INTERNAL REVENUE SERVICE
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Director of Field Operations, Western Compliance Practice Area - Southwest
Paul J. Curtis

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer:

Signals:

ISSUES:

1. For purposes of the domestic production activities deduction under § 199 of the Internal Revenue Code (Code), whether a package that includes multiple channels of video programming, or the Signals transmitted by Taxpayer to distribute the package of video programming (together referred to as a “Subscription Package”) is a qualified film within the meaning of § 199(c)(6), and § 1.199-3(k)(1) of the Income Tax Regulations.

2. Whether the gross receipts that Taxpayer derived from its Subscription Packages qualify as domestic production gross receipts (DPGR) under § 199(c)(4)(A)(i)(II) and § 1.199-3(k)(3).

CONCLUSIONS:

1. No. A Subscription Package is not a qualified film within the meaning of § 199(c)(6) or § 1.199-3(k)(1) because it is not property described in § 168(f)(3)("any motion picture film or video tape"), or "live or delayed television programming" within the meaning of § 1.199-3(k)(1).

2. No. The gross receipts that Taxpayer derived from its Subscription Packages were not from the disposition of a qualified film produced by Taxpayer and are not DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(k). However, the gross receipts that Taxpayer derived from any individual film included in a Subscription Package that is a qualified film produced by Taxpayer may qualify as DPGR. Thus, a portion of Taxpayer's gross receipts may be DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(k), and each qualified film produced by Taxpayer may be considered an "item" as provided by § 1.199-3(d)(1)(ii).

FACTS:

Taxpayer is a multichannel video programming distributor (MVPD) regulated by the Federal Communications Commission (FCC) as a telecommunications service provider. An MVPD is defined as "a person such as, but not limited to, a cable operator, a multichannel multipoint distribution service, a direct broadcast satellite service, or a television receive-only satellite program distributor, who makes available for purchase, by subscribers or customers, multiple channels of video programming." 47 U.S.C. § 522(13). As an MVPD, Taxpayer is subject to the rules in the Communications Act of 1934 (as amended by the Telecommunications Act of 1996). "Telecommunication services" are defined as "the offering of telecommunications for a fee, directly to the public, … regardless of the facilities used." 47 U.S.C. § 153(53). "Telecommunications" is defined as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." 47 U.S.C. § 153(50). The term "cable channel" or "channel" is defined as "a portion of the electromagnetic frequency spectrum which is used in a cable system and which is capable of delivering a television channel (as television channel is defined by the FCC by regulation)." 47 U.S.C. § 522(4).

In exchange for various monthly fees, Taxpayer distributed to customers, via the transmission of Signals, thousands of channels containing television programs, advertisements, and interstitials. The television content Taxpayer's customers received varied depending on their Subscription Package and geographic location. The reference to the gross receipts that Taxpayer derived from its Subscription Packages includes all fees attributable to each Subscription Package.

Some of Taxpayer's Subscription Packages included access to channels containing films and television programs with visual depictions of actual sexually explicit conduct for which records are required to be maintained under 18 U.S.C. § 2257. In addition, Taxpayer provided to customers access to pay-per-view films and television programs. Taxpayer also provided to customers the equipment necessary to receive the Signals transmitted by Taxpayer. The terms and conditions of the contractual relationship between Taxpayer and customers are set forth in customer agreements, which are service contracts.

In total, Taxpayer distributed around television channels to customers. Taxpayer licensed almost all of these television channels from unrelated third parties. For the tax years at issue, Taxpayer produced television programs for of the television channels it distributed. However, a significant portion of the content provided on these channels was also licensed from unrelated third parties. It is unclear how many Subscription Packages included these channels.

Taxpayer claimed a total of approximately $ in § 199 deductions for the tax years at issue.

Summary of Taxpayer and LB&I Positions

Taxpayer takes the position that each one of its Subscription Packages is a new film that is also a qualified film produced by Taxpayer. Thus, the various monthly fees customers paid to Taxpayer in exchange for access to its Subscription Packages qualify as DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(k). Taxpayer relies on I.R.S. Technical Advice Memorandum 201049029 (Dec. 10, 2010) (the 2010 TAM) to support its assertion.[1]

LB&I disagrees with Taxpayer that a package of television channels is a qualified film. According to LB&I, as a matter of law, a Subscription Package is not a film, and thus, is not a qualified film for § 199 purposes. LB&I asserts that the reference to any motion picture film, video tape, or live or delayed television programming (film) in § 199(c)(6) and § 1.199-3(k)(1) is limited to individual films. LB&I further disagrees that the gross receipts Taxpayer derived from the disposition of its Subscription Packages are DPGR from a qualified film produced by Taxpayer under § 199(c)(4)(A)(i)(II) and § 1.199-3(k).

