INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-123969-10

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer=

Date 1=

Date 2=

X=

Y=

Z=

ISSUE:

Whether gross receipts derived from Taxpayer's licensing of a group of programs that includes programs produced by Taxpayer, programs produced by third parties, commercial advertisements, and interstitials (together a "Programming Package") to customers in the normal course of Taxpayer's business can be domestic production gross receipts (DPGR) under § 199(c)(4)(A)(i)(II) of the Internal Revenue Code (Code)?

CONCLUSION:

Gross receipts derived from licensing a Programming Package can be DPGR under § 199(c)(4)(A)(i)(II).

FACTS:

Taxpayer's operations include cable/satellite networks (Cable Networks), domestic broadcast television network (Broadcast Network), and owned and operated domestic television stations (O&Os) (together referred to as "Networks"), among other divisions.

Taxpayer claimed domestic production activities deductions of $X and $Y for the taxable years ended Date 1 and Date 2, respectively. In determining whether its gross receipts qualified as DPGR, Taxpayer treated its Networks as licensing Programming Packages to customers in the normal course of business and treated each Programming Package as a qualified film produced by Taxpayer for purposes of § 199(c)(4)(A)(i)(II). As a result of Taxpayer's treatment, Taxpayer's DPGR included the gross receipts from the Networks attributable to both self-produced programs and programs produced by third parties included within the Programming Packages. LMSB does not challenge that Taxpayer's gross receipts attributable to Taxpayer's self-produced television programs that meet the requirements for being a qualified film produced by Taxpayer are DPGR. LMSB challenges that the gross receipts attributable to programs produced by third parties included within the Programming Packages are DPGR. LMSB also challenges that Taxpayer's Broadcast Network licensed Programming Packages; rather, LMSB maintains the Broadcast Network offers individual programs in the normal course of business for license to customers.

Cable Networks

Taxpayer has multiple Cable Networks that are each principally involved in the distribution of television content to multiple systems operators (MSOs), such as cable and satellite providers. A Cable Network enters into multiple-year license agreements with MSOs. In a typical license agreement an MSO agrees to broadcast a Cable Network's Programming Package in an unaltered manner to the MSO's customers. A Cable Network's Programming Package includes both self-produced programs, programs produced by third parties that Taxpayer has acquired the rights to broadcast, commercials, and interstitials. Self-produced programs include programs produced by a

Cable Network and programs produced by Taxpayer's television production companies. A Cable Network derives substantially all of its revenues from affiliate fees charged to MSOs in the license agreements and/or sale of time to advertisers in programs included within a Cable Network's Programming Package. A Cable Network transmits its Programming Package to MSOs using a signal.

Broadcast Network

Taxpayer operates a Broadcast Network, which as of Date 1 had Z affiliated stations operating under affiliation agreements located in virtually all of the top markets in the country. Under the Broadcast Network's affiliation agreements, a television station agrees to serve as an affiliated station to broadcast the Broadcast Network's programs in the community to which the television station is licensed by the Federal Communications Commission (FCC). Broadcast Network programs include Taxpayer produced programs and programs produced by third parties that Taxpayer has acquired the rights to broadcast. The Broadcast Network also transmits commercials and interstitials to affiliated stations for broadcast. Under the affiliation agreements the Broadcast Network pays varying amounts of compensation to affiliated stations for broadcasting the Broadcast Network's programs, commercials, and interstitials. The Broadcast Network derives substantially all of its revenues from the sale of time to advertisers in Broadcast Network programs for commercials. The Broadcast Network transmits the Broadcast Network's programs, commercials, and interstitials to affiliated stations using a signal.

The relationship of the Broadcast Network to affiliated stations differs from the relationship of the Cable Networks to MSOs because of regulatory and contractual differences that relate to, among other things, an affiliated station's right to reject a Broadcast Network program under FCC regulations, and because most affiliated stations program a number of local hours per day, a few hours on weekday mornings, and several more hours in late afternoons. These local hours are typically filled by news produced by the affiliate and syndicated programs. This is in contrast to the typical multi-year licensing agreement between a Cable Network and MSO that requires a MSO to broadcast the unaltered Programming Package, and does not require a MSO to program local hours per day.

