

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions :
of :
AMERICAN MULTI-CINEMA, INC. :
for Revision of Determinations or for Refund of :
Sales and Use Taxes under Articles 28 and 29 of :
the Tax Law for the Period June 1, 2004 :
through August 31, 2009. :

In the Matter of the Petition : DETERMINATION
of : DTA NOS. 823589,
823590 AND 823646
RKO CENTURY WARNER THEATRES, INC. :
for Revision of a Determination or for Refund of :
Sales and Use Taxes under Articles 28 and 29 of :
the Tax Law for the Period May 1, 2007 :
through March 31, 2008. :
:

Petitioner American Multi-Cinema, Inc. filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 2004 through August 31, 2009. Petitioner RKO Century Warner Theatres, Inc. filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period May 1, 2007 through March 31, 2008.

A consolidated hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on August 10,

2011 at 9:00 A.M. with all briefs to be submitted by January 6, 2012, which date commenced the six-month period for issuance of this determination (Tax Law § 2010[3]). Petitioners appeared by McDermott, Will & Emery, LLP (Arthur R. Rosen, Esq., and Leah Robinson, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Anita K. Luckina, Esq., of counsel).

ISSUE

Whether petitioners' payments to motion picture distribution companies for licenses to exhibit motion pictures delivered to petitioners' theatres in digital format via portable computer hard drives are subject to sales tax.

FINDINGS OF FACT¹

1. Petitioner American Multi-Cinema, Inc. (AMC) is a corporation organized under the laws of Missouri with its principal place of business in Kansas City, Missouri. Petitioner RKO Century Warner Theatres, Inc. (RKO) is a corporation organized under the laws of Delaware. During the periods in issue, each of the petitioners operated in the same manner.

2. During the period spanning May 1, 2007 through February 29, 2008, AMC paid sales tax in the amount of \$116,012.10 on its payments to motion picture distribution companies (distributors) in connection with AMC's exhibition of digital motion pictures. During the period spanning March 1, 2008 through August 31, 2009, AMC paid sales tax in the amount of \$490,433.58 in like fashion on its payments to distributors. During the period spanning May 1, 2007 through March 31, 2008, RKO paid sales tax in the amount of \$8,598.68 in like fashion on its payments to distributors. Petitioners each timely filed claims for refund of the foregoing

¹ The parties to these matters entered into a stipulation of facts, and those facts have been incorporated herein.

amounts of sales tax paid. The Division of Taxation (Division) denied petitioners' claims for refund, and petitioners, in turn, timely filed petitions challenging the refund denials.²

3. During the periods at issue, petitioners operated several theatres in New York State where motion pictures were exhibited to members of the public who purchased tickets to view such motion pictures. While the per-ticket charge to members of the public varies, one ticket authorizes one individual to view one motion picture one time.

4. The source of the feature-length motion pictures distributed for exhibition in petitioners' theatres include the major motion picture studios such as Sony, Disney, Warner Brothers, Universal, Paramount and Fox, as well as independent production companies that receive funding to produce motion pictures. The major studios distribute their own motion pictures, and sometimes distribute the independently produced motion pictures, which otherwise are distributed by the independent company that produced the particular motion picture. Petitioners do not own the motion pictures they exhibit, but instead receive the motion pictures from distributors who license petitioners to exhibit the motion pictures.

5. Traditionally, motion pictures were received by petitioners in tangible form on 35mm celluloid film (the 35mm Film Model). However, due to industry-wide changes in technology, motion pictures are increasingly being delivered in digital format (the Digital Model). Throughout the periods in issue, motion pictures were received by petitioners in both tangible form on 35mm film and in digital form. While the tax at issue in this proceeding concerns only

² AMC's refund claim in the amount of \$116,012.10, assigned Division of Tax Appeals (DTA) No. 823589, was denied on February 3, 2010. AMC's refund claim in the amount of \$490,433.58, assigned DTA No. 823590, was denied on February 12, 2010. RKO's refund claim in the amount of \$8,598.68, assigned DTA No. 823646, was denied on April 15, 2010.

motion pictures received by petitioners in digital form, both the 35mm Film Model and the Digital Model are relevant and each is discussed hereinafter.

