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**Memorandum**

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to: Robert Alpert  
Supervisor  
(LM:CTM:Group 1334)

from: Katherine Ankeny  
Industry Counsel for Media  
(CC:LM:CTM:LA)

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subject: Television Network Affiliation Agreement Issues

This memorandum is in response to your request for legal advice, dated August 25, 2006, in the audit of (" "). You have requested our advice with respect to 's section 1031 exchange of television stations that were affiliated with major television networks. This advice is subject to 15-day post-review by the National Office. CCDM 33.3.1.2.3.2. This advice may not be used or cited as precedent.

LEGEND

A	=
AA	=
A-th	=
B	=
BB	=
Broadcasters' Representative	=
Broadcasters' Representative (full name)	=

B-th	=
C	=
CC	=
City A	=
City B	=
City C	=
C-th	=
D	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date of Exchange	=
DD	=
E	=
EE	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=
M	=
Medical Drama (Network A)	=
Medical Drama (Network B)	=
Medical Drama (Network C)	=
N	=
Network A	=
Network A (full name)	=
Network A Station's Call Letters	=
Network B	=
Network B Station's Call Letters	=
Network B Station's Current Call Letters	=
Network B's (full name)	=

Network C	=
Network C (full name)	=
Network C Station's Call Letters	=
Network C's Second Station's Call Letters	=
Network D	=
Network D (full name)	=
O	=
Other Party to Exchange	=
Other Party to Exchange (full name)	=
P	=
Principal in Taxpayer's Appraiser	=
Principal in Taxpayer's Appraiser (full name)	=
Q	=
R	=
S	=
Service's Appraiser	=
Service's Appraiser (initials)	=
State A	=
State B	=
State C	=
State D	=
State E	=
T	=
Taxpayer	=
Taxpayer (full name)	=
Taxpayer's Appraiser	=
Taxpayer's Appraiser's (initials)	=
Time 1	=
Time 2	=
Time 3	=
Website A	=
Website B	=
Website C	=
Website D	=
X	=
Y	=
Z	=

## ISSUES

(1) Whether the value of the exchanged television stations' ability to affiliate was part of the value of their network affiliation agreements.

(2) Whether the stations' network affiliations agreements were like-kind property.

## CONCLUSIONS

(1) The value of any ability to affiliate was part of the value of the network affiliation agreements.

(2) The network affiliations agreements were like-kind property.

## FACTS

### The Exchange

In \_\_\_\_\_, the holdings of \_\_\_\_\_ included two VHF television stations: a station that was affiliated with \_\_\_\_\_ (“\_\_\_\_\_”), called \_\_\_\_\_ (the “\_\_\_\_\_ Station”); and a station that was affiliated with \_\_\_\_\_ (“\_\_\_\_\_”), called \_\_\_\_\_ (currently called \_\_\_\_\_) (the “\_\_\_\_\_ Station”). The \_\_\_\_\_ Station was located in \_\_\_\_\_, \_\_\_\_\_, which had four VHF stations and was ranked \_\_\_\_\_ in size among the top 100 geographic markets for television stations in the United States. The \_\_\_\_\_ Station was located in \_\_\_\_\_, \_\_\_\_\_, which had three VHF stations and was ranked \_\_\_\_\_ in size. (\_\_\_\_\_'s \_\_\_\_\_ letter to the Service, \_\_\_\_\_'s Ex. B, p. 5.) \_\_\_\_\_ also owned the \_\_\_\_\_ (“\_\_\_\_\_”).

In \_\_\_\_\_, the holdings of \_\_\_\_\_ and related entities (“\_\_\_\_\_”) included a UHF television station that was affiliated with \_\_\_\_\_ called \_\_\_\_\_ (the “\_\_\_\_\_ Station”). The \_\_\_\_\_ Station was located in \_\_\_\_\_, \_\_\_\_\_, which had four VHF stations and was ranked \_\_\_\_\_ in size. (\_\_\_\_\_'s \_\_\_\_\_ letter to the Service, \_\_\_\_\_'s Ex. B, p. 2.)

and entered into an Asset Exchange Agreement (“Exchange Agreement”) dated . relinquished the and Stations as well as \$ in cash. In exchange, received the Station.

### The Affiliation Agreements

In each of the affiliation agreements, the network agreed to deliver network programs to the station, including sports programs, children’s’ programs, soaps, news, and other entertainment. The affiliation agreement defined the network programs as the programs that were part of ’s network schedule, broadcast on a national basis, in the time period established for such broadcasts by the network. ( NAA, p. 3, ¶ 1(C).) The and affiliation agreements defined the network programs by specifying the programmed time periods. For example, agreed to deliver sufficient prime-time programs for the programmed time period from to on Sunday, and agreed to deliver sufficient prime-time programs for the programmed time period from to on Sunday. ( NAA, p. 2, ¶ 2(b); NAA, p. 2, ¶ 3(b).)

