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Entertainment, Media and Communications Tax Newsletter

A summary of selected tax developments for clients of the firm

Technical topics in this issue:

IRS rules cable/satellite network programming package qualifies as a Section 199 item

In a major clarification of the Section 199 rules for the cable network and satellite television industries, the IRS has ruled that the licensing of a group of programs ("programming package") by cable or satellite companies is a Section 199 "item." As a result, if the programming package qualifies as film, any revenue derived from its license qualifies as domestic production gross receipts ("DPGR").

In TAM 201049029, the IRS National Office addressed whether the gross receipts derived by a taxpayer from licensing a programming package to customers in the normal course of business can qualify as DPGR under Section 199. Programming package for this purpose includes programs produced by the taxpayer or by third parties, commercial advertisements, and interstitials.

The taxpayer in the TAM operated multiple cable/satellite networks ("cable networks") and a domestic broadcast television network ("broadcast network") and owned and operated domestic television stations (collectively "networks"). The taxpayer treated its networks as licensing programming packages to its customers in the normal course of business and treated each programming package as a qualified film produced by the taxpayer under Section 199. Accordingly, the taxpayer treated its gross receipts derived from the license by such networks that were attributable to the taxpayer's self-produced programs, as well as programs produced by third parties, as DPGR.

The IRS Large Business & International division (known as the Large & Mid-Size Business ["LMSB"] division at the time the TAM was issued) did not challenge the taxpayer's classification of gross receipts from self-produced programming as DPGR, but did challenge such classification with respect to programming produced by third parties that were included within the taxpayer's programming packages.

LMSB also challenged whether the "item" being offered for license by the taxpayer's broadcast network was the programming package. Specifically, LMSB questioned whether the broadcast network was licensing a programming package to its customers or was licensing each individual show within such programming package, such that only the gross receipts attributable to taxpayer-produced programming qualified as DPGR.

The IRS National Office confirmed that a programming package that was licensed to customers in the normal course of a taxpayer's business constituted the "item" for purposes of determining whether all Section 199 requirements have been satisfied. In support of this conclusion, the IRS National Office stated:

> [I]t is consistent to test a Programming Package offered by Taxpayer to customers in the normal course of business as a single qualified film (i.e., in the aggregate) for purposes of § 199(c)(6), because other property that consists of multiple properties is tested as a single property for purposes of § 199. This is true regardless of the fact that a Programming Package, the property offered in this case, includes multiple films of which some are Taxpayer produced films and some are third-party produced films.

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Accordingly, if such programming package constitutes a qualified film under Section 199, then any revenue, e.g. network compensation, advertising income, and product-placement income, derived by the taxpayer from the license of such programming package constitutes DPGR, without regard to whether the related programming was produced by the taxpayer or a third party.

The IRS National Office noted in the TAM that it did not resolve LMSB's factual disagreement with the taxpayer as to whether the taxpayer's broadcast network was a license of one collective programming package or the license of each individual program. Instead, the IRS National Office stated that if it is determined that the taxpayer's broadcast network is licensing a programming package to its customers, then its analysis in TAM 201049029 would be applicable to such broadcast network.

India high court issues favorable tax decision for foreign satellite operator

In a recent development, the Delhi High Court held that payments received by Asia Satellite Telecommunications Co. Ltd. ("AsiaSat"), a foreign satellite operator, from its customers outside of India for the provision of transponder capacity cannot be characterized as a royalty under the Indian Income Tax Act, 1961 ("Act").

This is a landmark decision ─ the first time an Indian high court has addressed the taxability of payments made by television channels and communications companies to satellite operators and other connectivity service providers, which has been a matter of controversy for many years. The case is likely to be appealed by the Income Tax Department (Government) to the Indian Supreme Court.

Background: AsiaSat, a Hong Kong-based company, is engaged in the business of providing data and video transmission services to customers. The company operates satellites in geostationary orbit 36,000 kilometers above the equator.

