



## Film Financing and Television Programming: A Taxation Guide

Now in its seventh edition, KPMG LLP's ("KPMG") Film Financing and Television Programming: A Taxation Guide (the "Guide") is a fundamental resource for film and television producers, attorneys, tax executives, and finance executives involved with the commercial side of film and television production. The guide is recognized as a valued reference tool for motion picture and television industry professionals.

Doing business across borders can pose major challenges and may lead to potentially significant tax implications, and a detailed understanding of the full range of potential tax implications can be as essential as the actual financing of a project. The Guide helps producers and other industry executives assess the many issues surrounding cross-border business conditions, financing structures, and issues associated with them, including film and television development costs and rules around foreign investment. Recognizing the role that tax credits, subsidies, and other government incentives play in the financing of film and television productions, the Guide includes a robust discussion of relevant tax incentive programs in each country.

The primary focus of the Guide is on the tax and business needs of the film and television industry with information drawn from the knowledge of KPMG International's global network of member firm media and entertainment Tax professionals.

Each chapter focuses on a single country and provides a description of commonly used financing structures in film and television, as well as their potential commercial and tax implications for the parties involved. Key sections in each chapter include:

### *Introduction*

A thumbnail description of the country's film and television industry contacts, regulatory bodies, and financing developments and trends.

### *Key Tax Facts*

At-a-glance tables of corporate, personal, and VAT tax rates; normal non-treaty withholding tax rates; and tax year-end information for companies and individuals.

### *Financing Structures*

Descriptions of commonly used financing structures in film and television production and distribution in the country and the potential commercial tax implications for the parties involved. The section covers rules surrounding co-productions, partnerships, equity tracking shares, sales and leaseback, subsidiaries, and other tax-efficient structures.

### *Tax and Financial Incentives*

Details regarding the tax and financial incentives available from central and local governments as they apply to investors, producers, distributors, and actors, as well as other types of incentives offered.

### *Corporate Tax*

Explanations of the corporate tax in the country, including definitions, rates, and how they are applied.

### *Personal Tax*

Personal tax rules from the perspective of investors, producers, distributors, artists, and employees.

### *Digital Media*

For the first time, we have included a discussion of digital media tax considerations recognizing its growing role in the distribution of film and television content.

### *KPMG and Member Firm Contacts*

References to KPMG and other KPMG International member firms' contacts at the end of each chapter are provided as a resource for additional detailed information.

Please note: While every effort has been made to provide up-to-date information, tax laws around the world are constantly changing. Accordingly, the material contained in this publication should be viewed as a general guide only and should not be relied upon without consulting your KPMG or KPMG International member firm Tax advisor.

Production opportunities are not limited to the countries contained in this Guide. KPMG and the other KPMG International member firms are in the business of identifying early-stage emerging trends to assist clients in navigating new business opportunities. We encourage you to consult a KPMG or KPMG International member firm Tax professional to continue the conversation about potential approaches to critical tax and business issues facing the media and entertainment industry.

Thank you and we look forward to helping you with any questions you may have.

#### **Tony Castellanos**

+1 212-954-6840

[acastellanos@kpmg.com](mailto:acastellanos@kpmg.com)

#### **Benson Berro**

+1 818-227-6954

[bberro@kpmg.com](mailto:bberro@kpmg.com)

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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

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# United States

## Introduction

The United States is the world's leader in film production, distribution, and technology. The United States film industry should continue to maintain its role as the international center of film production in the 21st century.

## Key Tax Facts

Highest effective corporate income tax rate	35%*
Highest personal income tax rate	39.6%*
Highest capital gains tax	20%
Net investment income tax for individuals, estates, and trusts	3.8%
Normal nontreaty withholding tax rate on dividends income	30%
Normal nontreaty withholding tax rate on interest income	30%
Normal nontreaty withholding tax rate on royalty income	30%
Tax year-end:	Companies may choose their own tax year-end subject to certain limitations; individuals utilize a calendar year unless they maintain appropriate books and records for a fiscal year.

\*In addition to the above federal tax rates, state and municipal taxes may be imposed, ranging from 0 to 12%. Branch profits tax imposes additional 30% tax on foreign corporations engaged in a U.S. trade or business. Alternative minimum tax is also imposed.

## Film Financing

### Financing Structures

#### *Co-Production*

A U.S.-resident investor may enter into a joint arrangement with a non-U.S. investor to finance and produce a film in the U.S. Under a co-production structure, each investor contributes funds to the project commensurate with its anticipated benefits from the exploitation of the film. The rights to exploit the film may be allocated to the partners according to their respective territories, with the remaining territories being divided or held jointly among the parties according to mutual agreement.

### United States

Where the investors contribute funds to, and share in the profits of, the project, the co-production will generally be characterized as a partnership for U.S. tax purposes. Generally, a partnership itself is not subject to federal income tax. In addition, many co-productions are carried on through a limited liability company (LLC), which can elect to be taxed as either a corporation or a partnership, the latter being the more common choice. Certain state and municipalities, however, may levy a tax on the partnership. For example, California levies an annual tax of US\$800 on limited partnerships and LLCs. California also assesses an annual fee based on an LLC's gross receipts up to a maximum of US\$11,790. The discussion below regarding partnerships and the taxation of partners applies where the co-production is characterized as a partnership.

A significant concern in a co-production that is characterized as a partnership is whether the non-U.S. investor is considered to be engaged in a trade or business in the U.S. A partner in a partnership that is engaged in a trade or business in the U.S. is deemed to be engaged in a U.S. trade or business. Such a non-U.S. investor, generally, must file a U.S. income tax return reporting his distributive share of the partnership's net effectively connected income and pay the tax due on such income. If considered engaged in a U.S. trade or business, a non-U.S. investor is required to file a federal income tax return even though the non-U.S. investor may have no income effectively connected with the U.S. trade or business or the income is exempt under the terms of a tax treaty. In such cases the federal tax return may be limited in scope. If the non-U.S. investor is a resident in a treaty country, the co-production partnership must be engaged in a trade or business through a permanent establishment before the partner is subject to federal income tax on his distributive share of the partnership's income that is attributed to the permanent establishment. Non-U.S. corporate investors may be subject to a branch profits tax and branch tax on interest at a statutory rate of 30%. These taxes can be reduced or eliminated by treaty in many cases.

Under certain circumstances, the co-production may not constitute a partnership for U.S. tax purposes. For example, if the co-production is conducted by a U.S. corporation, the corporation itself is subject to federal income tax, and the investors are subject to tax on dividends received (subject to potential treaty relief for non-U.S. investors) from the U.S. Corporation. If the co-production is conducted by a non-U.S. corporation, U.S. investors will be concerned with an assortment of U.S. tax provisions, including, for example, the subpart F rules and the passive non-U.S. investment company rules, which may require a U.S. shareholder to report and pay tax on certain income of the non-U.S. corporation in the year that the income is earned (rather than, in a later year, when it is distributed to the shareholder as a dividend). Double taxation of the activity's income is also a risk if the foreign tax authority does not view the arrangement as a partnership.

A co-production may also be structured as a "cost-sharing arrangement." Under such an arrangement, the co-production is not treated as a partnership for U.S. tax purposes, and a non-U.S. investor is not treated as engaged in a U.S. trade or business solely by reason of its participation in the cost-sharing arrangement. Under a cost-sharing arrangement, the U.S. and non-U.S. investors split the production cost in proportion to their respective share of the reasonably anticipated benefits from the film rights developed under the cost-sharing arrangement. Treasury Regulation Section 1.482-7 (effective August 27, 2013) provides detailed rules governing cost-sharing arrangements.

