AGENDA #2

WHITE PAPER ON LOS ANGELES BUSINESS LICENSE TAX FOR BROADCASTING INDUSTRY

Introduction

The Radio and Television Broadcasting Industries (Broadcasters) seek the assistance of the Business Tax Advisory Committee (BTAC) in obtaining clarity, consistency and equity in the methodology used to apportion the gross receipts of the radio and television broadcasting industry for Los Angeles Business License Tax purposes.

Background

A. *The Los Angeles Municipal Code*

Los Angeles Municipal Code (LAMC)[1] §21.45(a) concerns the classification and taxation of radio and television broadcasters. These entities are classified as "Class 5" taxpayers, and assigned "Tax Rate B" under §21.33(b) (currently $1.27 of tax for each $1,000 of taxable gross receipts or portion thereof).

LAMC § 21.45(a)(3)(Appendix 1) sets forth the standards by which the gross receipts of radio and television broadcasters are to be apportioned:

> "3. When gross receipts are constitutionally required to be apportioned and are derived from or attributable to activities engaged in both within and without the City, ***gross receipts shall be apportioned in a manner that is fairly calculated to determine the amount of gross receipts derived from or attributable to engaging in business in the City. This apportionment shall be made on the basis of payroll, value and situs of tangible property, general expense, or by reference to any of these or other factors, or by any other method of apportionment, that will fairly determine the amount of gross receipts derived from or attributable to engaging in business in the City.*** Gross receipts derived from or attributable to sources within the City shall include gross receipts from any activities carried on in this City."

Date: 6-12-12
Submitted in JBD Committee
Council File No: 09-1914-S13
Item No.: 2
From: MOTION PICTURE ASSOC. OF AMERICA
Deputy:

B. *The Industry and How Gross Receipts Are Generated*

Broadcasters generate gross receipts from the sales of advertising time on their respective stations. Some of this revenue is "national revenue", that is, revenue generated by sales of advertising time at the national level, usually by a corporate office in another City. By contrast, local advertising revenue is usually generated by a sales force employed by the station, which negotiates sales

[1] All references are to the Los Angeles Municipal Code ("LAMC") unless otherwise specified.

contracts with advertisers and ad agencies at various locations inside and outside the City limits.

The activities of broadcasters that account for their gross receipts is fundamentally multijurisdictional. Advertising time is priced according to audience. Broadcasters' audiences stretch well beyond the City's jurisdictional limits into other cities, other counties and in some cases, other states. Broadcasters may have physical property (studios, transmission equipment, etc.) located inside and outside the City. Other essential activities, such as news gathering, traffic reporting via live helicopter feed, etc, involve operations within and without Los Angeles.

In short, there is no reasonable doubt that the gross receipts of broadcasters are "attributable to activities engaged in both within and without the City...." and that broadcasters are entitled as a matter of law to apportionment of their gross receipts.

The Issues

A. Apportionment

The City's Office of Finance ("COF") and the Board of Review (BOR) have applied inconsistent and arbitrary apportionment methodologies to broadcasters. In some cases, however, the COF has denied any apportionment *at all.* When it does allow apportionment, the methods used by the City vary greatly, with the only common denominator to the City's choice of apportionment methodology it applies to individual broadcasters is that the method chosen seems to generate the most revenue for the City

Moreover, despite language in the LAMC cited above that requires the methodology to "fairly calculate" and "fairly determine" the amount of gross receipts attributable to in-city activities, where the BOR has proscribed an apportionment methodology in an appeals context, it has limited the methodology to expense-method apportionment, and has rejected consideration of all other forms of apportionment. This overattributes gross receipts to the City of Los Angeles, and results in excessive and illegal taxation. From the actions of the COF and the BOR, it appears that an illegal "underground regulation" is being applied.[2]

[2] See Appendix 2

B. Agency Fees

When advertising time is sold by the broadcasting industry, and the buy is placed by an advertising agency, the agency charges a fee for the labor it performs. That fee, however, is pursuant to an agreement between the agency and *its client*, not between the agency and the broadcaster. For example, if the advertiser defaulted on its payment for the advertising time it purchased, the agency's remedy would lie against its client, and not the broadcaster. Nonetheless, the COF has threatened to include agency fees within the measure of *the broadcaster's* gross receipts. Broadcasters maintain that these receipts are never those of the broadcaster to begin with, and should not legally be included in gross receipts.

Possible Solutions

- Amend the LAMC and Specify an Apportionment Methodology That is Appropriate for the Broadcast Industry

  A. There is virtually no nexus between the sources of a broadcaster's revenue (whether broadcasting or selling advertising) and expense apportionment.

Expense apportionment is not well-suited to the broadcast industry in general. As noted above, LAMC 21.45(a) does not require that any specific apportionment methodology be used to apportion a broadcaster's gross receipts; moreover, they do not offer a blanket approval of any specific methodology either. This is because all methods, including those expressly identified in the code, must still "fairly determine the gross receipts derived from or attributable to engaging in business in the City." In accord, the United States Supreme Court, in *Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, said that the apportionment formula used "must actually represent a reasonable sense of how income is generated."

The theory behind expense apportionment is that a strong correlation exists between where expenses are incurred, and where revenue is generated. For example, if one owns 4 liquor stores, and 2 of them are in Los Angeles and 2 are not, it is probably fairly easy to apportion income based on where expenses are incurred. But the same is not true when revenue is a result of a mobile sales force operating inside and outside the City, selling advertising that is being "delivered" into the household of multiple cities, counties and states. Thus, a court would **not** find that expense apportionment of the broadcast industry represents a "reasonable sense of how income is generated."

Moreover, as a practical matter, broadcasters don't track *where* expenses are incurred as part of their normal books and records. If one operates a news helicopter, those expenses are not routinely booked according to how much flight expense was incurred in Los Angeles airspace. Thus, expense allocation is inherently unreliable and expensive for taxpayers. The default, consequently, is for the City to allocate all expenses to a broadcaster's physical location inside the city limits.

B. Why Would Los Angeles Want to Use an Apportionment Method that Costs Them Jobs?

Under expense apportionment, for every job a broadcaster adds in Los Angeles, their business license taxes will go up. This is because 100 % of the expense incurred for placing a job in Los Angeles would be booked here. By contrast, using expense apportionment, the more jobs and property exported outside the City, the *lower* the broadcaster's business license tax expense apportionment would be. Thus, expense apportionment is both poor tax policy *and* poor economic policy. For the same reason, California is abandoning corporate income tax apportionment based partially on expenses (payroll and property).

C. Options for Reform

Numerous options for apportionment and overall reform exist. The Broadcasting industry favors three specific proposals:

1. *Use of a hybrid expense/sales approach, such as where advertising sales take place, and apportioning gross receipts based on sales force expense associated with those sales patterns.*

As discussed above, most broadcasters generate gross receipts through a sales force, which negotiates and executes contracts for the sale of local advertising time at locations inside and outside the City of Los Angeles (typically at the client's location). Sales personnel are typically compensated through a combination of salary and commission/bonus, which can be tied to the contracts the individual sales person has negotiated. As an apportionment methodology, one could develop a weighted-average sales compensation expense which would associate gross receipts from the sale of local advertising time (sourced based upon the location of the advertiser or agency) to the compensation expense associated with those gross receipts. This approach would give representation to the sales activity of the broadcaster, while being primarily rooted in expense apportionment methodology most familiar to the Office of Finance.

2. *Like the Motion Picture Industry, Place a Cap on the Total Amount of a Broadcaster's Gross Receipts (and therefore the amount of tax) that can be apportioned to the City.*

Section 21.109(c) caps the total amount of business license tax payable to the City by a motion picture, television and radio *producer*. Thus, without regard to the type, magnitude, or apportionment method used to determine gross receipts, this "cap" has the effect of recognizing the multijurisdictional nature of the motion picture industry, and the relationship between the industry's Los Angeles "footprint" and its tax liability. The motion picture cap is $9,245 per year in tax based on a gross receipts ceiling of $12,000,000.

A similar approach is appropriate for broadcasters. We propose an identical cap to that of the motion picture studios of $9,245.

3. *Amend the LAMC to Clarify That Agency Fees and National Advertising Revenue are Excluded from a Broadcaster's Gross Receipts.*

It is simply inappropriate to include the gross receipts of an advertising agency in the gross receipts of the broadcaster, particularly when the agency is retained by its client, and not by the station.

National advertising revenue, as explained above, has always been excluded by the COF from apportionable gross receipts. This practice should be codified formally in an amended ordinance.

APPENDIX 1-LAMC §21.45

SEC. 21.45. GROSS RECEIPTS FUND CLASS 5.

(Added by Ord. No. 178,101, Eff. 1/9/07.)

For every person engaged in the business of Radio and Television Broadcaster, and Theater, Tax Rate B, set forth in Section 21.33(b), shall be applicable.

(a) **RADIO AND TELEVISION BROADCASTER.**

1. Radio Broadcaster means any person engaging in the business of producing and broadcasting or broadcasting local or network radio programs or advertising material, including the furnishing of services, program elements or facilities in connection with production, production and broadcasting, or broadcasting.

2. Television Broadcaster means any person engaging in the business of producing and broadcasting or broadcasting local or network television programs or advertising materials, including the furnishing of services, program elements or facilities in connection with production, production and broadcasting, or broadcasting. A "television broadcaster" shall include any person operating a television system where the viewing audience pays a fee to view the broadcast.

3. When gross receipts are constitutionally required to be apportioned and are derived from or attributable to activities engaged in both within and without the City, gross receipts shall be apportioned in a manner that is fairly calculated to determine the amount of gross receipts derived from or attributable to engaging in business in the City. This apportionment shall be made on the basis of payroll, value and situs of tangible property, general expense, or by reference to any of these or other factors, or by any other method of apportionment, that will fairly determine the amount of gross receipts derived from or attributable to engaging in business in the City. Gross receipts derived from or attributable to sources within the City shall include gross receipts from any activities carried on in this City.

