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Memorandum

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to: Randy Perrin, Technical Advisor, Media and Entertainment Industry

from: Alan H. Cooper, Associate Industry Counsel for Media and Entertainment (CC:LM:CTM:LA:2)

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subject: **Involuntary Conversions of Broadcasting Equipment**

This memorandum responds to your request for advice regarding whether property exchanges mandated by the Federal Communications Commission (FCC) constitute involuntary conversions pursuant to § 1033 of the Internal Revenue Code. This advice is subject to 15-day post-review by the National Office. CCDM 33.3.1.2.3.2. This memorandum should not be cited as precedent.

QUESTIONS PRESENTED

Whether equipment replacements mandated by the Federal Communications Commission (FCC) constitute involuntary conversions pursuant to I.R.C. § 1033 of the Internal Revenue Code.

SHORT ANSWER

Yes, equipment replacements mandated by the Federal Communications Commission (FCC) constitute involuntary conversions pursuant to I.R.C. § 1033 of the Internal Revenue Code.

FACTS

The Federal Communications Commission (FCC) regulates the use of our nation's electromagnetic spectrum. Recently, the FCC has implemented a program designed to eliminate a serious interference problem that exists for public safety

wireless communications services, such as police, fire, EMT, Homeland Security, and other life-saving "First Responders." The FCC determined that this interference could be eliminated by shifting some current 800 MHz licensed services either to other portions of the 800 MHz band or to the 2 GHz band. This action would make it possible to allocate to public safety communications a dedicated block of spectrum in the 800 MHz band.

Presently, numerous broadcast stations operate on portions of the 800 MHz band that will be allocated to public safety wireless communications services. The FCC has ordered that these broadcast stations relocate some of their operations to a portion of the 2 GHz band (1990-2110 MHz) currently licensed to television broadcast stations for Broadcast Auxiliary Services ("BAS"). The primary use of BAS is mobile electronic news-gathering ("ENG"), principally providing on-the-spot television coverage of breaking news stories or other events of interest to the public.[1]

In order to accommodate new licensees in the 2 GHz band, the FCC requires each BAS broadcaster to cease using the 1990-2025 MHz portion of the spectrum by a specified date, and to limit future operations to a band of the spectrum narrower than that on which they currently operate. The equipment presently owned by these broadcasters will not operate (or will not operate without causing interference) on the new bands assigned. The FCC requires that these licensees be provided different equipment, including equipment components to conduct their operations immediately, upon the move to the newly authorized band location.

The FCC requires a Transition Administrator to furnish this equipment and to pay related costs necessary to provide the incumbent BAS broadcasters with "comparable facilities" (replacement equipment). The elements of "comparability" required of the BAS replacement equipment are: (1) equivalent channel capacity (both in the number of channels and in operational ability on the narrower bands); (2) equivalent signaling capability, baud rate and access time; (3) coextensive geographic coverage; and (4) equivalent operating costs. The replacement equipment is engineered to make possible substantially the same functionality on the new spectrum licensed to the BAS broadcasters as available in the broadcaster's current operations.

The Transition Administrator is obligated to pay the FCC / US Treasury for the newly-licensed 2 GHz spectrum that it will use. It will receive a credit towards this obligation for the FCC-determined value of its net disposition of access to spectrum in

[1] BAS equipment makes possible "live shots" that are transmitted to the local television studio, typically for integration into local news, sports, and entertainment programming and then broadcast to viewers. Broadcast stations may employ a number of BAS "mobile units" installed in news trucks that are equipped with antennas, transmitters, and other equipment operating in the licensed 2 GHz spectrum band. They may also maintain a number of "central receive sites" to which mobile units may transmit when, for instance, they are far from the studio. Central receive sites employ, among other things, receivers, antennas, and controllers, and serve to relay the ENG feed on to the studio for integration into the broadcast. Broadcast stations may also own a number of portable transmitters that are employed on an as-needed basis. Finally, they may own BAS transmitters, receivers and antennas that are installed in a helicopter for news gathering purposes.

the 800 MHz band. It will also receive an aggregate credit for its payment of the actual costs of providing comparable facilities to relocated incumbents in both the 800 MHz band (including public safety licensees) and the 2 GHz band (including BAS broadcasters).

The FCC requires that the Transition Administrator provide all equipment and related costs, or reimburse broadcasters for relocation costs incurred, including those for replacement equipment, integration, testing, and training costs to ensure that the replacement equipment provides comparable functionality to the broadcast stations. The replacement equipment will be ordered by the broadcast stations.[2] The equipment currently used by the broadcast stations will be transferred to the Transition Administrator. It is anticipated that the Transition Administrator will dispose of the equipment as scrap because it will be unsuitable for any use permitted by the FCC.

