CalCPA

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International Tax Entertainment Issues

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Ms. Maria-Soledad Otero Esq., Attorney Karlin & Peebles
Mr. Robin H. Park Esq. Tax Partner, SingerLewak

AGENDA

1. Domestic & International Film Production Tax Credit Regimes (Maria/Robin)
2. Film Fund Financing/Structuring (Maria)
3. Sourcing of Income (Maria)
4. Foreign Tax Credit Regulations (Robin)
   A. 2022 Final Regulations
   B. 2022 Proposed Regulations
5. Sch K-2/K-3 Reporting (Robin)
6. Q&A (Maria/Robin)

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Domestic Film Production Credits

Tax incentives are today an important part of film productions and are most definitely the strongest reason why a production is filmed in an area or country other than California for example. Individual state and country legislation enables producers to subsidize spent costs for production. Tax incentives often require a producer to hire a certain number of local crew employees, use local vendors, hotels and services etc. The draw back is that tax credits are often based on application processes and is usually lengthy, months and years are common for a single production and referred to as “soft money” since the benefits come post-production.

Alabama

- Alabama offers tax rebate to production companies on the first $20 million of qualifying production expenditures. Payroll paid to Alabama residents earn 35%, while all other qualified production expenditures earn 25%, including the first $500,000 of each nonresident below-the-line, and the first $1 million of each nonresident above-the-line. The program is capped at $20 million per year.
- Production companies that spend at least $150,000 in a 12-month span can apply to exempted from the state portion of sales, use, and lodging tax. Film production companies can not be exempted from local taxes.

Arkansas

- Effective July 29, 2021, film production companies can apply for a rebate on qualified production costs.
- There is a 20% on all qualified production costs in connection with a state certified film project.
- An additional 10% credit is available for the payroll of below-the-line employees who are full-time Arkansas residents, veterans, or expenditures paid to veteran-owned small businesses for qualified production costs
- The program is set to expire June 30, 2032.

California

- Beginning Jan. 1, 2020, California offers a tax credit of 20% or 25%. The credit offered to qualified motion pictures is dependent on specific criteria:

  - ✔ Qualified motion pictures, including televisions series that have relocated to the state in their second or subsequent year of production are eligible for a 20% credit on all qualified expenditures.
  - ✔ A television series that relocated to California in its first year of production is eligible to receive a credit of 25% of qualified expenditures
  - ✔ Independent films with a minimum budget of $1 million are eligible for 25% of all qualified expenditures
  - ✔ Additional credits are offered to productions that meet any of the following criteria
  - ✔ 5% of expenditures relating to out-of-zone filming, original photography, visual effects, and/or music scoring and track recording.
  - ✔ 10% of qualified wages paid for services performed relating to original photography outside of the Los Angeles zone to qualified individuals who reside in California but outside the Los Angeles zone shall be allowed as an additional credit for the production of a qualified motion picture

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Domestic Film Production Credits

Colorado

- On or after July 1, 2012, the Colorado Film Incentive program offers a 20% cash rebate for production costs taking place in the state.
- The incentive program covers feature films, television pilots, television series (broadcast and cable), television commercials, music videos, industrials, documentaries, video game design and creation, and other forms of content creation.
- To be eligible, a Colorado production company must have qualified local expenditures of at least $100,000
- An out-of-state production company must have at least $1 million in qualified local expenditures (the exception being television commercials and video game productions, which must have qualified local expenditures of $250,000).
- Productions must also hire a workforce (cast and crew) comprised of at least 50% Colorado residents

Connecticut

- Eligible production companies that produce qualified films, television, video, or digital media entertainment content in Connecticut are eligible for tax credits. Production companies are eligible if they:
  - ✔ Conduct at least 50% of its principal photography days in Connecticut.
  - ✔ Spend at least 50% of a film's postproduction costs in Connecticut.
  - ✔ Or spend at least $1 million of a film’s postproduction costs in Connecticut.
  - ✔ The tax credit is based on production costs.
  - ✔ For expenditures between $100,000 and $500,000 Connecticut offers a tax credit of 10%
  - ✔ For expenditures greater than $500,000 but less than $1 million Connecticut offers a tax credit of 15%
  - ✔ For expenditures greater than $1 million Connecticut offers a tax credit of 30%

