BACKGROUND AND ISSUES RELATING TO: (1) THE APPLICATION OF CODE SECTION 1071 UNDER THE FEDERAL COMMUNICATIONS COMMISSION'S TAX CERTIFICATE PROGRAM; (2) INVOLUNTARY CONVERSIONS UNDER CODE SECTION 1033; AND (3) THE EARNED INCOME TAX CREDIT

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 7, 1995, on the application of Internal Revenue Code ("Code") section 1071 under the Federal Communications Commission's ("FCC") tax certificate program.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides background information on Code section 1071 and the FCC tax certificate program. Part I of the document provides information on the background of Code section 1071 and the administration of the FCC tax certificate program, and discusses economic and tax policy issues concerning the application of Code section 1071. Part II of the document describes Code section 1033 regarding the tax treatment of involuntary conversions. Part III of the document describes certain provisions of H.R. 831, as passed by the House of Representatives on February 21, 1995, which repeal Code section 1071 and modify Code section 1033. Part IV of the document discusses certain aspects of the earned income tax credit ("EITC"), which is the subject of certain proposals included in the Administration's fiscal year 1996 budget submission. Specifically, Part IV of the document provides an overview of the EITC, and describes the Administration's proposal to modify the EITC, as well as the modifications to the EITC contained in H.R. 831.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Issues Relating to: (1) the Application of Code Section 1071 Under the Federal Communications Commission's Tax Certificate Program; (2) Involuntary Conversions Under Code Section 1033; and (3) the Earned Income Tax Credit* (JCX-8-95), March 6, 1995.

I. CODE SECTION 1071 AND THE FCC TAX CERTIFICATE PROGRAM

A. Background of Code Section 1071

Code section 1071 was originally enacted as part of the Revenue Act of 1943 to help the FCC implement a new policy that prohibited licensees from owning more than one radio station per market.[2] Congress believed that the involuntary conversion[3] rules (which generally permitted gain on sales of other dispositions of involuntarily converted property to be excluded from taxable income if the proceeds were reinvested in property similar to the property involuntarily converted) should be applied to these transactions, but needed to be liberalized for sales ordered by the FCC because, "[d]ue to wartime restrictions, the purchase of new radio property [would have been]... difficult."[4]

As initially reported by the Senate Committee on Finance in 1943, the provision would have allowed a rollover if the sale or exchange of the property were required by the FCC as a condition of the granting of an application.[5] 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."[6]

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]."[7]

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.[8] Congress was

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

[3] 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).

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

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

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

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

concerned that 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."[9] 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.[10] 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."[11]

The term "radio broadcasting" was expanded to include cable television in 1973.[12] The use of FCC tax certificates was recently expanded in connection with the auction of personal communications services (see discussion in Part I.B.1.).

B. 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.[13] 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).[14] After these rules were adopted, owners wishing to acquire

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

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

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

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

[12] Rev. Rul. 73-73, 1973-1 C.B. 371.

[13] 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).

[14] 8 Fed. Reg. 16065 (Nov. 23, 1943).

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 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 "involuntarily" to divest themselves of one of the licenses.[15]

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.[16] 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.[17]

"Minorities," within the meaning of the FCC's policy, include "Blacks, Hispanics, American Indians, Alaska Natives, Asians, and Pacific Islanders."[18] 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.[19] 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.[20] An acquisition can qualify

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

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

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

[18] 52 R.R.2d at n. 1.

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

[20] 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). Anti-trafficking rules require cable properties to be held for at least three years (unless the property is sold pursuant to a tax certificate).

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 arm's-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 certificate upon the subsequent sale of their interest in the minority entity.[21] 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. An investor can qualify for a tax certificate even if the sale of the interest occurs after participation by a minority in the entity has ceased. 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 fiscal year 1988, 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.[22] This limitation has not prevented an expansion of the existing program.[23]

Personal communications services ownership policy

In 1993, Congress provided for the orderly transfer of frequencies, including frequencies that can be licensed pursuant to competitive bidding procedures.[24] 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

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

[22] Pub. L. No. 100-202 (1987).