The 35mm Film Model

6. Under the traditional 35mm Film Model, a motion picture consists of thousands of separate images, each a “frame,” together with sound, on 35mm film. The film itself is physically moved through a projector via mechanical means such that, when the frames are shown in rapid succession with intermittent light, the result on screen is a motion picture. Because the images that comprise the motion picture are physically on the film stock, petitioners need a physical copy of a motion picture, commonly referred to as a “print” or a “release print,” for each screen on which the motion picture is to be exhibited.

7. Each print is composed of multiple 2,000-foot lengths of film stock loaded onto metal reels known as “shipping reels.” Five or six shipping reels, together, will hold an average-length motion picture. The shipping reels for a particular motion picture are shipped to petitioners via common carrier in two or three cases that are each about the size of a briefcase.

8. In addition to the motion picture, distributors send previews of other motion pictures, known as “trailers,” to petitioners. Each trailer is, like the motion pictures described herein, on 35mm film and is loaded onto a small plastic reel.

9. Upon receiving the motion picture loaded on shipping reels and the trailers loaded on small plastic reels, petitioners’ theatre personnel must assemble the motion picture before it can be exhibited. Petitioners’ employees, in an area commonly called the “build-up area,” remove the motion picture from the shipping reels, remove the trailers from the small plastic reels, and

then physically splice together a leader strip,³ several trailers, snipes,⁴ and the separate 2,000-foot lengths of the motion picture, and then load the resulting combined film onto a large round tray known as a “platter.” The process of splicing the various film segments together is accomplished using adhesive-backed splicing tape and a splicing machine to join the film segments.

Petitioners’ employees wear white film-editing gloves during this process so as to avoid damaging or dirtying the film sections and negatively impacting the playback quality of the film. The build-up process takes approximately one to one-and-one-half hours of labor. Under this method, petitioners’ employees are able to alter a motion picture, either advertently or inadvertently, because they have control over the content to be exhibited. They could, thus, advertently splice unauthorized frames into a motion picture or remove frames from a motion picture (a violation of petitioners’ agreement with the distributors) or could inadvertently splice the segments of the motion picture out of order.

10. After the build-up is completed, the 35mm film is loaded onto a projector by manually threading the film into the projector through a series of rollers. Once the film is threaded, the motion picture is exhibited by starting the projector, which causes light emitted by a xenon bulb to pass through the film and onto a lens that magnifies the image to fit the cinema screen. After a motion picture is exhibited, the film must be rewound and rethreaded for the next exhibition. Rewinding and rethreading the 35mm film into the projector is repeated for each exhibition of a motion picture. If petitioners decide to change the screen on which a particular motion picture is

³ A leader strip is a section of 35mm film with no images on it that is added during the build-up process to assist with threading the film into the projector.

⁴ A “snipe” is an industry term referring to petitioners’ own additions, such as a reminder to turn off cell phones or to purchase popcorn.

exhibited, the film has to be physically moved to the new auditorium and threaded into the projector in that auditorium.

11. The empty shipping reels, small plastic reels and shipping cases are stored by petitioners until the licensed exhibition period for the given motion picture ends, at which time petitioners' employees reverse the process by removing the splices, loading the motion picture segments and the trailers back onto the original shipping reels and small plastic reels and shipping the same back to the distributors in the original shipping cases via common carrier. While the trailers and small plastic reels are not always returned to the distributors, the motion picture segments and shipping reels are always returned.

12. Throughout the periods in issue, petitioners paid sales tax on their licenses to exhibit the motion pictures contained on 35mm film. Petitioners do not seek a refund, in this proceeding, of those amounts paid.

The Digital Model

13. Under the Digital Model, motion pictures are released in a digital format, after having been either shot digitally or shot on film and then transferred from film to digital format through what is known as a "telecine process." A digital motion picture is one in which the entire motion picture exists not as separate frames contained on 35mm film, but rather as a digital file (i.e., a set of computer-readable codes). The motion picture images and sound are in the form of compressed data that are stored on computer servers and exhibited through specialized digital projectors.

14. Because digital motion pictures exist as data files, they can be delivered in several different ways, including via a portable computer hard drive on which the data file has been saved, as a download transmitted via a network, or via a satellite transmission. The only

difference between a digital motion picture delivered on a portable hard drive and one delivered by network download or satellite transmission is the method of delivery. The content in each instance is identical.

