

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 11-03**

Letter Rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Whether [Taxpayer] qualifies as a bona fide Tennessee advertising agency and the criteria that must be met for payments made to a Tennessee advertising agency to promote and advertise a movie or television production to qualify for the 15% incentive credit administered by the Department of Revenue that is available for the production of movies or episodic television programs in Tennessee.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

The [Taxpayer] is a new venture organized for the purpose of promoting, advertising,

arranging and overseeing the distribution of primary [Type of Film Productions]. Its international headquarters are located at [Street Location Address], [City], Tennessee [Zip Code]. Its headquarters staff employees are located and employed at this address and its primary headquarters related functions and services are performed there.

Attached to this Letter Ruling is a summary [Summary Redacted] of the services that [Taxpayer] offers to its customers. [Taxpayer] will increase its staff for each film project by hiring sufficient personal, primarily Tennessee residents, to perform the services that it offers. As its client list and business volume grows over time, [Taxpayer] will add permanent employees at its headquarters facility in Tennessee.

[Taxpayer] is owned and managed by [Individual] who has [Experience Record] with an entertainment industry focus. [Individual] has done extensive work and research in the areas of film marketing and distribution and has developed a unique hybrid marketing/distribution model that addresses many of the inherent risks associated with film investment. He lives in the [Tennessee City] community and has raised and educated [Number] children in area schools, including [Names of Schools]. [Individual] serves on [Various Organizations].

Currently, [Taxpayer] has [Number] film projects in negotiation. These film projects are entitled [Names of Projects]. [Reference to Projects] films have a promotion and entertainment budget roughly estimated at just under [Dollar Amount in Excess of \$1 Million]. [Taxpayer] is also engaged in discussions with [Number] other film projects. All [Number] of these films will be Tennessee projects.

None of the Tennessee movie or episodic [Type of Projects] productions that [Taxpayer] plans to promote and advertise from Tennessee and [That] plan to qualify for the incentive provided by Tenn. Code Ann. § 67-4-2109(k) will be vulgar in nature or “obscene,” as the word is defined in Tenn. Code Ann. § 39-17-901.

QUESTIONS PRESENTED

1. Will [Taxpayer] qualify as a bona fide Tennessee advertising agency to which payments by a “qualified production company,” as the term is defined in Tenn. Code Ann. § 67-4-2109(k)(1)(C), will be considered “qualified expenses,” as the term is defined in Tenn. Code Ann. § 67-4-2109(k)(1)(A), for purposes of the 15% incentive credit offered by Tenn. Code Ann. § 67-4-2109(k) and administered by the Tennessee Department of Revenue?
2. What criteria must be met for payments made to a Tennessee advertising agency to promote and advertise a movie or television production to be considered “qualified expenses,” as the term is defined by Tenn. Code Ann. § 67-4-2109(k), for purposes of the 15% incentive available for the production of movies or episodic television programs in Tennessee?

RULINGS

1. Yes, provided that the qualified production company making promotion and advertising payments to [Taxpayer] meets all applicable statutory requirements set forth in Tenn. Code Ann. §§ 67-4-2109(k) and 67-6-224(3) and provided that [Taxpayer] meets the criteria set forth in this Letter Ruling.

2. (a) The advertising agency must be a bona fide Tennessee advertising agency that is engaged in the business of providing promotion and advertising services to its clients.

(b) The Tennessee advertising agency must conduct operations that have substantial economic substance and business purpose aside from securing tax benefits for its clients.

(c) The Tennessee advertising agency will normally have more than nominal income and expenses, will operate from a Tennessee business location and will have employees with expertise and experience in promoting and advertising movies and episodic television programs.

(d) If a Tennessee advertising agency subcontracts with an out-of-state advertising agency, or agencies, to assist with promoting and advertising a movie or episodic television program, payments to the out-of-state advertising agency under the subcontract cannot exceed 50% of the total amount that the Tennessee advertising agency charges the qualified production company for promoting and advertising the movie or episodic television program.

(e) The Tennessee advertising agency cannot act as a conduit to enable the qualified production company to secure the services of an out-of-state advertising agency.

(f) The Tennessee advertising agency cannot operate as a sham business enterprise whose primary activity and purpose is to receive advertising fees from a qualified production company and then contract with an out-of-state advertising agency in a scheme that attempts to enable the qualified production company to secure the services of an out-of state advertising agency and still qualify for a tax credit amounting to 15% of its advertising expenses.

ANALYSIS

REQUIREMENTS FOR THE PRODUCTION OF A MOVIE OR AN EPISODIC TELEVISION PROGRAM IN TENNESSEE TO QUALIFY FOR THE STATUTORY INCENTIVE PROVIDED BY TENN. CODE ANN § 67-4-2109(K)

The following definitions are set forth in Tenn. Code Ann. § 67-4-2109(k)(1) with regard to the availability of a credit for a percentage of the expenses incurred in producing a

movie or episodic television program in Tennessee.