District of Columbia

- The District of Columbia offers eligible production companies that spend a minimum of $250,000 on qualified expenditures incentive rebates of:
  - ✔ Up to 35% of the company’s qualified production expenditures that are subject to taxation in the District;
  - ✔ Up to 21% of the company’s qualified production expenditures spent in the District of Columbia with District of Columbia registered vendors, cast, or crew; but not subject to taxation in the District;
  - ✔ Up to 30% of the company’s qualified personnel expenditures that are subject to taxation in the District (resident cast and crew);
  - ✔ Up to 10% of the company’s qualified personnel expenditures that are not subject to taxation in the District (non-resident cast and crew);
  - ✔ Up to 50% of the company’s qualified job training expenditures
  - ✔ Up to 25% of the company’s base infrastructure investment; provided the facility is primarily used for business functions related to media production or postproduction activity.

Domestic Film Production Credits

Georgia

- The film tax incentive program in the state of Georgia was split into two credits, the Base Tax Credit and the Georgia Entertainment Promotion Tax Credit. Production companies must first qualify for the base tax credit to be eligible for the Georgia Entertainment Promotion Tax Credit.
- The production of new film, video, or digital projects in Georgia and approved by the department of economic development, including but not limited to feature films, series, pilots, and pre-released interactive games qualify for the base tax credit. The tax base credit applies as follows:
  - ✔ If annual production expenditures are $30 million or less, the credit equals 20% of the base investment.
  - ✔ If annual production expenditures are over $30 million, the credit equals 20% of the excess base investment
  - ✔ Production companies are eligible for an additional tax credit equal to 10% of their base investment if the production activity includes a qualified Georgia promotion.
  - ✔ There is no annual program cap.

Hawaii

- Hawaii offers a Motion Picture, Digital Media & Film Production Income Tax Credit. A refundable tax credit based on a production company's Hawaii expenditures while producing a qualified film, television, commercial, or digital media project is available for producers.
- The credit equals 20% of qualified production costs incurred on Oahu, and 25% on the neighbor islands (Big Island, Kauai, Lanai, Maui, Molokai). Qualified production costs between counties can be prorated based on the amounts spent in each county.
- Beginning Dec. 31, 2019, the program is capped at $50 million per year.
- The credit program sunsets Dec. 31, 2025.

Illinois

- The Film Production Tax Credit Act offers accredited productions a credit of 30% of the Illinois production spending for the taxable year approved by the Department of Commerce and Economic Opportunity; and
- 15% of the Illinois labor expenditures approved by the department for employees who earn more than $1,000 on the production and live in geographic areas of high poverty or high unemployment, as determined by the Department of Commerce and Economic Opportunity

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Domestic Film Production Credits

Indiana

- Effective July 1, Indiana will offer film credits. The funding is capped at $300 million and details have yet to be finalized.

Kentucky

- Kentucky's film incentive program is offered to companies filming or producing motion pictures or entertainment products in the state. As of April 2018, commercials are not eligible for the credit.
- In enhanced incentive counties, a 35% credit is offered for qualifying expenditures and resident labor.

  - ✔ Motion pictures or entertainment productions not filmed in an enhanced incentive county may receive credits of:

  - ✔ 30% of qualifying expenditures.
  - ✔ 30% of compensation paid for labor of non-residents.
  - ✔ As of Jan. 1, 2022, the film tax incentive program is capped at $75 million annually.