[23] The appropriations restriction "does not prohibit the agency from taking steps to create greater opportunity for minority ownership." H. Conf. Rep. No. 103-708, 103d Cong. 2d Sess. 40 (1994).

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

United States Treasury.[25]

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.[26] To help minorities and women participate in the auction of the PCS licenses, the FCC took several steps including up to a 25-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.[27]

The FCC will employ the tax certificate program 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.

Microwave relocation policy

PCS can operate only on frequencies below 3GHz. However, because that frequency range is currently occupied by various private fixed microwave communications systems (such as railroads, oil pipelines, and electric utilities), there are no large blocks of unallocated spectrum available to PCS. To accommodate PCS, the FCC has reallocated the spectrum; a portion of the 2GHz spectrum will be used exclusively for PCS, and the microwave systems will be required to move to higher frequencies. Current occupants of the 2GHz spectrum allocated to PCS must relocate to higher frequencies not later than three years after the close of the bidding process (anticipated to end in March or April, 1995).[28] In accordance with FCC rules, these current occupants have the right to be compensated for the cost of replacing their old equipment, which can operate only on the 2GHz spectrum, with equipment that will operate at the new, higher frequency. At a minimum, the winners of the new PCS licenses must pay for and install new facilities to enable the incumbent microwave operators to relocate. The amount of these payments and characteristics of the new equipment will be the subject of negotiation between the incumbent microwave operators and the PCS licensees; thus, the nature of the compensation (i.e., solely replacement equipment, or a combination of replacement equipment plus a cash payment) is

[25] Fifth Report and Order, 9 FCC Rcd 5532 (1994).

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

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

[28] The PCS auctions for portions of the 2GHz spectrum commenced in December, 1994.

unknown at present. If no agreement is reached within the 3-year voluntary negotiation period, the microwave operators will be required by the FCC to vacate the spectrum; however, the timing of such relocation is uncertain because the relocation would take place only after completion of a formal negotiation process in which the FCC would be a participant.

The FCC will employ the tax certificate program for PCS to encourage fixed microwave operators voluntarily to relocate from the 2GHz band to clear the band for PCS technologies.[29] Tax certificates will be available to incumbent microwave operators that relocate voluntarily within three years following the close of the bidding process. Thus, the certificates are intended to encourage such occupants to relocate more quickly that they otherwise would and to clarify the tax treatment of such transactions.[30]

2. FCC interpretation of tax certificate program

The standards for FCC 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 led it to require a showing of the involuntary nature of the divestiture.[31] 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.[32] Subsequently, the FCC determined that voluntary divestitures that effectuate specific ownership policies are "appropriate," and eliminated the "causal relationship" requirements.[33] Further, 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 . . . ."[34]

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[29] See, Third Report and Order and Memorandum Opinion and Order, 8 FCC Rcd 6589 (1993).

[30] The transaction between the PCS licensee and the incumbent microwave operator might qualify for tax-free treatment as a like kind exchange under Code section 1031 or as an involuntary conversion under Code section 1033. However, the availability of these Code provisions may be limited by certain technical requirements, including the treatment of cash in a like-kind exchange, and whether the transaction would qualify as an involuntary conversion under currently applicable IRS standards.

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

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

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

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

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.[35] 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.[36] 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. Data concerning FCC minority ownership programs

FCC tax certificate program

The FCC reports that it has issued 390 tax certificates since 1978.[37] Of that total, the FCC has issued 330 tax certificates under the minority ownership program[38] (an additional 18 certificates have been issued to parties contributing start-up capital to a minority-controlled entity to acquire broadcast or cable properties).[39] The majority (about 80 percent) of license transfers relating to minority ownership tax certificates involve radio properties, as would be expected because most outstanding licenses are for radio.[40]

The average sales price for the transactions in which tax certificates were granted was $3.5 million for radio, and $38 million for television.[41] No average sales price information is

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

[36] Id.

[37] Statement of William E. Kennard, General Counsel of the FCC, before the Subcommittee on Oversight of the Committee on Ways and Means, January 27, 1995.