In return, the stations agreed to broadcast the network programs, which included broadcasting the network’s commercial advertisements. ( NAA, p. 2, ¶ 1(B)(2)(a); NAA, pp. 3-4 ¶ 3(a), pp. 6-7, ¶ 5(a)(i); NAA, pp. 5-6, ¶ 5.)

The stations’ compensation for broadcasting network programs included non-monetary compensation: the stations had the right to broadcast local commercial advertisements during the period available for all commercial advertisements that was not occupied by the network’s commercial advertisements. ( NAA, Sch. A, ¶ (a)(iv); NAA, pp. 6-7m, ¶ 5(a); NAA, pp. 5-6, ¶¶ 5, 6.) In addition, and paid the and Stations monetary compensation, called station compensation. The station compensation paid by was based on a station rate, multiplied by fractions reflecting the time period of each program, the time during the program occupied with the network’s commercials, and the station’s share of the market. Compensation for ’s sports program and special events would be separately negotiated. also agreed to pay the Station an annual compensation guarantee. ( NAA, p. 4, ¶ III(A), Sch. A.) The station compensation paid by was similar, except that did not pay a compensation guarantee. also agreed to pay incentive compensation, based on the size of the Station’s market and the Station’s contribution to the total network audience. ( NAA, pp. 6-8, ¶¶ 5(a), 5(b); Exhs. E and F.) did not pay station compensation.

With respect to contractual remedies, both [redacted] and [redacted] indemnified their stations against claims made against the station arising out of the broadcast of network programs. ([redacted] NAA, p. 14, ¶ 6(T); [redacted] NAA pp. 12-13, ¶ 14.) [redacted] warranted that its programs would not violate any trade name, trademark, copyright, or literary or dramatic right, or right of privacy or publicity, or constitute a libel or slander, and [redacted] indemnified the [redacted] Station from liability caused by [redacted]'s breach of these specified warranties. ([redacted] NAA, p. 10, ¶ 15(a).)

The [redacted] affiliation agreement was dated as of [redacted] and had a ten-year term. ([redacted] NAA, p.p. 1, 3, ¶ II.) The [redacted] Station is still affiliated with [redacted] and has been since [redacted]. ([redacted].) The [redacted] affiliation agreement was dated [redacted] and had a ten-year term, with five-year renewal periods. ([redacted] NAA, p. 1, ¶ 1.) The [redacted] Station is affiliated with [redacted] and has been since [redacted]. ([redacted].)

The [redacted] affiliation agreement was dated [redacted] and had a five-year term with two-year renewal periods. ([redacted] NAA, pp. 1, 8, ¶ 10.) Although the [redacted] affiliation agreement expired in [redacted], the parties to the agreement continued to operate under its material provisions. (Asset Exchange Agreement, [redacted]'s Disclosure Schedules, Sch. 4.5(d), Contracts, ¶ 40.) The [redacted] Station, [redacted], had been affiliated with [redacted] since [redacted], shortly after [redacted] launched [redacted] in [redacted]. ([redacted].) After it acquired [redacted], [redacted] owned two stations in the [redacted] market: the [redacted] Station, which was a UHF station; and [redacted], which was a VHF station. As of [redacted], [redacted] switched the [redacted] affiliation from the [redacted] Station to [redacted] and switched the [redacted] Station's affiliation to [redacted] (“[redacted]”). ([redacted].)

Each station agreed not to assign its FCC license and the station's rights under the affiliation agreement without obtaining the network's consent, which would not be unreasonably withheld. ([redacted] NAA, pp. 9-10, ¶ VII(I); [redacted] NAA, pp. 14-15, ¶ 17(a); [redacted] NAA, p. 7, ¶ 8.)

The [redacted] and [redacted] affiliation agreements were governed by [redacted] law, and the [redacted] affiliation agreement was governed by [redacted] law. ([redacted]

[redacted] NAA, p. 13, ¶ VI(Q); [redacted] NAA, p. 19, ¶ 22; [redacted] NAA, p. 8, ¶ 11.) [redacted] and the [redacted] Station also agreed that neither party would have an adequate remedy at law and would be entitled to specific performance in addition to any other remedy to which either would be entitled. ([redacted] NAA, p. 13, ¶ VI(S).) [redacted] and the [redacted] Station agreed that neither party would be entitled to recover any lost profits or consequential damages. ([redacted] NAA, p. 12, ¶ 19(e).)

