Entertainment, Media, and Communications Tax Newsletter/ Volume 22/June 2014

In focus

How the wireless spectrum auction could affect your business and help you monetize your assets

Rethinking how your company could tap into additional value from their real estate assets through REIT conversion

Prepare now for the New York State tax changes -efforts to make the state more economically competitive will impact entertainment, media, and communication companies.

View EMC newsletter archives

Visit us online:
www.pwc.com/entertainment
www.pwc.com/communications

Spectrum auction offers new business and tax planning opportunities for TV broadcasters

On June 2, 2014, the FCC released a 484-page Report and Order adopting rules to implement a broadcast television spectrum incentive auction. The planned 2015 FCC auction of spectrum currently used for television broadcast across the United States presents a potential opportunity for broadcasters to monetize a valuable asset—their wireless spectrum—in a new way. Despite this opportunity, multiple concerns surrounding the auction exist including the costs, potential for business disruption, efficiency and effectiveness of such a broad initiative, and the potential impact to channel brand recognition.

As such, participating in the auction needs to be supported by careful strategic, financial, and tax planning. Auction paths such as channel sharing and band migration may be lucrative options, while tax treatments such as like-kind exchanges and involuntary conversions may further assist broadcasters in preserving the value received in the auction. Careful consideration of these options is critical in making the decision whether to buy/sell and maximizing asset value.

"Today, the opportunity for many broadcasters to receive a significant payout from the planned spectrum auction is on the horizon."

Background

The sale and purchase of wireless spectrum has become commonplace in the mobile communications industry. For television broadcasters, however, the planned 2015 auction of their spectrum is an event that is both unprecedented and unusual. The complexity of the planned auction, coupled with the ability for broadcasters to receive a share of the cash paid for their spectrum holdings, creates a strong need for thoughtful and deliberate strategic, financial, and tax planning.

The auction, which was mandated by the United States Congress in the 2012 Spectrum Act, is unprecedented in that it allows television broadcasters, for the first time ever, to sell the spectrum currently used for their broadcast services.[1] Similarly, the auction is unusual, as it will consist of both reverse (selling) and forward (buying) auctions. The "incentive auction," as it has been termed, will allow broadcasters to bid to relinquish their spectrum rights in exchange for a share of the proceeds from an auction of the repurposed spectrum to parties who will bid on licenses for flexible use in mobile communications networks.

Surging demand for mobile communications has caused the telecommunications industry to seek out significant new swaths of wireless spectrum. A projected 61% increase in wireless data consumption over the next five years (2013-2018 CAGR) means (in PwC's view) that there is a significant demand for spectrum to provide more bandwidth to support growth in mobile data traffic.[2]

Spectrum used for television, which propagates long distances and penetrates both foliage and buildings, is an ideal solution to the mobile industry's needs. And, while television viewership is still popular, and over the air viewing provides free access to vital information that serves a public interest, 93% of households do not rely on over-the-air, instead watching primarily via cable, satellite or online, resulting in a relatively inefficient use of the allocated spectrum.[3] As a result, Congress and the Federal Communications Commission (FCC) have decided to provide an incentive for broadcasters to give up a portion of their spectrum so that it may be reallocated for newer, more efficient uses.

Today, the opportunity for many broadcasters to receive a significant payout from the planned spectrum auction is on the horizon. However, there are potentially significant implications to broadcasters such as channel change costs and brand concerns, changes in their fundamental operating model or the termination of the broadcast of the TV station signal all together. Therefore, understanding the mechanics of the auction, evaluating potential options and deals to take advantage of the process, assessing the value of existing broadcast stations, and planning for the potential windfall require broadcasters to start planning now.

Selecting the best option

The planned incentive auction has several key differences from past spectrum auctions and private transactions. First, unlike past auctions, broadcasters have several potential options to choose from for the future of their business. They may:

1. *Continue broadcasting* as is, but be subject to a channel change ("repacking") which will be paid for by the overall auction proceeds.
2. *Move from UHF to VHF* to free up higher-band spectrum in exchange for a new VHF channel plus a share of auction proceeds.
3. *Share a channel* with one or more other stations in the same market, relinquishing at least one of the broadcasters' spectrum and sharing the proceeds among themselves.
4. *Distribute without broadcast* by continuing to provide content via cable, satellite, or online channels, receiving auction proceeds for the sale of spectrum.
5. *Close operations* by going off the air in exchange for a portion of the auction proceeds.