Louisiana

- Louisiana offers up to 40% tax credits on the base investment through their film incentive program. A Base Investment Credit of 25% is available for state certified productions with a total base investment over $300,000 or over $50,000 for Louisiana screenplay productions.
- Screenplay productions created by a Louisiana resident are eligible for an additional 10% credit of the base investment.
- An additional 5% credit of the base investment is offered for out of zone productions that have a production office and at 60% of photography based out of the New Orleans Metropolitan Statistical area.
- Credits for Specific Expenditures
- An additional 15% credit is offered for direct payments for services to Louisiana residents.
- An additional 5% credit is available if at least 50% of the visual effects budget is for services performed in Louisiana by an approved qualified entertainment company (QEC).

Domestic Film Production Credits

Maine

- The Entertainment Industry Credit in Maine is equal to 5% of a visual media company's expense if they exceed $75,000.
- A visual media production company is allowed a reimbursement equal to 12% of certified production wages to paid to employees who residents of Maine and 10% of certifies production wages paid to other employees

Maryland

- Maryland offers tax incentives to entertainment productions in the state. Film productions are offered credits of 25% of their total costs. Television series are eligible for a of 27% of total costs.
- Small or independent film entities may not receive more than $125,000 in credits and no single production activity may receive more than $10 million in credits.
- The film tax incentive is capped at $17 million in 2022 and will rise another $3 million in 2023. The program may not exceed $20 million.

Massachusetts

- In 2022, legislators in the state decided to permanently extend the film tax incentive program.
- Massachusetts offers film makers a 25% production credit, a 25% payroll credit, and sales tax exemption.
- Production companies must spend more than $50,000 in Massachusetts to qualify for the payroll credit. In order to qualify for the production credit and sales tax exemption, production companies must spend at least 75% of the total budget or filming/principal photography days in Massachusetts.

Minnesota

- The film production credit in Minnesota offers film project taxpayers 25% of eligible production costs incurred in Minnesota. The annual limit for the program is $5 million.

Mississippi

- The Mississippi Motion Picture Production Rebates program provides a cash rebate on eligible expenditures and payroll. Motion picture production companies that spend at least $50,000 in base investment, payroll, or both in Mississippi are eligible for the rebate.
- Production companies are eligible for a 25% rebate of their base investment and payroll for employees who are not residents.
- For employees on the payroll who are residents, the rebate is equal to 30%; an additional 5% is available for any employee that is an honorably discharged veteran.
- If the payroll paid for an employee exceeds $5million, then the rebate only applies for the first $5 million.
- The rebates are capped at $20 million annually.

Domestic Film Production Credits

Montana

- Montana's tax credit for media production offers qualified media production companies 20% of production expenditures.
- Additional credits may be earned for the following reasons:
  - ✔ 25% of the compensation paid per production to each crew member or production staff who is a resident.
  - ✔ 15% of the compensation paid per production to each crew member or production member who is not a resident.
  - ✔ 20% of the first $7.5 million of compensation paid per production or season of a television series to each actor, director, producer, or writer
  - ✔ 30% of compensation paid per production or season of a television series to a student enrolled in a Montana college or university who works on the production for college credit
  - ✔ An additional 10% of payments made to a Montana college or university for stage rentals, equipment rentals, or location fees for filming on campus
  - ✔ An additional 10% of all in-studio facility and equipment rental expenditures incurred in this state for a production that rents a studio for 20 days or more
  - ✔ An additional 5% for production expenditures made in an underserved area
  - ✔ An additional 5% of the base investment in the state if the state-certified production includes a Montana screen credit furnished by the state as provided in
  - ✔ The tax credits may not exceed 35% of the production company's base investment. The 2022 annual amount of allowable tax credits is $12 million.

Mississippi

- The Mississippi Motion Picture Production Rebates program provides a cash rebate on eligible expenditures and payroll. Motion picture production companies that spend at least $50,000 in base investment, payroll, or both in Mississippi are eligible for the rebate.
- Production companies are eligible for a 25% rebate of their base investment and payroll for employees who are not residents.
- For employees on the payroll who are residents, the rebate is equal to 30%; an additional 5% is available for any employee that is an honorably discharged veteran.
- If the payroll paid for an employee exceeds $5million, then the rebate only applies for the first $5 million.
- The rebates are capped at $20 million annually.

