Entertainment, media and communications tax newsletter

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Tax Court deems substantial compliance sufficient for Section 181 election

Taxpayers have struggled with the administrative requirements of complying with the rules for making a valid Section 181 election ever since the provision was enacted in 2004.

An election under Section 181 allows a taxpayer to treat the cost of any qualified film or television production as an immediate expense. The election must be made by the extended due date of the taxpayer's return which production costs are incurred.

The IRS regulations contain detailed rules on the information that needs to be supplied to make a valid election, such as the date production costs were first incurred, the amount of qualified compensation paid, and specific production cost information related to costs incurred in designated higher-limit areas.

A recent Tax Court ruling highlights a situation in which the IRS attempted to invalidate an election because the taxpayer had not provided all of the information required by the regulations. Regardless, the Tax Court ruled the taxpayer made a valid election based on the fact that the taxpayer had substantially complied with the election requirements (Storey v. Commissioner, T.C. Memo 2012-115).

Background of the case

The case involved a documentary on the 1960s music group Up with People. The taxpayer, Lee Storey, was the owner and principal producer of the documentary. Her husband, William Storey, was a singer in the music group. It was his involvement in the group that led Lee Storey to work on this documentary, although her primary job was as a full-time attorney and a law firm partner. (The Tax Court dismissed the IRS' primary argument that the production of this documentary was not a trade or business with the intent of making a profit.)

The taxpayer deducted the production expenses related to this documentary under Section 181.

Timely Section 181 election was made

The costs incurred to produce the documentary were incurred over the years from 2003 through 2008. However, the taxpayer made the Section 181 election with her 2006 tax return and deducted expenses from 2003-2006 on this return. While costs were incurred in previous years, the documentary did not "begin production" until late 2006 and was completed in 2008. The IRS argued that the election was not valid, since 2006 was not the first year in which production expenses were incurred. The taxpayer countered that she could not make the election in a prior year because the temporary regulations (issued in February 2007) do not permit an election until the first taxable year in which the documentary would be set for production.

The IRS further asserted that the taxpayer did not properly amend previous years' tax returns or file a Form 3115 for an accounting method change for this item. However, the Tax Court cited Temporary Regulation Section 1.181-2T(a)(3), which states that a timely election can be filed following the year in which the cost was first incurred if that is the first year in which the "reasonable expectation requirement" is satisfied. The reasonable expectation requirement refers to the first tax year in which the qualified film would be reasonably expected to be set for production. Since 2006 was the first year in which the documentary met this requirement, the Tax Court ruled that the taxpayer made a valid election and all expenses from previous years would be deductible in the year the election is made.

Substantial compliance with documentation requirement

The IRS also argued that the taxpayer's election was invalid because certain information required by the regulations was omitted. The omissions identified by the IRS were filming date, compensation, and the declaration regarding the owner's expectations of setting the movie for production and keeping costs below the relevant thresholds for qualification for Section 181.[1]

The Tax Court agreed with the IRS that the taxpayer's elections did not fully comply with the regulations. However, applying the doctrine of substantial compliance, the Tax Court ruled that the election was still valid. The substantial compliance doctrine excuses a taxpayer from strict compliance with a procedural requirement if the taxpayer substantially complied by fulfilling the essential statutory purpose. Since the statute only requires the taxpayer to make a timely election by notifying the IRS of their intent to deduct the expenses, the omitted information in this case was not sufficient for the Tax Court to conclude that the taxpayer had not met the essential statutory purpose. The election was therefore ruled by the Tax Court to be valid.

[1] During the tax year under audit, the Section 181 deduction was limited to productions with an aggregate cost of $15 million or less ($20 million in certain designated locations).

Impact on EMC companies

The Storey decision indicates that the IRS may evaluate more closely the election and documentation requirements of Section 181 temporary regulations. However, entertainment, media, and communications (EMC) companies can take comfort that the Tax Court appears to be flexible in its application of the law and that substantial compliance with the election documentation requirements of the temporary regulations may be sufficient.

Multinational EMC companies shouldn't overlook implications of FATCA

FATCA is the acronym for the Foreign Account Tax Compliance Act, which was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010 (P.L. 111-147). Many multinational EMC companies mistakenly believe FATCA affects only traditional financial services companies and will not impact them. However, FATCA may impact all multinational EMC companies in at least one of the following three ways: (1) additional documentation may need to be collected from certain non-US parties related to payments made as part of the treasury and accounts payable function; (2) entities within a company's worldwide group may, in fact, meet the definition of a *foreign financial institution* or *non-financial foreign entity* and may be required to take affirmative steps to be compliant under FATCA; and (3) EMC companies will need to verify whether their foreign banking or other financial relationships within their global organization are with foreign financial institutions that are FATCA compliant.

