

Section 199.-- Income Attributable to Domestic Production Activities

26 CFR 1.199-3: Domestic production gross receipts.

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ISSUE

May a package of films licensed to customers in the normal course of business be an item under § 1.199-3(d)(1)(i) of the Income Tax Regulations for determining the domestic production activities deduction under § 199 of the Internal Revenue Code (Code)?

FACTS

X Corporation (X) licenses a package of films (for example, a television channel) to customers for a fee in the normal course of its business. X's package contains films licensed to X by unrelated third parties and films produced by X. X pays license fees for distribution rights of the licensed films.

LAW AND ANALYSIS

Under § 199(c)(4)(A)(i)(II) and § 1.199-3(a)(1)(ii), domestic production gross receipts (DPGR) are 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.

Under § 1.199-3(d)(1), for purposes of §§ 1.199-1 through 1.199-9, 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) 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 the disposition of such property qualify as DPGR.

Section 1.199-3(d)(1)(ii) provides that, if § 1.199-3(d)(1)(i) does not apply to the property, then any component of the property described in § 1.199-3(d)(1)(i) is treated as the item, provided that the gross receipts from the disposition of the property described in § 1.199-3(d)(1)(i) that are attributable to such component qualify as DPGR. Each component that meets the requirements of § 1.199-3(d)(1)(ii) must be treated as a separate item and may not be combined with a component that does not meet these requirements.

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).

Together, § 199(c)(6) and § 1.199-3(k)(1) and (9) provide 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. A qualified film does not include property with respect to which records are required to be maintained under 18 U.S.C. § 2257.

Section 1.199-3 provides guidance on the determination of DPGR with specific rules for qualified film provided in § 1.199-3(k).

Section 1.199-3(k)(4) provides, for purposes of § 1.199-3(k), the term "compensation for services" means all payments for services performed by actors, production personnel, directors, and producers relating to the production of the film, including participations and residuals. Payments for services include all elements of compensation as provided in § 1.263A-1(e)(2)(i)(B) and (3)(ii)(D). Compensation for services is not limited to W-2 wages and includes compensation paid to independent contractors.

Section 1.199-3(k)(6) provides the general rule for determining whether a qualified film will be treated as produced by the taxpayer for purposes of § 199(c)(4)(A)(i)(II). A taxpayer meets this requirement if the film production activity performed by the taxpayer is substantial in nature within the meaning of § 1.199-3(g)(2). 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 and is not a factor for determining whether a taxpayer's film production activity is substantial in nature.

Section 1.199-3(k)(7) provides a safe harbor under which film is treated as qualified film under § 1.199-3(k)(1) and as produced by the taxpayer under § 1.199-3(k)(6) if the taxpayer meets the requirements of § 1.199-3(k)(7)(i) and (ii). A taxpayer that chooses to use this safe harbor must apply all the provisions of § 1.199-3(k)(7).

Generally, § 1.199-3(k)(7)(i) provides that a film will be treated as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States and the taxpayer satisfies the safe harbor in § 1.199-3(g)(3). Section 1.199-3(k)(7)(ii) provides that the not-less-than-50-percent-of-the-total-compensation requirement under § 1.199-3(k)(7)(i) is calculated using a fraction, the numerator of which is the compensation for services paid by the taxpayer for services performed in the United States and the denominator is the total compensation for services paid by the taxpayer regardless of where the production activities are performed.

In the situation described above, the package of films is property offered in the normal course of X's business for disposition to customers. Thus, the package of films can be an item under § 1.199-3(d)(1)(i) if the gross receipts that X derives from licensing the package of films qualify as DPGR.

The gross receipts that X derives from licensing the package of films may qualify as DPGR under § 199(c)(4)(A)(i)(II) and § 1.199-3(a)(1)(ii) if X establishes that the

package of films meets the criteria established under the general rules in § 1.199-3(k)(1) and § 1.199-3(k)(6) or, alternatively, under the safe harbor in § 1.199-3(k)(7) (including the safe harbor in § 1.199-3(g)(3)).

If *X* relies on the safe harbor in § 1.199-3(k)(7), the “not-less-than-50-percent-of-the-total-compensation” requirement in § 1.199-3(k)(7)(i) is a fraction where the numerator is the compensation *X* paid to actors, production personnel, directors, and producers for services performed in the United States that are directly related to the films in *X*’s package and the denominator is such compensation regardless of where the film production activities were performed. Furthermore, to satisfy the safe harbor in § 1.199-3(g)(3), *X*’s direct labor and overhead for the package of films must be 20 percent or more of *X*’s unadjusted depreciable basis in the package of films, or 20 percent or more of *X*’s cost of goods sold (CGS) of the package of films if *X* has CGS for the package of films. Direct labor and overhead include the costs for any films that are treated as self-produced by *X*, and do not include license fees of the licensed films. Under § 1.199-3(g)(3)(ii), “unadjusted depreciable basis” includes the costs that create basis under § 1012 and adjusted basis under § 1011 without regard to any adjustments described in § 1016(a)(2) or (3). This means that all costs that *X* paid or incurred for the package of films, including any fees *X* paid to unrelated third parties to license films included in the package, are included in unadjusted depreciable basis. Thus, *X*’s unadjusted depreciable basis includes costs of self-produced films plus license fees *X* paid to acquire distribution rights in the licensed films (CGS would also include these costs, in a transaction with CGS). Costs reasonably attributable to transmission and distribution

activities should not be included in X's direct labor, overhead, or unadjusted depreciable basis (or CGS, in a transaction with CGS).

X's films are treated as self-produced if X engaged in the film production activities, or if the films were produced pursuant to a contract with an unrelated party and X had the benefits and burdens of ownership as required under § 1.199-3(k)(8) and § 1.199-3(g)(4). X's film production activities include the following activities carried out by actors, production personnel, directors, and producers engaged in film: (1) pre-production (ideation, planning, and scripting); (2) production (shooting and recording images and sounds); and (3) post-production (film editing, scene sequencing, and the addition of audio/visual effects for self-produced films). X's transmission and distribution activities are not film production activities. Transmission and distribution activities include, for example: formatting the channel feed; assembly and transmission of the channel signal by collecting films by satellite, fiber optic cable, tape, and other means; decoding; reviewing; assessing; performing quality control for incoming and outgoing signals; converting to/from high definition and for viewing on mobile and other platforms; compressing and encoding signals for distribution; transmitting signals to customers; creating a seamless viewing format; adding overlay of special features and digital technologies; and inserting transition material.

If the gross receipts do not qualify as DPGR, then § 1.199-3(d)(1)(ii) applies, and X can treat any individual film included in the package of films as an item, provided the gross receipts attributable to the individual film qualify as DPGR. X cannot combine

films that meet the requirements under § 1.199-3(d)(1)(ii) with films that do not meet the requirements.

HOLDING

A package of films licensed to customers in the normal course of business may be an item under § 1.199-3(d)(1)(i) for determining the domestic production activities deduction under § 199.

This holding does not affect the characterization of the property at issue for any other purpose of the Code. For example, this holding does not mean that the package of films is described in § 168(f)(3) or constitutes one motion picture film or video tape for purposes of § 168(f)(3).

DRAFTING INFORMATION

The principal authors of this revenue ruling are James A. Holmes and James W. Rider of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Mr. Rider at (202) 317-4137 (not a toll-free call).