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Tax Aspects of Film Production

How and When To Deduct (Write-off) A Film Now That Sec. 181 Is Gone

Short-History of Sec. 181

Sec. 181 allowed you to deduct all film production costs and other indirect expenses immediately so it was an easy way to take a big write-off or loss for a Film Producer or Production Company and for the loss to flow through to investors.

Sec. 181 has been repealed for 2017 and no one knows when or if it will come back to be part of the tax code. Perhaps it will be addressed in the Tax Reform that Trump promises later this year but perhaps not.

Recognizing Income and Amortizing Film Costs

Capitalization of Film Costs

Direct expenses incurred in the production of a Film must be capitalized and amortized over time rather than immediately expensed as was previously possible under Sec. 181.

Capitalized Film Production Costs are to be amortized depending on the terms of sale or exploitation of the Film Production.

The Individual Film Forecast Method(IFFM)

A few rules are:

1. The appropriate recovery system or period may depend upon the terms of sale or exploitation of the Film.

2. The IFFM requires an estimate of the total income to be derived from the film over its expected life.

The basic computation is:

Revenue Received for The Taxable Year times Cost of The Film

Forecasted Total Income To Be Received

So a simple example would be:

Let's say revenue received for the year was $200,000, the forecasted total income to be received is $2,000,000 and the Cost of the Film was $600,000.

So $200,000/$2,000,000 equals 10% times $600,000 equals $60,000. If the deal was a 5 year deal then the amortization would be $600,000/10 equals $60,000 so the amortization would offset the income.

The forecast of income can be revised at the end of each taxable year, based on additional information.

Abandonment of A Film Project

This allows one to deduct the remaining unamortized portion of Film Production Costs.

Abandonment requires that the taxpayer show an **intent to abandon and makes an affirmative act of abandonment** in such a manner that the asset is not retrievable. This doesn't necessarily mean that an attempt was made to sell the film at one film festival that failed. However, failing to exhibit or attempting to sell a film can possibly show an intent to abandon if some time passes or not finishing a film for a number of years without any affirmative effort to do can show an intent to permanently abandon the project.

Fear Not – There is The Domestic Production Activities Deduction (DPAD)

The DPAD is a deduction against income derived from domestic manufacturing activities. The DPAD was enacted to encourage domestic production and related activities.

What Qualifies For The DPAD?

A Qualified Film does and is any motion picture film, videotape, or live or delayed TV programming, for which 50% or more of the total compensation required to produce the film is paid for services performed by actors, production personnel, directors and producers in the United States.

There is a **safe harbor** that will apply if the labor and overhead costs of manufacture, production, growth, or extraction of the property within the US are at least 20% of the total cost of goods sold. (Internal Revenue Bulletin - February 14, 2005 - Notice 2005-14) However, if the 20% test is not met, an activity can still qualify for the deduction based on facts and circumstances.

The DPAD is a fixed percentage of income (currently 9%) from:

Qualified Production activities, or

Adjusted Gross Income (AGI) for individuals, or

Taxable Income for C corporations,

whichever is lower

You must have paid wages to employees to claim the DPAD.

The DPAD may not exceed 50% of wages paid during the year.

Computing the DPAD

You start with Domestic Production Gross Receipts (DPGR) Let's say total Gross Receipts are $200,000 but DPGR are $150,000 equals 75% of total Gross Receipts.

Next, Determine Qualified Domestic Production Activity Income (QPDAI) by reducing DPGR by:

Cost of goods allocable to DPGR, Assume this $50,000 times 75% ='s $37,500

Wages allocable to DPGR,   Assume this is $40,000 times 75% equals $30,000

Other expenses directly related to DPGR, Assume this is $6,000 times 75% equals $4,500

These three expenses total $72,000. Subtract this from $150,000 and it equals $78,000. This is your QDPAI. Multiply $78,000 times 9% and it equals $7,020.

