

Indie Producers: the Fed is here to help — Really!

The American Jobs Creation Act of 2004 included a provision to encourage certain lower budget motion picture makers to keep their productions — and the jobs that accompanied them — within the U.S. The “encouragement” came in the form of federal income tax incentives for investors in those productions. However, like most anything the federal government and Internal Revenue Service are involved in, the incentives were somewhat complex to understand and apply. In this article, entertainment attorney Hal “Corky” Kessler decodes the IRS Code and brings us up to date on the state of federal tax incentives. Help with tax terms can be found at moneycentral.msn.com/taxes/glossary/glossary.asp and www.irs.gov —Editor

By Hal “Corky” Kessler

Despite some confusion surrounding the American Jobs Creation Act of 2004 (the “Act”), it is a highly beneficial law for independent producers in film and television.

In passing the Act, the expressed purpose of the Congress was to provide an incentive to certain filmmakers and television producers to not move their production activities outside of the United States. How? By providing new income tax incentives for investors in independent film and television projects.

The Act, which took effect October 22, 2004, included a new Internal Revenue Code Section 181. Prior law required all filmmakers and television producers to capitalize all production costs in accordance with Code Section 263A [recover or deduct them over the period of time that the product is producing income]. Code Section 181 now provides filmmakers and television producers with the option to not capitalize the production costs but rather to elect to *expense* any and all “qualified film or television production,” the aggregate cost of which does not exceed \$15,000,000 (\$20,000,000 if significantly incurred in a low-income community or a distressed county or isolated area of distress).

An election must be made by the due date (including extensions) for filing the taxpayer’s federal tax return for the taxable year in which the production costs are first incurred. If the election is properly made, then no depreciation or amortization deduction may be taken. In order to be a “qualified film or television production,” 75% of the total compensation of the production must be “qualified compensation,” which is compensation for services performed in the U.S. by actors, directors, producers and other relevant production personnel. It does not include participations

and residuals. Each episode of a television series up to 44 episodes can be treated as a qualified television production.

It is important that any production company accountant who wishes to use Section 181 makes the proper election and refrain from capitalizing any production expenses.

Note that, unless it is extended, Section 181 sunsets (expires) on January 1, 2009.

Although the Act took effect in October 2004, no rules or regulations regarding Code Section 181 were published by the IRS until early 2007. On February 9, 2007, the IRS published temporary rules and regulations interpreting Section 181. The IRS stated that if the owner reasonably expects a film or television production will be a qualified film or television production for which the production costs will not exceed the prescribed limit, the owner may elect to treat all production costs as expenses in the year paid (for a cash basis taxpayer) or in the year incurred (for an accrual basis taxpayer). The deduction is subject to recapture if the limits are exceeded.

The temporary regulations provide that the following are included in production costs: “participations and residual, compensation paid for services, compensation paid for property rights, non-compensation costs, and costs paid or incurred in connection with obtaining financing.” The costs paid in any taxable year become 100% deductible to the investor taxpayer. Production costs do not include distribution or exploitation costs, or costs to prepare a new release or new broadcast of an existing film after the initial release.

The temporary regulations also provide guidance with respect to qualified film and television productions produced in a low-income community or a distressed county or isolated area of distress. “Significantly incurred” means either (a) at least 20% of the total production costs incurred in connection with the first-unit principal photography that takes place in such areas, or (b) at least 50% of the total number of days of the first-unit principal photography takes place in such areas.

Confusion and Clarification

After the passage of the act, many industry professionals and their legal accounting advisors found the new Section 181 lacking in detail. This led to uncertainty and confusion. Rumors started to circulate. Many of the industry unions had issues and concerns. Most involved in the entertainment industry wondered about how to

treat a loss. Was it an ordinary loss written off against any income or was it a passive loss to be written off primarily against passive income?

Many of the issues were a direct result of the failure of the United States Congress to address many issues in greater detail in Section 181. Many of the questions have been answered by the technical correction to Section 181 and the temporary rules and regulations issued by the IRS on February 9, 2007.

The Amendments

In December 2005, Section 1245 was amended by a technical correction which made it clear that the Section 181 deductions are subject to recapture under Section 1245 when the owner of a production sells it. This makes any recapture amounts on a sale ordinary income and not a capital gain.