What is FATCA?

FATCA is the US government's response to a concern that certain US persons were using foreign accounts to hide income offshore either by directly owning these accounts or indirectly controlling non-US entities that held the accounts.

FATCA creates a new tax information reporting and withholding regime for certain payments made to certain foreign entities. Additionally, FATCA creates an information reporting mechanism that may require foreign entities to disclose financial accounts held by high-net-worth US persons. The information reporting is designed to increase income tax compliance by US persons.

Under the proposed regulations issued on February 8, 2012, any US company or its subsidiary (including a controlled foreign corporation of a US shareholder) that pays, or a non-US company that receives or pays, a "withholdable payment" is a withholding agent and may be impacted by FATCA in a number of unanticipated ways. A withholdable payment is defined as US source interest, dividends, royalties (and similar income often referred to as fixed or determinable annual or periodic [FDAP]), and gross proceeds from the sale of an asset that could produce US source interest or dividends.

Although the primary focus of FATCA is to require non-US banks, custodians, investment vehicles, and insurance companies (referred to as foreign financial institutions) to identify US account holders and report account balances (among other information) to the Internal Revenue Service (IRS), FATCA also requires withholding agents (US and non-US entities) to provide certain information to the IRS. Specifically, withholding agents may need to identify foreign financial

institutions and certain nonfinancial foreign entities (NFFE), including NFFEs that have substantial US ownership.

If the NFFE fails to provide the proper certification or if a foreign financial institution is not compliant, the withholding agent is required to withhold tax at 30% on the withholdable payments.

The discussion below summarizes some primary areas of impact for multinational EMC companies.

Almost any EMC company making payments of US source income will feel the impact of FATCA

EMC companies and their subsidiaries, wherever located, that make withholdable payments to non-US persons are withholding agents under FATCA. As a withholding agent, an EMC company may be required to obtain certain documentation regarding the payee's ("the recipient's") status, report these payments to the IRS and the recipient, and in certain cases withhold 30% from these payments and remit the withholding to the IRS.

Impact on the treasury function

FATCA generally will impact the treasury department of an EMC company because it is responsible for maintaining worldwide cash management. In general, with respect to a treasury operation in the United States, payments it makes may be treated as US source withholdable payments. If so, FATCA withholding and reporting may be required. Withholding may be avoided with proper FATCA-specific documentation identifying the recipient (foreign financial institutions and NFFEs) as FATCA compliant.

If third-party foreign financial institutions are used by a treasury department to assist with worldwide cash management, the EMC company should examine these legal relationships to assess (1) whether the relationship causes the foreign financial institution to have to comply with FATCA; and (2) if so, whether each foreign financial institution will be compliant under FATCA. This is important in determining whether an EMC company or its subsidiaries might be required to withhold on payments under FATCA.

In some cases, the treasury department's derivatives, swaps, and other hedging arrangements will be affected. These types of transactions frequently involve non-US counterparties that are banks (either directly or through assignment through a multibranch or multiparty ISDA agreement), and in some cases the payments made are treated as being US source payments. If an EMC company or its subsidiary makes US source payments to a foreign financial institution that is not in compliance with FATCA, the entity may need to withhold tax at 30%.

Impact to accounts payable and other departments

The proposed regulations indicate that payments made in the ordinary course of a trade or business are not subject to withholding under FATCA. Consequently, the majority of payments that are made in an accounts payable function should not be affected by FATCA. However, one-time payments such as litigation settlements, large acquisitions, and similar transactions raise questions about whether such transactions are in the "ordinary course of business."

Similarly, payments that are defined as "financial services payments" do not enjoy this exception. Moreover, the proposed regulations do not provide a functional definition of what types of payments constitute financial services payments.

It will be important for accounts payable departments to identify the FATCA-relevant payments and ensure procedures are in place to capture payments not made in the ordinary course of business.

Documentation changes

While these requirements are similar to existing withholding and reporting requirements for payments of US source FDAP to non-US persons, the documentation that EMC companies will be receiving from recipients (e.g., Forms W-8 and Forms W-9) is going to be enhanced to accommodate FATCA.