The broadcast stations will receive only equipment that the Transition Administrator provides under the FCC's "comparable facilities" standard. The broadcast stations will be reimbursed for only those approved expenditures for related necessary items such as the removal of old equipment, and installation and testing of the replacement equipment. The broadcast stations will have no opportunity (as it might with conventional insurance proceeds for loss or damage) to forego reinvestment in similar replacement property, or to keep the conversion proceeds for other purposes.

DISCUSSION

I.R.C. § 1033(a)(1) provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized.[3]

The basic purpose of I.R.C. § 1033(a) is to allow a taxpayer to replace property or to continue an investment without realizing gain. S. E. Ponticos, Inc., v. Commissioner, 40 T.C. 60, 64 (1963). Courts have long recognized that I.R.C. § 1033 is a relief provision that should be liberally construed to effect its purpose. E.g., Massillon-Cleveland-Akron Sign Co. v. Commissioner, 15 T.C. 79, 83 (1950) (interpreting former I.R.C. § 112(f), the precursor to I.R.C. § 1033).

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[2] The cost of the replacement equipment itself represents the core relocation cost. However, the FCC also requires that the Transition Administrator cover all costs of removing existing equipment, which the broadcast stations have on towers and buildings, and in helicopters, trucks, and studios; and of installing the replacement equipment. This equipment is part of an engineering system. Therefore, costs for design, integration, testing, and training will be incurred to ensure that the replacement equipment provides comparable functionality to the broadcast stations. These costs must also be covered by the Transition Administrator.

[3] I.R.C. § 1033(a)(2) provides that if property so converted is converted into money or property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent thereafter provided in that section.

I.R.C. § 1033(a) deals with property that is compulsorily or involuntarily converted as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof. For purposes of I.R.C. § 1033(a), a "conversion" by condemnation or requisition means the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation. Rev. Rul. 57-314, 1957-2 C.B. 523. Accordingly, the concept of a governmental taking for purposes of I.R.C. § 1033(a) has three components: (1) there must be a "taking" of the taxpayer's rights in private property; (2) the taking must be for "public use;" and (3) the taxpayer must receive "payment of just compensation."

I.R.C. § 1033(a)(1) provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory under Treas. Reg. § 1.1033(a)-2(b).

In the present case, nonrecognition of gain under I.R.C. § 1033(a)(1) will apply if three requirements are met: (1) the BAS equipment of the broadcast stations are "taken" by a governmental authority as a result of requisition or condemnation (or threat or imminence thereof); (2) the "taking" is for public use; and (3) the replacement equipment is similar or related in service or use to the equipment so converted. These requirements are discussed below.

A. "Taking" of Rights in Private Property

For purposes of I.R.C. § 1033, a taking by governmental authority may include the regulation against otherwise lawful use of private property in order to effect a public purpose. Courts have recognized two categories of regulatory action that are compensable: (1) an action that effects a permanent physical "invasion" of the property, and (2) an action that denies all economically beneficial or productive use of the property. Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1015 (1992). However, a taking as a result of the exercise of governmental police powers will not qualify as an involuntary conversion. E.g., Rev. Rul. 58-11, 1958-1 C.B. 273 (a taxpayer's court-ordered disposition of stock, the ownership of which was in violation of the Sherman Anti-Trust Act, does not constitute a taking for public use for purposes of I.R.C. § 1033); and Rev. Rul. 57-314, 1957-2 C.B. 523 (the sale of rental properties in order to avoid compliance with building, fire, and health code requirements, even though failure to comply would result in the owner's loss of the legal right to rent such properties, does not fall within I.R.C. § 1033).

The FCC, as part of its regulation of spectrum to promote the general public interest, reallocates spectrum to other purposes and relicenses the use of allocated spectrum among both public and private users. The Communications Act of 1934 ("the Act") provides that the Act's purpose is, among other things, "to provide for the use of such channels, but not the ownership thereof, by persons for limited periods of time,

under license granted by Federal authority, and no such license shall be construed to create any right, beyond the terms, conditions, and periods of the license." 47 U.S.C. § 301 (2005). The Act also provides that any station license or construction permit may be modified by the Commission either for a limited time or for the duration of the term thereof, if in the judgment of the Commission such action will promote the public interest, convenience, and necessity. 47 U.S.C. § 316(a)(1). Therefore, the FCC's reallocation of spectrum for other uses and the relicensing of such spectrum to new licensees is in itself a regulatory act that does not result in a conversion of any private property rights of the licensee in the license or the spectrum. However, the reallocation of spectrum in the present case also has resulted in the condemnation of the broadcast station's related equipment.

