NEW YORK STATE
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :

of :

Meredith Corporation : **DTA No. 822396**

For Redetermination of a Deficiency/Revision of a :
Determination or for Refund under Article 9-A of
the Tax Law for the year(s) ending June 30, 1998, :
June 30, 1999, and June 30, 2000

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AMICUS CURIAE BRIEF OF THE MOTION PICTURE ASSOCIATION OF AMERICA, INC.

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I. AMICUS' INTEREST IN THIS CASE

The Motion Picture Association of America, Inc. (the "Amicus" or "MPAA") respectfully submits this brief *amicus curiae* in support of Meredith Corporation's appeal of the determination made by the administrative law judge Timothy Alston (the "Administrative Law Judge") (Determination No. 822396).

The MPAA is the trade association representing the nation's leading producers and distributors of motion pictures and television productions including Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLP, Walt Disney Studios Motion Pictures, Warner Bros. Entertainment Inc. and CBS Corporation as an affiliate member. The MPAA member companies produce and distribute their products for release in theatrical, home video, Internet, satellite, cable, subscription and over-the-air broadcast television markets.

This case presents an important issue to MPAA's members: whether film programming, for theatrical or television broadcast, (hereinafter referred to as "film") is tangible personal property that is included in the property factor, regardless of the medium used to deliver the film. The issue is important to the members of Amicus, who have complied with the New York tax law as interpreted by the New York State Department of Taxation and Finance (the "Department"). If the Administrative Law Judge's decision is allowed to stand, it will upset settled expectations and significantly change the way the motion picture industry is taxed by New York.

II. STATEMENT OF THE CASE

Meredith Corporation ("Meredith") is a media company engaged in various businesses, including ownership and operation of several television stations across the country. (ALJ Findings of Fact ¶ 1). Meredith's television stations acquired programming from unrelated third-parties.

Meredith licensed the right to broadcast film programming (television or motion picture programs) from third parties. The license agreement provided Meredith the right to broadcast the program over its stations. (ALJ Findings of Fact ¶ 16). Pursuant to the license agreements, most programming was delivered to the station by satellite transmission, which was downloaded in tangible format by each station prior to broadcast. In addition, the license agreements provided for the delivery of a hard copy of the film program by shipment, generally as a backup arrangement in the event of a failure of the satellite delivery. (ALJ Findings of Fact ¶ 17-18). Following the broadcast of the programs, Meredith generally was required to either return any copies of the programs to the third-party-licensor or to destroy or erase the copies. (ALJ Findings of Fact ¶ 22).

Meredith amended its New York franchise tax returns for the period ending June 30, 1998 to June 30, 2000, and included in its property factor the value of the film programming it licensed from third-parties. (ALJ Findings of Fact ¶ 8). The inclusion of the licensed film programming in the property factor resulted in refund claims. (ALJ Findings of Fact ¶ 11). The Department did not grant Meredith's refund claims, nor did it issue any notices of disallowance with respect to the claims. (ALJ Findings of Fact ¶ 9).

On August 8, 2008, Meredith filed a Request for Conciliation Conference from which it received a Conciliation Order denying its request on April 11, 2008. Meredith subsequently filed a petition with the Division of Tax Appeals on July 7, 2008 for review of the determination. Specifically, the issue presented to the Administrative Law Judge was:

> [w]hether amounts paid by petitioner's television stations pursuant to certain license agreements to broadcast television programs are properly considered rentals of tangible personal property for purposes of petitioner's property factor calculations under Tax Law § 210(3)(a)(1).

Matter of Meredith Corporation, Dkt. No. 822396 (A.L.J. January 14, 2010).

III. SUMMARY OF ARGUMENT

A. The Administrative Law Judge's reliance on the *Matter of Disney Enterprises*, Dkt. No. 818378 (A.L.J. February 12, 2004) and *Matter of Disney Enterprises, Inc.*, Dkt. No. 818378 (Tax App. Trib. October 13, 2005) was misplaced because the *Disney* decisions do not stand for the proposition that film is excluded from the property factor. Therefore, the Administrative Law Judge's analysis is flawed and must be reversed.

B. The Department violated the New York State Constitution and the Administrative Procedures Act by creating a rule that film is not tangible personal property without conforming its actions to the proper administrative procedures. Therefore, the Department's actions are invalid and unenforceable.

C. The Administrative Law Judge's determination contravenes New York's longstanding tax policy on the taxation of the media industry and must be overturned to maintain the consistency and rationality of that policy. If this Tribunal upholds the Administrative Law Judge's reasoning, the State's historic policy of including film in the property factor abruptly changes with no concomitant change in the law or in the industry; the State's concept of "film" becomes inconsistent and irreconcilable with that concept as defined in other states; and the accuracy of the property factor (and, thus, the entire business allocation percentage) is undermined for an entire industry. The force of these policy issues further demonstrates that the Administrative Law Judge's reasoning and determination should be reversed by this Tribunal.

IV. ARGUMENT

A. THE ADMINISTRATIVE LAW JUDGE'S RELIANCE ON *DISNEY* WAS MISPLACED BECAUSE THE *DISNEY* DECISIONS DO NOT STAND FOR THE PROPOSITION THAT FILM IS EXCLUDED FROM THE PROPERTY FACTOR

The Administrative Law Judge incorrectly applied New York tax law and misapplied the *Disney* decisions to exclude the value of film from the property factor. New York tax law and administrative guidance requires taxpayers to include the value of film in the property factor. The *Disney* decisions specifically addressed the proper *valuation* of film for property factor purposes - not whether the film was excluded from the property factor. *Matter of Disney Enterprises*, Dkt. No. 818378 (A.L.J. February 12, 2004); *Matter of Disney Enterprises, Inc.*, Dkt. No. 818378 (Tax App. Trib. October 13, 2005). A proper reading of the *Disney* decisions supports the proposition that film must be included in the property factor.

