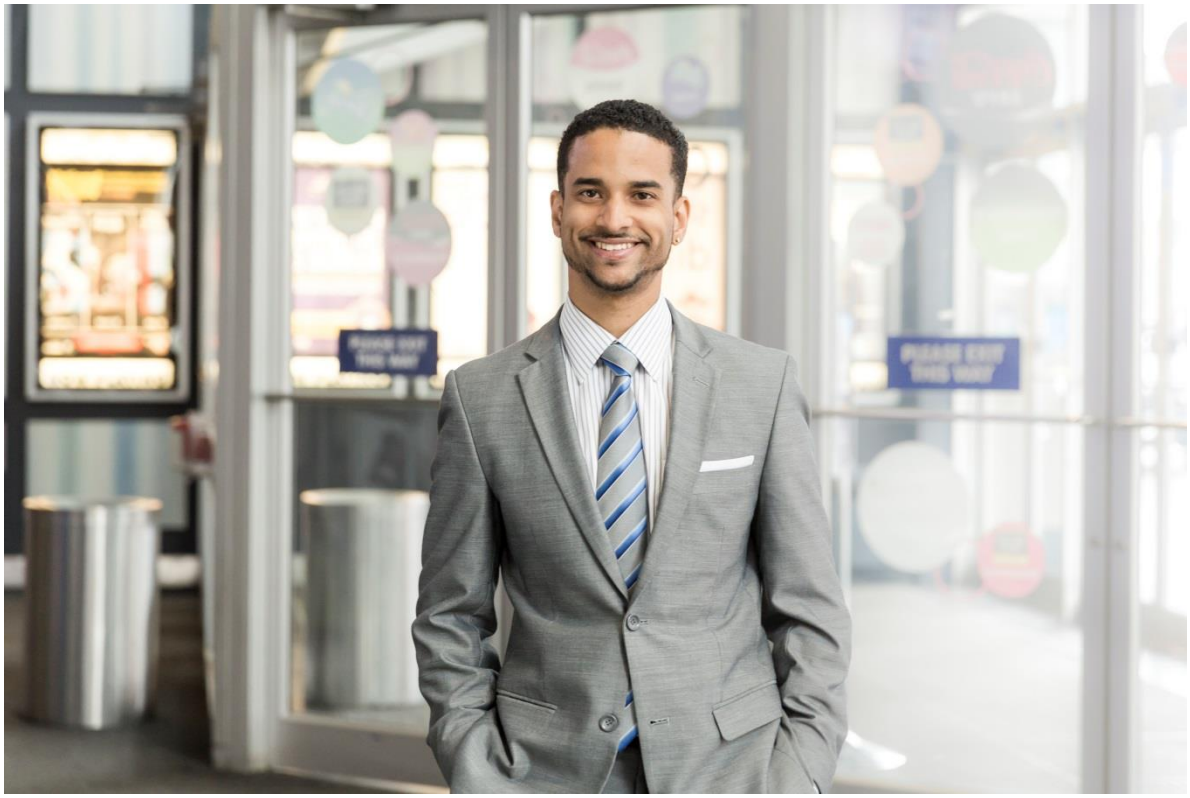
Entertainment, Media, and Communications Tax Newsletter/ Volume 20/December 2013

In focus



New developments in the continuing controversy surrounding the benefits & burdens determination under Section 199. How New York State and New York City tax regimes are adding complexity to communications companies. More court guidance on long-standing issue of goodwill in station swaps.

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Tax Court and IRS provide new guidance on controversial Section 199 benefits and burdens issue

The US Tax Court has released its long-awaited decision in *ADVO v. Commissioner*, 141 T.C. No. 9 (2013). In ADVO, the court addressed for the first time how Section 199 applies to taxpayers that manufacture products through agreements with contract manufacturers. The court held in favor of the IRS and disallowed the Section 199 deduction claimed by ADVO with respect to income derived from certain advertising materials. The IRS also released an updated Industry Director Directive providing guidance to examiners for use in determining whether a taxpayer has the

benefits and burdens (B&B) of ownership for federal income tax purposes. Under the directive, an examiner should not challenge a taxpayer that meets the specified requirements of the directive.

