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Focus

Tax-Incentive for Filmmakers Holds Trap in Calculation of Movies' Costs

By Marvin A. Kirsner

A new film tax incentive that was created by the Jobs Creation Act of 2004 to encourage low- to middle-budget films contains a serious flaw that could render it virtually unusable for many projects that this new tax break was intended to benefit.

The new incentive was created to encourage domestic production by allowing all production expenses to be deducted in the year the production costs are incurred. This creates an up-front tax write-off, rather than having to write off the investment only as the project generates revenue. This special tax incentive was intended to make it easier to obtain financing for film and television projects produced in the United States.

To be eligible for this special tax benefit, two major requirements must be met: At least 75 percent of the production wages must be paid for services performed in the United States, and the total cost must be less than $15 million.

If a project costs more than $15 million, then all of the production costs must be capitalized, and the project will get none of the benefits of this new incentive.

The major flaw in this bill is that it appears that participation and residuals are included in the "total cost." If a project that initially had a total cost of less than $15 million, allowing an immediate write-off, becomes moderately successful, the participation and residuals will likely cause the total cost to go over the $15 million limit and the project would no longer be eligible for these benefits, and prior tax benefits would have to be repaid by the investors, who would have to file amended tax returns.

This flaw will have the result of making investors think twice about putting money into a project because of the uncertainty about the tax incentive.

It would seem Congress could not have meant to adapt a tax incentive that would be virtually useless, so maybe lawmakers didn't mean to include participations and residuals in the calculation of total cost. Discussions with the staff of the Joint Committee on Taxation, however, have confirmed that this is, in fact, the case.

There are two solutions to this problem. The most obvious fix would be to have Congress amend the tax code so that participations and residuals are not counted toward the $15 million limit. However, in the tight budget climate in Washington, this will not happen overnight. The film industry had hoped that Congress might have added this clarification in the technical corrections portion of the Hurricane Katrina tax relief bill that was signed by President Bush on Dec. 21. But although this bill clarified that the $15 million limit applied separately for each television episode (up to the first 44 episodes), there was no clarification on the participation and residuals question.

The entertainment industry will need to flex its muscle for this to be a reality. However, because this does not really impact the large studios (because they have few projects that would qualify for the $15 million limit), they would likely not use up any political capital on this issue. The burden will fall on the guilds and independent filmmakers to persuade Congress to clarify this incentive.

The second fix involves the way a project is structured. If the project is done through a limited partnership or LLC, then the writers, directors and actors who might negotiate participations could, instead, be given a partnership interest, which would pay only a percentage of the profits. Amounts paid to a partner as a profits interest is not considered an expense of the partnership, so would not count toward the $15 million limit.

In order for this to work, the "participant/partner" would not be able to receive a percentage of the gross/gross of a project, since a gross/gross payment is not dependent on the profits of the project and would be treated as a "cost" to the partnership. However, a net/gross arrangement would work, since such payments are made only after the project has recovered its costs, and so would be treated as a payment of profits. A net/net participant would, of course, also fall into the category of a profits partner.

It should be noted that the partnership or LLC agreement could be structured so that the participant/partner has no voting rights, and no right to transfer his or her interest.

Unfortunately, it might not be possible to structure the payment of residuals to treat the payment as a payment to a partner because this would require the guilds to become partners in the project, an unlikely event. The guilds also would not be likely to agree to a net profits interest, since they are already entitled to a gross residual under their agreement with producers.

As a practical matter, if the residuals cause the total cost to exceed the $15 million limit more than three years after the costs are written off upfront, the statute of limitations for the year of the write-off would likely be closed, and the IRS would not be able to force the investors to pay back the tax benefits.

Marvin A. Kirsner, a partner at Greenberg Traurig, practices tax law in the firm's Boca Raton, Fla., office, specializing in tax issues of interest to the technology, media and telecommunications industries.

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