Selecting from among these options is a critical decision for broadcasters, and it needs to be informed by a clear business strategy, view of future demand, and financial valuation of each viable scenario. For publicly-traded or multi-owner broadcasters, thoroughly evaluating auction options and values is a fiduciary duty which is already being recognized by many boards and management teams. For many stations, such as major network affiliates, closing operations or ceasing broadcast activities will likely not be the most economical choice. However, recent trials of channel sharing held in Los Angeles make that option a potentially lucrative one with strong technical feasibility.[4]

Additionally, this auction is expected to attract significant interest given the low-band frequencies to be made available which provide strong in-building coverage for dense, urban areas and outstanding coverage for less dense, rural areas. This could greatly increase the value to broadcasters, with some industry experts anticipating that the auction could generate as much as $20 billion to $30 billion in total proceeds.[5] While the specific mechanisms to distribute proceeds to broadcasters for each of these options are still being finalized by the FCC, the resulting proceeds could generate anywhere from tens to hundreds of millions of dollars for television station owners, particularly those in the largest, most desirable, urban markets such as New York, San Francisco, Los Angeles, Chicago, and Boston.

Finally, as highlighted in the recently-published *Overview of the KLCS/KJLA Channel Sharing Pilot*, the available options will potentially require new operating models for broadcasters. Channel sharing will require well-defined governance and cost-sharing approaches. These must also be balanced with ownership structures and operations in order to fairly allocate both capacity and cost. Furthermore, this must all be evaluated in light of the potential tax implications of the funds received via the spectrum auction.

Taxes are important in making an informed decision:

Tax considerations will play an important role in evaluating which option is best for a broadcaster. A clear picture of the tax characteristics of the broadcaster will be needed to determine their potential after-tax benefit from each option. In addition, depending on the option chosen and what is done with the proceeds, there could be significant opportunities for deferring tax, given the low tax basis many broadcasters have in their stations.

A key question for broadcasters is whether participation in the auction is voluntary for tax purposes. If participation is not voluntary, then the tax could be deferred if the incentive auction is an "involuntary conversion" and the broadcaster reinvests in property that is "similar or related in service or use" within the applicable two year period.[6] However, the availability of these rules is unclear both in whether the planned incentive auction meets the requirements for an involuntary conversion and in what would constitute property that is similar or related in service or use. It may take guidance from the Internal Revenue Service in order for this tax planning strategy to be implemented with confidence.

Alternatively, the tax could be deferred by the broadcaster by engaging in a "like-kind exchange."[7] This strategy would require the broadcaster to acquire property that is of a "like kind" to the property that was disposed of in the auction within 180 days of a spectrum sale. While the like-kind exchange rules are more certain in their application to the planned incentive auction, they are more restrictive in terms of timing and require the cash received to be held by a third party. In addition, the acquisition of replacement property of a like kind is likely to be more limiting than replacement property that is similar or related in service or use.

Under either tax deferral strategy, the broadcaster likely would have to remain invested in the broadcasting business in order to achieve tax deferral.

Reaping the benefits

Broadcasters need to carefully plan for whether they are going to participate in the planned incentive auction. Which option is best will depend on a multitude of factors, including their business outlook, future strategy, ownership structure, and available options under the auction rules. Since the value of the various options should include a comparison of after-tax proceeds, the ability to defer taxes should play an important role in the decision-making process.

EMC companies receive favorable REIT rulings while IRS proposes REIT real property definition

"Many companies, including EMC companies, are now rethinking how to tap into additional value from their real estate assets through REIT conversion."

In brief

Over the past several years, a number of companies holding non-traditional real estate assets (e.g., assets such as cell towers are not traditional real estate assets like buildings and land, but are nonetheless considered real property under the real estate investment trust rules) have elected to become real estate investment trusts (REITs) for federal income tax purposes. In recent months, EMC companies have been at the forefront of some of these conversions. So much so, that two EMC companies announced recently that the IRS had issued favorable private letter rulings with respect to their plans to convert to REITs. According to one EMC company making the switch would allow it to "unlock true value… and enhance its ability to return capital to shareholders."

In detail

In order to be a REIT, a company must predominantly own real property and derive a predominance of its income from real property rents and mortgage interest. As a REIT, a company can avoid paying corporate-level income taxes (through a dividends paid deduction) if it distributes at least 90% of its taxable income to shareholders in the form of dividends.