In detail

Background

Since the enactment of Section 199 in 2004, the determination of which taxpayer has the B&B in a contract manufacturing arrangement has been the subject of frequent controversy between taxpayers and the IRS. The regulations do not supply a list of factors to consider in applying the B&B test, but they include two examples that illustrate the application of the facts and circumstances determination. These examples highlight several factors for determining which taxpayer to a contract possesses the B&B, including an express restriction on the unrelated party's use of the property, retention of control over the development process of the property by the taxpayer, who retains legal title to the property during the manufacturing process, and who bears the risk of loss or damage during the manufacturing process.

" The determination of B&B has been one of the most difficult and controversial areas of Section 199, primarily due to the potential for IRS 'whipsaw,' in which both parties to a contract manufacturing agreement seek to claim the Section 199 deduction with respect to the same qualifying activity."

In February 2012, the commissioner of the IRS Large Business and International Division (LB&I) issued IRS LB&I Directive LB&I-04-0112-001, providing examiners a three-step process emphasizing nine factors for use in determining whether a taxpayer had the B&B in a contract manufacturing agreement. In July 2013, the LB&I commissioner issued IRS LB&I Directive LB&I-04-0713-006, instructing examiners not to challenge a taxpayer's claim that it has the B&B if that taxpayer provides a statement explaining why the taxpayer qualifies and provides a certification executed by each party designating which party will claim, and not claim, the Section 199 deduction. In addition, on October 29, 2013, the LB&I commissioner issued another LB&I Directive, LB&I-04-1013-008, which modified the July 2013 LB&I Directive by revising certain procedural aspects of the July 2013 that may make the LB&I Directive easier for taxpayers to avail themselves of.

The *ADVO* decision

ADVO Inc. is a direct mail advertising company which engages in the distribution of advertising material, referred to as solo direct mail and shared mail packages, distributed through the US Postal Service to residential recipients. ADVO's shared mail packages consist of individual printed wraps, inserts, and a detached address label combined into a single delivery mechanism. In varying degrees, ADVO's graphics print department assists its customers with the design of advertisement graphics, which are supplied solely by ADVO or directly by customers. After an advertisement is complete, ADVO's graphics print coordinators (GPCs) send the PDF files containing the artwork to one of ADVO's contract printers to print. When the printed materials are received back, ADVO uses a machine to wrap and prepare the materials for mailing.

The IRS challenged the Section 199 deduction claimed by ADVO with respect to income derived from this advertising material. The central issue to be decided in this case was whether ADVO or the contract printers had the benefits and burdens of ownership, for federal income tax purposes (B&B), of the advertising materials during the printing process. In its analysis, the court used a list of nine factors to determine whether ADVO had the B&B of the advertising materials. These factors, which are based on *Grodt & McKay v. Commissioner*, 77 T.C. 1221 (1981), Section 936, and an example in the Section 199 regulations, reflect the court's opinion that the holdings in cases decided under Section 263A are not binding for purposes of Section 199. The non-exclusive list of factors includes the following:

1. Legal title to the goods
2. Intention of the parties
3. Equity (at-risk) interest in the property
4. Creation of a present obligation
5. Right of possession and control
6. Payment of property taxes
7. Risk of loss or damage
8. Profits from operation and sale
9. Active and extensive participation in the management and operations of the activity

Based upon an analysis of the above factors, the court held that ADVO did not have the B&B of the printed materials while the advertising material was being printed. Prospectively, it is anticipated that the IRS will begin to examine contract manufacturing arrangements using, at a minimum, the B&B factors analyzed by the *ADVO* court. For now, the LB&I's updated Directive provides guidance to examiners for use in determining whether a taxpayer has the B&B of ownership under federal income tax principles, of qualifying production property, qualified films, or utilities produced under a contract manufacturing arrangement.

