

Film-Related Provisions of the American Jobs Creation Act

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ABSTRACT

Schuyler M. Moore reviews the film-related provisions of the American Jobs Creation Act of 2004.

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Moore asserts that the American Jobs Creation Act of 2004 contains several provisions that have a profound beneficial impact on the film and television industries. He identifies several provisions and notes that they include the ability: (a) to immediately expense the cost of producing qualified audio-visual works; (b) to elect to either deduct participations and residuals when paid or to immediately increase the amortizable basis of a film by the amount estimated to ultimately be owed; (c) to calculate income forecast amortization based on gross, not net, income; and (d) to exclude a portion of taxable income attributable to audio-visual works produced in the United States.

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I. Deduction of the Cost of Certain Works

A. In General

The American Jobs Creation Act of 2004 (P.L. 108-357; the act) showered gifts on the film industry, but none is more striking than new IRC section 181, which permits a 100 percent write-off (the film deduction) for the cost of certain audio-visual works, regardless of what media they are destined for (theatrical, television, DVD, and so forth), referred to herein as "qualified audio-visual works." While it is manna from heaven for the film industry, section 181 requires a vivid imagination to decipher its meaning -- it makes "napkin deals" look good in comparison.

B. Requirements for Qualified Audio-Visual Work

There are several requirements for an audio-visual work to be a qualified audio-visual work, outlined below:

1. Limitation on aggregate cost. The aggregate cost of the audio-visual work (film costs) cannot exceed \$15 million (or \$20 million in certain cases, discussed below). The test is all or nothing; if the film costs exceed \$15 million, you lose -- you don't get to deduct the first \$15 million. Based on the legislative history, it appears that in the case of a television series, the \$15 million test applies separately to each episode.

Many taxpayers will assume that the standard budget used for financing purposes applies for purposes of the \$15 million test. However, it appears that film costs include all direct and indirect costs of producing the audio-visual work that would normally be required to be capitalized under section 263A, including, without limitation, development costs, an allocation of general and administrative costs based on the portion of those expenses relating to production activities, depreciation of property used in production, and, in most cases, financing costs. That issue is discussed in section 5.01 of my treatise, *Taxation of the Entertainment Industry* (referred to herein as the treatise). Section 263A requires capitalization of those expenses that are incurred by either the taxpayer or any parties that are related to the taxpayer.¹ Thus, film costs will include costs that are not normally included in the budget. However, there may be items in the budget that are not included in film costs, such as "overhead fees" or "producer fees" that are merely amounts retained by the production company (although they might be included if they are paid to another party, even an affiliate). If transaction costs are incurred in connection with a tax shelter financing transaction using the film deduction, it may be possible to treat those costs as part of the film costs that are entitled to be deducted.

Although section 181 is not clear on the issue, it appears logical to exclude deferments, participations, and residuals for purposes of calculating film costs for purposes of the \$15 million ceiling. Otherwise, a successful film could be disqualified retroactively.

The \$15 million ceiling is increased to \$20 million if the film costs are "significantly incurred" in designated low-income communities. It is risky to rely on the \$20 million ceiling for two reasons: First, it is not clear what percentage is "significant." Second, the test compares the costs incurred in the low-income communities to the *total* film costs, not just to the total costs of principal photography. In most cases, the costs of shooting in a particular area will be dwarfed by other film costs, including editing, preproduction, financing, and so forth.

2. U.S. costs. Seventy-five percent of the total compensation relating to the audio-visual work (total compensation) must be paid for services performed in the United States by actors, directors, producers, and production personnel (U.S. production compensation). There is no requirement that the individuals be U.S. citizens or residents. The definition of the United States does not include its possessions, such as Puerto Rico. For both total compensation and U.S. production compensation, deferments, participations, and residuals are excluded.

Only compensation relating to *production* is included in U.S. production compensation, and it appears likely that the intent of section 181 is to also apply this limit to total compensation. For example, it appears that a payment to a *writer* (that is, a nonproduction cost) would not be included in total compensation. Otherwise, a large payment to a U.S. writer might disqualify a film, which would be anomalous.