Assuming a U.S. participant in a cost-sharing arrangement is entitled to only the U.S. distribution rights under the terms of the cost-sharing arrangement, the U.S. participant is

## United States

subject to federal income tax on profits arising from the exploitation of the film in the U.S. Assuming a non-U.S. participant in a cost-sharing arrangement retains only the non-U.S. distribution rights and has no U.S. trade or business, such investor may not be subject to U.S. federal income tax upon distribution of the film outside the U.S.

The following are examples of relief available under selected treaties (assuming business profits are attributable to a U.S. permanent establishment and interest, dividends and royalties are not attributable to a U.S. permanent establishment):

UK– United Kingdom	Branch profits tax rate is generally 5% and some U.K. companies are exempt (Article 10); interest withholding tax eliminated for noncontingent interest (Article 11); U.S. income tax on business profits creditable against U.K. tax (Article 24); royalty withholding tax eliminated (Article 12).
The Netherlands	Branch profits tax rate is generally 5% and some Dutch companies are exempt (Article 11); interest withholding tax eliminated for noncontingent interest (Article 12); business profits exempted from tax where already taxed in the U.S. (Article 25); royalty withholding tax eliminated (reduction not applicable to film and television royalties; instead, such royalties are treated as business profits under the treaty) (Article 13).
Australia	Branch profits tax rate is generally 5% and some Australian companies are exempt (Article 10); interest withholding tax rate reduced to 10% (Article 11); U.S. tax on business profits creditable against Australian tax (Article 22); royalty withholding tax reduced to 5% (Article 12).
Japan	Branch profits tax is generally 5% and some Japanese companies are exempt (Article 10); interest withholding tax rate reduced to 10% (Article 11); U.S. tax on business profits creditable against Japanese tax (Article 23); royalty withholding tax eliminated (Article 12).

### *Partnership*

Financial investors from several territories and film producers may become limited and general partners, respectively, in a U.S. limited partnership formed to produce a film and contract with independent distributors to distribute the film for a fee. Each partner under this arrangement contributes funds to the partnership in return for a share of the partnership profits; the partnership may receive royalties under distribution agreements from residents of both treaty and nontreaty countries and proceeds from the sale of any rights remaining after exploitation.

### **United States**

Sometimes a partner in a partnership will contribute a promise to perform services in the future instead of property. If by reason of the promise, the partner is allocated a portion of the partnership capital, the partner will recognize income in an amount equal to the value of the interest in capital received, and the partner will have a tax basis in the partnership equal to the amount of that income recognized (plus the amount of cash paid for the interest, if any). If, on the other hand, the partner receives an interest in the partnership profits only (i.e., no claim to existing partnership capital), the partner will generally not recognize any income when the interest is granted, but instead recognize income and increase tax basis as partnership profits are allocated to the partner in the future.

Generally, a partnership itself is not subject to federal income tax. The partners in the partnership take into account their distributive share of the partnership's profits and losses when determining their tax liability. Partnership profits and losses may be allocated by the partnership agreement, but such allocations must reflect the economic substance of the partnership arrangement. Complex regulations determine the amount of partnership losses that a partner may deduct in a taxable year, but these losses generally cannot exceed the partner's basis in the partnership (which includes certain liabilities allocable to the partner). In taking into account losses, partners may also be limited by the at-risk rules of section 465 and the passive activity loss rules of section 469.

#### *Limited Liability Company*

The joint venture may also take the form of a limited liability company (LLC). An LLC provides limited liability to its members while being treated as a partnership for federal income tax purposes (although it is possible to elect to have the LLC treated as an entity taxable as a corporation) and most state income tax statutes. Although the body of law surrounding LLCs is not as developed as corporate or partnership law, the LLC has quickly become the entity of choice in many industries due to its partnership-type flexibility with regard to distributions and its corporate-type liability limitations. As noted, for federal income tax purposes, an LLC treated as a partnership generally is not considered a taxable entity, but rather the LLC's members are taxed as partners on their share of the LLC's income. To the extent that the LLC is taxed as a partnership, the preceding discussion regarding partnerships is generally applicable to the LLC as well.

#### *Effectively Connected Income*

A U.S. partner's tax base for the purpose of calculating tax includes its worldwide income. A nonresident partner's taxable base, however, includes only income that is "effectively connected" with a U.S. trade or business and certain U.S.-source income.

U.S. tax law requires that any partnership, whether domestic or non-U.S., having effectively connected income that is allocable to a non-U.S. partner, withhold federal taxes from that income (section 1446). The partner takes the withheld taxes into account as a credit when determining his tax liability. The amount of withholding is based on the "applicable percentage" of the effectively connected income of the partnership that is allocable to the non-U.S. partners. The applicable percentage is the highest U.S. marginal tax rate for the partner, and is dependent on the tax status (i.e., individual or corporation) of the partner. If the business profits are attributable to a U.S. permanent establishment, there is no practical treaty relief for the section 1446 tax. Certain states, such as California, also impose a similar withholding requirement on partnerships with non-U.S. partners.

## United States



Tax treaty benefits, generally, cannot be claimed where an LLC is treated as a partnership for U.S. federal income tax purposes and a U.S. corporation under the tax law of the applicable tax treaty country, and is not otherwise taxed as a resident of the treaty country under the treaty country's tax laws.

#### *Yield Adjusted Debt*

A film production company may finance its films using loans obtained from financial institutions or other third parties. The loans may be secured by presale contracts with respect to the film or by the general assets of the production company.

A film production company may sometimes issue a security with a yield linked to revenue from specific films. The principal amount of such a security is typically due at maturity, and the security may have a low (or even nil) rate of stated interest. The security also usually provides for a supplemental (and perhaps increasing) interest payment that becomes due when a predetermined financial target (such as revenue or net cash proceeds) is reached or exceeded.

For U.S. tax purposes, this security might be characterized as equity because the periodic payments are dependent on the profitability of specific films. In this event, such periodic payments would be recharacterized as dividend distributions taxable to the recipient to the extent of the corporation's earnings and profits. Such distributions are not deductible in determining the corporation's taxable income for the year. The repayment of the principal amount of the security would typically be characterized as a return of capital.

However, if the security carries both a stated interest rate that closely approximates a market rate of interest and a contingent payment, the security would be more akin to a debt instrument. In this case, all or a portion of the periodic payments would likely be deductible as interest by the production company. Various rules affect the amount and timing of such deduction (e.g., the OID rules, the earnings stripping rules, the applicable high-yield discount obligations rules, etc.).

Regardless of the characterization of a periodic payment as dividend or interest, if the payment is made to a non-U.S. person, withholding tax will be levied on the U.S.-source portion of the payment, unless the payment is effectively connected with a U.S. trade or business of the payee. In addition, a treaty may reduce or eliminate the withholding tax.

#### *Equity Tracking Shares*

These shares provide for dividend returns dependent on the profitability of a film production company's business. These shares typically have the same voting rights as the production company's ordinary (i.e., common) shares, except that dividends are profit-linked and have preferential rights to assets on liquidation of the company.

If the production company is a U.S. corporation, dividends on such stock would generally be treated in the same manner as dividends on ordinary shares.

## United States

If the tracking shares are acquired by a U.S. investor and the production company is incorporated outside of the U.S., any tracking dividends received would be income to the U.S. investor in the same manner as dividends received on ordinary shares. Generally, a direct non-U.S. tax credit is allowed for withholding taxes paid on the dividend, and “deemed paid” non-U.S. tax credits may be allowed to a 10% or greater U.S. corporate shareholder for the amount of tax paid by the non-U.S. corporation with respect to the earning and profits out of which the dividend is paid.

