

Request for Permission to Proceed with Formal Rulemaking Process on the Adoption of California Code of Regulations, Title 18, Section 25137-8, Relating to Motion Picture and Television Film Producers, Distributors, and Television Networks – Apportionment of Income.

Regulation section 25137-8 was adopted in 1982 and provides special apportionment rules to address the unique aspects of the motion picture and television industries. Since that time, the industry has undergone significant changes. In the television industry, technology has changed and there are many more networks producing various types of programming that are transmitted via digital signal to satellites, accessed by affiliates and released to subscribers across the country. Similarly, in the motion picture industry at the time the regulation was adopted in 1982, the focus was on major studios, and while the regulation was subsequently enlarged to include independent television broadcasters, there was no inclusion of independent film distributors and so 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.

The Multistate Tax Commission (MTC) provides model regulations, statutes and guidelines, approved and adopted by a majority of states, to promote uniformity in the states' taxation of interstate and foreign commerce. The MTC's model regulation for television and radio broadcasters, Regulation IV.18(h), was last amended in 1996. The proposed amendments to Regulation section 25137-8 include amendments to align the California regulation with provisions contained in the MTC's model regulation. Other amendments are made to reflect the rules contained in existing Regulation section 25137-12, which addresses the print media industry, as well as to reflect changes suggested by interested parties.

To provide greater clarity to the existing rules, advertising revenue is now specifically identified as part of "gross receipts" assigned by the regulation. This amendment is in conformity to MTC Regulation IV.18(h)(1) as well as Regulation section 25137-12 and is consistent with the department's view of the existing rules. As amended, regulation section 25137-8 also identifies "distributors" as a part of the industry covered by this regulation, redefines "film" to include news or sports films produced for telecast, and identifies new technology used by the industry since the prior regulation was adopted.

Interested Parties Meetings were held on January 8, 2008 and May 15, 2009 to solicit public comment. Telephonic working parties meetings were held on April 9, 2008 and April 23, 2009 to permit industry representatives to discuss the proposed changes. All comments received have been posted on the Franchise Tax Board website for public review.

The proposed amendments to Regulation section 25137-8 will become effective for taxable years beginning on or after January 1, 2010.

Staff requests permission to begin the formal rulemaking process to adopt the proposed amendments to this regulation.

EXPLANATION OF PROPOSED DRAFT OF REGULATION SECTION 25137-8: MOTION PICTURE AND TELEVISION PRODUCERS, DISTRIBUTORS, AND TELEVISION NETWORKS – APPORTIONMENT OF INCOME

This discussion of the proposed draft of Regulation section 25137-8 attempts to take into account the concerns of the various interested parties. Although we have attempted to note all input, this draft may not include all parties' recommendations. The key points of the discussion draft are set forth with explanations below:

1. *Descriptive title:* While the working title of any regulation is drafted and inserted by the publisher and is not a substantive part of the regulation, we have suggested the title be changed to include the word "Distributors" to make it clear that they are a member of the group covered by this regulation.
2. Proposed Regulation section 25137-8(a)"In General" mirrors MTC Regulation IV.18(h)(1) as amended April 25, 1996. This is not a substantive change. Because this MTC language has been adopted in large part by many other states, it provides a level of uniformity. The application years originally contained in this introductory paragraph have been removed and inserted at the end of the regulation (see Regulation section 25137-8(d)) in order to conform to the format set forth in other special regulations under Revenue and Taxation Code (R&TC) section 25137.
3. *Definitional Sections:* This part of the discussion draft addresses definitions of various terms contained in the rules to follow. This section includes definitions contained in MTC Regulation IV.18(h)(3), existing Regulation section 25137-12, and those suggested by interested parties.
 - (1) By eliminating the former exclusionary language, proposed Regulation section 25137-8(b)(1) redefines "film" to include news or sports films produced for telecast. This is consistent with the definition of "film" in MTC Regulation IV.18(h)(3)(i). The proposed change recognizes that (1) since the inception of the existing definition of film in the 1970's, news and sports films have become similar to other film types already included in the existing definition, and (2) this inclusion of news and sports film makes the definition of "film" similar to that set forth in MTC Regulation IV.18(h)(3)(i)and thus provides a level of uniformity with other states.