LMSB maintains these differences result in the Broadcast Network offering programs to affiliated stations on a program-by-program basis, while Taxpayer maintains that the Broadcast Network licenses a Programming Package to affiliated stations. As a result of this factual disagreement, in this statement of facts we expressly refer to the content offered by the Broadcast Network as the Broadcast Network's programs, commercials, and interstitials, rather than the Broadcast Network's Programming Package. Our Office addresses the relevance of this factual disagreement at the end of our analysis.

O&Os

Taxpayer's O&Os are television stations that Taxpayer owns in certain locations throughout the country. O&Os are all affiliated with the Broadcast Network. O&Os' content includes programs produced by the O&O, Broadcast Network programs, programs produced by third parties as to which the O&Os acquired the rights to broadcast, commercials, and interstitials.

O&Os derive revenues from the sale of time to advertisers in programs for commercials in addition to payments from the Broadcast Network for broadcasting the Broadcast Network's programs. Taxpayer grants MSOs rights to receive and simultaneously retransmit the signals of the O&O stations.

Activities Related to Production or Transmission of the Networks' Content

The Networks transmit content by signal. LMSB and Taxpayer agree the following activities occur, but disagree whether the activities are production activities related to the Networks' content or are activities related to the transmission of the Networks' content. The activities described are performed by employees who are in separate subsidiaries from Taxpayer's television program production employees. Taxpayer's Networks engage in: (1) the scheduling of programs into a particular time sequence based on extensive research, market analysis and measuring techniques designed to maximize the appeal and value of the content to television viewers; (2) the application of a rigorous review process of every element of the signal (including programs, commercial announcements, and interstitials) by a legal team to ensure compliance with the Broadcast Network's standards and federal regulatory laws; (3) the ingesting or downloading of programs, commercial announcements and interstitials by a team of engineers onto a server to enable the content to be transmitted by signal; (4) the editing of the signal on the server to add voice-overs, graphics, close captioning and the network logo; and (5) the production of interstitials to promote the content of the network, to link segments together, and to entertain television viewers between programs.

Tax Treatment of the Networks' Content

Taxpayer capitalized costs paid or incurred by its television production companies to produce certain self-produced programs or series by including the costs in basis for the program or series. Taxpayer treated these self-produced programs or program series as separate properties with separate bases. The capitalized self-produced program costs are recovered through Taxpayer's depreciation deduction determined under the income forecast method of § 167(g).

Taxpayer deducted the costs paid or incurred by the Networks in producing programs that had a useful life of less than one year, for example, daily newscasts and local interest programs. Taxpayer also deducted license fees for rights to broadcast programs produced by third parties. Taxpayer deducted the costs of “Activities Related to Production or Transmission of the Networks’ Content” as described above.

LAW:

Under § 199(a), the § 199 deduction is determined by applying a percentage to the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 3 percent for taxable years beginning in 2005 and 2006, 6 percent for taxable years beginning in 2007 through 2009, and 9 percent for taxable years beginning after 2009.

Under § 199(c)(1), QPAI is determined by taking DPGR for the taxable year less cost of goods sold (CGS) allocable to such DPGR, less other expenses, losses, or deductions, which are properly allocable to such DPGR.

Section 199(c)(4)(A)(i) provides that DPGR means the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of: (I) qualifying production property (QPP), which was manufactured, produced, grown or extracted (MPGE) by the taxpayer in whole or significant part within the United States.; (II) any qualified film produced by the taxpayer; or (III) electricity, natural gas, or potable water produced by the taxpayer in the United States.

Section 199(c)(6) defines the term “qualified film” as any property described in § 168(f)(3) if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code (regarding material containing the depiction of sexually explicit conduct).

Section 168(f)(3) property is any motion picture film or video tape.

Under § 1.199-3(d)(1) of the Income Tax Regulations, a taxpayer may use any reasonable method satisfactory to the Secretary based on all facts and circumstances to determine whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis).