1. <u>New York Tax Law – Treatment of Film</u>

For the years at issue, a New York taxpayer was required to use a three factor apportionment formula to calculate its New York business allocation percentage, including a property factor. N.Y. Tax Law § 210(3)(a). New York tax law provided that the property factor was composed of the average value of the taxpayer's real and tangible personal property, whether owned or rented to it, within New York divided by the average value of all the taxpayer's real and tangible personal property everywhere. N.Y. Tax Law § 210(3)(a)(1). New York tax law defined "tangible personal property" to mean "corporeal personal property such as machinery, tools, implements, goods, wares and merchandise" and expressly excluded from the definition money, bank deposits, stocks, bonds, notes, credits or any other evidence of an interest in property. N.Y. Tax Law § 208(11).

New York's standard valuation method of owned real and tangible personal property was "the adjusted bases of such properties for federal income tax purposes." N.Y. Tax Law § 210(3)(a)(1). Rented property was valued by multiplying "the gross rents payable for the rental of such property during the taxable year" by eight. *Id.* However, New York tax law permitted taxpayers to make a one-time election to value owned and rented property at its fair-market-value instead of its cost-basis-value. *Id.*

New York has a longstanding history of treating film as tangible personal property. *Petitions of MCA, Inc.*, TSB-H-78(7)C (May 3, 1978); TSB-M-81(19)C (Nov. 20, 1981); TSB-M 83(20)C (July 20, 1983); New York State Department of Taxation and Finance, Office of Counsel Letter (July 2, 1991). In fact, all guidance prior to 2008 consistently required taxpayers to treat film as tangible personal property.

In *Petition of MCA, Inc.*, the New York State Tax Commission stated that film constituted tangible personal property. TSB-H-78(7)C (May 3, 1978). The decision addressed the proper treatment of film negatives for purposes of the property factor and New York's investment tax credit. *Id.* The Tax Commission reasoned that "costs incurred in the production of film negatives represented...tangible personal property" and that film was tangible personal property. *Id.* Further, the Tax Commission determined that the taxpayer had properly included the film in the New York property factor. *Id.*

In 1981, the Department expressly stated that "motion picture films" are property for purposes of computing the property factor of the New York business allocation percentage. TSB-M-81(19)C, (November 20, 1981). TSB-M-81(19)C defines a motion picture film as the "embodiment of a play, story or other literary or artistic work, created for public entertainment or for educational purposes." While TSB-M-81(19)C does not address motion picture film programming created solely for television presentation, the principles used by the Department to define "motion picture film" are not limited to those created for theater presentation.[1]

In 1983, the Department issued another TSB-M which expressly provided that the definition of "film" for television programs practically was identical to that used in defining "motion picture film" for theater presentation. TSB-M-83(20)C (July 20, 1983). The Department stated that "film" for television exhibition constitutes tangible personal property. Specifically, the Department defined "film" as the "physical embodiment of a play, story, or other literary, artistic, or other work created for public entertainment or educational purposes." *Id.*

In 1991, the Department issued an Office of Counsel Letter ("1991 Letter") that addressed whether film licenses constituted the rental of tangible personal property and are includible in the property factor. Office of Counsel Letter (July 2, 1991). The Department analyzed whether the licensing agreement for film constituted tangible personal property. *Id.* The Department reasoned that,

> [t]he transfer of the copy, combined with the licensing agreement to broadcast that copy, constitutes a lease of tangible personal property....The transfer of the copy may not be separated from the licensing agreement. The license to exhibit without the transfer of possession would be valueless. Together they are one transaction. *Id. (internal quotes omitted).*

The Department specifically determined that the transaction to license film was a lease of tangible personal property. *Id.*

2. <u>*Disney* – Division of Tax Appeals Decisions</u>

In *Matter of Disney Enterprises*, Dkt. No. 818378 (A.L.J. February 12, 2004), the taxpayer included the value of its film in the property factor at cost-basis-value in its originally

[1] The 1981 TSB-M indicates that the policy is effective for tax years beginning after December 31, 1974.

filed New York State Corporate Franchise Tax return. When the Department audited the return, the taxpayer changed the method of valuing the film from cost-basis-value to fair-market-value. *Id.* The Department rejected the taxpayer's valuation change and the taxpayer brought an action before the Division of Tax Appeals.

The issue presented to the *Disney* Administrative Law Judge was "[w]hether film masters owned by the Disney corporate group should be included in the property factor at their fair market value instead of at a value equal to their original cost." *Id.* The taxpayer asserted that it was permitted to use the fair-market-value of the film, instead of the cost-basis-value it had used on its original return, because it had made the statutory election to use fair-market-value for all property for its property factor. *Id.* The Department countered that the difference between the cost-basis-value and the fair-market-value of the film was value connected to an intangible right. *Id.* Further, the Department argued that the intangible right could not be included in the property factor.

The *Disney* Administrative Law Judge held for the Department that the value of an intangible (i.e., the difference between cost-basis-value and fair-market-value) could not be included in the property factor. Specifically, the *Disney* Administrative Law Judge held:

> Most of the value prescribed by the petitioner's expert for the film masters represents the value of the right to reproduce the films for sale in the consumer market. This copyright, which justified the extraordinary value for the films, represents an intangible asset. Since there is no legal requirement that intangibles should be factored into New York's formula...petitioner's contention that it should be permitted to include in the property factor its expert's value for the film masters is also rejected.