There will be new tax certifications and new recipient statuses. In addition, the withholding regime will become more complex as it is transitioned to meet the new requirements. Reporting functions will have to be enhanced to capture and report any additional data required by FATCA. As a result, treasury and accounts payable departments that process tax documentation, determine withholding, and ensure proper reporting will be required to adapt to these changes.

As part of determining if FATCA withholding applies, a number of EMC companies are using this effort to also review current information reporting and withholding processes performed by accounts payable and other departments to ensure compliance with other withholding obligations. Withholding agents that make US source FDAP payments to non-US persons may currently be required to report the payments to the IRS and withhold 30% generally. Compliance reviews related to US source FDAP payments made to non-US persons are occurring because these issues are required to be reviewed during an IRS examination. Consequently, preparation for FATCA presents a good opportunity to ensure compliance with current information reporting and withholding regimes.

Unexpected foreign financial institutions

Some EMC companies are surprised to learn that affiliated entities could meet the definition of a foreign financial institution as the definition generally includes (in part) any entity that is primarily engaged in investing in securities. The definition of a foreign financial institution is very broad and may encompass entities that are not typically considered financial institutions, such as financing companies engaged in the factoring of receivables, special purpose securitization vehicles, captive insurance companies, and foreign retirement plans that do not meet the limited exclusions in the FATCA regulations.

Foreign banking relationships

EMC companies using foreign financial institutions for cash management, custody, and credit services may be affected by FATCA because of these relationships. For most EMC companies, avoiding the FATCA withholding requirements means scrutinizing existing and future cash management and banking relationships to ensure that these relationships are only with entities that are FATCA compliant. Financial relationships maintained by non-US subsidiaries (or non-US branches) located in countries where compliance with FATCA conflicts with local law may prove to be a significant challenge.

EMC companies may also be required to update account information and provide additional documentation to foreign financial institutions where they have existing cash management, banking, and credit relationships.

Effective dates

Information reporting under FATCA begins with certain data collected in 2013. The withholding provisions of FATCA apply to withholdable payments made on or after January 1, 2014 (withholding on gross proceeds is delayed an additional year to 2015). Treasury and IRS still expect to issue the final regulations before the end of this year.

What should EMC companies do?

EMC companies will find that FATCA has an unexpected impact on their organization; therefore, early assessment and planning are critical to reduce risks and administrative burdens. Given the impact of these changes and the fact that FATCA withholding will begin for certain recipients on January 1, 2014, it is not too early for EMC companies to begin revising information reporting and withholding policies and procedures, developing new checklists for validating recipient certifications, and planning for training the personnel involved in the withholding and reporting process.

New repair regulations will significantly impact EMC companies

On December 23, 2011, the US Treasury published regulations (the "repair regulations" or "temporary regulations") that create new rules related to the acquisition, production, or improvement of tangible property. These rules are meant to help taxpayers better distinguish between currently deductible repair and maintenance expenses under Section 162(a) and expenditures that must be capitalized under Section 263(a).

EMC companies often make improvements associated with office leaseholds, refreshing the layout and appearance of production stages/studios, repairing communications and broadcast equipment, and incurring removal/moving costs. Expenditures associated with these activities may relate to real property or personal property. Real property may include buildings, production lots, or other outside structures. Personal property may include broadcast equipment, FF&E, signage, or computers and peripherals.

Beginning in 2012, all EMC companies will need to evaluate the impact of these new rules on their businesses. Because of the nature of the activities described above and the type of property involved, the new repair regulations will likely have a significant impact on the industry, especially because many EMC companies own or lease multiple locations throughout the country. Most will likely discover that they need to change their method of accounting associated with repairs and maintenance to conform to the new rules.

Some of the potential impacts of the new repair regulations to EMC companies are outlined below.

Real property: Although a building and its structural components are generally treated as a single unit of property, the new repair regulations require that the improvement standards be applied separately to the primary components of a building (whether owned or leased), meaning the building structure (e.g., floors or walls) or any of the specifically defined building systems.

The building systems are broken out into nine components, such as heating, ventilation, and air conditioning (HVAC) systems, plumbing systems, electrical systems, escalators, elevators, fire protection and alarm systems, security systems, gas distribution systems, and other structural components as defined in published guidance. Accordingly, a cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems.

