Office of Chief Counsel
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Memorandum

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from: Paul Handleman, Chief, Branch 5, Office of the Associate Chief Counsel (Passthroughs & Special Industries) CC:PSI:5

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subject:

This Chief Counsel Advice responds to your request for assistance dated April 15, 2014. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Channels =

Network A =

Tax Year 1 =

Tax Year 2 =

Tax Year 3 =

Date 1 =

Shows =

Z =

Y =

X =

W =

V =

U =

T =

S =

R =

ISSUES

1. For purposes of the domestic production activities deduction under § 199 of the Internal Revenue Code, whether the gross receipts Taxpayer derives from the distribution of multiple channels of video programming (Subscription Packages) qualify as domestic production gross receipts (DPGR) derived from the disposition of qualified films produced by the Taxpayer?

2. Whether license fees that Taxpayer pays to unrelated third-party programming producers for the right to broadcast and distribute programming are overhead costs for purposes of the safe harbor in § 1.199-3(g)(3)(i) of the Income Tax Regulations?

CONCLUSIONS

1. No. Gross receipts derived from the distribution of Subscription Packages do not qualify as DPGR. Taxpayer can apply the rules of § 1.199-3(d)(1)(ii) to components of Subscription Packages and determine whether separate components individually qualify as an item for purposes of § 199.

2. No. License fees do not constitute overhead costs for purposes of the safe harbor in § 1.199-3(g)(1).

FACTS

Taxpayer is categorized as a multichannel video programming distributor (MVPD) under the FCC rules and regulations. MVPD is "a person such as, but not limited to, a cable operator, a multichannel multipoint distribution service, a direct broadcast service, or a television receive-only program distributor, who makes available for purchase, by subscribers or customers, multiple channels of video programming."

47 U.S.C § 522(13). For Tax Year 1 through Tax Year 2, Taxpayer filed claims for refund and for Tax Year 3 filed a tax return claiming the deduction under § 199. Taxpayer's position is that it is deriving gross receipts from the disposition of qualified films produced by the Taxpayer. Taxpayer claimed additional deductions under § 199 relating to other activities, but those activities are not addressed in this Chief Counsel Advice.

Taxpayer broadcasts roughly Z channels to televisions and other devices and distributes content over the Internet to individual consumers. Subscription Packages vary because Taxpayer's customers have a choice over what and how many channels they will receive by selecting among different groups of channels.[1] A minimum (or base) Subscription Package consists of around Y channels. The types of available Subscription Packages, their pricing, and channel composition vary from time to time and differ based on a customer's geographic location. The more expensive Subscription Packages generally include the channels of the cheaper Subscription Packages plus additional channels.

The programming that Taxpayer distributes can be classified into two categories. First, video programming that Taxpayer does not produce but licenses for distribution (licensed programming). Second, a much smaller category, video programming that Taxpayer produces through related entities (self-produced programming).

Licensed programming: Almost all of the approximately Z channels that Taxpayer distributes are produced by unrelated third-party video content creators or aggregators. Generally, these parties are the television and cable networks (Networks). Taxpayer licenses the channels and then distributes them via its and other proprietary technologies, by making the digital channel signals (if included in a customer's Subscription Package) available to the customer for viewing on the customer's televisions or other devices.

Generally, Taxpayer acquires the rights to broadcast the Network's channels by entering into the license agreements, called "carriage contracts," and paying the "carriage fees." The carriage fees are Taxpayer's biggest expense. In contrast, Taxpayer's signal transmission costs were, on average, only about X percent of the carriage fees for Tax Year 1 through Tax Year 3.

Most contracts require Taxpayer to rebroadcast the channel feed it receives without altering the content in the signal in any way. Other contracts allow Taxpayer to add advertisements, including locally based advertisements. Taxpayer does not modify the licensed channel feed on W channels (V percent of the channels). Taxpayer modifies the licensed channel feed by embedding advertisements on U channels (T percent of the channels). Generally, Taxpayer sells this air-time to third-party advertisers who

1. A customer's agreement provides for other services in addition to the programming/channels, but Subscription Package as defined for purposes of this advice does not include those services.

provide advertisements for Taxpayer to integrate into a channel's signal. Taxpayer does not produce advertisements for third-parties, but produces advertisements promoting itself. Some carriage contracts allow Taxpayer to add interstitials into a channel's feed. These are brief programs that fill in gaps in a channel's lineup. Normally, interstitials are short advertisements for Taxpayer.