Id. Therefore, the Administrative Law Judge held that the taxpayer was not allowed to switch from cost-basis-value to fair-market-value of the film for purposes of its property factor. *Id.*

On appeal to the *Disney* Tax Appeals Tribunal, the parties presented two issues (related to the property factor): 1) whether the taxpayer could change the method it used to value film for property factor purposes from cost-basis-value to fair-market-value, and 2) whether the taxpayer's valuation report was accurate. *Matter of Disney Enterprises, Inc.*, Dkt. No. 818378 (Tax App. Trib. October 13, 2005). The *Disney* Tribunal summarizes the Administrative Law Judge's holding as "the Administrative Law Judge rejected petitioner's argument that the film masters should be included in the property factor at their fair-market-value instead of at a value equal to their original cost." *Id.*

The *Disney* Tribunal rejected the taxpayer's argument that the fair-market-value of the film should be used, reasoning that the fair-market-value reflected an intangible asset that cannot be included in the property factor. *Id.* The *Disney* Tribunal stated "that for New York tax purposes, the value of an intangible asset cannot be included in the property factor of the combined group's numerator for its BAP." *Id.* Therefore, the *Disney* Tribunal upheld the Administrative Law Judge's decision that the film could not be included in the property factor at fair-market-value instead of at cost-basis-value.

The underlying premise of the *Disney* controversy is that film is included in the property factor. In fact, the questions presented concede the fact that the value of the film is included in the property factor. Further, the Department did not allege in any of its briefs in the *Disney* case that film should be excluded from the property factor, at any level of the adjudicatory process. If the film negatives were not tangible personal property, the Department would not have disputed the taxpayer's valuation method; rather the Department would have excluded any value of the films from the property factor.

3. <u>The Administrative Law Judge Misapplied New York Statutory Law and Disney</u>

The Administrative Law Judge incorrectly interpreted the New York tax law regarding the characterization of film for property factor purposes. As described above, New York tax law requires that taxpayers include owned or rented tangible personal property in their property factors. N.Y. Tax Law § 210(3)(a)(1). New York has a longstanding history of treating film as tangible personal property for purposes of the property factor. *Petitions of MCA, Inc.*, TSB-H-78(7)C (May 3, 1978); TSB-M-81(19)C (Nov. 20, 1981); TSB-M 83(20)C (July 20, 1983); New York State Department of Taxation and Finance, Office of Counsel Letter (July 2, 1991). Therefore, the proper analysis must conclude that film is tangible personal property for purposes of the property factor.

The Administrative Law Judge's decision does not address the New York tax law definition of tangible personal property or the industry specific guidance which consistently had required taxpayers to include film in the property factor as tangible personal property. Instead, the Administrative Law Judge held that *Disney* overruled the Department's guidance on the treatment of film as tangible personal property for property factor purposes. Such a finding is not supported by *Disney*. The Administrative Law Judge's determination glosses over the fact that the reasoning from *Disney* could not be "controlling" over whether film is included in the property factor. This holding is not supported by *Disney* because the taxpayer in *Disney* did include films in its property factor.[2] The determination of whether film is tangible personal property is fundamentally different from the determination of the proper valuation of such tangible personal property, which was the issue in *Disney*.

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[2] The *Disney* decisions impliedly accept the fact that film is tangible personal property for purposes of the property factor in calculating the business allocation percentage because, if film were not tangible personal property for property factor purposes the value of film (the issue in *Disney*) would not even be a relevant inquiry.

The Administrative Law Judge misapplied the *Disney* decisions by confusing the reasoning for determining the proper valuation of the film with the characterization of film for property factor purposes. The Administrative Law Judge mischaracterizes the *Disney* Tribunal decision by stating that the Tribunal held that "the fair market value of film negatives was not properly included in property factor calculations where a large portion of such fair market value represented the value of the right to reproduce the films for sale in the consumer market." *Matter of Meredith Corporation*, Dkt. No. 822396 (A.L.J. January 14, 2010). The Administrative Law Judge's description fails to recognize that the Disney decisions did <u>not</u> exclude the value of the film from the property factor but rather determined that the cost-basis-value was the appropriate valuation measure for the film. Instead, the Administrative Law Judge tried to extend the reasoning from *Disney,* that supported the conclusion that the taxpayer was not permitted to use fair-market-value as the value of film for property factor purposes, to determine that licensed film was entirely excluded from the property factor.

While the *Disney* decisions did reason that the difference between the cost-basis-value and the fair-market-value of film is comprised of value representing intangible assets, the *Disney* decisions do not exclude the film or any part thereof from the property factor. The Administrative Law Judge misapplied the reasoning by taking it out of the valuation context and using it as the sole basis for excluding film from the property factor. Specifically, the Administrative Law Judge recognized the distinction between the characterization of film as tangible personal property and the valuation of such tangible personal property but erroneously concluded that the distinction was not relevant. The Administrative Law Judge decision provided:

> [p]etitioner further sought to distinguish Disney by noting that the amount to be included in the property factor, that is, the value of the assets rented is not at issue

in the present matter, while in *Disney* the Division took issue with the fair market value as established by an expert at the hearing. <u>This is an insignificant difference; for although the valuation of the assets was contested by the Division in Disney, the Tribunal's decision did not address this issue.</u>

Matter of Meredith Corporation, Dkt. No. 822396 (A.L.J. January 14, 2010) (emphasis added). The Administrative Law Judge's reading of *Disney* is erroneous. The Administrative Law Judge has confused the *Disney* reasoning for the determination that cost-basis-value was the appropriate value of the film in the property factor with the incorrect theory that the film, or some part of it, was not included in the property factor. Such a finding is <u>not</u> consistent with the *Disney* decisions. The Administrative Law Judge plainly misapplied the *Disney* Tribunal decision.

B. THE DEPARTMENT'S NEW POSITION VIOLATED THE NEW YORK STATE ADMINISTRATIVE PROCEDURE ACT

The Department's action violates the New York State Constitution ("State Constitution") and Administrative Procedure Act ("APA") because the Department has created a "rule" without comporting with New York procedural requirements. The Department's position that the value of film is excluded from the property factor constitutes an administrative "rule" that is governed by the procedural requirements of the APA. Absent strict adherence to the APA rule-making procedures, the Department's action is invalid and unenforceable.