The takeaway

The determination of B&B has been one of the most difficult and controversial areas of Section 199, primarily due to the potential for IRS 'whipsaw,' in which both parties to a contract manufacturing agreement seek to claim the Section 199 deduction with respect to the same qualifying activity. Both the *ADVO* decision and the Directive provide further guidance on this historically controversial Section 199 issue. Taxpayers that currently are claiming a Section 199 deduction for production activities performed pursuant to a contract manufacturing arrangement should review the *ADVO* decision to determine the extent to which the facts of the case align with their particular circumstances. Taxpayers engaging in such B&B analysis should also consider the updated Directive in tandem with the *ADVO* decision.

Complexity drives state and local taxation of communications companies

Communications companies are no strangers to complexity, whether in regulation, technology, customer demands, or taxation. The most obvious is the ever-changing and fast-growing technology that drives the industry and its plethora of new products and services. Communications companies, however, must also navigate through an intricate set of state and local taxes. Perhaps no state adds more complexity to the taxation of communications companies than New York. Both New York State (NYS) and New York City (NYC) impose tax regimes that can be just as confusing as the technology underlying the industry.

Overview

"As more companies have begun providing some version of communications services, the inequities of tax administration become more apparent. These complexities and burdens are exemplified by the tax regimes in NYS and NYC."

In 2004, the Council on State Taxation (COST) analyzed the tax burdens placed on communications companies, documenting the inequity of state taxation systems on communications service providers as compared with those for general business corporations. The study highlighted the complex and burdensome nature of state communications excise taxes and found that the state and local effective transactional tax rate for communications companies was 14.17%; compared with 6.12% for general business corporations.

In addition, the study showed that there were almost three times as many taxes for communications services (344) as there were for general businesses (123). Compared with general business corporations, communications companies have over 6,500 more taxing jurisdictions with which to contend — communications companies have exposure to approximately 13,879 jurisdictions, while general business corporations are exposed to approximately 7,196 jurisdictions — and almost 48,000 returns to prepare, compared with the approximately 7,500 returns for general businesses.

As more companies have begun providing some version of communications services, the inequities of tax administration become more apparent. These complexities and burdens are exemplified by the tax regimes in NYS and NYC.

NYS income tax

General business corporations doing business in New York normally file under Article 9A of the New York Tax Law (Article 9A) and file Form CT-3, *General Business Franchise Tax Return*. If the general business corporation also does business in the Metropolitan Commuter Transportation District (MCTD), that is, counties in and around New York City, it must also file Form CT-3M/4M*, General Business Corporation MTA Surcharge Return*.

Corporations principally engaged in a telegraph or telephone business, however, are subject to tax under Article 9 of the New York Tax Law (Article 9), instead of Article 9A.

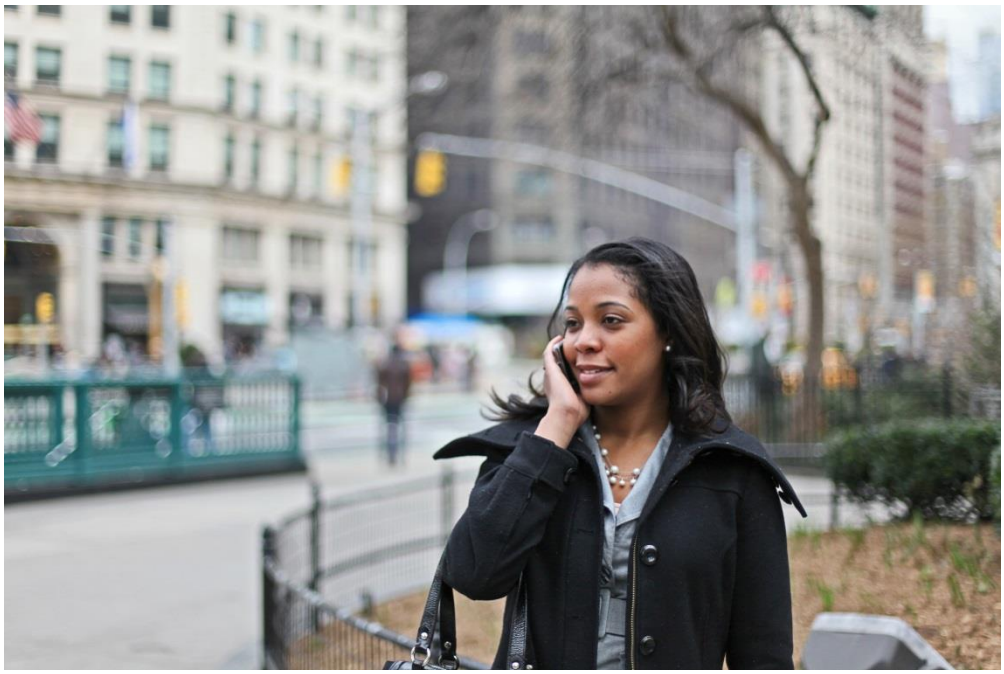
How does a company with communications business activities determine which article applies?