The Appraisals

employed and the Service employed to appraise the stations' assets. 's appraised value of each station's affiliation agreement was substantially less than 's appraised value:

Affiliation Agreements			
Appraiser	Station	Station	Station
	\$	\$	\$

stated that its appraised value of each affiliation agreement "is reflected in the costs associated with procurement of such an affiliation, adjusted to reflect the anticipated usefulness." ( appraisal, p. 31.) asserted that "any benefits resulting from a network affiliation are, ultimately, tied to the FCC license ...." ( appraisal, p. 26; appraisal, p. 28; appraisal, p. 28.) This assertion explains, in part, why 's appraised value of each station's FCC licenses<sup>1</sup> was substantially greater than 's appraised value:

FCC Licenses			
Appraiser	Station	Station	Station
	\$	\$	\$

<sup>1</sup> did not directly value the FCC licenses. Instead, it directly valued the fixed assets and the intangible assets (except the FCC license and goodwill), subtracted the total value of these assets from the exchange price, and allocated the difference to the FCC license. ( appraisals, unnumbered pages 2-3, Valuation Summary.) described its direct method for valuing going concern as "based upon the current costs of developing operational systems, procedures, and relationships for stations" with comparable facilities in similar markets. ( appraisal, p. 27.) allocated less than one percent of the exchange price of each station to the station's going concern value.


used the discounted-cash-flow method to value the affiliation agreements. See *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. 435, 451 (1992), *aff'd*, 995 F.2d 530 (4th Cir. 1993) (Court accepted the discounted-cash-flow method for valuing an FCC license). In particular, for each of the three markets,

computed the present value of the cash flow projected from through December 31, for a hypothetical startup station. To that value, it added the present value of the proceeds from the sale of the hypothetical station on December 31, performed two computations, one based on the assumption that the hypothetical startup station was affiliated and one based on the assumption that the hypothetical startup station was not affiliated.

then computed the value the affiliation agreement as the difference between these two computations. For example, valued the affiliation agreement as follows:

Affiliated hypothetical startup station in

Present value	–	cash flow	\$ million	
Present value		sales proceeds	\$ million	
Total value				\$ million

Unaffiliated hypothetical startup station in

Present value	–	cash flow	\$ million	
Present value		sales proceeds	\$ million	
Total value				\$ million

Difference = value of affiliation agreement \$ million

(Rounded numbers from appraisal, p. 11, Tables C-4B, C-4C.)

According to 's appraisal, most of the value of the affiliation agreements was attributable to the affiliation agreement's value at the time of the hypothetical sale in . For example, 's appraisal of the affiliation agreement may be viewed as follows:

	<b>Affiliated Station</b>	<b>Unaffiliated Station</b>	<b>Difference</b>
Present value cash flow	\$ million	\$ million	\$ million



-			
Present value sale proceeds	million	million	million
Total Value	million	million	million

(Rounded numbers from [redacted] appraisal, Tables C-4B, C-4C.) In other words, \$ [redacted] million of the appraised value of the [redacted] affiliation agreement was attributable to the present value of the cash flow from its use from [redacted] through December 31, [redacted]. The remaining \$ [redacted] million was attributable to the present value of the proceeds from its hypothetical sale on December 31, [redacted]. That means that 70% ( $\$ [redacted] \div \$ [redacted]$ ) of the value of the [redacted] affiliation agreement was attributable to its value on December 31, [redacted].

Finally, we note that, according to [redacted]'s appraisal, the affiliation agreements were the stations' most valuable intangible assets:

Asset	Station	Station	Station
Affiliation Agreement	\$ [redacted]	\$ [redacted]	\$ [redacted]
FCC License			
Goodwill/Going Concern			

( [redacted] appraisal, p. 12.)

**LAW AND ANALYSIS**

**(1) The value of any ability to affiliate was part of the value of the network affiliation agreements.**

For the purpose of this advice, we assume that the [redacted], [redacted], and [redacted] Stations had an ability to affiliate. By this we mean that on the date of the exchange the parties to the exchange reasonably expected that their affiliation agreements would be renewed and their stations would remain affiliated. We use the broad definition of the term "ability to affiliate," defined in *Hearst* as "the ability, due to

the local market and the station's characteristics, to affiliate in general." *Hearst Corp. v. United States*, 13 Cl. Ct. 178, 183 (1987).<sup>2</sup>

In the Coordinated Issue Paper Media Industry - Like-Kind Exchanges Involving Federal Communications Commission Licenses (May 27, 2005) (the "Coordinated Issue Paper"), the Service rejected the position that an ability to affiliate should be valued as part of the FCC license. We now consider an issue not resolved in the Coordinated Issue Paper: whether a station's ability to affiliate exists as an asset separate from the affiliation agreement.