1. <u>Administrative Procedure Requirements</u>

The State Constitution provides: "No rule or regulation made by any state department, board, bureau, officer, authority or commission...shall be effective until it is filed in the office of the department of state." N.Y. Constitution, Article 4, Section 8. The State Constitutional requirements are embodied in the APA, which is a statutory regime that regulates the conduct of most state agencies with respect to their rule making, adjudicatory, and licensing authority. *See generally* N.Y. A.P.A. § 101 *et. seq.*

Specifically, the APA requires that, "prior to the adoption of a rule, an agency shall submit a notice of proposed rule making to the secretary of state for publication in the state register." N.Y. A.P.A. § 202(1)(a). The notice of proposed rule-making must provide, among other things, 1) the statutory authority under which the rule is proposed for adoption; 2) the date, time, and place of public hearing; 3) the complete text of the proposed rule; 4) a regulatory impact statement; and 5) contact information of departmental personnel knowledgeable on the rule. N.Y. A.P.A. § 202(1)(f). The public must be afforded an opportunity to submit comments regarding the proposed rule. N.Y. A.P.A. § 202(1)(a). Generally, the agency issuing a rule must also hold public hearings. N.Y. A.P.A. § 202(1). In this case, the Department followed none of these procedures in establishing a new position regarding the proper treatment of film in the property factor.

The APA requirements apply to any "agency" which is defined as "any department, board, bureau, commission, division, office, council, committee or officer of the state, or a public benefit corporation or public authority at least one of whose members is appointed by the governor, authorized by law to make rules or to make final decisions in adjudicatory proceedings" N.Y. A.P.A. § 102(1). Several state agencies are expressly excluded from the APA requirements, but the Department is not one of them. Therefore, the Department is an "agency" for purposes of the APA.

2. <u>"Rule" Defined</u>

New York law defines a "rule" as "the whole or part of each agency statement, regulation or code of general applicability that implements or applies law...." N.Y. A.P.A. § 102(2)(a).

New York State courts have, on several occasions, addressed whether an agency position or policy is a "rule" as defined by the APA. Such cases have defined a "rule" as "a fixed, general principle to be applied by an administrative agency without regard to other facts and circumstances relevant to the regulatory scheme of the statute it administers." *See e.g. HD Services, LLC v. New York State Comptroller*, 51 A.D.3d 1236 (N.Y. App. Div., 3 Dept. 2008); *New York City Transit Authority v. New York State Dept. of Labor*, 88 N.Y.2d 225 (N.Y. 1996).

In *HD Services,* a New York State Office of Unclaimed Funds ("OUF") requirement that certain forms be notarized was challenged. *HD Services,* 51 A.D.3d 1236 (N.Y. App. Div., 3 Dept. 2008). The Petitioner filed its forms without the required notary acknowledgment and the OUF rejected the forms. *Id.* The petitioner argued that the OUF should be forced to accept the forms at issue without notarization because the notarization requirement was an invalid "rule". *Id.* The Petitioner argued that the OUF was subject to the APA and that it had not followed the proper rule making procedures to enact the notary requirement for the forms. *Id.* The OUF argued that N.Y. A.P.A. § 102 exempts from the definition of a rule "forms and instructions, interpretive statements and statements of general policy which in themselves have no legal effect but are merely explanatory." *Id.* The appellate court held that, regardless of the reasonableness of the position, the notarization requirement constituted a rule because the policy was 1) "nondiscretionary," 2) "rigid," and 3) "applied across-the-board." *Id.* Therefore, the appellate court struck down the notary requirement because it violated the New York APA requirements.

By contrast, in *New York City Transit Authority,* the New York State Department of Labor ("Labor Department") assessed penalties for regulatory violations after an investigation of the petitioner's facilities. 88 N.Y.2d 225 (N.Y. 1996). The Labor Department based its penalty computations on guidance from an internal manual. *Id.* The petitioner argued that the imposition of penalties based on the internal memorandum constituted an impermissible rule in violation of the APA. *Id.* The Court of Appeals rejected the petitioner's argument and noted that "although the [penalty] guidelines specify a numerical formulas for calculating the ultimate amount of the penalty, they do not establish 'a rigid, numerical policy invariably applied across-the-board to all claimants without regard to individualized circumstances or mitigating factors.'" *Id.* (internal citation omitted). As a result, the penalty schedule did not constitute a rule for purposes of the New York APA requirements.

State tax cases from other jurisdictions have addressed whether a state tax authority's action constitutes a "rule" for state administrative procedure rules. *See Metromedia, Inc. v. Director*, 478 A.2d 742 (N.J. 1984); *CBS Inc. v. Comptroller,* 575 A.2d 324 (Md. 1990). In *Metromedia,* the New Jersey Supreme Court addressed whether the New Jersey Division of Taxation's ("Division") decision to apply an "audience factor" on audit to calculate a broadcaster's receipts factor was *de facto* rulemaking subject to the New Jersey State Administrative Procedures Act. 478 A.2d 742 (N.J. 1984). The Division asserted its equitable apportionment authority, pursuant to N.J. Stat. Ann. § 54:10A-8, to change the taxpayer's returns from the standard apportionment rules by using an audience factor to source receipts for sales factor purposes. *Id.* The New Jersey Supreme Court evaluated the Division's action based on whether the agency determination:

1. would encompass a large segment of the regulated or general public;
2. would be applied generally and uniformly to all similarly situated persons;
3. was designed to operate only prospectively;
4. prescribed a legal standard or directive that is not otherwise expressly provided by or clearly and obviously inferable from the enabling statutory authorization;
5. reflected an administrative policy that (i) was not previously expressed in any official and explicit agency determination, adjudication or rule, or (ii) constitutes a material

and significant change from a clear, past agency position on the identical subject matter; or

6. reflected a decision on administrative regulatory policy in the nature of the interpretation of law or general policy. *Id.*

The court held that the Division's action to change a broadcaster to an audience factor sourcing methodology did constitute *de facto* rulemaking. *Id.* Specifically, the court held that the Division's application of the audience factor sourcing methodology to the taxpayer would have broad coverage and applicability to all similarly situated taxpayers. *Id.* Further, the determination was prospective in nature, notwithstanding the Division's application of the audience factor on audit, because it marked a change in the Division's treatment of taxpayers. *Id.* The court held that the Division's assertion of the audience factor sourcing amounted to a new legal standard not clearly expressed or provided for in the New Jersey statute. Therefore, the Division's actions constituted an impermissible rulemaking procedure in violating the New Jersey administrative procedure rules.