3. Television series. For television series, only the first 44 episodes can be qualified audio-visual works.

4. Commencement of principal photography. Principal photography must commence after October 22, 2004, and before January 1, 2009.

5. Content of work. The audio-visual work cannot include a "depiction of actual sexually explicit conduct." Other than that one limit, there are no other limits as to content.²

C. Costs Subject to Film Deduction

1. Film costs. It appears that the film deduction applies, at a minimum, to all film costs discussed above so it is not limited to U.S. production compensation or even to production costs. For example, it would appear to apply to the entire cost of producing *Monday Night Football*, including the cost of acquiring the underlying rights.

2. Development costs. One important question is the treatment of film costs incurred before commencement of principal photography, such as development and preproduction costs. There are two possible approaches to dealing with those costs, and it is not clear which is correct. One approach is to capitalize them and permit a deduction only on commencement of principal photography on the basis that this is the date that a qualified audio-visual work comes into being. The other approach is to permit the deduction of those expenses as incurred if they were reasonably thought to be incurred for a future qualified audio-visual work.

3. Contingent payments. Although section 181 is ambiguous on the issue, it appears that the film deduction *does* apply to deferments, participations, and residuals paid for a qualified audio-visual work, even if they are excluded from film costs for purposes of calculating the \$15 million/\$20 million ceiling. It would seem odd to require capitalization of those costs if all other costs of the film were deductible.

D. Film Deduction Limited to Owner

1. Must be owner while film costs are incurred. Based on the legislative history and a bit of interpolation, it appears that only the *owner* of the qualified audio-visual work that pays the film costs can take the film deduction. It does not appear that a payment to *purchase* or *license* all or some of the rights to a qualified audio-visual work that has already been produced will qualify for the film deduction. For example, if a film company acquires rights to a qualified audio-visual work *on delivery*, such as pursuant to a negative pick-up or presale, the payment is probably not deductible. It appears possible for the owner of only limited rights during production to be entitled to the film deduction, such as when a film company pays a portion of film costs in exchange for a grant of limited distribution rights that vests before the time the relevant film costs are incurred. Thus, there could be multiple owners each entitled to deduct their contribution to film costs.

2. Subcontracting production. There is no requirement that the owner be the actual producer of the qualified audio-visual work; the owner should still be entitled to the film deduction even if it pays an independent film production company to physically produce the film, as long as the rights are not transferred to the production company during production (as often occurs for financing and guild reasons).

3. Production services. If the production entity does not own any rights and is merely rendering production services, then it could deduct 100 percent of the costs of production, even under prior law, because it does not own any asset to capitalize those costs to.³ In that case, however, the entity paying the production entity for production services would not be entitled to the film deduction until payment is

made to the production entity,⁴ and the production entity would generally have to use the accrual method and pay tax on any deferred payments,⁵ so there would be no mismatching opportunity as there is under section 181 (as discussed below).

E. Election

The taxpayer is required to make a binding election to deduct the film deduction in lieu of normal income forecast amortization regarding each particular qualified audio-visual work. The legislative history suggests that the IRS should liberally permit the fact of simply deducting the film deduction on a tax return to be treated as an election, without requiring any special form.

F. Other Tax Provisions

More important than what *is* written in section 181 is what is *not* written, because taxpayers must consider all the other provisions and doctrines of existing tax law, some of which are discussed below.

1. Alternative minimum tax. For individuals, as long as the production activity constitutes a trade or business, the film deduction will be deductible for purposes of calculating the alternative minimum tax.⁶ It thus becomes critical to determine whether the particular production activity constitutes a trade or business. Although there is substantial conflicting law on this question,⁷ it is likely that production activities alone, even before the receipt of income, will be treated as a trade or business,⁸ so the film deduction should not subject individuals to the AMT.

