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INSIGHT: Section 181 and Film Financing

BY KELLY FREY

The Tax Cuts and Jobs Act (Pub. L. No. 115-97), otherwise known as "The Act," was a watershed event for film finance.

Prior to the Act, tax code Section 181 was used as a buzzword by film financiers to describe the complete deductibility by passive investors in pass-through entities of film production expenses in the year those expenses were incurred. Section 181 treatment was available for qualified film productions (up to a deductible expense cap of $15 million, or $20 million in certain economically depressed areas) from 2004 through 2017, typically via legislation passed in December that applied retroactively during the year.

This pass-through deduction against earned income of the investor was a significant selling point for passive equity ownership in these single-purpose independent film production companies—ultimately reducing the actual money at risk by a passive investor in proportion to the highest marginal tax rate of the investor. The practical result was that investors with taxable income subject to a 30 percent-plus marginal rate would have only 70 percent (or less) of every invested dollar actually "at risk." The Section 181 pass-through deduction reduced, dollar for dollar, the passive investor's taxable income subject to this highest marginal rate in the tax year the costs of production were incurred. When combined with various state rebates and/or film incentives that could guarantee additional (even if deferred) revenue to these film production companies, the actual "at risk" portion of an individual's cash contribution could fall to as little as 50 percent of the nominal capital investment, making the "risky business" of film investing a little less risky.

While the Act retains references to Section 181, the provision now survives only as a definitional reference for "qualifying property" and the actual deductibility of film production costs has completely changed. Thus, the Section 181 buzzword may still be a part of the film industry finance vernacular, but the historical individual investor benefits associated with that buzzword are no longer available.

The Old Regime

Section 181 treatment was originally developed to prevent so-called "runaway productions," which refers to the flight of U.S. film productions to offshore locations that offered significant tax incentives and rebates.

Under old Section 181, if at least 75 percent of the production costs for a film were incurred in the U.S., a film production company could elect to treat the costs incurred throughout production of a film as a deductible expense during the taxable year in which such costs were incurred, up to a maximum of $15 million, or $20 million in certain economically depressed areas. Film productions that were made outside of the U.S. were forced to capitalize or depreciate their production costs under an income forecast method over the amortization period applicable to film or copyright.

This Section 181 deductible expense was typically passed-through to individual passive investors via single-purpose LLCs used by film production companies to finance and make independent films, further allowing passive investors in such pass-through entities to offset other earned income at their highest incremental tax rate with the Section 181 pass-through deduction, which was not chargeable to the investor's capital account.

This pass-through deduction was significant enough to be part of almost every investment pitch and investor disclosure document for independent feature films while Section 181 was available. Additionally, film companies did in fact make more films in the U.S. as a result of Section 181—because those U.S. productions were the projects that could find financing, thanks to the generous passive investor tax treatment of capital contributions used to fund the costs of production.

The New Regime

Under the Act, qualified film productions are now eligible for bonus depreciationñwith qualified film productions having the same definition as under the former Section 181.

This bonus depreciation permits the complete deduction of the production costs of a feature film in the year the film is placed in service, as opposed to the old 181 accelerated depreciation deduction in the year the cost was incurred. This new bonus depreciation is no longer capped at $15 million or $20 million and no express election by the taxpayer is required to receive this favorable tax treatment, as under the prior Section 181 provisions.

While these changes would appear to be good news for independent film production companies and their investors, these changes cannot be applied without reference to other limitations imposed on Section 181 qualified property by the Act.

Under the Act, individual investors are now subject to passive loss rules. For example, deduction of expenses for qualified property that meets the Section 181 definition, such as film, can only be against passive income *rather than all taxable income*, as allowed under Section 181 provisions prior to the Act.

The Act also ushered in limitations on excess business losses. Such limitations capped losses at $250,000 for single taxpayers or $500,000 for married or filing jointly taxpayers, with all disallowed loss being characterized as net operating loss that can be carried forward indefinitely, but which cannot be carried back and which loss carried forward is limited to 80 percent of taxable income of the investor.

The end result is that under the Act, individual investors that historically invested in independent film can no longer realize the same tax savings they enjoyed under the prior incarnation of Section 181.

As with former Section 181, the new bonus depreciation provisions for film production costs under the Act also have an expiration date (2027), plus the new bonus depreciation is now subject to phase-out provisions after 2022.

The One Added Tax Benefit for Independent Films: Everything Old is New Again

While the Act substantially reduced the tax incentive individual investors in independent film production investment had under the old Section 181, it did create a new opportunity within the film community: the Act expands bonus depreciation to used qualified property.

Due to this expansion, a film distribution company may be able to completely deduct the cost of acquiring an older film, either via limited license or assignment of copyright. Currently such acquisition would appear to have to be of the individual asset (the license or copyright is the qualified property), rather than acquisition of a slate of old films via acquisition of a company owning rights in that slate of films (as equity in a company would not be qualified property under the Act).

However, it is still not obvious whether indie films that have previously been placed in service (used), will experience any net benefit as a result of this new tax treatment.

What *is* obvious is that thousands of film production jobs and millions of film production dollars that were originally scheduled for U.S. productions, because of the tax benefits of Section 181 to film investors prior to the Act, are now, once again, "running away" to foreign jurisdictions that provide more favorable incentives which effectively reduce the economic risks for film production investors.

Kelly Frey is a partner in Nelson Mullins Riley & Scarborough LLP's Nashville office where he represents indie film production companies and high-net-worth film investors.He has also served as executive producer for several feature films, including "The Dead Center" (starring multiple Sundance award winner Shane Carruth) and "The Odds" (by 2018 Edgar Allen Poe award winning screenwriter Bob Giordano), scheduled for release in 2019, in addition to the healthy eating documentary "Eating You Alive" (featuring James Cameron and Samuel L. Jackson) and the recently released thrillers "Fogg" (with Best Actor award winner Ryan Wotherspoon) and "All Light Will End" (with Andy Buckley from the hit comedy, "The Office" and stage, movie and television star John Schuck from "Annie,""MASH" and "Star Trek").