Observation: This new unit of property guidance will likely require taxpayers to begin capitalizing costs that they would have otherwise historically deducted as repairs and maintenance. This may also significantly increase the likelihood of a positive (i.e., unfavorable) Section 481(a) adjustment upon adoption of the new regulations.

While the new repair regulations clarified the unit of property rules related to buildings and their structural components by specifically enumerating applicable building systems, they did not clarify the improvement standards by creating an exception, safe harbor, or bright-line test associated with minor and recurring store refresh or remodel costs. Instead, the analysis of whether refresh or remodel costs result in an improvement continues to be focused on the specific facts and circumstances.

Accordingly, the new regulations merely provide additional detailed examples that result in a wide range of outcomes, based on the nature and extent of the work performed on the building and its structural components. While some of these examples are helpful and provide insight into the rationale for the conclusions reached, others seem to draw conclusions without providing much explanation.

In addition, because of the subjective nature of the improvement standards, taxpayers may continue to experience uncertainty in the application of the law to situations involving refresh or remodel costs—and further controversy upon audit. This may require taxpayers to spend more time documenting their related tax return positions, as well as their financial statement reserves for uncertain tax positions.

Dispositions associated with real property: A disposition of an asset includes the sale, exchange, retirement, physical abandonment, destruction, and transfer to a supplies, scrap, or similar account. The temporary regulations provide that the definition of a disposition for MACRS property is expanded to include the retirement of a structural component of a building and recognition of a loss.

Observation: Prior regulations disallowed partial retirements of a building because buildings were treated as a single unit of property. Even though a subsequent capital improvement was made, the taxpayer was required to continue depreciating the remaining basis of the replaced component. Under the new repair regulations, a

partial retirement is allowed. Therefore, taxpayers can now claim a retirement loss on the disposition of a building component or system.

For example, capital improvements made to the lighting and electrical system of a broadcast studio may result in a retirement loss for any previously capitalized lights, conduit, and wiring replaced during a remodel. Unfortunately, most taxpayers do not currently identify the newly defined building systems from the costs of a building. Taxpayers will now need to evaluate and determine the adjusted tax basis of retired components and building systems to claim a retirement loss.

Personal property: As they relate to personal property, the new repair regulations generally define the unit of property to include all functionally interdependent components. However, the new repair regulations also contain a provision requiring that component property be treated as separate units of property if properly treated as being within a different MACRS class (or if depreciated under Section 167 or 168 using a different depreciation method) than the unit of property of which the component property is a part (the "depreciation consistency rule").

Observation: If a cost segregation study is performed, resulting in component property being reclassified from longer-lived Section 1250 property to shorter-lived Section 1245 property, then the reclassified property must also be treated as separate units of property for capitalization purposes.

De minimis rule: The de minimis capitalization threshold contained in the new repair regulations generally allows costs incurred to acquire property (including materials and supplies) to be deducted for federal income tax return purposes to the extent expensed for financial statement purposes, unless a predefined ceiling is reached (i.e., the greater of 0.1% of a company's gross receipts for federal income tax return purposes or 2% of a company's depreciation and amortization for financial statement purposes). If the amounts to be deducted for federal income tax purposes exceed the ceiling, then the taxpayer could make an election to capitalize the excess over the ceiling as tax-only depreciable assets and continue to deduct the amounts up to the ceiling.

However, the preamble to the temporary regulations indicates that this de minimis rule was not intended to disturb current agreements with exam, such that the taxpayer could continue to deduct any amounts in excess of the ceiling if the IRS agrees that amounts deducted in excess of the ceiling do not distort the taxpayer's income.

Observation: EMC taxpayers will need to consider how assets capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes. This could mean a change to internal processes, controls, and related systems.

Action items and benefits for EMC taxpayers

There are a number of items that EMC companies should consider in analyzing the impact of the new regulations on their businesses. Some of these items are outlined below.

Review current capitalization policies and prior year repairs studies: Except in limited circumstances, the regulations require a full Section 481(a) adjustment, which means taxpayers are going to need to review their current

capitalization policies and all prior year repairs studies to conform to the new rules. Based on the new rules, some taxpayers may find that they have overcapitalized their repair expenditures, while others (especially those that previously undertook a repairs study) may find that they have overdeducted them.