The language "any other type of format or medium" is taken directly from the definition of "film" in MTC Regulation IV.18(h)(3)(i), thereby updating the existing definition (1) to include new and always changing technology, and (2) to provide the definition with a level of uniformity with other states.

Recognizing that a "film" is deemed to be tangible personal property for purposes of this regulation is not new language and is not a substantive change. The existing language of Regulation section 25137-8(b)(4) has been included verbatim in proposed Regulation

section 25137-8(b)(1) so that all definitions of "film" are placed in the same paragraph for easier reference.

Proposed Regulation section 25137-8(b)(1) clarifies that film intended for home viewing is "deemed to be tangible personal property" for sales factor purposes. The term "intended for home viewing" is replaced by "sold for personal use." This is not a substantive change.

- (2) Proposed Regulation sections 25137-8(b)(3) and 25137-8(b)(4) have been expanded to include additional definitions for "producer" and "distributor." The inclusion of these groups and the clarification that "a distributor does not include theaters" were requested by interested parties. The proposed Regulation section 25137-8(b)(4) does not include cable television networks as "distributors."
 - (3) Proposed Regulation section 25137-8(b)(9) defines "telecast" by using language taken directly from MTC Regulation IV.18(h)(3)(vii). This MTC language has been adopted in large part by many other states and therefore provides a level of uniformity. This revision makes no substantive change to the existing regulation.
 - (4) Proposed Regulation section 25137-8(b)(10) has been added to define "advertising revenue" as used in this regulation. This is clarifying language requested by interested parties who must use the term for apportionment purposes. The proposed revision makes no substantive change to the existing regulation.
 - (5) Proposed Regulation section 25137-8(b)(11) has been added to define "cable television services" as used in this regulation. This is clarifying language requested by interested parties who must use the term for apportionment purposes.
4. Proposed Regulation section 25137-8(c) "Apportionment of Business Income" adds "distributors" to the list of those taxpayers covered by this regulation for purposes of consistency.
 5. Proposed Regulation section 25137-8(c)(3)(A) clarifies that gross receipts include those derived from all sources within this state, including but not limited to those categories specifically identified in the regulation. Gross receipts from advertising revenue is added to make it congruent with both historical practice and the language set forth in MTC Regulation IV.18(h)(4)(iv)(B)(1). This language addresses the concern expressed by some taxpayers over categories not specifically identified. This revision makes no substantive change to the regulation.
 6. Proposed Regulation section 25137-8(c)(3)(A) (i), (ii), and (iii) now specifically includes advertising revenue in gross receipts. This language is taken from existing Regulation section

25137-12 and MTC Regulation IV.18(h)(4)(iv)(B)(1), thereby making the regulatory language in proposed Regulation section 25137-8 consistent with other special regulations under R&TC section 25137 and providing uniformity with other states. This revision makes no substantive change to the regulation.

7. Proposed Regulation section 25137-8(c)(3)(A)(ii) and (iii) add "provided that the source selected is consistently used from year to year for that purpose." This wording clarifies historical administrative practice and provides consistency in reporting of data. This proposed language makes no substantive change to the regulation.
8. Proposed Regulation section 25137-8(3)(A)(iv) clarifies that receipts from sales and rentals also include receipts from "licensing or other disposition" of video cassettes and discs "or any other format or medium intended for personal use," and that these receipts shall be included in the numerator of the sales factor. This language is taken in large part from MTC Regulation IV.18(h)(4)(iv)(B)(4) to provide uniformity with other states. It makes no substantive change to the regulation.
9. Proposed Regulation section 25137-8(d) provides that this regulation will apply to taxable years beginning on and after January 1, 2010 at the request of interested parties. While there are substantive changes from the existing regulation (specifically identifying distributors as a part of the industry covered by this regulation, redefining "film," and identifying new technology used by the industry since the prior regulation was adopted), the specific identification of advertising revenue as a gross receipt makes the regulatory language in Regulation section 25137-8 consistent with other special regulations and provides uniformity with other states. It makes no a substantive change to the regulation and makes no new demands upon taxpayers.
10. Proposed Note: The authority cited for this regulation is updated from R&TC Section 26422 to R&TC Section 19503, since the prior section is no longer applicable as a result of the passage of SB 3 (Stats. 1993, ch. 31). This makes no substantive change to the regulation. The reference remains Section 25137, Revenue and Taxation Code.