Further, in *CBS,* the Maryland Court of Appeals examined whether a Maryland circuit court's reversal of a Maryland Tax Court decision was valid. 575 A.2d 324 (Md. 1990). The case involved the Maryland Comptroller's ("Comptroller") attempt to require the taxpayer, a broadcaster, to use an audience factor to apportion its receipts. *Id.* Before the Maryland Tax Court, the taxpayer argued that the Department's actions violated Maryland's Administrative Procedures Act. *CBS Inc. v. Comptroller,* 1988 WL 136914 (Md. Tax 1988). The Department contended that its actions were authorized under Maryland's equitable apportionment statute. *Id.* The Maryland Tax Court held that the audit adjustment was an "agency statement of interpretation and policy having general application, future effect and adopted to carry out the Comptroller's taxing authority." *Id.* When the case reached the Maryland Court of Appeals, that court addressed the Comptroller's actions and the Maryland Tax Court's decision. *CBS*, 575

A.2d 324 (Md. 1990). In upholding the Maryland Tax Court's decision, the Maryland Court of Appeals reviewed the case law regarding when agency rule making is required in place of agency adjudication. *Id.* The Maryland Court of Appeals noted that promulgation of a "rule" is usually necessary where the Comptroller's new policy represented a change from a generally applicable position: i.e., the use of an audience factor, emphasizing the inherent fairness of such an approach as compared to adjudicatory ruling making. *Id.*

In summary, New York's APA empowers agencies to make and implement certain rules. When an agency adopts a rule, the APA requires agencies to follow certain administrative procedures. These procedures consist of notice and public hearing requirements. Rules are fixed, general principles, that apply to all taxpayers across the board and implement law.

3. The Department's Actions Constitute An Impermissible *De Facto* Rule

The Department's determination that the value of film is excluded from the property factor constitutes a *de facto* rule. The Department's policy is of general applicability that will apply to all taxpayers owning film. In addition, the Department's position represents an interpretation of the law that will apply prospectively. Whenever the Department attempts to interpret specific provision of the law prospectively for all taxpayers, that interpretation must comply with the requirements of the APA, unless the standard is clearly inferable from the law.

The Department has articulated a new legal standard not clearly inferable from the statute. For decades taxpayers have relied on the Department's position that film is included in the property factor, regardless of the media. The Department has audited countless taxpayers applying such a legal standard. No material change in the statutes or regulations addressing the property factor has occurred with respect to this issue. Were this standard clearly inferable from the statute, the Department would not have taken an inconsistent position in previously published guidance and in audit practice for over twenty years.

No published guidance supports the Department's position. To the contrary, the Department's actions represent a marked departure from the long-standing departmental policy articulated in TSB-M-81(19)C, TSB-M-83(20)C, and the July 2, 1991 Office of Counsel letter. Where the Department intends to interpret in a new manner a statute that has not changed, such interpretation must be adopted as a "rule" within the prescriptions of the APA before it may be applied to taxpayers. Nor is the Department's determination appropriate as adjudicatory rule-making under the APA. Although the APA permits state agencies such as the Department to hold administrative hearings, these hearings are not the preferred method to establish a "rule" of general applicability. The general applicability of the rule to a wide range of taxpayers and the fairness inherent in the APA's rule-making procedure all weigh in favor of rule promulgation as compared to agency adjudication.

Therefore, the Department's exclusion of the value of film from the property factor constitutes a "rule" that applies generally to all taxpayers. The position represents a new legal standard not clearly inferable from the statute as represented by the Department's historical position on the issue. Furthermore, the position represents the abandonment of longstanding, published departmental guidance to the contrary. Therefore, the Department's action is invalid and unenforceable because the rule-making process failed to comport with the requirements of the APA.

C. THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE CONTRAVENES NEW YORK'S LONGSTANDING TAX POLICY ON THE TAXATION OF THE MEDIA INDUSTRY AND MUST BE OVERTURNED TO MAINTAIN THE CONSISTENCY AND RATIONALITY OF THAT POLICY.

Policy considerations underlying the existence of both the property factor in general and New York's specific rules for determining the property factor of corporations engaged in the business of broadcasting television programs and producing "films" for television exhibition also support the requirement that film, in whatever form the rights are owned and however delivered, is included in the property factor.[3] These policy considerations are informed by: the Department's longstanding policy of including film in the property factor; a comparison of similar provisions in other states; and the fundamental purpose of the property factor's existence in the business allocation formula.

1. Proof that New York's Tax Law, as interpreted by the Department, requires inclusion of film in the property factor regardless of the form of ownership rights or the method of delivery is supported by the history of state taxation of the broadcast industry

The special broadcast industry allocation rules used by New York have a unique history and national context that should inform any decision by this Tribunal as to what constitutes "film" and whether such an item should be included in the property factor. New York's policy of including "film" in the property factor of the business allocation percentage adopts definitional language similar to that of many other states and no other state adopting this definitional language has included some film property and excluded other film property from the property factor based on either type of ownership rights or method of delivery.

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[3] The Administrative Law Judge attempts to avoid the important policy considerations that underlie the concept of "film" in the property factor by determining that "the method of delivery is not a factor in determining whether programming received by television stations is properly included in the property factor." *Matter of Meredith Corporation*, Dkt. No. 822396 (A.L.J. January 14, 2010). Notwithstanding the Administrative Law Judge's pronouncement, the method of delivery is discussed in this section because the use of satellites rather than physical tapes to distribute films seems to have influenced the Administrative Law Judge's concept of what constitutes "film" if not overtly, at least subliminally.