Historically, experts have opined and courts have adopted the opinion that a television station's affiliation agreement is the station's most valuable intangible asset:

Case Name	Affiliation Agreement	FCC License, Goodwill, Going Concern Value, & Other Intangibles
Hearst <sup>3</sup>	\$3,000,000	\$3,697,498
Forward Commc'ns <sup>4</sup>	\$1,000,000	\$838,659
Miami Valley Broad. <sup>5</sup>	65% of intangibles	35% of intangibles
Roy H. Park Broad. <sup>6</sup>	\$186,000	\$75,000
Gulf Television <sup>7</sup>	\$2,740,000	\$795,416
Meredith Broad. <sup>8</sup>	\$250,000	\$250,000
Indiana Broad. <sup>9</sup>	\$4,750,000	\$1,450,842
Westinghouse Broad. <sup>10</sup>	\$5,000,000	\$1,500,000

<sup>2</sup> We use this broad definition because the Station did not fit into either of the narrower contexts. The term "ability to affiliate" was discussed by the *Hearst* court in the narrowest context of a balanced market, meaning a market in which the number of stations and networks was equal. 13 Cl. Ct. at 181. In its letter to the , discussed a VHF stations' ability to affiliate in the broader context of a market in which the number of VHF stations was no more than the number of major networks. ( letter, Ex. A, pp. 2, 4.) Since launched in , there have been four major networks. In , the and Stations were VHF stations in markets in which there were no more than four VHF stations. The Station, however, was a UHF station in a market with four VHF stations.

<sup>3</sup> *Hearst Corp. v. United States*, 13 Cl. Ct. 178, 183 (1987).

<sup>4</sup> *Forward Commc'ns Corp. v. United States*, 1978 WL 4195, *rev'd and remanded*, 608 F.2d 485, 509 (Ct. Cl. 1979).

<sup>5</sup> *Miami Valley Broad. Corp. v. United States*, 499 F.2d 677, 687 (Ct. Cl. 1974).

<sup>6</sup> *Roy H. Park Broad., Inc. v. Commissioner*, 56 T.C. 784, 811 (1971).

<sup>7</sup> *Gulf Television Corp. v. Commissioner*, 52 T.C. 1038, 1040 (1969).

<sup>8</sup> *Meredith Broad. Co. v. United States*, 405 F.2d 1214, 1228-30 (Ct. Cl. 1968).

<sup>9</sup> *Indiana Broad. Corp. v. Commissioner*, 41 T.C. 793, 795 (1964), *rev'd on other grounds*, 350 F.2d 580 (7<sup>th</sup> Cir. 1965).

<sup>10</sup> *Westinghouse Broad. Co. v. Commissioner*, 36 T.C. 912 (1961), *aff'd*, 309 F.2d 279, 281 (3<sup>rd</sup> Cir. 1962) (The parties allocated \$1,500,000 to goodwill and, one assumes, to the FCC license. The court stated merely that the parties "allocated \$5,000,000 of the \$8,500,000 purchase price of [the television station]

Rev. Rul. 57-377 <sup>11</sup>	\$3X	\$2X
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They have not separated the value of an affiliation agreement into two separate assets. Consistent with this historical approach employed by experts and adopted by courts, [redacted] opined that the affiliation agreements were the most valuable of the [redacted] Station's, the [redacted] Station's, and the [redacted] Station's intangible assets:

Asset	Station	Station	Station
Affiliation Agreement	\$	\$	\$
FCC License			
Goodwill/Going Concern			

( [redacted] appraisal, p. 12.)

Citing *Hearst* and TAM 9738001 (May 2, 1997),

argued on behalf of the broadcasting industry that this historical approach toward valuing affiliation agreements has changed: “[T]he court in *Hearst* determined that the ability to affiliate was separate and distinct from any particular network affiliation agreement. The IRS in TAM 9738001 adopted this same approach.” [redacted] letter, p. 23.

This historical approach has not changed.<sup>12</sup> The court in *Hearst* found that the ability to affiliate and the affiliation are part of the same asset:

[The government’s expert Dr. Rolland] Johnson takes the position that in most circumstances, the asset in which the value inheres is not the affiliation with a *particular* network, but the ability, due to the local market and the station's characteristics, to affiliate in general. He testified that the ability to affiliate and an

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to the network affiliation contract, \$1,500,000 to goodwill and the balance to tangible assets and receivables”).

<sup>11</sup> Rev. Rul. 57-377, 1957-2 C.B. 146, 147.

<sup>12</sup> The approach of [redacted], as exemplified by the approach of [redacted], may have changed. As *Hearst*’s appraiser, Mr. Bond testified that the value of *Hearst*’s NBC affiliation agreement in 1980 may have been as much as \$6,000,000. 13 Cl. Ct. at 182-83. That valuation would have left only \$697,498 as the amount allocable to the other intangibles, including the FCC license. [redacted] was a founder of [redacted]. [redacted] opined that the value, for example, of the [redacted] Station’s affiliation agreement in [redacted] was \$ [redacted], which was a negligible amount when compared to the \$ [redacted] residual amount that [redacted] allocated to the [redacted] Station’s FCC license.

affiliation do not exist, as a practical matter, apart from each other in the marketplace.