4. Notwithstanding the foregoing, the gross receipts used in the measurement of the tax under this section shall be limited to receipts that are generated, produced, or attributable to local activities in the State of California.

5. The provisions of this section shall apply only to business tax periods commencing on or after January 1, 1984.

(b) **THEATER.** Theater Operator means any person engaged in the business of conducting a theater containing a permanent stage upon which movable scenery and theatrical appliances are used, where regular theatrical or vaudeville performances are given and for the privilege of viewing the performances, a fee is charged, collected or received, or conducting, managing or carrying on a moving picture theater or drive-in theater, where moving or motion pictures are exhibited and a fee is charged, collected or received, or conducting, operating or promoting any entertainment, show or exhibition not otherwise required to pay a tax under other provisions of this article, where an admission fee is charged, collected or received, or where no admission fee is charged, collected or received but donations of any kind or character are solicited or accepted. Provided, that in connection with any entertainment, show or exhibition, if no admission fee is charged, collected or received, and no donations of any kind or character are solicited or accepted, or if the person conducting, operating or presenting the entertainment, show or exhibition taxed under this section is a person mentioned in Section 21.49 (c)3.(iv), Professions and Occupations, or if the person is a strolling musician who performs on sidewalks, in parks and similar publicly owned places where no admission fee is charged, collected or received, even though donations are solicited and collected, no tax shall be required to be paid for those performances by that person.

APPENDIX 2- The Reappearance of Ruling 20

In the mid 1990's the City Clerk's Office contemplated the adoption of a new Ruling 20 concerning Radio and Television broadcasters (Attached). The ruling proposed, *inter alia*, that:

1. There would be no exclusion for agency commissions;

2. All advertising placed within California (as opposed to within the City) is taxable;

3. Production activity was taxable when it occurred inside the City and was sold or licensed to be broadcast within California;

4. Apportionment was only to be allowed on an expense ratio basis, and use of an audience factor was specifically prohibited; and

5. Deviations from the expense allocation apportionment formula were only permitted after written application to the City Clerk.

Significantly, this proposed Ruling *was never adopted by the City Clerk.* Yet, it appears that the audit staff of the Office of Finance has been illegally and improperly applying this "underground regulation" to broadcasters generally while performing audits.

Amended 8/18/11

CITY OF LOS ANGELES
OFFICE OF CITY CLERK
TAX AND PERMIT DIVISION

CITY CLERK'S RULING 20 (NEW SERIES):
RADIO AND TELEVISION BROADCASTERS

Reference: Sections 21.189.2 and 21.00 Los Angeles Municipal Code.

General Statement

Radio and television broadcasters generate revenue primarily from these sources:

1. advertising;
2. production ;
3. furnishing services/program elements; and
4. rental of facilities, equipment, etc.

Their activity is classified under L.A.M.C Section 21.189.2. It is not necessary for a business entity to be directly involved in the actual broadcast to be classified under Section 21.189.2 as long as their business activity in some way contributes to a radio or television broadcast. If their business activity involves one or more of the elements listed above then Section 21.189.2 would apply.

Gross receipts will be determined as defined in Sections 21.00 and 21.189.2 L.A.M.C. with no exclusion for "agency commissions."

Interstate Exclusion

In determining taxable gross receipts, revenues generated from interstate activites are to be excluded.

Advertising

The City Clerk deems that revenue derived from advertising placed within California is taxable. This revenue is typically denoted as local sales within the industry. Revenue derived from advertising placed outside the State of California is exempt. This revenue is typically denoted as 'national sales' within the industry.

Production

A taxable activity would occur when the production occurs within the City and is sold within California or is licensed to be broadcast in California. If the production is "licensed" to a broadcaster (producer retaining rights) for interstate distribution, the revenue would be excludable from gross receipts.

Furnishing Services/Program Elements/Facilities

These activities are considered local activities and if performed within the City, would be subject to tax.

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Apportionment

In order to have a uniform method of allocating gross receipts, the following formula shall be used:

$$\frac{\text{In City costs}}{\text{Total costs}} \times \text{California gross receipts} = \text{taxable gross receipts}$$

Note: Costs to be used will consist of payroll, owned property and general expense and should be supportive to California gross receipts. The audience location, share, or ratings will not be used as an element of the apportionment.

Provision for Modification of Apportionment Formula

Any person who believes that the percentage of gross receipts determined to be subject to tax under this ruling is greater than the facts justify, may apply to the City Clerk for a modification of the percentage. Such application shall be made in writing to the City Clerk and shall be accompanied by a statement of facts supporting the basis for such modification. The City Clerk shall make his determination on the basis of evidence presented to him, and such other evidence as he may have, may request from the taxpayer, or may discover from other sources. The City Clerk shall increase, reduce, or allow to stand the percentage originally determined, depending on the facts.

Should the City Clerk be of the opinion that the percentage of gross receipts determined to be subject to tax under this ruling is less than the facts justify in any particular case, he shall make such investigation as is necessary to ascertain the facts and revise the percentage, if required.

Any variation from the percentages provided for under this ruling shall be approved in writing by a Chief of the Tax and Permit Division.