If this Tribunal upholds the Administrative Law Judge's determination, New York will be uniquely out-of-step with the rest of the states because New York will be the sole jurisdiction that does require some film, but not all film, be included in the calculation of the property factor. All other states either include all film property or specifically exclude all film property factor from the calculation. The New York Department has defined "film" as "the physical embodiment of a play, story, or other literary, artistic, or other work created for public entertainment or educational purposes except that it does not include programs such as news and news specials relating to current affairs and shows consisting of sporting events." TSB-M-83 (20)C (July 20, 1983). This definition is the same definition used by California, various iterations of the Multistate Tax Commission's model regulations and numerous other states for the determination of what is to be included in the property factor of television and radio broadcast companies. Cal. Code Regs. tit. 18 § 25137-8(c)(1)(A)(ii); Multistate Tax Commission Proposed Reg. IV.18(h)(3)(i) (1989 draft version). Importantly, while the various states have come to different conclusions as to the valuation of film for purposes of the property factor numerator and whether film should be in the property factor at all, states that have a special industry rule either include all film – regardless of ownership rights or delivery method – or specifically exclude all film in calculating the property factor. Unlike the Administrative Law Judge in this case and in an unusually consistent fashion, the other states using the same definition of "film" as New York have in no instance further considered to what extent the value of the film was a result of an intangible aspect of the film property.

a. *California*

California was the leader in adopting special rules with respect to the apportionment of income for tax purposes of the motion picture and television industries. California's interpretation of "film" for purposes of determining the property factor is important because of its long history, participation in assisting with the drafting of the Multistate Tax Commission model regulation (see below) and its importance to the industry. The history of California's special industry apportionment regulations is described in the California Franchise Tax Board Internal Procedures Manual. As noted in this Manual, regulations dealing with apportionment issues in the motion picture and television industries were adopted by California in 1987, effective for years after January 1, 1982. *See* California Multistate Audit Technique Manual, p. 23. However, even prior to the adoption of the regulations, the FTB followed a similar methodology pursuant to its "Guideline for Motion Picture and Television Film Producers and Television Network Broadcasters Apportionment Formula" issued in 1974. *Id.*

Recently, the California FTB further explained this history. *See* Request by Franchise Tax Board to Hold an Interested Parties Meeting to Consider Revising Regulation Section 25137-8 (Sept. 5, 2007) (the special industry regulation on the apportionment of income for motion picture and television film producers and television networks). The FTB stated: "[m]any years before the Uniform Division of Income for Tax Purposes Act (UDITPA) was adopted by California, the Franchise Tax Board and the motion picture industry had recognized that special rules were needed for the allocation and apportionment of income from the industry's activities. Working together, the department and industry developed guidelines. These guidelines have been modified several times over the years. The most recent version of those guidelines was adopted in 1982 as Regulation section 25137-8." *Id.*

Like New York, California currently defines "film" as "the physical embodiment of a play, story or other literary, commercial, education or artistic work; as a motion picture, video tape, disc or other similar medium." Cal. Code Regs. tit. 18 § 25137-8(c)(1)(A)(ii). California's regulation provides that for purposes of the property factor, "[f]ilms are deemed to be tangible personal property" and included in the property factor.[4] This statement reflects what New York's policy inherently acknowledges.[5] As a result of this commonality of definition, California's interpretation is useful in considering the appropriate interpretation under New York tax law.

Once an item meets the definition of film, California does not consider what type of rights are held by the taxpayer in the film or how the film is delivered. This indifference is not because California has not kept current with changes in the industry. The FTB has recognized that technology has changed over the years[6] and is currently in the process of amending its industry apportionment regulation to, in part, reflect the changes in technology.[7] Nevertheless, the FTB has not proposed any changes to the definition of "film" or to the scope of the property factor that would result in the rights at issue in this case being removed from the California property factor. Nor has the FTB taken other steps to distinguish between types of film rights for property factor purposes. Thus, notwithstanding the acknowledged changes in the industry, such

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[4] California provides that generally the value of a film for purposes of computing the property factor was "the original cost of producing the film as determined for federal income tax purposes . . . and will include talent salaries." Cal. Code Regs. tit. 18 § 25137-8(c)(1)(A)(ii). Films are included in the property factor for twelve years beginning with the release date. Cal. Code Regs. tit. 18 § 25137-8(c)(1)(B)(ii). After the twelve year period ended, any films for which income was received during the taxable year were aggregated and treated as a single film property. Cal. Code Regs. tit. 18 § 25137-8(c)(1)(B)(ii). The property was then valued at eight times the aggregate gross receipts generated by the films during the year. *Id.*

[5] If New York did not consider film to be tangible personal property, there would be no need for a policy on how to calculate the property factor numerator for film.

[6] As an example that the FTB is fully aware of the current industry technology (the same technology utilized by the Taxpayer in this case), in a recent Interested Party Notice the FTB observes that: "Network programs and advertising are transmitted as a digital signal to satellites, which are then accessed by cable operators and satellite television affiliates and released to their subscribers across the country." Request by Franchise Tax Board to Hold an Interested Parties Meeting to Consider Revising Regulation Section 25137-8 (September 5, 2007).

[7] *Id.* Franchise Tax Board, Request to Proceed with Formal Rule-Making Process on the Adoption of California Code of Regulations, Title 18, Section 25137-8 (June 16, 2009), *available at* http://www.ftb.ca.gov/law/meetings/attachments/061609/4.pdf.

as changes in method of delivery and method of ownership, "film" for California apportionment purposes, using the same definition as New York, remains solidly part of the property factor.

b. Multistate Tax Commission[8]

Like California, the Multistate Tax Commission's[9] treatment of "film" for purposes of the property factor is relevant to an interpretation of New York's Tax Law because of both the similarities in and the differences between New York's apportionment and definitional language and the MTC's. The MTC's interpretation of the scope of the term "film" is particularly relevant in New York, because three of the authorities specifically relied upon by the Hearing Officer in making recommendations on the substance of the 1990 version of the regulation were from New York Tax Law – specifically TSB-M-81(19)C (Nov. 20, 1981); TSB-M-86(4)C (May 19, 1986), and 20 NYCRR § 4-4.