Self-produced programming: Besides self-promotional advertising, Taxpayer's self-produced content appears to be limited to S Shows. The Shows were produced by production companies that Taxpayer controls. It is currently not clear from the facts developed whether the Shows are qualified films, or how Taxpayer distributes or derives gross receipts from the disposition of this self-produced programming (via its Channels or otherwise). With respect to these Shows, the production personnel included: technical directors, graphics personnel, assistant directors, on-air talent/anchors/analysts, managing and other editors, producers, and camera and lighting technicians. It appears that the production companies used their equipment and facilities in producing content for the Shows.

In Date 1, Taxpayer acquired interests in R Channels. Taxpayer distributes the Channels to some Taxpayer customers via premium Subscription Packages. In addition to Taxpayer, other MVPDs distribute the Channels programming and pay license fees. Taxpayer may or may not be considered the producer of these Channels. It appears the content shown on the Channels consists of: (1) broadcasts filmed by Taxpayer, (2) Taxpayer's original programming, and (3) programming from Network A, an unrelated third party. The facts have not been established concerning the individual programs Taxpayer or its production studios produce. Furthermore, it is not known how much of each Channels total programming was produced by Network A. With respect to the Channels, Taxpayer provides that "[Channels] derive revenue from fees paid by cable and direct-to-home operators pursuant to affiliation agreements entered into with the Channels and the sale of advertising time to local and national advertisers."

Distribution activities: Taxpayer conducts the multichannel video programming distribution activities, including distribution of its Subscription Packages, from its broadcast centers. The activities that take place at the broadcast centers may be summarized as follows: (1) receive programming via , fiber optic cable or tape from the Networks; (2) decode and review the incoming content; (3) insert interstitials and advertisements into the signal, embed metadata, encode the content for outside broadcast; (4) balance the amount of the outgoing signal; and (5) digitalize, encode and transmit the signal through its fleet and the Internet. The technical work at the broadcast centers is carried out mostly by Taxpayer's engineers.

LAW AND ANALYSIS

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” to mean 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. A qualified film shall include any copyrights, trademarks, or other intangibles with respect to such film. The methods and means of distributing a qualified film shall not affect the availability of the deduction under this section.[2]

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 (collectively referred to as disposition) to customers, if the gross receipts from such property qualify as DPGR.

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2. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Public Law 110-343, 122 Stat. 3765 (2008)) revised the definition of qualified film. For taxable years beginning before 2008, the definition of qualified film in § 199(c)(6) is 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.

Section 1.199-3(d)(1)(ii) provides that, if § 1.199-3(d)(1)(i) does not apply to the property, 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(i)(5)(ii)(C) provides that a taxpayer's gross receipts derived from the lease, rental, license, sale, exchange, or other disposition 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) provides that the term "qualified film" means any motion picture film or video tape under § 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. For purposes of § 1.199-3(k), the term "actors" includes players, newscasters, or any other persons who are compensated for their performance or appearance in a film. For purposes of § 1.199-3(k), the term "production personnel" includes writers, choreographers and composers who are compensated for providing services during the production of the film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and other persons who are compensated for providing services that are directly related to the production of the film. Except as provided in § 1.199-3(k)(2), the definition of a qualified film does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

Section 1.199-3(k)(3)(i) 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)(4) provides for purposes of § 1.199-3(k), the term "compensation for services" means all payments for services performed by actors, production personnel, directors, and producers relating to the production of the film, including participations and residuals. Payments for services include all elements of compensation as provided in § 1.263A-1(e)(2)(i)(B) and § 1.263A-3(e)(2)(ii)(D). Compensation for services is not limited to W-2 wages and includes compensation paid to independent contractors.

Section 1.199-3(k)(5) provides the not-less-than-50-percent-of-the-total-compensation requirement under § 1.199-3(k)(1) is calculated using a fraction. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine compensation for services performed in the United States and the total compensation for services regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

Section 1.199-3(k)(6) provides that a qualified film will be 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 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. Sections 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(g)(2), as modified by § 1.199-3(k)(6) for purposes of determining substantial in nature with respect to a qualified film, provides that a qualified film will be treated as produced for purposes of § 1.199-3(k)(6) if the production of the film by the taxpayer is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's production activity, the nature of the qualified film, and the nature of the production activity that the taxpayer performs. The production of a key component of a qualified film, does not, in itself, meet the substantial-in-nature requirement with respect to a qualified film under § 1.199-3(g)(2).