A corporation is considered to be principally engaged in a business from which more than 50 percent of its receipts are derived (the 50 percent test). This is an annual test, and the term “receipts” means gross receipts. Therefore, to determine whether a corporation is required to file under Article 9A or Article 9, a corporation must compare its Article 9 gross receipts to its total gross receipts. If the corporation's Article 9 gross receipts are more than 50 percent of its total gross receipts, then the corporation is classified as an Article 9 corporation rather than an Article 9A corporation.

If it is an Article 9 corporation, the communications company does not file a Form CT-3; instead, an Article 9 corporation pays the tax imposed under section 183 of the New York Tax Law and files Form CT-183, Transportation and Transmission Corporation Franchise Tax Return on Capital Stock. If the corporation does business in the MCTD, the corporation must also pay a surcharge on the tax and file Form CT-183-M, Transportation and Transmission Corporation MTA Surcharge Return.

Why does the classification matter?

Communications companies filing under Article 9 are not eligible to be included in a NYS combined group, and any losses cannot be captured as a net operating loss (NOL). If the company is in an income position and utilizes a NOL for federal purposes, due to the NYS NOL rules, that NOL cannot be utilized for NYS purposes for that year, and the NOL attributed to that year for federal purposes is effectively lost for NYS purposes.



In addition, if the communications company is formed for or "principally engaged" (i.e., the 50 percent test) in local telephone business, then the company is also subject to section 184 of the New York Tax Law and must file Form CT-184, *Transportation and Transmission Corporation Franchise Tax Return on Gross Earnings*. A local telephone business is defined as the provisioning or furnishing of telecommunications services for hire, where the service consists of carrier access service or the service originates and terminates within the same local access and transport area. If the corporation does business in the MCTD, the corporation must also pay a surcharge on the tax and file Form CT-184-M, *Transportation and Transmission Corporation MTA Surcharge Return*.

NYS utility excise tax

To make matters even more difficult, New York State imposes a separate utility excise tax under section 186-e of the New York Tax Law (Section 186-e). This transaction tax applies to all businesses, including partnerships and disregarded entities that are providing telecommunications services. Even if the business does not meet the 50 percent test (i.e., Article 9A filer), Section 186-e still applies to the business's telecommunications gross receipts.

As a transaction tax, the sourcing of each transaction is essential. Generally, Section 186-e employs the two out of three rule (that is, the Goldberg rule, stating that all calls have an origination point, a termination point, and a service address point, and that the call can be sourced to the state in which two out of three of these points are

located) for retail calls, the primary place of use for mobile, and a 50/50 split for private line service that originate or terminate in NYS (100% if both points are in NYS and 0% if neither point is in NYS). Each service offering must be analyzed to determine the correct methodology of sourcing.

