



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

OFFICE OF THE CHIEF COUNSEL

July 14, 2015

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 Concerning Tax Exempt Organizations
Applicable to the FCC's Proposed Broadcast Incentive Auction

Dear Mr. Symons:

This letter supplements the July 3, 2014, letter to the Federal Communications Commission ("FCC") providing general information concerning how federal income tax laws could be expected to apply to participants in the FCC's Incentive Auction. Specifically, this letter responds to your request for information concerning how federal income tax laws could be expected to apply to tax exempt participants in the FCC's 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 repacking, the FCC will involuntarily reassign the channels of some broadcasters that 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 tax exempt broadcasters, including broadcasters exempt under section 501(c)(3) of the Code¹ and broadcasters that are integral parts of a state or political subdivision, in each of four scenarios: (1) broadcasters who sell their spectrum usage rights in the reverse auction and go off the

¹ Unless otherwise noted, all Code references are to the Internal Revenue Code of 1986, as amended.

air; (2) broadcasters who relinquish their rights in exchange for a payment and then enter into a channel sharing arrangement with another broadcaster; (3) broadcasters who exchange the rights for payment and an assigned frequency in a portion of the VHF spectrum; and (4) broadcasters who are involuntarily reassigned to new channels and receive reimbursement for the expenses incurred in such an involuntary move.

The federal income tax law is complex, and tax consequences depend highly on particular facts and circumstances. A broadcaster that is an integral part of a state or local government generally is not subject to federal income tax. However, a broadcaster that is a state college or university described in section 511(a)(2)(B) or an organization exempt from tax under section 501(a) is subject to tax under section 511 on its unrelated business taxable income (as defined in section 512). We have identified below the federal income tax provisions most likely to be relevant to broadcasters subject to section 511 and possible outcomes under such provisions. Although the discussion focuses on section 501(c)(3) organizations, the rules discussed below concerning the unrelated business income tax also generally apply to other organizations described in section 501(c)² and to state colleges and universities defined in section 511(a)(2)(B).

Taxation of Exempt Organizations Generally

Section 501(c)(3) provides, in part, for the exemption from federal income tax of organizations organized and operated exclusively for religious, charitable, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Section 1.501(a)-1(c) defines "private shareholder or individual" as referring to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized exclusively for exempt purposes unless it serves a public rather than a private interest. The organization must "establish that it is not organized or operated for the benefit of private interests." An organization formed for the purpose of advancing religion and/or education that, in furtherance of this purpose, broadcasts religious and/or educational programs, that devotes all but an insubstantial part of its broadcast time to

² Organizations described in sections 501(c)(7), (9), (17), and (20) are subject to special unrelated business income tax rules under section 512(a)(3).

religious and educational programming, and that otherwise meets the requirements of section 501(c)(3), is engaging in activities that accomplish exempt purposes. Accordingly, the organization is operated exclusively for religious and educational purposes and is exempt from federal income tax under section 501(c)(3). See Rev. Rul. 78-385, 1978-2 C.B. 174.

Though exempt from federal income tax, section 501(c)(3) organizations, such as some tax-exempt broadcasters, are subject to the tax on unrelated business taxable income ("UBTI") under section 511.

Section 511(a)(1) imposes a tax on the UBTI of certain tax-exempt organizations. Section 511(a)(2)(A) provides that this tax applies specifically to organizations described in sections 401(a) and 501(c). Section 511(a)(2)(B) provides that this tax also applies to state colleges and universities. A state college or university under section 511(a)(2)(B) includes any college or university that is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions.

Section 512(a)(1) describes the term UBTI as the gross income derived by an exempt organization from any unrelated trade or business, as defined under section 513, regularly carried on by it, less certain deductions. Section 513(a) provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption or, in the case of state colleges and universities, to the exercise or performance of any purpose or function described in section 501(c)(3).

Section 512(b) provides certain modifications to the computation of UBTI. Generally, passive income such as interest, dividends, royalties, rents, and other investments are excluded from UBTI. Section 512(b)(5) excludes from the computation of UBTI gains and losses from the sale, exchange, or other disposition of property other than stock in trade/inventory or property held primarily for sale to customers.

Section 1.512(b)-1(d) of the regulations provides that the exclusion under section 512(b)(5) applies with respect to gains and losses from involuntary conversions, casualties, etc., other than gains derived from the sale or other disposition of debt-financed property.

Section 1.513-1(b) of the regulations provides that, for purposes of section 513, the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business is "regularly carried on," within the meaning of section 512, consideration must

be given to the frequency and continuity with which the activities are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be “regularly carried on” if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(c)(2) of the regulations provides that a trade or business is related to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than the production of income), and a trade or business is “substantially” related to exempt purposes if the causal relationship is a substantial one.