Domestic Film Production Credits

Nebraska

- Nebraska offers a film production grant to films and television series that feature state-based stories. Production companies must spend a minimum of $1 million and can request up to $400,000 in Film Office Grant Funding. Additionally, at least 50% of cumulative production workdays must employ the services of Nebraska residents.

Nevada

- Nevada offers film production tax incentives to production companies that produce film, television, and visual media productions in the state and spend at least $500,000 on eligible expenditures.
- Companies are eligible to receive a 15% credit of the qualified production expenditures plus an additional 5% if more than 50% of the production's below-the-line personnel are Nevada residents. An additional credit of 5% of the qualified production expenditures is available if more than 50% of the productions filming days occurred in Nevada county in which qualified productions incurred less than $10 million of qualified direct production expenditures in each of the two years immediately preceding the credit application date.
- Each project cannot receive more than $6 million in credits.

New Jersey

- Qualified film production companies are eligible for the Film Production Tax Credit which is equal to 35%. A credit of 30% of the qualified film production expenses during a privilege period that are incurred for services performed and tangible personal property purchased for use at a sound stage or other location in New Jersey within a 30-mile radius of the intersection of Eighth Avenue/Central Park West, Broadway, and West 59th Street/Central Park South, New York, New York.
- The Film Production Tax Credit Program is not to exceed $100 million annually.

New Mexico

- Beginning Jan. 1, 2019, New Mexico's Film and Television Tax Credit is equal to 25% for direct production and postproduction expenditures. The production and post production expenditures must meet the following requirements:
  - ✔ Are directly attributable to the production of a commercial film or audiovisual product.
  - ✔ Are for services performed in New Mexico.
  - ✔ Are subject to taxation by the state of New Mexico.
  - ✔ Exclude postproduction expenditures for which another taxpayer claims the new film production tax credit.
  - ✔ Do not exceed the usual and customary cost of the goods or services acquired when purchased by unrelated parties.
  - ✔ An additional 5% credit may be available for production expenditures on work, services, or items provided on site in New Mexico but at least 60 miles outside of the exterior boundaries of counties with net taxable value of property of $6 billion and either a standalone pilot intended for series television in New Mexico, series television produced for commercial distribution with an order for at least six episodes in a single season, if each episode's budget exceeds $50,000, or a production in a qualified production facility.
  - ✔ There is another credit of 15% for the wages, fringe benefits, and per diem paid to below-the-line nonresident crew.

Domestic Film Production Credits

New York

- New York allows five different film production credits:
  - ✔ The Television Writer’s and Director’s Fees and Salaries Credit allows commercial production companies to receive a tax credit equal to 30% for the fees and wages paid to television writers and directors. The credit can not exceed $150,000 in total for each writer or director. The annual amount of credit available is $ 5million.
  - ✔ The Empire State Commercial Production Credit gives advertisement production companies a credit equal to 20% of the qualified production costs paid or incurred in the production of a qualified commercial. Production companies that film outside of the metropolitan area are eligible for a credit of 30% of qualified production costs.
  - ✔ The Empire State Film Production Credit offers qualified film production companies a credit of 25% if qualified production costs.
  - ✔ The Empire State Film Production Incentives-Wage credit provides an additional 10% credit for the wages or salaries paid to qualified individuals is available as well. A credit for the wages and salaries paid to individuals for services performed on a qualified film in certain counties.
  - ✔ The Empire State Film Postproduction Credit offers a credit of 30% of the qualifies postproduction costs for a qualified film at a qualified postproduction facility within the metropolitan district, the credit is equal to 35% for facilities located outside of the district.