## Tax and Financial Incentives

### *Federal Incentives*

#### *Income Attributable to Domestic Production Activities*

The Domestic Production Activities Deduction under section 199 allows for a deduction in an amount equal to 9% of “qualified production activities income.” “Qualified production activities income” is equal to “domestic production gross receipts” reduced by the sum of (1) allocable cost of goods sold and (2) other expenses, losses, or deductions that are properly allocable to such receipts. While the eligibility of receipts must be determined on an item-by-item basis, the final regulations clarify that allocation of expenses, for example, may be performed on an aggregate basis. Two limitations apply: the deduction is the applicable percentage of the lesser of qualified production activities income or taxable income, and the deduction may not exceed 50% of W-2 wages. The wage limit is based on wage expense, which may include such items as stock options and designated contributions to a Roth IRA. Note that for taxable years beginning after May 17, 2006, W-2 wages are limited to those attributable to domestic production activities. The definition of “W-2 wages” also includes any compensation paid for services performed in the United States by actors, production personnel, directors, and producers incurred in the production of “qualified film.” “Qualified film” includes any motion picture film, videotape, television program, copyrights, trademarks, or other intangibles with respect to such film if 50% or more of the total compensation relating to the production of such property (including participations and residuals) constitutes services performed in the U.S. by actors, production personnel, directors, and producers. A ruling holds that licensing of a programming package (a group of programs that includes programs produced by the taxpayer, programs produced by third parties, commercial advertisements, and interstitials) to customers in the normal course of business can give rise to “domestic production gross receipts.” A more recent Internal Revenue Service (IRS) advice memorandum indicates that the gross receipts that a multichannel video programming distributor derived from the distribution of multiple channels of video programming (subscription packages) do not qualify as “domestic production gross receipts,” but that the taxpayer could determine whether separate components of the subscription packages qualified individually under section 199.

“Domestic production gross receipts” include gross receipts derived from any lease, rental, license, sale, exchange, or other disposition to an unrelated person of a “qualified film” produced by the taxpayer. The deduction is not to be affected by the means and methods of distributing such “qualified film.” The distribution of such film via digital distribution is thus considered to be a disposition of the film for purposes of determining domestic production gross receipts (DPGR). If the film is viewed online or downloaded, and whether or not a fee is charged, there is still considered to be a disposition of the film for purposes of calculating the deduction; this scenario is most likely distinguishable from theater showings, which the regulations indicate do not constitute dispositions.

## United States



### *Election to Treat Film Costs as Expenses*

Section 181 generally allows a taxpayer to elect to deduct certain costs of any qualified film or television production in the year the expenditure is incurred, rather than capitalizing those costs, for productions beginning before January 1, 2015. It provides that the first \$15 million of costs (\$20 million for costs incurred in certain designated low-income or distressed areas) are eligible for the election under Section 181. For purposes of this provision, a qualified film or television production is one for which at least 75% of the total compensation is for services performed within the United States by production personnel (not including participations and residuals). For purposes of a television series, only the first 44 episodes of the series are taken into account, and the \$15 million production cost limitation and the 75% qualified compensation requirement are to be determined on an episode-by-episode basis.

The final regulations under Section 181 clarify that (1) distribution costs are specifically excluded from the definition of production costs, (2) costs associated with acquiring a production are treated as a production costs, (3) costs associated with obtaining financing are production costs, and (4) participations and residuals costs are considered production costs, all for purposes of the production cost limitation. In addition, the final regulations further define “initial release or broadcast” as the first commercial exhibition or broadcast to an audience. Initial release or broadcast does not include certain limited exhibitions primarily for purposes of publicity, marketing to potential purchasers or distributors, determining the need for further production activity, or raising funds for the completion of production.

The final regulations under section 181 issued for film and television productions commencing before January 1, 2015 also provide for a deduction of the first \$15 million (or \$20 million in certain low-income or distressed areas) of aggregate production costs, regardless of the total cost of the production. In determining whether a production qualifies for the \$15 million deduction limit, compensation to actors, directors, producers, and other relevant production personnel is allocated entirely to first-unit principal photography. Costs of a postamendment production that are not allowable as a deduction under section 181 may be deducted under any other applicable provision of the Code.

Except as otherwise provided, the final regulations apply to productions for which the first day of principal photography occurs before January 1, 2015. Certain provisions of the final regulations apply to productions to which section 181 is applicable and for which the first day of principal photography or in-between animation occurred on or after December 7, 2012. The final regulations also apply to any production to which section 181 applies and for which the first day of principal photography (or in-between animation) occurred before December 7, 2012, for any taxable year for which the period of limitation on refund or credit has not expired.

## **United States**

### *State Incentives*

Approximately 40 states offer tax or financial incentives, most notably California, Georgia, Louisiana, New Mexico, New York, and Pennsylvania.

In **California**, film and television production credits first became available in tax years beginning on or after January 1, 2011. Under the first film credit program, the California Film Commission (CFC) was authorized to allocate \$100 million of tax credits each fiscal year through and including the 2016/2017 fiscal year on a first-come, first-served basis. For tax years beginning on or after January 1, 2016, California's film and television tax credit program has been significantly revised. Under the revised program, qualified taxpayers may claim a credit against net tax, subject to a computation and ranking by the CFC and the allocation amount categories, in an amount equal to 20% or 25%, whichever is the applicable credit percentage, of the qualified expenditures for the production of a qualified motion picture in California. As such, the prior allocation lottery is being replaced with \$330 million of tax credits based on a merit system of allocation with emphasis on job creation, effective through the 2019/2020 fiscal year. Any unallocated credits or credits that were previously allocated but not certified may be carried forward and allocated in the next fiscal year.

Taxpayers may assign any portion of the credit to one or more affiliated corporations for each taxable year in which the credit is allowed. For tax years beginning on or after January 1, 2016, the credit will be 20% of the qualified expenditures attributable to the production of a qualified motion picture in California, including, but not limited to, a feature film, or a television series that relocated to California that is in its second or subsequent years of receiving a tax credit allocation. The credit only applies to the first \$100 million in qualified expenditures. A 25% credit is allowed if "qualified motion picture" is a television series that relocated to California that is in its first year of receiving a tax credit allocation or up to \$10 million of qualified expenditures related to an "independent film." There is also a 5% Uplift credit for out-of-zone filming, music scoring and music track recording by musicians, and visual effect. The total maximum credit, however, is limited to 25%. Credits applied to income tax liability are not refundable. Only tax credits issued to an independent film may be transferred or sold to an unrelated party. If a credit exceeds the "tax," the excess credit may be carried over to reduce the "tax" in the following taxable year, and succeeding five taxable years, if necessary, until the credit has been exhausted.

For purposes of the revised film credit, a "qualified motion picture" is defined as a motion picture that is produced for distribution to the general public, regardless of the medium, that is one of the following:

- A feature with a minimum production budget of \$1 million
- A movie of the week or miniseries with a minimum production budget of \$500,000
- A new television series produced in California with a minimum production budget of \$1 million
- An independent film
- A television series that relocated to California
- A pilot for a new television series with a minimum production budget of \$ 1 million

### **United States**

For purposes of the revised credit, an “independent film” is defined as a motion picture with a budget of at least \$1 million produced by a company that is not publicly traded or more than 25% owned directly or indirectly by a publicly traded company. The CFC is required to set aside up to \$10 million of motion picture tax credits each year for independent films. To qualify as a “qualified motion picture,” several conditions must be met, including the requirement that at least 75% of the principal photography days occur wholly in California or 75% of the production budget is incurred and used for goods, services performed, and/or wages within the state.

“Qualified expenditures” are amounts paid or incurred to purchase or lease tangible personal property used within California in the production of a qualified motion picture and payments, including qualified wages, for services performed in California in the production of a qualified motion picture.

**Georgia** offers a tax credit to commercial, video, movie, and television production companies, interactive entertainment project developers, and their affiliates for qualified production activities in Georgia. The production company must invest at least \$500,000 in a state-certified production approved by the Department of Economic Development. Projects over a single tax year may be aggregated to meet the \$500,000 threshold. The production company and/or affiliate(s) must not be in default on any tax obligation of the state or have a loan made or guaranteed by the state.

