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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR _____, CC:LM:CTM

Attn: _____, CC:LM:MCT:

FROM: Susan J. Reaman, CC:PSI:5
Chief, Branch 5, Associate Chief Counsel (Passthroughs and
Special Industries)

SUBJECT: PCS License - Utility ISP
Technical Assistance Request

This Chief Counsel Advice responds to your memorandum dated May 9, 2001. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

In the memorandum, you requested that we review a Utility ISP technical assistance paper on personal communication service (PCS) licenses that you plan to distribute to examiners in the field.

We sent the paper to the Office of the Associate Chief Counsel (Income Tax & Accounting) for review on the issues 2 & 3 involving §§ 162 and 263. They agree with the analysis and conclusions in the technical assistance paper regarding § 263. They concluded that the Acquisition Costs¹ described in the technical

1. Internal costs described in the technical assistance paper would include such items as salaries, wages, benefits, and travel for employees of the bidder. External costs would include payments to non-employee parties such as lawyers, consultants, and engineers. These costs were incurred for the primary purpose of obtaining a PCS license. Such costs include but were not limited to:

- 1) Internal costs of the employees, management, and engineer teams who were involved in each stage of acquiring a license;
- 2) Internal and external costs for participating in "mock" auctions conducted by the FCC. (These "mock" auctions allowed a bidder to become familiar with the auction process and the software that was being utilized by the FCC.);

(continued...)

assistance paper are required to be capitalized under § 263. They also concluded that the Microwave Relocation Costs² described in the technical assistance paper are incurred to perfect rights under the license, and therefore, such costs must be capitalized under § 263.

Our office has jurisdiction over § 197 and we have the following comments on the § 197 discussion in the technical assistance paper.

PCS License Amortization

Section 197(a) provides that a taxpayer is entitled to an amortization deduction for any amortizable section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over the 15-year period beginning with the month in which the intangible was acquired.

Section 197(c)(1) defines the term "amortizable section 197 intangible" to mean any section 197 intangible which is acquired by the taxpayer after the date of enactment of § 197, and which is held in connection with the conduct of a trade or business or an activity described in § 212. Section 197(c)(2) provides that the term "amortizable section 197 intangible" shall not include any "section 197 intangible" which is not described in § 197(d)(1), (D), (E), or (F), and which is created by the taxpayer.

Section 197(d)(1)(D) defines the term "section 197 intangible" to include, among other intangible items, any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof.

1(...continued)

- 3) Internal and external costs for participating in pre-auction seminars conducted by the FCC; and
- 4) Internal and external costs for the interpretation of FCC rules, documents, bidder information packages, and notices; completion of FCC required forms; identification of PCS markets to bid on; development and implementation of strategies and plans to acquire PCS licenses; participation in the auction; and defense of any opposition to the bidder's receipt of a license, and of any penalties the FCC may have imposed on the bidder during the auction process.

2. Generally, Microwave Relocation Costs are costs, under FCC rules, that require PCS licensees to reimburse existing microwave users ("incumbents") for costs attributable to relocating the incumbents to other frequency bands.

Section 1.197-2(b)(8) of the Income Tax Regulations provides that section 197 intangibles include any license, permit, or other right granted by a governmental unit (including, for purposes of § 197, an agency or instrumentality thereof) even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period. These rights include, for example, a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license.

Section 197(e)(4)(D) excepts from the term “section 197 intangible,” to the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right has a fixed duration of less than 15 years, or is fixed as to the amount and, without regard to § 197, would be recoverable under a method similar to the unit-of-production method.

Section 1.197-2(c)(13)(i) provides that section 197 intangibles do not include any right under a contract or any license, permit, or other right granted by a governmental unit if the right (A) is acquired in the ordinary course of a trade or business (or an activity described in § 212) and not as part of a purchase of a trade or business; (B) is not described in § 197(d)(1)(A), (B), (E), or (F); (C) is not a customer-based intangible, a customer-related information base, or any other similar item; and (D) either (1) has a fixed duration of less than 15 years; or (2) is fixed as to the amount and the adjusted basis thereof is properly recoverable (without regard to § 1.197-2) under a method similar to the unit-of-production method.

Section 1.197-2(d)(2)(i) provides that, except as provided in § 1.197-2(d)(2)(iii), amortizable section 197 intangibles do not include any section 197 intangible created by the taxpayer (a self-created intangible). Section 1.197-2(d)(2)(ii) defines a self-created intangible as an intangible created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the contracted creation, production, development, or improvement occurs. However, § 1.197-2(d)(2)(iii)(A) provides that the exception for self-created intangibles does not apply to any section 197 intangible described in § 197(d)(1)(D).