North Carolina

- North Carolina offers a rebate up to 25% on qualifying expenses and purchases made in the state. This rebate is offered to television productions that spend a minimum of $500,000 per episode feature films that spend a minimum of $1.5 million a minimum of $500,000 for made-for-tv movies a minimum of $250,000 for commercials
- The program is capped at $31 million per year

Ohio

- The Motion Picture and Broadway Theatrical Credit program provides a credit equal to 30% of budgeted or actual eligible production expenditures, whichever is less. The annual program limit is set at $40 million per year. Since Oct. 17, 2019, the credit for each production contractor id equal to 30% of the eligible expenditures for the production. Production companies that intend to hire and provide on the job training to certified film and multimedia trainees are also able to apply for a credit equal to 50% of the salaries paid for film and multimedia trainees.

Oregon

- Film Production Development Contribution Credit allows for a maximum reimbursement of 10% of payments made for employee salaries, wages, and benefits for work done in Oregon and 20% of all other actual expenses. The maximum credits available annually are $20 million.

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Domestic Film Production Credits

Pennsylvania

- The film production tax credit in Pennsylvania is determined based on several factors. At least 60% of production expenses must be incurred in Pennsylvania to be eligible production expenses. The tax credit cannot exceed 25% of the qualified film production expenses for feature films and certain television commercials or shows. The taxpayer is also eligible for a tax credit equal to 30% of qualified postproduction expenses.
- Feature films, television film, or television series that are intended for a national audience or a film that is recorded in a qualified production facility, qualify for a credit equal to 5% of the qualified film production expenses. The film Production Tax Credit Program cap is $70 million annually.

Rhode Island

- Rhode Island's Motion Picture Production credit offers production companies a credit equal to 25% of the state certified production costs. Productions must have a minimum budget of $300,000 and credits for and motion picture production cannot exceed $5 million.

South Carolina

- Productions that film in South Carolina can receive up to a 25% cash rebate on in-state employee wages. Out-of-state performing artists (including stunt performers) are eligible for a 20% cash rebate. To be eligible, wages for each qualifying person must be less than $1 million and must be subject to South Carolina withholding tax.
- Additionally, the state offers up to a 30% cash rebate on in-state supplier expenditures if at least $1 million is spent in the state.
- There is an annual cap on the amount of rebate funds available per year. Generally, there is a minimum of $15 million available in rebate funds per fiscal year

Tennessee

- Tennessee offers filmmakers film incentives through the Credit for Gross Premiums Tax and Job Tax program. A credit equal to 40% of qualified payroll expenses is available to production companies. For payroll expenses paid to residents who live in tier 2, tier 3, or tier 4 enhanced counties, the payroll credit is equal to 50%.

Texas

- Texas offers a grant of:
  - ✔ 5% for $250,000 - $1 million
  - ✔ 10% for $1 million - $3.5 million
  - ✔ 20% for $3.5 million+
  - ✔ Production companies must film 60% of the production in the state and 70% of paid crew and 70% of cast members must be Texas residents.

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Domestic Film Production Credits

Utah

- In 2021, the annual limit for the Motion Picture Incentive was raised from $6,793,700 to $8,393,700. Film production companies can receive a credit of 20% of their expenditures in the state. An additional 5% is available to companies that meet certain requirements, including:
  - ✔ Employing a significant percentage of cast and crew from Utah.
  - ✔ Highlighting the state of Utah and the Utah Film Commission in the motion picture credits.
  - ✔ Or other promotion opportunities as agreed upon by the office and the motion picture company.

Virginia

- Motion picture productions filmed in Virginia that spend minimum $250,000, are eligible for a credit of 15% of qualifying expenses or 20% if the film was produced in a distressed area of Virginia
- The state also offers a 10% credit of the aggregate payroll expenses for Virginia residents employed by the production when production costs fall between $250,000 and $1 million. If production costs exceed $1 million, the credit offered is equal to 20% of the total aggregate payroll.
- There is an additional 10% credit for Virginia residents employed for the first time as actors or members of a production crew in connection with the production of a film in Virginia.
- There is an annual limit of $6.5 per year.