Section 1.199-3(d)(1)(i) defines the “item” as the property offered by the taxpayer in the normal course of business of taxpayer’s business for lease, rental, license, sale, exchange, or other disposition to customers, if the gross receipts from such property qualify as DPGR.

Section 1.199-3(d)(1)(ii) provides that, if such property does not qualify under § 1.199-3(d)(1)(i), then any component of such property described in § 1.199-3(d)(1)(i) is treated as the item, provided that the gross receipts that are attributable to the disposition of the component of such property qualify as DPGR. Each component that meets the requirements to be treated as the item must be treated as a separate item and may not be combined with a component that does not meet the requirements of § 1.199-3(d)(1)(ii).

Section 1.199-3(d)(2)(i) provides that, for purposes of § 1.199-3(d)(1)(i), in no event may a single item consist of two or more properties unless those properties are offered for disposition, in the normal course of the taxpayer's business, as a single item (regardless of how the properties are packaged).

Section 1.199-3(d)(4), Example 3, provides that R manufactures toy cars in the United States. R also purchases cars that were manufactured by unrelated persons. R offers the cars for sale to customers, in the normal course of R's business, in sets of three, and requires no minimum quantity order. R sells the three-car sets to toy stores. A three-car set may contain some cars manufactured by R and some cars purchased by R. If the gross receipts derived from the sale of the three-car sets do not qualify as DPGR under this section, then, under § 1.199-3(d)(1)(ii), R must treat a toy car in the three-car set as the item, provided the gross receipts derived from the sale of the toy car qualify as DPGR under this section.

Section 1.199-3(g)(3)(i) provides that a taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States for purposes of § 1.199-3(g)(1) if, in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States account for 20 percent or more of the taxpayer's CGS of the QPP, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's unadjusted depreciable basis (as defined in § 1.199-3(g)(3)(ii)) in the QPP.

Section 1.199-3(i)(5)(ii)(C) provides that a taxpayer's gross receipts derived from the license of a qualified film include advertising income and product-placement income with respect to that qualified film, but only if the gross receipts, if any, derived from the qualified film are (or would be) DPGR.

Section 1.199-3(k)(1) states that a qualified film means any motion picture film or video tape under section 168(f)(3), or live or delayed television programming (film), if not less than 50 percent of the total compensation relating to the production of such film is compensation for services performed in the United States by actors, production personnel, directors, and producers.

Section 1.199-3(k)(3) provides, in general, that DPGR include the gross receipts from any lease, rental, license, sale, exchange, or other disposition of any qualified film produced by such taxpayer.

Section 1.199-3(k)(5) provides the fraction by which the not-less-than-50-percent-of-the-total-compensation requirement under § 1.199-3(k)(1) is calculated. The numerator of the fraction is the compensation for services performed in the United States. The denominator of the fraction is the total compensation for services regardless of where the production activities are performed.

Section 1.199-3(k)(6) treats a qualified film as produced by the taxpayer for purposes of § 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of § 1.199-3(g)(2). The special rules of § 1.199-3(g)(4) regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer's production activity is substantial in nature. Section 1.199-3(g)(2) and (4) are applied by substituting the term qualified film for QPP and disregarding the requirement that the production activity must be within the United States. The production activity of the taxpayer must consist of more than the minor or immaterial combination or assembly of two or more components of a film. For purposes of § 1.199-3(g)(2), the relative value added by affixing trademarks or trade names as defined in § 1.197-2(b)(10)(i) will be treated as zero.

Section 1.199-3(k)(7) provides that a film will be treated as a qualified film under § 1.199-3(k)(1) and produced by the taxpayer under § 1.199-3(k)(6) (qualified film produced by the taxpayer) if the taxpayer meets the requirements of § 1.199-3(k)(7)(i) and (ii). A taxpayer that chooses to use this safe harbor must apply all the provisions of this § 1.199-3(k)(7).

ANALYSIS:

The issue is whether the gross receipts derived from Taxpayer's licensing of a Programming Package to customers in the normal course of business can qualify as DPGR under § 199(c)(4)(A)(i)(II). If gross receipts derived from licensing a Programming Package are DPGR, then, under § 1.199-3(i)(5)(ii)(C), both LMSB and Taxpayer agree that any advertising income and product-placement income with respect to such Programming Package is DPGR.