The MTC began discussing the substance of a special industry regulation as early as 1988. Industry representatives as well as representatives from various states spent several years discussing, revising, and refining the model. Various iterations of the regulations were discussed and numerous hearings were held on drafts of the regulations. The first version was officially adopted by the MTC in 1990 and amended in 1995. The MTC Hearing Officer Reports for both the original and the amended versions provide an informative analysis of the language ultimately adopted by the MTC. A comparison of the policy choices behind the language of the MTC's

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[8] The discussion of the MTC's special apportionment rule for television and radio broadcasters does not represent either industry support or opposition to the provisions discussed. The discussion is intended to demonstrate the thought process behind the MTC's adoption and its implications for interpreting the extent to which all manifestations of "film" should be included in New York's property factor.

[9] The MTC is an intergovernmental state tax agency that, among other things, drafts model regulations with the intent that states will adopt the model in order to increase uniform apportionment rules. The heads of state revenue departments, or their representatives, participate in MTC meetings and drafting efforts. The member states representatives are responsible for voting on MTC proposals, such as model regulations, on behalf of their states.

regulation and the Administrative Law Judge's analysis of New York's Tax Law in this case demonstrates that the Administrative Law Judge misapplied the reason that a special industry apportionment rule exists at all, and this lapse has resulted in a New York property factor calculation at odds with the rest of the states for no legally or rationally supportable reason.

Initially, the MTC drafts of its special apportionment formula for television and radio broadcasting used language identical to New York's and California's language in defining "film." *See* Multistate Tax Commission Proposed Reg. IV.18.(h) (1989 draft version).[10] By the 1995 version, the language had been amended,[11] but because there is no commentary in the Hearing Officer's reports reflecting any specific controversy or reason for the change, it does not appear to have been considered a material amendment.

The MTC regulation and the Hearing Officer Reports on both the original and the amended regulation include two important points that lead to the conclusion that the intent of the regulation was that all film, by whatever method delivered and regardless of the rights acquired, is the same for purposes of determining the property factor. First, the method of delivery is not a relevant factor. At the time the original regulation was adopted, the MTC member states were fully cognizant of the use of satellites to deliver film. Notably for purposes of this case, in his 1989 Report, the Hearing Examiner stated that: "The type of property at issue, radio and television programming, is delivered most often by direct electronic transmission or by satellite." Multistate Tax Commission, Report of Hearing Officer Regarding Proposed Adoption of

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[10] "'Film' means the physical embodiment of a play, story or other literary, commercial, education or artistic work; as a motion picture, video tape, disc or other similar medium." Multistate Tax Commission Proposed Reg. IV.18(h)(3)(i) (1989 draft version).

[11] "Film" or "film programming" means any and all performances, events or productions telecast on television, including but not limited to news, sporting events, plays, stories or other literary, commercial, educational or artistic works, through the use of video tape, disc or any other type of format or medium. MTC Reg. IV.18(h)(3)(i)(1996).

Multistate Tax Commission Regulation IV.18.(h), p. 10 (1989). Thus, the MTC's industry apportionment regulation clearly contemplates delivery by satellite and yet does not base either the definition of "film" or the determination of the property factor on the delivery method. Second, the MTC's regulation also clearly contemplates that "film" may exist in different forms, but that form was not relevant. In the 1989 Report, the Hearing Examiner noted that film sometimes lacks "physical embodiment – such as a reel of film or an audio or video-tape"; nevertheless, the Hearing Examiner did not recommend any distinction based on physical characteristics.[12] Multistate Tax Commission, Report of Hearing Officer Regarding Proposed Adoption of Multistate Tax Commission Regulation IV.18.(h), p. 11 (1989).

The differences between the MTC regulation and New York tax law also provide an important indication that the Administrative Law Judge has misinterpreted the New York law. The initial drafts, but not the final version, of the MTC's 1990 regulation specifically included film in the property factor.[13] The final version specifically excluded film from the property factor.[14] The exclusion of "film" from the property factor was controversial and was one of 13 items noted by the Hearing Officer in a subsequent report as an important element of discussions over a period of years. *See* Multistate Tax Commission, Final Report of Hearing Officer (December 18, 1995). The MTC's decision to ultimately provide a specific throwout rule for film is important to the analysis of the New York Tax Law for two reasons. First, the very existence of a throwout rule in the MTC regulations but the lack of any such a rule in New York

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[12] This physical embodiment language was part of a discussion of what to include in the numerator of the property factor. Obviously, for an item to be included in the numerator, the decision must already have been reached that it is properly included in the property factor at all.

[13] Multistate Tax Commission Proposed Reg. IV.18(h)(4) (1989 draft version).

[14] "No value or cost attributable to . . . film or radio programming property shall be included in the property factor at any time." Multistate Tax Commission Reg. IV.18(h)(4)(ii)(A)(2).

tax law suggests that New York did not intend for film to ever be excluded from the property factor. Second, the MTC throwout rule applies to all film. The New York Administrative Law Judge, however, interpreting the same or a similar definition of film as the MTC's somehow created a bifurcation of film types. The result of the Administrative Law Judge's decision is that New York has a "partial" throwout rule for film even though it has the same or similar definition of film as the MTC but has no provision that parallels the MTC's throwout provision. This inconsistency provides another strike against the validity of the Administrative Law Judge's determination in this case.

2. The industry has relied on the special allocation rules provided for sourcing film for purposes of the property factor, and excluding film based solely on ownership rights or delivery method frustrates this reliance

Nothing before the tax years at issue in the history of New York's apportionment of the film industry for purposes of the franchise tax has ever indicated that the type of ownership rights or the method of delivery makes a difference as to whether film is included in the property factor. Surely the New York Department was cognizant of the technological advances in the film industry that were changing the concepts of ownership and the possible methods of delivery. Yet the Department never indicated that these changes – which have nothing to do with whether "film" actually exists under the still relevant definition – might affect the calculation of the property factor.