Businesses providing telecommunications services that can be allocated to NYS file Form CT-186-E, Telecommunications Tax Return and Utility Services Tax Return. If the business does business in the MCTD, the business must also pay a surcharge on the tax. (Note: Telecommunications companies are also subject to Section 186-a of the New York Tax Law on certain non-telecommunications services; Section 186-a taxes are also reported on Form CT-186-E.)

Caution

Taxes under Section 186-e are imposed on the communications company and not the customer; therefore, when the communications company charges these taxes on its customer's invoices as a discretionary pass-through, the amount collected is considered additional revenue to the company.

NYC utility taxes

"Confusion is often created when the excise tax under Section 186-e is compared to the sales tax on telecommunications services. Unlike Section 186-e, the sales tax is a tax on the customer, and the company is responsible for the collection and remittance of such tax."

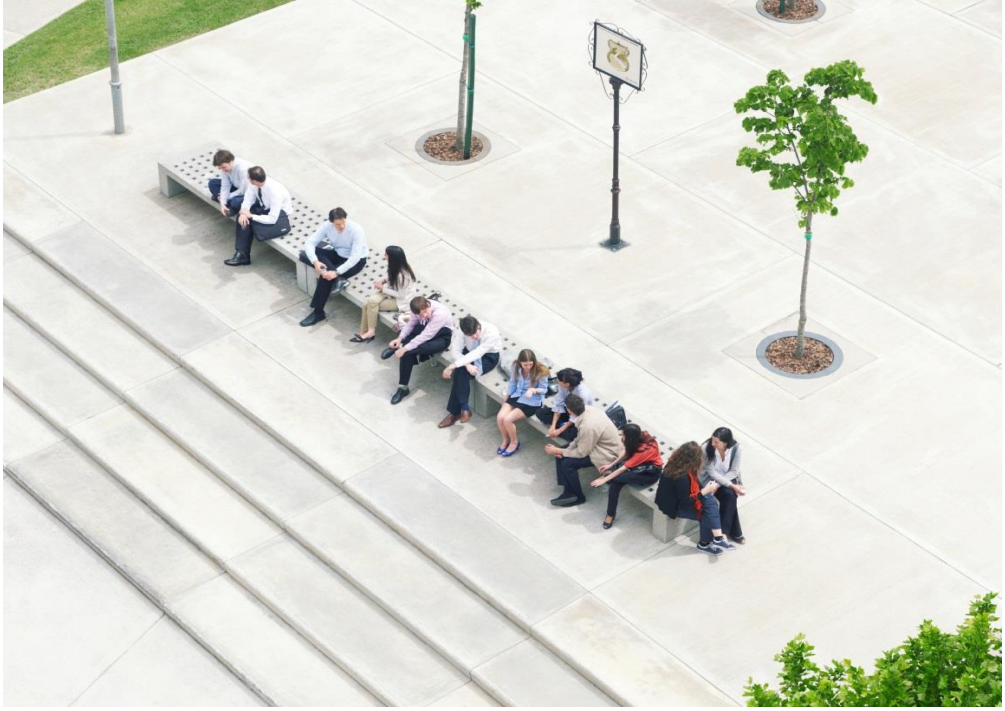
A company doing business in NYS will also often be doing business in NYC. A general business corporation normally files under the General Corporation Tax (GCT) or, if the company is not incorporated, under the Unincorporated Business Tax (UBT). NYC provides for a classification methodology for a company providing communications services, but such classification is different from that of NYS. In NYC, a company providing the telecommunications services can be classified as either a Class 1 utility or a vendor of utility services.

A Class 1 utility is defined as any person subject to the supervision of the department of public service (DPS), and it pays tax on its gross receipts, which generally means all receipts received in or by reason of any sale made or service rendered in NYC without deduction for any cost or expense. The Class I utility is not subject to either the GCT or the UBT, and files its return on Form NYC-UXP, *NYC Return of Excise Tax by Utilities*. A Class I utility is typically one of the well-established communications companies; these companies would typically also file under Article 9 for NYS purposes.