In the transmission chain, AsiaSat's customers outside of India typically uplink signals carrying data and programs to a transponder on one of AsiaSat's satellites. Once these signals reach the transponder, they are down-linked over the area covered by the satellite, i.e., the satellite's "footprint." The satellite footprint includes India, among other countries. By availing services from AsiaSat, customers are able to relay their signals to a wide geographical area.

To provide these transmission services, AsiaSat uses its own assets and infrastructure comprising the satellite and a control center, all of which are located outside of India. Furthermore, these assets (including the satellite) are controlled, operated, and maintained by the company from outside of India.

The Government first assessed an income tax against AsiaSat for the 1997-98 tax year. The assessing officer held the company to be taxable in India on the basis that it has a business connection in India. On appeal, the tax commissioner held that the company does not have a business connection in India. However, the commissioner held that the revenues earned by the company from its customers outside India are taxable as royalties under section 9(1)(vi) of the Act. On further appeal, the Tax Tribunal upheld the findings of the commissioner. Subsequently, both AsiaSat and the Income Tax Department appealed to the Delhi High Court.

(Note that since India and Hong Kong do not have an income tax treaty, the decision in this case was based on an analysis of domestic Indian law. The analysis may have been different had there been a tax treaty.)

AsiaSat's position:

- AsiaSat does not have any office, employees, machinery, or equipment in India. Hence, in the absence of any business operations in India, it has no business connection under section 9(1)(i) of the Act.
- The consideration received by the company from its customers represents payment for services only. As such, the consideration cannot be characterized as a royalty.
- The receipts do not constitute consideration for the use or right to use any process or equipment. AsiaSat uses its process, equipment, and satellite itself in the course of rendering transmission services.
- AsiaSat has complete control over the operation of its satellites and the processes involved therein. Accordingly, no right to use is granted by the satellite company to its customers for the income to qualify as a royalty.

- The transponder is not severable from the satellite and cannot function without the continuous support of various other systems and components of the satellite. Hence, control and possession of the transponder cannot be handed over to the company's customers.

- Not every process would fall within the definition of a royalty. Even if it is assumed that a right-to-use a process has been granted by AsiaSat to its customers, this right must be in relation to a secret process for it to qualify as a royalty. Since satellite technology is available in the public domain, there is nothing secret about it; hence the payment cannot be a royalty.

Government's position:

- AsiaSat was making available the signals owned by its customers in the footprint including India for the consumption of end users in India. Since the company was making available footprints in India, there was a direct business connection in India.

- The essence of the agreements between AsiaSat and its customers is the use of AsiaSat's transponders and the processes embedded therein to relay customers' programs to India.

- The customer is granted an exclusive right to use the transponder and the process embedded therein for the purpose of uplinking and downlinking its signals in the footprint area including India.

- Physical control is neither necessary nor warranted in the present context. However, the effective control of the use of the transponder is with the customers. Accordingly, the income is in the nature of a royalty.

High court conclusions:

- The Government's contention that AsiaSat has a business connection in India because its footprint area includes India and end users are viewing the programs of AsiaSat's customers in India is not tenable. No business activity of the company is being carried out in India so as to tax it under section 9(1)(i) of the Act.

- The transponder is an inseparable part of a satellite and is incapable of functioning on its own. The process in the transponder of receiving and retransmitting signals is inseparable from the process of the satellite.

- The substance of the agreement between AsiaSat and its customers is not to grant any right to use, since the entire control of the satellite and transponder remains with the company. Thus, the revenues earned by AsiaSat cannot be said to be for the use of a process or equipment by its customers. The business of the satellite company is to provide transmission services. In the course of providing these services, the satellite company does not provide any asset or process on either a use or right-to-use basis to its customers.

- The court did not adjudicate whether the process needs to be secret before it can qualify as royalty, since AsiaSat has not given a use / right to use to its customers.

- The high court also indicated that (a) the substance of the agreement would need to be analyzed and the use of the terms "lease of the transponder capacity," "lessor," "lessee," and "rental" would not be determinative factors, and (b) the transponder is not an item of equipment in and of itself.