15. Petitioners receive delivery of digital motion pictures from distributors by electronic transmission or by portable computer hard drives on which the digital motion picture is stored. All of the receipts at issue herein are related to digital motion pictures delivered via portable computer hard drives. Each portable hard drive contains one or two digital motion pictures, and digital trailers, and is shipped to petitioners via common carrier in a case about the size of a child's lunch box.

16. Upon receipt of a portable hard drive, petitioners' personnel copy or "upload" the digital motion picture onto a digital media block or computer server that is part of petitioners' digital motion picture projection computer system. To upload or "ingest" the digital motion picture, the hard drive is connected by cord to a designated port on the server via a common universal serial bus (USB) interface. The files that comprise the digital motion picture are copied from the hard drive onto the media block or server. The original data files remain on the hard drive. The copied files are stored on the media block or server, and are available for exhibition until the digital motion picture is no longer being exhibited by petitioners, at which time petitioners' personnel delete the files containing the digital motion picture from the media block or server. Using a single hard drive received from a distributor, petitioners can, and often do, follow this process and upload the files containing a digital motion picture onto multiple media blocks or servers for exhibition on multiple screens. Petitioners also receive digital versions of trailers from distributors, and these digital files are uploaded onto petitioners' media blocks or servers in the same manner.

17. Some theatres have a central “library” server onto which all content is copied from the portable hard drives. Particular content is then copied from the library server onto a projector-based server for each screen on which that particular content will be exhibited. During the periods in issue, most of petitioners’ locations used library servers. Other theatres only have projector-based servers, in which case the content is copied directly from the hard drive onto each separate projector-based server. Regardless of the type of server and the number of copies involved, the content remains identical. The Digital Model presents a significant advantage in comparison to the 35mm Film Model in instances where a high-demand motion picture opens, because petitioners are able to exhibit the same motion picture on multiple screens without needing multiple 35mm prints of the motion picture, each of which would require the described lengthy build-up process.

18. For security reasons such that no unauthorized uses of the content can be made, most digital motion pictures are encrypted, or “locked,” and require a separate digital key known as a “KDM” in order to unlock the files and exhibit the digital motion picture.⁵ Distributors transmit the KDM to petitioners’ personnel via e-mail, usually immediately before the first authorized exhibition date and time. Petitioners’ personnel must upload the KDM, either using the same USB interface used to upload the digital motion picture or by typing the KDM code using a computer keyboard, to be able to exhibit the digital motion picture. A KDM is set to be active for a particular period of time, typically coinciding with the agreed upon period during which petitioner is authorized to exhibit the digital motion picture, at the end of which period the KDM

⁵ The portable hard drives, digital servers and projectors are devices that must meet Federal Information Processing Standards for security, referred to as “FIPS.” In instances where separate projector-based servers, as opposed to a central library server, are used, the distributors will transmit a separate KDM for each projector-based server.

will typically have been programmed by the distributor to expire. Upon expiration, the digital motion picture data files relock, petitioners lose access to the digital motion picture, and the content can no longer be exhibited. Thus, once the exhibition period, or run of a particular digital motion picture is complete, petitioners do not return the digital motion pictures but simply delete the digital motion picture data file from their server or servers.

19. Once the digital motion picture is uploaded onto petitioners' media block or server, and is unlocked via the KDM, petitioners are able to exhibit the digital motion picture without further use of the hard drive. That is, the digital motion picture is exhibited directly from the media block or server and not from the hard drive. The hard drive is put back into its shipping packaging for return to the distributor when a courier (or common carrier) arrives for the next scheduled delivery. In fact, the portable hard drive may be returned to the distributor before the digital motion picture has ever been exhibited to an audience, and distributors often erase the contents of the hard drive upon its return and reuse the hard drive for distribution of another digital motion picture. The content (i.e., the movie and trailers) remains on the hard drives until the hard drives are returned to the distributors, and is not erased by petitioners upon, during or after the ingestion process.

20. Distributors do not separately charge petitioners for the use of the hard drives. While possession of the hard drives are temporarily transferred to petitioners so that digital motion pictures can be uploaded as described, there is no transfer of title to the hard drives because they remain the distributors' property and are returned to the distributors, as described.

21. Because of the security features installed by distributors, petitioners' personnel cannot alter the digital motion picture in any fashion since all elements (the digital motion picture, trailers, etc.) arrive in the form of separate digital files that can only be copied or ingested,

scheduled, exhibited (after being unlocked via the KDM) and, eventually, deleted from petitioners' media blocks or servers, typically at the end of the time period during which petitioners are authorized to exhibit the digital motion picture.