The industry has consistently relied on the special allocation rules in calculating its tax liability and included in that reliance is the obvious assumption that film is film regardless of ownership rights or delivery method. The industry is an important part of the New York economy. The business choices the industry makes include tax considerations and unexpected, retroactive changes in taxing the industry obviously have significant effects on the future choices the industry makes. Any change in policy should be made with input from and discussions with the industry, as has been the State's approach in the past. Further, changes in policy through audit and litigation result in inconsistent treatment of similar taxpayers. Absent any evidence that the industry's reliance was unfounded, this reliance alone should be sufficient to find that the Administrative Law Judge's conclusion should be reversed.

3. <u>Excluding a principal category of property used in a taxpayer's business violates the reason for the existence of the property factor in the apportionment formula</u>

a. The property factor reflects the location of capital used to generate income

The policy underlying the property factor of the apportionment formula demonstrates that film, in whatever form, however delivered, and whether owned or licensed by the taxpayer, must be included in that factor.[15] The policy issues surrounding the reason for the property factor have been discussed in numerous cases and the underlying policy remains consistent. The property factor measures the capital that creates a corporation's wealth. Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 8.06[1], at 8-53 (3d ed. 2001-2009). Hellerstein and Hellerstein state:

> The property. . .factor[] . . . reflect[s] both of the underlying justifications for the three-factor formula identified by the U.S. Supreme Court. On the one hand, [the property factor] reflect[s] the geographic "source" of the taxpayer's income, which may reasonably be attributed to the locus of the taxpayer's property . . . . On the other hand, [the property factor] constitute[s] [a] rough indici[um] of the protection, benefits, and services that the state furnishes to the [taxpayer] and of the costs that the [taxpayer] imposes upon the state.

[15] Clearly a state could for reasons other than the policy underlying the existence of the property factor, specifically exclude film rights at issue here. But, absent a clear statement by New York of its intent to do so, the reasons for the property factor should weigh heavily in treating film consistently regardless of the characterization of the rights or method of delivery.

Id.

A significant percentage of capital used or invested by media companies for the production of income is the acquisition of film for broadcast – through production, purchase, or license. Without such film, media companies could not generate any receipts. Therefore, in order for the property factor to have any significance (or relevance) in the measurement of business activity, use of capital to acquire film must be included in the factor. To exclude large amounts of business capital based solely on form of delivery or type of acquisition results in a meaningless property factor that lacks consistency between taxpayers.

b. *The property factor specifically includes both owned and rented property to reflect an investment by the taxpayer in property used to generate the taxable income*

That the property at issue here is licensed rather than owned is also not relevant to the determination as to whether it is to be included in the property factor. Since 1986, all states that have a property factor include rented property in the calculation of that factor.[16] Hellerstein and Hellerstein, in commenting on a case involving the reverse situation (exclusion of owned property rented to another), state that "if one does not take account of the rented property in the lessor's . . . property factor, it could create unacceptable apportionment differences as between owner-users and owners of property that they rent out in a state." *Id.* ¶ 9.16[a][1], at 9-150. The exact same problem would exist if the Administrative Law Judge's emphasis on the type of ownership rights in the film as a pivotal determination of whether the film is to be included in the property factor is allowed to prevail.

[16] "New Jersey was one of the last states to adopt (in 1986) a provision including rented property in the lessee's property factor." Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 9.16[1] n.573, at 9-147 (3d. ed. 2001-2009), citing N.J. Admin. Code § 18:7-8.5(b) (1998).

The property factor, as part of an apportionment formula, reflects the in-state generation of value because a state in which property resides provides the situs for the wealth creating aspects of the multistate corporation. Capital invested in a state is property owned in a state, while use of capital in a state is property rented in a state. Both of these methods of employment of capital are used to generate the corporation's income; therefore, recognition of both is necessary to fairly measure business activity within a state.

Other states have followed this policy of not distinguishing between the type of rights to property maintained by a taxpayer in determining what is to be included in the property factor. For example, in New Jersey, the Tax Court upheld that the Director's authority to require leased property be included in the property factor because the policy considerations behind the factor was to fairly determine what percentage of the value of a multi-state corporation was generated in the state. *See Brunswick Corp. v. Director, Division of Taxation,* N.J. Tax Court, CCH ¶ 400-131 (May 21, 1991). The reason that the property factor reflects value generated in-state is that "the property factor reflects (i) the capital invested in-state by the corporation, or (ii) the corporation's use of capital located within the state." *Id.*

IV. CONCLUSION

The Administrative Law Judge has incorrectly applied the New York tax law and misapplied the *Disney* decisions to arrive at the conclusion that film is not included in the property factor for New York corporate franchise tax purposes. The *Disney* decisions are limited to the valuation issue which the decisions addressed. *Disney* clearly does not stand for the proposition that film is not tangible personal property for purposes of the property factor.

Further, the Department violated the requirements of the New York State Constitution and the APA by creating a *de facto* rule that film is not tangible personal property without comporting with the procedural requirements. As a result, the Department's rule is invalid and unenforceable.

Finally, the Administrative Law Judge's determination contravenes New York's longstanding tax policy on the taxation of the media industry and must be overturned to maintain the consistency and rationality of that policy. If this Tribunal upholds the Administrative Law Judge's reasoning, the State's historic policy of including film in the property factor abruptly changes with no concomitant change in the law or in the industry; the State's concept of "film" becomes inconsistent and irreconcilable with that concept as defined in other states; and the accuracy of the property factor (and, thus, the entire business allocation percentage) is undermined for an entire industry. The force of these policy issues further demonstrates that the Administrative Law Judge's reasoning and determination should be reversed by this Tribunal.

The Tax Appeals Tribunal should reverse the Administrative Law Judge's determination.

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Respectfully Submitted,
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