Entertainment, Media and Communications Tax Newsletter

A PwC Industry Publication

December 2011

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Online gambling may soon be coming to a state near you — a look ahead at what tax issues may follow

The allure of online gambling goes well beyond a gambler's hope for easy cash from a quick win — many states are looking into how online gambling might solve a myriad of budget woes. As the topic of online gambling continues to color newspaper headlines, the challenges of legalizing, regulating, and taxing online gambling have been brought into focus.

Online gambling is, in effect, the Internet version of the land-based gambling industry, which generally can be segregated into four groups: (1) sports betting; (2) casino games, such as blackjack or roulette; (3) poker; and (4) bingo and other games. Online gambling uses online payment providers that transfer funds through a credit card or e-wallet. The e-wallet can aggregate funds through various methods including electronic check, wire transfer, credit card, or cash deposit. Wagers are tabulated as they are withdrawn and winnings as they are deposited into an account. Additionally, players can withdraw funds from the account through various methods, including the payment provider's ATM cards.

Current federal prohibition

The Interstate Wire Act of 1961 (Wire Act) imposes penalties on persons engaged in the business of betting or wagering who knowingly use interstate or foreign wire communications for the purpose of transmitting gambling-related information. The Unlawful Internet Gambling and Enforcement Act of 2006 (UIGEA) prohibits the transfer of funds from a financial institution to an Internet gambling site.

In addition, while the Federal Bureau of Investigation ("FBI") has determined that some free online games (e.g., fantasy sports, lotteries, horse/harness racing) are not prohibited under the Wire Act, the US Department of Justice asserts that online gambling is illegal under the Wire Act.

In recent years, however, there have been a number of Congressional bills proposed that would relax some of the rules related to interstate online gambling, in some cases in exchange for the payment of a federal licensing fee. Examples include: the Interest Gambling Regulation, Consumer Protection, and Enforcement Act, proposed in 2009 (H.R. 2267); the Internet Gambling Regulation and Tax Enforcement Act of 2010 (H.R. 4976); and the Bipartisan Tax Fairness and Simplification Act, proposed in 2010 (S. 3018).

In addition, despite the current federal government’s approach to online gambling, it is generally understood that the states retain control over whether to prohibit or regulate online gambling within their borders, based on certain caveats contained within the Wire Act and the UIGEA. The UIGEA provides that unlawful Internet gambling does not include intrastate wagering, provided that the state verifies the age and in-state presence of the person gambling.

With the technological ability to accurately monitor a person’s exact location, through geolocation, the barrier to intrastate regulation and taxation of Internet gambling may be removed. Just as importantly, states may be able to monitor how wagers are placed and funds transferred to ensure that online gambling does not run afoul of the Wire Act prohibition on wire transfers of funds.

Some states are already anticipating what state regulation and taxation of online gambling would look like.

Despite the current federal prohibition on online gambling, some states have started to investigate the possibility of online gambling as an additional source of much-needed revenue.

District of Columbia. The District has enacted legislation to allow online gambling within its boundaries. The District, in April 2011, was the first jurisdiction to enact online gambling. Fiscal Year 2011 Supplemental Budget Support Act of 2010 (Bill 18-1100). The law allows the District to offer games of skill and games of chance over the Internet only within the geographical limits of the District of Columbia, provided that the ways in which the games are offered do not violate federal law. The law grants the District of Columbia chief financial officer significant authority to issue rules to implement the online gambling provisions, such as establishing which games will be offered and the terms and conditions on the conduct of the games. Such terms and conditions may include specifying the percentage of wagered amounts retained by the Lottery Board, the maximum and minimum amount of wagers, and time limitations on the games.

As of July 2011, D.C. Lottery Board officials indicated that finalized rules would provide that no player would be allowed to deposit more than $250 per week, that payments could be made only through debit cards, and that online gambling would not be available between 4 and 10 a.m. In addition, the Board indicated that it would establish procedures that would allow it to verify the age and Internet protocol address of every player, and that it generally would limit the hot spots from where players could wager (e.g., hotels, restaurants, other establishments that offer a wireless Internet connection) and that wagering patterns of players would be monitored electronically, and those who did not gamble responsibly would be cut off.

While the issue of online gambling remains the subject of much debate in the District of Columbia, government officials assert that the online gambling provisions, as enacted, do not violate federal law, as the games would be completely intrajurisdictional. However, resolution of legal and practical issues related to restricting interstate access and access by minors may delay implementation.