[38] Id.

[39] Letter from William E. Kennard, General Counsel of the FCC, to Kenneth J. Kies, Chief of Staff of the Joint Committee on Taxation, dated February 7, 1995.

[40] Statement of William E. Kennard, General Counsel of the FCC, before the Subcommittee on Oversight of the Committee on Ways and Means, January 27, 1995.

[41] Id.

available for cable system sales, although the average sales prices is expected to be much larger.[42] No information is available concerning the lost tax revenue associated with the transactions for which the FCC has issued tax certificates in minority ownership transfers because the FCC does not request such information.

FCC records indicate that four of 40 television licenses have been transferred by a minority-controlled entity after the license was acquired in a tax certificate transaction.[43] The average holding period for these four licenses prior to transfer was 2.25 years. In radio, 130 of 183 (71 percent) stations acquired in tax certificate transactions during the period 1979-1992 for which the FCC has data were sold at the close of 1992. The average holding period was 3.5 years. The FCC was unable to provide data on the number of cable licenses acquired in tax certificate transactions and the average holding period prior to transfer. No holding period data is available for transactions that do not involve tax certificates.

FCC minority ownership programs

There is no data that documents the overall effectiveness of the FCC minority ownership programs (including the tax certificate program) or the effectiveness of any particular FCC minority ownership program. Some limited empirical data exists on minority ownership of broadcast facilities generally. The National Telecommunications and Information Administration reports that minority persons hold 2.9 percent of all broadcast licenses.[44] 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.

5. Viacom transaction

On January 20, 1995, Viacom Inc. (a publicly-traded company) and Mitgo Corp., a company wholly owned by Frank Washington, an African American media executive, 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, RCS-Pacific L.P., of which Mitgo is the general partner and InterMedia Partners IV, L.P. is the limited

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[42] Id.

[43] Letter from William E. Kennard, General Counsel of the FCC, to Kenneth J. Kies, Chief of Staff of the Joint Committee on Taxation, dated February 7, 1995.

[44] National Telecommunications and Information Administration, United States Department of Commerce, *Analysis and Compilation of Minority-Owned Commercial Broadcast Stations*, 1994. According to U.S. Census Bureau statistics, minority-owned firms account for slightly under 4 percent of all business revenues.

partner, for approximately $2.3 billion in cash.[45] A subsidiary of TeleCommunications Inc. (a national cable television operator) is one of the limited partners of InterMedia.[46] Recent news reports state that TeleCommunications Inc. will provide "nearly all" of the money for the cable system purchase.[47]

The sale is subject to customary conditions, approvals of local franchise authorities and receipt of an FCC tax certificate.[48] Viacom has indicated that proceeds from the transaction, which is expected to be completed in the second half of 1995, will be used to repay debt.[49]

RCS-Pacific will, in turn, transfer one of the cable systems (located in Nashville, Tennessee) to another partnership, RCS-Nashville, L.P. RCS-Nashville has substantially the same ownership structure as RCS-Pacific, i.e., Mitgo is the sole general partner (and a 21-percent equity owner) and an affiliate of InterMedia is the sole limited partner (and a 79-percent equity owner).

Under the terms of the RCS-Pacific partnership agreement (as filed with the FCC as part of Viacom's application for an FCC tax certificate), Mitgo Corp., the general partner that is controlled by Mr. Washington, has a put option to be cashed out for the greater of $3 million or the fair market value of its interest (determined by an outside appraiser and subject to a cap). The put option can be exercised between 42 and 46 months after the close of the transaction.

In addition, under the same partnership agreement, InterMedia, the limited partner, has a call option to cash out Mitgo at the same option price described above. The call option can be exercised between 36 and 40 months and after 48 months after the close of the transaction.

Under the terms of the RCS-Nashville partnership agreement, Mitgo has a put option on its RCS-Nashville general partnership interest for the greater of $3 million (plus any amounts outstanding on any loans from the limited partners) or the fair market value of the interest (determined by an outside appraiser and subject to a cap). InterMedia has a call option to cash out Mitgo at the same option price. The exercise period for these options is the same as the exercise period for the RCS-Pacific options. Thus, the combined value of the options under the two partnership agreements is the greater of $6 million or fair market value of the interests.

