

REQUEST FOR PERMISSION TO HOLD AN INTERESTED PARTIES MEETING TO
CONSIDER REVISING EXISTING REGULATION SECTION 25137-8, REGARDING THE
APPORTIONMENT OF INCOME FOR MOTION PICTURE AND TELEVISION FILM
PRODUCERS AND TELEVISION NETWORKS

Background

Many years before the Uniform Division of Income For Tax Purposes Act (UDITPA) was adopted by California, the Franchise Tax Board and the motion picture industry had recognized that special rules were needed for the allocation and apportionment of income from the industry's activities. Working together, the department and industry developed guidelines. These guidelines have been modified several times over the years. The most recent version of those guidelines was adopted in 1982 as Regulation section 25137-8. It has now been almost 25 years since that regulation was adopted and staff believes it is time to revisit the regulation with industry to determine what, if any, changes might be appropriate.

A. Television Network Broadcasting

The television network broadcasting industry has undergone significant changes since 1974, and is continuing to do so. As a result, television network broadcasters are challenging the application of this regulation as applied to gross receipts received from television advertisements.

In the 1970's television advertising was primarily limited to three networks and local, independent stations. Multistate advertising revenues were not a significant issue. Today, there are numerous television networks operating almost exclusively on a multistate basis and traditionally local stations now have access to multistate markets. Network programs and advertising are transmitted as a digital signal to satellites, which are then accessed by cable operators and satellite television affiliates and released to their subscribers across the country.

Television network broadcasters have two primary sources of gross receipts: advertising receipts from television and internet advertisements, and affiliate fee receipts. Advertising is the primary source of receipts and comprises approximately 80 percent of the industry's total receipts. Affiliate fees are monthly payments received from cable and satellite television systems for access to the network's programming. In some circumstances, the advertising revenue and affiliate fees may be interrelated.

Since its inception in 1972, regulation section 25137-8 has apportioned, without challenge, "all gross receipts of the taxpayer from sources within this state," including advertising. However, this regulation is now being challenged as ambiguous because, unlike the MTC model regulation that was developed in 1991 and unlike regulation section 25137-12 for print media, which was adopted in 1995, regulation section 25137-8 does not specifically include gross receipts from advertising.

Other changes are also occurring in the television network industry. For example, sales of television broadcast advertising are now expanding beyond the television network broadcaster. One of the World Wide Web search companies has now entered the market for selling television advertising, and is seeking to become the premier broker of advertising to the internet, TV, radio, print publications, and other advertising-driven media.

September 5, 2007

It is possible for advertisers to make as many as 600 versions of one commercial for different demographics. With just a bit of information about each person watching, the advertiser can tailor the audio and video to suit. Allocating revenue from this type of activity may be challenging.

In addition, what is defined as an advertisement is rapidly changing. With the personal computer replacing the television set for a growing number of people, traditional TV advertising is under pressure to develop new markets. For years, people have been able to circumvent TV ads with digital video recordings, but that requires some effort. It's much easier with the click of a mouse. So advertisers are adapting ads and filling online ad time in ways they can't on TV, with interactive videos and competitions.

Arguably, the most effective ads are those embedded in the programs itself, such as when characters search for buried treasure in a Brand X car, drink Brand X soda, or wear Brand X shoes. TV networks are also looking at taking away commercial breaks entirely. Instead, an advertisement might appear as a logo as a show plays, as a ticker scrolling across the bottom of the screen, or as a pop-up like the ones on a personal computer.

Whatever form it takes, advertising in the television industry is big business. It is estimated that \$2.9 billion will be spent on online advertising in 2010, up from \$775 million this year. By comparison, advertisers committed to spend \$93 billion for TV airtime during the current year.

B. Film Distributors

When the guidelines were drafted in 1974, the movie industry was controlled by major studios such as Paramount and Disney. Independent distributors were not represented and the regulatory history makes no mention of independent distributors, other than a request that they be excluded from a special payroll factor rule. While the regulatory form of the guideline was changed in 1984 to include independent television broadcasters, there was still no discussion or inclusion of independent film distributors and they are not covered by regulation section 25137-8.

Today, the industry has changed and major studios no longer control the entire process. More commonly now, each part of the motion picture production process is conducted by a separate entity, whether affiliated or independent. While the regulation clearly recognizes that distribution of a film may occur, it does not contemplate that the producer would not also be the distributor. As a result, section 25137-8 does not reflect the industry as it exists today.

In addition, there is no specific California authority on the question of whether film distribution rights are tangible or intangible. This question may become more significant if the industry is able to deliver a motion picture to the local theater through a digital signal rather than providing a copy of a print to be shown through the use of a projector.

Staff would like to discuss with industry how regulation section 25137-8 could be updated to reflect the changes in the industry and the advent of new forms of advertising-driven media. Staff requests that the Board authorize it to hold one or more interested parties' meetings to receive input on adapting this regulation. After input is received from interested parties, staff will report back to the Board for further direction.

September 5, 2007

§ 25137-8. Motion Picture and Television Film Producers and Television Networks –
Apportionment of Income.

(a) This regulation applies to motion picture and television film producers, producers of television commercials, and to television networks. The provisions of this regulation shall also apply to independent television stations to the extent they are members of a chain of commonly owned stations all of which operate as network affiliates or all of which are unaffiliated with a network but which operate collectively in purchasing properties for telecast or in marketing air time, or which operate as a producer. This regulation applies to income years beginning on and after January 1, 1982.

(b) Definitions.

(1) "Film" means the physical embodiment of a play, story or other literary, commercial, education or artistic work; as a motion picture, video tape, disc or other similar medium, except that it does not include news or sports films produced for telecast.

