DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting
Regulation Section 25137-8: Motion Picture and Television Film Producers and Television Networks
January 8, 2008

1. Overview and History of Regulation Section 25137-8.

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 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 special rules which were adopted in 1982 as Regulation section 25137-8. Since the regulation in its current form was adopted over 25 years ago, it may be time to revisit the regulation at this time to determine what, if any, changes might be appropriate.

A. Television network broadcasters:

Subsequent to the adoption of the existing regulation in 1982, the television network broadcasting industry has undergone significant changes, and is continuing to do so. For example, in the 1970's, television advertising was primarily limited to local, independent stations, and multistate advertising revenues did not appear to be an issue. Today, television networks operate almost exclusively on a multistate basis. Technology has changed as well and network programs and advertising are transmitted as a digital signal to satellites, accessed by affiliates and released to subscribers across the country and, in some cases, around the world. Staff would like to elicit input regarding the application of the existing regulation to the television industry as it is today. Should the rules be adjusted to specifically address advertising revenue? If so, what methodology should be utilized? What other areas are in need of amendment to address the changes in the broadcasting industry?

B. Independent film distributors:

At the time the regulation was drafted, the focus was on major studios and independent distributors do not appear to have been represented at the hearings. While the regulation was subsequently enlarged to include independent television broadcasters, there was no discussion or inclusion of independent film distributors and they are not covered by the existing regulation. At one time, major studios controlled all stages of production and distribution. Now, many of these functions are commonly conducted by a separate entity, whether affiliated or independent. As a result, the existing regulation does not reflect the industry as it exists today.

There is also the issue of what property would be included for independent film distributors under a special factor formula, including, but not limited to, whether film

distribution rights are tangible or intangible property. In addition, there are the alternative marketing arenas such as the sale of merchandise, videocassettes and DVD's. Potentially, a distributor could receive an income stream from licensing agreements without ever "distributing" the film.

C. Online advertising-driven media:

The changes in advertising-driven media continue to cross industry lines. Today, television, print and film industries regularly utilize online advertising formats and web companies are brokering advertisements in the television, radio, print and gaming industries as well as the internet. These multiple formats mean that what is defined as an advertisement is rapidly changing. Advertisers are adapting ads and filling online ad time in ways they can't on TV or in other formats. Ads are now frequently embedded in programs, games and films. It appears that the format of advertising throughout the film and television industry is changing radically and may be spawning other, related online advertising-driven industries that the existing regulation does not address.

D. Are there other participants within the industry that should be included in the existing regulation:

In addition to what appears to be a growth in independent film distributors, there may be other types of activities occurring within the industry that have been placed in separate entities. Should these other type of activities be included within the provisions of this regulation or would it be appropriate or necessary to develop other special rules for the assignment of their income?

2. Let's talk about it!

The department anticipates having an open discussion to address these and other concerns that may be present in the industry, together with possible approaches to resolve potential problems.

Staff believes that the following core principles provide an objective basis to guide the discussion and to evaluate proposed solutions:

A. Equity: Are all taxpayers being treated similarly?
B. Administrability: Is the rule clear and simple? Can taxpayers and the department apply the new rule.
C. Elimination of potential disputes: Does the new rule raise concerns that could lead to new disputes.
D. Recordkeeping: Does the new rule use existing records as much as possible to minimize taxpayer recordkeeping burdens.

Given this basic framework, it appears to staff that possible changes to the existing regulation may include:

A. Clearly defining the terms used in the regulation or adding additional definitions where needed. For example, there appears to be a need to clarify or add definitions for "gross receipts," "advertisement," "independent film distributor," and "tangible/intangible" property with regard to distribution rights.
B. Including advertising revenues from online advertising in the calculation of the sales factor on the basis of a market assignment approach rather than through the standard formula's income-producing activity approach.
C. Considering language that would identify a market-based determination rule for sourcing advertising revenue similar to that contained in Regulation section 25137-12 for print media.
D. Addressing the fact that the industry is changing and boundaries between media are becoming blurred.
E. Considering methods of identifying and sourcing new ad forms.
F. Addressing other industry concerns that may exist.

3. Let's think about it!

The existing regulation could be updated to (a) incorporate relevant aspects of the MTC Model Regulation for Television Networks and (b) to parallel the market-based determination rule for sourcing advertising revenue similar to that contained in Regulation section 25137-12 for print media. A market-based determination rule for sourcing advertising revenue has the potential for providing one industry-wide formula that provides clarity and consistency for both taxpayers and the department. This would make the determination of the sales factor congruent with that of other special regulations both in California and other states.

To acknowledge the blending of industries, new terms could be added and/or defined to specifically include new entities such as independent film distributors and/or new industries such as online advertising-driven media in the special regulation.

Perhaps simply consolidating Regulation section 25137-8 and Regulation section 25137-12 might sufficiently reflect and address industry changes together with applying definitional clarity to new terms and/or terms of art that reflect industry norms. Or, a new regulation applying specifically to all advertising-driven media industry may be a better choice.

Note: The department is currently reviewing Regulation section 25137-12, for print media, as well. An interested parties meeting on Regulation section 25137-12 is scheduled for January 8, 2008 at 9:30 a.m. at the Franchise Tax Board, Golden State Room A/B, 9646 Butterfield Way, Sacramento, CA 95827 (Use North Lobby Entrance). Topics related to advertising revenue generated by print and related advertising-driven media will be discussed. A notice of that meeting and a list of discussion topics can be found at www.ftb.ca.gov. Highlight "Public Meetings" under the "News and Events" heading on the home page and click on "Interested Parties Meetings." You may also contact Marguerite Mosnier, the lead legal staff person for Regulation section 25137-12, at Marguerite.Mosnier@ftb.ca.gov.