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New Tax Benefits Available for Film and Television Producers in the United States

Film and television producers in the United States can now benefit from a new tax law that went into effect last Friday, October 22, 2004. The American Jobs Creation Act of 2004 (P.L. 108-357) allows producers of qualifying films and television productions to deduct the full negative cost of the film or television production in the year the cost is incurred. The Act also offers producers a new deduction based on its production income and provides favorable depreciation deductions by including participations and residuals in the producer's tax basis of the production. These new provisions, which will provide significant tax savings to producers of qualified film and television projects, are summarized below:

Changes to the Recovery of Production Expenditures

Election for current deduction. To encourage producers to bring feature film and television production projects back into the U.S., under the new law a producer may elect to deduct the cost of any qualified production of a film or television program in the year incurred. Where a qualifying film is co-produced, the benefits of this new provision must be allocated among the owners of the film in a manner that reasonably reflects each owner's proportionate investment and economic interest in the film.

Qualifying production defined. A qualifying production is any production of a motion picture (whether released theatrically or directly to video cassette or any other format), mini-series, scripted, dramatic television episode or a movie of the week if at least 75% of the total compensation expended on the production (excluding participations and residuals) is for services performed in the United States by actors, directors, producers and other relevant production personnel. With respect to an episodic television series, only the first 44 episodes qualify for the deduction under the new law. Sexually explicit productions, as defined by the United States Code, do not qualify.

Limitations. Generally, the new law applies only to qualifying productions that cost $15 million or less, and allows each qualifying production to expense (rather than capitalize) up to $15 million in production expenditures. The new law also applies to qualifying productions that cost up to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or as a distressed county or isolated area of distress, and allows each such qualifying production to expense up to $20 million in production expenditures. This provision is effective for qualified productions the first day of principal photography of which commences after October 22, 2004 and before January 1, 2009.

This is a significant tax concession in an effort to keep entertainment productions filming in the United States – now producers of qualifying pictures can take a deduction for the full negative cost of a production in the year the cost is incurred (when the income from the production is arguably the highest), thereby reducing or even eliminating the taxable income during the first year of exploitation.

Deduction Against Income Attributable to U.S. Production Activities

New deduction. An entirely new deduction – the "U.S. production activities deduction" -- is allowable for U.S. film producers and other U.S. manufacturers. The amount of the deduction allowable to a film producer is specified as a percentage of the producer's "qualified production activities income" (*i.e.*, the net income from U.S. film production). The specified percentage will be 3% for 2005 and 2006, 6% for 2007 through 2009 and 9% for 2010 and thereafter.

Definitions. The term "qualified production activities income" includes the net income from the license, sale, exchange, or other disposition of any "qualified film" produced by the taxpayer. A "qualified film" is any motion picture film or video tape, including live or delayed television programming (but not including certain sexually explicit films and videotapes), if at least 50% of the total compensation relating to the production of that property is compensation for services performed in the U.S. by actors, production personnel, directors, and producers. For this purpose, compensation will include residuals and participations, and, to the extent that a producer has included an estimate of participations and/or residuals in its income forecast calculation, that producer will have to use the same estimate of participations and/or residuals for purposes of determining total compensation.

Deduction limit. The deduction is limited to 50% of the W-2 wages paid by the producer for the tax year. Special rules apply in determining the W-2 wage limitation on pass-through entities such as partnerships, limited liability companies and S corporations. The deduction is also limited to the taxable income (or modified adjusted gross income, in the case of individuals) of the film producer, determined without regard to the deduction.

Impact on choice of entity. The W-2 wage limitation may have an effect on the producer's choice of entity for doing business. For example, where an individual is a partner in a partnership, that individual cannot also be an employee; therefore, no amount paid to that individual by the partnership – even amounts which do not depend on the success of the business – constitutes "wages." For a company which would otherwise have significant amounts of qualified production activities income and which either pays its principal owners a salary or which gives some small amount of equity to its non-principal employees, this can be quite significant. If the company operates as a limited liability company (taxed as a partnership), it could potentially run into the wage limitation, whereas it might not do so if it operated as a corporation.

This means that, for a production company with qualified production activities income, the corporate form is now more attractive from a tax perspective than it was previously. At the same time, significant disadvantages to corporate form – in particular, double taxation of earnings (unless S corporation treatment is available, with its attendant lack of flexibility) – remain. What might in the past have been a simple decision to use a limited liability company has now become significantly more complex; the possible advantage of using a corporation in order to maximize the deduction for qualified production activities income must now be weighed against the various other disadvantages of the corporate form.

Alternative minimum tax. The U.S. production activities deduction will be allowed in computing the producer's alternative minimum tax, subject to certain limitations.

Modification of Application of Income Forecast Method of Depreciation

Participations and residuals included in basis. The new law provides that, for purposes of computing the depreciation deduction allowable for property under the income forecast method, a producer may include participations and residuals with respect to the property in the adjusted basis of the property for the tax year in which the property is placed in service. However, the inclusion in adjusted basis is permitted only to the extent that the participations and residuals relate to income estimated (for purposes of the income forecast method) to be earned in connection with the property before the close of the 10th tax year following the tax year in which the property is placed in service. This provision applies to property placed in service after October 22, 2004.

Codification of <u>Transamerica Corp. v. U.S.</u> Congress clarified that the inclusion of participations and residuals in adjusted basis under this new rule applies *solely* for purposes of computing the allowable deduction for property under the income forecast method of depreciation. Thus, Congress has adopted the rule in *Transamerica Corp. v. U.S.,* 999 F.2d 1362 (9th Cir. 1993), that included – at least for taxpayers in the Ninth Circuit – certain participations and residuals in adjusted basis for purposes of applying the income forecast method.

Optional deduction. Instead of including participations and residuals in the adjusted basis of property depreciated under the income forecast method, a producer may exclude the participations and residuals from the adjusted basis of the property and deduct the participations and residuals in the tax year that they are paid. The optional deduction method can be done on a property-by-property basis, but must be applied consistently with respect to a given property afterwards. This election may be beneficial to a film producer where, because of the structure of the payment of participations and residuals, they will be payable before a significant amount of the anticipated income from the property is earned.

Clarifications. The new law clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property. Further, the new law also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the new law.

For additional information, and to explore the opportunities presented by this new law, contact:

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