22. Unlike the 35mm Film Model, which involves significant physical labor to assemble the 2,000-foot reels, trailers and snipes onto a platter before exhibition can be possible, petitioners' personnel can start the copying or ingestion process and then walk away to perform other tasks while the digital motion picture is copied. Thereafter, petitioners' personnel can simply create an electronic "playlist" consisting of digital trailers, snipes, and the digital motion picture by selecting the desired elements from a menu displayed on a computer screen attached to the media block or server and the digital projector. Petitioners' personnel automate play times so that each exhibition starts automatically at the predetermined time.

23. The comparative viewing experience with 35mm film and digital motion pictures differs in that digital motion pictures offer higher resolution and no degradation over time and with usage. Specifically, the first time a digital motion picture is shown it is brighter and crisper than its 35mm film counterpart. Further into the motion picture's run there will be no change in the quality of the digital version, whereas the 35mm version will degrade with repeated exhibitions (via exposure to dirt and other contaminants) and may need to be replaced.

24. Petitioners contract with distributors to acquire the rights to exhibit motion pictures, paying the distributors a fee for the rights to exhibit the motion pictures for a specified period of time. Typically, the distributors are paid an agreed-upon percentage of box office ticket receipts collected by petitioners for each motion picture. The percentage of box office ticket receipts petitioners agree to pay to a distributor varies based on a number of factors, including whether petitioners have exclusive exhibition rights within a geographic area, the length of the period

during which petitioners may exhibit the motion picture, the number of screens on which petitioners are authorized to exhibit the motion picture, and various other factors.

25. The contractual relations between petitioners and distributors regarding the right to exhibit each motion picture under the 35mm Film Model and the Digital Model are defined by two elements, to wit: the master license agreements (MLAs) coupled with short-term oral contracts. The MLAs address the general terms and conditions of the dealings between petitioners and the distributors.

26. According to the MLAs:

[Distributor] grants and [petitioner] accepts a limited, nonexclusive license under copyright to exhibit publicly the [motion picture(s)] set forth in the Confirmation, at the film rental terms specified in the Confirmation (**'Film Rental'**), and at the theatre(s) and on the consecutive days for said theatre(s) specified in the Confirmation (which consecutive days shall be deemed the (**'Run'**), at the particular auditorium specified in the Confirmation (hereinafter the "**Screen**") and for no other use or purpose.

27. Pursuant to the MLAs, there are several ways in which petitioners' payment for the rights to exhibit the motion pictures can be computed. All of the receipts from which the tax at issue herein were computed were from licenses that utilized the "Percentage Picture" method.

According to the MLAs:

[T]he term **'Percentage Picture'** shall mean and refer to a [motion picture] for which the license fee is computed and determined in whole or in part upon a percentage of the 'Gross Receipts' **'Gross receipts'** shall mean all monies received, receivable or deemed received . . . for admission to the theatre premises for the performance of any [motion picture], regardless of when or where paid

28. Under the foregoing provisions, then, the fees petitioners pay to distributors equals gross receipts from theatre admission ticket sales multiplied by a negotiated predetermined percentage. The amount as calculated under this method is the same whether the motion pictures

exhibited by petitioners are received in 35mm film format or in digital motion picture format, and is the same regardless of the manner in which petitioners receive the digital motion pictures (i.e., via portable drive, network download or satellite). The amount is the same whether petitioners receive only one, or more than one, portable hard drive containing a motion picture, and regardless of the period of time during which petitioners retain possession of the portable hard drives (i.e., regardless of whether the portable hard drive is returned to the distributor immediately after its content is ingested or rather is retained until the end of the run). The license fee, computed in the foregoing manner as a percentage of gross box office receipts, is the only amount paid by petitioners for the right to exhibit the motion picture.