For corporations, if the film deduction is deductible for purposes of calculating "earnings and profits," the deduction will not subject them to the AMT.⁹ Because the act did not create any special rules for treatment of the film deduction in calculating earnings and profits, it appears that the film deduction is deductible for purposes of calculating E&P and thus should not trigger the AMT for corporate taxpayers.¹⁰

2. Passive loss rules. If the production activity constitutes a trade or business, as is likely, the film deduction will be subject to the passive loss rules with respect to some taxpayers, including individuals and personal service corporations.¹¹ C corporations that are more than 50 percent owned by five or fewer individuals (closely held corporations), and that are not personal service corporations, cannot use passive losses to shelter investment income but can use passive losses against other income. The passive loss rules do not apply to non-closely-held corporations.

Individuals and personal service corporations that do not "materially participate" in the activity can deduct passive losses, including the film deduction, only to the extent of "passive income," which generally is limited to income from real estate and from passive interests in businesses held by passthrough entities. Passive income also includes income from the qualified audio-visual work. If the film deduction is restricted under the passive loss rules, the excess carries forward and may be deducted against all ordinary income when it is "freed up" by future passive income, including gain from the sale of the qualified audio-visual work. That is so even if this gain is long-term capital gain (discussed below). Thus, the taxpayer would be able to deduct the film deduction against ordinary income and would still be entitled to long-term capital gain treatment on the sale proceeds.

3. At-risk rules. For individuals and closely held corporations, the film deduction will also be subject to the at-risk rules. Under the at-risk rules, the taxpayer may take a deduction only for direct investment and borrowed amounts for which the taxpayer has ultimate direct recourse liability. For example, if any portion of the film deduction is funded with debt, the taxpayer must have ultimate liability for that debt directly to the lender, without a right to reimbursement from any third party. Such a liability will be included in the "at-risk" amount even if the risk is ameliorated with future license payments from a creditworthy licensee.

4. Deferral of income. The benefit of the film deduction will be magnified if income from the qualified audio-visual work can be deferred. One way income could be deferred is with an installment sale of the qualified audio-visual work if it does not constitute inventory. That approach would permit the seller to defer gain while permitting the buyer an immediate stepped-up basis for purposes of calculating the

buyer's available depreciation or amortization. That approach effectively permits mismatching of the seller's income and the buyer's deduction.

Under the installment sale rules, an additional annual interest charge is imposed on the deferred tax liability attributable to the portion of the installment sale in excess of \$5 million. The \$5 million test is applied at the individual-owner level in the case of a passthrough entity.¹²

If an installment sale cannot be used, it may be possible to interpose a licensee that is indifferent to the income that would otherwise be taxable (for example, income from presales), such as a licensee with net operating losses or that is in a tax-free jurisdiction outside the United States.

5. Long-term capital gain. Most remarkably, the film deduction does not appear to be treated as depreciation or amortization (which are subject to recapture at ordinary income rates) because the statute states that the deduction is "an expense which is not chargeable to capital account," notwithstanding a reference in the statute to the denial of "other depreciation or amortization." Thus the film deduction does not appear to be subject to recapture at ordinary income rates. It is possible that this result was unintended, but that is the same favorable result that is intentionally provided for the deduction of research and development expenses under section 174,¹³ and the policy of encouraging the activity is the same in both cases.

If the film deduction is not depreciation or amortization, then if the qualified audio-visual work is sold after being held for one year, and if it does not constitute inventory, the entire gain, including the gain attributable to the film deduction, will be taxed at a maximum federal rate of 15 percent applicable to long-term capital gains for individuals.¹⁴ This is a remarkable benefit that effectively converts ordinary income into long-term capital gain. There is no special capital gain rate for C corporations, so there is a tremendous incentive to partially finance films by effectively transferring this benefit from film companies that are C corporations to pass-through entities held by individuals.