A vendor of utility services (also referred to as a Class II utility) is generally every person not subject to the supervision of the DPS who furnishes or sells telecommunications services. A vendor of utility services is still registered with the DPS and monitored, but is subject to much less scrutiny than a Class I utility. There is no 50 percent test on a vendor of utility services; rather (and more similar to Section 186-e), vendors of utility services pay the utility tax on gross operating income, which generally means receipts received in or by reason of any sale made or service rendered. The tax is due on whatever telecommunications receipts are present. Vendors of utility services file Form NYC-UXS, *Return of Excise Tax by Vendors of Utility Services*. Unlike the Class I utilities, the vendor of utility services must also file either the GCT or the UBT return; however, the taxpayer will receive a credit (although not necessarily dollar for dollar) on its respective GCT or UBT return for the tax paid on its Form NYC-UXS.

Important impact on income tax combination

This credit mechanism creates an interesting departure from the treatment of communications companies in NYS. As stated previously, in NYS, the combined group does not include an Article 9 company; instead, the Article 9 company is included as subsidiary to the combined group. In NYC, though, all the communications companies, if qualified under the combination rules, would be part of the NYC combined group, with the group simply receiving a credit for the utility taxes paid. Those filing in NYS and NYC on a combined basis can attest to the added complexities where the NYS group is different from the NYC group, both of which could be different from the federal consolidated group.



As NYC utility taxes are transactional taxes, it is vital to understand how to allocate the transactions to NYC. For both Class I utilities and vendors of utility services, the sourcing methodology is the same: the utility tax may not be imposed upon the gross income from any transaction originating or consummated outside of the territorial limits of NYC. This is different from the sourcing imposed under Section 186-e, and it can create considerable confusion for taxpayers new to NYS and NYC.

NYS/NYC sales and use taxes

NYS imposes a statewide sales tax on sales of interstate telecommunications services. The liability for the tax rests upon the consumer, who cannot shift the liability for payment to another person. The NYS sales tax applies to the company's sales of telecommunications services, other than for resale, and is charged at a rate that includes both NYC and local impositions. If the activity is in NYC, the rate would include NYS, NYC, and the MTA surcharge for services sold within the MCTD. The rates vary, depending on the location of the services.

Confusion is often created when the excise tax under Section 186-e is compared to the sales tax on telecommunications services. Unlike Section 186-e, the sales tax is a tax on the customer, and the company is responsible for the collection and remittance of such tax. Thus, the sales tax is a trust tax, and when collected it is treated as a liability to the state rather than as additional revenue from the taxes collected under Section 186-e. In addition, sales taxes on telecommunications services are imposed on intrastate telecommunications services only, while the taxes under Section 186-e are imposed on intrastate, interstate, and international telecommunications receipts.

Companies can avoid complications by understanding the various taxes that can be imposed on telecommunications services and their respective presentation on an invoice

Conclusion

Communications companies doing business in NYS and NYC need to be aware of the extra complexities they face with their tax exposure and administrative burdens, versus doing business in other jurisdictions. In addition to the taxes discussed herein, there are also a variety of local taxes and fees that apply to communications companies, including the federal and state Universal Service Funds, local utility taxes, E911 fees, and unique property taxes. These taxes all create great confusion and frustration for unsuspecting communications services providers. When navigating the intricacies of NYS and NYC, it is important to understand that they are two separate jurisdictions with two different tax regimes and analyze each tax requirement carefully.

Claims Court finds no transfer of goodwill in radio station like-kind exchange

In brief

In *Deseret Management Corp. v. United States*, Fed. Cl., No. 1:09-cv-00273-FMA (7/31/2013), the US Court of Federal Claims held that no appreciable goodwill was transferred in an exchange of two radio stations for purposes of the like-kind exchange provisions under Section 1031.

In detail

" In the case of transactions involving television and radio station swaps, there is often the issue of the exchange of underlying intangible assets. These intangible assets include, among other things, the FCC licenses, any network affiliation agreements, going concern, and goodwill."

