

Immediate Write-off of Cost of Producing a Film

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Section 181 of the Internal Revenue Code of 1986, as amended (the Code), enacted last year, provides an election to expense the costs of production of a domestic motion picture. The conditions that must be met for such election are (i) that production costs not exceed \$15 million* and (ii) that at least 75% of the costs represent compensation for services performed in the United States by actors, directors and producers and other production personnel. Participations and residuals (including contingent fixed deferments) are not considered compensation for this purpose and are not taken into account. In the absence of Section 181 the cost of production of such a film would be capitalized and would be subject to depreciation under the income forecast method, designed to recover the cost of the film in accordance with the anticipated income of the film after its release over the period of its initial release in all media.

There is a pitfall that should be considered if production of the picture is to be financed by way of a syndication. Section 469 of the Code, applicable to individuals, estates and trusts, limits their ability, prior to the disposition of the investment, to use losses derived from a "passive activity" against income from any source other than from a passive activity. In general, a passive activity is one in which a pass-through entity, such as a partnership (including a limited liability company taxable as a partnership) or an S corporation, operates an active business in which the investor does not personally materially participate. Losses which are not able to be used in a given year are suspended and available for use in a subsequent year against appropriate income, including that of the particular investment from which they arose. Any such losses may be used to offset any income of the individual when there is a disposition of the investment (by way of a sale of the investment or the liquidation of the company).

In general, a C corporation, other than a personal service company and a closely held corporation, is not limited by the passive loss provisions of Section 469 of the Code. A closely held corporation is one in which five or fewer individuals own, directly or indirectly, more than 50% in value of the corporation. It may use passive losses to offset its regular business income but not investment income (such as dividends and interest). A personal service corporation is generally one in which services are performed substantially by employee-owners (e.g., any professional corporation or other service provider that is held largely by the employee-owners). Such a C corporation is limited by Section 469 of the Code in the same way as is an individual.

The benefit of the immediate deduction of production costs under Section 181 of the Code may thus be delayed as to certain taxpayers.

*The dollar limitation may be increased to \$20 million if the production is a significant part of the aggregate cost in a low-income community or community that is distressed.