To qualify for long-term capital gain treatment, the property must be "held" for one year.¹⁵ For 100 percent of the gain to qualify for long-term capital gain treatment, the qualified audio-visual work needs to be held for one year from the date of completion (probably of the answer print).¹⁶ As mentioned above, it is critical that the qualified audio-visual work not constitute inventory. If the ultimate sale is made pursuant to a contract entered into before production, the qualified audio-visual work may be treated as inventory.¹⁷ It is also critical that the transaction constitute a "sale" for tax purposes.¹⁸

6. Case law limitations. Tax shelters based on the film deduction need to comply with limitations imposed by case law, including: (a) the taxpayer may need a profit motive¹⁹ and (b) the transaction must not be vulnerable to being recast based on the doctrine of substance over form in a manner that would eliminate the tax benefits.²⁰

7. Summary. The home run is to finance a film on a leveraged basis that complies with the at-risk rules using a passthrough entity with investors that can either immediately deduct the film deduction against passive income or that do not mind postponing the deduction until a sale. The qualified audio-visual work could then be held for one year after completion and sold, generating long-term capital gain subject to the 15 percent maximum federal capital gain rate. If the investors were able to deduct the film deduction against prior passive income, the sale could be made on the installment method, further postponing the gain while permitting the buyer immediate basis for its own deductions.

II. Deducting Residuals and Participations

A. In General

Effective for films placed in service²¹ after October 22, 2004, the act permits taxpayers to elect, on a film-by-film basis, to irrevocably adopt one of two approaches regarding the deduction of participations and residuals for that film.²² Under one approach, the taxpayer may elect to increase the adjusted tax basis of the film by the amount of participations and residuals that the taxpayer ultimately may owe based on its

estimate of the income from the film during the first 10 years after the film is placed in service. That choice effectively codifies the *Transamerica*²³ case. Alternatively, the taxpayer may elect to deduct the participations and residuals when paid. In most cases, it would seem that this later election would be preferable, particularly if there were substantial participations payable in the early years of a film's release.

B. Definition of Participations and Residuals

Participations and residuals are defined as amounts that "by contract vary with the amount of income earned in connection with" the film. It appears that deferrals payable out of gross receipts are included within that definition, and even box office bonuses may be included, because the statute does not say whom the "income" has to be earned by, and in any event box office gross typically affects the income earned by whoever has to pay the participations. If deferrals are included, that creates an incredible opportunity to accelerate deductions by converting talent salaries (which would normally be capitalized) into equivalent deferrals payable out of 100 percent of gross receipts (which would now be fully deductible when paid). It also appears that contingent payments owed to licensors would qualify as "participations" under that definition, so it may be possible to accelerate the deduction of advances or minimum guarantees by converting them into payments out of 100 percent of gross receipts.

III. Income Forecast Amortization

The act states that in calculating income forecast amortization for films placed in service²⁴ after October 22, 2004, the calculation will be based on the taxpayer's *gross* income from the film.²⁵ Before the act, the IRS and the courts required the calculation to be made based on *net* income,²⁶ which had the effect of substantially delaying the amortization of film costs because theatrical distribution expenses reduced or eliminated early net income.

IV. Partial Exclusion of Income From Films

A. In General

The act provides for an exclusion²⁷ of a percentage of worldwide net income attributable to audio-visual works if at least 50 percent of the total compensation relating to production of the audio-visual work is compensation for services performed in the United States.²⁸ The exclusion is 3 percent in 2005 and 2006, 6 percent from 2007 through 2009, and 9 percent thereafter. In no event may the exclusion exceed 50 percent of the total W-2 wages paid by the taxpayer during the applicable tax year. The exclusion also applies for purposes of the AMT.

B. Type of Audio-Visual Works

The exclusion applies regardless of the medium of intended exploitation (such as theatrical, television, or DVD). Films will not qualify for that benefit if the film includes "visual depictions of actual sexually explicit conduct." Other than that restriction, there are no limits on content or type of production. For example, even *Monday Night Football* qualifies.²⁹

C. Income Exclusion Limited to Owner

The exclusion applies only to films "produced by the taxpayer," and it appears based on analogous case law that whoever is the owner of the film during production will be treated as the producer, even if it pays an independent film production company to physically produce the film, as long as the rights are not transferred to the production company during production.³⁰ Thus, the issue is analogous to the requirement of ownership for the film deduction, discussed above.