\* \* \* \* \*

Johnson's position is not that the affiliation has no value, but that in a stable, three-station-or-fewer market, the ability of a VHF station to affiliate is indistinguishable from the affiliation itself.

\* \* \* \* \*

The court adopts Dr. Johnson's analysis because it recognizes the station and market circumstances that, under precedent, have to be taken into account. 13 Cl. Ct. at 183, 190, 191 (emphasis in original).

In particular, the court adopted Mr. Johnson's opinion that the \$3,600,000 Hearst allocated to the value of the NBC affiliation agreement consisted of the value of the station's ability to affiliate and the value of the affiliation.

In TAM 9738001, the Service assumed that when a taxpayer did not allocate a separate amount to an ability to affiliate, the amount that taxpayer allocated to the affiliation agreement also included the value of the ability to affiliate:

36 .... Because Taxpayer asserts that its ability to affiliate arises solely from the FCC license, according to Taxpayer it follows that the entire [\$] allocated to the Network X contract relates solely to value in excess of Taxpayer's ability to affiliate, attributable solely to the particular value of the Network X affiliation agreement.

\* \* \* \* \*

43 .... [A]fter *Hearst* it is not unreasonable, when presented with a schedule allocating various amounts to intangibles such as an FCC license and a network affiliation contract, with no separate amount set forth for the ability to affiliate, to assume that the amount allocated to the network affiliation contract also includes the value of the taxpayer's ability to affiliate. Taxpayer's argument is premised on the assumption that the amount allocated to its affiliation agreement with Network X, pursuant to the intangible asset settlement initiative, necessarily includes only the additional value of its affiliation with Network X over the value of its ability to affiliate. In our view this assumption is unwarranted.

Although the court in *Hearst* was the first court to adopt the term “ability to affiliate,” the concept is not new. The concept is that, in certain circumstances, taxpayers have a reasonable expectation that their stations’ affiliation agreements will be renewed and their affiliated stations will remain affiliated. Before section 197 was enacted in 1993, permitting taxpayers to amortize affiliation agreements, taxpayers claimed that their affiliation agreements were depreciable under section 1.167(a)-3. Courts disallowed these claims, holding that these taxpayers had failed to prove that their stations’ affiliation agreements had a limited useful life. The courts found that these taxpayers expected that their affiliation agreements would be renewed and that their stations would remain affiliated. This finding is analogous to finding that these stations had “the ability, due to the local market and the station's characteristics, to affiliate in general.” *Hearst*, 13 Cl. Ct. at 183.

For example, the Tax Court held that Westinghouse Broadcasting failed to prove that the useful life of its NBC affiliation agreement could be determined with reasonable accuracy. *Westinghouse Broad. Co. v. Commissioner*, 36 T.C. 912, 918, *aff'd*, 309 F.2d 279 (3<sup>rd</sup> Cir. 1962). Noting that Westinghouse Broadcasting bought the television station with only seven months remaining on the term of the NBC affiliation agreement: “petitioner claims it paid \$5 million [for the NBC affiliation agreement, as an asset of the \$8 million station]. It is incredible that petitioner was not reasonably certain of renewals.” 36 T.C. at 919.

The Tax Court next found that Indiana Broadcasting did prove that its CBS affiliation agreements, which had a two-year term with two-year renewals, had a twenty-year useful life. *Indiana Broad. Corp. v. Commissioner*, 41 T.C. 793, 805, 815 (1964), *rev'd*, 350 F.2d 580, 583 (7th Cir.1965). Reversing the Tax Court’s unanimous, reviewed finding as clearly erroneous, the appellate court explained that “taxpayer attached substantial significance to the renewal prospects of its contracts and purchased the stations with the expectation that the contracts would be continued in force indefinitely.” 350 F.2d at 586.

The next time the Tax Court returned to this issue, again in a unanimous, reviewed decision, it noted that Gulf Television’s station had been affiliated with CBS for more than fourteen years and the affiliation agreement had been renewed six times. *Gulf Television Corp. v. Commissioner*, 52 T.C. 1038, 1054 (1969). This time, the Tax Court found that the taxpayer had failed to prove that its affiliation agreement had a limited useful life. *Id.* at 1066; see Rev. Rul. 57-377, 1957-2 C.B. 146, 149 (“in the industry a cancellation or termination of a station's single network affiliation contract represents an unusual exception to the rule of long-continued affiliation.”)

