New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

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Corporation Tax
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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C020722A

On July 22, 2002, a Petition for Advisory Opinion was received from Discovery Communications, Inc., 7700 Wisconsin Avenue, Bethesda, Maryland 20814. Petitioner, Discovery Communications, Inc., submitted additional information pertaining to the Petition on July 21, 2003.

The issue raised by Petitioner is whether the lease payments made to unrelated third parties for the use of extraterrestrial satellite transponders should be included in the numerator and denominator of the property factor for purposes of determining the business allocation percentage under section 210.3(a) of Article 9-A of the Tax Law.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner is a Delaware corporation founded in 1985, and is currently headquartered in Bethesda, Maryland. Petitioner is a global media and entertainment company, offering a number of distinctive cable entertainment brands, including: the Discovery Channel, The Learning Channel, Animal Planet and The Travel Channel. Domestically, Petitioner reaches almost 85 million households through 11 networks, producing 2,100 hours of original programming each year in the United States. Internationally, Petitioner has programming in 155 countries and territories reaching over 700 million total subscribers.

The general process used by Petitioner to produce television programming to be viewed by the cable subscriber is outlined below. Typically, the process begins with Petitioner contracting with an outside (unrelated third party) production company to produce and tape a show at the producer's own facility. Petitioner does not operate its own production studios; thus, all programming is obtained from independent third parties. Taped shows purchased from third-party production houses are then sent to an *uplink facility* which mounts the tape and sends a signal to extraterrestrial satellite transponders. The signals from the transponders are then sent from space to ground equipment owned by independent cable operators who then transmit the programs to their cable subscribers.

Petitioner does not own or lease any of the uplink facilities or ground equipment used in the transmission process. Petitioner contracts for uplink services with an unrelated third party whose uplink facility is located in Connecticut. Petitioner owns some transponders outright and leases other transponders from an unrelated third party. Lease agreements for transponders range between ten to fifteen years in duration. Petitioner leases office space in New York, which is used solely for advertising and sales functions. All of Petitioner's employees located in New York perform advertising and sales functions.

Petitioner has submitted portions of one transponder lease agreement for the full-time lease of transponder capacity by Petitioner. Pursuant to that lease agreement, if the transponder capacity

is provided from a portion of a transponder, consisting of a transponder segment, the transponder capacity is power and bandwidth limited. The particular transponder or transponder segment that makes up Petitioner's transponder capacity is to be identified in the agreement. Petitioner pays a monthly lease fee and a monthly *in-orbit protection fee*. (The facts submitted do not indicate whether Petitioner pays any other fees with respect to this agreement.) In the event that there ceases to be at least one preemptible transponder segment available for use by Petitioner, the in-orbit protection fee will cease. The initial lease agreement is for a term of seven years and may be extended for an additional three years.

Pursuant to Petitioner's transponder capacity lease agreement, the transponder capacity may be used by Petitioner solely for transmission of its own *television service*, which means video programming, with associated audio, control and data signals, for broadcast, cable, direct-to-home, or similar mass distribution. Petitioner's *television service* includes the television services of its parent companies and subsidiaries identified in the agreement, and joint venture companies as defined in the agreement. However, the agreement provides that these provisions are not meant to permit resale or sublease of Petitioner's transponder capacity.

Petitioner has also submitted a transponder lease agreement for the full-time lease of a specific transponder from the owner of the satellite on which it is located. In this lease agreement, Petitioner receives satellite transponder service on one fully protected transponder specified in the agreement. Petitioner has the exclusive right to use the transponder for all purposes allowed under the agreement, and has control of the content of the communications transmitted over the transponder. For the lease of this transponder, Petitioner pays a monthly fee which includes all charges for tracking, telemetry and control services (TT&C) and full protection (in-orbit protection) provided by the satellite owner, which is the lessor. The satellite owner has the sole and exclusive control and operation of the satellite. Petitioner may only use the transponder for video services and the transponder is used by Petitioner as the primary feed of its principal cable programming service. Petitioner shall not assign or transfer its rights or obligations under the agreement, except to its parent corporation or to a wholly-owned subsidiary, without getting the lessor's agreement. The initial term of the agreement is 10 years, and may be extended.