- (A) "Qualified expenses" means those expenses incurred in this state that are necessary for the production of a movie or episodic television program in this state; provided, however, that such expenses shall not qualify under this subdivision (k)(1)(A) unless both the commissioner of revenue and the commissioner of economic and community development determine, in their sole discretion, that the production and the allowance of the credit are in the best interests of this state. For purposes of this subdivision (k)(1)(A), "best interests of this state" means a determination by the commissioner of revenue and the commissioner of economic and community development that the production is a result of the credit provided in this subsection (k) and that the production is not found to be obscene as defined in § 39-17-901;
- (B) "Qualified investor" means any entity that has established a headquarters facility as defined in § 67-6-224 that has invested in a qualified production company; and
- (C) "Qualified production company" means any entity that incurs at least one million dollars (\$1,000,000) in qualified expenses.

The word "obscene" used in Tenn. Code Ann. § 67-4-2109(k)(1)(A) set forth above is defined in Tenn. Code Ann. § 39-17-901(10) as follows:

(10) "Obscene" means:

- (A) The average person applying contemporary community standards would find that the work, taken as a whole, appeals to the prurient interest;
- (B) The average person applying contemporary community standards would find that the work depicts or describes, in a patently offensive way, sexual conduct; and
- (C) The work, taken as a whole, lacks serious literary, artistic, political, or scientific value[.]

The terms "community," "patently offensive," "prurient interest," and "sexual conduct" used in Tenn. Code Ann. § 39-17-901(10), set forth above, are defined as follows in Tenn. Code Ann. § 39-17-901(2), (11), (12) and (14):

- (2) "Community" means the judicial district, as defined in § 16-2-506, in which a violation is alleged to have occurred[.]
- (11) "Patently offensive" means that which goes substantially beyond customary limits of candor in describing or representing such matters;

(12) “Prurient interest” means a shameful or morbid interest in sex;

(14) “Sexual conduct” means:

(A) Patently offensive representations or descriptions of ultimate sexual acts, normal or perverted, actual or simulated. A sexual act is simulated when it depicts explicit sexual activity that gives the appearance of ultimate sexual acts, anal, oral or genital. “Ultimate sexual acts” means sexual intercourse, anal or otherwise, fellatio, cunnilingus or sodomy; or

(B) Patently offensive representations or descriptions of masturbation, excretory functions, and lewd exhibition of the genitals[.]

Tenn. Code Ann. § 67-6-224(b)(3), referenced in Tenn. Code Ann. § 67-4-2109(k)(1)(B), set forth above, defines a “headquarters facility” as follows:

(3) “Headquarters facility” means a facility in this state that houses the international, national, or regional headquarters of a taxpayer, where headquarters staff employees are located and employed, and where the primary headquarters related functions and services are performed.

Tenn. Code Ann. § 67-4-2109(k) makes the following provisions for a qualified production company or a qualified investor that has established a headquarters facility in Tennessee to obtain a credit for a percentage of the expenses incurred in producing a movie or episodic television program in Tennessee:

(2) A credit in an amount equal to fifteen percent (15%) of any qualified expenses shall be allowed against the combined franchise and excise tax liability of any qualified production company that has established a headquarters facility as defined in § 67-6-224. If the qualified production company does not have a headquarters facility as defined in § 67-6-224, then any qualified investor shall be allowed a credit equal to the amount of credit to which the qualified production company would have been entitled had it established a headquarters facility as defined in § 67-6-224, multiplied by the qualified investor’s percentage ownership interest in the qualified production company.

(3) In order for either a qualified production company or a qualified investor to become entitled to a credit under this subsection (k), the qualified production company shall submit documentation verifying that the qualified expenses have been incurred and paid.

(4) The commissioner shall review the documentation and notify the qualified production company of the approved credit.

(5) Once the qualified production company has been notified of the approved credit, either the qualified production company or the qualified investment company, as

appropriate, may submit a claim for the credit. To the extent that any amount allowed as a credit under this subsection (k) exceeds the current and outstanding combined franchise and excise tax liability of the claimant, the amount of such excess shall be deemed an overpayment and shall be refunded to the claimant. For qualified expenses incurred and paid during any tax year, the commissioner is authorized to issue a refund as described in this subdivision (k)(5) prior to the expiration of such tax year if the amount of the approved credit exceeds the claimant's current and outstanding franchise and excise tax liability on the date of such refund. Any refund under this subsection (k) shall be subject to the procedures of § 67-1-1802; provided, however; notwithstanding any procedure of § 67-1-1802 to the contrary, that a claim for refund shall be filed with the commissioner within three (3) years from December 31 of the year in which the qualified expenses were incurred. In no case shall a refund for the same qualified expenses be allowed twice.