Section 514 provides for taxation of income otherwise excluded by section 512(b), including section 512(b)(5), to the extent that the property from which the income is derived is debt-financed. “Debt-financed property” is defined in relevant part by section 514(b)(1) as “any property which is held to produce income and with respect to which there is an acquisition indebtedness” at any time during the taxable year (or during the 12 months preceding disposition in the case of property disposed of during the taxable year).

Income from the Sale or Exchange of Spectrum Usage Rights by Section 501(c)(3) Organizations

For tax exempt broadcasters like the broadcaster described in Rev. Rul. 78-385, the *use* of their spectrum usage rights is substantially related to their exempt purpose. However, the *sale, exchange or other disposition* (referred to throughout as “disposition”) of these spectrum usage rights, in most circumstances, would not be considered a transaction substantially related to the organization’s exempt purpose and thus may constitute an “unrelated trade or business.” In the context of the incentive auction, this would generally be the case whether the broadcasters (1) relinquish their spectrum usage rights in the reverse auction in exchange for a payment and go off the air; (2) relinquish their spectrum usage rights in exchange for a payment and then enter into a channel sharing arrangement with another broadcaster; (3) exchange their spectrum usage rights for payment and an assigned frequency in a different portion of the spectrum; or (4) are involuntarily reassigned to new channels and receive reimbursement for the expenses incurred in such an involuntary move. However, as discussed below, the gain from the disposition would not necessarily be subject to unrelated business income tax.

First, even if the disposition of spectrum usage rights were an unrelated trade or business activity, the gain from the disposition would not be subject to unrelated business income tax if the activity was not “regularly carried on.” Whether a trade or business is “regularly carried on” for purposes of section 512 depends on the facts and circumstances of each case. According to section 1.513-1(c)(1) of the regulations, specific business activities of an exempt organization will ordinarily be deemed to be “regularly carried on” if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt

organizations. For tax exempt broadcasters that have rarely or never disposed of spectrum rights, participation in the reverse auction or the involuntary reassignment would likely not qualify as a “regularly carried on” trade or business under section 512.

Second, even if an organization’s disposition of spectrum rights is an unrelated trade or business that is regularly carried on, section 512(b)(5) would likely exclude the gain from the computation of unrelated business taxable income. Section 512(b)(5) excludes all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. The only exception would be if the spectrum usage rights constitute debt-financed property under section 514.

In addition, we note that, if the organization used the spectrum rights in a trade or business unrelated to the organization’s exempt purpose, there may be other tax rules that apply upon the sale or exchange of the rights. For example, see our discussion of depreciation recapture in the July 3, 2014, letter to you.

Additional Considerations for Section 501(c)(3) Organizations Entering into Channel Sharing Arrangements

One of the scenarios contemplated for the FCC’s upcoming reverse auction is that of a broadcaster who participates in the reverse auction, relinquishes its spectrum usage rights in exchange for a payment from the FCC, and then stays on the air by entering into an arrangement to share a UHF or VHF channel with another broadcaster. Tax exempt broadcasters described in section 501(c)(3) who are considering the channel sharing option should ensure that any channel sharing arrangement with a for-profit, commercial broadcaster complies with the statutory and regulatory requirements regarding prohibited inurement and impermissible benefit to private parties. See Treas. Reg. sections 1.501(c)(3)-1(c)(2) and 1.501(c)(3)-1(d)(1)(ii). In general, whether inurement or impermissible private benefit results from a particular arrangement between a section 501(c)(3) organization and private parties will depend on all the facts and circumstances. See, e.g., Rev. Rul. 98-15, 1998-1 C.B. 718 (analyzing whether impermissible private benefit occurred in two situations based on whether the terms and conditions of contracts with private parties, including the fee structure and terms for renewal and termination, are reasonable); Rev. Rul. 2004-51, 2004-1 C.B. 974 (considering the facts and circumstances of relationships with private parties, including whether the terms of the contracts and transactions created impermissible private benefit, in determining that the activity of an ancillary joint venture is substantially related to the exempt purpose of the organization). In addition, tax exempt broadcasters should also be aware that if the terms of the channel sharing agreement create a joint venture that is treated as a partnership for tax purposes, then for purposes of determining exemption under section 501(c)(3), the activities of the joint venture are considered to be the activities of the partners, including the tax exempt organization. *Id.*

As previously stated, the federal income tax consequences of participation in the

reverse auction or an involuntary reassignment for broadcasters subject to section 511 depend on the particular facts and circumstances of each broadcaster. This letter provides general tax principles that apply to the scenarios you describe. Broadcasters and their tax advisers may consider requesting a private letter ruling that applies the law to their particular facts. See Rev. Proc. 2015-1, 2015-1 I.R.B. 1.; Rev. Proc. 2015-3, 2015-1 I.R.B. 129. If you have any questions regarding this letter or the private letter ruling request process, please contact Casey Lothamer at 202-317-4821.

Sincerely,



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(Tax Exempt and Government Entities)
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