TAX DEVELOPMENTS AFFECTING FILM COMPANIES

By Schuyler M. Moore*

The IRS Threatens to End State Tax Credit Party

For the last several years, the largest source of “soft money” for film financing has been U.S. state tax credits, but the IRS recently issued a Chief Counsel Advice that threatens the viability of this vital source of financing by holding that the receipt of the proceeds from the sale of state tax credits is immediately taxable.¹

Up until now, film companies have been treating the proceeds of the sale of state tax credits as reducing the cost of the film. While there is no direct authority for this treatment, it seems reasonable by analogy to the treatment of price rebates, which are not treated as taxable income but instead are treated as a retroactive reduction in the cost of the purchased item.² The net result of this treatment is that if a film costs $15 million before tax credits, and the tax credits are sold for $3 million, the film company treats the film as costing $12 million. This $12 million net cost is then amortized using the income forecast method, commencing in the tax year that the film is released to the public.

Under the IRS approach, the film company in the above example has $3 million of taxable income when it receives the proceeds from the sale of the tax credit, and the film is treated as costing $15 million. The worst part for the film company is that it cannot offset the $3 million of taxable income by any portion of the cost of the film until the film is released to the public, and even then it has to use income forecast amortization to deduct the film cost over a number of years pro rata with the actual and expected income from the film. Further, it does not appear that the $3 million of income from the sale of the tax credit would be included in calculating income forecast amortization, since it is not attributable to exploitation of the film.

Prior to 2012, this issue was not as significant as it is now, because Section 181 permitted the immediate deduction of the first $15 million of film production costs for films produced in the United States. Thus, the Section 181 deduction would have offset any income from the sale of tax credits. However, Section 181 lapsed at the end of 2011, and there is currently no bill pending that would extend it.

The key going forward will thus be to push the taxation of the tax credit sale out as far as possible – at least to the year that the film is released. If the transaction is structured as an outright sale of the tax credits, the film company will have taxable income when it receives the sale proceeds, even if the tax credits have not been received yet.

¹ IRS Chief Counsel Advice 201147024 (Sept. 15, 2011)
However, a tax credit transaction can also be structured as a “loan,” and if properly structured, this will delay the day of reckoning to the date that the tax credit is actually received and applied in repayment of the loan. Even under this structure, however, there is a risk that the transaction will be treated as a sale, resulting in immediate taxation when the “loan” proceeds are received, if the “loan” is nonrecourse and secured only by the tax credits. There will thus be a premium on properly structuring tax credit transactions with an eye on the IRS position.

Alternatively, film companies could just damn the torpedoes, since it was only an IRS Chief Counsel Advice, which technically cannot be considered – or even cited – as persuasive authority to a court. There is strong logic in treating the proceeds from the sale of tax credits as analogous to a price rebate, and it is a coin flip as to which way a court would go. But film companies taking this route are now on notice of the IRS position, and forewarned is forearmed.

**California is a Tax Haven For Film Companies**

Many people complain of California having one of the highest tax rates in the country – and it does – but the truth is that California is one big tax haven for film companies that are formed as C corporations, because of the way the tax system works. Indeed, it is a publicity gaffe that California isn’t advertising it’s tax haven status to the film industry; if the state is going to subsidize film companies that are based here (unintentionally or not), it might as well shout it from the rooftops.

The devil of taxation is in the details, and the relevant detail here is that California permits companies to elect to allocate their taxable income to California in one of two ways for tax years that start after January 1, 2011.\(^3\) And whenever taxpayers have an election, you can bet that they elect to pay the least taxes. The election that film companies are sure to elect is the “single factor” formula, which allocates all taxable income based on where sales are deemed to occur.\(^4\) Up until recently, it wasn’t entirely clear how this rule would be applied to film companies, but recent regulations make the rules clear, and they are quite favorable for any companies, such as film companies, that license intangible rights.\(^5\)

In summary, the regulations allocate income from the licensing of intangible rights, such as films, to the point of exhibition to the ultimate consumer, not to the location where the sales activity occurs. Thus, if a film company licenses its film library from an office in Los Angeles, the film company’s net income will be allocated to California based on the ratio of the income from California consumers compared to worldwide.

An example is the best way to show the impact of this election: Assume that a film company based entirely in California has $100 million of net taxable income that is

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\(^3\) Cal Rev. & Tax. Code section 25128.5(a).
\(^4\) Cal Rev. & Tax. Code section 25136.
\(^5\) FTB Reg. 25128.5.
attributable to $1 billion of worldwide income from the licensing of its film library. Also assume that the gross income from California consumers represents 5% of the worldwide gross income. On these facts, only $5 million of the film company's net taxable income would be allocated to California, and at an approximately 9% tax rate, the California tax would be about $450,000, or less than one-half percent of the film company's total taxable income. Not bad.

A bill was proposed in November, 2011 to eliminate taxpayers' ability to make an election on how to allocate income, but the bill would make the "single factor" approach mandatory (as opposed to the alternative approach, which is far less favorable to film companies), so film companies are safe whether or not this bill passes.

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