DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

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Mr. Howard Symons
Vice-Chair of the Incentive Auction Task Force
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Reference: Federal Tax Principles Applicable to the FCC's Proposed Broadcast Incentive Auction

Dear Mr. Symons:

This responds to the Federal Communications Commission's ("FCC") request for general information concerning how the federal tax laws could be expected to apply to participants in the FCC's upcoming Incentive Auction.

As we understand the facts, the FCC is planning to expand the amount of UHF spectrum available for wireless broadband uses. The FCC will conduct a "reverse auction" to allow television broadcasters to voluntarily relinquish UHF or VHF spectrum usage rights. The FCC will then conduct a "forward auction" of UHF spectrum in the form of licenses suitable for providing mobile broadband services.

In addition, the FCC plans a reorganization ("repacking") of the broadcast television spectrum. Under the repacking, the FCC will involuntarily reassign the channels of some broadcasters who do not participate in the reverse auction or whose reverse auction bids are not accepted. Broadcasters that are reassigned will incur costs to acquire new equipment or modify existing equipment for use on the new channel. The FCC is authorized to reimburse broadcasters for reasonably incurred costs for relocating to the new channel, up to a maximum aggregate amount of $1.75 billion.

You ask specifically about the federal tax consequences to broadcasters who voluntarily relinquish spectrum usage rights or are involuntarily reassigned to new channels under the four scenarios outlined below. The federal income tax law is complex, and tax consequences depend highly on particular facts and circumstances, including how a broadcaster structures its particular transaction. However, we have identified below the federal income tax provisions most likely to be relevant to each of the four scenarios.

Scenario 1: Go off the air -- A broadcaster participating in the reverse auction relinquishes its spectrum usage rights in exchange for a payment from the FCC and goes off the air.

The broadcaster will have gain or loss as determined by the difference between the amount realized, that is, the amount of money received from the FCC, and its adjusted basis in the relinquished spectrum usage rights as determined under Internal Revenue Code (IRC) §§ 1001 and 1011. This is simply a sale of the broadcaster's spectrum usage rights. Therefore, the full amount of gain or loss generally would be included in the broadcaster's gross income pursuant to IRC § 61(a)(3).

If the sale results in a loss, the law may not permit a broadcaster to recognize the loss for tax purposes if the spectrum usage rights are amortizable § 197 intangibles and the broadcaster acquired such rights and one or more other amortizable § 197 intangibles in the same transaction or series of related transactions. In that situation, no loss is recognized by the broadcaster on the sale of its spectrum usage rights if the broadcaster retains the other amortizable § 197 intangibles. Instead, the broadcaster adjusts the adjusted basis of the remaining amortizable § 197 intangibles.

The character of the gain for federal income tax purposes generally depends on when the broadcaster acquired the spectrum usage rights and whether the spectrum usage rights are of a character subject to the allowance for depreciation provided in IRC § 167. If the spectrum usage rights are not depreciable or amortizable assets, the gain is capital gain treated as long-term capital gain if the rights were held for longer than one year. If the spectrum usage rights are depreciable or amortizable assets, the gain is first subject to IRC § 1245 depreciation recapture. This amount is ordinary income and generally is equal to the lesser of (a) the gain realized by the broadcaster on the sale of the spectrum usage rights, or (b) the depreciation or amortization deductions previously claimed by the broadcaster with respect to the spectrum usage rights. The remaining gain, if any, is subject to IRC § 1231 if the broadcaster held the spectrum usage rights for more than one year. The character of the IRC § 1231 gain depends on what other IRC § 1231 property was disposed of by the broadcaster in that given year and whether, in the aggregate, the broadcaster had a net IRC § 1231 gain or a net IRC § 1231 loss on all § 1231 property. In general, a net IRC § 1231 gain is taxed at long-term capital gain rates and a net IRC § 1231 loss receives ordinary loss treatment.

Scenario 2: Move From UHF to VHF or from High VHF to Low VHF-- A broadcaster participating in the reverse auction relinquishes its UHF spectrum usage rights in exchange for a payment from the FCC plus an assigned frequency in the VHF spectrum, or relinquishes spectrum usage rights in the upper portion of the VHF band ("high VHF") in exchange for a payment plus an assigned frequency in the lower portion of the VHF band ("low VHF"). The broadcaster is responsible for purchasing new equipment for use in broadcasting on the new channel and will not receive reimbursement of those costs from the FCC.

In this scenario, the broadcaster may be able to defer immediate taxation of a portion of the gain resulting from the relinquishment of spectrum usage rights under the like-kind exchange provisions under IRC § 1031. To qualify for nonrecognition of gain or loss on an exchange, IRC § 1031(a) requires that both the "relinquished property" and the "replacement property" must be held by the taxpayer for productive use in a trade or business or for investment; the relinquished property and the replacement property must be of "like kind" to each other; the replacement property must be identified as property to be received in the exchange on or before 45 days after the date on which the taxpayer transfers the relinquished property; and the replacement property must be received on or before the earlier of 180 days after the date on which the taxpayer transfers the relinquished property, or the due date for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

If the taxpayer receives money and/or other property not of a like kind to the relinquished property ("boot") in addition to receiving the like-kind replacement property, IRC § 1031(b) requires the taxpayer to recognize gain in an amount not in excess of the sum of the money and the fair market value of the other property received. Under IRC § 1031(d), the taxpayer's basis in the replacement property is equal to the taxpayer's basis in the relinquished property decreased in the amount of any money received by the taxpayer and increased in the amount of gain (or decreased in the amount of loss) to the taxpayer that was recognized on such exchange.

Based on the description in the FCC materials that were provided to us, the UHF spectrum usage rights and the VHF spectrum usage rights, and the high VHF and low VHF spectrum usage rights, appear to us to constitute like-kind property. However, certainty as to the like-kind characterization of the properties exchanged will depend on the specific facts of the transaction.

Assuming all of the other requirements of IRC § 1031 are met, taxation of the gain on the relinquishment of the spectrum usage rights is deferred, except that realized gain must be recognized in an amount not to exceed the amount of any boot received in the exchange. The broadcaster's basis in the new VHF spectrum usage rights is determined under IRC § 1031(d).

The character for federal income tax purposes of the gain resulting from the receipt of "boot" by the broadcaster would be determined in the same manner as described under Scenario 1 above, except that in this scenario the § 1245 depreciation recapture amount is the lesser of (a) the gain recognized on the exchange under IRC § 1031, or (b) the depreciation or amortization deductions previously claimed by the broadcaster with respect to the spectrum usage rights.

With respect to the new equipment that the broadcaster purchases for use in broadcasting on the new VHF channel, the broadcaster's basis in the new equipment will be its cost under IRC § 1012. The broadcaster will depreciate such equipment under IRC § 168.

Scenario 3: Channel Sharing -- A broadcaster participating in the reverse auction relinquishes its spectrum usage rights in exchange for a payment from the FCC. The broadcaster stays on the air by entering into an arrangement to share a UHF or VHF channel with another broadcaster. Some or all of the payment from the FCC could be used by the participating broadcaster to obtain sharing rights in the new channel under the arrangement with the other broadcaster.

The treatment of a channel-sharing arrangement for federal income tax purposes will depend on the agreement between the parties, their actions, and other facts and circumstances regarding their arrangement. Two possible tax alternatives are that the arrangement results in a partnership or, alternatively, results in a cost-sharing arrangement for federal income tax purposes.

A channel-sharing arrangement may be treated as a partnership for federal income tax purposes if there is sufficient joint activity by the parties as well as other factors. If the arrangement is treated as a partnership, the rules under subchapter K (Partners and Partnerships) of the Code will affect how the parties are taxed and may affect the ability of the parties to engage in a like-kind exchange under IRC § 1031.

If the arrangement is treated as a cost-sharing arrangement, a broadcaster who relinquishes spectrum usage rights in return for cash that is used to obtain channel sharing rights may qualify under IRC § 1031 if the broadcaster (1) meets the requirements of IRC § 1031 as described above under Scenario 2 (including the requirement that the replacement property be of like-kind to the relinquished property); and (2) meets the requirements for a deferred like-kind exchange set forth in § 1.1031(k)-1 of the regulations.

