

## Runaway Productions: Myth and Reality

The American Jobs Creation Act of 2004 (the "Act") which took effect October 22, 2004 included a "new" Internal Revenue Code section 181. A copy of Section 181 is included as Section 3 of this Booklet. The expressed purpose of the Congress was to provide an incentive to certain film makers and television producers not to move their production activities outside of the United States by providing new income tax incentives for investors in independent film and television projects.

Prior law required all film makers and television producers to capitalize all production costs in accordance with Code Section 263A. Code Section 181 now provides film makers 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 "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. Unless extended, Section 181 sunsets (expires) on January 1, 2009.

Prior to February 9, 2007, there were no rules or regulations ever published by the IRS. On February 9, 2007, the IRS published temporary rules and regulations interpreting Code Section 181. A copy of the temporary rules and regulations is included as Section 2 of this booklet. The IRS stated that if the owner reasonably expects that 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 (in the case of a cash basis taxpayer) or in the year incurred (in the case of 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 provides 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 the first-unit principal photography for the production is incurred in connection

with the first-untill 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.

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

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 as to how to treat the loss. Was it an ordinary loss to 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 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 2006-47 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 taxpayers next-filed. Federal income tax return. A copy of Notice 2006-47 is included as Section #6 of this booklet.

On February 9, 2007, under the IRS temporary rules and regulations, 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 regulations 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.

The good news. Additional 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.

Despite some of the confusion surrounding the Act, it is a highly beneficial law for independent producers in film and television and can help put a serious dent into runaway productions.