Nevada. The state of Nevada also has considered legislation to authorize online gambling, should online gambling clear federal hurdles. On June 10, 2011, A.B. 258 was signed by the governor of Nevada, with the express intent "to provide for licensed and regulated interactive gaming and to prepare for possible federal legislation . . . [and to] develop the necessary structure for licensure, regulation and enforcement." The legislation defines "interactive gaming" as the conduct of gambling games through the use of communications technology that allows a person, utilizing money, checks, electronic checks, electronic transfers of money, credit cards, debit cards, or any other instrumentality, to transmit to a computer information to assist in the placing of a bet or wager and corresponding information related to the display of the game, game outcomes, or other similar information.

The term specifically includes Internet poker and excludes the operation of a race book or sports pool that uses communications technology. Further, the legislation sets a framework for future regulations to govern the licensing and operation of interactive gaming.

A.B. 258 states that any license to operate interactive gaming does not become effective until: (1) a federal law authorizing the specific type of interactive gaming for which the license was granted is enacted, or (2) the US Department of Justice notifies the Board or Commission in writing that it is permissible under federal law to operate the specific type of interactive gaming for which the license was granted. Therefore, the legislative intent appears to be a preparatory measure for possible federal legislation.

Other states. On May 26, 2011, Iowa enacted S.B. 526, which allows "advanced deposit method" horse wagering, and requires the Iowa Racing and Gaming Commission to perform a study of intrastate Internet poker, to be concluded by December 1, 2011.

In 2010, California introduced S.B. 1485 to legalize, regulate, and tax online poker. The legislation was amended on March 31, 2010, to include a 10% license fee tax on all fees collected by licensed Internet poker entities from Internet poker players. The bill would have adhered to the intrastate safe harbor provision in the UIGEA by requiring standards for verifying age and intrastate presence. Although the bill was debated in various committees, it received no further action beyond June 29, 2010.

In 2010, New Jersey introduced S.B. 490, which would have legalized, regulated, and taxed Internet casino games. The bill passed both Houses, but on March 3, 2011, Republican Gov. Chris Christie vetoed the bill.

Many state tax questions remain

A host of state tax questions arise if online gambling is legalized, including: Will entities with no physical presence in a state be subject to tax? How can the physical presence of the player be accurately monitored? Will states grapple with similar taxing and sourcing issues as other digital products? Does the Wire Act apply to the Internet, and what about intrastate activity? Are tribal casinos allowed to operate online sites? What effect will online gaming have on land-based casinos?

Conclusion

Following the recent enactment of the District of Columbia online gambling provisions, other states' interest in online gambling will increase. As shown in the legislation enacted in Nevada and Iowa, lawmakers are preparing their states for the possible lift of the federal ban on Internet gambling. With states so desperate to replenish deleted budgets, and an untapped revenue stream such as online gambling under the radar, this topic likely will become a popular item on many states' legislative agendas in the forthcoming years. As other states observe the issues that online gambling introduces, tax practitioners should monitor federal and state legislation for developments.

IRS issues appeals settlement guidelines on federal reporting of state film incentives

State governments continue to promote film tax credits and other incentives to encourage the creation and expansion of their local film and television production industry. Just recently, California extended for one year its tax credit for film and television production (A.B. 1069).   And while earlier this year Michigan converted its refundable film tax credit program to a smaller, capped program, there has been recent legislative activity in Michigan to restore some of the state's generous film tax incentives (SB 569).

In light of the continuation of these tax incentives in many states, Entertainment, Media and Communications ("EMC") companies need to consider the federal tax return impact of claiming these benefits. This year, the Internal Revenue Service ("IRS") weighed in with the issuance of appeals settlement guidelines on the tax consequences of state or local tax incentives received by corporate taxpayers.

State incentives available to corporate taxpayers could take the form of tax rate reductions, tax abatements and credits for in-state activities, exemptions from income or property tax, and/or tax credits for the creation of additional jobs (collectively, tax incentives). Some corporate taxpayers have argued these tax incentives should be treated as payment to the taxpayer by the state or local government, followed by a deemed payment of the incentive back to the state or local government by the taxpayer. Applying this approach, these taxpayers claim the tax incentive payment from the state or local government should be Section 61 income but potentially excludible from income by the taxpayer as a non-shareholder contribution to capital under Section 118(a), reducing tax basis under Section 362(c). In addition, these taxpayers claim that the deemed payment of the tax incentive back to the state or local government qualifies as a Section 164 deduction for state or local taxes paid or accrued.

The IRS disagrees with these positions with respect to tax incentives for the reasons laid out in the audit settlement guidelines. According to the guidelines, the tax incentives are not income under Section 61. These incentives are simply designed to lower the tax imposed by the jurisdiction, and the taxpayer is not realizing an accession to wealth that results in Section 61 gross income. And because having Section 61 income is a prerequisite for the application of Section 118, these tax incentives are not non-shareholder contributions to capital under Section 118(a), and therefore do not reduce basis under Section 362(c).