In general, companies have obtained private letter rulings from the IRS confirming that their non-traditional assets qualified as real estate assets under the REIT rules. The IRS' acknowledgment of the different types of non-traditional real estate assets that may be held by a REIT, as well as the relaxation of the rules governing taxable REIT subsidiaries, has driven several corporations to convert to REITs in recent years, while others with eligible assets have undertaken or are in the process of undertaking tax-free spin-offs of such assets into REITs.

However, last year, the IRS announced that it had suspended issuing REIT private letter rulings involving non-traditional assets while it was forming an internal group to study the contours of the real property definition under the REIT rules, creating uncertainty among taxpayers as to whether the IRS was changing its view regarding non-traditional real estate assets for REIT purposes.

Nevertheless, in April 2014, two EMC taxpayers announced that they had received favorable private letter rulings regarding the eligibility of their outdoor advertising displays (i.e., billboards) to qualify as real property for REIT purposes. In Rev. Proc. 2014-3, the IRS announced that it would no longer rule that outdoor advertising displays constitute real property for purposes of REITs, but mentioned the Section 1033(g) election to treat outdoor advertising displays as real property. Therefore, the rulings likely are based on the companies making elections under Section 1033(g). If so, the IRS would be permitting the election to treat outdoor advertising displays as real property to be effective outside of a transaction involving Section 1033 (which deals with involuntary conversions).

In addition, on May 9, 2014, the IRS released proposed regulations that clarify the definition of real property for purposes of the asset tests applicable to REITs. The proposed regulations define real property to include three broad categories: (1) land, (2) inherently permanent structures, and (3) structural components. In addition, the proposed regulations identify certain types of intangible assets that are real property for purposes of the REIT rules. The proposed regulations provide that each distinct asset (each unit of property) is tested individually to determine whether the distinct asset is real property (i.e., land, inherently permanent structure, or structural component) or personal property.

The proposed regulations also provide a safe harbor list of distinct assets that are deemed inherently permanent structures or structural components and therefore clearly would be treated as real property for purposes of the REIT rules. If an asset is not specifically listed in the regulations as constituting real property, then it must be analyzed through an analysis of the facts and circumstances. Under the proposed regulations, outdoor advertising displays for which an election has been properly made under Section 1033(g) are included in the safe harbor list of inherently permanent structures (i.e., real property).

The proposed regulations are consistent with a number of prior published and private rulings. Thus, the proposed regulations are intended to be a clarification and not a modification of the existing definition of real property for REIT purposes. While the proposed regulations are solely for purposes of the REIT rules, the IRS is requesting comments on whether and how differing definitions of real property in various regulations should be reconciled. These proposed regulations are proposed to be effective when they are finalized.

Takeaway

Many companies, including EMC companies, are now rethinking how to tap into additional value from their real estate assets through REIT conversion. As more and more businesses consider REIT status for tax purposes, the revival of REIT rulings and the recent IRS proposed regulations on the definition of real property, could mean good news for EMC companies with these nontraditional assets. However, the rules governing taxation and qualification of REITs are complex, and REIT conversions should not be entered into lightly. Therefore, EMC companies considering converting to REITs should only make the decision after careful analysis, planning and consideration of the tax impact.

New York State Corporate Tax Reform – Impact on EMC Companies

On March 31, 2014, New York State (NYS) enacted significant corporate tax reform.8 Most of the provisions will take effect for tax years beginning on or after January 1, 2015, with some exceptions. With the goals of reducing the complexity of NYS' current corporation franchise tax regime and improving the state's economic competitiveness, NYS Tax reform contains many broad changes that will impact EMC companies. This article is limited to the changes directly affecting the industry such as sales factor sourcing, nexus, tax rates, and combined reporting.

Unitary filing rules changes

Under pre-reform rules, an affiliated group of corporations is required to file on a combined basis if they meet the following three requirements:

(a) the corporations meet an 80% capital stock ownership or control test;

(b) the group of corporations are engaged in a unitary business; and

(c) there are substantial intercorporate transactions among the related corporations (i.e., 50% of receipts or expenses are attributable to a related corporation).

Alternatively, if there are no substantial intercorporate transactions, a group may file on a combined basis if filing on a separate basis would distort its NYS activities, business, income or capital.

Under the new law, the provision that required combination based on the existence of substantial intercorporate transactions is repealed. This will alleviate much of the confusion over the application of that test in the tax community.

" One of the key changes of the new law is NYS' broad adoption of a market based sales factor sourcing methodology, and the creation of a new category: receipts from digital products. EMC companies will be particularly concerned with revenue classified under the new law as: digital products, advertising, licensing, and other services receipts."

