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# **TAXATION of the ENTERTAINMENT INDUSTRY**

Schuyler M. Moore



Wolters Kluwer

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# Taxation of the Entertainment Industry

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2016 Edition

Schuyler M. Moore

*Stroock & Stroock & Lavan LLP*



Wolters Kluwer

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# Preface

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When I marched out of law school, freshly scrubbed and brimming with legal knowledge, I looked forward to applying an imperfect tax law to a perfect world where the facts, at least, would not be in doubt. To be sure, the law was rife with latent and patent ambiguities forged in a fire of political reality, but my goal was to unravel the law through application to concrete facts.

By complete circumstance, the factual laboratory I was thrown into was the entertainment industry, as I did not realize what a large percentage of my new firm's business was entertainment. I soon had a surfeit of entertainment contracts floating across my desk, and my task was to sort out the tax issues. During this time, my vision of a perfect world rapidly disintegrated, as the contracts told a sad story of muddled facts, ambiguous relationships, and wild aspirations, all tied together with incomprehensible terminology. The complexity and confusion was, and is, compounded by the following factors:

- (1) Films are based on copyright, an intangible asset, and it is possible to splinter that asset into a thousand pieces with little effort.
- (2) Entertainment lawyers, who draft the contracts, are often indifferent to the legal niceties of form and structure. It seems that they sometimes title an agreement with the first word that strikes their fancy, and the process goes downhill from there.
- (3) The contracts are laced with unique jargon, much of which has no legal meaning even when translated into English.
- (4) The entertainment industry is rife with dreamers and schemers. Dreamers have grand visions but often lack the basic business knowledge necessary to implement their visions. Schemers think they have the knowledge, or worse, pretend they do, and attempt to baffle and bamboozle their way to success; to some, success consists of parting people from their money.
- (5) The informality with which the entertainment industry does business shocks normal businesspeople. Napkin deals do, in fact, occur. The majority of deals are documented by pathetic, sparse "term-sheets" that allude to some long form to follow. In those rare cases when the long form does follow, it is usually after the transaction is over.

When this chaos is stirred in a pot, it is not surprising that what is brewed is litigation—and lots of it. The badge of a successful film is the amount of litigation heaped upon it, from claims of ownership, to hopeful participants cut out of the process, to actual participants that wonder what happened to "net profits."

Stage two of my career was the Quest for Truth. Certainly, I concluded, the legal issues had been thought through carefully by the drafters, and it was only my ignorance that prevented me from seeing the light. I asked questions, I read, I

studied. I was somewhat astounded to learn that there were few answers and fewer questions. That is, entertainment lawyers did not seem to raise the questions or issues until an IRS audit.

Stage three of my career was the realization that I lived in a chaotic world, and since then I have been driven by my somewhat obsessive nature to attempt to sort out the chaos, perhaps in a vain attempt to achieve my youthful vision of a perfect world. In any event, this book represents my ongoing efforts to bring order to the chaos.

**Schuyler M. Moore**

**June 2016**

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## About the Author

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**Schuyler M. Moore, Esq.**, is a partner in the Corporate Entertainment Department at the Los Angeles office of the national law firm of Stroock & Stroock & Lavan LLP. He was the founding Chairman of the Entertainment Tax Subsection of the Los Angeles County Bar Association Taxation Section (1988-1991). Mr. Moore holds undergraduate and law degrees from the University of California at Los Angeles, where he was first in his law school class. He has published numerous articles dealing with a wide variety of tax subjects. He is the author of *The Biz: The Basic Business, Legal and Financial Aspects of the Film Industry*.

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## ¶ 101 TERMINOLOGY

This book examines the significant tax issues that often arise in the entertainment industry. In the case of tax issues that are not unique to the entertainment industry, this book provides an overview, giving the reader a general issue-spotting checklist.

For tax issues that are unique to the entertainment industry, this book provides substantially more detail.

To understand fully the subject of this book, it is helpful to become acquainted with terminology that is unique to the entertainment industry. Certain key terms are defined in the paragraphs below.

**Negative pick-up.** A negative pick-up is an agreement whereby a distributor agrees in advance to acquire usually worldwide rights in a film in perpetuity upon delivery by the producer. The distributor agrees to pay the producer a fixed amount upon delivery of the film and to make additional payments contingent on success of the film. The producer pledges the distribution agreement to a bank in exchange for a loan to use for production of the film. As long as the film meets certain pre-approved criteria, the distributor must accept delivery, and the distributor's payment is then used to pay down the bank loan.

**PFD agreement.** In a "production, finance, and distribution agreement" (a PFD agreement), a distributor acquires worldwide rights in perpetuity, and owns all film rights during production, by directly funding the cost of production. The distributor has the right to make changes in production as long as the distributor pays for any additional costs. The producer is entitled to fixed producer fees plus contingent compensation based on the success of the film.

**Pre-sale.** A "pre-sale" is an agreement whereby a producer enters into an advance license of film rights for a particular territory and term prior to completion of the film. In some cases, the licensee pays some cash at the time of entering into the pre-sale, and the balance is due upon delivery. In other cases, the payment may be due only upon delivery, but this obligation may be backed up by a letter of credit. In either case, the producer will often borrow against the contractual commitment or the letter of credit to produce the film.

**Talent.** The actors, writers, and directors are referred to as "talent."

**Loan-out corporation.** Talent often renders services through wholly owned, one-person corporations referred to as "loan-out corporations."

**Above-the-line and below-the-line costs.** Motion picture costs are often categorized as either "above-the-line" costs or "below-the-line" costs. "Above-the-line" costs are payments to creative and executive personnel, such as talent. "Below-the-line" costs are all expenses that relate to the actual on-site shooting of the film and the post-production costs (such as editing and soundtrack).

**Deficit financing.** In the television industry, it is common for a network to finance a substantial portion of the cost of a television show. The producer must provide the balance of financing through sales of foreign rights or loans. This process is often referred to as "deficit financing."

**P and A.** After a film is completed, it must be distributed. In the case of a so-called theatrical release (a release through motion picture theaters), substantial costs are incurred in making duplicate film prints and in advertising. These costs are often referred to as prints and advertising (P and A).

**Minimum guarantee plus overages.** Most film rights are licensed for a "minimum guarantee," which is a flat fee plus "overages," which are additional payments to the licensor based on a percentage of the net or gross receipts from the film.

**Participations.** Talent will often receive "participations" entitling them to payments based on a percentage of the revenues from the film. Participations are usually tied to net revenues and are defined in such a way that they are rarely earned. If the

talent have a strong bargaining position, they may have a participation tied to gross revenues, which is certain to earn them at least some income.

**Residuals.** “Residuals” are essentially the same as participations, but the term “residuals” is used when the payments are made to unions pursuant to guild agreements.

## ¶102 CHARACTERIZATION ISSUES

### .01 *Tangible Versus Intangible Property*

One tax issue that repeatedly arises in the film entertainment industry is whether films are considered tangible or intangible property.<sup>1</sup> After more than 90 years, this issue is still unresolved. The tangible versus intangible property question finds its way into many areas of taxation, including depreciation, investment tax credit, Subchapter S, passive activity losses, and Subpart F. It is also relevant for state sales tax and unitary taxation. As a broad generalization, the courts have held that films are tangible property. On the other hand, the IRS has consistently argued and ruled that films are intangible property.

Congress has passed many statutes that effectively treat films as intangible property for certain purposes and as tangible property for other purposes. One of the areas where Congress has effectively treated films as intangible property is depreciation. Under Code Sec. 168, films are prohibited from using the accelerated cost recovery system (ACRS); under current law, films are therefore relegated to the income forecast method of amortization or straight-line depreciation. Outside of the express statutory provisions, taxpayers have the best of both worlds; if they want to treat films as tangible property, they can rely on the case law, and if they want to treat films as intangible property, they can rely on the IRS’s pronouncements.

### .02 *Ownership*

Notwithstanding the tax characterization of films as tangible or intangible, the value of a film lies in the intangible right under copyright law to exploit the film (i.e., a film print is not worth much if it cannot be exhibited). This intangible right can be splintered into numerous parts based on the medium of exhibition, territory (geographic scope of rights), and time (term of grant). This ability to splinter film rights does not fit well with general tax principles, which seek to find an “owner” of the film.

The fact that it is not always clear who is the owner of a film for tax purposes has implications that run throughout the Internal Revenue Code. For example, it is often necessary to determine whether a transaction is a sale or whether it is a lease or license.<sup>2</sup> This issue is important in calculating gain, amortizing costs, accruing in-

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<sup>1</sup> See ¶ 201 *infra*.

<sup>2</sup> See ¶ 202 *infra*.

come, and characterizing income. If, for example, all film rights to Canada are “sold” in perpetuity for a contingent price, is the transaction a sale or a license? What if the parties call the transaction a “license”? What if the payment is a fixed sum instead of contingent? The determination of ownership is also important in determining who is taxed on income received<sup>3</sup> and who is entitled to depreciation.<sup>4</sup>

### *.03 Rents Versus Royalties*

Another issue of uncertainty, which tends to overlap with the tangible versus intangible distinction, is whether or not income from the exploitation of a film is “rents” or “royalties.”<sup>5</sup> This distinction is extremely important in applying many tax provisions such as the personal holding company rules,<sup>6</sup> the foreign personal holding company rules,<sup>7</sup> Subchapter S,<sup>8</sup> the passive activity rules,<sup>9</sup> and treaty provisions.<sup>10</sup> In general, it appears that theatrical film income is characterized as rent, and film income from other sources is characterized as royalties.<sup>11</sup> This generalization gives way to the rules applicable to each specific statutory provision, which rules are sometimes found only in the legislative history.

### *.04 Licensee Versus Agent*

The determination of whether a person is a licensee or a distribution agent can have significant tax implications. Although the terms are often used interchangeably, the distinction is important, for example, in determining who is entitled to the foreign tax credit for any withheld taxes.

### *.05 Royalties Versus Compensation*

To determine the timing and character of income and the appropriate level of withholding, payments must be characterized as either royalties or compensation. In general, payments are characterized as royalties or sale proceeds (and not compensation) if the property (e.g., film or screenplay) was completed on “spec” and not pursuant to any contract with a third party.<sup>12</sup> In addition, payments for a name and

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<sup>3</sup> See Chapter 4 *infra*.

<sup>4</sup> See Chapter 5 *infra*.

<sup>5</sup> See ¶ 203 *infra*.

<sup>6</sup> See ¶ 306.03 *infra*.

<sup>7</sup> See ¶ 707 *infra*.

<sup>8</sup> See ¶ 305 *infra*.

<sup>9</sup> See ¶ 908 *infra*.

<sup>10</sup> See ¶ 705 *infra*.

<sup>11</sup> See ¶ 203 *infra*.

<sup>12</sup> See ¶ 204 *infra*.

likeness license are characterized as royalties, while payments for product endorsement are characterized as compensation.<sup>13</sup>

### *.06 Inventory*

To determine the timing, character, and amount of gain recognized on a sale, film rights must be characterized either as inventory or as Section 1231 property or a capital asset.<sup>14</sup> In general, film rights will be characterized as inventory if they are frequently sold or if they are created pursuant to a pre-existing contract of disposition.<sup>15</sup>

### *.07 Partnership*

The parties in a transaction may find themselves with unintended tax consequences and liabilities if the transaction is recharacterized as a partnership for tax purposes.<sup>16</sup> For example, foreign corporations in a partnership doing business in the United States may be taxed in the United States, and U.S. partners may be liable for the foreign corporation's U.S. tax.<sup>17</sup>

In general, the characterization of an entity as a partnership for U.S. tax purposes does not depend on the labels applied by the parties. Instead, the IRS and the courts will look to the intent of the parties and whether there is a sharing in profits or losses and a joint contribution of property or services.<sup>18</sup>

## **¶ 103 DOMESTIC PRODUCTION AND DISTRIBUTION**

### *.01 Choice of Entity*

Careful tax planning is required at all stages in the production and distribution of motion picture films. The first, and most basic, task is choosing the appropriate business entity through which production or distribution activities will operate. If the wrong entity is chosen, all further tax planning may be useless. The available entity choices are sole proprietorships, general partnerships, limited partnerships, S corporations, C corporations, or limited liability companies.<sup>19</sup>

Sole proprietorships and general partnerships offer simplicity of form and low transaction costs. However, both forms entail unlimited liability to the owners. Limited partnerships, S corporations, and limited liability companies offer the ability

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<sup>13</sup> *Id.*

<sup>14</sup> See ¶ 402 *infra*.

<sup>15</sup> See ¶ 205 *infra*.

<sup>16</sup> See ¶ 206 *infra*.

<sup>17</sup> See ¶ 804.01 *infra*.

<sup>18</sup> See ¶ 206 *infra*.

<sup>19</sup> See Chapter 3 *infra*.



to pass through income and losses directly to the owners while maintaining limited liability for the owners.<sup>20</sup> From a tax perspective, a C corporation is the least advantageous entity, yet it is often used simply because it is the most familiar.

### *.02 Depreciation and Amortization*

The costs incurred in producing a film or in acquiring film rights can be depreciated or amortized.<sup>21</sup> The income forecast method allows the cost of the film to be amortized based on the ratio of the net revenues received each year to the net revenues expected over the life of the film. The only other depreciation method allowed is straight-line depreciation over the useful life of the film, with an allowance for the salvage value of the film at the end of that useful life.

### *.03 At-Risk Rules*

The ability of the producer or distributor to deduct amortization of their costs in a film depends, in part, on the application of the at-risk rules.<sup>22</sup> In general, the at-risk rules limit the ability of individuals and closely held C corporations to deduct losses in excess of their amounts "at risk." A taxpayer's amount "at risk" generally includes any money and the fair market value of any property the taxpayer has contributed to the activity, as well as any debts for which the taxpayer is personally liable if the lender does not have a prohibited interest in the activity.

### *.04 Capitalization of Film Costs*

A common tax issue faced by film producers is deciding which costs must be capitalized as part of the cost of producing the film and which costs can be immediately deducted.<sup>23</sup> If a film project is shelved, can the costs incurred on the film be deducted at that time? Similarly, if a completed film is a flop, at what point can the costs be written off?

### *.05 Timing of Deductions and Income*

Timing issues often arise in connection with the deduction of expenses and the accrual of income. Producers often receive advance payments pursuant to pre-sale agreements. The producers view the advances as loans and generally do not recognize the income for accounting purposes until the film is completed. For tax purposes, however, such advance payments are generally fully taxable upon receipt, if

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<sup>20</sup> The general partner of a limited partnership is not shielded from liability; however, use of a corporate general partner will solve this problem.

<sup>21</sup> See ¶ 503 *infra*.

<sup>22</sup> See ¶ 904 *infra*.

<sup>23</sup> See ¶ 501 *infra*.