LB&I asserts that the only gross receipts that are DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(k) are those derived from the individual films that are the components of a Subscription Package, if such films, on an individual basis, meet the

[1] As a preliminary matter, the 2010 TAM has no precedential value and Taxpayer cannot rely on it directly or indirectly. See § 6110(b)(1)(A) and (k)(3).

requirements to be a qualified film produced by Taxpayer. Accordingly, the gross receipts Taxpayer derived from its Subscription Packages are not DPGR because they are not attributable to the disposition of a qualified film produced by Taxpayer. Thus, a Subscription Package is not Taxpayer's "item" under § 1.199-3(d)(1), and Taxpayer must apply the rules of § 1.199-3(d)(1)(ii) to each individual film included in its Subscription Packages.

However, LB&I recognizes that Taxpayer may be entitled to include the gross receipts allocable to each individual film that meets the definition of qualified film, and that was produced by Taxpayer under § 1.199-3(k)(6) in its § 199 deduction calculation. That is, LB&I asserts that only films that Taxpayer establishes are, individually, a qualified film produced by Taxpayer, may be treated as the item under § 1.199-3(d)(1)(ii) because the gross receipts from such films are DPGR. Thus, only the gross receipts Taxpayer derived from those individual qualified films (components) that were produced by Taxpayer may qualify as DPGR.

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)(II) provides that DPGR means the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition (collectively "disposition") of any qualified film produced by the taxpayer.

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 18 U.S.C. § 2257 (regarding material containing the depiction of sexually explicit conduct). 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.

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

Under § 1.199-3(d)(1), 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 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(k)(1) states 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)(1), 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)(1), the term production personnel includes writers, choreographers and composers who are compensated for providing services during the production of a 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) provides, in general, that DPGR include the gross receipts from the disposition of any qualified film produced by such taxpayer.

Section 1.199-3(k)(5) provides that 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 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. Sections 1.199-3(g)(2) and (4) are applied by substituting the term qualified film for qualifying production property (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 the safe harbor must apply all the provisions of § 1.199-3(k)(7).

ANALYSIS:

An income tax deduction is a matter of legislative grace and a taxpayer has the burden of proving that it is entitled to the deduction. ADVO, Inc. v. C.I.R., 141 T.C. 298, 322 (2013). Taxpayer can satisfy its burden by showing that it meets all the requirements to receive the deduction under § 199, and the amount deductible. To demonstrate that it meets the requirements of § 199(c)(4)(A)(i)(II), Taxpayer must show that it derived gross receipts from a qualified film that it produced. In this case, Taxpayer must first establish that a Subscription Package is a qualified film as defined in § 199(c)(6) and § 1.199-3(k)(1). To do this, Taxpayer must show that a Subscription Package: (1) is property that is a film ("motion picture film or video tape under § 168(f)(3), or live or delayed television programming"); (2) at least 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; and (3) it is not property for which records are required to be maintained under 18 U.S.C. § 2257.

Issue 1: For purposes of the domestic production activities deduction under § 199, whether a Subscription Package is a qualified film under § 199(c)(6) and § 1.199-3(k)(1).

A. A Subscription Package is not a qualified film under § 199(c)(6) because it is not property described in § 168(f)(3) or § 1.199-3(k)(1)

Section 199(c)(6) defines the term “qualified film” as any property described in § 168(f)(3), provided such property meets the other requirements of § 199(c)(6). Property described in § 168(f)(3) is “any motion picture film or video tape.” See BedRoc, Ltd. v. United States, 541 U.S. 176, 183 (2004)(“[The] inquiry begins with the statutory text, and ends there as well if the text is unambiguous.”). Our Office does not consider a Subscription Package a “motion picture film or video tape” under even the most liberal reading of the phrase in § 168(f)(3), and we are unaware of any authority that indicates otherwise. Instead, we view each of the individual films included in a Subscription Package as a “motion picture film or video tape” under § 168(f)(3).

The definition of the term “qualified film” under § 1.199-3(k)(1) is also limited to individual films. In addition to property described in § 168(f)(3), § 1.199-3(k)(1) includes “live or delayed television programming” within the definition of the term “film” for § 199 purposes. While this added language describes a type of programming, the phrase must be read in conjunction with the statutory reference to § 168(f)(3). This leads to the conclusion that the phrase refers to individual television programs that are broadcast live or on a delayed basis. It is, therefore, inappropriate to interpret the inclusion of the word “programming” as allowing for a package of live or delayed programs to be considered an individual film for § 199 purposes. This is also consistent with the regulatory text. To illustrate, immediately following the phrase “live or delayed television programming” is a parenthetical with an express reference to the term “film” in the singular. Thus, while each program is a film that may individually be a qualified film, a package of multiple programs is not a film, and therefore, not a qualified film.