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 § 1.199-3(k)(7).

Section 1.199-3(k)(7)(i) is a safe harbor providing that 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 in the United States and the taxpayer satisfies the safe harbor in § 1.199-3(g)(3). The special rules of § 1.199-3(g)(4) regarding a contract with an unrelated person and aggregation

apply in determining whether the taxpayer satisfies § 1.199-3(g)(3). Sections 1.199-3(g)(3) and (4) are applied by substituting the term “qualified film” for QPP but not disregarding the requirement that direct labor and overhead of the taxpayer to produce the qualified film must be within the United States. Section 1.199-3(g)(3)(ii)(A) includes any election under § 181.

Section 1.199-3(g)(3)(i), as modified by § 1.199-3(k)(7)(i) for purposes of the safe harbor, provides a taxpayer will be treated as having produced a qualified film within the United States for purposes of § 1.199-3(k)(6) if, in connection with the qualified film, the direct labor and overhead of such taxpayer to produce the qualified film within the United States account for more than 20 percent or more of the taxpayer’s CGS of the qualified film, 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 qualified film. For taxpayers subject to § 263A, overhead is all costs required to be capitalized under § 263A except direct materials and direct labor. For taxpayers not subject to § 263A, overhead may be computed using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under § 263A if the taxpayer were subject to § 263A.

Section 1.199-3(g)(3)(ii) provides that the term “unadjusted depreciable basis” means the basis of property for purposes of § 1011 without regard to any adjustments described in § 1016(a)(2) and (3).

Under § 1011, the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis, determined under § 1012, or other applicable sections of the Code, adjusted as provided in § 1016. Under § 1012, the basis of property shall be the cost of such property, except as otherwise provided in Code. Under § 1.1012-1(a), the cost is the amount paid for such property in cash or other property.

Section 1.199-3(k)(7)(ii) provides that the not-less-than-50-percent-of-the-total-compensation requirement under § 1.199-3(k)(7)(i) is calculated using a fraction. 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. For purposes of § 1.199-3(k)(7)(ii), the term “paid by the taxpayer” includes amounts that are treated as paid by the taxpayer under § 1.199-3(g)(4). A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine compensation for services paid by the taxpayer for services performed in the United States and the total compensation for services paid by the taxpayer regardless of where the production activities are performed. Among the factors to be considered in

determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

Issue 1

LB&I asked our Office whether gross receipts derived from the distribution of Subscription Packages qualify as DPGR derived from the disposition of qualified films produced by the Taxpayer. Our Office concludes that gross receipts derived from the Subscription Packages do not qualify as DPGR. However, Taxpayer can apply the rules of § 1.199-3(d)(1)(ii) to components of Subscription Packages and determine whether separate components individually qualify as an item for purposes of § 199.

Section 199(c)(4)(A)(i)(II) provides gross receipts derived from a disposition of a qualified film produced by the taxpayer qualify as DPGR. Taxpayers generally must determine whether gross receipts qualify as DPGR on an item-by-item basis under § 1.199-3(d)(1). Section 1.199-3(d)(1)(i) explains that a taxpayer must identify the property it offers in the normal course of its business for disposition to customers, and determine whether the gross receipts derived from that property qualify as DPGR. If the gross receipts are DPGR, then that property is considered taxpayer's "item" for purposes of § 199. 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.

LB&I indicates that Taxpayer has inconsistently identified the property that it offers in the normal course of its business to customers. Taxpayer at times has indicated that it offers its entire collection of Z channels to customers in the normal course of business, and at others said the properties offered are various Subscription Packages. In our view, Taxpayer offers multiple Subscription Packages (containing different groups of channels) in the normal course of its business to customers. Thus, for purposes of its § 199 calculation, Taxpayer must determine whether gross receipts derived from the Subscription Packages are DPGR.