One of the assumptions underlying \_\_\_\_\_’s appraisal is that the \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ affiliation agreements would be renewed. This assumption is reflected in the substantial portion of the value of the affiliation agreements that \_\_\_\_\_ attributed to the sale of the hypothetical startup stations. For example, 70% of the value of the \_\_\_\_\_ affiliation agreement is

attributable to its value at the end of \_\_\_\_\_, more than seven years after the exchange date. This assumption is consistent with the reasoning in these three court cases. Adopting the Tax Court's logic from *Westinghouse Broadcasting*, given that 70% of the value of the \_\_\_\_\_ affiliation agreement is attributable to the proceeds from the \_\_\_\_\_ sale of the hypothetical startup station, it would be incredible if the hypothetical buyer of this asset was not reasonably certain of renewals. 36 T.C. at 919. Put differently, the \_\_\_\_\_ Station has been affiliated with \_\_\_\_\_ since \_\_\_\_\_. As noted by the court in *Indiana Broadcasting*, "[a] very high degree of stability is reflected in the history of [affiliation agreements that] have continued in force for more than eight or nine years." 350 F.2d at 585. Similar to the station in *Gulf Television*, the \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ Stations had all been affiliated "for more than fourteen years" when the stations were exchanged in \_\_\_\_\_.

The relevance of these court cases is what the courts and the experts on whom the courts relied did not do. They did not divide the value of an affiliation agreement into two separate assets – the ability to affiliate and the affiliation. For example, the Tax Court did not find that Gulf Television could depreciate that station's current, two-year-term CBS affiliation agreement, but could not depreciate the value of station's expectation that it would continue to be affiliated at the end of those two years.

Although \_\_\_\_\_ did not use the term "ability to affiliate," \_\_\_\_\_'s use of the discounted-cash-flow method captured the value of the stations' ability to affiliate. \_\_\_\_\_ valued each affiliation agreement as one asset. That asset may be viewed as the sum of the value a hypothetical affiliation agreement with a term from \_\_\_\_\_ through December 31, \_\_\_\_\_ plus the value of the expectation that the hypothetical affiliation agreement would be renewed and the station would remain affiliated.

Based on the historical approach employed by experts and adopted by courts for valuing affiliation agreements, we conclude that the value of the \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ Stations' ability to affiliate was part of the value of the affiliation agreements. The \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ Station's ability to affiliate should not be separated from their affiliation agreements, either as an asset separate from their affiliation agreements or as part of the stations' goodwill and going concern value.

(2) The network affiliation agreements were like-kind property.

We consider another issue not resolved In the Coordinated Issue Paper, which is whether affiliation agreements are like-kind property.

Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for

productive use in a trade or business or for investment. Whether intangible personal property is of like kind depends both on the nature or character of the rights involved (e.g., a patent or a copyright) and on the nature or character of the underlying property to which the intangible personal property relates. Treas. Reg. § 1.1031(a)-2(c)(1).

For example, an exchange of a copyright on a novel for a copyright on a different novel is a like-kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not a like-kind exchange. Treas. Reg. § 1.1031(a)-2(c)(3). “[A]lthough the differences between copyrights on different novels may best be described as differences of grade or quality, the differences between a copyright on a novel and a copyright on a song may best be described as differences of nature or character.” 55 Fed. Reg. 17635 (April 26, 1990).

The reason for allowing nonrecognition of gain or loss under section 1031 is that the taxpayer's economic situation following a like-kind exchange is essentially the same as it had been before the transaction. H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 564. For example, oil payment assignments, which were effectively assignments of future income, were held not to be of like kind to real property. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 268 (1958).

As another example, a rancher's exchange of cattle of different genders is not a like-kind exchange because ranchers holding male calves are in the business of selling those calves, but ranchers holding female calves are in the business of breeding cows:

There appear to have been representations that male calves can be traded for female calves tax free as a like-kind exchange. The importance of this arises from the fact that ordinarily the ratio of males to females in a calf crop is approximately 50-50. Since few males are normally retained in a typical cattle operation, the remaining male calves are castrated and sold as steers at ordinary income rates. If a tax-free trade of male calves for female calves were allowed, a breeding herd of females could be built up more quickly without tax consequences.

.... When male calves are exchanged for female calves, the exchange does not involve like-kind property since the male animals are not held for breeding purposes and, in fact, are not of a 'like-kind' with females. S. Rep. No. 91-552 (1969).

Similarly, an insurance company's exchange of Swiss francs for U.S. Double Eagle gold coins is not a like-kind exchange because the insurance company could use Swiss francs in Switzerland's open market, but could use U.S. Double Eagle gold coins only as a collector. *California Fed. Life Ins. Co. v. Commissioner*, 76 T.C. 107, 115 (1981), *aff'd*, 680 F.2d 85 (9<sup>th</sup> Cir. 1982).