Section 25137-8 is amended to read:

§ 25137-8. Motion Picture and Television Film Producers, Distributors, 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.~~
- (a) In General. When a business entity in the business of producing or distributing motion picture, film, or television programming, whether broadcast or telecast through the public airwaves, by cable, direct or indirect satellite transmission, or any other means of communication, either through a network (including owned and affiliated stations) or through an affiliated, unaffiliated, or independent television broadcasting station has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to this regulation. This regulation does not apply to a business entity which earns receipts from the provision of cable television services.
- (b) Definitions.

For purposes of this regulation only, the following definitions shall apply.

(1) "Film" means the physical embodiment of a play, story, or other literary, commercial, educational, or artistic work, produced for telecast, as a motion picture, video tape, disc, or any other similar type of format or medium, ~~except that it does not include news or sports films produced for telecast. A "film" is deemed to be tangible personal property. "Film" does not include video cassettes or discs sold for personal use. 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) A "producer" is a business entity which develops and creates motion picture, television, or web-based content.

(4) A "distributor" is a business entity which, upon completion of production, licenses a film for exhibition by a related or unrelated third party. The distributor may also develop and fund the campaign to market the film. A theatre which exhibits the film is not a distributor. A producer may also be a distributor if it licenses its own films or those of others for exhibition.

~~(3)~~(5) "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)~~(6) "Rent" shall include license fees for the exhibition or telecast of films.

~~(6)~~(7) "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)~~(8) A "subscriber" to a subscription television telecaster is the individual residence or other outlet which is the ultimate recipient of the transmission.

~~(8)~~(9) "Telecast" means the transmission of an electronic signal or other signal by radiowaves or microwaves or by wires, lines, coaxial cables, wave guides, fiber optics, satellite transmissions directly or indirectly to viewers or subscribers, or by any other means of communication. ~~or other tangible conduits of communication.~~

(10) "Advertising revenue" includes advertising from all sources, including but not limited to online advertisements, embedded advertisements, product placement, barter transactions, and the sale of air time used for advertising purposes.

(11) "Cable television services" means the transmission to subscribers of video programming or other programming service over a cable system.

(c) Apportionment of Business Income. The property, payroll, and sales factor of the apportionment formula for motion picture and television film producers, distributors and television networks shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulations 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 of 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 or satellite 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.

~~(2)~~(3) Sales Factor.

(A) The numerator shall include all gross receipts ~~for~~ derived by the taxpayer from sources within this state including, but not limited to, the following:

~~(A)~~ (i) Gross receipts, including advertising revenue, from films in release to theaters and television stations located in this state.

~~(B)~~ (ii) Gross receipts, including advertising revenue, 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 provided that the source selected is consistently used from year to year for that purpose.

~~(C)~~ (iii) Gross receipts, including advertising revenue, 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, provided that the source selected is consistently used from year to year for that purpose.

~~(D)~~ (iv) Receipts from sales and rentals, licensing or other disposition of video cassettes and discs or any other format or medium intended for personal use shall be included in the numerator of the sales factor as provided in Regulations 25135 and 25136.

(d) This regulation applies to taxable years beginning on and after January 1, 19822010.

Note: Authority cited: Section ~~26422~~19503, Revenue and Taxation Code.
Reference: Section 25137, Revenue and Taxation Code.