

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 352

January 8, 1973

FOREIGN TAXES PAID BY MOTION PICTURE DISTRIBUTORS OR PRODUCERS

Syllabus:

Taxes, on or according to or measured by income or profits, which are paid to a foreign country by a motion picture distributor, and treated as a distribution expense in accordance with the usual form of agreement between the distributor and the producer of the picture, are a tax solely on the distributor; they are a distribution expense with respect to the producer. The taxes are not an allowable deduction, by statute, to the distributor.

Independent motion picture producers generally distribute their motion picture productions for exhibition through one of several major distribution organizations. In general, the Distribution Agreements which are executed between producers and distributors are basically the same, but may vary somewhat depending upon whether the distributor either finances or guarantees the financing of the productions.

Under such an agreement, the distributor receives the total receipts from the exhibition of the picture or other related sources. From these funds it pays all of the costs of distribution, including its own fee or distribution services. Among these payments by the distributor are taxes paid to foreign countries, including taxes on or according to or measured by income or profits, from the exhibition of the picture in the foreign countries. The distributor renders a distribution statement to the producer at regular intervals, reporting in detail the income and distribution expenses of the picture. The foreign taxes paid by the distributor are included as a distribution expense. The distributor pays over to the producer the balance determined to be owing.

Under the federal income tax law, the foreign taxes may be taken either as a deduction or as a credit against the income tax. On the other hand, California law permits neither a deduction nor a credit for foreign taxes on or according to or measured by income or profits. For federal purposes, the producer does not claim a deduction for foreign taxes as a distribution expense but, rather, claims a tax credit for such foreign taxes. Also, in many instances, the distributor claims a credit for the same taxes. In its California return, the producer always includes the foreign taxes as a distribution expense, as that is the only method by which it can get a benefit.

The rule has been established in federal cases that where a tax is imposed by

a foreign country upon the payment of income to a nonresident of the country, the credit may be taken only by the taxpayer to whom the income received belongs at the time it is paid. Badger Co., Inc., T.C. Memo 1967-178, 26 TCM 869. See also, Irving Air Chute Co. v. Commissioner, 143 Fed.2d 256 (1944). Accordingly, the question presented must be resolved by establishing to whom the income upon which the foreign tax is levied belongs at the time it is paid, whether to the distributor or to the producer.

As between the producer and the distributor, the one to which the income belongs is determined from the provisions of the Distribution Agreement. An examination of the agreement leads to the conclusion that it is the intent of the parties that the distributor be an independent agent in performing its obligations to the producer. The producer grants virtually all of its rights in the motion picture, except ownership of the film, to the distributor. In addition, the distributor is given complete control and responsibility for the manner in which the picture is marketed. Without reciting specific provisions of the agreement, it can be stated incontestably that the whole tenor of the agreement establishes the complete independence of the distributor. The agreement does not require the producer to reimburse the distributor for any deficit incurred in the distribution of the picture; apparently, the distributor absorbs any net expenditures. It can only be concluded that the distributor operates without control, and is a completely independent agent acting on its own behalf; it is not an agent acting on behalf of the producer as its principal.

Accordingly, the payment by the distributor to the producer is essentially a payment by the grantee to the grantor for distribution rights to the motion picture. It is not an accounting to the principal by an agent for money received or expended by the agent on behalf of the principal, even though the distributor does account to the producer for the gross receipts from the picture and for the distribution expense. While in most instances, in its tax return the producer reports the gross income from the picture and deducts all distribution expenses and fees, as reported by the distributor, the nature and effect of the agreement is that the distributor's receipts and expenses of distribution are attributable solely to the business operations of the distributor and are not received or paid "on behalf" of the producer. This view is confirmed by a provision of the agreement which provides: "All of the Producer's share of the gross receipts shall be retained by [the Distributor] as its property until [the Distributor] shall have reimbursed itself, and shall have recouped therefrom the sum equal to the total cost and charges expended and incurred by [the Distributor] for the account of Producer, for the following items relating to the Picture . . ."

Based upon the foregoing, it is concluded that the foreign taxes on or according to or measured by income or profits, which are paid by the distributor, are an expense solely of the distributor; nevertheless, they may not be claimed as a deduction by the distributor since the tax is disallowed as

a deduction by Section 24345(a)(2)(A). It is concluded, further, that the income of the producer is only the amount paid or payable to it by the distributor pursuant to the terms of the agreement. If the producer, however, does include in its tax return both the gross receipts of the picture as well as the distribution expenses incurred by the distributor to arrive at its net income, it may deduct as a distribution expense the foreign taxes paid by the distributor and included in distribution expenses.

The matter of whether the producer may apportion any part of its income outside of this state is dependent upon whether the producer has a source of income outside the state. It is not essentially dependent upon whether the producer engages in business activities outside of the state through an agent in a principal-agent relationship. The ownership of property having its situs outside the state is a source of income that is outside the state. Accordingly, the ownership of film located outside the state entitles a producer to apportion some part of its income outside the state, by allocating the property outside the state for purposes of the numerator of the property factor in the apportionment formula. Similarly, the receipts from the films exhibited outside the state are allocated outside the state for the sales or receipts factor. With respect to the allocation of receipts, the amounts to be used are the amounts actually received as income by the producer from the distributor, rather than any gross amounts which are received by the distributor and which may be reported or accounted for to the producer.