The new law provides that the taxpayer is required to file a combined report with other corporations engaged in a unitary business with the taxpayer if a more than 50% common ownership test is met (as measured by voting power). The test is met if:

(1) a taxpayer owns or controls directly or indirectly, more than 50% of the capital stock of one or more other corporations,

(2) or more than 50% of the taxpayer's capital stock is owned or controlled either directly or indirectly by one or more other corporations,

(3) or more than 50% of the capital stock of which, and the capital stock of one or more other corporations, is owned or controlled, directly or indirectly, by the same interests and is engaged in a unitary business with those corporations.

Corporations that meet this test are referred to as "related corporations." It should be noted that the new law does not provide a definition of what constitutes a unitary business (federal constitutional principles and pre-reform New York case law should still be applicable).

Under the new law, related corporations that meet the more than 50% test can elect to file on a combined basis even if they are not engaged in a unitary business. This election must be made on a timely filed original return and is irrevocable for seven taxable years. Further, any corporation entering the commonly owned group while the election is in effect is automatically included. If a corporate filing group does not wish to renew this election, a revocation must be made at the end of the seven year period. If the revocation is not made, the combined group election is automatically renewed for another seven years. If there is a revocation, a new election cannot be made for three taxable years.

A combined reporting group can include general domestic corporations, certain alien corporations, captive real estate investment trusts, captive regulated investment companies, and combinable captive insurance companies. An alien corporation is includable if treated as a domestic corporation or has effectively connected income as defined under Internal Revenue Code §882 (this is an additional departure from pre-reform law; previously, alien corporations were automatically excluded from filing on a combined basis).

Under the new law, combinable captive insurance companies are includable in the combined return. A combinable captive insurance company is defined as a corporation sharing more than 50% common ownership, licensed as a captive insurance company, whose business includes providing insurance or reinsurance covering the risks of its parent and/or members of its affiliated group, and 50% or less of whose gross receipts for the taxable year consist of premiums from arrangements that constitute insurance for federal income tax purposes.

Receipts factor - market based sourcing expanded

Under pre-reform law, receipts from services were sourced based on where the services were performed, and "other business receipts," a catch-all category that often included services and products delivered electronically to customers, were sourced based on where the receipts were earned. One of the key changes of the new law is NYS' broad adoption of a market based sales factor sourcing methodology, and the creation of a new category: receipts from digital products. EMC companies will be particularly concerned with revenue classified under the new law as: digital products, advertising, licensing, and other services receipts.[9]

Under the new law, digital products are defined as any property, service or a combination thereof delivered by various electronic media. Digital products include, but are not limited to, audio works, audiovisual works, visual works, books or literary works, graphic works, games, information or entertainment services, storage of digital products and computer software. NYS does not differentiate between the delivery methods. Starting in 2015, receipts from digital products are sourced pursuant to a hierarchy:

(1) the customer's primary use location;

(2) the location where the digital product was received by the customer;

(3) the taxpayer's apportionment fraction for receipts from sales of digital products used for the preceding year; or

(4) the taxpayer's apportionment fraction for the current year for those digital products that can be sourced using numbers one and two above.

Similar to digital products, advertising, licensing, and other services revenue are in general sourced to the location of use.[10] Advertising is sourced to the location of the audience (where print media is delivered or where listeners or viewers of electronic media such as television or radio are located). Licensing of intangible property is sourced to the location of use.

The pre-reform category of "other business receipts" has been expanded and is now referred to as "receipts from other services and other business receipts." Services are no longer sourced based on the location of performance, and other business receipts are no longer sourced based on where they were earned. Receipts from services and other business receipts which are not addressed in any other sourcing provision will be sourced according to the location of the customer as determined by a hierarchy:

(1) where the benefit is received;

(2) delivery destination;

(3) the percentage used by the taxpayer for the preceding year to apportion such receipts; or

(4) the taxpayer's apportionment fraction for the current year for those other services that can be sourced using numbers one and two above.

Tax rate calculation changed

Currently, the NYS corporate franchise tax is the sum of (i) the greatest amount of tax calculated using four alternative tax bases (i.e., entire net income (ENI), capital, minimum taxable income (MTI), and a fixed dollar minimum) plus (ii) an amount of tax calculated on subsidiary capital. The tax rate imposed on those taxpayers paying on the ENI base is 7.1% for general business corporations.

Under the new law, starting in 2015, the MTI and subsidiary capital bases are eliminated, and the ENI base is renamed and redefined as the business income base.