29. The MLAs include terms pertaining to motion pictures provided via 35mm film, with provisions addressing “Delivery and Return of Prints,” “Loss and Damages to Prints,” and “Cutting and Alteration of Prints Prohibited.” Pursuant to these terms, the failure to timely return 35mm film prints constitutes a material breach of the MLA specifically subject to damages resulting from such failure. The MLAs include supplemental terms pertaining only to motion pictures provided in digital format, with provisions addressing “Digital Content Management,” “Reporting/Auditing,” the specific equipment a theatre must use to exhibit digital motion pictures, and additional terms related to anti-piracy measures. The “Digital Content Management” section indicates that the distributor will provide a digital version of a motion picture in a secured format and will provide the necessary keys (KDMs), via e-mail, to allow petitioners to unlock the motion picture. This section further provides that it is petitioners’ responsibility to load (ingest or upload) the digital content supplied by the distributor onto petitioners’ equipment, and to delete all such copies of the content from that equipment immediately upon conclusion of the run of the motion picture. In addition, the MLAs provide

that “if the digital version of the [motion picture] was delivered on physical media, [petitioners agree] to return the physical media to [distributor] or an agent designated by [distributor] no later than immediately upon conclusion of the [run of the motion picture].” Finally, the MLAs provide that petitioners:

shall not attempt to copy, reprogram, duplicate, subrent or part with possession of any materials supplied by [distributor] to [petitioners]. In no event shall [petitioners] attempt to deencrypt, reprogram, reverse engineer or otherwise alter or tamper with any of the security measures installed in any materials supplied by [distributors] to [petitioners].

30. The short-term oral contracts are the result of weekly negotiations between petitioners and the distributors. These contracts are specific to each motion picture and address when petitioners will receive a particular motion picture, the number of screens on which petitioners will exhibit the motion picture, the period of time during which petitioners may exhibit the motion picture, and the percentage of gross box office receipts petitioners will pay to the distributors for the license to exhibit the motion picture.

SUMMARY OF THE PARTIES' POSITIONS

31. Petitioners assert that the transactions here at issue do not constitute taxable sales of tangible personal property. The basis for this argument is that neither title to nor permanent possession of the hard drives is transferred, that no consideration is paid for them, and that the temporary transfer of the hard drives from the distributors to petitioners is insufficient to support imposition of the tax. Petitioners also maintain that the transactions at issue are nontaxable reproductions as opposed to rentals, leases or licenses to use tangible personal property.

32. The Division posits that in the transactions at issue in these matters, the licenses to exhibit the digital motion pictures are inseparable from the tangible personal property (the hard drives) on which the digital motion pictures are captured, stored and delivered to petitioners and

that the licenses would be valueless without possession of the hard drives being transferred. The Division further asserts that the “Reproduction Rule” of 20 NYCRR 526.7(f) is inapplicable in these matters because the transactions at issue involve licenses to exhibit rather than merely rights to reproduce. The Division maintains that petitioners’ possession of the hard drives is a sufficient transfer of tangible personal property to constitute a taxable sale.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) imposes sales tax upon the “receipts from every retail sale of tangible personal property” within New York, except as otherwise provided. A “sale” is defined as the transfer of title or possession, or both, or license to use or consume tangible personal property that is supported by consideration (Tax Law § 1101[b][5]; 20 NYCRR 525.2[a][2]). It is well-established that “only transactions involving passage of title or of actual exclusive possession constitute sales” (*Matter of Darien Lake Fun Country v. State Tax Commn.*, 118 AD2d 945, 946 [1986], *affd* 68 NY2d 630 [1986], *rearg denied* 68 NY2d 808 [1986], *citing Matter of Shanty Hollow Corp. v. State Tax Commn.*, 111 AD2d 968, 969 [1985], *lv denied* 66 NY2d 603 [1985]), and that rental agreements and licenses to use tangible personal property may meet the definition of a sale (*see Matter of American Locker Co. v. Gallman*, 32 NY2d 175 [1973]; Tax Law § 1101[b][5]). The Sales Tax Regulations further define “sale” to mean “any transaction in which there is a transfer of title or possession, or both, of tangible personal property for a consideration” (20 NYCRR 526.7[a][1]), and instruct that the determination of whether a transaction constitutes a sale, rental, lease, or license to use is determined in accordance with the provisions of the parties’ agreement (*see* 20 NYCRR 526.7[c][1]).

B. The term “tangible personal property” is defined as “[c]orporeal personal property of any nature” (Tax Law § 1101[b][6]), and includes “artistic items, such as . . . moving picture films and recordings . . .” (20 NYCRR 526.8[a][3]).