The Communications Act of 1934 (“the Act”) provides, in part, that the FCC may make reasonable regulations governing the interference potential of devices which, in their operation, are capable of emitting radio frequency energy by radiation, conduction, or other means in sufficient degree to cause harmful interference to radio communications. 47 U.S.C. § 302(a). The Act further provides that the FCC may make such regulations not inconsistent with law as it may deem necessary to prevent interference between stations and to carry out the provisions of this Act. 47 U.S.C. § 303(f).

If the reallocated spectrum and the equipment are conceived as one economic unit, then it is evident that the reallocation of spectrum under these facts is tantamount to the taking of the equipment. The “economic unit" approach was applied in Masser v. Commissioner, 30 T.C. 741 (1958), where the taxpayer sold property physically adjacent to, and used in connection with, certain converted property. In that case, the Tax Court determined that the subsequent sale was encompassed within the involuntary conversion. Under the economic unit analysis, the Court recognized that certain business assets are so necessarily intertwined that the condemnation of a portion of such assets is in effect a conversion of all of the assets of the economic unit. The Service likewise has formally recognized this same “economic unit” approach for determining the scope of involuntary conversions under I.R.C. § 1033. See Rev. Rul. 59-361, 1959-2 C.B. 183.

In the present case, the BAS spectrum and the equipment permitted by the FCC for use on such band form an economic unit. The reallocation and relicensing of the spectrum (which in itself does not constitute a taking of any property right of the broadcast station) necessitates the removal and replacement of the existing BAS equipment. This circumstance constitutes a “taking” of the broadcast station's equipment. When, as here, the FCC requires a broadcaster to discontinue use of its own equipment, rendering such equipment useless for any purpose, the previously-used equipment has been “taken” by a governmental authority for purposes of I.R.C. § 1033.

B. Public Use Requirement

A "public use" includes the advancement of a “public purpose” by a transfer of

ownership of privately-held property to (i) a governmental entity, or (ii) a private enterprise, provided that in each case there is an advancement of "the broader and more natural interpretation of public use as public purpose." Kelo v. City of New London, 545 U.S. 469, 480 (2005). Moreover, the Supreme Court in Kelo stated, “The public end may be as well or better served through an agency of private enterprise than through a department of government.” Id., at 486 fn.16, citing Berman v. Parker, 348 U.S. 26, 33-4 (1954). Accordingly, for purposes of I.R.C. § 1033, it makes no difference if the property taken for public use is being transferred to a third party as opposed to a governmental entity.

Further, as described above, such costs paid by the Transition Administrator offset dollar-for-dollar the amount otherwise payable by the Transition Administrator to the FCC / US Treasury. Thus, the net effect of this offset is that the cost of replacement is borne by the FCC / US Treasury.

The FCC's "clearing" of the BAS equipment and provision of comparable equipment for efficient, uninterrupted BAS service, as part of a larger project intended to promote the general public good, is a taking for a "public use" under I.R.C. § 1033. In fact, since the FCC is charged by Congress with acting to promote the fair use of spectrum in the public interest, all its actions are presumptively undertaken in furtherance of that public purpose. In addition, and more specifically, the particular public use driving the reallocation of spectrum is the enhancement of the communications abilities of the nation's public safety first responders. Further, the FCC sought to ensure the continuity of BAS with minimal disruption to television broadcast services to the public because BAS is a part of the broadcast system by which emergency information is provided to the American public. Such a condemnation for the advancement of public purposes is analogous to the type of "public use" described by the Supreme Court in Kelo.

Through the Act, Congress delegated plenary powers to the FCC to regulate use of the public spectrum. The Supreme Court in Kelo stated that "once the question of the public purpose has been decided, the amount and character of the land to be taken for the project and the need for a particular tract to complete the integrated plan rests in the discretion of the legislative branch." Kelo, at 489, citing Berman v. Parker, 348 U.S. 26, 35-6 (1954). Here, since the FCC's purposes in regulating the spectrum, eliminating interference for public safety users, and ensuring the continuation of BAS are clearly for the public benefit, the particular details of implementation of this mandate is within the FCC's purview and discretion. Accordingly, the plan for reallocation of spectrum is for the advancement of a public purpose for the purposes of I.R.C. § 1033.