The credit computation is based on the amount of total production expenditures in the current year (“base investment”) as follows:

- 1) If annual total production expenditures in 2002, 2003, and 2004 were \$30 million or less, a credit of 20% of the base investment in Georgia. An additional 10% of the base investment may be claimed if the production activities include a qualified Georgia promotion (additional 10% does not apply to commercials).
- 2) If annual total production expenditures in 2002, 2003, and 2004 were \$30 million or greater, a credit of 20% of the excess base investment in Georgia (excess base investment is computed by taking the current-year expenditures and subtracting the average of the annual total production expenditures for 2002, 2003, and 2004). An additional 10% of the excess base investment may be claimed if the production activities include a qualified Georgia promotion.

“Base investment” is the amount actually invested or expended as production expenditures in Georgia. The “excess base investment” is defined as the current-year production expenditures minus the average of the annual total production expenditures for 2012, 2013, and 2014.

## United States

Qualified production expenditures include preproduction, production, and post production expenditures incurred in the state that are directly used in a qualified production activity, such as set construction and operation, wardrobe, makeup, costs associated with photography, lighting and office supplies and furniture. Qualified production activities include new film, video, and digital projects produced in Georgia (in whole or in part) such as feature films, series, pilots, movies for television, commercial advertisements, music videos, interactive entertainment, or sound recording projects. The projects recorded in Georgia can be in short or long form, animation or music, or fixed on a delivery system and must be intended for multimarket commercial distribution via theatres, licensing for exhibition by individual television stations, corporations, live venues, the Internet, or any other channel of exhibition. Television coverage of news and athletic events do not qualify. Preproduction, production, and post production costs incurred in Georgia and used directly in a qualified activity are eligible.

The credit is first taken in the year the production company meets the investment requirement. The credit may be claimed against 100% of the company's Georgia corporate income tax liability and any excess credit may be taken against Georgia withholding. Any unused credit may be carried forward for five years. Further, unused film credits may be sold or transferred, in whole or in part, to another Georgia taxpayer, subject to certain conditions.

**Louisiana** offers a motion picture production tax credit that has two components as follows:

- 1) Motion Pictures – For expenditures related to state-certified productions approved by the Governor's Office of Film and Television Development, if the base investment is greater than \$300,000 a taxpayer can qualify for a 30% transferable income tax credit on total qualified in-state production activities.
- 2) Employment of Louisiana Residents –To the extent that the base investment is expended on payroll for Louisiana residents employed in connection with a state-certified production, each investor may be eligible for an income tax credit of 5% of the Louisiana payroll (excluding the salary of any one person exceeding \$1 million).

A Production Audit Report is required to be submitted prior to certification of a project. The production audit report is a report containing an opinion by a qualified accountant that the production's cost report presents fairly, in all material aspects, the production expenditures in Louisiana. Qualified accountant means an independent certified public accountant.

Note that the credits are fully transferable and may be sold to another Louisiana taxpayer subject to certain conditions.

**New Mexico** offers three incentive programs. First, a refundable film production tax credit is available for up to 25 % of all direct production and post production expenditures (including New Mexico labor) incurred within the state. Note that the credit amount is limited to 20% if the taxpayer also receives a credit pursuant to the federal new market's tax credit program. An additional 5% credit is available for either (1) direct production expenditures for a qualifying television series or (2) payments to resident crew (wages and fringes only) for services during production in New Mexico if a production utilized a qualifying soundstage for a minimum of 10 to 15 days of principal photography. Second, a production company can receive a gross receipts tax (i.e., sales tax) exemption at point of

## United States

purchase by presenting the vendor with a “nontaxable transaction certificate.” Production companies intending to take the film production refundable tax credit may not use the gross receipts tax exemption. Third, New Mexico offers fixed rate production loans capped at \$15 million, provided certain criteria are met.

**New York** State’s Film Production Tax Credit Program has two separate components: the Film Production Credit and the Post Production Credit. The production credit is available for companies that film a substantial portion of their project in the state of New York. The post production credit is available where the project was filmed predominantly outside of New York and the film production company contracts their post production work to companies in New York State specializing in post production work.

The amount of the refundable credit is up to 30% of the qualified production costs and post production costs incurred for a qualified film or television production in New York. An additional 5% credit may be available for post production costs incurred in Upstate New York, outside the Metropolitan Commuter Transportation District (MCTD). The MCTD includes New York City, Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk, and Westchester counties. Beginning in 2015, productions with budgets over \$500,000 can also receive an additional 10% credit on qualified labor expenses incurred in certain upstate counties in New York. The amount of the credit is allocated annually by the New York State Governor’s Office for Motion Picture and Television Development. Applications must be submitted to that agency within certain strict time limits, prior to starting principal and ongoing photography. A final application is then submitted after the completion of the project. The program is administered on a first-come, first-served basis.

In order to qualify, all productions must incur at least 75% of its qualified production costs (excluding post production costs) at a qualified production facility in New York. If such costs are less than \$3 million, the production must shoot at least 75% of its location days in New York to qualify; if not, the credit is available only for qualified production costs incurred at the qualified production facility. “Qualified production costs” generally means below-the-line costs incurred in the production (including preproduction and post production) of the qualified film or television production.

Program credits of \$420 million per year can be allocated and used to encourage companies to produce projects in New York. Up to \$25 million of the \$420 million will be dedicated to supporting and growing the post production industry in New York each year. There are no per project caps for credits and there is no rollover in the annual \$420 million allocation going forward until 2019. There is a maximum of \$5 million per year that can be allocated for the additional 10% credit on qualified labor expenses.

Companies that are ineligible for the film production credit can still qualify for the post production credit. The post production credit equals 30% of qualified post production costs paid in the production of a qualified film at a qualified post production facility, which is generally a facility in New York State. An additional credit of 5% is available for post production costs incurred in Upstate New York. To be eligible, the costs at such facility must at least equal 75% of the total post production costs at any post production facility. A film production company can also qualify for the post production credit if the qualified VFX/animation costs incurred at a qualified post production facility in New York either meet or exceed (1) 20% of the total VFX/animation costs paid or incurred for VFX/animation for the qualified film at any post production facility or \$3 million.

## United States

The basic film production and post production credits are generally claimed on the applicant's tax return in the later of the tax year in which the production is completed or the tax year immediately following the allocation year from which the taxpayer was awarded credit. Effective for tax years beginning on or after January 1, 2009, a credit that is more than \$1 million, but less than \$5 million, must be claimed over a two-year period, with half of the state credit claimed each year, and a credit that is at least \$5 million must be claimed pro rata over a three-year period, with one-third claimed each year. If the credit is less than \$1 million, the entire credit can be claimed in the tax year in which the film is completed.

New York allows qualified independent film production companies to claim the film credit. Requirements are that such company have a maximum budget of \$15 million, have control over the film during production, and not be a publicly traded entity or have no more than 5% beneficial ownership held by a publicly traded entity. Independent film production companies, and shooting of pilots, will not be required to meet a further eligibility test—that at least 10% of total principal photography shooting days be spent at a qualified production facility.

New York treats the creation of a feature film, television film, commercial, and similar film and video production as manufacturing activities that result in the production of tangible personal property. Accordingly, a taxpayer producing a film for sale is afforded the same exemptions available to New York's manufacturers. In addition to covering purchases of machinery, equipment, parts, tools, and supplies used in production, the exemption also covers services like installing, repairing, and maintaining production equipment. Film and video production receive a sales tax exemption for all production consumables and equipment rentals and purchases, as well as related services, so long as such are used directly and predominantly in the actual filming process. Thus, for example, a rented truck used 70% for transporting set props and only 30% during actual filmmaking would not qualify for the sales tax exemption.

