

## Articles

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### Lights! Action! Deduct!

*IP Buzz*

There may be a documentary film to be made about the documentary filmmaker who stood up to the IRS and won! A recent tax court case could be an extremely important precedent for independent filmmakers and documentarians. The issue in the case was the ability of the filmmaker to take deductions for expenses incurred in creating a documentary film given the fact that many documentary films do not make a profit.

The IRS has two different tax regimes. One for people who are, for lack of a better word, deemed "professionals," and the other for "hobbyists." Deductions are permitted for professionals: "those who engage in an activity for profit." The "professional" may deduct ordinary and necessary business expenses incurred in carrying on a trade or business. The tricky part for documentarians or independent filmmakers is satisfying the IRS that their filmmaking is in fact engaging in a trade or business and not a hobby. In order to do that, the filmmaker must show the IRS that she or he had a bona fide intent to make a profit. The burden for that is on the taxpayer. Whether one is considered to be "engaged in an activity for profit" is handled on a case by case basis, taking into account the facts and circumstances of each separate situation, and the factors provided in IRS Section 183. Since documentarians often do not make a profit, the IRS has taken the position that documentary filmmaking is not an activity engaged in for profit, but rather a "hobby." The IRS does this even though the legal requirement is not that the filmmaker actually make a profit, but rather that it was her or his expectation and bona fide intent (even if not a reasonable expectation) to make a profit.

In the recent case of *Lee Story and William Story v. Commissioner of Internal Revenue*, (T.C. memo 2012-15 April 19, 2012), we find a filmmaker who, as many independent film makers and documentarians, has a 9-to-5 job. In this case she was an attorney, and made a film called *Smile 'Till it Hurts*, which was about the "Up With People" story. In the Tax Court opinion (which is laid out with a bit of tongue in cheek, as the sections of the opinion are entitled Prequel, Light, Camera...Action, Publicity, Applause, Credit, the Fine Box Office Arrangements, Tracking the Numbers and Sequel), the court ruled that even though a profit was not made on this film, and even though the taxpayer had another job as her principal occupation, when viewing the nine factors set out in the regulations, she was still entitled to take appropriate deductions.

The reason this case is so important to independent creators is that if they are deemed to be a "trade or business" (engaged in an activity for profit), and they have expenses that exceed the revenues from the activity (in this case the creation of the film), they can deduct them against other income. If they are not considered to be in "trade or business," but rather a "hobbyist," then they can only take the deductions against the income generated from the activity. So in the case of a documentary where there is no theatrical release, or the revenue from festivals are nominal, then the percentage of the cost of making the film that the filmmaker can actually deduct is usually going to be relatively slight. If, however, the filmmaker is in "trade or business" and has a 9-to-5 job or investments to support the filmmaking, then he or she can deduct the losses incurred in making the film against other non-film related income (there are, of course, procedures to be followed and limits). There are scores of fascinating cases in this area of law, where the IRS challenged writers, filmmakers, musicians, artists, etc. (all who struggle to make a profit yet who truly consider themselves to be profit oriented professionals) as to whether the artistic endeavors were in fact a bona fide trade or business, and their ability to take full deductions.

What is important to note is how the court analyzed the nine factors. The key take away from the analysis, and one of the reasons that the taxpayer in this case won, and is true throughout all of these types of cases, is the professionalism in which the taxpayer undertook her activities. In this case, she had a separate bank accounts, separate credit cards (in other words, no comingling of funds), spent a great deal of time on the project, engaged the appropriate experts and consultants, tried to commercially exploit the film, went to all the appropriate type of conferences, festivals, conferences and

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the like. She made every reasonable effort to try and make money on the project.

If you have any questions about this case or the issues raised, please feel free to contact **Joshua Kaufman**.