(a) The nature or character of the rights involved

Applying the first prong of the like-kind test, we compare the stations' rights under the affiliation agreements.<sup>13</sup> The stations have identical legal rights under federal law. For example, under the Federal Communications Act of 1934, each affiliated station had the right to demand that cable operators in its geographic zone delete duplicate network programming. 47 C.F.R. § 76.94(a).

There are some differences among the stations' legal rights under state law. The \_\_\_\_\_ and \_\_\_\_\_ Stations' contractual rights were governed by \_\_\_\_\_ law, and the \_\_\_\_\_ Station's contractual rights were governed by \_\_\_\_\_ law. Regardless of which state law governs the contract, the principal purpose of rules governing breach of contract is to place the injured party in as good a position as he would have been in had the contract been performed. 24 Williston on Contracts § 64.1 (4<sup>th</sup> ed. 2006); Restatement (Second) of Contracts ch. 16, Reporters Note. (2006). The \_\_\_\_\_ Station's state-law remedies were somewhat broader in that the parties agreed that there was no adequate remedy at law and they would be entitled to specific performance. The \_\_\_\_\_ Station's state-law remedies were somewhat more limited, in that the parties agreed that neither party would be entitled to recover any lost profits or consequential damages. But these are differences of grade or quality, not nature or character.

There are also differences in the duration of the terms of the stations' rights under the affiliation agreements in effect when the stations were exchanged in \_\_\_\_\_.

The \_\_\_\_\_ affiliation agreement was dated \_\_\_\_\_ and had a ten-year term with no stated renewal provision. The \_\_\_\_\_ affiliation agreement was dated \_\_\_\_\_ and had a ten-year term with a five-year renewal provision. The \_\_\_\_\_ affiliation agreement was dated \_\_\_\_\_ and had a five-year term with two-year a renewal provision.

These differences in the terms of the affiliation agreements are differences of grade or quality, not nature or character. \_\_\_\_\_ reasonably assumed that all three affiliation agreements would be renewed.

We recognize that the \_\_\_\_\_ Station changed affiliations in the year \_\_\_\_\_ following the exchange. As of \_\_\_\_\_, after \_\_\_\_\_ had acquired a VFH station in the \_\_\_\_\_

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<sup>13</sup> One court has addressed this issue. The trial court found without analysis and even without the issue being raised by the parties that a television station's CBS and ABC affiliation agreements were of like kind. *Forward Commc'ns Corp. v. United Sates*, 1978 WL 4195, \* 19, *rev'd and remanded*, 608 F.2d 485 (Ct. Cl. 1979). The appellate court declined to affirm on this basis, stating there was no exchange when the taxpayer lost its CBS affiliation agreement, but retained the more valuable ABC affiliation agreement. 608 F.2d at 502.



, market, switched the affiliation to that VHF station  
and switched the Station's affiliation to .

That switched the affiliation away from the  
Station when found a better use for the affiliation is not  
inconsistent with 's assumption that the affiliation  
agreement would be renewed. 's assumption that the affiliation  
agreements would be renewed is reasonable because the Station has been  
affiliated with since , shortly after launched in

(b) The nature or character of the underlying property to which the intangible personal property relates

Applying the second prong of the like-kind test, we compare the underlying property, consisting of the network programs. Based on the example in the regulations, we conclude that comparing a program or program to a program is more like comparing a novel to a novel than comparing a novel to a song. Admittedly, the content of the network programs, which include sports programs, children's programs, soaps, news, and other entertainment, is diverse and would attract different viewers. These different categories of programs may include different genres, such as comedy, drama, and reality, which would attract different viewers. Even within the same subgenre (for example medical dramas such as 's , 's , and 's , the programs may attract different viewers.

But we consider these differences to be differences in grade or quality, not nature or character.<sup>14</sup> The Service has been criticized for focusing on NAICS codes when analyzing whether intangibles in manufacturing industries are of like kind. Kelly E. Alton

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<sup>14</sup> All of these diverse network programs could be grouped together under the North American Industrial Classification System ("NAICS"), the Copyright Act, and the Internal Revenue Code. Except as otherwise provided in IRS published guidance, depreciable personal properties in the same 6-digit product class within Sectors 31-33 (manufacturing industries) of NAICS are of like kind. Treas. Reg. § 1.1031(a)-2(b). While the properties underlying the stations' rights under the affiliation agreements are not in these product classes, reference to NAICS codes is a useful analogy. For example, viewing the underlying property as the network programs, we could group together all network programs with other motion pictures and video productions in NAICS code 51211. In the alternative, viewing the underlying property as the television broadcast, we could group together all network programs with all television broadcasting under NAICS code 51312. We could distinguish all motion pictures and video productions and television broadcasts from record production, which would be grouped in NAICS code 51221 and from radio broadcasting, which would be grouped in NAICS code 51311. Similarly, under the Copyright Act, we could group together all network programs with other motion pictures and audiovisual works and could distinguish them from sound recordings. 17 U.S.C. §§ 102(a)(6), 102(a)(7). Finally, under the Internal Revenue Code, we could group together all network programs with other film and video tape and could distinguish them from sound recordings. *E.g.*, §§ 168(f)(3), 168(f)(4). Conversely, referring back to the novel-to-song comparison, all of network programs could be distinguished from sound recordings.