Multiply QPDAI by 9% and compare this to

AGI for an individual or taxable income for a C Corporation

Wages paid during the year to not forget the wage limitation

The QPDAI is passed to LLC members or S Corp shareholders via a K-1.

DPAD Applied to S Corp Shareholder and Members of LLC's

S Corp. shareholders, partnership partners or LLC members that own (directly or indirectly) 20% or more of the equity in the SCorp, Partnership or LLC are treated as having engaged in any film produced by the entity and the entity is treated as having engaged directly in any film produced by the SCorp Shareholder, Partner or LLC member.

Entity Selection

The two best entities to form for a Film Production generally are:

1. LLC's, and
2. S Corporations.

Both generally have limited liability to the extent of entity assets.

My preference for many reasons is to form an LLC but make a timely S Corp election for tax purposes for three main reasons:

1. To avoid the California LLC Gross Receipts Tax.
2. To reduce potential social security and medicare taxes on profits.
3. To reduce the upkeep of corporate formalities such as corporate minutes since the legal entity is an LLC.

Note: In this scenario the LLC becomes a disregarded entity for tax purposes.

Limited Partnership

Another possibility is to form a Limited Partnership, which may be attractive to investors since their liability would be limited to the amount of their investment. However, the General Partners would have unlimited liability unless the General Partner(s) were another legal entity.

Obtaining Investors To Fund Your Film?

Here's Some Added Responsibilities To Be Aware of:

This segment comes curtesy of Nancy and consulting an Attorney is a must.

There are three Regulation D Exemptions: Rules 504, 505 and 506 that allow a film producer to offer and sell securities in an entity formed to produce a Film Project. I would definitely consult with a securities attorney to see which rule(s) to utilize.

Once you obtain funding for a film, you have certain fiduciary duties to fellow shareholders or partners or LLC members. Some of these are:

1. To use entity or project funds for their intended purpose, i.e., to create, shoot and produce the film and not loot the entity and spend the money frivolously, and
2. To provide a full and complete accounting of how all funds were spent and how all income was accounted for, and
3. To have tax returns prepared by a competent tax professional and provide all fellow shareholders/partners or LLC members with their annual federal and state K-1's.
4. To honor any and all contractual terms of contracts entered into by or on behalf of the entity.

Again, I would definitely consult with an attorney since there are likely more fiduciary duties than those listed above and breach of one or more fiduciary duties can cause you to be held legally liable for damages caused to all fellow shareholders/partners or LLC members. You can also be held liable for failure to pay state minimum taxes as well.

Investors/Producers Beware – The Character of The Investors Participation Will Determine The Character of The Profits and Losses That Flow Through To The Investor

Passive v. Active

A Passive Investor is one that takes the risk of losing his money but does not take an active part (materially participate) in the management of the production (project).

An Active Investor (Participant) must meet the Material Participation Test. He/She must work on the production either more than 500 hours in a year or spend more than 100 hours participating and no one else spends more hours (tough to do on a film production).

Why Is This Important?

Because passive losses can only offset passive income such as some rental real estate activities and vice versa.

Likewise, active losses can only offset active income. So losses and income must be properly characterized to be correctly utilized.

What is Basis?

For an S Corp shareholder basis is generally:

Capital Contributed such as purchase of stock

Plus Income from the S Corp the Shareholder has paid tax on

Plus amounts that a shareholder is at risk for such as personally guaranteeing a corporate loan

Less losses previously deducted from the S Corp

Less Distributions taken

Why is This Important?

Because of **basis limitations**. **An S Corp shareholder can only deduct losses to the extent of his basis**. If a shareholder has no basis, the losses are suspended until he/she obtains basis or the entity is sold.

What is Sweat Equity?

Trading one's services for stock or equity in an entity.

When services are performed in exchange for stock, the fair market value (FMV) of the services is taxable compensation. The amount included in income becomes the shareholder's stock basis. This, if a Post Production professional trades his services for shares of an entities stock. He/She should be issued a 1099 for the FMV of his/her services.

What Is A Net Operating Loss(NOL)?