Section 199(c)(6) and § 1.199-3(k)(1) describe a qualified film as including any motion picture film or video tape under § 168(f)(3), and live or delayed television programming (collectively "film"). A qualified film cannot include any property with respect to which records are required to be maintained under 18 U.S.C. § 2257. Thus, a Subscription Package must consist entirely of film as described in § 199(c)(6) and § 1.199-3(k)(1). Our Office notes that any non-qualifying services provided by Taxpayer pursuant to a customer subscription agreement do not result in immediate application of § 1.199-3(d)(1)(ii). Gross receipts should be allocated to the non-qualifying services and treated as non-DPGR, but Taxpayer can still determine whether the Subscription Package (group of channels) is a qualified film produced by the Taxpayer.

If a Subscription Package consists entirely of film, which is required for a “qualified film,” then Taxpayer must show under § 1.199-3(k)(1) that 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. This calculation applies to the entire film, and includes the compensation paid by third parties to actors, production personnel, directors, and producers for production of all film included in a Subscription Package. This step is important for showing that at least 50 percent of film related compensation was paid for services in the United States. Because this requirement includes compensation for services paid by all parties (Taxpayer and third parties), meeting this requirement does not mean a particular taxpayer is considered the producer of such film. In this case, LB&I indicated to our Office that Taxpayer has not provided information showing any Subscription Package meets this requirement.

In performing the calculation under § 1.199-3(k)(1), our Office notes the limited types of compensation included in determinations under § 1.199-3(k) for production personnel. Compensation for production personnel is limited to persons that are providing services directly related to the production of the film. This does not include compensation for services related to the transmission or distribution of the film. This makes sense as § 199(c)(6) provides that the methods and means of distributing a qualified film do not affect the availability of the deduction under § 199. As provided in the facts, Taxpayer has five activities relating to the distribution of Subscription Packages. These activities are not part of producing any of the film contained in a Subscription Package, and compensation related to the activities should not be included under any determination in § 1.199-3(k). For example, inserting an advertisement is not the production of a qualified film, and does not create a new qualified film. See § 1.199-3(i)(5)(ii)(C), which requires a taxpayer to a producer of the qualified film for gross receipts from any advertisement in the qualified film to qualify as DPGR. Our Office notes Taxpayer may have film production activities with respect to its Shows, advertisements or interstitials promoting Taxpayer, and possibly the Channels.

Even if Taxpayer can demonstrate that a Subscription Package is a qualified film, our Office does not consider Taxpayer a producer of such film. 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 film production activity performed by the taxpayer is substantial in nature within the meaning of § 1.199-3(g)(2). The production activity of a 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. Based on the facts presented, our Office sees no scenario where any of the Subscription Packages should be treated as produced by the Taxpayer under § 1.199-3(k)(6).

Taxpayer is not the producer of a Subscription Package because its production activities with respect to the film within a Subscription Package are not substantial in

nature. Section 1.199-3(g)(2), for purposes of determining substantial in nature with respect to a qualified film, provides that a qualified film will be treated as produced for purposes of § 1.199-3(k)(6) if the production of the film by the taxpayer is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's production activity, the nature of the qualified film, and the nature of the production activity that the taxpayer performs. The production of a key component of a qualified film, does not, in itself, meet the substantial-in-nature requirement with respect to a qualified film under § 1.199-3(g)(2).

Our Office thinks examining Taxpayer's business and the nature of the product is important. Taxpayer's business involves providing groups of channels to customers that customers can navigate to choose their program of choice. The nature of Taxpayer's product is a group of channels offered for disposition together rather than one cohesive film. A Subscription Package is made up of various films. Taxpayer essentially produced none of these films. V percent of the channels distributed are unaltered by Taxpayer, and the remaining T percent of channels are only altered for purposes of inserting advertisements and interstitials (excluding the Channels). While it is allowable for Taxpayer to determine whether it produced enough of the film to be considered the producer of all of the film in a Subscription Package, it is incorrect to say Taxpayer is producing a new film. Taxpayer's disposition of the films as a package (which is its method of distribution), and its activities enabling that distribution, do not affect whether Taxpayer is a film producer. Taxpayer argues that distributing a number of films together as a package can make a taxpayer the producer of the films within that package. Our Office does not agree with that argument. Our Office views Taxpayer's business and activities as the distribution of groups of films, rather than film production.