**Pennsylvania** provides a film production tax credit for investments made towards film production expenses. A project is eligible if at least 60% of the project's total production budget is used for Qualified Pennsylvania Production Expenses. The amount of the film tax credit available for an eligible project is equal to 25% of Qualified Pennsylvania Production Expenses for the project. Film tax credits may be applied against personal income tax, corporate net income tax, capital stock and franchise tax, bank shares tax, and insurance premiums tax. An eligible project may receive an additional 5% tax credit if the taxpayer films a feature film, television film, or television series, which is intended for programming to a national audience, and the taxpayer films the project in a qualified production facility that meets the minimum staging filming requirements.

The tax credit must be applied against the taxpayer's qualified tax liability for the year in which the credit certificate is issued. Any carryover credits from previous years will be applied on a first-in, first-out (FIFO) basis and may be carried forward for up to three tax years. Unused credits may not be carried back. The credit may be transferred or sold subject to the approval of the Pennsylvania Film Office. Additionally, a taxpayer claiming the credit who fails to incur the amount of qualified film expense agreed to in the contract must repay the amount of credit to the Commonwealth.

## United States



The term “Qualified Pennsylvania Production Expenses” includes nearly all production (including pre- and post production) expenses incurred in Pennsylvania, subject to certain limitations and exceptions. The term includes, but is not limited to, salaries and wages earned in Pennsylvania, if such amounts are subject to Pennsylvania taxation, music and story rights if the rights are acquired from a Pennsylvania resident or entity subject to Pennsylvania tax, costs of production operations including construction, photography, visual effects and food and lodging, costs of rental facilities and equipment from a Pennsylvania taxpayer, and production-related services such as legal and accounting fees, if paid to a Pennsylvania taxpayer.

A “film” is defined to include a feature film, television film, television talk show or game show series, television commercial, television pilot, or each episode of a television series that is intended as programming. Pennsylvania excludes from the term “film” a production featuring news, current events, weather and market reports, public programming, sports events, awards shows, or other gala events. Additionally, productions that solicit funds, contain obscene material or performances, or productions made primarily for private, political, industrial, corporate, or institutional purposes are also excluded from the credit.

To obtain the credit, a qualified taxpayer must file an application for the credit with the Pennsylvania Film Office. This program is not administered on a first-come, first-served basis. The Pennsylvania Film Office will determine the competitiveness of applications by conducting a quantitative analysis of certain criteria. All Film Tax Credit awards are subject to the availability of funds.

#### Other Financing Considerations

##### *Exchange Controls and Regulatory Rules*

The U.S. does not have any exchange control regulations.

## Corporate Taxation

### Recognition of Income

#### *Production Fee Income*

##### *U.S.-Resident Production Company*

A special purpose company may be set up in the U.S. for the limited purpose of producing a film, video, or television program, without acquiring any rights in the product (i.e., a “work-for-hire” company). Such a special purpose company would be required to disclose transactions with its foreign-related parties. Consequently, the Internal Revenue Service (IRS), the U.S. taxing authority, would be notified of income received from a non-U.S.-related party and would be able to scrutinize the allocation or attribution of income to the special purpose company.

U.S. tax law requires that payments made pursuant to transactions between the special purpose company and its non-U.S. affiliates be equal to the amount that would have been paid or charged for “the same or similar services in independent transactions with or between unrelated parties under similar circumstances”—the so-called arm’s length standard. Taxpayers ordinarily carry out economic studies to document the arm’s length nature of their significant intercompany transactions in order to mitigate potential penalties in the event the IRS successfully adjusts the income or deductions arising from such transactions.

## United States

It is also possible to obtain an Advance Pricing Agreement (APA), in which the U.S. (or the both the U.S. and another country) agree as to the arm's length charge due in a particular intercompany transaction, e.g., the amount or percentage of income to be attributed to the special purpose company. The APA process can be costly and time-consuming and may be impractical for a "work-for-hire" company organized to produce a single film.

#### *Non-U.S.-Resident Production Company with an Office in the U.S.*

A non-U.S. company that has a production office in the U.S. to administer location shooting in the U.S. may be subject to U.S. tax if its activities amount to a U.S. trade or business that produce effectively connected income. In general, operating a production office to oversee a U.S. location shooting may constitute a U.S. trade or business. Also, some of the income earned by the production company may be effectively connected with that trade or business. Whether the income, in fact, is effectively connected will depend upon the character of the income generated by the production company once the film is complete (e.g., rental or royalty income or gain from the sale of property) and the source of such income (e.g., domestic or non-U.S.). U.S. taxation may turn on whether the production company continues to have an office in the United States at the time the income is realized.

Even if some of the income generated by the non-U.S. production company is effectively connected with a U.S. trade or business, if the company is resident in a treaty country and is eligible to claim the benefits of that treaty, the U.S. may not tax that income unless the activities of the production company create a permanent establishment in the U.S. and the income is attributable to the permanent establishment. Generally, if the production company has a U.S. office through which it carries on business, it will have a permanent establishment in the U.S. Whether the income is attributable to the permanent establishment will generally depend upon the same factors that determine whether the income is effectively connected. However, some recent U.S. income tax treaties follow the "authorized OECD approach" for attributing profits and losses to a permanent establishment.

#### *Non-U.S.-Resident Production Company without an Office in the U.S.*

A nonresident company that does not maintain a production office but undertakes location shooting in the U.S. may be considered engaged in a U.S. trade or business and, as discussed above, income generated by the production company may be considered effectively connected with that trade or business. If the company is resident in a country that does not have an income tax treaty with the U.S., the company's effectively connected business income will be taxed on a net basis at U.S. corporate tax rates. U.S.-source fixed or determinable, annual, or periodical income (e.g., rents and royalties that are not effectively connected) earned by the production company will be subject to a 30-percent gross-basis withholding tax.

If the company is resident in a country that has an income tax treaty with the U.S., the company's effectively connected business income will be taxed only if the company has a permanent establishment in the U.S. In general, location shooting should not create a permanent establishment if it takes place at multiple locations for a limited period of time. If, however, the activity is carried on in a single location, the risk of such activity creating a permanent establishment would increase as the duration of the activity increases. The factors bearing on whether the income of the production company may be attributable to a permanent establishment are discussed above.

## United States

### *Transfer of Distribution Rights*

Income arising from the transfer of all, or substantially all, copyright rights to exploit or distribute a film or television program within a specified geographic area for the remaining life of the copyright is gained from the sale of property under U.S. tax law. As discussed below, the U.S. generally does not tax gain realized by a non-US person from the sale of intangible property, provided the consideration is not contingent on the productivity or use of the transferred intangible. In determining whether a transfer will be treated as either a sale or a license, certain factors are considered, including: whether all or part of the rights to the film or television program are transferred, whether key rights have been reserved by the transferor, whether the transfer covers specific geographic regions, whether the transfer is exclusive or nonexclusive, and whether the rights are transferred for the remaining life of the copyright.

If a transfer of copyright rights by a non-U.S. person is characterized as a license, and not as a sale for U.S. tax purposes, the U.S. will tax the U.S.-source royalty generated by the license. In addition, gain realized by a non-U.S. person from the sale or exchange of intangible property for a series of payments contingent on the productivity or use of the property in the U.S. (e.g., based on revenue generated by the property for use in the U.S.) is taxed in the same manner as U.S.-source royalty income.

U.S. income tax treaties generally tax transfers of intangible property in a manner consistent with U.S. domestic tax law. Some treaties, however, distinguish the license of film rights from other intangible assets in the royalties article of the treaty for purposes of determining the rate of tax at source, and some treaties consider income from the license of film rights as business profits, not royalties.