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

[46] Id.

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

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

[49] Id.

As designed, the sale does not appear to fail any of the standards articulated by the FCC to qualify for a tax certificate pursuant to Code section 1071. Publicly available information indicates 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.[50] The tax deferral, including State tax, could be in the range of $440 million to $640 million.[51] Viacom may be able permanently to defer this gain as a result of utilizing the technique for complying with the requirement to purchase replacement property described in Part II whereby the replacement property is actually purchased from a related corporation within the same controlled group.

In addition, it appears that InterMedia would be eligible to apply for a tax certificate upon sale of its interests in RCS-Pacific and RCS-Nashville as a provider of start-up capital to a minority entity. Thus, InterMedia could defer gain on the sale of its interests in RCS-Pacific and RCS-Nashville, irrespective of whether such sale occurred after Mitgo was no longer a partner (and such partnerships were no longer minority controlled). The revenue costs associated with such a deferral are unknown because they would depend on the amount of deferred gain at the time of the sale.

C. Application of Tax Rules

1. Tax treatment of a seller of broadcast property

General tax rules

Under generally applicable Code provisions, the seller of a business, including a broadcast business, recognizes gain to the extent the sale price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is then subject to the current income tax unless the gain is deferred or not recognized under a special tax provision.

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

[51] 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 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).

Special rules under Code section 1031

Under Code section 1031, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for productive use in a trade or business or for investment. The nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind.[52] The different classes of property are: (1) depreciable tangible personal property; (2) intangible personal property; and (3) real property.[53]

If an exchange consists not only of like-kind property, but also of other property or money, then gain from the transaction is recognized to the extent of the money and the fair market value of the other property, and no loss from the transaction may be recognized. The basis of property received in a like-kind transaction generally is the same as the basis of any property exchanged, decreased by the amount of money received or loss recognized on the exchange and increased by the amount of gain recognized on the exchange. Special rules apply to exchanges between related persons, which generally require the parties to the transaction to hold the exchanged property for at least two years after the exchange.

Special rules under Code section 1033

Under Code section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

Only involuntary conversions that result from destruction, theft, seizure, or condemnation (or threat or imminence thereof) are eligible for deferral under Code section 1033. In addition, the term "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation, according to a ruling by the Internal Revenue Service (IRS).[54] Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or a threat or imminence thereof), and the divestiture is not eligible

[52] Treas. Reg. sec. 1.1031(a)-1(b).

[53] Treas. Reg. sec. 1.1031(a)-2.

[54] Rev. Rul. 58-11, 1958-1 C.B. 273.

for deferral under this provision.[55] Under another IRS ruling, the "threat or imminence of condemnation" test is satisfied if, prior to the execution of a binding contract to sell the property, "the property owner is informed, either orally or in writing by a representative of a governmental body or public official authorized to acquire property for public use, that such body or official has decided to acquire his property, and from the information conveyed to him has reasonable grounds to believe that his property will be condemned if a voluntary sale is not arranged."[56] However, under this ruling, the threatened taking also must constitute a condemnation, as defined above.

Special rules under Code section 1071

Under Code section 1071, if the FCC certifies that a sale or exchange of property is necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of "radio broadcasting stations," a taxpayer may elect to treat the sale or exchange as an involuntary conversion. The FCC is not required to determine the tax consequences of certifying a sale or to consult with the IRS about the certification process.[57] No other provision of the Internal Revenue Code grants a Federal agency or any other party the type of complete discretion conveyed to the FCC by section 1071.

Under Code section 1071, the replacement requirement in the case of FCC-certified sales may be satisfied by purchasing stock of a corporation that owns broadcasting property, whether or not the stock represents control of the corporation. In addition, even if the taxpayer does not reinvest all the sales proceeds in similar or related replacement property, the taxpayer nonetheless may elect to defer recognition of gain if the basis of depreciable property that is owned by the taxpayer immediately after the sale or that is acquired during the same taxable year is reduced by the amount of deferred gain.