Interpreting the definition of the term “qualified film” in the singular is also consistent with Congress’ expressed intent to limit the tax benefits of § 199 to film production rather than film distribution. The Code and regulations both reference compensation paid for services performed in the United States by actors, production personnel, directors, and producers that relate to the production of a film. Rather than producing programming content, Taxpayer’s activities with respect to a Subscription Package primarily consist of distributing, through the transmission Signals, the television channels included in the Subscription Package. The Signals are the medium in which the films are distributed. Generating and transmitting Signals to distribute a Subscription Package does not result in the production of any new programming content. Further, it does not involve the performance of services performed by actors, production personnel, directors, and producers. The assertion that Taxpayer’s activities are not those that Congress intended to incentivize is further supported by § 199(c)(6), which provides, in relevant part, that “[t]he methods and means of distributing a qualified film shall not affect the availability of the deduction under this section.” Congress intended to exclude transmission and distribution activities from the production of a qualified film as they do not affect the availability of the deduction under § 199. Consequently, expanding the definition of qualified film to include a package of films could improperly extend the benefits of § 199 to taxpayers engaged film distribution via the transmission of Signals, rather than film production.

The legislative history surrounding the provisions relating to film production reinforces both the statutory and regulatory language cited above. Congress was concerned by the decreasing number of films being produced domestically. See S. Rep. No. 108-192 at 73 (2003).[2] To best effectuate Congress' express desire to encourage domestic film production, the qualified film determination must be made on an individual film basis. If the determination was made on a Subscription Package basis, Taxpayer could potentially claim the § 199 deduction for films produced outside the United States, qualified films that it did not produce, and films that are property described under 18 U.S.C. § 2257. The legislative history indicates Congress' intent to encourage the production of films domestically. There is nothing, however, to suggest that Congress intended to incentivize the transmission of Signals and distribution of films within the United States.[3]

If any of the terms used to define qualified film are ambiguous, they must be interpreted in a manner that is consistent with their common meaning. Perrin v. United States, 444 U.S. 37, 42 (1979) ("A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning."). Merriam-Webster's online dictionary defines the term "motion picture" as "a series of pictures projected on a screen in rapid succession with objects shown in successive positions slightly changed so as to produce the optical effect of a continuous picture in which the objects move" and "a representation (as of a story) by means of motion pictures." It also defines the term "video tape" as "a movie, TV program, etc., that is recorded on videotape." It is our Office's view that a Subscription Package does not fall within the common meaning of the term "motion picture film" or "video tape." Further, the phrase "live or delayed television programming" in § 1.199-

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[2] Specifically, the Senate Report states that, while discussing provisions making depreciation rules more favorable to the film industry:

> The Committee understands that over the past decade, production of American film projects has moved to foreign locations. Specifically, in recent years, a number of foreign governments have offered tax and other incentives designed to entice production of U.S. motion pictures and television programs to their countries. These governments have recognized that the benefits of hosting such productions do not flow only to the film and television industry. These productions create broader economic effects, with revenues and jobs generated in a variety of other local businesses. Hotels, restaurants, catering companies, equipment rental facilities, transportation vendors, and many others benefit from these productions.

[3] Congress specifically did not intend to benefit the distribution of television signals. H.R. Rep. No. 108-755 n. 30 (2004) (Conf. Rep.), 2004 U.S.C.C.A.N. 1341 n. 30 (explaining that distribution activities do not affect whether taxpayer qualified for benefits); Staff of J. Comm. On Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress n.294 (Comm. Print 2005), JCS-5-05 (explaining the same). The proposed regulations under § 199 also clarify that film production activities do not include film transmission or distribution, including the transmission of a film by electronic signal and the activities facilitating such transmission (such as formatting that enables the film to be transmitted). Prop. Reg. § 1.199-3(k)(6), 80 FR 51978-01, 51989 (Aug. 27, 2015).

3(k)(1) refers to live television programming or delayed television programming. Both are types of programs that fall within the definition of the term “film.” However, a Subscription Package, as a whole, does not fall within the common meaning of either of those types of programs. Rather, only the individual films that were included in Taxpayer’s Subscription Packages satisfy the common meaning of film for § 199 purposes. Further, reading the common meaning of these terms to refer to a particular type of film, in the singular, is consistent with the statutory reference to § 168(f)(3). Thus, a Subscription Package, and the television channels upon which such films are simultaneously distributed, does not fall within the common meaning of any terms used to define qualified film for § 199 purposes.

Section 199 and the regulations thereunder, as well as the legislative history, require a qualified film to be an individual film, and not a package including multiple films like the Subscription Package. Consequently, Taxpayer cannot circumvent the statutorily prescribed mandate that only one individual film may be a qualified film for § 199 purposes.