Various rules apply to the transfer of intangible assets by a U.S. person to a non-U.S. person. If the transferee is a related party, U.S. transfer pricing rules require the consideration received by the transferor be commensurate with the income derived from the intangible. Under this rule, the IRS, under certain conditions, may adjust the income received by the transferor, taking into account the income realized from the intangible in years after the transfer. Also, a transfer of an intangible asset to a non-U.S. corporation in a nonrecognition transaction (such as in tax-free exchange for shares or in a tax-free reorganization) is generally treated as a sale of the intangible for payments contingent upon its productivity or use. The consideration received by the transferor may also be adjusted by the IRS.

### *U.S.-Resident Production Company – Transfer of Distribution Rights to Non-U.S. Person*

Generally, a transfer of distribution rights is characterized as either a sale or a license for U.S. tax purposes. Whether a sale or a license produces a potentially more favorable tax result depends on various factors, including the non-U.S. tax credit position of the transferor, the terms of any applicable income tax treaty, and treatment of the transaction in the transferee's jurisdiction. Transfers of distribution rights are subject to the rules generally applicable to the transfer of intangible assets described above.

### *U.S.-Resident Distribution Company – Acquisition of Distribution Rights*

The timing of the deduction of the payments for tax purposes depends on whether the distribution rights are purchased or licensed and on whether the transferee is a cash or accrual method taxpayer.

## **United States**

Whether the acquisition of the distribution rights is treated as a purchase or license, both cash and accrual method taxpayers must capitalize the payments for the distribution rights. The acquisition costs, then, may be depreciated by one of two methods: the straight-line method (which allows equal amounts of depreciation over the useful life of the intangible right or over a 15-year period if the rights are acquired in connection with the acquisition of a trade or business or substantial portion thereof) or the income-forecast method (which allows as depreciation a percentage of capitalized distribution costs equal to the year's actual revenue divided by the total projected revenue). See discussion below regarding "Amortization of Expenditure."

For contingent royalty payments, whether paid under a purchase or license of a film, the timing of the deduction of payments made depends on whether the company uses the cash or accrual method. Generally, the cash method company may deduct payments when paid. Conversely, the accrual method company will be able to deduct only that portion of the license payment that relates to the current tax year.

If the payments constitute advances, the federal tax rules suggest that the payments should be amortized over the term of the license using the straight-line method. However, industry practice has been to amortize the payments over the term of the license using the income forecast method because it provides for much closer matching of deductions with income. An argument also exists for amortizing the payment over the term of the recoupment of the advance.

The type of income arising from exploiting rights in a given country depends on the applicable treaty and the characterization of the acquisition of such rights as either a purchase or a license. Certain treaties characterize income from either the purchase (including contingent payments) or the license of films rights as royalties. Under other treaties, all payments from either a sale or a license of the use or right to use cinematographic films or films used for television broadcasting are excluded from the definition of "royalties" and instead are treated as trading income (business profits).

#### *Non-U.S.-Resident Company*

If the company is resident in a nontreaty country, the analysis is the same. The income from exploiting the distribution rights is generally treated as royalty income or capital gain, depending on the specific facts involved.

#### **Transfer of Distribution Rights between Related Parties**

Where a worldwide group of companies holds rights to films and videos, and grants sublicenses for the exploitation of those rights to a U.S.-resident company, care needs to be taken to ensure that the profits in the various entities can be justified. Upon examination, the IRS will typically query the level of profit earned by the U.S. sublicensee by examining the payments made to related non-U.S. companies. Generally, the amount of the license fee must be commensurate with the income generated by the intangible, as discussed above.

The IRS may assess substantial penalties if it determines that the transfer of property (e.g., a sale or a license) between related parties was not for arm's length consideration. However, certain penalties do not apply if the taxpayer attempted to ascertain the appropriate arm's length charge and contemporaneously documented its transfer pricing methodology in accordance with the regulations.

#### **United States**

## Amortization of Expenditures

### *Treatment of Production Costs*

A film producer who retains film rights may incur substantial costs over a period of several years in connection with the production of a film. Two methods are available to the film producer for the amortization of the production costs of the film—the income forecast method and the straight-line method. As discussed above, a film producer may elect for any “qualifying film and television productions” for which production commences before January 1, 2015 to deduct as incurred the cost of productions up to \$15 million (\$20 million incurred in certain low-income or distressed areas), in lieu of capitalizing the cost and recovering it through amortization.

Under Section 263A, all direct and indirect costs of producing property, including films, videotapes, or similar property, must be capitalized. Expenses related to the marketing, selling, advertising, and distributing a film are not required to be capitalized. Interest only has to be capitalized if the production period exceeds two years or the production period exceeds one year and the cost is greater than \$1 million.

### *Income Forecast Method*

Typically, the film and television industry claims amortization deductions for production costs under the “income forecast” method. Under this method, taxpayers determine the amortization deduction for a taxable year by multiplying the capitalized production cost of the property by a fraction, the numerator being the current-year income and the denominator being the forecasted total income.

“Current-year income” means the net income generated by the property in the current taxable year (gross income less distribution costs for such year), and “forecasted total income” equals the sum of the current-year income for the year the property is released, plus all reasonably estimated net income (gross income less distribution costs) from subsequent years up to and including the 10<sup>th</sup> taxable year after the year the property is released. Gross income, not net income, from the property is used to calculate current-year income and forecasted total income for purposes of computing the allowable deduction under the income forecast method.

### *Determination of Income (Current Year and Forecasted Total)*

In the case of films, television programs, and other similar property, income (current year and forecasted total) includes, but is not limited to, income from foreign and domestic theatrical, television, and other releases and syndications; income from releases, sales, rentals, and syndications of videotape, DVD, and other media; and income from the financial exploitation of characters, designs, titles, scripts, and scores earned from ultimate sale to, or use by, unrelated third parties. Examples of this third income category include the sales of toy figurines related to animated films or television programs, or licensing income from the use of an image.

In the case of a television series produced for distribution on television networks, income (current year and forecasted total) need not include income from syndication of the television series before the earlier of the fourth taxable year beginning after the date the first episode in the series is placed in service, or the earliest taxable year in which the taxpayer has an agreement to syndicate the series.

## United States

The forecasted total income from the film or television program for purposes of the income forecast method includes all income expected to be generated by the production up to and including the 10<sup>th</sup> taxable year after the year of release. Any income expected to be earned after this term is not included in the formula. Forecasted total income is based on the conditions known to exist at the end of the tax year of release (subject to revision in later years). These rules also apply to the “look-back” method described below.

#### *Revised Forecasted Total Income*

Pursuant to proposed Treasury regulations, if information is discovered in a taxable year following the year in which the property is placed in service that indicates the forecasted total income is inaccurate, a taxpayer must revise the forecasted total income. Under the revised computation, the unrecovered depreciable basis of the property is multiplied by a fraction, the numerator of which is the current-year income and the denominator of which is obtained by subtracting from revised forecasted total income the amounts of current-year income for prior taxable years.

The revised computation must be used in any taxable year following the year in which the income forecast property is placed in service if forecasted total income (or, if applicable, revised forecasted total income) in the immediately preceding taxable year is either less than 90% of the revised forecasted total income for the taxable year, or greater than 110% of the revised forecasted total income for the taxable year.

#### *Determination and Treatment of Basis of Property*

The basis of the property includes only costs that have been incurred pursuant to section 461 of the Code. For that purpose, the economic performance requirement can be met at different times, depending on the facts and circumstances of a transaction. For example, if a taxpayer incurs a noncontingent liability to acquire property, economic performance is deemed to occur when the property is provided to the taxpayer. In addition, the rules of IRC Section 461(h)(3) relating to the recurring item exception may apply.

The following costs incurred after the property is placed in service are treated as a separate piece of property:

- Any costs incurred with respect to any property after the 10<sup>th</sup> taxable year beginning after the taxable year in which the property was placed in service
- Any costs incurred after the property is placed in service and before the close of the aforementioned 10<sup>th</sup> taxable year if such costs are significant and give rise to a significant increase in the income from the property that was not included in the estimated income from the property.