Background

With the passage of the Telecommunications Act of 1996, Pub. L. 104-04, Congress significantly relaxed the radio and television station ownership regulations. This relaxation paved the way for many consolidations within the radio industry, as companies either acquired competitors or traded stations in one market to acquire stations in another. The latter scenario, a so-called 'station swap,' is at issue in the current case.

Section 1031(a)(1) provides generally that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. In addition, Section 1031(b) provides in relevant part that if money or unqualified property is received in an otherwise qualifying like-kind exchange, then the gain, if any, shall be recognized in an amount not to exceed the sum of such money and the fair market value of such unqualified property.

In the case of transactions involving television and radio station swaps, there is often the issue of the exchange of underlying intangible assets. These intangible assets include, among other things, the FCC licenses, any network affiliation agreements, going concern, and goodwill. While the exchange of FCC licenses and the exchange of network affiliation agreements qualify as like-kind assets, exchanges of goodwill or going concern value do not qualify as like-kind assets under Treas. Reg. Sec. 1.1031(a)-2(c)(2).

Historically, many taxpayers have taken the position that the exchange of television or radio station intangibles under Section 1031 are exchanges of like-kind assets, because broadcast stations have no goodwill separate from the value of the FCC license.

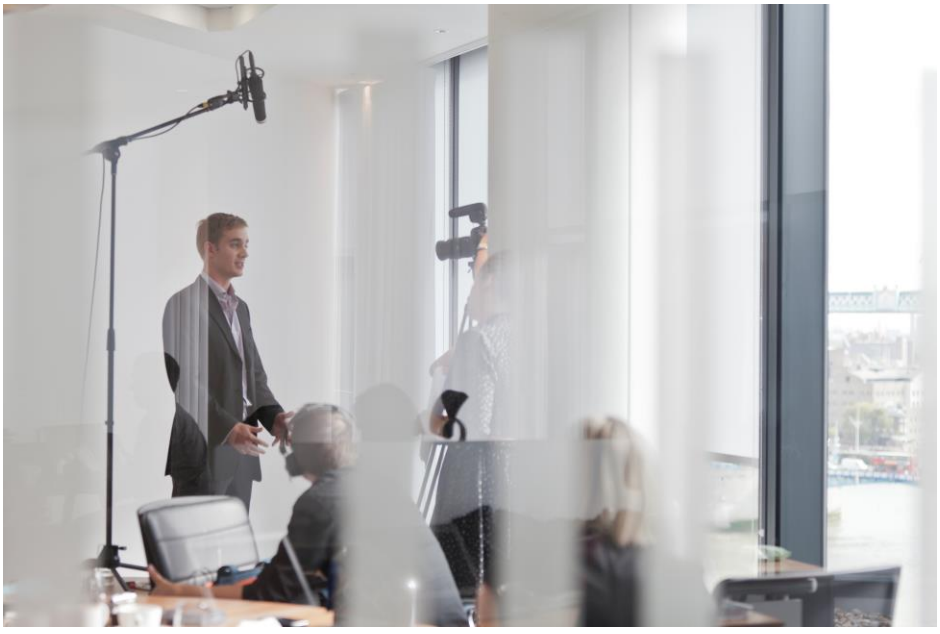
The IRS takes a different view; it has previously provided guidance on how the going concern and goodwill should be treated in the case of the media industry. For example, in its revised Coordinated Issue Paper, *Like-Kind Exchanges Involving Federal Communications Commission Licenses*, April 3, 2007, the IRS concluded that: the exchange of an FCC license of a radio station for an FCC license of a television station was a like-kind exchange subject to the nonrecognition rules under Section 1031; the network affiliation agreement and any claimed ability to affiliate should be valued separately from the FCC license under Section 1031; and goodwill should be valued separately from the FCC license under Section 1031. Similar issues are addressed here in the *Deseret* case.