In May 2006, the IRS released Notice 2006-7 specifying how taxpayers can elect to deduct production expenses of a qualifying production. After November 15, 2006, taxpayers may make the election by filing a Form 3115, application for Change in Accounting Method, for the taxpayer’s first or second taxable year ending on or after December 31, 2005, in accordance with any IRS requirements. If a taxpayer made a Section 181 election on a federal tax return that was filed before June 15, 2006, but did not include all the information required in Notice 2006-47, that taxpayer must attach a statement containing the specified information to the taxpayer’s next-filed federal income tax return.

Under the IRS temporary rules and regs of February 2007, the IRS answered many of the outstanding questions and concerns. It stated that Section 181 deductions may be taken only by the owner of a production, including pass through entities that received investments from investors. The investors, who had no active participation in the production or were not a part of the production company, could only take their loss under Section 181 as a passive loss and not against ordinary income.

The IRS temporary rules and regs also stated, for the first time, that all contingent compensation (residual or otherwise), when paid, became part of the production budget. If these payments brought the production over the qualifying limit, then the production no longer could claim any loss under Section 181 and any benefits given to taxpayers will be recaptured and included in ordinary income of the taxpayer.

Many of the senators who supported

and/or sponsored Section 181 strongly believe that these temporary rules and regulations as to contingent compensation and the passive loss treatment of the deductible expenses violate the intent of Congress. We are hopeful that Congress will act to clarify the situation and also extend Section 181.

In addition to the tax reduction incentives under Section 181, the income received also has some tax reduction opportunities under Code Section 199, which was also added by the Act. Under the manufacturing sections of the Act, film production businesses are considered "manufacturing businesses." From 2007 until 2010 manufacturing businesses can deduct from their qualified production activities income an amount equal to 6% of such income, and from 2010 and beyond they can deduct 9%. This deduction may also apply to television productions. The deduction may be limited by the amount of W-2 wages paid. For example, if \$100 is received from 2007 up to 2010, then the taxable income is \$94. If \$100 is received after 2010, then the taxable income would be \$91.

Section 199 provides income tax benefits to a taxpayer, which are separate from those provided under Section 181. A film could qualify under both sections. However, even if a film does not qualify for income tax benefits under Section 181, the film may be a "qualified film production" pursuant to Section 199 if (a) direct labor and overhead costs incurred within the United States account for 20% or more of the total costs of the film, and (b) 50% or more of the total cost of the film is spent on services performed in the United States.

The Good News

More good news for independent filmmakers is that the benefits of the Act can be combined with any state film or television incentive programs. Currently, 38 states have incentive programs available to film and/or television production projects. Producers, their attorneys and their tax advisers should evaluate projects to determine which state has the best incentives for them to add to those contained in the Act.

The Current Situation

At press time, an extension of Section 181 is in Senate limbo. Every bill or act which needs to be extended is grouped together under what is called "The Extender Bill." It is all or nothing. The House of Representatives passed the Extender Bill and now it is for the Senate to vote sometime in September.

Most of Congress is in favor of extending 181, but I do not know about the other acts or bills included in the Extender Bill. If extended, the major amendment would be that if your film or television budget goes over the qualifying limit of \$15 million, then you are not excluded from 181 (as is the present situation), but you are given 181 benefits for the first \$15 million and then nothing thereafter. This would solve the residual issue which, depending on the success of the picture, could take you over the limit. The limit could be increased to \$20 million if more than 50% is spent in a low income or depressed area.

If not extended, then if your production is in meaningful pre-production before the end of this year, your project or projects will be "grandfathered" into the next year. Part of meaningful pre-production includes one day of principal photography.

Entertainment attorney Hal "Corky" Kessler, a partner with the Chicago firm of Levin Ginsburg, successfully worked with governors and United States Congressmen in several states to implement new laws and federal tax incentives for investments in qualifying film and television projects, which led to Sections 181 and 199 of the American Jobs Creation Act of 2004. He regularly speaks on business and legal aspects of feature film development and tax incentives and has authored a reference book covering tax incentives. Email him ckessler@lgattorneys.com