice to RTFC's counsel in the USVI rather than to RTFC. Section 6212(b) requires the Respondent to send the Notice of Deficiency to RTFC's last known address. RTFC has no address within the USVI, and Respondent knew or should have known that the addressee of the Notice of Deficiency is an outside attorney for RTFC and said attorney's address is not RTFC's address.

PRAYER FOR RELIEF

WHEREFORE, Petitioner RTFC prays that the Court:

1) Declare the Notice of Deficiency to be invalid and of no legal effect to the extent it states no viable justification for tax liability;

2) Determine that there is no deficiency in income tax due from RTFC for the 1996-1997 and 1999-2005 taxable years;

3) Determine that no "surcharge," penalties, interest, or other fees or costs are due from RTFC for the 1996-1997 and 1999-2005 taxable years; and

4) Grant to RTFC such other and further relief as the Court, in its discretion, deems just and proper.

Dated: September 4, 2015

/s/ Alex Golubitsky

Alex Golubitsky (V.I. Bar No. 1269)
Marjorie Rawls Roberts
Law Office of Marjorie Rawls Roberts, P.C.
P.O. Box 6347
St. Thomas, U.S. Virgin Islands 00804
Tel. 340.776.7235
Fax 340.776.7951