In addition, Petitioner has submitted a transponder lease agreement for the full-time lease of a specific transponder that was purchased by the lessor from the owner of the satellite on which the transponder is located. The transponder sales agreement between the owner of the satellite and the lessor of the transponder has been incorporated into the transponder lease agreement between the lessor and Petitioner. Under this transponder lease agreement, Petitioner agrees that it will use the transponder solely in accordance with, and subject to, the provisions and restrictions in the sales agreement. The owner of the satellite has represented that the transmission of digital signals through the transponder is acceptable usage. Petitioner may assign its rights under the agreement to a subsidiary majority-owned by Petitioner only if certain conditions of the agreement are met. (In a separate letter agreement between Petitioner and the lessor, Petitioner may sublease the transponder or a portion thereof in accordance with the letter agreement.) Petitioner pays a monthly fee to the lessor which includes the lease of the transponder and TT&C services and in-orbit protection for the

transponder. The lease will expire at the *end-of-life* of the satellite unless previously terminated in accordance with the provisions of the agreement.

Applicable law and regulations

The United States Government has exclusive sovereignty of airspace of the United States (49 USCS § 40103).

Section 208.11 of the Tax Law provides that "[t]he term 'tangible personal property' means corporeal personal property, such as machinery, tools, implements, goods, wares and merchandise, and does not mean money, deposits in banks, shares of stock, bonds, notes, credits or evidences of an interest in property and evidences of debt."

Section 210.3(a) of the Tax Law contains the provisions for the business allocation percentage, consisting of a property factor, a payroll factor and a receipts factor, for purposes of allocating business income and business capital to New York State. Section 210.3(a)(1) of the Tax Law contains the provisions for the property factor of the business allocation percentage, and provides, in part:

> ascertaining the percentage which the average value of the taxpayer's real and tangible personal property, whether owned or rented to it, within the state during the period covered by its report bears to the average value of all the taxpayer's real and tangible personal property, whether owned or rented to it, wherever situated during such period....

Section 210.8 of the Tax Law provides:

> If it shall appear to the [commissioner of taxation and finance] that any business or investment allocation percentage or alternative business allocation percentage determined as hereinabove provided does not properly reflect the activity, business, income or capital of a taxpayer within the state, the [commissioner of taxation and finance] shall be authorized in [his] discretion, in the case of a business allocation percentage or alternative business allocation percentage, to adjust it by (a) excluding one or more of the factors therein, (b) including one or more other factors, such as expenses, purchases, contract values (minus subcontract values), (c) excluding one or more assets in computing such allocation percentage, provided the income therefrom is also excluded in determining entire net income or minimum taxable income, or (d) any other similar or different method calculated to effect a fair and proper allocation of the income and capital reasonably attributable to the state....

Section 4-3.1(c) of the Business Corporation Franchise Tax Regulations ("Regulations") provides:

> Tangible personal property of the taxpayer is considered to be within New York State if and so long as it is physically situated or located here, even though it may be stored in a

bonded warehouse. Property of the taxpayer held in New York State by an agent, consignee or factor is considered to be situated or located within New York State. Property in transit between locations of the taxpayer is considered to be at its destination for purposes of the property factor. Property in transit between a buyer and a seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices is included in the numerator of its property factor if its destination is New York State.

Section 4-3.2 of the Regulations provides, in part:

(a) In computing the property factor, real and tangible personal property rented to the taxpayer must be included. In order to avoid unnecessary hardship on taxpayers and for ease of administration, the value of real and tangible personal property, both within and without New York State, which is rented to the taxpayer is determined by multiplying the gross rents payable during the period covered by the report by eight.

* * *

(d) In exceptional cases, use of the general method described in this section may result in inaccurate valuations of rented real or tangible personal property. In such cases, any other method which properly reflects the value may be adopted by the department either on its own motion or at the request of the taxpayer. Another method of valuation may not be used unless approved by the department. A request for a different method of valuation must provide full information with respect to the property, including the basis for the valuation proposed by the taxpayer. Once approved or required by the department, such other method of valuation must be used in subsequent taxable years unless the facts materially change. If the facts materially change, the taxpayer must report such change in facts to the department and the department may consent to or require a change from the method of valuation previously approved.