2. Tax treatment of a buyer of broadcast property

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. 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 the assets. This treatment applies whether or not the seller of the broadcast property has received an FCC certificate exempting the sale transaction

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[55] Id.

[56] Rev. Rul. 74-8, 1974-1 C.B. 200.

[57] The FCC allows sellers applying for FCC certificates in cable transactions to delete both the sales price and the number of subscribers from the transaction documents submitted with the request for the certificates.

from the normal tax treatment.

D. Economic and Tax Policy Issues Pertaining to Section 1071

1. Economic Analysis

Economic value of Code section 1071 tax benefit

As described in Part I.C.1. above, under Code section 1071 a seller receiving a tax certificate from the 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.

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.

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. 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. Thus, 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 (unless the basis reduction is applied against stock, as described in Part II).

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 may be transferred to the buyer.

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 Treasury Department has estimated the tax expenditure at $300 million for fiscal year 1995, $315 million for fiscal year 1996, $330 million for fiscal year 1997, $345 million for fiscal year 1998, $360 million for fiscal year 1999, and $380 million for fiscal year 2000, for a six-year cost of $2.03 billion.[58] 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.

Just as it is difficult to measure the aggregate social benefits and costs arising from Code section 1071, it is difficult to measure the social benefits and costs of any individual transaction. An inherent problem arising from providing benefits through the tax system is that a tax benefit may have different values to different taxpayers. Similarly, the social benefits from increased competition and diversity may be expected to vary from community to community. For example, a community already served by ethnically diverse broadcasters would benefit less from the diversity an additional minority broadcaster might bring to the community than would a community currently served by no such broadcasters. In developing its rule on granting tax certificates, the FCC does not take into account the size of the potential tax benefit involved and attempt to weigh this against the benefits to the affected community that may arise from increased competition and diversity. Indeed, the FCC does not request information concerning the

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[58] Executive Office of the President, Office of Management and Budget, *Budget of the United States Government, Analytical Perspectives, Fiscal Year 1996*, Washington, D.C., 1995, p. 49. The Joint Committee on Taxation recently estimated that repeal of Code section 1071 (as proposed in H.R. 831) would increase Federal revenues by $1.386 billion over the period 1995 through 2000. H. Rept. No. 104-32, 104th Cong., 1st Sess., 26 (1995).

magnitude of the tax benefit granted in determining whether to issue tax certificates.

The cost, in deferred taxes, of any one transaction also will vary because the value of broadcast properties varies with the markets they serve. However the benefit of deferred taxes under Code section 1071 always depends, in part, on the sales price of the property. The market value of a broadcast property depends on its potential viewers or listeners, that is, on the size of the market served. 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, because a large transaction value generally implies a large market or several markets are involved.

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).

Administrative difficulties of targeting benefits through the tax system

Tax benefits are similar to open-ended entitlements available to all who may legally claim them. 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. However, targeting tax benefits may be difficult without incurring administrative and compliance costs. For example, in providing tax benefits to sellers for sales to minority purchasers under Code section 1071, the FCC must certify the purchaser as a qualified minority purchaser. In practice, the FCC must engage in a review and certification process equivalent to one that might occur under a direct expenditure program. There is a tradeoff between having targeting in a program and having limited administrative involvement. In the case of Code section 1071, two administrative agencies are involved. The IRS is not expert in the business of broadcast properties and the FCC is not expert in tax administration. Coordination on administrative matters and policy goals between the IRS and the FCC may be difficult to achieve.

2. 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 nautical 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.

II. INVOLUNTARY CONVERSIONS UNDER CODE SECTION 1033

As described in Part I.C.1., under Code section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property.

Under rulings issued by the IRS to taxpayers, property (stock or assets) purchased from a related person may, in some cases, qualify as property similar or related in service or use to the converted property.[59] Thus, in certain circumstances, related taxpayers may obtain significant (and possibly indefinite or permanent) tax deferral without any additional cash outlay to acquire new properties. In cases in which a taxpayer purchases stock as replacement property, section 1033 permits the taxpayer to reduce basis of stock, but does not require any reduction in the basis of the underlying assets. Thus, the reduction in basis does not result in reduced depreciation deductions.