Even if these tax incentives were an item of gross income, the IRS' position is that they likely would not qualify for the Section 118(a) exclusion under the following five factors required for exclusion under the Supreme Court decision in *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 US 401 (1973):

1). The contribution must become a permanent part of the transferee's working capital structure.

2). The contribution must not be compensation for specific, quantifiable services provided by the transferee to the transferor.

3). The contribution must be bargained for.

4). The asset transferred must result in a benefit to the transferee commensurate with its value.

5). The asset transferred ordinarily, if not always, will be used to produce additional income.

Under the audit settlement guidelines, these tax incentives also cannot be deductible as state or local income taxes under Section 164 because the taxpayer can only deduct what is paid or accrued — in this case, the amount remaining after factoring in the tax incentives.

Conclusion

Although state and local governments will continue to offer tax incentives to attract EMC businesses, taxpayers must be aware of the federal tax implications of these state tax benefits, and potential challenges to their federal tax treatment as a non-shareholder capital contribution on audit by the IRS.

IRS addresses Section 199 "Shrink Back Rule" for telecommunications industry

In our June 2011 newsletter, we reported that PwC had submitted a comment letter to the Internal Revenue Service ("IRS") and Department of the Treasury ("Treasury") regarding how to apply the so-called "Shrink Back Rule" in Section 199 to transactions in which telecommunication products and services are provided to customers, and how to determine whether such transactions should be categorized as a "service," a "lease/rental," or a combination thereof.

On September 16, 2011, the IRS issued guidance in Rev. Rul. 2011-24. While the IRS concedes that Section 199 does not require that a transaction between a telecommunications company and its customer be classified as either a service or a lease, it also indicated that "analysis of the relevant factors may lead to a determination of a single character."

Illustrative example: Mixed service/lease scenarios

In the Rev. Rul., the IRS analyzes three common mixed service/lease telecommunications scenarios and concludes that two of three are single-character services, and thus not eligible for Section 199. The IRS only found a mixed service/lease and application of the Shrink Back Rule where the telecommunications company owns the equipment on the customer's premises and leases it to the customer. In this situation, while the telecommunications company must maintain the equipment, the customer has a possessory interest in it.

In situation 1, Z provides telecommunication services and contracts with A to transmit A's telecommunications. Z's optical and digital transmission equipment, usually a Synchronous Optical Network ("SONET") ring, and the associated Public Switched Telephone Network ("PSTN") are used to transmit A's telecommunications. Z's SONET ring interconnects multiple business locations designated by A so that telecommunications can be transmitted between those locations without being transmitted to Z's PSTN. The SONET ring also connects with Z's central office, switching center, or remote terminal so that telecommunications can be transmitted to and from Z's PSTN. A owns some telecommunications equipment that connects with the SONET ring to allow transmission of A's telecommunications between A's locations or to the PSTN, and transmission of others' telecommunications to A from the PSTN.

In situation 2, the facts are the same as in situation 1, except A does not have multiple business locations and Z's dedicated circuit, instead of a SONET ring, is used to transmit A's telecommunications to the PSTN and others' telecommunications from the PSTN. All telecommunications to or from A must be transmitted using the PSTN.

In situation 3, the facts are the same as situation 2 except that A does not own the customer premises equipment required to connect with the dedicated circuit to allow transmission of A's telecommunications. As part of the contract, Z also provides the customer premises equipment and provides support services in relation to managing the equipment.

Illustrative example: Tax implications of each scenario

In situations 1 and 2, Z's gross receipts are derived from the performance of telecommunication services without the lease or rental of Z's SONET ring, dedicated circuit, or PSTN to A and do not constitute domestic production gross receipts ("DPGR").

In situation 3, Z's gross receipts are derived from a combination of the performance of services using its dedicated circuit and PSTN and a lease of the customer premises equipment. Z's receipts from the performance of services do not constitute DPGR, and Z's receipts from the lease of the equipment only qualify as DPGR if Z meets the other requirements of Section 199 with respect to the equipment.

While the IRS guidance is helpful in clarifying the IRS views on basic scenarios, it leaves open how telecommunications companies should treat the more complicated real-life situations that represent their current product and service offerings to customers.

To have a deeper discussion on the topics covered in this issue, please contact:

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Recommended reading:

Global Gaming Outlook: The casino and online gaming market to 2015

http://www.pwc.com/gx/en/entertainment-media/publications/global-gaming-outlook.jhtml

Global entertainment and media outlook 2011-2015

http://www.pwc.com/us/en/industry/entertainment-media/publications/global-entertainment-media-outlook.jhtml

2010 North American Wireless Industry Survey

http://www.pwc.com/us/en/industry/communications/publications/2010-North-American-wireless-industry-survey.jhtml

US GAAP convergence & IFRS

http://www.pwc.com/usifrs