Section 4-6.1 of the Regulations provides, in part:

(a) Generally, the business allocation percentage results in a fair allocation of the taxpayer's business capital and business income to New York State.... However, experience in this and other states which impose similar franchise taxes has shown that due to the nature of certain businesses the formulas used to compute the percentages may work hardship in some cases and not do justice either to the taxpayer or to the State. Article 9-A of the Tax Law authorizes the commissioner to use other methods to more accurately reflect the business activity within New York State. If a different method is used, it must be calculated to effect a fair and proper allocation of the business income [and] business capital ... reasonably attributable to the State.

(b) When it appears that the business allocation percentage ... does not properly reflect the activity, nature of business, income or capital of the taxpayer in New York State, the commissioner, in his or her discretion, may adjust the business allocation percentage ... by:

(1) excluding one or more factors;

(2) including one or more factors, such as expenses, purchases or contract values minus subcontract values;

(3) excluding one or more assets used in computing any factor included in the business allocation percentage ... provided the income therefrom is also excluded in determining entire net income ... or

(4) any other similar or different method calculated to effect a fair and proper allocation.

Opinion

Before Petitioner's issue can be addressed, it is necessary to provide some background with respect to satellite transponders.

The following is part of a discussion of *Settlement Guidelines for Transponders*, an Internal Revenue Service coordinated issue paper under its Industry Specialization Program, issued April 26, 1994:

"A 'transponder' is the device on a communications satellite which amplifies and relays transmissions between 'transmit' and 'receive' earth stations." *In the Matter of Domestic Fixed-Satellite Transponder Sales*, 90 FCC 2d 1238 n.2 (1982). (Hereinafter referred to as *"Domsat Transponder Sales*, 90 FCC 2d 1238.") More precisely, a transponder is a device in a satellite that accepts communication signals relayed to it from the satellite's receiver antenna (which signal was received from a transmit antenna for transmission to a receive earth station), amplifies the signal, converts the signal into another frequency and relays the signal to the satellite's transmit antenna for transmission to receive earth station.

A single satellite may have from 12 to 36 transponders. The receive and transmit antennas on the satellite handle all the signals relayed through the various transponders. Each transponder accepts only signals on the frequency for which it is programmed.

The satellite is normally powered by solar panels and once the satellite becomes operational the transponders will operate automatically. The satellite, itself, is maintained in its geosynchronous orbit by rocket motors. Besides the transponders, the satellite has communication devices and switches to control its position and operation. The transponders,

however, are the heart of the communications link between transmit and receive earth stations.

Transponders are typically used to transmit telephone, television, and radio signals and various kinds of data between the earth stations.

Prior to 1982, satellite operators (hereinafter referred to as "domsat operators") were generally required to "lease" transponders on a common carrier basis, pursuant to Title II of the Communications Act of 1934. 47 USCA sections 201-224 (1962 & Supp 1988.) (Hereinafter referred to as the "Act") (The best known common carriers are the various telephone companies.) Under 47 USCA sections 201 and 202 a domsat operator (the common carrier) was required to furnish communications services to customers on a first-come, first serve basis. The domsat operator was also subject to considerable regulation with respect to the prices it charged customers (referred to as tariffs), including price controls. 47 USCA section 203.

The Federal Communications Commission (FCC) allowed domsat operators to enter into long term exclusive leases of transponders even though the leases were technically on a common carrier basis. The leases gave the end user-lessee the exclusive right to use the transponder over the transponder's useful life.

The rents charged end users were often equivalent in amount to the purchase of transponders under the sales at issue here.

In 1982, the FCC ruled that certain satellite owners could *sell* transponders on specific satellites to end users. *Domsat Transponder Sales,* 90 FCC 2d 1238. In so holding, the FCC expressly removed the transponders that were to be sold from the jurisdiction of Title II of the Act.

The United States Court of Appeals for the District of Columbia affirmed the FCC's holding in *World* [*sic*] *Communications, Inc. v Federal Communications Commission*, 735 F2d 1465 (D.C. Cir 1984). The court, in describing the sale of transponders stated:

A transponder sale contract conveys to the purchaser an exclusive ownership right in a specific transponder during its useful life. The purchaser may use the property thus acquired as collateral for loans, and may enjoy certain tax benefits as a result of transponder ownership-notably, accelerated depreciation deductions and investment tax credit. The satellite owner, however, retains responsibility for the operation of the satellite. Sale transactions are not subject to the first-come, first-served allocation mechanism of common carrier service. Buyers negotiate the right to use specific transponders directly with the satellite operator, sometimes even before the satellite is launched. The price is set by contract and is not subject to government regulation.

