Cite as Det. No. 13-0401, 33 WTD 217 (2014)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	
	)	No. 13-0401
. . .	)	
	)	Registration No. . . .
	)	

> [1] RCW 82.04.2907; RCW 82.04.290(2)(a): BUSINESS AND OCCUPATION TAX – CLASSIFICATION – VIRTUAL PRINT FEES. Income from virtual print fees collected from a movie distributor each time that distributor's movie is exhibited using digital equipment is not income from royalties. Such income is properly classified as income from service and other activities.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Yonker, A.L.J. – Taxpayer leases digital equipment to movie theatres and also receives income in the form of virtual print fees from contracted movie distributors each time that distributor's movie is booked for showing on a theatre screen equipped with Taxpayer's leased digital equipment. Taxpayer protests the Department's reclassification of the income Taxpayer received from the virtual print fees from the retailing and the wholesaling business and occupation (B&O) tax classification to the service and other activities B&O tax classification. Further, although Taxpayer reported the VPFs under retailing, it now argues that the fees are properly taxable under the income from royalties B&O tax classification. We affirm the reclassification to the service and other business activities B&O tax classification and deny Taxpayer's petition.[1]

ISSUE

Should income from virtual print fees be taxed as income from royalties under RCW 82.04.2907 or as service income under RCW 82.04.290?

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

Taxpayer is a . . . limited liability company that leases digital projection equipment to movie theatres (exhibitors).[2] Taxpayer also has entered into separate agreements with movie distributors (distributors) in which the contracted distributor agrees to pay Taxpayer a virtual print fee (VPF) each time that distributor's movie is booked for exhibition on a movie screen equipped with Taxpayer's leased digital projection equipment.

The VPF is a fairly new phenomenon that has only come into existence in recent years as exhibitors have gradually transitioned their theatres over to digital projection technology. Historically, exhibitors employed projection systems that used 35mm celluloid film prints to exhibit movies in their theatres. In the 1990s, digital projection technology was developed that no longer required 35mm celluloid film prints to exhibit movies. However, bringing digital technology to the nearly 36,000 movie screens in the United States was initially slow due to the cost of that transition because exhibitors had to incur the full cost to obtain expensive digital projectors and other equipment in order to exhibit digital movies.[3] On the other hand, distributors stood to make a substantial savings in their business costs with the transition to digital technology because the 35mm celluloid film prints the distributors historically had to produce would no longer be necessary.[4]

. . . VPFs work [in the following manner]:

> The VPF structure was put in place to finance the conversion of movie theater screens from 35mm to digital projection systems. The use of digital projection (and in the future digital delivery) systems will ultimately save the movie industry hundreds of millions of dollars in annual print production and delivery services while improving on-screen presentation and offering more choices to moviegoers. **VPFs are structured to mimic the cost of producing a 35mm film print.** Instead of producing a physical print, distributors pay a fee to play digitally. That fee goes toward amortizing the cost of the digital projection equipment over time.[5]

In accordance with this model, entities like Taxpayer emerged as "deployers" of digital technology, leasing digital equipment to the exhibitors, and also entered into separate agreements

---

[2] Taxpayer is a subsidiary of . . .

[3] Traditional film projectors cost approximately $30,000 while the comparable digital equipment costs up to $150,000. *See* http://en.wikipedia.org/wiki/Virtual_Print_Fee, last visited on November 14, 2013.

[4] The VPF has been described as a mechanism or business model designed "to better balance savings and expenditures for both exhibitors and distributors." *See* [Taxpayer's parent's website],, last visited on October 22, 2013. With such a mechanism available, allowing for a more even allocation of transition costs between exhibitors and distributors, the exhibitors were presumably more willing to convert their theatres to digital technology. As evidenced by the widespread deployment of digital projection technology to the majority of U.S. movie screens in a matter of years, the VPF model appears to have been instrumental in that speedy transition In 2000, there were only 31 movie screens with digital capability. By 2010, the number of movie screens with digital capability had increased to 36,242, with full deployment of digital technology to all screens worldwide expected to occur by the end of 2015. *See* http://en.wikipedia.org/wiki/Digital_cinema, last visited on November 18, 2013.