The facts and circumstances support our position that Taxpayer conducted few film production activities with respect to any potential Subscription Package. The facts indicate that Taxpayer, at most, produces the R Channels, S Shows, and advertisements and interstitials promoting the Taxpayer. The facts indicate that Taxpayer did not produce roughly Z other channels or any of the advertisements for unrelated third parties. This is an enormous disparity. Even in the case of a base Subscription Package, the issue would be whether Taxpayer's production activities were substantial with respect to a package that contains around Y channels.[3] Again, the amount of Taxpayer's film production compared to the whole is minimal. Based on these facts, Taxpayer's film production activities with respect to any Subscription Package are clearly not substantial.

Section 1.199-3(k)(7) provides a safe harbor that treats a film as a qualified film under § 1.199-3(k)(1) and produced by the Taxpayer under § 1.199-3(k)(6). Under § 1.199-3(k)(7)(i), Taxpayer must show that not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United

3. It would likely be more than Y channels, although we do not have an exact number, as Taxpayer's Channels are only included within premium Subscription Packages.

States and that Taxpayer satisfies the safe harbor in § 1.199-3(g)(3). Based on Taxpayer's activities, it appears possible that in some Subscription Packages Taxpayer may have paid no compensation related to film production for purposes of this safe harbor. Notwithstanding that note, Taxpayer has maintained that it meets the safe harbor in § 1.199-3(g)(3). An important part of this argument is whether Taxpayer's costs to license unrelated third party produced programming are included within "overhead" within the meaning of § 1.199-3(g)(3)(i). Based on the facts as presented, Taxpayer will not meet the safe harbor under § 1.199-3(k)(7) if the costs are not included within overhead. Our Office addresses this in Issue 2 below.

To the extent that Taxpayer is not the producer of a Subscription Package, Taxpayer can apply § 1.199-3(d)(1)(ii) to the components of a Subscription Package. Thus, for example, if Taxpayer can show that it meets the requirements of § 1.199-3(k) with respect to the Channels, then Taxpayer's gross receipts attributable to those Channels could qualify as DPGR.

Lastly, our Office provides an additional reason that gross receipts for Tax Year 1 do not qualify as DPGR. Tax Year 1 is not subject to the 2008 amendment to § 199(c)(6). Section 1.199-3(k)(3)(ii) describes the rules that applied prior to the 2008 amendment. It provides that "the showing of a qualified film (for example, in a movie theater or by broadcast on a television station) by a taxpayer is not a lease, rental, license, sale, exchange, or other disposition of the qualified film by such taxpayer. Example 3 of § 1.199-3(k)(10) illustrates this rule. In Tax Year 1, Taxpayer's activities with respect to its Subscription Packages are similar to those activities described, and are not considered a disposition. Thus, gross receipts from the Subscription Packages in Tax Year 1 would not qualify as DPGR.

Issue 2

LB&I also asked our Office whether license fees that Taxpayer pays to unrelated third-party programming producers for the right to broadcast and distribute programming are overhead costs for purposes of the safe harbor in § 1.199-3(g)(3)(i). As described below, we conclude that the license fees paid to unrelated third-parties do not constitute overhead costs for purposes of the safe harbor.

As indicated in the facts, Taxpayer distributes video programming that can be classified into two categories. The first category is video programming produced by unrelated third parties that Taxpayer licenses for distribution (licensed programming). Almost all of the approximately Z channels that Taxpayer distributes fall into this category. The second category is video programming that Taxpayer produces through related entities (self-produced programming).

Section 1.199-3(g)(3)(i) provides two alternative safe harbors for determining whether QPP is manufactured, produced, grown, or extracted (MPGE) in whole or in significant part by a taxpayer. Under §1.199-3(k)(7)(i), the § 1.199-3(g)(3)(1) safe-harbor is

applied to films by substituting the term "qualified film" for QPP but not disregarding the requirement that the direct labor and overhead of the taxpayer to produce the qualified film must be within the United States.

The first safe harbor under § 1.199-3(g)(3)(i) applies for transactions with CGS. Under this safe harbor, if in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States accounts for 20 percent or more of the taxpayer's CGS of the QPP, a taxpayer will be treated as having MPGE QPP in whole or significant part within the United States. Under the second safe harbor for transactions without CGS, if in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States accounts for 20 percent or more of the taxpayer's unadjusted depreciable basis in the QPP, a taxpayer will be treated as having MPGE QPP in whole or significant part within the United States.