If costs are incurred more than 10 years after the property was originally placed in service and no resulting income is expected, such costs are deducted as incurred. At this time, there is no comprehensive guidance on what constitutes a “significant” cost or increase in income.

Finally, any adjusted basis of the production not recovered by the 10<sup>th</sup> taxable year after the property was placed in service can be taken as a depreciation deduction in that year. Presumably, this deduction ignores salvage value.

## United States



### *Look-Back Method*

Taxpayers that use the income forecast method for amortization of production costs are required to apply the “look-back” method of accounting. The “look-back” method requires a taxpayer to pay or receive interest by recalculating amortization deductions (and the corresponding increase/decrease in tax) using newly revised forecasted total income from the property. It is applicable to any “recomputation year,” defined generally as the third and 10<sup>th</sup> taxable year after the taxable year the property was placed into service. This requirement does not apply when forecasted total income or revised forecasted total income for preceding taxable years is within 10% of revised forecasted total income for the potential recomputation year. For purposes of applying the look-back method, income from the disposition of the property is taken into account in determining revised forecasted total income.

In applying the “look-back” method, any costs not treated as separate property and taken into account after the property was placed in service can, if so elected, be taken into account by discounting such cost to its value as of the date the property was placed into service. This discounting is based on the federal midterm rate determined under IRC Section 1274(d). The “look-back” method does not apply to property with a total capitalized cost basis of \$100,000 or less as of the close of a potential recomputation year.

### *Treatment of Participations and Residuals*

For purposes of computing the allowable deduction under the income forecast method, participations and residuals may be included in the adjusted basis of the eligible property, beginning in the year such property is placed in service. The provision applies only if such participations and residuals relate to income that would be derived from the property before the close of the 10<sup>th</sup> taxable year, following the year the property was placed in service. Alternatively, the taxpayer may choose, on a property-by-property basis, to exclude participations and residuals from the adjusted basis of such property and deduct such participations and residuals in the taxable year paid.

### *Straight-Line Method*

Under the straight-line method, depreciation for the year is computed by dividing a film’s production costs over the film’s estimated useful life. A film’s useful life for depreciation purposes has been the subject of controversy. A film based on a contemporary theme may have a shorter useful life than one based on a historical event.

If a film right is acquired as a part of the acquisition of assets constituting a trade or business or substantial portion thereof, the cost of such film right must be amortized over a period of 15 years.

## **United States**

### *Treatment of Pre-Production Costs of Creative Properties*

Film production companies routinely incur costs to acquire, produce, and develop creative properties. Production companies may acquire creative properties with exclusive rights of ownership, or they may have limited exploitation rights. Sometimes, the rights acquired survive indefinitely while in other situations, the companies may acquire rights with a limited term. The film company may ultimately set for production only a small percentage of the creative properties acquired. Most of the creative properties set for production are set within three years of acquisition of the property. However, production companies set some properties for production that have been held for longer than three years. These companies do not usually discard, release to the public domain, or otherwise dispose of the creative properties not set for production or sold. Generally, film production companies retain these properties indefinitely.

The IRS has provided clarification on the treatment by a film producer of costs incurred in acquiring and developing screenplays, scripts, treatments, motion picture production rights to books, plays and other literary works, and other creative properties. Under the safe harbor method described in Rev. Proc 2004-36, creative property costs for properties not set for production within three years of the first capitalized transaction may be amortized ratably over a 15-year period, beginning on the first day of the second half of the tax year in which the costs were properly written off for financial accounting purposes. Property costs associated with a particular creative property set for production subsequent to the initial write-off and paid by the film producer after the property is set for production must be capitalized from the time the property is set for production and depreciated using an allowable depreciation method for produced films (i.e., the income forecast method). If, during the 15-year period, the film producer disposes of the creative property rights, the producer must continue to amortize the costs over the remainder of the 15-year period.

Additionally, a film producer may not deduct the capitalized costs of acquiring or developing creative properties as a loss under IRC Section 165(a) unless the producer establishes an intention to abandon the property and an affirmative act of abandonment occurs, or identifiable events evidencing a closed and completed transaction establishing worthlessness occur.

### *Other Expenditures*

Neither a film distribution company nor a film production company has any special status under U.S. law. Consequently, they are subject to the same rules as any other U.S. company, and are generally allowed to deduct the expenses of running their day-to-day operations to the extent such expenditures are ordinary and necessary and not of a capital nature.

Certain expenditures of U.S. companies can never be deducted. The following are some examples of such nondeductible expenditures: fines, penalties, bribes, certain executive life insurance, a portion of meals and entertainment, country club membership dues, and certain related-party losses. In addition, other expenditures cannot be currently deducted, such as capital expenditures, but must be deducted over the time period of their benefit to the company.

## United States

### *Losses*

Net operating losses (i.e., losses from operations) may be carried forward for 20 years to offset future income, or may be carried back for two years and offset against prior year's income, resulting in a refund of tax. Some states also allow the carryforward and carryback of net operating losses.

Losses attributable to the sale of certain assets used in the taxpayer's trade or business may be currently deducted. Capital losses on investment assets, however, are only deductible to the extent that there are capital gains for the year. An excess capital loss for a corporation may be carried back three years or forward five years. States generally follow the federal treatment.

### *Foreign Tax Relief*

Foreign tax relief is provided to U.S. taxpayers by allowing such taxpayers a foreign tax credit or foreign tax deduction for foreign taxes paid. Generally, the foreign tax credit provides the greatest relief from double taxation.

If foreign tax is paid directly by a U.S. taxpayer, a direct credit is allowed, but the credit is generally limited to the amount of U.S. tax that would have been paid had the income been earned in the U.S. If a 10% or greater U.S. corporate shareholder receives a dividend from a foreign subsidiary, a "deemed paid" credit may be allowed for the amount of income tax paid by the foreign corporation that is related to the income out of which the dividend is being paid.

## **Indirect Taxation**

### *Value Added Tax (VAT)*

The U.S. has no VAT on the sale of goods or services.

### *Sales/Use Tax*

Sales taxes are generally imposed on all sales of tangible personal property (unless an exemption applies) and specifically enumerated taxable services. A complementary use tax is imposed on property purchased for storage, use, or other consumption in the state if sales tax was not paid on the purchase. Most states allow for an offsetting credit against the use tax for any sales taxes legally imposed and paid.

All states except Alaska, Delaware, Montana, New Hampshire, and Oregon impose sales/use taxes. In addition, many local governments impose sales/use taxes. Rates generally range from 3 to 10%.

As a general rule, most states impose sales/use tax on the sale or use of production equipment and supplies. If a production company is providing services without corresponding sales of tangible personal property, then production services are likely exempt from sales and use taxes. Production companies are typically required to register for sales/use tax purposes in states where filming or production work is performed.

## **United States**

### Customs Duties

For 2015, the following customs duty rates are generally applied for the described goods:

35 mm or wider positive release prints	Free
Negatives, 35 mm or wider	Free
Sound recordings on motion picture film, 35 mm or wider, suitable for use with motion picture exhibits	1.4% of dutiable value (NAFTA Free)
Videotape recordings VHS between 4 mm and 6.5 mm	33 cents per linear meter
Video discs	Free
Publicity materials (e.g., posters, promotional, flyers, etc.,)	Free

## Personal Taxation

### Income Tax Implications

#### *Nonresident Artists*

The U.S. taxes nonresident artists on their income originating in the U.S. An artist's income that is "effectively connected" with a U.S. trade or business is taxed at the graduated income tax rates. Effectively connected income includes income earned by a nonresident artist performing or providing personal services in the U.S. An income tax exception applies for nonresidents present in the U.S. for a period of 90 days or less during the taxable year, performing services on behalf of non-U.S. persons and earning less than \$3,000 in the aggregate. When a nonresident artist performs personal services both within and outside the U.S. during the tax year, the income received must be allocated between U.S. and foreign sources in a way that most accurately reflects the proper source of the income based on all the facts and circumstances. In many cases, the facts and circumstances will call for an allocation on the time basis.