The *Deseret* decision
KZLA was a Los Angeles radio station acquired by subsidiaries of Deseret Management Corporation (Deseret) in 1998. KZLA was the only country FM station in the city at the time. From 1998 to 2000, Deseret's subsidiaries owned and operated the radio station but achieved less than desirable success in the market. KZLA's revenue declined from $17.25 million in 1998 to $16.4 million in 2000, at a time when the Los Angeles market was experiencing an annual 12 percent increase in revenue, on average.

In 2000, Deseret entered into an agreement to transfer the assets of KZLA to Emmis Communications in exchange for four St. Louis radio stations in a transaction that otherwise qualified as a like-kind exchange for purposes of Section 1031. The agreement valued KZLA at $185 million, most of which consisted of the value of its Federal Communications Commission (FCC) license (according to Deseret's valuation). As stated above, under the like-kind exchange provisions of Section 1031, a taxpayer must recognize gain to the extent of fair market value of any nonqualifying property exchanged, including goodwill. Deseret argued that KZLA contained no appreciable goodwill, while the IRS argued that the FCC license was overvalued and nearly $75 million of goodwill was involved, resulting in additional tax due on the exchange. KZLA benefited from some competitive advantages due to its licenses. There were 40 FM radio stations licensed to be broadcast in Los Angeles, but only 14 were licensed (including KZLA) to transmit from antennas located on Mt. Wilson, which is the highest peak near Los Angeles and allows more broadcast coverage of FM signals. KZLA also enjoyed the advantage of being one of 17 grandfathered FM stations exempt from FCC restrictions that limit the amount of power used to broadcast signals from elevated antenna locations.

In its analysis of whether KZLA's value included goodwill, the Court of Federal Claims first looked at the definition of goodwill. Because goodwill is not defined in Section 1031 or its regulations, the court looked to Section 197, which defines goodwill as "the value of a trade or business attributable to the expectancy of continued customer patronage" under Reg. Sec. 1.197-2(b)(1).

The court then considered prior case law involving broadcast stations to evaluate both the qualitative and quantitative aspects of goodwill. The court disagreed with the taxpayer that broadcast stations such as KZLA can *never* possess any goodwill. The court found a few qualitative indications that KZLA may have possessed some goodwill, although far less than other stations. For example, the court explained that there was likely to be some loyalty from listeners and advertisers because KZLA was the only country FM station in Los Angeles, even though its 'brand depth' and 'music image' were underdeveloped.



To determine whether the goodwill was appreciable, the court then looked at quantitative evidence. The court looked for whether there was "some residual cost over the fair value of the identifiable net assets acquired." While the taxpayer did not find any goodwill in KZLA, the IRS's expert used a discounted cash flow method to determine the value of the license and goodwill. However, the court was not convinced that the IRS's expert opinion was reliable, because the calculations were adjusted multiple times due to errors, and the assumptions were questionable. Additionally, if the method was completely corrected for all errors, the court determined it would have yielded a value for KZLA's goodwill of below zero. In conclusion, the court found that because there was no dispute that KZLA was valued at $185 million and that value lay almost exclusively in its FCC license, the value of any goodwill remaining would be 'negligible and insignificant.

The takeaway

Although the court in this case found in favor of Deseret, it should be noted that the ruling is not entirely taxpayer friendly. As was the case in Deseret's valuation, the residual method is often used to assign value to an FCC license in a station swap. In order to support this valuation method, taxpayers have argued, among other things, that the value of the intangibles should be included in the value of the FCC license (e.g., the FCC license is similar to the McDonald's franchise in *Canterbury v. Commissioner*, 99 T.C. 233 [1992]) or, as the taxpayer argued here, that broadcast stations *per se* have no goodwill.

The court here dismisses the taxpayer's argument and refuses to create a bright line rule in determining when a radio station would have goodwill for federal income tax purposes. As a result, the use of the residual method in determining the value of the FCC license in a station swap is undermined. Consequently, taxpayers will have to continue to determine the value of radio station goodwill in like-kind exchanges circumstances, on a case-by-case basis.

Let's talk

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