

High Return Investment Opportunity

Did you know you can immediately deduct the cost of Qualified Film Productions? When coupled with the available state film production incentives, initial returns of 50-70% on your investment can be attained in the first year.

Section 181

Previously, some costs of film production were recoverable through depreciation deductions spread over a period of years. However, the 2004 Tax Act added a new Section 181 to the Internal Revenue Code that allows a current deduction for the cost of "qualified film or television productions" in the year of the expenditure.

For any qualified film or television production that commences before January 1, 2010, a taxpayer may elect to deduct expenses in an amount not to exceed an aggregate cost of \$15,000,000. The limitation is increased to \$20,000,000 if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress. A production is treated as commencing on the first date of principal photography.

The "aggregate cost" of a qualified film or television production may include all costs previously required to be capitalized, such as (a) development costs, (b) general and administrative costs, (c) depreciation of property used in production, and, (d) financing costs.

An individual or company who makes an investment into Section 181 qualified productions can take a 100% deduction of their investment against their passive income in the year their investment was made.

A deduction can be made against active income should the investment be made by or through a widely held C corporation. The law is in effect until December 31, 2009 (it was extended by the recently passed TARP legislation), therefore investments must be made before that date and the money invested into qualifying productions. *For further specific information on Section 181 see below.*

Example of Section 181 Deduction

For instance, should an individual or corporation that is taxed at a 35% tax rate have passive income to take a deduction against, then should that individual make a \$10,000 investment into a qualified production or film fund, the actual net investment will be \$6,500 since they can take a deduction against that full \$10,000 against their passive income, and 35% of \$10,000 is \$3,500, which is the value of the deduction they can make in the year they make their investment.

Various State Production Incentives

Many states offer various film and video production incentives. These can be in the form of cash payments, tax credits, tax rebates, and waiver or reduction of sales and various other taxes. Some credits are transferable to other business entities. Every state is different, but usually the film production company must;

- Meet certain spend criteria
- Meet a minimum amount spent in state
- Be approved
- Submit applicable documents
- Go through an audit process

After production is complete and all conditions of the state's requirements are met, the state then issues a refund in the form of a check, credit, or rebate. *For further specific information on some individual states see below.*

Example of State Production Incentive

In New Mexico (NM), which is considered a Tier 1 state by the film industry, a 25% tax credit for all production expenses and labor is given. There is no minimum spend. Should that same individual make a \$10,000 investment into a qualified production in NM, then the actual net investment will be \$7,500 since they are given a cash tax credit against the full amount of \$10,000 spent in the state.

Example of Federal and State Film Incentives Combined

In the previous two examples an individual made an investment of \$10,000 in a qualified film production. Section 181 allowed a first year deduction against taxes of \$3,500. Since the production was filmed in New Mexico, the state paid a tax credit to the individual in the amount of \$2,500. Together, these total \$6,000. This results in an immediate return on investment of 60% to the individual (\$6k is 60% of \$10k).

Further specifics of Section 181

Section 181 also allows for all other recourse debt costs which are usually associated with film finance, a \$10 million dollar film, where only \$3.5 million is equity, an investor can deduct \$3.5 million dollars against the \$10 million, especially if the latter is mezzanine or gap finance.

A qualified film or television production may be a motion picture (whether released to theatres or directly to video, cassette or any other format), a miniseries, a scripted, dramatic television episode, or a movie of the week. In the

case of a television series, only the first 44 episodes may qualify. Sexually explicit productions are excluded.

To qualify for the deduction, 75 percent of the total compensation of the production must be "qualified compensation", meaning compensation for services performed in the United States by actors, directors, producers, and other relevant production personnel. There is no requirement that the individual be a U.S. citizen or resident. However, compensation does not include participations and residuals.

If the election to deduct the expenses is made, no other deduction for depreciation or amortization with respect to the qualified film or television production is allowed.

Only the owner of the qualified film or television production that pays the costs can take the Section 181 deduction. However, there is no requirement that the owner be the actual producer of the production. So even though the owner may subcontract production to another entity, as long as the owner retains the ownership rights over the production, the deduction should still be available. In addition, there can be multiple owners of the production. In that case, each owner would be allowed the deduction in proportion to the amount of his or her contributions.

Application of the Section 181 Deduction

The production activity should constitute a "trade or business", therefore, the Section 181 deduction would be subject to the passive income/loss rules. Individuals and personal service corporations that do not "materially participate" in an activity (regular, continuous and substantial participation in the activity) can only deduct passive losses to the extent of "passive income." Passive income generally includes income from real estate and other passive investments, and will include the income from the film, television show, etc. produced. Any passive losses not used can be carried forward and offset against passive income in subsequent years, or may be deductible against ordinary income if the loss is "freed up" (i.e., by sale or disposition of the passive activity asset). This would apply even if the future gain were long-term capital gain.