D. Allocations

The remarkably complex aspect of the act, which is left to the IRS to figure out, is how to allocate all the

expenses of the taxpayer for purposes of calculating the net income from the audio-visual work for purposes of the exclusion. It goes far beyond determining what costs should be capitalized to the film,³¹ because it will now require allocations that never before had to be made for tax purposes, such as allocations of indirect expenses relating to distribution activities. It is a safe bet that film companies will not use the same allocations that they use in calculating third-party participations, or there may not be much net income left to exclude.

FOOTNOTES

¹ Reg. section 1.263A-1(j)(1)(i) (applying the rules of section 482). Section references are to the Internal Revenue Act of 1986, as amended, or the regulations thereunder, except as otherwise noted.

² The Senate report refers to motion pictures (regardless of format), miniseries, scripted dramatic television episodes, and movies of the week, which could be read as excluding reality shows and sports programs, but those categories are not set forth in the text of the statute.

³ Reg. section 1.263(a)-4(b)(3)(iii).

⁴ Section 404(d).

⁵ Section 448.

⁶ Sections 56(b)(1)(A)(i), 67(b), 63(d)(1), and 62(a)(1).

⁷ See treatise, section 5.03[A] [2].

⁸ *U.S. v. Manor Care Inc.*, 490 F. Supp. 355 (D.Md. 1980) (preopening activities for a nursing home were a trade or business); *Blitzer v. U.S.*, 684 F.2d 874 (Ct. Cl. 1982) (construction of rental real property constituted a trade or business).

⁹ Section 56(g)(4)(C)(i).

¹⁰ Compare section 312(k)(3)(B), requiring the deduction under section 179 to be amortized over five years for purposes of calculating earnings and profits.

¹¹ Section 469. See treatise, section 9.08.

¹² IRS Notice 88-2, 1988-1 C.B. 387.

¹³ Rev. Rul. 85-186, 1985-2 C.B. 84.

¹⁴ *Desilu Productions v. Commissioner*, T.C. Memo. 1965-307 (rejecting the IRS position in Rev. Rul. 1962-141, 1962-2 C.B. 182, that the sale of film and television properties always generated ordinary income).

¹⁵ Section 1222(3).

¹⁶ Cf. Rev. Rul. 62-140, 1960-2 C.B. 181, and Rev. Rul. 75-524, 1975-2 C.B. 342 (completion of construction of real property).

¹⁷ See treatise, section 2.05.

¹⁸ See treatise, section 2.02.

¹⁹ See treatise, section 9.02. However, it is not at all clear that the film deduction requires a profit motive, because section 181 flatly permits the deduction without any trade or business or investment requirement.

²⁰ See treatise, section 9.03.

²¹ See treatise, section 5.03[a] [1].

²² New section 167(g)(7).

²³ *Transamerica Corp. v. U.S.*, 999 F.2d 1362, Doc 93-7639, 93 TNT 146-6 (9th Cir. 1993). See treatise, section 5.03[g].

²⁴ See treatise, section 5.03[a] [1].

²⁵ New section 167(g)(5)(E).

²⁶ See treatise, section 5.03[C] [1].

²⁷ New section 199. The exclusion is somewhat awkwardly worded as a "deduction" of a portion of net income, but the practical effect is the same as a partial exclusion because it cannot be used to create a carryforward net operating loss.

²⁸ The legislative history states that participations and residuals are excluded from "compensation."

²⁹ The legislative history states that the benefit does not apply to "transitory" programs, but the statute contains no such limitation.

³⁰ Reg. section 1.263A-2(a)(1)(ii)(A); *Suzy's Zoo v. Commissioner*, 273 F.2d 875, Doc 2001-29250, 2001 TNT 227-64 (9th Cir. 2001).

³¹ See treatise, section 5.01.

END OF FOOTNOTES

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