[5] [citation redacted; *see also* http://en.wikipedia.org/wiki/Digital_cinema, last visited on November 18, 2013.]..

called digital cinema deployment agreements (deployment agreement) with various distributors.[6] As part of Taxpayer's example deployment agreement, it agreed to "deploy" up to 20,000 digital projection systems to the theatres nationwide. The deployment agreement also contained the following relevant provisions:

- The distributor agreed to pay Taxpayer the applicable VPF for each booking of a digital movie on a screen equipped with a digital system only during the term of the deployment agreement. (Section 8(a)). The distributor is specifically not required to pay VPFs to Taxpayer after the term of the deployment agreement has passed. (Section 8(e)).
- The term of the deployment agreement ends on the earlier of the two following dates:
  - The tenth anniversary of the "mean deployment date"; or
  - The last day of the quarter following the quarter in which "cost recoupment" occurs. (Section 3).
- Cost recoupment occurs when the "revenues" Taxpayer has received exceeds its costs plus an identified profit margin. (Section 9(a)(i)). The agreement further defined "revenues" to include, among other things, both the amounts Taxpayer receives from distributors in the form of VPFs, and also the amounts Taxpayer receives from each exhibitor for the lease of Taxpayer's digital equipment. (Section 9(a)(iii)).
- After the term of the deployment agreement has passed, the distributor may book a movie with an exhibitor without having to pay a VPF. (Section 8(e)).
- The decision to book a particular movie at a particular theatre rests solely with the distributor. (Section 7(a)).

As stated above, Taxpayer also "deployed" the digital projection systems by leasing such systems to exhibitors through separate lease agreements.[7] Taxpayer's example lease agreement contained the following relevant provisions:

- In consideration for the exhibitor's use of Taxpayer's equipment, the exhibitor will pay a monthly lease payment during the term of the agreement. (Section 6(A)(i)).
- The initial term of the lease is twelve years from the date on which the digital projection system at issue is "deployed" to the exhibitor. (Section 4).
- The decision to book a particular movie at a particular theatre rests solely with the exhibitor. (Section 6). . . .

In 2013, the Department's Taxpayer Account Administration (TAA) conducted an audit of Taxpayer's books and records for March 1, 2010 through June 30, 2012 (audit period). TAA found that during the audit period, Taxpayer reported the VPFs under the retailing business and occupation (B&O) tax classification, and reported the fees for retail sales tax purposes, but

---

[6] On appeal, Taxpayer provided a copy of the Amended and Restated Digital Cinema Deployment Agreement between Taxpayer and [a distributor], dated February 23, 2010, as an example of the deployment agreements it has with other major movie distributors.

[7] On appeal, Taxpayer provided a copy of the Master Equipment Lease Agreement dated March 10, 2010, executed between Taxpayer and [a lessee]., as an example of the standard lease agreement Taxpayer has with exhibitors.

claimed an “other” deduction. TAA reclassified the VPFs Taxpayer received during the audit period under the service and other activities B&O tax classification.

On April 8, 2013, the Department issued a tax assessment for $. . . in additional tax liability, a $. . . five percent assessment penalty, and $. . . in interest, for a total tax assessment of $. . . . The tax assessment remains unpaid. On May 6, 2013, Taxpayer timely appealed the full amount of the tax assessment. On appeal, Taxpayer argued that the VPFs it received during the audit period should be reclassified under the royalties B&O tax classification.

ANALYSIS

Washington imposes a B&O tax “for the act or privilege of engaging in business” in this state. RCW 82.04.220(1). The B&O tax measure is “the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.” *Id.* The rate used is determined by the type of activity in which a taxpayer engages. *See generally* Chapter 82.04 RCW. Generally, if a taxpayer is engaged in an activity “other than or in addition to an activity taxed explicitly” under Chapter 82.04 RCW, that activity is subject to service and other activities B&O tax. RCW 82.04.290(2)(a). The TAA division found that the income from the VPFs was taxable under the service and other activities B&O classification because VPFs are not an activity taxed explicitly under Chapter 82.04 RCW.