To meet the requirements under § 1.1031(k)-1 for a deferred like-kind exchange, the broadcaster relinquishing its spectrum usage rights cannot actually or constructively receive the cash payment from the FCC. To be eligible as a qualifying like-kind exchange, the safe harbors under § 1.1031(k)-1(g) of the regulations must be used in order to prevent actual or constructive receipt by a taxpayer of money or other property. The safe harbors include use of "qualified escrow accounts" and "qualified intermediaries" to hold the money and acquire the replacement property as set forth in § 1.1031(k)-1(g)(3) and (g)(4).

The mechanics of a deferred like-kind exchange under § 1.1031(k)-1 are complex and broadcasters should consult with a tax advisor if they wish to take advantage of this nonrecognition provision. A broadcaster who complies with the requirements for a deferred like-kind exchange will obtain many of the same tax consequences set forth in Scenario 2.

If the broadcaster in this scenario does not meet the requirements of IRC § 1031, then the tax consequences described in Scenario 1 regarding the recognition and character of any gain or loss will apply with respect to the payment received by the broadcaster from the FCC.

Scenario 4: Repacking -- A broadcaster that does not participate in the reverse auction, or whose bid is not accepted, may be moved involuntarily to a new channel in its existing band (or sub-band, in the case of a VHF broadcaster) as part of the FCC repacking process. A broadcaster that has its channel involuntarily changed will incur costs for new equipment or modifications to existing equipment, engineering studies, and construction services to operate on the new channel. The Incentive Auction statute provides that "reasonably incurred" costs for new equipment and other costs of relocating to the new channel will be reimbursed by the FCC from the TV Broadcaster Relocation Fund. We assume that these costs will be capital expenses under IRC § 263(a).

It is anticipated that some or all of the broadcaster's existing equipment will no longer be usable by the broadcaster as a result of the FCC's actions in assigning it to a new channel. Under this scenario, the broadcaster may not be required to include the reimbursement payments from the FCC for relocating to the new channel in income. Under IRC § 1033(a)(2), if property is compulsorily or involuntarily converted into money, gain (if any) will be recognized only to the extent the amount realized exceeds the cost of property purchased by the taxpayer during the period specified in IRC § 1033(a)(2)(B) and the taxpayer elects to apply the provisions of IRC § 1033. The compulsory or involuntary conversion of property must be a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof. Property purchased by the taxpayer must be similar or related in service or use to the property so converted. The period specified in IRC § 1033(a)(2)(B) begins with the date of the disposition of the converted property or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and generally ends 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

Under IRC § 1033(b)(2), if property is purchased in a transaction described in IRC § 1033(a)(2) which resulted in the nonrecognition of any part of the gain realized as the result of the compulsory or involuntary conversion, the basis is the cost of such property

decreased in the amount of gain not so recognized; and if the property purchased consists of more than one piece of property, the basis is allocated to the purchased properties in proportion to their respective costs.

This scenario could be viewed as an involuntary conversion by condemnation of the broadcaster's property because it can no longer be used as a result of the involuntary move to the new channel. The reimbursement provided by the FCC could be viewed as an amount realized by the broadcaster from this involuntary conversion. Depending on a broadcaster's specific facts, the cost of new equipment, modifications to existing equipment, engineering studies and construction services in connection with the channel change may be treated as the cost of property that is similar or related in service or use to the property so converted. Because the Incentive Auction statute limits reimbursement to the "reasonable incurred" costs of relocation, a broadcaster that has its channel changed by the FCC under this scenario will not recognize gain from the reimbursement proceeds it receives if the requirements of IRC § 1033(a)(2) are met.

If IRC § 1033 does not apply, the reimbursement proceeds would be included in gross income by the broadcaster. The broadcaster's use of the reimbursement proceeds to purchase new equipment or modify existing equipment would increase the basis in the equipment.

As previously stated, the federal income tax consequences depend on the particular facts and circumstances of the transaction entered into between the FCC, the broadcaster, and any other parties. This letter provides general tax principles that apply to the four scenarios you describe. Broadcasters and their tax advisers are welcome to request a private letter ruling from the IRS national office that applies the law to their particular transactions. See Revenue Procedure 2014-1, 2014-1 Internal Revenue Bulletin 1. If you have any questions regarding this letter, please do not hesitate to call me at (202) 317-7002.

Sincerely,

Andrew J. Keyso
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(Income Tax & Accounting)
Office of Chief Counsel