Application of Item Rule to a Programming Package

Section 199(c)(4)(A)(i)(II) provides that DPGR includes gross receipts that are derived from a qualified film produced by the taxpayer. Section 1.199-3(d) describes the general rules for determining whether gross receipts qualify as DPGR. Section 1.199-3(d)(1) provides that a taxpayer generally determines whether gross receipts qualify as DPGR on an item-by-item basis. Section 1.199-3(d)(1)(i) defines the term item to mean the property offered by the taxpayer in the normal course of the taxpayer's business for lease, rental, license, sale, exchange, or other disposition to customers, if the gross receipts from such property qualify as DPGR. If gross receipts are DPGR, then that property is the item under § 1.199-3(d)(1). If gross receipts are not DPGR, then, under § 1.199-3(d)(1)(ii), a taxpayer should determine if gross receipts from any components of such property are DPGR, and each component that meets the requirements is treated as a separate item.

Under these general rules of § 1.199-3(d), a taxpayer first determines the property that taxpayer offers in the normal course of business to customers, then taxpayer determines whether gross receipts from such property are DPGR, and if not, taxpayer determines whether gross receipts from any components of such property are DPGR. In this case, Taxpayer determined that it offered individual Programming Packages to customers in the normal course of business, and that gross receipts derived from licensing the individual Programming Packages qualified as DPGR. LMSB agreed in certain cases that Taxpayer offered Programming Packages to customers in the normal course of Taxpayer's business.

Our Office believes it is consistent to test a Programming Package offered by Taxpayer to customers in the normal course of business as a single qualified film for purposes of § 199(c)(6), because other property that consists of multiple properties is tested as a single property for purposes of § 199. This is true regardless of the fact that a Programming Package, the property offered in this case, includes multiple films of which some are Taxpayer produced films and some are third-party produced films. Section 1.199-3(d)(2)(i) provides that a single item can consist of two or more properties if those properties are offered for disposition in the normal course of taxpayer's business as a single item. Example 3 of § 1.199-3(d)(4) illustrates that gross receipts derived from the sale of each component of property offered by the taxpayer to customers do not have to qualify as DPGR if the gross receipts derived from the sale of the aggregate property offered by the taxpayer to customers qualify as DPGR. In Example 3, as long as the taxpayer can determine gross receipts from the 3-car set (containing some cars produced by taxpayer and some produced by third parties) in the aggregate qualify as DPGR, then the taxpayer is not required to show that gross receipts from the individual cars in the 3-car set qualify as DPGR. Therefore, as § 1.199-3(d) illustrates, it is consistent to allow Taxpayer to test a Programming Package in the aggregate to determine if its gross receipts derived from the license of the Programming Package are DPGR.

The fact that a Programming Package is not treated as a single property under other Code sections does not require § 199 to treat a Programming Package as multiple properties. Taxpayer offers individual Programming Packages to customers in the normal course of business as single properties. Therefore, for purposes of § 199, Taxpayer should test a Programming Package in the aggregate regardless of the tax treatment of a Programming Package for purposes of other Code sections.

We conclude that gross receipts derived from licensing a Programming Package can be DPGR if the Programming Package, when tested as a single property (i.e. in the aggregate)[1], meets the requirements of § 199(c)(6) and is treated as produced by Taxpayer as § 199(c)(4)(A)(i)(II) requires. Our Office describes below how to determine whether gross receipts from a Programming Package are DPGR.

<u>Determining Gross Receipts Derived from a Programming Package are DPGR</u>

To determine that gross receipts derived from licensing a Programming Package are DPGR under § 199(c)(4)(A)(i)(II), Taxpayer must show that a Programming Package is a qualified film (as described in § 199(c)(6) and § 1.199-3(k)(1)) and produced by the taxpayer (as described in § 1.199-3(k)(6)), or apply the safe harbor in § 1.199-3(k)(7). If a Programming Package is not a qualified film produced by the Taxpayer so that gross receipts attributable to the Programming Package are not DPGR, then under § 1.199-3(d)(1)(ii), Taxpayer should shrink back to the components of a Programming Package and determine whether gross receipts derived from licensing each component qualify as DPGR.