C. The Regulations, at 20 NYCRR 526.7(f), specifically address reproduction rights, providing that:

- (1) The granting of a right to reproduce an original painting, illustration, photograph, sculpture, manuscript or other similar work is not a license to use or a sale, and is not taxable, where the payment made for such right is in the nature of a royalty to the grantor under the laws relating to artistic and literary property.
- (2) Mere temporary possession or custody for the purpose of making the reproduction is not deemed to be a transfer of possession which would convert the reproduction right into a license to use [internal citation omitted].
- (3) Where some other use other than reproduction is made of the original work, such as retouching or exhibiting a photograph, the transaction is a license to use, which is taxable.

Thus, the Regulations clarify that granting the right to reproduce an original work, without more, is a nontaxable transaction (*see* 20 NYCRR 526.7[f][1]). However, where the party to whom the reproduction right is granted employs or utilizes the original transferred work in some additional capacity, i.e., “retouching or exhibiting” (20 NYCRR 526.7[f][2]) the transaction will instead constitute a license to use upon which sales tax is imposed (*see* 20 NYCRR 526.7[f][2], [3]).

D. There is no dispute that license payments for the exhibition of a digital motion picture are not subject to sales tax where that motion picture is transferred from the distributor to the exhibitor electronically, whether by satellite or network download, with no accompanying transfer of tangible personal property. Likewise, there is no dispute that license payments for the

exhibition of a motion picture under the 35mm Film Model, which involves the transfer and use of tangible personal property (the film), are subject to sales tax (*Matter of United Artists Corp. v. Taylor*, 273 NY 334 [1937]). Unlike the purely electronic transfer, where no tangible personal property is involved, the 35mm Film Model necessarily requires the transfer of tangible personal property, both to physically deliver the content (the motion picture) to the location of its intended display (petitioners' theatres) as well as to exercise the license and effectuate the display itself. This transfer and use is necessary given that the content is embodied on tangible personal property (the film), and is not capable of being displayed if such physical property is not present and utilized.

E. Standing in the middle ground between the foregoing two models is the digital hard drive model, where the intangible content (data files containing the motion picture) exists in electronic (digital) format but is housed or stored within tangible personal property (the hard drive), at least for purposes of transport and delivery to the location of its intended display. At the same time, the tangible personal property itself, unlike the 35mm film, is not necessary to each (or even any) instance of displaying the content. Further, the tangible personal property transferred, the hard drive, is not itself the desired object of the transaction. In fact, under the circumstances at issue herein (digital content transferred via portable hard drive), the transfer of tangible personal property is necessary only to move the content from its distributors to petitioners' theatres such that the content can, ultimately, be displayed to the public.

F. In *Matter of United Artists Corp. v. Taylor*, the Court of Appeals determined that a distributor's transfer of possession of films to an exhibitor with license to exhibit them for a seven-year period, pursuant to a contract, constituted a taxable sale, explaining:

[t]he transaction which is the subject of the tax under review consists of the transfer by the distributor to the exhibitor of the possession of corporeal property in the form of positive and negative prints of photoplays with the license to use or exhibit them for a specified time. The license to exhibit without the transfer of possession would be valueless. Together they are one transaction and constitute a sale . . . (*id.* at 341).

G. The result in *United Artists* is perhaps more easily conceived in the 35mm Film Model than in the Digital Model, since under the 35mm Film Model the final aspect of the transaction, the exhibition of the motion picture to the public for viewing, requires the continuous possession and use of the corporeal medium upon which the content is embodied, i.e., the 35mm film itself, for the entire period of licensure and exhibition. In contrast, the tangible personal property in question here (the hard drive) is not necessary to carry out exhibition of the motion picture content. Under either model, what is desired is the content (the motion picture), tangibly and corporeally existing and embodied on film under the 35mm Film Model, as in *United Artists*, versus existing electronically as code under the Digital Model.

H. The only apparent distinction between the nontaxable digital satellite and digital network download models versus the digital hard drive model is the method by which the content is delivered to the theatres. The first two models involve digital content transported by electronic signals, while the latter involves digital content transported by hard drive (*see* Findings of Fact 14 and 15). In each instance, however, the content remains the same and the method of delivery is irrelevant to exercising the license and exhibiting the content. That is, once downloaded or ingested onto petitioners' servers, the motion pictures can be exhibited (when KDM enabled) with no further involvement or need for the medium of delivery (either the signals or the hard drives). In contrast to the foregoing, the 35mm Film Model is distinguished from all of the digital models by the fact that the corporeal medium upon which the content exists (the film),

remains necessary in order to exercise the license and exhibit the content even after the film is removed from the shipping reels, assembled and loaded onto a platter for exhibition (the “build up” process described in Findings of Fact 7 through 10).