& Louis S. Weller, *IRS Ruling Unveils Restrictive Approach to Like-Kind Exchanges of Intangibles*, 104 J. Tax'n 208, 214 (2006). The Service's focus, however, is consistent with the reason for section 1031, which is to allow nonrecognition of gain or loss when a taxpayer's economic situation is essentially unchanged. In this instance, 's investment in the affiliation agreement is essentially a continuation of its investment in the and affiliation agreements because continues in the business of broadcasting network programs.

Applying the second prong of the like-kind test, we also compare the income streams from the underlying property. 's compensation for broadcasting the , , and network programs included the income stream from its broadcast of local commercial advertisements during the network programs. But received network compensation only for broadcasting the and network programs, not for broadcasting the network programs. In addition, because it owned , may have achieved economies of scale when it acquired the affiliation agreement. Again, we find these differences to be differences in grade or quality, not nature or character.

A subsidiary question is whether part of the value of the affiliation agreements is so closely related to goodwill and going concern value that the affiliation agreements cannot be of like kind. The network could be viewed as establishing a brand name in the station's market. An affiliation agreement could be viewed, in part, as a license of the network's brand name. For example, the Station is permitted to superimpose the station's call letters with 's logo on the network's programs. ( NAA, p. 11, ¶ 10(b).) In another case we recently advised that trademarks and trade names are not of like kind because are they "a component of a larger asset, either of goodwill, or of going concern or both." TAM 200602034 (Sept. 29, 2005).

Goodwill and going concern value are never of like kind because "the nature and character of goodwill and going concern value of a business are so inherently unique and inseparable from the business." T.D. 8343, 1991-1 C.B. 165, 167. Unlike goodwill and going concern value, network programs are separable from the station's business. For example, the rights to , , and could be transferred, and those programs could be broadcast by any station. Therefore, the implicit question is whether the total value of an affiliation agreement should be bifurcated into the value of the network programs apart from the network brand and the value added by the network brand. This question would require expert testimony, for example, about the extent to which viewers watch 's , 's , or 's because they enjoy the program's story and characters or because the program is broadcast with a particular network brand.

While there may be a theoretical basis for doing so, requiring bifurcation of the value of the affiliation agreements would be inconsistent with the purpose of the residual

method. Congress mandated application of the residual method of allocation in section 1060 to eliminate the “endless controversy” caused by the difficulty in valuing goodwill and going concern value. S. Rep. No. 99-313 (1986). The residual method alleviates this controversy because it does not require taxpayers and the Service to obtain a separate determination of the value of goodwill and going concern. T.D. 8215, 1988-2 C.B. 304, 305. Requiring taxpayers and the Service to obtain a separate determination of the value of each network’s brand, based on additional expert testimony on the value a network brand adds to network programs, would be a step backwards into this controversy.

In conclusion, the affiliation agreements are of like kind. The differences between both the nature or character of the rights involved and the nature or character of the underlying property to which the affiliation agreements relate are best be described as differences of grade or quality, not nature or character.

### (3) Tax implications.

We conclude that the value of any ability to affiliate was part of the value of the affiliation agreements and that the affiliation agreements were of like kind. Assuming had no basis in the and affiliation agreements, the adjustment attributable to the affiliation agreements will be a function of ’s \$ million exchange group surplus under section 1.1031(j)-1(b)(2)(iv).  
 (\$ million - (\$ million + \$ million) = \$ million.)

If we had reached a different conclusion, ’s adjustment would be substantially greater. For example, if we concluded that virtually all of the value of the affiliation agreements existed only as part of goodwill and going concern value or that the affiliation agreements were not of like kind, then the adjustment attributable to the affiliation agreements and the ability to affiliate would be \$ million, as part of the residual group under section 1.1031(j)-1(b)(2)(iii) and as part of the property that is neither in an exchange group nor in the residual group under section 1.1031(j)-1(b)(3)(ii).

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (213) 894-3027 ext. 155 if you have any further questions.

Michael P. Lackner

Associate Area Counsel  
(Large & Mid-Size Business)

By: \_\_\_\_\_  
Katherine Ankeny  
Industry Counsel for Media  
(Large & Mid-Size Business)