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[59] See, e.g., PLR 8132072, 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.

III. DESCRIPTION OF SECTIONS 2 AND 3 OF H.R. 831

A. In General

On February 21, 1995, the House of Representatives passed H.R. 831 by a vote of 381 to 44. As passed, H.R. 831 would (1) extend permanently the 25-percent deduction for health insurance costs for self-employed individuals; (2) repeal the provision permitting nonrecognition of gain on sales and exchanges effectuating policies of the FCC; (3) provide that the nonrecognition of gain on involuntary conversions is not to apply if replacement property is acquired from a related person; and (4) deny the EITC to individuals who have more than $3,150 of taxable interest and dividend income and phase out the EITC for individuals with more than $2,500 of taxable interest and dividend income.[60]

B. Repeal of Code Section 1071 (sec. 2 of the bill)

Section 2 of the bill repeals Code section 1071. Thus, a sale or exchange of broadcast properties would be subject to the same tax rules applicable to all other taxpayers engaged in the sale or exchange of a business. The repeal of section 1071 is effective for (1) sales or exchanges on or after January 17, 1995[61], and (2) sales or exchanges before that date if the FCC tax certificate with respect to the sale or exchange is issued on or after that date. The provision does not apply to taxpayers who have entered into a binding written contract (or have completed a sale or exchange pursuant to a binding written contract) before January 17, 1995, and who have applied for an FCC tax certificate by that date. A contract is treated as not binding for this purpose if the sale or exchange pursuant to the contract (or the material terms of the contract) were contingent on January 16, 1995, on issuance of an FCC tax certificate. A sale or exchange would not be contingent on January 16, 1995, on issuance of an FCC tax certificate if the tax certificate had been issued by the FCC by that date.

C. Modification of Code Section 1033 (sec. 3 of the bill)

Under section 3 of the bill, a taxpayer may not defer gain under Code section 1033 when the replacement property or stock is purchased from a related person. For purposes of the bill, a person is treated as related to another person if the relationship between the persons would result

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[60] For a description of H.R. 831, as reported by the House Committee on Ways and Means, see H. Rept. No. 104-32, 104th Cong., 1st Sess. (1995).

[61] On January 17, 1995, House Committee on Ways and Means Chairman Archer issued a press release announcing that the Committee on Ways and Means would immediately review the operation of section 1071 to explore possible legislative changes to section 1071, including the possibility of repeal. The press release stated that any changes to section 1071 may apply to transactions completed, or certificates issued by the FCC, on or after the date of the announcement.

in a disallowance of losses under the rules of Code section 267 or 707(b). This provision is intended to apply to all cases involving relationships to the taxpayer described in Code sections 267(b) or 707(b)(1), including members of controlled groups under Code section 267(f). The prohibition against nonrecognition of gain in certain related-party transactions applies to replacement property or stock acquired on or after February 6, 1995 (the date of introduction of H.R. 831).

IV. EARNED INCOME TAX CREDIT

A. Present Law

EITC, in general

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or adjusted gross income, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or adjusted gross income, if greater) exceeds the phaseout limit.

The parameters for the EITC depend upon the number of qualifying children the taxpayer claims. For 1995 the parameters are as follows:

	Two or more qualifying children--	One qualifying child--	No qualifying children--
Credit rate	36.00%	34.00%	7.65%
Phaseout rate	20.22%	15.98%	7.65%
Earned income threshold	$8,640	$6,160	$4,100
Maximum credit	$3,110	$2,094	$314
Phaseout threshold	$11,290	$11,290	$5,130
Phaseout limit	$26,673	$24,396	$9,230

The earned income threshold and the phaseout threshold are indexed for inflation; because the phaseout limit depends on those amounts, the phaseout rate, and the credit rate, the phaseout limit will also increase if there is inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates and phaseout rates for the EITC change over time under present law. For 1996 and after, the credit rate will be 40 percent and the phaseout rate will be 21.06 percent for taxpayers with two or more qualifying children. The credit rate and the phaseout rate for taxpayers with one qualifying child or no qualifying children will be the same as those listed in the

table above.