Generally, U.S.-source income other than effectively connected income—royalties, for example—is subject to 30-percent rate, unless an applicable treaty reduces this rate.

#### *Self-Employed*

A self-employed artist's effectively connected income is subject to U.S. tax at the regular graduated income tax rates; however, the income is subject to withholding at a rate of 30% when paid (absent the application of a more favorable treaty provision). Income from self-employment usually falls under the "Independent Personal Services" or Business Profits provisions of income tax treaties. Under these provisions, income arising from services rendered by a nonresident artist in the U.S. will usually be taxable in the U.S. only if the artist has a fixed base or permanent establishment in the U.S.

#### *Employees*

Treaty relief may be available for compensation earned during short, temporary periods of presence in the U.S.

### United States

Some treaties contain an “Artists and Athletes” provision that overrides the otherwise applicable treaty protection for both employees and self-employed artists working in the U.S. The Artists and Athletes provision often provides relief from U.S. tax only if specific income or physical presence limitations are not exceeded.

#### *Resident Artists*

Artists resident in the U.S. must generally pay taxes in the same manner as other U.S. residents. Consequently, the resident artist is subject to U.S. taxation on worldwide income. Double tax relief is provided by allowing U.S.-resident taxpayers a foreign tax credit or foreign tax deduction for non-U.S. income taxes paid; however, the foreign tax credit is limited to the U.S. tax attributable to the non-U.S.-source income.

Under domestic law, tax residency is determined under the “substantial presence test” or the “lawful permanent residence test.” Under the substantial presence test, an individual is considered a U.S. resident if he or she is present in the U.S. for 183 days during a calendar year, or if he or she is present for at least 31 days in the current calendar year and a total of 183 days during the current and two preceding calendar years (weighting each day in the first prior year as one-third of a day and each day in the second prior year as one-sixth of a day). Under the lawful permanent residence test, any foreign citizen who is a lawful permanent resident of the U.S.—a “green card” holder—is a resident for tax purposes regardless of the time actually spent in the U.S. Many exceptions to the residency rules apply, and tax treaties may override the residency determination under U.S. law.

#### *Self-Employed*

Self-employed artists are required to make estimated self-employment (SE) income tax payments on a quarterly basis if their annual combined income and SE tax liability is expected to equal or exceed \$1,000.

#### *Employees*

Employers with employees resident in the U.S. are obliged to make regular, periodic payments to both the federal government and, possibly, state and local governments with respect to the employee’s personal tax liabilities arising from wages paid by the employer. An employer makes these payments to the federal and state governments with moneys withheld from the employee’s wages.

The amount of income tax required to be withheld and remitted to the government is generally set forth in tax schedules provided by the government. Salaries and wages include both cash remuneration and, generally, the value of fringe benefits. However, reimbursements of deductible employee business expenses are nontaxable as are certain fringe benefits if they are of a de minimis value.

## **United States**

## Social Security Tax Implications

### Employees

For resident artists working in the U.S. as employees, the Social Security and Medicare taxes are divided equally into employer and employee shares. For artists who are resident and working in the U.S., employers are required to withhold the employee's share of Social Security and Medicare taxes from the artist's salary and remit this amount, along with the employer's share, to the proper tax authorities. For 2015, Social Security tax is computed at 6.2% for both the employer and employee (12.4% total) up to a taxable annual wage base of \$118,500. The Medicare tax rate is 1.45% for both the employer and employee (2.9% total) with no applicable wage base limitation. Additionally, a Medicare surtax of 0.9% is due from the employee (but not the employer) on compensation paid in excess of \$200,000 (\$250,000 of combined compensation of a married couple filing jointly).

Nonresident artists employed in the U.S. are generally subject to Social Security tax on U.S.-source wages in the same manner as U.S.-resident employees (discussed above).

Partial or complete relief from U.S. Social Security taxes may be available to both resident and nonresident artist employees pursuant to a Social Security Totalization Agreement.

### Self-Employment

In addition to income taxes, self-employed artists who are resident in the U.S. must pay both the employer and employee portion of the Social Security tax, referred to as the self-employment (SE) tax. The SE tax is imposed on artists with net earnings from self-employment. The SE tax is imposed at a rate of 12.4 % on earnings within a specified base indexed for inflation (\$118,500 for 2015), and at 2.9 % on all earnings without limit. An additional SE tax of 0.9% is due on self-employment income in excess of \$200,000 (\$250,000 of combined self-employment income of a married couple filing jointly).

The SE tax is not imposed on self-employed artists who are U.S. nonresidents.

### Digital Media

The past few years has seen a proliferation of the digital distribution of media content through various distribution platforms and "over the top" service options. As digital content is mobile, stored on servers in multiple locations and accessible by customers anywhere, various tax issues arise, especially those regarding the proper characterization, taxability, source of the income, and location of the sale. These attributes drive sales tax decisions, income tax allocation and apportionment, and withholding tax rules.

### Characterization

The type of transaction will generally impact the character of income. Online or streaming access to a motion picture or television series could be characterized as a sale, a rental or royalty, or service depending on the type of rights provided and the intent of the parties. Technology innovations such as temporary downloads and live-channel access via mobile device continue to blur the lines and make accurate characterization more difficult. Further, deployment models that combine downloads, streaming, and tangible rentals for a single lump sum price require an analysis of the complex bundling and de-bundling rules.

### Sourcing

The sourcing rules depend on the tax type. For example, while a sales tax is generally sourced to the location of the sale, an income tax may be sourced to the location of the

## United States



income producing activities. This is further complicated by the new “over the top” or direct to consumer models as they are often subject to amusement and broadcasting-type taxes that have different sourcing rules.

#### *Other Taxes*

In addition to the traditional sales and income taxes, the states impose transaction and gross receipts taxes on amusement, entertainment, broadcasting, and communications. Some of these taxes are imposed at the state level and some at the local level. While there is an argument that these taxes do not apply to the new streaming delivery models, a few call out streaming services specifically and many others are drafted broad enough to capture streaming services. For example, the City of Chicago subjects streaming video and video gaming services to its amusement tax and the State of Washington applies its Business and Occupation tax on the gross income received from streaming video.

#### **United States**

## KPMG's Media and Entertainment Tax Network Members:

### **Anthony Castellanos**

#### **KPMG LLP**

345 Park Avenue  
New York, NY 10154  
USA

**Phone:** +1 212-954-6840

**Fax:** +1 212-409-8390

### **Benson R. Berro**

#### **KPMG LLP**

21700 Oxnard Street  
Woodland Hills, CA 91367  
USA

**Phone:** +1 818-227-6954

**Fax:** 818-302-1469

### **Penny Mavridis Sales**

#### **KPMG LLP**

345 Park Avenue  
New York, NY 10154  
USA

**Phone:** +1 212-872-3650

**Fax:** +1 718-504-3942

### **Joseph Bruno**

#### **KPMG LLP**

345 Park Avenue  
New York, NY 10154  
USA

**Phone:** +1 212-872-3062

**Fax:** +1 212-409-8657

### **Binti Yost**

#### **KPMG LLP**

550 South Hope Street  
Los Angeles, CA 90071  
USA

**Phone:** +1 213-593-6649

**Fax:** +1 213-403-5470

### **Natalie Astrahan**

#### **KPMG LLP**

21700 Oxnard Street  
Woodland Hills, CA 91367  
USA

**Phone:** +1 818-227-6913

**Fax:** +1 818-302-1523

## **United States**