The first safe harbor in § 1.199-3(g)(3)(i) does not apply to Taxpayer's video programming transactions because these transactions do not have any CGS. CGS arises from the sale of property, and neither category of programming (licensed programming and self-produced programming) is sold by Taxpayer to its customers. Although Taxpayer charges fees for distributing its video programming, for federal income tax purposes such fees are properly characterized as license fees or fees for service (or are akin to rent) and not as sales receipts.

The second safe harbor in § 1.199-3(g)(3)(i), however, applies to transactions that do not have CGS, and therefore should apply to Taxpayer's video programming. As noted above, this safe harbor is applied by dividing the amount of a taxpayer's direct labor and overhead to MPGE the QPP within the United States by the taxpayer's unadjusted depreciable basis in the QPP. The question remains, therefore, whether the fees that Taxpayer pays to unrelated third-party programming producers for the right to broadcast and distribute programming are overhead costs for purposes of the safe harbor.

License Fees are Not Overhead under § 1.199-3(g)(3)(i): The safe harbor in § 1.199-3(g)(3)(i) provides two alternative definitions of overhead costs. Which alternative definition applies to a taxpayer depends on whether the taxpayer is subject to § 263A. For taxpayers subject to § 263A, overhead is all costs required to be capitalized under § 263A, except direct materials and direct labor. For taxpayers not subject to § 263A, overhead may be computed using any reasonable method that is satisfactory to the Secretary based on all the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under § 263A if the taxpayer were subject to § 263A.

Taxpayer creates the self-produced programming, and these production activities subject Taxpayer to § 263A. Because Taxpayer is subject to § 263A, Taxpayer's overhead, incurred in connection with its video programming, is all costs required to be capitalized under § 263A, except direct materials and direct labor. Section 1.199-3(g)(3)(i).

Costs required to be capitalized under § 263A include all direct costs and certain indirect costs properly allocable to: (1) real property and tangible personal property produced by the taxpayer, including, for this purpose, films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator thereof, and (2) real property and personal property described in § 1221(a)(1), which is acquired by the taxpayer for resale. Sections 1.263A-1(a)(3)(i) and 1.263A-2(a)(2)(ii).

Unlike the self-produced programming, the licensed programming is not created by Taxpayer. Rather, the licensed programming is created by third parties and licensed to Taxpayer for transmission and distribution over Taxpayer's network.

Furthermore, the licensed programming is not real property or personal property described in § 1221(a)(1). Section 1221(a)(1) refers to (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or (2) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Taxpayer's licensed programming is not affixed to a tangible medium for sale. Nor does Taxpayer sell the copyright in the property or sell its more limited license to broadcast the licensed programming. Accordingly, the licensed programming is not merchandise for which the production, purchase, or sale is an income-producing factor for Taxpayer, and, therefore, is not the type of property that would be included in inventory. See § 1.471-1. In addition, because the licensed programming is not sold, the licensed programming is not property held by Taxpayer primarily for sale to customers in the ordinary course of Taxpayer's trade or business.

Because the licensed programming is neither produced by Taxpayer nor described in § 1221(a)(1), the costs of the licensed programming are not required to be capitalized under § 263A. Accordingly, the license fees are not overhead costs for purposes of § 1.199-3(g)(3)(i).

Unadjusted Depreciable Basis Includes License Fees: For completeness, our Office notes that unadjusted depreciable basis in this case includes the license fees Taxpayer pays to unrelated third parties.

Under § 1.199-3(g)(3)(ii), unadjusted depreciable basis means the basis of property for purposes of § 1011, without regard to any adjustments described in § 1016(a)(2) or (3).

Under § 1011, the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis, determined under § 1012, or other applicable sections of the Code, adjusted as provided in § 1016. Under § 1012, the basis of property shall be the cost of such property, except as otherwise

provided in Code. Under § 1.1012-1(a), the cost is the amount paid for such property in cash or other property.

The amounts paid for the licensed programming are the cost of such property, and such amounts create basis under § 1012 and adjusted basis under § 1011. The amounts paid to produce the self-produced programming also create basis under § 1012 and adjusted basis under § 1011. Therefore, Taxpayer's unadjusted depreciable basis, determined for purposes of the § 1.199-3(g)(3)(i) safe harbor, should include Taxpayer's § 1011 adjusted basis, without regard to any adjustments described in § 1016(a)(2) or (3), in both the self-produced programming and the licensed programming.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call James Holmes at 202-317-4137 if you have any further questions.