Therefore, in the initial year of production, the production costs would be deductible to the taxpayer under Section 181, but only against passive income. Any excess of the deduction (or "loss") would carry forward and could be used to offset any ongoing income stream from the produced material. Presumably, if the produced material were sold in the same year as the costs were incurred, the deduction amount could be offset against the passive income from the gain on sale. If the produced material were sold in a subsequent tax year, the taxpayer could apply the loss carry forward from the first year against ordinary income and

also be entitled to capital gain treatment of the proceeds of the sale of the produced material.

If the produced material is held for more than 1 year from the date of completion, the capital gain will be a long-term capital gain. There are no preferential capital gains rates for corporations, but if the taxpayer were an individual, the long-term capital gain rate would be 15% under current laws.

Potential limitations on the application or effect of the Section 181 deduction under existing tax law may include the "At-Risk Rules" (under which a taxpayer may only take a deduction for direct investment and borrowed amounts for which the taxpayer has ultimate direct recourse liability), the Alternative Minimum Tax (though as long as the production activity constitutes a trade or business (for individuals) or is deductible for purposes of calculating "earnings and profits" (corporations) the deduction should not trigger the alternative minimum tax) and established case law relating to the Internal Revenue Service's ability to recast a transaction based on the doctrine of substance over form in a manner that would eliminate the tax benefits.

Effective for films placed in service after October 22, 2004, taxpayers may elect, on a film-by-film basis, to irrevocably adopt one of two approaches for the deduction of participations and residuals for the film. Participations and residuals are amounts that "by contract vary with the amount of income earned in connection with" the film (i.e., payables based on gross receipts, or box office bonuses). 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 an estimate of the income from the film during the first ten years after the film is placed in service. Alternatively, the taxpayer may elect to deduct the participations and residuals when paid.

- **Partial Exclusion of Income For Films Produced In The U.S.**
The 2004 Tax Act also provides for an exclusion of a percentage of worldwide net income attributable to audio-visual works if at least 50% of the total compensation relating to production of the audio-visual work is compensation for services performed in the United States. The exclusion is 3% in 2005 and 2006, 6% from 2007 through 2009, and 9% thereafter. In no event may the exclusion exceed 50% of the total W-2 wages paid by the taxpayer during the applicable tax year. The exclusion also applies for purposes of the alternative minimum tax.
- The exclusion applies regardless of the medium (i.e., theatrical, television, or DVD). Films will not qualify for this benefit if the film includes "visual depictions of actual sexually explicit conduct."

- Again, as with the Section 181 deduction, the income exclusion is limited to the owner of the film during production.

Further Specifics of State Film Production Incentives

Tier One States

New Mexico: Offers a 25% tax credit for all production expenses and New Mexico labor. The provisions have caused some concern that demand exceeds the labor pool, but a subsidiary of NBC Universal recently opened the largest equipment shop west of LA for TV, film and commercial productions.

Massachusetts: The state offers a 25% credit for production expenses above 50% of the total production costs (\$7 million maximum). For Massachusetts production companies, an income and corporate excise tax credit is also available, equal to 20% of the production payroll (excluding payroll over \$1 million) and 100% sales tax exemption.

Connecticut: The state offers a 30% credit for production expenses. Equipment brought into the state can qualify, provided it is used in the state. By allowing non-residents to qualify, productions can use New York labor and avoid some housing expenses.

Rhode Island: A 25% credit applies to all in-state spending in excess of \$300,000, provided 51% of the production is shot in state.

Louisiana: A 25% credit on all expenditures, including non-resident labor, for work done in state and a 35% credit for payroll for Louisiana residents. An additional 40% credit can apply to infrastructure projects.

Tier Two States

North Carolina: A comprehensive tax credit, offsetting purchases, leases in state and wages paid to residents and non-residents for work performed in the state, seemed to put this state in the first tier.

Illinois: A 20% transferable tax credit, for state labor and expenditures, led to an increase in film and television work. Further, the state waives a 14.9% hotel bed tax, if occupied for 30 days. Already deep with talented and skilled labor, the credit seemed to create more work.

New York: A new 5% city tax credit adds to the 10% state tax credit and the unique and historic backdrops help to overcome the higher expenses of working in New York City.

Hawaii: Weather, setting and refundable tax incentives help overcome the limited size of the local crew. The state offers a 15% credit for a minimum of \$200,000 in production costs on the island of Oahu, rising to 20% for work on the smaller islands. In the alternative, a separate 100% credit is available to the investors.

Florida: Great weather and talented and skilled local crews, are offset by a less generous credit and hurricane season. Florida offers a 15% credit for Florida

expenses, goods purchased or leased, but a minimum qualifying project is \$625,000 with a maximum reimbursement of \$8 million.

Suggested links:

IRS Section 181

<http://www.taxalmanac.org/index.php/Sec. 181. Treatment of Certain Qualified Film and Television Productions>

Federal, State, and International Production Incentives

[http://www.entertainmentpartners.com/products_and_services/services/tax incentives/](http://www.entertainmentpartners.com/products_and_services/services/tax_incentives/)

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