In either case, taxpayers should consider filing a Form 3115. By doing so, taxpayers that have overcapitalized their repair expenditures will receive an additional benefit through a one-year cumulative catch-up adjustment. On the other hand, those that have overdeducted their repair expenditures will receive future audit protection, but at the cost of recapturing disallowed deductions over a four-year period. Taxpayers that have overdeducted their repair expenditures, and are required to recapture disallowed deductions over a four-year period, should be especially vigilant about understanding the impact this might have on cash flow assumptions and estimated tax payment obligations, as well as financial statement reserves for uncertain tax positions. The impact on tax returns should also be considered.

Evaluate the need for systems enhancements: The rules contained in the new repair regulations will require many taxpayers to evaluate the adequacy of certain systems and software programs. For example, the new unit of property and de minimis rules will require taxpayers to consider how assets that may have to be capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes. Similarly, the new disposition rules that impact building assets will likely make it more difficult to track adjusted tax basis associated with partial dispositions.

Industry Issue Resolution (IIR): Because of the significant amount of controversy experienced upon examination, many members of the EMC industry supported an IIR program for repairs and maintenance issues. The IRS has issued a revenue procedure specifically for the telecommunications industry, in addition to other industries with "network assets." Telecommunication companies should look to the IIR resolutions in conjunction with the new regulations.

Submit comment letters: The new repair regulations were issued in both temporary and proposed form. Accordingly, members of the EMC industry should consider requesting clarification by submitting comment letters focused on areas of law that lack clearly defined rules and safe harbors. One area of concern is the treatment of refresh, remodel, and moving costs.

Conclusion

Complying with the new repair regulations will likely require most taxpayers to change their accounting methods. The impact of these changes will depend largely on a taxpayer's current policies related to repair expenditures. While the new repair regulations were issued very recently, affected companies may find it wise to begin performing a thorough review of their capitalization policies in light of the new regulations as soon as possible, especially given the nature and extent of the assets found in EMC businesses.

EMC companies may benefit from tax deferral on unbilled receivables

In the film and television industries, it is common for producers to license film and television programming and utilize a "sale model" for financial statement purposes. To the extent this recognition results in an unbilled receivable (i.e., revenue recognized that has not been billed), the revenue likely will be recognized *prior to* the time required under the tax law.

Background: EMC companies following a sale model for tax purposes likely have taken the position that their unbilled receivables are earned for federal income tax purposes as soon as the film or television program is delivered to the customer, rather than as it is being provided and the customer is enjoying the right to use it.

Under most contracts for licensed intangible property, performance occurs as the taxpayer's customer has the right to use the property, not when the property is made available to the customer. Thus, under the general rule, prior to a payment being made or due to a taxpayer, revenue should be recognized for federal income tax purposes as the customer is enjoying the right to use the intangible, not when the licensed property is made available.

Cash tax deferral opportunity: An opportunity exists for some EMC companies to change their method of accounting for federal income tax purposes to defer the recognition of licensing revenue until the earliest of when: (1) performance under the contract occurs (i.e., as the licensee has the right to use the film or television program), (2) payment is received, or (3) payment is due and the amount can be determined with reasonable accuracy.

A threshold issue in assessing the applicability of this tax deferral accounting method is that the taxpayer's arrangement with its customer is actually a license, as opposed to a sale. Thus, the contractual arrangement with the customer should be reviewed to determine if it transfers all substantial rights in the intangible to the customer, in which case it may be a sale, or whether it transfers only limited rights to use the intangible for certain periods of time, in certain markets, and/or in geographic areas, in which case it may be a license.

Accounting method change: EMC companies that currently are recognizing income related to the licensing of film and television content under the sale model that would like to defer the recognition of this income in accordance with Section 451 must file an application for change in accounting method. This accounting method change is a nonautomatic accounting method change under Rev. Proc. 97-27. For a nonautomatic accounting method change, a Form 3115 must be filed no later than the last day of the taxable year for which the accounting method change is filed.

Note that when computing the Section 481(a) adjustment for this change, corollary adjustments to imputed income and income forecast amortization likely will be required.

To have a deeper discussion on the topics covered in this issue, please contact:

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NEW!! Global entertainment and media outlook 2012-2016

http://www.pwc.com/us/en/industry/entertainment-media/publications/global-entertainment-media-outlook.jhtml

2011 North American Wireless Industry Survey

http://www.pwc.com/us/en/industry/communications/publications/North-American-wireless-industry-survey.jhtml

US GAAP convergence & IFRS

http://www.pwc.com/usifrs