screen magazine

Glamorous Investments: Tax Advantage Still Available for Film Investments

Year-end tax planning for passive income recipients

Passive income recipients are about to lose an under-utilized, unusual and legal way to reduce their tax bill this year and potentially receive a significant return on a glamorous investment.

Under the Federal Jobs Creation Act of 2004, enacted a mere 20 days before George W. Bush was re-elected president for a second term, U.S. citizens and residents who receive passive income and invest in motion pictures or television programming within the statutory requirements, may deduct their investment dollar for dollar from their income tax returns in the year or years in which the funds are spent by the production on qualified expenditures up to $15,000,000 in most cases, although some locations qualify for a $20,000,000 deduction. The investor must also be an owner of the entity producing the film or television program and the production must commence before December 31, 2009.

This article will review the basic requirements to be eligible for the deduction, its effect on the investor and the producer of the film, and some likely scenarios. We'll focus on a qualified motion picture, but the same rules apply to qualified television productions.

THE REQUIREMENTS: The investor must be a US citizen or resident and must have passive income. For this purpose, passive income means income from rental real estate, and from business enterprises in which the Investor does not materially participate. Dividend and interest income are called “portfolio income” in this context, and cannot be offset by losses from passive motion picture activities. The investor need not have an active role in the production of the picture. The investor must be an “owner” of the picture and thus cannot be simply a lender or a “participant” in revenues. If the production commenced before December 31, 2009, there is no time limit on when the funds may be invested. The extent of the deduction is limited by the amount of the investor’s passive income. The election to take this deduction is made on the investor’s tax return.

The production entity, typically a limited liability company, must grant the investor an ownership interest in the entity. The picture must fall within the parameters of the statute and relevant IRS regulations (no pornography, no commercials, etc.), and the production must be primarily undertaken in the United States (75% of the costs must be domestic). The entity must file its tax returns properly and affirmatively elect to deduct the production costs currently by attaching a statement to its tax return with the information required by the income tax regulations.

PRACTICAL EFFECT: Assume a picture with a budget of $2 million (“Negative Cost”). The company raises equity from two investors, who are US citizens or residents, at $1,000,000 each, both of whom received an equity interest in the LLC. The investors are collectively entitled to recoup their investment first. They then share 50% of the net profits on a pro rata basis, based on the amount of their investment as compared to the total investment. The producer retains the remaining 50% of net profit, and a portion is given to talent and other participants. Each of the investors/owners will deduct a pro rata share of the qualifying expenses incurred. Thus, assuming all expenses are qualified, each investor will deduct $1,000,000 in 2009. If the investors live in New York City for example, or other jurisdictions where the combined highest marginal tax rate is 44%, the investor need only recover 56% of the investment to be made whole (before considering the tax liability on the recovery). In our case, the investors must recover $560,000 each, or 56% of $1 million since they already received a “benefit” of $440,000 by virtue of the deductions.[1]

EFFECT OF LICENSE AGREEMENT FOR LESS THAN NEGATIVE COST: The producer, in completing a picture in early 2010, finds herself selling a picture into a distribution marketplace that is far less receptive to independent pictures than at any time in the last 15 years. Although the picture costs $2 million, let’s assume that a distributor buys worldwide rights to the picture for $1.5 million.

Since the $1.5 million sale price exceeds the total invested after taking the section 181 deduction into account, the investors may well invest again with the producer. While the producer does not have net profits to show, she does have investors who had the benefit of a tax deduction in 2009, and who are receiving an amount in excess of the investor’s net investment in 2009, but subject to tax in 2010.

CONCLUSION: There is a short window left. This tax-advantaged investment structure will not be applicable to productions that commence after December 31, 2009. When coupled with the many states that offer tax credits or rebates ranging from 15% to 42% of eligible expenses, filmmaking, handled properly, can result in a relatively low risk investment, with an infinitely large upside potential.

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[1]The investor will have tax liability on the $560,000 received. This liability will be created when the income is received, probably in 2010 or beyond.

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