A Net Operating Loss (NOL) occurs when a taxpayer or entity has losses greater than income in a given tax year from one or more qualifying activities.

What Events Typically Generate An NOL?

An NOL is typically generated by:

A Net Business Loss

A Casualty Loss – Theft, Earthquake, Flooding

Sale of an Asset Used in a Trade or Business

Abandonment of an Asset Used in a Trade or Business

Utilization of An NOL

Generally, an NOL can be carried back 2 years or carried forward 20 years to offset other tax year's income and taxes but can't offset self-employment tax. The carryback period is 3 years for Farming or qualified disaster losses, and 10 years for a specified liability loss.

Election To Forego A Carryback

Waiving the Carryback period – You can elect to waive the carryback if you make the election in a timely filed return (including extensions) or within six months on an amended return (excluding extensions) if the original return was timely filed.

Why Would One Want To Forego An NOL Carryback?

If the carryback years were breakeven or low income years and one was reasonably certain that higher income years were coming, it would be advantageous to forego the carryback so as to use the NOL in a year in which you were in a higher tax bracket since it would be more valuable,

Dangers, Pitfalls and Mistakes To Avoid

Failure to put actors, cameramen, and the rest of the production crew on payroll as employees and withhold payroll taxes is a biggie and can get you in big trouble with the IRS because if you treat these people as Independent Contractors and 1099 them, the IRS can reclassify them as employees. The IRS and EDD will then assess you for taxes, interest and penalties and the bill can be steep!

Failure to take a reasonable salary if you're an S Corp or C Corp Officer/Shareholder.

Failure to conduct the activity as a for-profit business.

Independent Contractor v. Employee

There are 20 common law factors used by the IRS to determine if a worker is an employee. In a nutshell, it typically comes down to who sets the hours and whether the employer exercises control over how the job is to be done.

There are Safe Harbor Relief Provisions under Sec. 530 if one can show 1) Reporting Consistency, 2) Substantive Consistency, and 3) A Reasonable Basis for not treating the worker as an employee.

Industry norm is a consideration but not determinative by itself.

An Independent Contractor keeps his/her own hours, works for others, and has control over how to perform the job.

Start-Up Costs

If incurred by a taxpayer or entity in the process of acquiring a new business, expenses such costs of investigating business possibilities such as market analysis, facilities etc. The first $5,000 is deductible in the year expenses are incurred and the remainder, if any, are amortized over 15 years. Thus, you may want to file a Schedule C Sole Proprietorship for the first year and then form an entity when you are clear on going forward with a Film Production just in case you change your mind about going forward with it.

Hobby Loss Rules

An activity must be conducted as a for-profit business in order to deduct expenses that are ordinary and necessary in carrying on the trade or business. If the activity doesn't show a profit in three out of five consecutive years the for-profit presumption can be lost and the IRS will look at nine factors in the regulations and apply a Facts and Circumstances Test. If found to be a hobby, IRS can disallow the losses claimed and hit a taxpayer with taxes, interest and penalties as a result.

Other Tax Reduction Strategies

Income Shifting

Paying a relative a salary if they are in a lower tax bracket than the owner. Must be a bona-fide employee, work and keep time sheets and rate of pay must be reasonable for the work performed.

This can work for the owner's children who are 17 years old or younger and help fund their college.

A Medical Reimbursement Plan (MERP)

One can hire their spouse, adopt a MERP and be able to deduct medical expenses at the business level. Helps save self-employment tax for a self-employed owner and allows one to deduct medical expenses not otherwise deductible. Doesn't work for S Corps or LLC's.

Renting Your Home or Vacation Home Tax-Free

You can rent your house out 14 days or less per year tax-free. This can work well in an AirBNB situation. Also, the owner's business entity can rent the owners house tax-free as long as it's an arm's length transaction and the entity gets a deduction and the owner doesn't have to report the rental income as long as he/she in under the 14 days. For rental of a vacation home, there are more rules such as limits on personal use days.