I. In both the Digital Hard Drive Model and the 35mm Film Model, the medium of transport and transfer, the hard drives and the shipping reels, respectively, serve essentially the same purpose, that is as containers housing the desired content during its transport and delivery to petitioners. There is no sense that theatres such as those operated by petitioners necessarily want, need or use the shipping reels upon which the 35mm film is wound for containment, transport and transfer to the theatres, notwithstanding that the same are necessary to effect such containment, transport and transfer in an orderly manner.⁶ Similarly, there is no sense that petitioners necessarily want, need or use the hard drives, save for the fact that they, like the shipping reels, are necessary to contain, transport and transfer the digital content in an orderly manner. The critical distinction and the basis upon which taxation is supportable under the 35mm Film Model, but not under the Digital Model, remains the necessity of using the transferred tangible personal property (the film) in order to exercise the license and exhibit the motion picture content. Under the Digital Model, the content is loaded onto, stored and transported within the hard drives and transferred therefrom onto petitioners’ servers. Unlike content on 35mm film, content in digital form does not become an inseparable part of tangible personal property (the hard drives), and that tangible personal property is not necessary to exercise the license and exhibit the content. While neither the shipping reels nor the hard drives

⁶ As a practical matter, it seems unlikely that theatre operators would choose exhibition by 35mm film, with its attendant higher costs of labor to prepare and exhibit and its potential for picture quality degradation over time and repeated use (*see* Finding of Fact 23), as opposed to the digital alternative. However, testimony at hearing established that the digital alternative is not yet available in all theatres.

are necessary to actually exhibit the content, the physical film is necessary to exhibit the content under the 35mm Film Model. Hence the Court's conclusion in *United Artists* that the license and the transfer, possession and use of the tangible property itself (the film), constituted one transaction, and that such transaction, including of necessity a transfer and use of tangible personal property without which the license was valueless, was properly a sale subject to tax.⁷

J. The parties agree that the primary purpose of the transaction controls taxability (20 NYCRR 526.7[c][1]). The primary purpose of the subject transactions was to exhibit motion pictures to the public in exchange for payment. That primary purpose, in the 35mm film context (as in *United Artists*), cannot be achieved without the continuous possession and use of the physical film during the exhibition. In the digital realm, tangible property is not employed in carrying out the primary purpose of the transaction, to wit, exhibition of the content. Regardless of the method utilized to deliver the licensed content to the exhibitor (35mm film via shipping reels, or digital content via hard drive, satellite or network download), the consistent element in the case of a license to exhibit a motion picture is the content to be exhibited, the value of which is measured as a percentage of the gross receipts earned from the exhibition of that content. Of the various technologies, only one involves and, in fact, requires the exhibitor's possession and use of that content in corporeal form. That is the 35mm Film Model, where exhibition is not possible, and the license is valueless, without physical possession and use of the tangible personal property itself (*see United Artists Corp. v. Taylor* at 341). In contrast, possession and use of the content in corporeal form in order to exhibit the motion picture in accordance with the

⁷ *United Artists* was decided in 1937, well prior to the advent of digital motion picture technology, and at a time when exhibiting motion pictures on film was simply the existing technology whereby the only means of exercising the license and carrying out the exhibition was by physical transfer of possession and actual use of the film.

rights granted by the license are unnecessary to the transaction under any of the digital models. It is not sufficient to accept that the durable and reusable container (the hard drive) used to deliver the intangible content to its place of exhibition is any more necessary to the transaction than are the shipping reels used to deliver the 35mm film. Rather, it is the necessary corporeal existence and physical use of the content to exercise the license, and not the container that houses that content, that determines taxability under the 35mm Film Model.