The facts of the technical assistance paper state that the PCS licenses are issued for a 10-year period and may be renewed for an additional 10-year term. PCS renewal applications are not subject to auctions. However, under the FCC rules, third parties may oppose renewal applications and file competing applications. If one or more competing applications are filed, a renewal application will be subject to a comparative renewal hearing. The FCC’s rules grant PCS renewal applicants involved in comparative renewal hearings a “renewal expectancy.” The renewal

expectancy is the most important factor in a comparative renewal hearing and is granted if the PCS renewal applicant has: (1) provided "substantial service" during its license term; and (2) substantially complied with all applicable laws and FCC rules and policies. The FCC's rules define "substantial service" in this context as service that is sound, favorable and substantially above the level of mediocre service that might minimally warrant renewal. The technical assistance paper concludes that it appears that a license would typically be renewed and the revocation of a license would be an extraordinary regulatory measure. Footnote 1 on page 3 notes that an FCC PCS auction question and answer document dated October 1994 states that the FCC's authority to conduct auctions is limited to the "initial" licenses, so renewal applications will not be subject to auction. It compares the PCS renewal to cellular license renewal in that if the licensee operates in the public interest and has met all applicable performance standards, they are entitled to renewal expectancy at the expiration of the initial license term.

Section 1.197-2(c)(13)(i)(D)(1) provides that section 197 intangibles do not include any right under a contract or any license, permit, or other right granted by a governmental unit if the right that has a fixed duration of less than 15 years. Section 1.167(a)-14(a) provides rules for the amortization of certain intangibles that are excluded from § 197 including intangibles described in § 1.197-2(c)(13). Section 1.167(a)-14(c)(3)(i) provides that the duration of a right under a contract (or granted by a governmental unit) includes any renewal period if, based on all the facts and circumstances in existence at any time during the taxable year in which the right is acquired, the facts clearly indicate a reasonable expectancy of renewal. In addition, § 167(a)-14(c)(3)(ii) provides that the mere fact that a taxpayer will have the opportunity to renew a contract right or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will generally not be taken account in determining the duration of such right provided the bidding produces a fair market value price comparable to the price that would be obtained if the rights were purchased immediately after renewal from a person (other than the person granting the renewal) in an arm's-length transaction.

Based on the facts in the technical assistance paper, we agree with the paper's conclusion that the subject PCS licenses are section 197 intangibles under § 197(d)(1)(D) because the licenses were granted by a governmental agency and that there is a reasonable expectancy within the meaning of § 1.167(a)-14(c)(3)(i) that a PCS license will be renewed by the FCC.

Conduct of a Trade or Business

Section 197(c)(1) defines the term "amortizable section 197 intangible" to mean any section 197 intangible which is acquired by the taxpayer after the date of enactment of § 197, and which is held in connection with the conduct of a trade or business or an activity described in § 212.

Section 1.197-2(f)(1) provides, that except as provided in § 1.197-2(f)(2), the amortization deduction allowable under § 197(a) is computed as follows: (i) the basis of an amortizable § 197 intangible is amortized ratably over the 15-year period beginning on the later of (A) the first day of the month in which the property is acquired; or (B) in the case of property held in connection with the conduct of a trade or business, the first day of the month in which the conduct of the trade or business begins.³

Section 197(c)(1)(B) allows amortization if the licenses are held in connection with the conduct of a trade or business. It is a question of fact whether a taxpayer has started a new trade or business or expanded an existing trade or business. Footnote 3 on page 5 notes that, in general, PCS licenses were acquired by newly created entities. Many of these entities were solely established to participate in the FCC auction, acquire licenses, and build networks for the provision of PCS service. Many existing telecommunication companies also acquired licenses, but they too typically established a new entity (subsidiary, affiliate, partnership, or joint venture) that would acquire the license and build a network. The factual scenario in the technical assistance paper involves a newly established entity that had no prior active trade or business.

Section 197 was enacted to provide uniform amortization rules for most intangibles. Within this statutory framework, exists rules for excluding certain §197 intangibles⁴ and applying other amortization provisions including §§ 167⁵ and 1253⁶ both of which impose a section 162 standard for when a trade or business begins.

3. See also Explanation of provisions accompanying final § 197 regulations published in the Federal Register on January 20, 2000.

4. See § 197(3)(A) (certain computer software); § 197(e)(4) (separately acquired rights); § 197(f)(4)(C) (§1253(d)(1) franchises); and §197(f)(9) (anti-churning rules).

5. See e.g., Lemmen v. Comm'r, 77 T.C. 1326 (1981).

6. See e.g., Herrick v. Comm'r, 85 T. C. 237 (1985) and Jackson v. Comm'r, 864 F.2d 1521 (10th Cir. 1989).

Applying this standard under §197 insures consistent treatment for the amortizing intangibles.

Consequently, if a PCS license is acquired by a new trade or business, the standard for determining when an amortizable section 197 intangible is held in connection with the conduct of a trade or business under § 197(c)(1)(B) is the standard under § 162. This determination under § 162 will depend on the facts of each case, in particular when the taxpayer began carrying on a trade or business within the meaning of § 162.

We therefore recommend that the footnotes with respect to the above issues be incorporated into the body of the paper.

Please call _____ at _____ if you have any further questions on this memorandum.