C. Conversion into Property Similar or Related in Service or Use.

As stated earlier, Rev. Rul. 57-314, 1957-2 C.B. 523, provides that a conversion by condemnation or requisition means the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation. Under I.R.C. § 1033(a)(1), conversion by a taking for public use into other “property similar or related in service or use to the property so converted”

qualifies for nonrecognition of gain. In fact, such nonrecognition of gain is mandatory. *See* Treas. Reg. § 1.1033(a)-2(b).

With respect to owner-users of converted property, replacement property will be considered to be similar or related in service or use to the converted property if the "physical characteristics and end uses of the converted and replacement properties are closely similar." Rev. Rul. 64-237, 1964 C.B. 319.[4] Stated differently, the statute requires a "reasonably similar continuation of the petitioner's prior commitment of capital and not a departure from it." Maloof v. Commissioner, 65 T.C. 263, 269 (1975) citing Harvey J. Johnson v. Commissioner, 43 T.C. 736, 741 (1965).

The broadcast stations will receive replacement equipment which will enable them to continue operations without interruption and with "comparable functionality" on the remaining licensed bandwidth. Pursuant to the FCC Order, the Transition Administrator must provide the broadcasters with "comparable facilities." Comparable facilities are those that will provide the same level of service as the incumbent's existing facilities, with transition to the new facilities as transparent as possible to the public end users of the broadcast services. The FCC requires that the Transition Administrator provide all equipment and related costs, or reimburse broadcasters for relocation costs incurred, including those for replacement equipment, integration, testing, and training costs to ensure that the replacement equipment provides comparable functionality to the broadcast stations. Accordingly, the provision of "comparable facilities" includes not only the replacement equipment itself, but also the related installation and other capital costs that the FCC has ordered the Transition Administrator to pay.

It is not necessary to acquire property which duplicates exactly that which was converted. Maloof, at 269. Thus, the fact that the new equipment may be more valuable, or may employ more efficient circuitry than the converted equipment (in that it uses digital rather than analog circuitry) does not matter for purposes of I.R.C. § 1033(a)(1). Rather, what matters is that the replacement equipment received by Taxpayer is similar or related in service or use to that rendered worthless by the FCC action. In addition, the broadcast stations, as owner-users of the converted equipment, will continue to be owner-users of the replacement equipment. Therefore, the replacement equipment is similar or related in service or use to the converted equipment.

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[4] Rev. Rul. 64-237 delineates between the functional use of property held by the taxpayer as an owner-user and property held for investment but not used directly by the taxpayer (i.e., property owned by a taxpayer but leased to another party). For property to qualify as replacement property for I.R.C. § 1033 purposes, the physical characteristics of, and the taxpayer's relationship to, the replacement property must be similar to the physical characteristics of, and the taxpayer's relationship to, the converted property. If a taxpayer is an owner/user of the converted property (as opposed to an owner/lessor), the required relationship of the taxpayer to the replacement property is to continue as an owner/user of the replacement property.

CONCLUSION

The FCC has implemented a spectrum reallocation plan to improve the communications capabilities of the nation's public safety first responders. Under this plan, incumbent BAS broadcasters must relocate to different and narrower frequency assignments. Such relocation necessitates, and the FCC Order requires, the broadcast stations to cease using certain of its existing equipment, the use of which would otherwise cause interference with the new users of the reallocated and relicensed spectrum. Pursuant to the FCC Order, the broadcast stations will be provided with "comparable facilities," that is, replacement equipment and related installation and other capital costs that will allow the broadcast stations to continue operations on the new and narrower spectrum licensed to them. Under the plan, the cost will be borne initially by the Transition Administrator and ultimately by the FCC / US Treasury.

Based on the foregoing, it is Counsel's opinion that the mandated replacement to facilitate the FCC plan meets the following three requirements: (1) the BAS equipment of the broadcast stations are "taken" by a governmental authority as a result of requisition or condemnation (or threat or imminence thereof); (2) the "taking" is for public use; and (3) the replacement equipment is similar or related in service or use to the equipment so converted. Accordingly, the mandated replacements constitute involuntary conversions pursuant to I.R.C. § 1033(a)(1) for which non-recognition of gain is mandatory under Treas. Reg. § 1.1033(a)-2(b).

At this time, we are closing our file in this matter. If you have any questions, please contact Attorney Alan H. Cooper at (213) 894-3027 ext. 195.

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