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# Section 181: A 'Runaway Failure' for Film Financing

*By Kelly Frey, Esq.*[*]

The passage of the 2017 tax act (Pub. L. No. 115-97) was a watershed event for film finance.

Prior to the 2017 tax act, the old "§181" election was used as a buzzword by film financiers to describe the complete deductibility (when 75% of certain compensation costs were incurred in the United States) by passive investors in pass-through entities of film production expenses in the year those expenses were paid or incurred (as discussed below).

This old §181 deduction against earned income of an individual investor was a significant selling point for passive equity ownership in 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 greater than 30% marginal tax rate would have only 70% (or less) of every invested dollar actually "at risk." The §181 pass-through deduction reduced, dollar for dollar, the passive investor's taxable income subject to this highest marginal tax 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 "at risk" portion of an individual's cash contribution could fall to as little as 50% of the nominal capital investment, making the "risky business" of film investing a little less risky.

While the 2017 tax act retains references to old §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 §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 the old tax provisions in effect from 2004 through 2017, film productions primarily produced in the United States could deduct qualified costs of production for a film (up to $15 million, or $20 million in certain economically depressed areas) by simply electing such treatment by the due date for filing the taxpayer's/owner's federal income tax return for the first taxable year in which production costs were paid or incurred.[1] Film productions that were made outside of the United States were forced to capitalize or de-

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[1] §181(a)(2). The election had to include the name of the production, the date on which production costs were paid or incurred, the aggregate costs paid or incurred, and certain declarations with respect to the location where expenses were incurred. Reg. §1.181-2. This tax treatment was typically authorized for short/annual periods and extended via legislation passed in December 2018 that applied retroactively during the year. Practically, such sunset provisions and retroactive application of §181 led independent film production companies to arrange for at least one day of "principle photography" in the tax year during which such treatment was allowed in order to "grandfather in" their production (just in case §181 was not renewed for the subsequent tax year, during which the bulk of production expenses were incurred). All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless

preciate their production costs under an income forecast method over the amortization period applicable to film or copyright.

The §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 §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 §181 was available. Additionally, film companies did, in fact, make more films in the United States as a result of §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 2017 tax act, while ''qualified film productions'' are still defined with reference to the prior §181, new bonus depreciation rules effectively replace the old accelerated depreciation treatment of production expenses.[2]

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 paid or incurred).[3] This new bonus depreciation is no longer capped at $15 million or $20 million, and no election is required to receive this favorable tax treatment, as under the prior §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 the practical effect as to timing of the deduction and other limitations imposed on §181 qualified property by the 2017 tax act.

Practically, expenses related to film production are incurred over a fairly extended time period – during development/rights acquisition of the underlying properties; during pre-production when creative elements, cast, and crew are assembled for the project; during production when filming actually occurs; during post-production (which now includes all of the necessary color correction, sound equalization, dialog replacement, additional visual special effects, music, and Foley sound effects that must be added to produce a ''theatrical/broadcast release quality'' projects); and during distribution (which may be delayed for months after a film is actually completed). For most feature films, this means expenses will be incurred over at least a two-year time period prior to be being eligible for bonus depreciation under the 2017 tax act triggering event of being ''placed in service'' via a theatrical release or broadcast of the finished product.[4]

Also, under the 2017 tax act, individual investors are now subject to passive loss rules. For example, deduction of expenses for qualified property that meets the §181 definition, such as film, can only be made against passive income **rather than all taxable income**, as allowed under §181 provisions prior to the 2017 tax act.[5]

The 2017 tax act also ushered in limitations on excess business losses. Such limitations cap losses at $250,000 for single taxpayers or $500,000 for married 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 in which loss carried forward is limited to 80% of taxable income of the investor.[6]

The end result is that under the 2017 tax act, individual investors that historically invested in independent film can no longer realize the same tax savings they enjoyed under the prior incarnation of §181.

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otherwise indicated.

[2] *See* §168(k), effective for property acquired after Sept. 27, 2017, and placed in service after Sept. 27, 2017 (and before Jan. 1, 2027). See also REG-104397-18 for proposed regulations for taxpayers with respect to deduction of depreciation for qualified property under §168(k). Under Prop. Reg. §1.168(k)-2(b)(5)(ii), if qualified property is acquired by contract/acquisition, such contract must be in writing and **entered into by the taxpayer** after Sept. 27, 2017.

[3] Pursuant to §168(k)(2)(H), a qualified film production is ''placed in service'' upon initial release or broadcast, as defined under §1.181-1(a)(7). REG-104397-18.

[4] *See* Frey, *A Legal Primer for Making Indie Movies*, Law Journal Newsletters (July 2018). Expenses for film production may need to be capitalized until the product is ''placed in service,'' which creates yet another conundrum with respect to distribution decisions that have to be made by production companies – early release under less favorable terms in order to trigger the ''placed in service'' requirements to claim bonus depreciation on behalf of investors, or later release under potentially more favorable terms but for the ''time value of money'' involved with respect to an inability to pass along the bonus depreciation to their investors – a decision that will only become more problematic as the sunset date of Jan. 1, 2027 approaches. Practically, a ''theatrical release'' may not be at all possible for some indie filmmakers. *See* Stephen Follows, *How many films are released each year?*, Film Data Blog (Aug. 14, 2017)(Statistics suggest that out of the tens of thousands of indie films made/submitted to film festivals each year, less than 800 feature films a year obtain a theatrical release in the United States). That said, distribution outlets such as Netflix and Amazon now offer ''broadcast'' release to almost any film and short-run, limited theatrical releases are available for hundreds of ''film festival favorite'' indie films.

[5] *See* §469.

[6] §461(l), effective for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2027.



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As with prior §181, the new bonus depreciation provisions for film production costs under the 2017 tax act are also subject to phase-out provisions after 2022, such that there will be no bonus depreciation treatment available after 2027.[7]

## THE ONE ADDED TAX BENEFIT FOR INDEPENDENT FILMS: EVERYTHING OLD IS NEW AGAIN

While the 2017 tax act substantially reduced the tax incentive individual investors in independent film production investment had under the old §181, it did create a new opportunity within the film community: the 2017 tax act expands bonus depreciation to used qualified property.[8]

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 2017 tax act). The 2017 tax act also requires a written binding contract (entered into by the taxpayer after September 27, 2017) in conjunction with such acquisition.[9]

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

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 old §181 to film investors prior to the 2017 tax 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.

[7] §168(k)(2).

[8] §168(k)(2)(A)(ii), §168(k)(2)(E)(ii).

[9] §13201(h)(1)(A) of the 2017 tax act. See generally §1.168(k)-1(b)(4)(ii) for definition of ''binding contract.''



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