- The court relied on a decision in another case of the Authority for Advance Rulings (ISRO Satellite Center), which held that income of a satellite company is from provision of services and is not for granting any process or equipment on a use or right-to-use basis to its customers. While the transponder usage by the customer in ISRO was passive and the transponder usage by the customer in AsiaSat's case is active, the court did not consider this difference to be material.

An important aspect of this case is that the court did not decide or analyze whether the payments would qualify as fees for technical services under the Act, although arguments on this point had been touched upon by both AsiaSat and the Government.

Conclusion:

The decision of the Delhi High Court will have a significant impact on taxability of revenues earned by satellite operators and other connectivity service providers (such as undersea cable companies) under the Act and also under the Direct Taxes Code Bill, 2010, which is slated to replace the Act effective April 1, 2012 (and wherein the definitions of "royalty" and "fees for technical services" have been further widened).

Companies providing these communications transmission services would be well advised to analyze their contracts and business relationships in light of this decision. Documentation of favorable business practices and relationships may be warranted, especially since litigation at various appellate levels in India over the tax treatment of communications transmission income is likely to continue.

Final regulations issued on electing capital asset treatment for self-created musical works

The IRS has published final regulations (T.D. 9514), effective February 7, 2011, that describe how and when an individual may elect to treat as capital gain, rather than ordinary income, any income received from the sale or exchange of musical compositions or copyrights in musical works created by the individual. The final regulations adopt, with minor changes, proposed regulations published in February 2008.

Background:

IRC Code Section 1221(a) generally provides that capital assets include all property held by a taxpayer with certain specified exclusions. Section 1221(a)(1) excludes from the definition of a capital asset inventory property or property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Section 1221(a)(3) excludes from the definition of a capital asset certain property — a copyright; a literary, musical, or artistic composition; a letter or memorandum; or similar property — held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of such property in the hands of the taxpayer whose personal efforts created the property).

Section 1221(b)(3), added by the Tax Increase Prevention and Reconciliation Act of 2005 and amended by the Tax Relief and Health Care Act of 2006, provides an election so that the section 1221(a)(1) and (a)(3) exclusions from capital asset status would not apply to a musical composition or a copyright in a musical work sold or exchanged by a taxpayer described in section 1221(a)(3).

As a result, an individual may elect to treat gains or losses from such sales or exchanges either as capital gains or losses, taxed at a 15% capital gains rate, or as ordinary income.

Time and manner for making the election:

The election is made separately for each musical composition (or copyright in a musical work) sold or exchanged during the taxable year, for each tax year beginning after May 17, 2006. An election must be made on or before the due date (including extensions) of the income tax return for the taxable year of the sale or exchange. The election is made on Schedule D, "Capital Gains and Losses," of the appropriate income tax form (for example, Form 1040, Form 1065, or Form 1120) by treating the sale or exchange as the sale or exchange of a capital asset.

The election is revocable with the consent of the Commissioner. To seek consent to revoke the election, a taxpayer must submit a request for a letter ruling. Alternatively, an automatic extension of six months from the due date of the taxpayer's income tax return (excluding extensions) is granted to revoke the election, provided the taxpayer's income tax return was timely filed and, within this six-month extension period, the taxpayer files an amended income tax return that treats the sale or exchange as the sale or exchange of property that is not a capital asset.

Recommended reading:

Annual Global CEO Survey
http://www.pwc.com/gx/en/ceo-survey/index.jhtml

Consumer Intelligence Series
http://www.pwc.com/us/en/industry/entertainment-media/publications/consumer-intelligence-series.jhtml

Communications Review: A journal for telecom, cable, satellite, and Internet executives
www.pwc.com/communicationsreview

EMC Perspectives: Technical accounting guidance for entertainment and media companies;

- Film-financing and passive investor arrangements (Volume 1)
- Revenue recognition matters unique to the motion picture industry (Volume 2)
- Filmed entertainment: Cost capitalization, amortization, and impairment (Volume 3)

www.pwc.com/emcperspectives

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- Preparing your first IFRS financial statement: Adopting IFRS

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10 Minutes on international tax increases
www.pwc.com/us/en/10minutes/index.jhtml