Taxpayer originally reported its income from the VPFs as retailing and wholesaling income, but now concedes that the gross income at issue is not properly taxable under either of those classifications. Instead, Taxpayer argued on appeal that the income is properly taxable under the income from royalties B&O tax classification, which states the following:

> (1) Upon every person engaging within this state in the business of receiving income from royalties, the amount of tax with respect to the business is equal to the gross income from royalties multiplied by the rate of 0.484 percent.
>
> (2) For the purposes of this section, “gross income from royalties” means compensation from the **use of intangible property**, including charges in the nature of royalties, regardless of where the intangible property will be used. For purposes of this subsection, “intangible property” includes copyrights, patents, licenses, franchises, trademarks, trade names, and similar items. “Gross income from royalties” does not include compensation for any natural resource, the licensing of prewritten computer software to the end user, or the licensing of digital goods, digital codes, or digital automated services to the end user . . . .

RCW 82.04.2907 (emphasis added). As the statute makes clear, in order for gross income to qualify as income from royalties, the income must be received for “the use of intangible property.” RCW 82.04.2907 also makes clear that the “intangible property” at issue must be similar to copyrights, patents, licenses, franchises, trademarks, and trade names, in order to qualify.

Taxpayer has the burden of showing its entitlement to a particular B&O tax rate. *See* Det. No. 89-3, 7 WTD 105, 114 (1989); Det. No. 91-110, 11 WTD 163 (1991) ("The burden is therefore upon the taxpayer to provide acceptable documentation to substantiate the sought tax classification for the income in question"). Taxpayer argues that under the VPF model, a distributor pays Taxpayer a VPF in exchange for Taxpayer granting that distributor an "intangible" property right to show its movie on Taxpayer's leased equipment. We disagree. Taxpayer grants distributors neither intangible property rights nor rights to use tangible personal property. As such, Taxpayer has failed to meet its burden of proving that it is entitled to report its income from the VPFs as royalty income.

Instead, we agree with TAA that Taxpayer's income from the VPFs is properly taxable as service income under RCW 82.04.290(2)(a). Based on our analysis of the history of the VPF model and the structure of the deployment agreement, we conclude that the distributors paid the VPFs as an incentive for the speedy deployment of digital technology to exhibitors. This is because the distributors paid the VPFs per "screen," thus motivating Taxpayer to maximize the number of screens with digital capability, and thereby maximizing the VPFs it received from distributors. This is consistent with the history behind the development of the VPF model. As discussed earlier, prior to the emergence of the VPF, exhibitors were reluctant to incur the cost of transitioning to digital projection technology due to the cost they had to incur. On the other hand, a speedy and complete deployment of digital technology was most advantageous to distributors because they would then be able to distribute their movies without incurring the business expense of producing 35mm celluloid film prints.

The VPF model provided a mechanism through which distributors could provide an incentive to convert to digital technology without incurring additional business costs. Distributors essentially shifted funds from paying for 35mm celluloid film production to payment of VPFs to deployers like Taxpayer who were willing to lease the expensive digital equipment to exhibitors. Indeed, as Taxpayer's parent company described on its website, the VPFs are specifically meant to "mimic" the business cost of producing the old film prints. As such, distributors were willing to pay that equivalent amount to Taxpayer – as opposed to paying that amount toward the production of 35mm celluloid film prints – until such time as digital deployment was complete and Taxpayer had recovered its deployment costs. At that time, the distributors would forever eliminate the business cost of producing the old film prints, and according to the deployment agreement, would also no longer have to pay the VPFs. Based on these findings, we conclude that the purpose of the distributors' payment of VPFs was to incentivize Taxpayer's digital deployment services in order to permanently save distributors certain business costs in the future.

Since we find that the purpose of the VPF transactions was not to grant an intangible right of some kind, the gross income of such transactions is not properly taxable as income from royalties. Instead, we conclude that since gross income from the VPF transactions is not specifically enumerated elsewhere in Chapter 82.04 RCW, it is properly taxable under the services and other activities B&O tax classification as described in RCW 82.04.290(2)(a). As such, we affirm TAA's findings in this case.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 27th day of December, 2013.