In analyzing whether to treat a Programming Package as a qualified film under § 199(c)(6) and § 1.199-3(k)(1), because the content of a Programming Package is a motion picture film or video tape under § 168(f)(3), or live or delayed television programming (film), a Programming Package is treated as a film for purposes of § 199. Taxpayer also must show that not less than 50 percent of the total compensation relating to the production of a Programming Package is compensation for services performed in the United States for a Programming Package to be considered a qualified film. This test should apply to a Programming Package in the aggregate. Our Office is unable to determine from the facts provided whether any of Taxpayer's Programming Packages meet this 50-percent-compensation test.

If a Programming Package is treated as a qualified film, it must still be produced by Taxpayer. Section 1.199-3(k)(6) provides that a qualified film is treated as produced by the taxpayer for purposes of § 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of § 1.199-3(g)(2). The production activity of Taxpayer must consist of more than the minor or immaterial combination or assembly of two or more components of a film. The relative value added by affixing trademarks or trade names is zero. Our Office's advice does not determine whether Taxpayer's production activities with respect to a Programming Package are substantial in nature.

[1] A Programming Package that extends for multiple years should be tested on a year-by-year basis, so that the requirements of § 199(c)(6) are applied to the gross receipts derived from the license of the portion of the Programming Package offered during the taxable year.

Production activities are the activities performed by actors, production personnel, directors, and producers relating to the production of a film. Our Office notes that, in considering Taxpayer's production activities, the production activities related to Taxpayer's self-produced programs and interstitials that are included within a licensed Programming Package should be considered when determining whether a Taxpayer's activities with respect to a Programming Package are substantial in nature. However, § 1.199-3(g)(2) provides that the production of a key component does not in itself meet the substantial in nature requirement. Production activities do not include activities with respect to transmission of a Programming Package.

Rather than relying on §§ 1.199-3(k)(1) and (k)(6), Taxpayer also may choose to apply the safe harbor under § 1.199-3(k)(7). Under § 1.199-3(k)(7), a film will be treated as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States, and the taxpayer satisfies the safe harbor in § 1.199-3(g)(3). Under § 1.199-3(k)(7)(ii), for purposes of calculating the safe harbor's 50 percent total compensation requirement, the numerator of the fraction is the compensation for services paid by the taxpayer for services performed in the United States and the denominator is the total compensation for services paid by the taxpayer regardless of where the production activities are performed. This 50 percent total compensation requirement should be applied to a Programming Package in the aggregate.

Under § 1.199-3(g)(3), Taxpayer must show a Programming Package meets the 20 percent test related to direct labor and overhead, and Taxpayer should apply the 20 percent test to a Programming Package in the aggregate. The numerator should include Taxpayer's direct labor and overhead necessary for Taxpayer to produce a Programming Package, and the denominator should include Taxpayer's aggregate unadjusted depreciable basis in a Programming Package as defined in § 1.199-3(g)(3)(ii). Taxpayer should not include any costs associated with activities related to the transmission of a Programming Package in the 20 percent test.

Broadcast Network Affiliation Agreements: Factual Dispute between LMSB and Taxpayer

LMSB and Taxpayer disagree that Taxpayer's Broadcast Network affiliation agreements are licenses of a Programming Package, with LMSB maintaining that the affiliates are offering programs on a program-by-program basis. Both parties agree on the § 199 analysis of individual programs offered for license. However, if it is later determined that the Broadcast Network offers a Programming Package to its affiliated stations, our Office's analysis above applies to that Programming Package.

CAVEAT(S):

Our analysis does not determine whether any of Taxpayer's gross receipts do qualify as DPGR. Our analysis is limited to situations where Taxpayer licenses a Programming Package and not individual programs. Our analysis does not determine which of Taxpayer's activities with respect to a Programming Package are production or transmission activities, other than those noted in our analysis.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.