Treasury Issues Final Regulations for Film and TV Production Expensing

December 28, 2012

Section 181 of the Internal Revenue Code (Code) allows taxpayers to deduct certain film and television production costs in the year the costs are incurred, instead of having to capitalize such costs and depreciate them using one of the traditional depreciation methods applicable to film and television productions. Section 181's most recent regulatory history, key requirements and special rules and limitations are explained below.

Recent Regulatory History

The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 extended the availability of Section 181 and also removed the overall cap on the size of productions eligible for the deduction. On October 18, 2011, the IRS issued temporary and proposed regulations reflecting these 2008 changes. On December 7, 2012, the IRS finalized these proposed regulations and removed the temporary regulations.

Treasury Regulations Sections 1.181-1 through 1.181-5 apply to productions the first day of principal photography for which occurs on or after September 29, 2011. Paragraphs 1.181-1(a)(1)(ii), (a)(6), (b)(1)(ii), (b)(2)(vi), and (c)(2) of Section 1.181-1 apply to productions to which Section 181 is applicable and for which the first day of principal photography or in-between animation occurs on or after December 7, 2012. For any taxable year for which the period of limitation on refund or credit under Code Section 6511 has not expired, the owner may apply Treasury Regulations Sections 1.181-1 through 1.181-5 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, provided the owner applies all relevant provisions of Treasury Regulations Sections 1.181-1 through 1.181-5 to the production.

Key Requirements

Generally, film and television productions eligible for the Section 181 deduction include those commencing after December 31, 2009 and before January 1, 2012. For purposes of Section 181, the term "production" means any film or video production, including digital video, if the production cost is subject to capitalization under Code Section 263A, or would be subject to capitalization if Code Section 263A applied to the production's owner.

The taxpayer must make an election to deduct costs under Section 181 by the due date, including extensions, for filing the taxpayer's tax return for the first tax year in which the eligible production costs have been paid or incurred. However, the taxpayer may not make the election until the first tax year in which the taxpayer reasonably expects, considering all facts and circumstances, that: (1) the production will be set for production (or has been set for production); (2) the production will, upon completion, constitute a qualified film or television production; and (3) for eligible productions that commenced before January 1, 2008, the aggregate production costs paid or incurred with respect to the production will at no time exceed the applicable dollar limitation. Once the reasonable expectation requirement is met, eligible production costs incurred in prior years may be treated as deductible under Section 181. A separate election is required for each qualified production. If the reasonable expectation test under (1) above is satisfied, there is no requirement that the production ever be placed in service.

Only the owner of a production may make a Section 181 election. A person who only obtains a limited license or right to exploit the production or other limited interest in the production generally would not be eligible to make the Section 181 election.

Production costs that are deductible under Section 181 include all costs that the taxpayer pays to produce or acquire a production that would be required, in the absence of Section 181, to be capitalized under Code Section 263A. Eligible production costs include, but are not limited to: compensation paid for services and property rights, participations and residuals, and financing costs.

Section 181 also requires that 75 percent of the total compensation of the production must consist of qualified compensation. "Qualified compensation" means compensation for services performed in the United States by actors, production personnel, directors and producers, but does not include participations and residuals.

Special Rules and Limitations to Consider

Production costs that may not be deducted under Section 181 include the following: predevelopment costs amortized under Rev. Proc. 2004-36, 2004-1 C.B. 1063, before the time the production is set for production; costs to distribute or exploit a production; and costs to prepare for a DVD release of a theatrically-released film or to prepare an edited version of a theatrically-released film for television broadcast. Generally, video games are also not eligible for Section 181 treatment.

A taxpayer will be required to recapture any deductions taken in excess of the amount that would otherwise be allowable in the absence of Section 181 if one or more of the following conditions are met: (1) for eligible productions that commenced before January 1, 2008, the aggregate production costs for the production exceeds the applicable dollar limitation; (2) the taxpayer no longer reasonably expects that the production will be set for production, that the production will be a qualified film or television production, and for eligible productions that commenced before January 1, 2008, that the aggregate production costs will not exceed the applicable dollar limitation; or (3) the taxpayer formally revokes its Section 181 election. A taxpayer is also required to recapture any deduction taken under Section 181 with respect to a production if the taxpayer sells the production.

Conclusion

The federal deduction under Section 181, in combination with state and local tax incentives, has significantly bolstered domestic film and television production that, prior to Section 181's enactment, the United States had been losing to foreign locations at an alarming rate. The indirect benefits to local economies from the increased production activity include but are not limited to the growth of complementary businesses such as hotels, restaurants, catering companies, equipment vendors and transportation vendors.

Despite tightening budgets, the need to maintain economic growth requires that we preserve film and TV production tax incentives at the federal, state and local levels. Should you have any questions or wish to discuss Section 181 or any related matters, please contact any one of the attorneys in the Firm's Tax Department.