Id. at 1471....

* * *

Although the FCC removed certain transponders from Title II regulation, the domsat operator is still subject to Title III of the Act. 47 USCA sections 301-399b. Title III of the Act generally requires that the operator of a transmitter of radio signals have a license from the FCC granting him the authority to use a particular frequency for transmissions. The FCC considers a communications satellite a transmitter of radio signals and, thus, the domsat operator must have a FCC license to operate the satellite. *Domsat Transponder Sale*, 90 FCC 2d 1238.

The license granted the domsat operator contains authorization to position the satellite in a particular orbit above the Earth and authorization to use various frequencies for transmission of communication signals to Earth. The various frequencies for transmission of communication signals to Earth are emitted by the transponders on the satellite, one frequency per transponder.

* * *

The operator of a transmit earth station which transmits communication signals to the satellite must also obtain a license from the FCC because a transmit earth station is also considered a transmitter of radio signals under Title III of the Act. *Domsat Transponder Sales*, 90 FCC 2d 1238....

The purchaser of a transponder is not required to have a license to use the transponder. The FCC held, in *Domsat Transponder Sales*, 90 FCC 2d 1238, that the sale of a transponder does not constitute a transfer of control of a radio transmitter, which requires the transfer of the FCC license and FCC approval pursuant to 47 USCA section 310(d). In explaining why it did not think a transponder purchaser is required to have a license, the FCC stated:

> We do not believe there is anything intrinsic to transponder sales that now requires us to individually license the transponders. The buyer of a transponder, like a lessee under tariff, [i.e., the lease of a transponder from a common carrier,] is unable to exercise licensee responsibilities because of the limited nature of its ownership rights. Each of the sellers has represented to the Commission [FCC] requirements regarding operation of the satellite in orbit. The buyer only obtains ownership rights to the transponder equipment. Any rights to use the associated frequency are the same whether provided by the sales contract or pursuant to a tariffed lease arrangement. Therefore, it has no means to control the facilities power or transmissions. Thus, we believe that these transactions do not involve the transfer of control of a Title III license.

Id. An operator of a receive earth station is also not required to have a FCC license.

A FCC license does not give the licensee any ownership rights, or a vested interest in, the orbit assigned the satellite or the frequencies assigned to the transponders....

* * *

A typical transponder sales contract transfers title to one or more transponders from the domsat operator to the purchaser for an indefinite period of time. The sales contract usually contains an estimate of approximately ten years for the useful life of the satellite and transponders. The agreement usually states the title to the transponders is conveyed free from all liens, charges, claims or encumbrances and without limitations. In effect, the purchaser has the exclusive right to the transponders.

* * *

The sales contract usually contains warranties that if any of the purchased transponders fail to function properly after transfer of title and during their useful lives, the seller will, if available, transfer title to a spare transponder on the same or a different satellite to the purchaser for no extra charge.

* * *

The sales contract usually contains an agreement in which the domsat operator agrees to maintain the satellite and keep it in its designated orbit. This function is typically called "Tracking, Telemetry and Control" or "T,T&C".

* * *

It can be argued that the sales contract contains an implied agreement between the domsat operator and the transponder purchaser giving the transponder purchaser the right to use the frequencies allocated to the purchased transponders. The domsat operator obtained the license from the FCC, has control over the frequencies and is responsible for their use. Thus, even though the sales contract does not expressly mention such an agreement the agreement must implicitly exist because otherwise the purchaser could not use the frequencies allocated to the transponders.

* * *

A transponder purchaser not only purchases a tangible asset, i.e., the transponder, but also intangible assets. The basis of the transponder for investment credit and accelerated depreciation cannot exceed its fair market value at the time of the purchase. Therefore, the gross purchase price must be apportioned between the transponder and the other intangible

> rights acquired by transponder purchaser based on their fair market values. Some of the other intangible rights may include maintenance and service agreements, nonstandard and additional warranties, rights to use Federal Communication designated frequencies, preferred orbital positions, etc.
>
> Therefore, the values of the transponders and various intangibles should be determined and assigned their separate tax basis for investment credit and accelerated depreciation purposes....