In order to claim the EITC, a taxpayer must either have a qualifying child or must meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the EITC without a qualifying child, a taxpayer must not be a dependent and must be over age 24 and under age 65.

To satisfy the identification test for a qualifying child, taxpayers must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1995, taxpayers must provide a taxpayer identification number (TIN) for all qualifying children who were born on or before October 31, 1995. For returns filed with respect to tax year 1996, taxpayers must provide TINs for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, taxpayers must provide TINs for all qualifying children, regardless of their age.

A taxpayer's TIN is generally that taxpayer's social security number. Some taxpayers are exempted from social security self-employment taxes because of their religious beliefs. These taxpayers do not have a social security number; instead, the Internal Revenue Service administratively assigns them a taxpayer identification number.

Nonresidents and the EITC

The EITC may be claimed by a taxpayer meeting the above requirements if the taxpayer is a U.S. citizen or a resident alien.

Section 7701(b) defines a resident alien for income tax purposes. Aliens who do not meet this definition are nonresident aliens. For income tax purposes, an individual is generally considered a resident if the individual:

(1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for 183 or more days during a three-year period weighted toward the present year (the "substantial presence test"). (An individual who is present in the United States for fewer than 183 days and establishes that he has a closer connection with a foreign country than with the United States is generally not subject to tax as a resident alien on account of the substantial presence test.)

The implementing legislation for the General Agreements on Tariffs and Trade (P.L. 103-465) made individuals who are nonresident aliens for any portion of the taxable year ineligible to claim the EITC for taxable years beginning after December 31, 1994, unless an election under Code section 6013(g) or (h) is in effect for the taxable year.

Under section 6013(g), a nonresident alien who is married to an individual who is either a citizen or resident alien of the United States at year end may elect to be treated as a resident for the entire year. The election applies to the year for which it is made and all subsequent years until terminated. However, the election will be suspended if neither spouse is a U.S. citizen or resident at any time during a taxable year.

Under section 6013(h), an individual who (1) is a nonresident alien at the beginning of the year and a resident alien at the end of the year and (2) is married to an individual who is either a citizen or resident of the United States at year end may elect to be treated as a resident for the entire year. Thus, this election can be made by a foreign married couple who arrive in the United States during the taxable year and who are resident aliens at year end.

Mathematical errors

The IRS may summarily assess additional tax due as a result of a mathematical error without sending the taxpayer a notice of deficiency and an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. This procedure is the only one a taxpayer may use for contesting an assessment arising out of a mathematical or clerical error.

B. Description of Administration Proposal and Section 4 of H.R. 831

1. President Clinton's Fiscal Year 1996 Budget Proposal

Earned income tax credit denied to individuals not authorized to be employed in the United States

Taxpayers would not be eligible for the EITC if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number would be defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits). Thus, if an individual obtained a social security number solely because that individual is an applicant for, or a recipient of, Federally funded benefits, the individual would be ineligible to claim the EITC.

If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error. Thus, any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

Earned income tax credit denied to individuals with substantial unearned income

A taxpayer would not be eligible for the EITC if the aggregate amount of interest and dividends includible in his income for the taxable year exceeds $2,500. For taxable years beginning after 1996, the $2,500 limit would be indexed for inflation with rounding to the nearest multiple of $50.

These proposals would be effective for taxable years beginning after December 31, 1995.

2. Section 4 of H.R. 831

Section 4 of H.R. 831 provides that a taxpayer is not eligible for the EITC if the aggregate amount of interest and dividends includible in his or her income for the taxable year exceeds $3,150. The otherwise allowable EITC amount is phased out ratably for taxpayers with aggregate taxable interest and dividend income between $2,500 and $3,150. For taxable years beginning after 1996, the $2,500 threshold and the $650 size of the phaseout will be indexed for inflation, with rounding to the nearest multiple of $10.

The provision is effective for taxable years beginning after December 31, 1995.