Beginning on or after January 1, 2016, the new law reduces the current tax rate on the business income base from 7.1% to 6.5%. The current capital base rate of .15% will be preserved, but there is a phasedown for the rate such that the capital base will be eliminated after January 1, 2021.

Further, NYS' capital base cap is also increased from $1 million to $5 million. The fixed dollar minimum tax (which is currently capped at $5,000) will be significantly increased as follows (based on the level of New York receipts):

- Receipts over $50 million up to $100 million, the tax will be $10,000;
- Receipts over $100 million up to $250 million, tax will be $20,000;
- Receipts over $250 million up to $500 million, tax will be $50,000;
- Receipts over $500 million up to $1 billion, tax will be $100,000; and
- Receipts over $1 billion, tax will be $200,000.

For a combined group each taxable member will be required to pay a fixed dollar minimum.

The metropolitan transportation business tax surcharge (MTA Surcharge) becomes permanent under the new law, and may be imposed, starting in 2015, if a corporation derives $1,000,000 or more in receipts from the metropolitan commuter transportation district.[11] The MTA Surcharge is computed on the MTA district's portion of the highest of the tax bases before credits. The MTA Surcharge rate for 2015 is 25.6% and the 2016 rate will be set by the NYS Department of Taxation and Finance (Department) in accordance with certain financial projections. Further, the MTA surcharge will continue to be computed using the three-factor evenly weighted formula, but will utilize the new law's market-sourcing rules in determining its sales factor.

Economic nexus adopted

The NYS corporate franchise tax is currently imposed on every corporation for the privilege of exercising its corporate franchise, doing business, employing capital, owning or leasing property, or maintaining an office in the state. Under the new law, the corporate franchise tax will additionally be imposed on every domestic or foreign corporation deriving receipts from activity in the state. A corporation is deriving receipts from activity in the state to the extent it has NYS receipts of $1,000,000 or more within the taxable year. This represents a major shift because physical presence in the State is no longer required in order for the State to assert nexus.[12]

In summary

The NYS tax changes reflect the Legislature's desire to make the state more economically competitive and draw more businesses to New York. The shift to economic nexus, the changes in the combined reporting, and the new sourcing laws, in particular, will impact EMC companies.

To date, the Department has not issued any regulations or guidance, formal or informal, discussing the application of the new legislation. There are many areas of the reform where questions exist concerning the application of the law due to discrepancies in language, omissions of relevant provisions and unintended oversight at the legislative level. PwC understands that the Department has received, and is in the process of reviewing, requests for clarification, and will be issuing guidance in the months ahead.

---

1. FCC incentive auctions overview http://wireless.fcc.gov/incentiveauctions/ learn-program/faq.html
2. Cisco 2014 Visual Networking Index
3. 2013 Consumer Electronics Association study
4. Overview of the KLCS/KJLA Channel Sharing Pilot http://www.ctia.org/docs/ default-source/fcc filings/technical-report-of-the-klcs-kjla-channel-sharingpilot.pdf
5. http://www.attpublicpolicy.com/public-safety/more-on-auction-limits/
6. Internal Revenue Code Section 1033
7. Internal Revenue Code Section 1031
8. Note that New York City (NYC) has not adopted the provisions enacted by NYS, which will result in differences between NYS and NYC filings.
9. Please note that this is not an all-inclusive list.
10. Receipts from advertising and licensing were sourced based on the location of use under pre-reform law. As such, the sourcing rules for such receipts have not changed.
11. The metropolitan commuter transportation district includes Manhattan, Brooklyn, Queens, the Bronx, Staten Island, Long Island, and Westchester, Rockland, Orange, and Putnam Counties
12. New York's ability to levy taxes is limited by the Due Process Clause and Commerce Clause of the U.S. Constitution. Although a growing number of states have passed economic nexus statutes, it remains to be seen whether economic nexus may be constitutionally permissible for corporate income tax purposes.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

US Entertainment, Media & Communications Tax Leader

Peter D'Avanzo, *New York*

Partner

+1 (646)471-5611

peter.davanzo@us.pwc.com

US Entertainment, Media and Communications
State and Local Tax Leader

Brian Goldstein, *New York*

Partner

+1 (646)471-0520

brian.goldstein@us.pwc.com

US Entertainment, Media and Communications

Thomas Nardozzi, *New York*

EMC Tax Newsletter Editor, EMC Tax Managing Director

+1 (646) 471-4463

thomas.c.nardozzi@us.pwc.com