In this case, Petitioner contracts for uplink services with an unrelated third party that sends Petitioner's taped shows through a signal to satellite transponders. The signals from the transponders are then sent from space to receiving ground equipment owned by independent cable operators who then transmit the programs to their cable subscribers. Petitioner's contracted uplink services are provided in Connecticut. Petitioner owns some of the satellite transponders, and some are leased from unrelated third parties under ten to fifteen year lease agreements.

Following the Internal Revenue Service and FCC determinations, satellite transponders are tangible personal property as defined in section 208.11 of the Tax Law. However, leasing certain capacity on a transponder enables the lessee to obtain the right to use FCC designated frequencies, which constitutes intangible personal property.

Accordingly, the lease agreements where Petitioner is only leasing capacity on a transponder are for the right to use FCC designated frequencies, and the leasing of such capacity constitutes intangible property. Such intangible property is not included in the numerator or denominator of the property factor of the business allocation percentage under section 210.3(a)(1) of the Tax Law and section 4-3.1(c) of the Regulations.

The transponders owned by Petitioner, and transponders leased by Petitioner from either the satellite owner itself or the owner of a transponder previously purchased from the satellite owner, constitute tangible personal property and are included in the denominator of the property factor of the business allocation percentage under section 210.3(a)(1) of the Tax Law. Since the satellite transponders are not physically situated or located in New York State, pursuant to section 210.3(a)(1) of the Tax Law and section 4-3.1(c) of the Regulations the transponders would not be included in the numerator of the property factor.

When determining the value of Petitioner's owned or leased transponders that are included in the computation of the property factor of the business allocation percentage under section 210.3(a)(1) of the Tax Law, only the value of the tangible personal property, excluding any intangible assets that may also be acquired, may be included in the computation. Following the Internal Revenue Service treatment, when Petitioner purchases or leases a transponder, the gross purchase price or lease payment must be apportioned between the transponder, which is the tangible property, and any intangible rights that are also acquired by the purchase or lease. Such intangible rights may include maintenance and service agreements, nonstandard and additional warranties,

rights to use FCC designated frequencies, preferred orbital positions, etc. The portion attributable to such intangibles may not be included in valuing the transponder that is included in the property factor.

Further, with respect to a transponder leased by Petitioner, the general method of valuation contained in section 4-3.2(a) of the Regulations of multiplying the gross rents payable with respect to the transponder (excluding any portion of the lease payment attributable to intangible property) by eight, may result in an inaccurate valuation of such leased transponder if the lease charges are the equivalent in amount to the purchase price of the transponder, if sold. Pursuant to section 4-3.2(d) of the Regulations, if the general method does result in an inaccurate valuation of a leased transponder, the Department of Taxation and Finance may adopt another method of valuation that properly reflects the value of the transponder leased by Petitioner, for purposes of computing the property factor pursuant to section 210.3.(a)(1) of the Tax Law. Such determination is a factual matter that is not susceptible of determination within the scope of an advisory opinion. (An advisory opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to "a specified set of facts." Tax Law, §171.Twenty-fourth; 20 NYCRR 2376.1(a).)

Finally, it should be noted that section 210.8 of the Tax Law and section 4-6.1 of the Regulations authorize the Commissioner of Taxation and Finance to use other methods to more accurately reflect the business activity within New York State when it appears to the Commissioner that the business allocation percentage determined pursuant to section 210.3(a) of the Tax Law does not properly reflect the activity, business, income or capital of a taxpayer within New York State. If a different method is used, it must be calculated to effect a fair and proper allocation of the business income and business capital reasonably attributable to New York State. The determination of whether the business allocation percentage determined pursuant to section 210.3(a) of the Tax Law results in a fair allocation of Petitioner's business capital and business income to New York State is also a factual matter that is not susceptible of determination within the scope of an advisory opinion. (Tax Law, §171.Twenty-fourth; 20 NYCRR 2376.1(a).)

DATED: May 12, 2004

/s/
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.