For purposes of this Letter Ruling, it is assumed that the production company that is engaged in the production of a movie or episodic television program in Tennessee and that is making payments to [Taxpayer] to promote and advertise such production is a "qualified production company," as the term is defined in Tenn. Code Ann. § 67-4-2109(k)(1)(C) and meets all of the all statutory requirements set forth in Tenn. Code Ann. §§ 67-4-2109(k) and 67-6-224(3).

**1. & 2 PAYMENTS MADE TO [THE TAXPAYER] BY A "QUALIFIED
PRODUCTION COMPANY" WILL BE CONSIDERED "QUALIFIED
EXPENSES" ELIGIBLE FOR THE INCENTIVE CREDIT PROVIDED
TENN. CODE ANN § 67-4-2109(k) IF CERTAIN REQUIREMENTS ARE MET**

Under the definition of "qualified expenses" contained in Tenn. Code Ann. § 67-4-2109(k)(1)(A), promotion and advertising expenses ". . . incurred in this state that are necessary for the production of a movie or episodic television program in this state . . ." are "qualified expenses" if paid by a qualified production company to a bona fide Tennessee advertising agency that is engaged in the business of providing promotion and advertising services to its clients.

In order to be considered a bona fide Tennessee advertising agency that is engaged in the business of providing promotion and advertising services to its clients, the Tennessee advertising agency must conduct operations that have substantial economic substance and business purpose. It will normally have more than nominal income and expenses, will operate from a Tennessee business location and will have employees with expertise and experience in promoting and advertising movies and episodic television programs. It cannot operate as a sham business enterprise whose primary activity and purpose is receiving advertising fees from a qualified production company and then contracting with an out-of-state advertising agency in a scheme that attempts to enable a qualified production company to secure the services of an out-of state advertising agency and still qualify for a tax credit amounting to 15% of its advertising expenses.

For example, suppose that a qualified production company pays a fee of \$500,000 to a Tennessee advertising agency to promote and advertise a movie production. The Tennessee advertising agency has no experience or expertise in promoting and advertising a movie production and has little substance. The Tennessee advertising agency subcontracts with a California advertising agency to do all promotion and advertising of the movie production for a \$500,000 fee. The \$500,000 promotion and advertising fee that the qualified production company pays to the Tennessee advertising agency will not qualify for the statutory 15% incentive credit because the Tennessee advertising agency is merely acting as a conduit to enable the qualified production company to secure the services of an out-of-state advertising agency.

A bona fide Tennessee advertising agency may subcontract with an out-of-state advertising agency, or agencies, to assist with promoting and advertising a movie or episodic television program; provided, that payments to the out-of-state advertising agency do not exceed 50% of the total charge that qualifies for the 15% incentive credit.

For example, suppose that a Tennessee advertising agency with a Tennessee business location and employees who have expertise and experience in promoting and advertising movies and episodic television programs, receives \$500,000 from a qualified production company to promote and advertise a movie. The Tennessee advertising agency has substantial promotion and advertising operations but subcontracts with a New York advertising agency to assist in doing 10% of the promotion and advertising work with regard to the movie. Under the subcontract, a fee of \$255,000, which is 51% of the \$500,000 fee, is paid to the New York advertising agency. The \$500,000 that the qualified production company pays to the Tennessee advertising agency will not qualify for the 15% incentive credit.

In another example, suppose that a Tennessee advertising agency with a Tennessee business location and employees who have expertise and experience in promoting and advertising movies and episodic television programs, receives \$500,000 from a qualified production company to promote and advertise a movie. The Tennessee advertising agency subcontracts with a New York advertising agency to assist in doing 90% of the promotion and advertising work with regard to the movie. Under the subcontract, a fee of \$245,000, which is 49% of the \$500,000 fee, is paid to the New York advertising agency. The \$500,000 that the qualified production company pays to the Tennessee advertising agency will qualify for the 15% incentive credit.

The facts presented state that [Taxpayer] is an advertising agency with a Tennessee business location. Its owner and chief manager is a Tennessee resident who has done extensive work and research in the areas of film marketing and distribution and has developed a unique hybrid marketing and distribution model that addresses many of the inherent risks associated with film investment. Its functions and activities are consistent with those of a bona fide Tennessee advertising agency that is engaged in the business of providing promotion and advertising services to its clients and its operations appear to have substantial economic substance and business purpose aside from securing tax benefits for its clients. The facts presented show that the operations of [Taxpayer] are

not nominal and that it is not sham business enterprise.

Promotion and advertising fees paid to [Taxpayer] by qualified production companies that meet the movie and episodic television production incentive requirements set forth in Tenn. Code Ann. § 67-4-2109(k) will qualify for the 15% incentive credit; provided that [Taxpayer] complies with the requirements set forth in this Letter Ruling.

Arnold B. Clapp
Assistant Commissioner for
Compliance and Integrity

APPROVED: Charles A. Trost, Commissioner

DATE: 1-12-11