B. Application of the other elements in the definition of the term “qualified film” in § 199(c)(6) and § 1.199-3(k)(1) supports analyzing films on an individual basis

Section 199(c)(6) provides, in part, that property is a qualified film if: (1) it is property described in § 168(f)(3); (2) at least 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; and (3) it is not property for which records are required to be maintained under 18 U.S.C. § 2257. Above, our Office explained why a Subscription Package is not property described in § 168(f)(3) and § 1.199-3(k)(1). Consideration of the other qualified film requirements makes clear that treating a Subscription Package as a qualified film is inconsistent with the statutory and regulatory scheme of § 199.

Taxpayer argues that a Subscription Package, as a whole, is a qualified film that meets the 50 percent compensation requirement because most of its activities with respect to a Subscription Package occur in the United States. At the same time, however, Taxpayer intends to exclude property described under 18 U.S.C. § 2257 on an individual, film-by-film, basis so that the inclusion of such property in the Subscription Package does not disqualify the entire package. Taxpayer’s position results in an inconsistent application of two statutory requirements found in the definition of qualified film. The failure to satisfy either element results in the exclusion of property from the definition of qualified film. Each element of § 199(c)(6) must be applied on an individual, film-by-film, basis.

Taxpayer also relies on § 1.199-3(d)(1) (the “item” rule) to further support its position that a Subscription Package is a qualified film, as long as Taxpayer can establish that it

meets the 50 percent compensation requirement on a Subscription Package basis. However, Taxpayer's position misconstrues the item rule. The item rule provides that the term "item" means the property offered by the taxpayer in the normal course of the taxpayer's business for disposition to customers, if the gross receipts from such disposition qualify as DGPR. Taxpayer argues that the rule implies that a Subscription Package can be a film, and even a qualified film, because Taxpayer disposed of the Subscription Package in the normal course of its business and the Subscription Package included films. The item rule provides only the basis for determining whether gross receipts are DPGR. It does not modify the statutory or regulatory definitions of qualified film. Thus, whether Taxpayer satisfies the 50 percent compensation requirement, or any other requirement of § 199, on a Subscription Package basis is immaterial because a Subscription Package is not a film. Consequently, a Subscription Package may not be the item under § 1.199-3(d)(1) because it does not satisfy the requirements of § 199(c)(6).

Issue 2: Whether the gross receipts Taxpayer derived from the disposition of its Subscription Packages qualify as DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(k)(3).

As explained above, a Subscription Package does not meet the statutory or regulatory definitions of the term "qualified film" because a Subscription Package is not a film. As a result, the gross receipts Taxpayer derived from its Subscription Packages were not derived from the disposition of a qualified film produced by Taxpayer. Thus, the gross receipts Taxpayer derived from its Subscription Packages are not DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(k)(3). Further, any gross receipts Taxpayer derived from non-qualifying services are non-DPGR.

Under § 1.199-3(d)(1)(ii), any component (in this case, any individual film) included in Taxpayer's Subscription Packages may be treated as an "item," provided the gross receipts from the disposition of the Subscription Packages that are attributable to the components qualify as DPGR. In this case, Taxpayer licensed nearly all of the television channels included in its Subscription Packages from unrelated third parties. These channels included the individual films that are the components of its Subscription Packages. Because Taxpayer licensed all of these films from unrelated third parties, Taxpayer cannot be considered to have produced any of these films within the meaning of § 1.199-3(k)(6). As a result, a significant portion of the gross receipts that Taxpayer derived from its Subscription Packages are attributable to films that were not produced by Taxpayer. Here, the facts indicate that Taxpayer only produced programs on channels that were included in its various Subscription Packages. Thus, it is appropriate to evaluate the individual films included in a Subscription Package to determine whether any one film is a qualified film produced by Taxpayer, and a potential item under § 1.199-3(d)(1)(ii).

For the gross receipts from any of these films to qualify as DPGR, Taxpayer must establish that an individual film meets the requirements of § 199(c)(6) and § 1.199-

3(k)(1) to be a qualified film (outlined above), and that Taxpayer produced the qualified film within the meaning of § 1.199-3(k)(6). Alternatively, Taxpayer may apply the safe harbor in § 1.199-3(k)(7) to determine whether a film may be treated as a qualified film under § 1.199-3(k)(1) and produced by Taxpayer under § 1.199-3(k)(6). In either case, Taxpayer's activities relating to the transmission of Signals and distribution of licensed television channels via Signals are not qualified film production activities for purposes of § 1.199-3(k)(6) or § 1.199-3(k)(7) because qualified film production activities are limited to those activities that result in the creation of property described in § 199(c)(6) and § 1.199-3(k)(1).

In conclusion, Taxpayer may be entitled to include as DPGR in its § 199 deduction calculation, gross receipts from the components of its Subscription Packages that Taxpayer can establish meet the definition of qualified film, and which were produced by Taxpayer, assuming all of the other requirements of § 199 are met for each component.

CAVEATS:

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