"Film" does not include video cassettes or discs intended for home viewing.

(2) Each episode of a series of films produced for television shall constitute a separate film notwithstanding that the series relates to the same principal subject and is produced during one or more television seasons.

(3) "Release date" means the date on which a film is placed in service. A film is placed in service when it is first telecast or exhibited to the primary audience for which the film was created. Thus, a motion picture theater film is placed in service when it is first publicly exhibited for entertainment purposes and an educational film is placed in service when it is first exhibited for instructional purposes. Each episode of a television series is placed in service when it is first telecast. A film is not placed in service merely because it is completed and therefore in a condition or state of readiness and availability for telecast or exhibition, or merely because it is telecast or exhibited to prospective exhibitors, sponsors, or purchasers, or it is shown in a "sneak preview" before a select audience.

(4) A "film" is deemed to be tangible personal property.

(5) "Rent" shall include license fees for the exhibition or telecast of films.

(6) "Tangible personal property" used in the business whether owned or rented, shall include but is not limited to sets, props, wardrobes, and other similar equipment.

(7) A "subscriber" to a subscription television telecaster is the individual residence or other

outlet which is the ultimate recipient of the transmission.

(8) "Telecast" means the transmission of an electronic signal by radiowaves or microwaves or by wires, lines, coaxial cables, wave guides or other tangible conduits of communication.

(c) Apportionment of Business Income.

The property, payroll and sales factor of the apportionment formula for Motion Picture and Television Film Producers and Television Networks shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulation adopted pursuant thereto except as provided in this regulation.

(1) Property Factor.

(A) In General.

(i) In the case of rented studios, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage and other permanent equipment such as sound recording equipment rented from other sources or from the studio not covered in the basic or flat rental charge and used for one week or longer (Even though rented on a day-to-day basis) shall be included. Lump-sum net rental payments for a period which encompasses more than a single income year shall be assigned ratably over the rental period.

(ii) The value of the films shall:

(I) be the original cost of producing the film as determined for federal income tax purposes, before any adjustment for federal credits which have not been claimed for state purposes, and

(II) include talent salaries.

(iii) The value of a film shall not be included in the property factor until its release date.

(iv) Video cassettes and discs shall be included in the property factor at their inventory cost as shown in the taxpayer's books and records.

(B) Denominator.

(i) All real property and tangible property (other than films) whether owned or rented, which is used in the business, shall be included in the denominator.

(ii) Films, other than films the cost of which is expensed for California tax purpose at the time of production, shall be included in the property factor at original cost for twelve years beginning with the release date.

(iii) Films for a topical nature including news or current event programs, sporting events or interview shows, the cost of which is expensed for California tax purposes at the time of production, shall be included in the property factor at original cost for one year beginning with the release date.

(iv) All other films, other than those included in the denominator under clause (ii) or (iii) of this subparagraph, shall be aggregated and treated as a single film property which shall be included in the property factor. Such property shall be valued at eight times the gross receipts generated during the income year from the theater distribution, network television, television syndication, cable television, subscription and the marketing of video cassettes and discs through licensing or direct selling, or similar receipts, but in no event in an amount greater than the total original cost of such aggregated film property.

(C) Numerator.

(i) If tangible personal property (other than films) is located or used in this state for part of the income year, its value shall be determined by applying the ratio which the number of days the property is located or used in this state bears to the total number of days such property was owned or rented during the income year.

(ii) The total value of films that are included in the property factor under subparagraph (B) of paragraph (1) of this subsection shall be attributed to this state in the same ratio in which the total California receipts from such films as determined in subparagraphs (A), (B) and (C) of paragraph (3) of this subsection pertaining to the sales factor bears to the total of such receipts everywhere.

(2) Payroll Factor.

(A) In General.

(i) The denominator shall include all compensation paid to employees during the income years, including talent salaries. Residual and profit participation payments constitute compensation paid to employees.

(ii) The amount paid to a corporation for providing the services of an actor or director who is an employee of such corporation or for loaning the services of an actor or director who is under contract with such corporation shall, if substantial, be included in the producer's payroll factor as if the amount paid was compensation paid to an employee of the producer.

(B) Numerator. Compensation of employees in the production of a film on location shall be attributed to the state where the services are or were performed. Compensation of all other employees shall be governed by Regulations 25132 and 25133.

(3) Sales Factor Numerator. The numerator shall include all gross receipts for the taxpayer from sources within this state including the following:

(A) Gross receipts from films in release to theaters and television stations located in this state.

(B) Gross receipts from films in release to or by a television network for network telecast shall be attributed to this state in the ratio that the audience for such network stations (owned and affiliated) located in California bears to the total audience for all such network stations (owned and affiliated) everywhere. The audience shall be determined by rate card values published annually in the Television & Cable Factbook, Vol. I, "Stations Volume," Television Digest, Inc., Washington, D.C., if available, or by other published market surveys, or if none is available, by population data published by the U.S. Bureau of Census.

(C) Gross receipts from films in release to subscription television telecasters shall be attributed to this state in the ratio that the subscribers for such telecaster location in California bears to the total subscribers of such telecaster everywhere. If the number of subscribers cannot be determined accurately from records maintained by the taxpayer, the ratio shall be determined on the basis of the applicable year's statistics on subscribers published in Cable Vision, International Thompson Communication Inc., Denver, Colorado, if available, or by other published market surveys, or, if none is available, by population data published by the U.S. Bureau of the Census for all states in which the telecaster has subscribers.

(D) Receipts from sales and rentals of video cassettes and discs shall be included in the sales factor as provided in Regulations 25135 and 25136.

Note: Authority cited: Section 26422, Revenue and Taxation Code.
Reference: Section 25137, Revenue and Taxation Code.