K. While both the shipping reels and the hard drives may be said to be tangible personal property necessary to the transaction, that necessity is only as a medium by which delivery of the desired content is achieved. Thus, like the shipping reels, the hard drives are ancillary vessels serving to accomplish delivery of the desired content to its place of exhibition in an orderly fashion, but neither the reels nor the hard drives are necessary to carry out the licensed use of the content. The fact that the content is susceptible to transport in various ways supports the conclusion that it is the content (the motion picture), its state of existence either as tangible personal property or as an intangible, and the necessity of its corporeal existence for exhibition as licensed (in the case of the 35mm Film Model), that determines the issue of taxability. The temporary transfer of the hard drives, tangible containers within which the intangible content is contained and delivered but which are unnecessary to the exhibition of the content, is simply an insufficient predicate to support the imposition of sales tax under Tax Law § 1105(a).⁸

⁸ In fact, 35mm film itself may be housed and transported in a variety of ways (e.g., on shipping reels as is customary, or perhaps loosely in a box notwithstanding the impracticability of such a disorganized method), yet the particular tangible container used in such transport is not the basis upon which taxability turns. Rather, it is the corporeal existence of the content and the necessity of using that transferred corporeal property to exercise the rights granted by the license that supports taxation. Put differently, it is not the shipping box or the shipping reels that cause the transaction to be taxable, but it is the transfer of possession and use of the content (the motion picture on tangible personal property as 35mm film) that supports taxation. Similarly, in the digital context, it is not the tangible container used to transport the intangible content that determines or is sufficient to support taxation.

L. Additional support for the foregoing conclusion may be found in the terms of the parties' agreements. Nothing in the MLAs indicates that the parties contemplated that petitioners would be purchasing either the shipping reels (in the 35mm film context) or the hard drives (in the digital context), and indeed it is clear that petitioners did not purchase or take title to either type of transport medium. In fact, the MLAs speak directly to petitioners' contractual obligation to care for and return the 35mm film, and provide that the failure to return the film would specifically constitute a material breach of the parties' contract subjecting petitioners to damages (Petitioners' Exhibit G at section 5.01). In contrast, while the MLAs require petitioners' erasure of the content from their theatre servers and return of the hard drives, there is no specified consequence for failure to do so (Petitioners' Exhibit G at section 5.08, as modified by Exhibit C section C.02[c] thereto). This seeming lapse is understandable since there is no apparent significant detriment nor any practical consequence for failure to erase, inasmuch as it is undisputed that the content downloaded to (or ingested by) petitioners' servers, unlike the 35mm film, is unuseable for purposes of exhibition once the KDM has expired. While the content can be downloaded or ingested, it cannot be exhibited without an enabling KDM. Moreover, upon expiration of the KDM exhibition is not possible. While exhibition of the content in 35mm film format thus can continue beyond the tenure of the parties' license agreement (subjecting the exhibitor to damages for breach of contract), the content in digital format cannot.⁹

⁹ It is also noteworthy that the motion picture content is not erased by petitioners during, upon completion of, or after ingestion or copying of the content onto petitioners' digital media blocks or servers. Instead, the content remains on the hard drives until they are returned to the distributors, who then may erase or clear the hard drives for reuse (*see* Finding of Fact 19). If a problem arose with a media block or server petitioners could, if still in possession of the portable hard drive, reingest the content (or could be given another hard drive from which to reingest the content). Still, the hard drives serve only as the medium of containment by which the content is transported, and unlike the film in the 35mm Film Model have no role in the exercise of the license by exhibition of the motion picture. The fact that a reload may be a very rare event is at most a testament to the reliability of the particular technology.

M. In view of the foregoing conclusion that the license payments under the Digital Model are not subject to sales tax, it is not strictly necessary to address petitioners' alternative argument that the transactions escape taxation pursuant to the "reproduction rule" of 20 NYCRR 526.7(f). On this point it is sufficient to note that the subject transactions do not merely involve reproduction of the content, but rather involve possession and use of the content for the purpose of commercial exhibition. Here, in the digital context, the content, though contained within tangible personal property, is intangible and is, unlike content existing in tangible form (i.e., on film), capable of exhibition without possession or use of any tangible medium upon which it is embodied. The hard drives are containers serving as the media for transport to move the content from one point (the distributors) to another (petitioners' theatres). Unlike 35mm film, they are not necessary to fulfill the purpose of the licensed transaction, the exhibition of the motion pictures. Thus, unlike the 35mm film itself, the hard drives, like the shipping reels, are at best necessary incidentals to the principal business aim of licensing motion pictures for exhibition and carrying out that exhibition.

N. The petitions of American Multi-Cinema, Inc. and RKO Century Warner Theatres, Inc. are hereby granted, and the Division's denials of petitioners' refund claims dated February 3, 2010, February 12, 2010 and April 15, 2010 (*see* Footnote 2) are reversed.

DATED: Albany, New York
June 21, 2012

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE