BACKGROUND AND ISSUES RELATING TO THE APPLICATION OF CODE SECTION 1071 UNDER THE FEDERAL COMMUNICATIONS COMMISSION'S TAX CERTIFICATE PROGRAM

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

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Prepared by the Staff

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INTRODUCTION

The Oversight Subcommittee of the House Committee on Ways and Means has scheduled a public hearing on January 27, 1995, to examine the operation and administration of Internal Revenue Code ("Code") section 1071. Under Code section 1071, as enacted in 1943, gain from the sale or exchange of property may be deferred in cases where the sale or exchange is certified by the Federal Communications Commission (the "FCC") "to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations...." The term "radio broadcasting" was later expanded to include television and cable television. In addition, personal communication systems have recently been added to the FCC tax certificate program.

In 1978, the Federal Communications Commission ("FCC") announced a policy of promoting minority ownership of broadcast facilities by offering an FCC tax certificate to those who voluntarily sell such facilities to minority individuals or minority-controlled entities. The receipt of an FCC tax certificate entitles the recipient, the seller of the property, to defer for an indefinite time the payment of tax which would otherwise be due on the gain realized on the sale. The Subcommittee hearing will focus on (1) whether the FCC's 1978 policy is consistent with the underlying intent of Code section 1071; (2) whether the FCC's administration of Code section 1071 constitutes an impermissible exercise of legislative authority; (3) whether the tax incentive provided in Code section 1071 in fact fosters minority ownership of broadcast facilities; and (4) whether the FCC policy is a necessary or appropriate means of achieving this goal.

Congressman Bill Archer (R-TX), the Chairman of the Committee on Ways and Means, issued a press release on January 17, 1995, indicating that his Committee will review Code section 1071. The press release indicated "[a]ny changes to section 1071 may apply to transactions completed, or certificates issued by the FCC, on or after today, January 17, 1995."

This document,* prepared by the staff of the Joint Committee on Taxation, provides background information on Code section 1071 and the FCC tax certificate program and discusses certain relevant issues. Part I of the document provides the background of Code section 1071 and the FCC tax certificate program, and a brief discussion of how Code section 1071 is applied. Part II discusses economic and tax policy issues concerning the application of Code section 1071. An Appendix provides FCC data on the number of FCC tax certificates issued and the number of minority broadcast facilities involved.

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*This document may be cited as follows: Joint Committee on Taxation, Background and Issues Relating to the Application of Code section 1071 Under the Federal Communications Commission's Tax Certificate Program (JCX-3-95), January 26, 1995.

I. SUMMARY AND BACKGROUND

A. Summary

Under present law, a taxpayer is required to include in gross income the gain recognized upon the sale or disposition of property. An exception to this general rule under Code section 1071 provides that a seller of certain property who receives a tax certificate from the FCC may defer the recognition of gain on the sale indefinitely by either (1) electing to purchase replacement property within two years after the taxable year in which the sale occurs or (2) electing to reduce the basis of depreciable property held by the seller immediately after the sale or acquired by the seller in the taxable year of the sale. The deferred gain may be recognized upon the subsequent disposition, if any, of the replacement property. The purchaser of a broadcast business, whether or not pursuant to a tax certificate program, acquires a basis in the business equal to the purchase price paid, which may be eligible for depreciation or amortization deductions. The tax benefit provided by Code section 1071 is the ability to defer, in some cases indefinitely, what would otherwise be a current tax payment to later years.

Code section 1071 was originally enacted to facilitate sales of properties required to be disposed of because of certain prohibitions on ownership of multiple radio stations within the same market. This tax certificate program has been modified and expanded a number of times and is presently used (1) to promote minority ownership of broadcast facilities and (2) to provide for the orderly transfer of frequencies, including frequencies that can be licensed pursuant to competitive bidding procedures. Under the current FCC minority ownership program, a tax certificate may be issued (1) to a seller of property to a minority owner buyer or (2) to investors who contribute to the stabilization of the capital base of a minority enterprise by providing start-up financing to allow a minority to acquire broadcast or cable properties or by purchasing shares in a minority-controlled entity within the first years after licenses necessary to operate the entity are issued. Since 1987, the Congress has prohibited, through an annual appropriations rider, the FCC from changing or reexamining any of its race or gender preference programs, including the tax certificate program. This rider was recently modified to prevent only the imposition of limitations in the existing program but not expansion of the existing program.

The FCC tax certificate program functions as an open-end tax expenditure with the FCC as authorizing agency. Since 1978, the FCC has issued 378 tax certificates under Code section 1071, 317 of which related to the sale of broadcast properties to minority-owned buyers. The staff of the Joint Committee on Taxation has previously estimated the tax expenditure relating to Code section 1071 to be $500 million over the five fiscal years 1995-1999, although it is in the process of reviewing this estimate in light of new information it is receiving. The Treasury Department has estimated the tax expenditure at $1.5 billion over the same period.

On January 20, 1995, Viacom Inc. and Mitgo Corp., a company wholly owned by Frank Washington, and affiliates of InterMedia Partners announced an agreement under which Viacom will sell its cable systems to a partnership, of which Mitgo is the general partner, for approximately $2.3 billion in cash. News reports and other publicly available information indicate that the deferred gain on the Viacom sale can be reasonably expected to be in the range of $1.1 billion to $1.6 billion. The

tax deferral including State tax, is, therefore, expected to be in the range of $440 million to $640 million.

B. Legislative Background

Code section 1071 was originally enacted as part of the Revenue Act of 1943 to help the FCC implement a new policy that prohibited licensees from owning more than one radio station per market.[1] Congress believed that the involuntary conversion[2] rules (which generally permitted gain on sales to be excluded from taxable income if the proceeds of a sale were reinvested in property similar to the property involuntarily converted) should be applied to these transactions but needed to be liberalized for the FCC-ordered sales because, "[d]ue to wartime restrictions, the purchase of new radio property [would have been]... difficult."[3]

As initially reported by the Senate Finance Committee in 1943, the provision would have allowed a rollover where the sale or exchange of the property was required by the FCC as a condition to the granting of an application.[4] However, the conference report stated that because "the Commission does not order or require any particular sale or exchange, it has been deemed more appropriate to provide that the election, subject to other conditions imposed, shall be available upon certification by the Commission that the sale or exchange is necessary or appropriate to effectuate the policies of the Commission with respect to ownership or control of radio broadcasting stations."[5]

In 1954, this provision was adopted as section 1071 of the 1954 Code without change. In adopting the provision, Congress noted that the term "radio broadcasting" has an "established meaning in the industry and in the administration of the Federal Communications Act which is sufficiently comprehensive to include telecasting (i.e., television)."[6]

In 1958, Code section 1071 was amended to provide that the tax certificates should be granted only when the FCC certified that a disposition was necessary or appropriate to effectuate a change in the policy of, or the adoption of a new policy by, the FCC.[7] Congress was concerned that

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[1] Revenue Act of 1943, Pub. L. 78-235, sec. 123.

[2] An involuntary conversion is generally defined by the Code to occur only when property is compulsorily or involuntarily converted as a result of its destruction, in whole or in part, by theft, seizure, or requisition or condemnation or threat or imminence thereof. Code sec. 1033(a).

[3] S. Rept. No. 627, 78th Cong., 1st Sess., 23 (1943).

[4] S. Rept. No. 627, 78th Cong., 1st Sess., 23, 53-54 (1943).

[5] H. Rept. No. 1079, 78th Cong., 2d Sess., 49-50 (1943).

[6] S. Rept. No. 1622, 83rd Cong. 2d Sess., 429 (1954).

[7] Technical Amendment Act of 1958, Pub. L. 85-866, sec. 52.

taxpayers had "on occasion purchased additional facilities in excess of the maximum number of facilities permitted under then existing FCC rules, and then obtained a certification from the FCC that the disposition of the older facility was necessary or appropriate, thereby obtaining tax deferment on the gain from the sale."[8] In response to this practice, the FCC announced that in the future it would grant tax certificates only where the disposition was required because of a change in FCC policy or rules with respect to the ownership and control of broadcast facilities.[9] In adopting the 1958 changes, Congress agreed that "the announced policy of the FCC in the Federal Register is a desirable way of eliminating these voluntary transactions from the application of Code section 1071."[10]

The term "radio broadcasting" was expanded to include cable television in 1973.[11] The use of FCC tax certificates was recently expanded in connection with the auction of personal communications services (see discussion at section C).

C. FCC Administration of Tax Certificate Program

1. FCC tax certificate program

Multiple ownership policy

The FCC originally adopted multiple ownership rules in the early 1940s.[12] These rules prohibited broadcast station owners from owning more than one station in the same service area, and, generally, more than six high frequency (radio) or three television stations. Owners wishing to acquire additional stations had to divest themselves of stations they already owned in order to remain in compliance with the FCC's rules.

In November 1943, the FCC adopted a rule that prohibited duopolies (ownership of more than one station in the same city).[13] After these rules were adopted, owners wishing to acquire additional stations in excess of the national ownership limit had to divest themselves of stations they already owned in order to remain in compliance with the FCC's rules. After Code section 1071 was adopted in 1943, in some cases, parties petitioned the FCC for tax certificates pursuant to Code section 1071

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8 S. Rept. No. 1983, 85th Cong., 2d Sess., 73-74 (1957).

9 FCC Policy for Tax Certificates, 21 Fed. Reg. 7831 (Oct. 13, 1956).

10 H. Rept. No. 775, 85th Cong., 1st Sess., 29-30 (1957).

11 Rev. Rul. 73-73, 1973-1 C.B. 371.

12 5 Fed. Reg. 2382 (June 26, 1940) (multiple ownership rules for high frequency broadcast stations); 5 Fed. Reg. 2284 (May 6, 1941) (multiple ownership rules for television stations).

13 8 Fed. Reg. 16065 (Nov. 23, 1943).

when divesting themselves of stations. These divestitures were labeled "voluntary divestitures" by the FCC. When the duopoly rule was adopted, 35 licensees that held more than one license in a particular city were required by the rule to "involuntarily" divest themselves of one of the licenses.[14]

Minority ownership policy

In 1978, the FCC announced a policy of promoting minority ownership of broadcast facilities by offering an FCC tax certificate to those who voluntarily sell such facilities (either in the form of assets or stock) to minority individuals or minority-controlled entities.[15] The FCC's policy was based on the view that minority ownership of broadcast stations would provide a significant means of fostering the inclusion of minority views in programming, thereby serving the needs and interests of the minority community as well as enriching and educating the non-minority audience. The FCC subsequently expanded its policy to include the sale of cable television systems to minorities as well.[16]

"Minorities," within the meaning of the FCC's policy, include "Blacks, Hispanics, American Indians, Alaska Natives, Asians, and Pacific Islanders."[17] As a general rule, a minority-controlled corporation is one in which more than 50 percent of the voting stock is held by minorities. A minority-controlled limited partnership is one in which the general partner is a minority or minority-controlled, and minorities have at least a 20-percent interest in the partnership.[18] The FCC requires those who acquire broadcast properties with the help of the FCC tax certificate policy to hold those properties for at least one year.[19] An acquisition can qualify even if there is a pre-existing agreement (or option) to buy out the minority interests at the end of the one-year holding period, providing that the transaction is at arms-length.

In 1982, the FCC further expanded its tax certificate policy for minority ownership. At that time, the FCC decided that, in addition to those who sell properties to minorities, investors who contribute to the stabilization of the capital base of a minority enterprise would be entitled to a tax

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[14] FCC Announces New Policy Relating to Issuance of Tax Certificates, 14 FCC2d 827 (1956).

[15] Minority Ownership of Broadcasting Facilities, 68 FCC2d 979 (1978).

[16] Minority Ownership of Cable Television Systems, 52 R.R.2d 1469 (1982).

[17] 52 R.R.2d at n. 1.

[18] Commission's Policy Regarding the Advancement of Minority Ownership in Broadcasting, Policy Statement, and Notice of Proposed Rulemaking, 92 FCC2d 853-855 (1982).

[19] See Amendment of Section 73.3597 of the Commission's Rules (Applications for Voluntary Assignments or Transfers of Control), 57 R.R.2d 1149 (1985).

certificate upon the subsequent sale of their interest in the minority entity.[20] To qualify for an FCC tax certificate in this circumstance, an investor must either (1) provide start-up financing that allows a minority to acquire either broadcast or cable properties, or (2) purchase shares in a minority-controlled entity within the first year after the license necessary to operate the property is issued to the minority. In these situations, the status of the divesting investor and the purchaser of the divested interest is irrelevant, because the goal is to increase the financing opportunities available to minorities. Since 1987, in appropriations legislation, the Congress has prohibited the FCC from using any of its appropriated funds to repeal, to retroactively apply changes in, or to continue a reexamination of its comparative licensing, distress sale and tax certificate policies. This limitation has not prevented an expansion of the existing program.

Some recent news reports suggest that FCC tax certificates are not fostering "real" minority ownership of broadcast stations.[21] In some instances, a minority investor purports to control the buyer (often a limited partnership or other syndication) but effectively does not because of the small economic interest of the minority investor. In other instances, minority buyers are reported to have resold the broadcast property (or their interest in the property) shortly after the original sale.[22]

Personal communications services ownership policy

In 1993, Congress provided for the orderly transfer of frequencies, including frequencies that

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[20] Commission Policy Regarding the Advancement of Minority Ownership in Broadcasting, 92 FCC2d 849 (1982).

[21] "1492 and All That", *Forbes* (February 6, 1995); "Viacom Deal's Big Tax Break Concerns FCC, *Washington Post*, (January 11, 1995); "FCC Minority Programs Spurs Deals--and Questions", *Washington Post*, (June 3, 1993); "How the Rich Get Richer", *Forbes*, (May 15, 1989).

[22] See also Wilde, "FCC Tax Certificates for Minority Ownership of Broadcast Facilities: A Critical Reexamination of Policy," 138 *U. Penn. L. Rev.* 979 (1990). This article examines the following four questions: (1) Is conditioning the grant of a tax benefit based on the race of the buyer of a broadcasting station a lawful exercise of the FCC's administrative discretion?; (2) Is this type of racial classification by government consistent with the equal protection and due process guarantees of the fourteenth amendment?; (3) Is the current structuring of the program as an element of the income tax system an efficient and effective means of pursuing the FCC's minority ownership policy? and (4) Assuming that the FCC's policy is to be pursued through the tax system, is it being properly administered and controlled from the standpoints of effectiveness, efficiency, and avoidance of abuse? The article concludes that a conversion to a direct spending program would offer significant advantages. Mr. Wilde is now a lawyer at Rogers and Wells in New York.

can be licensed pursuant to competitive bidding procedures.[23] The FCC has adopted rules to conduct auctions for the award of more than 2,000 licenses to provide personal communications services ("PCS"). PCS will be provided by means of a new generation of communication devices that will include small, lightweight, multi-function portable phones, portable facsimile and other imaging devices, new types of multi-channel cordless phones, and advanced paging devices with two-way data capabilities. The PCS auctions (which began last year) will constitute the largest auction of public assets in American history and are expected to generate billions of dollars for the United States Treasury.[24]

In their proposed rules, the FCC has designed procedures to ensure that small businesses, rural telephone companies and businesses owned by women and minorities have "the opportunity to participate in the provision" of PCS, as Congress directed in 1993.[25] To help minorities and women participate in the auction of the PCS licenses, the FCC took several steps including a 15-percent bidding credit, a reduced upfront payment requirement, a flexible installment payment schedule, and an extension of the tax certificate program for businesses owned by minorities and women.[26]

The tax certificate program for PCS will be extended in three ways: (1) initial investors (who provide "start-up" financing or purchase interests within the first year after license issuance) in minority and woman-owned PCS businesses will be eligible for FCC tax certificates upon the sale of their investments; (2) holders of PCS licenses will be able to obtain FCC tax certificates upon the sale of the business to a company controlled by minorities and women; and (3) a cellular operator that sells its interest in an overlapping cellular system to a minority or a woman-owned business to come into compliance with the FCC PCS/cellular cross-ownership rule will be eligible for a tax certificate.[27]

2. FCC interpretation of tax certificate program

The standards for tax certification have been progressively loosened over time. As noted above, in 1956, the FCC's construction of the term "necessary or appropriate" in Code section 1071

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[23] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, Title VI.

[24] Fifth Report and Order, 9 FCC Rcd 5532 (1994), July 15, 1994.

[25] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, section 6002(a).

[26] Installment payments are available to small businesses and rural telephone companies.

[27] Tax certificates also have been employed as a means of encouraging fixed microwave operators to relocate from spectrum allocated to emerging technologies. See Third Report and Order and Memorandum Opinion and Order, 8 FCC Rcd 6589 (1993). An AM expanded band policy also is available, but has never been used. Review of the Technical Assignment Criteria for the AM Broadcast Service, 6 FCC Rcd 6273 (1991).

led it to require a showing of the involuntary nature of the divestiture.[28] However, in 1970, the FCC lessened the required showing to a "causal relationship" between the divestiture and the specific FCC policy, as a condition for the issuance of a certificate.[29] Subsequently, the FCC determined that voluntary divestitures that effectuate specific ownership policies are "appropriate," and eliminated the "causal relationship" requirements.[30] Finally, in adopting the minority ownership policy described above, the FCC stated that "originally tax certification was used to remove the hardship of involuntary transfer as a result of divesture imposed by the Commission's multiple ownership rules. Now, however, tax certificates are routinely approved in voluntary sales . . . ."[31]

3. Other FCC minority ownership programs

Apart from the FCC tax certificate program, there are other programs administered by the FCC to foster minority ownership. The FCC awards comparative merit in licensing proceedings to minority applicants in the interest of promoting minority entrepreneurship.[32] In addition, the FCC's distress sale policy allows broadcasting licensees whose licenses have been designated for revocation hearing, prior to the commencement of a hearing, to sell their station to a minority-owned or controlled entity, at a price "substantially" below its fair market value.[33] A licensee whose license has been designated for hearing would ordinarily be prohibited from selling, assigning or otherwise disposing of its interest, until the issues have been resolved in the licensee's favor.

4. Viacom transaction

On January 20, 1995, Viacom Inc. (a publicly-traded company) and Mitgo Corp., a company wholly owned by Frank Washington, and affiliates of InterMedia Partners announced that they had signed a definitive agreement under which Viacom will sell its cable systems serving 1.1 million customers to a partnership, of which Mitgo is the general partner, for approximately $2.3 billion in cash.[34] A subsidiary of TeleCommunications Inc. (a national cable television operator) is one of the

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[28] FCC Announces New Policy Relating to Tax Certificates, 14 FCC2d 827 (1956).

[29] Issuance of Tax Certificates, 19 RR 1831 (1970).

[30] In re Issuance of Tax Certificates, 59 FCC2d 91 (1976).

[31] Minority Ownership of Broadcasting Facilities, 68 FCC2d 979 (1978).

[32] Commission Policy Regarding the Advancement of Minority Ownership in Broadcasting, 92 FCC2d 849 (1982).

[33] Id.

[34] Viacom press release dated January 20, 1995.

limited partners of Intermedia.[35] Recent news reports suggest that TeleCommunications Inc. will provide "nearly all" of the money for the cable system purchase.[36] Mr. Washington is an African American who will invest about $1 million of his money in the acquisition.[37]

The sale is subject to customary conditions, approvals of local franchise authorities and receipt of an FCC tax certificate.[38] Viacom said proceeds from the transaction, which is expected to be completed in the second half of 1995, will be used to repay debt.[39]

As designed, the sale appears to meet the standards articulated by the FCC to qualify for a tax certificate pursuant to Code section 1071. News reports and other available information indicate that the deferred gain on the Viacom sale can be reasonably expected to be in the range of $1.1 billion to $1.6 billion.[40]

D. Application of Tax Rules

1. Tax treatment of a seller of broadcast property

General rules

Under generally applicable Code provisions, the seller of a broadcast business, or any other business, recognizes gain to the extent the sale price (and any other consideration received) exceeds the seller's basis in the property.

Special rules under Code section 1071

Under Code section 1071, a seller receiving a tax certificate from the FCC can defer recognizing gain on the sale indefinitely by making either one or a combination of two elections on its tax return for the year of the sale.

Replacement property election.--The seller may elect to treat the sale or exchange as an

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[35] Id.

[36] "Viacom to Get Big Tax Break in Cable Deal", *Washington Post*, January 4, 1995.

[37] "Cable operator defends role in Viacom deal", *USA Today,* January 13, 1995.

[38] Viacom press release dated January 20, 1995.

[39] Id.

[40] Securities and Exchange Commission Form 10-K of Viacom Inc. for year ended December 31, 1993.

"involuntary conversion" under section 1033 of the Code. If this election is made, the taxpayer will generally avoid recognizing gain on the sale to the extent that it reinvests the sale proceeds in qualifying replacement property within two years from the end of the tax year in which the sale occurs. If the taxpayer sells assets rather than stock, it may be required to recapture depreciation under certain circumstances.[41]

Qualifying replacement property, within the meaning of this section of the Code, includes the following:

(1) Stock of corporations operating "radio broadcasting stations"[42] (a term that the Internal Revenue Service ("IRS") interprets as including television stations and cable television stations[43]). The seller may purchase any number of shares of a broadcast corporation, including a publicly-traded company (and may invest in more than one broadcast company).[44]

(2) Assets "similar or related in service or use" to the property sold.

Under the "involuntary conversion" election and the general involuntary conversion rules, the taxpayer's basis in the acquired replacement property will generally be the "carryover" basis of the property that was sold, rather than a fair market value basis reflecting the full reinvested proceeds. If the replacement property is stock of a corporation conducting a qualifying business, the carryover basis would apply to the stock but generally would not change the basis of assets inside the corporation. Depending on the basis and remaining depreciable lives of the assets inside the

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[41] Code sections 1245(b)(5) and 1250(d)(5). The regulations limit the depreciation recapture depending on the type and the amount of property repurchased. Treas. Reg. sections 1.1245-4(e)(1), 1.1250-3(e)(2). There is a full depreciation recapture when assets are sold and replaced with stock of a broadcast company. The recapture amounts are likely to be relatively small in the case of a sale of broadcast properties given the nature of the assets sold.

[42] In order for stock to qualify as replacement property, the corporation must engage "primarily" in the business of operating "radio broadcasting stations." Rev. Rul. 82-70, 1982-1 C.B. 114. The IRS, in a private ruling, explained that a corporation that derives more than 50 percent of its gross income from broadcasting operations satisfies the "primarily" test. See PLR 8421002 (January 13, 1984).

[43] Treas. Reg. section 1.1071-1(d) and Rev. Rul. 73-73, 1973-1 C.B. 371.

[44] Because many publicly traded companies are organized as holding companies, their stock is not eligible replacement property. The IRS has ruled that the purchase by a taxpayer of stock of a corporation which does not operate broadcasting stations, but which owns all the stock of a subsidiary corporation which owns and operates such stations, is not a purchase of stock of a corporation "operating a radio broadcasting station" within the meaning of Code section 1071. Rev. Rul. 66-33, 1966-1 C.B. 183.

corporation, this might result in significant deferral of any tax detriment resulting from the carryover basis, as long as the stock is not sold.

The IRS has issued private letter rulings holding that the purchase of stock or assets from a related party can qualify as a replacement purchase.[45] Thus, it appears that in certain circumstances related taxpayers may obtain significant tax deferral without any additional cash outlay to acquire new properties after a qualifying FCC tax certificate sale. The involuntary conversion election could provide greater flexibility as to the allocation of reduced basis than the alternative election to reduce basis of depreciable property.

Reduction in basis of depreciable property.--If the seller chooses not to purchase "replacement property" or would otherwise recognize gain (because it reinvested only a portion of its cash proceeds in qualifying replacement property), Code section 1071 allows the seller to elect not to recognize the gain to the extent it is applied to reduce the basis of depreciable property (within the meaning of Code section 167) that is either held by the seller immediately after the sale or acquired by the seller in the taxable year of the sale. Eligible property includes most tangible property (not just broadcast property), but does not usually include items such as inventories, stock in trade, and securities. Eligible property also includes goodwill and other intangible property that is depreciable under Code section 197 (which generally applies to intangible property acquired after August 10, 1993). A seller that elects to reduce its basis in depreciable property must reduce its basis in all of its depreciable property by reference to a regulatory formula--it cannot allocate the reduction disproportionately unless authorized by the IRS to do so.[46]

2. Tax treatment of a buyer of broadcast property from an electing seller

Under generally applicable Code provisions, the purchaser of a broadcast business, or any other business, acquires a basis equal to the purchase price paid. In an asset acquisition, a buyer must allocate the purchase price among the purchased assets to determine the buyer's basis in these assets. This allocation of basis will determine the amount (if any) of allowable depreciation or amortization deductions. For intangible assets, which may account for a substantial portion of the value of a broadcast or cable business, an amortization deduction is allowed over a 15-year period under Code section 197. In a stock acquisition, the buyer takes a basis in the stock equal to the purchase price paid, and the business retains its basis in its assets.[47]

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[45] See, e.g., PLR 8132072 and PLR 8020069. Private letter rulings do not have precedential authority and may not be relied upon by any taxpayer other than the taxpayer receiving the ruling but are some indication of IRS administrative practice.

[46] Treas. Reg. section 1.1071-3.

[47] Code section 338 allows certain stock acquisitions to be treated as asset acquisitions.

II. DISCUSSION OF ISSUES

A. Overview

The FCC reports that it has issued 378 tax certificates since 1978. Of that total, the FCC has issued 317 tax certificates under the minority ownership program. Thus, minority ownership transfers have represented more than 80 percent of total tax certificate transfers over the past 16 years. Of the 110 tax certificates issued since 1989, all but five have been issued under the minority ownership program. (See data in Appendix Table 1.) The majority of license transfers relating to minority ownership tax certificates involve radio properties, as would be expected as most outstanding licenses are for radio. (See data in Appendix Table 2.)

The National Telecommunications and Information Administration reports that minority persons hold 2.9 percent of all broadcast licenses.[48] This is an increase from the 1978 level estimated at 0.5 percent, but is lower than a peak of 3.0 percent attained in the mid-1980s. Such ownership numbers do not measure the extent of equity investments, but rather are an attempt to measure "control" of the broadcast and cable television properties. For example, a corporation that is 51-percent owned by minority persons or a general partner who is a minority person and owns a 21-percent equity interest in the partnership generally would satisfy the FCC's requirement of minority ownership for purposes of Code section 1071.[49] Moreover, these percentages probably overstate the degree of minority ownership in broadcasting as the percentage of minority ownership in large markets is less than the national percentage would suggest. Hence in terms of potential listeners or viewers, the current 2.9 ownership percentage probably overstates minority representation. The 317 license transfers reported over the past 16 years do not reflect net additions to the number of licenses held by minority persons, because some of the certificate transfers under the minority ownership program represent sales from one minority person to another minority person. As discussed in Part I, the FCC administers other programs to encourage minority ownership of broadcast properties. Thus, it is not possible to distinguish the extent to which Code section 1071 is responsible for the current level of minority ownership.

B. Economic Analysis

1. Economic value of Code section 1071 tax benefit

As described in Part I, under Code section 1071 a seller receiving a tax certificate from the

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[48] National Telecommunications and Information Administration, United States Department of Commerce, *Analysis and Compilation of Minority-Owned Commercial Broadcast Stations*, 1994.

[49] For example, the *USA Today* of January 13, 1995, reports that Viacom's sale of its cable television properties will be to a partnership, the general partner of which will have contributed only $1 million in cash to obtain his 21-percent equity position.

FCC may elect one of two options, each of which has the effect of deferring payment, perhaps indefinitely, of some or all of the tax on gain from the sale that would otherwise be payable in the current year. Within two years of the date of sale, the seller may reinvest the proceeds in qualifying broadcast or telecommunications property (replacement property option) and reduce its basis in that property by the amount of the gain deferred. Alternatively, the seller may elect to reduce its basis in qualifying assets that it currently owns (basis reduction option).

Purchase of qualifying replacement property

Under the Federal income tax, a taxpayer generally is liable for tax on the sale of asset when the gain is recognized. Under Code section 1071, the gain on sale of qualifying assets does not result in a tax liability until the taxpayer disposes , if ever, of the replacement property. The value of this deferral of tax liability depends upon the taxpayer's tax rate, the discount rate, and the length of time for which the liability is deferred. For example, suppose a taxpayer recognizes $1 million of gain in 1995. If the taxpayer were in the 35-percent marginal tax bracket, the gain would give rise to a 1995 Federal income tax liability of $350,000. If the taxpayer could defer including the $1 million gain in income until 2005, the taxpayer would have a 2005 income tax liability of $350,000. However, if the interest rate were 10 percent, the 1995 present value of that 2005 liability of $350,000 would be $134,940. The longer the deferral, the smaller the present value of the tax liability. If the taxpayer can defer the liability indefinitely, the tax benefit is equivalent to a complete exemption from tax.[50]

The benefit of deferral depends not only on the taxpayer's current tax rate, but also on its future tax rate. The benefit of deferral is increased for a taxpayer who currently is in a high marginal tax bracket, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is in a low marginal tax bracket and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually be worth less (in present value) than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

For individual taxpayers, deferral of tax may result in complete exemption from tax if the taxpayer defers the gain until death. Upon disposition to the taxpayer's heirs, the heirs may "step up" the basis of the bequeathed assets, and any liability from previously deferred gains is eliminated.

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[50] As a result of the fact that many State income tax systems have what is referred to as a "piggyback" system by which they measure taxable income by reference to the Federal definition of taxable income, section 1071 probably provides a State tax benefit as well as a Federal tax benefit. For example, if the taxable income deferred in a transaction were $100 million, the Federal tax benefit would be $35 million for a corporate taxpayer while the State tax benefit at a State tax rate of 10 percent would be $10 million, for a total tax benefit of $45 million (before the effect of the deductibility of State taxes).

Reduction in basis of the taxpayer's existing depreciable assets

If a taxpayer were to elect to reduce the basis of existing depreciable or amortizable assets, rather than purchase qualifying replacement assets, any tax for which the taxpayer would have been liable in the current year is deferred until disposition of the existing assets. However, the reduction in basis of existing assets would reduce any depreciation and amortization deductions that the taxpayer may claim. Reducing current year tax deductions is equivalent to recognizing partially the gain. Reducing future year tax deductions is equivalent to recognizing partially the gain in those future years. By effectively recognizing part of the gain prior to disposition of the assets, not all of the gain is deferred until disposition. Hence the present value of deferral under the basis reduction option of Code section 1071 is less than if the gain could be fully deferred until disposition.

2. Economic incidence of Code section 1071 tax benefit

While the Code specifies that the seller may defer the gain, the economic incidence of the tax benefit provided by Code section 1071 depends upon market conditions. A qualifying buyer could capture all or part of the tax benefit. The seller is interested in the net, after-tax return from the sale of its property. A qualifying buyer could be a successful bidder for a property even though it makes a bid lower than the current market value, or lower than other competing bids, because acceptance of the offer of a qualifying buyer carries the benefit of deferral, while the bids of other potential buyers may not. Hence, the qualifying buyer may be able to offer the seller a higher after-tax return despite offering a lower price. For example, assume the seller owns a property with zero basis and a market value of $1 million. Assume the seller is in the 35-percent tax bracket and that the interest rate is 10 percent. If the seller sold at market value to a non-qualifying buyer, the seller would incur a $350,000 income tax liability in the current year and net $650,000 after tax from the sale. If the seller had the opportunity to defer the recognition of any gain for 10 years, a qualifying buyer could offer $760,000 and that offer would dominate the $1 million offer from the non-qualifying buyer. A $760,000 selling price at a 35-percent marginal tax rate would create a $266,000 tax liability to the seller. If that tax liability could be deferred 10 years at a 10-percent interest rate, it would have present value of $102,554. The sale to the qualified buyer would produce a net, after-tax present value of the sale to the seller of $657,446 ($760,000 less the present value of the tax liability, $102,554).

In general, whether the buyer receives the benefit or the seller receives the benefit depends upon the number of sellers offering properties and the number of qualifying buyers seeking properties. In the example above, if there were a second qualifying buyer, it might bid more than $760,000, because the seller would see any such bid as superior to both the first qualifying buyer and any non-qualifying buyer who offered $1 million or less. If more qualifying buyers competed for a given property, one would expect that they would drive the selling price up, thereby returning some or all of the benefit of deferral to the seller. On the other hand, if many potential sellers offered properties for sale, the number of qualifying buyers might be sufficiently small that the buyer retains most of the tax benefit.

The number of broadcast licenses is limited by the electromagnetic spectrum, and fixed by the FCC. This might imply that the number of properties that could be sold is small relative to the number of potential qualifying buyers and that the tax benefit largely is retained by the seller. On the other hand, the data presented above indicates relatively little minority holding of broadcast licenses. This may imply that the pool of qualifying buyers with experience in the broadcast business is small relative to the number of properties available to be purchased at any one time, with the consequence that all or part of the tax benefit is transferred to the buyer.

3. Efficacy of targeted tax preferences for the transfer of broadcast properties

Measuring costs and benefits of the tax preference

The legislative history indicates that Code section 1071 is intended to facilitate certain policies of the FCC. These policies have included, among others, limitations on number of broadcast properties that any one taxpayer may control and the promotion of minority ownership of broadcast properties. A common goal of each of these policies is to provide competition and diversity in the presentation of ideas, news, and entertainment. The Joint Committee on Taxation staff previously has estimated an annual tax expenditure cost for Code section 1071 at $500 million over the fiscal year period 1995-1999 (approximately $100 million per year),[51] although it is in the process of reviewing this estimate in light of new information it is receiving. The Treasury Department has estimated the tax expenditure at $290 million for fiscal year 1995, $305 million for fiscal year 1996, $320 million for fiscal year 1997, $335 million for fiscal year 1998, and $350 million for fiscal year 1999, for a five-year cost of $1.6 billion.[52] The tax expenditure may be thought of as an annual Federal subsidy to effectuate these policies. It is more difficult to compute a dollar value for the benefits of these policies. The data reported above indicate that since the 1978 implementation of the policy related to minority ownership, minority ownership of broadcast properties has increased, although not markedly so. Moreover, this increase may be attributable to FCC policies other than its tax certificate program. Minority ownership in and of itself does not guarantee diversity of programming. In addition, granting a tax certificate does not guarantee that the transferred property remains under the control of minority persons for more than a short period of time. Arguably competition in broadcasting has increased over the past two decades, although this may be more of a consequence of growth in the number of networks and the expansion of cable systems, both of which may be phenomena unrelated to FCC policies on the transfer of broadcast properties.[53]

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[51] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1995-1999*, (JCS-6-94), November 9, 1994.

[52] Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Analytical Perspectives, Fiscal Year 1995*, Washington, D.C., 1994, p. 55.

[53] The growth in the number of networks and the expansion of cable television may be the result of other FCC policies.

Issues of equity

A tax preference for the transfer of broadcast properties may cause taxpayers who do not receive a benefit to perceive the tax system as unfair. The incidence of the tax benefit may be uncertain, but a comparable tax benefit is not provided for the sale of other business assets. This creates horizontal inequities in taxation. Otherwise similarly situated individuals or businesses do not incur the same tax liabilities. One might argue that the case of broadcast licenses is different because the industry is regulated and availability is limited by technology and the electromagnetic spectrum. On the other hand, similar treatment is not offered in other regulated industries or where nature or technology limits supply (*e.g.*, telephone service or landing rights at airports). Similarly, some may question the equity of a policy to provide tax preferences to designated sub-groups of the population.

Difficulties of targeting benefits through the tax system

Providing tax benefits to encourage certain policy outcomes may have the advantage of leaving the market system to allocate the benefit, rather than creating an administrative agency to identify eligible individuals and disburse subsidies. On the other hand, tax benefits are similar to open-ended entitlements available to all who may legally claim them. As such, targeting the benefits may be difficult without incurring administrative and monitoring costs for the IRS or the FCC. For example, in the FCC's minority owner certificate program, a 21-percent equity interest by a minority person is required of a qualified investment partnership. With complicated financial structures, a 21-percent equity interest, however measured, may or may not give the minority person effective control over the business. There is a tradeoff between having targeting in a program and having limited administrative involvement.

Because different taxpayers are in different tax situations, an additional problem of providing a benefit through the tax system is that it may have different values to different people. The FCC in developing its rule on granting FCC tax certificates does not take into account the size of the potential tax benefit involved. Indeed, neither the FCC nor the IRS request information concerning the magnitude of the tax benefit granted in determining whether to issue tax certificates. On the other hand, the value of broadcast properties varies with the markets they serve. If the goal is to further competition and diversity there may be no reason to deny a certificate merely because of the size of the transaction. Lastly, the IRS is not expert in the business of broadcast properties. Coordination on policy goals between the IRS and the FCC may be difficult to achieve.

C. Congressional Oversight of Code Section 1071

As drafted, Code section 1071 permits the FCC to grant qualifying certificates in transfers that further FCC policy goals. This leaves the granting of the tax benefit largely in the hands of the FCC. There are other programs where the Congress has delegated to other agencies the ability to deliver tax benefits. For example, under the low-income housing tax credit (Code section 42) and in the case of certain private activity tax-exempt bonds (Code section 141), State agencies are authorized to certify taxpayers to receive certain Federal income tax benefits. In each of those programs, however,

the Congress has not left the policy goals to the agency and has limited the total amount of benefit that the agencies may grant in any one year. Code section 7518 may be another related example. Section 7518 provides certain tax benefits to the owners of naval vessels used in the foreign or domestic commerce of the United States or in the fisheries of the United States to the extent such owners establish a fund under section 607 of the Merchant Marine Act, 1936. The determination of whether a taxpayer may establish such a fund generally is made pursuant to an agreement with the Secretary of Transportation or Commerce. Allowing a Federal agency to provide an open-ended amount of tax benefits is akin to providing a discretionary entitlement that is not governed by the Congressional appropriations process.

APPENDIX

Table 1.--FCC Tax Certificates Issued for Broadcast Stations and Cable Television Facilities, 1978-1994

Year	All	Minority Ownership
1978	9	4
1979	14	12
1980	24	10
1981	18	15
1982	18	15
1983	14	10
1984	16	11
1985	21	17
1986	24	16
1987	34	31
1988	34	32
1989	42	39
1990	43	42
1991	20	17
1992	11	10
1993	17	17
1994	19	19
Total	**378**	**317**

Source: Federal Communications Commission

Table 2.--Distribution of Minority Ownership Tax Certificates by Type of License and Type of Minority Group, 1978-1994

	Television	Cable Television	AM Radio	FM Radio	Total[1]
Black	12	18	87	84	201
Hispanic	2	2	48	20	72
American Indian	1	1	1	--	3
Asian American	9	6	4	6	25
Aleut	1	--	--	--	1
Alaskan Native	1	--	3	9	13
Total[1]	**26**	**27**	**143**	**119**	**315**

Source: Federal Communications Commission

Note 1--Grand total is different from that of Appendix Table 1 due to incomplete information on two transactions.