Washington

- Washington has a tax rebate program for production companies. To qualify, motion pictures and episodic series with less than six episodes are eligible for a rebate of up to 30%. Episodic series with at least six episodes are eligible for a rebate of up to 35%. Commercials can receive a rebate of up to 15%.
- Motion pictures must spend at least $500,000, television series must spend $300,000 per episode, and commercials have to spend a minimum of $150,000.

West Virginia

- West Virginia reinstated its film incentive program in 2021. Film production companies must spend at least $50,000 to qualify for a credit equal to 27%.
- The annual cap on tax credits is $10 million per year.

Offshore Film Production Credits

Puerto Rico

- Puerto Rico's Act 27 offers film tax incentives to production companies that spend a minimum of $50,000 per project. There is a 40% production credit for all payments made to residents and companies in the territory and a 20% credit on all payments made to qualified nonresident individuals

U.S. Virgin Islands

- Film production companies that spend at least $250,000 are eligible to receive up to 17% in tax credits. The base tax credit for production companies that meet the requirements the tax is equal to 9%. An additional 10% is offered to production that include a U.S. Virgin Islands promotion. If motion picture is produced in St. Croix, there is an additional 10% credit.
- Film production companies who hire between 20%-25% residents out of their total employees are eligible for a 10% tax credit, if the number is 25.1%-30% residents the credit is 15%, for productions where over 30.1% of the employees are residents the tax credit is equal to 17%.

Canada

- 16% federal tax credit for resident labor, plus tax credits issued by the various Canadian provinces, including the following:
- British Columbia: 33% tax credit (35% for Canadian content) for resident labor. Budget must be greater than C$1 million for feature film, C$200,000 per episode for series or pilot over 30 minutes. Minimum spend: C$0
- Alberta: (1) 25% grant (26% if shoot more than thirty (30) days in Alberta) for resident labor and vendor services. Alberta company must own less than 50% of the production company. Must have at least 4 resident department heads; or (2) 29% grant (30% if shoot more than thirty (30) days in Alberta) for resident labor and vendor services, if Alberta company owns more than 50% of the production company. Must have at least 8 resident department heads. Minimum spend: C$50,000 for projects with a commercial license agreement, C$100,000 for projects without a commercial license agreement.

Ireland

- Up to 37% tax credit on eligible production, post-production and/or VFX expenses for local and International cast and crew, and goods and services. 90% of the tax credit can be available up front upon proof of either (1) 68% of eligible expenditure is deposited into the project's production account, or (2) production company obtains a completion guarantee, bond, production loan or similar banking instrument secured against the 90% payment of the tax credit. Must pass a cultural test. Project cap: the lower of €70 million or 80% of the total production budget. Minimum budget: €250,000. Minimum spend: €125,000

International Film Production Credits

United Kingdom

- UK Film Tax Relief: Up to 25% cash rebate of qualifying expenditure. Must pass a cultural test or qualify as an official co-production (that is, made under UK's co-production treaties). Project cap: 80% of qualifying expenditure. Minimum spend: 10% of qualifying production expenditure
- National Funding: National funding incentives available to international producers include BBC Films, BFI Production & Development Funding, Film4 and Pinewood Pictures.
- Regional Funding: Regional incentives include the following:
  - ✔ the Yorkshire Content Fund (will invest the lower of up to 10% of the total production budget or up to £500,000);
  - ✔ Film Cymru Wales Production Funding (provides grants of up to £300,000 for writers, directors and producers who are either born or currently residing in Wales working in English or Welsh);
  - ✔ Creative Scotland Screen Funding (provides single project development Funding of £3,000-£50,000, Slate Development Funding of £50,000-£100,000, production funding of £50,000-£500,000, and distribution and exhibition funding of £5,000 – £15,000);
  - ✔ Northern Ireland Production Funding of a maximum of £800,000 for feature film and television production and £500,000 for interactive content production, up to a ceiling of 25% of the overall project budget. Funding is in the form of a recoupable loan with profit participation or in limited circumstances a grant. Available to productions with more than 65% of funding already in place.

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International Film Financing/Structuring

Co-Production

- U.S. resident investor enters into a joint arrangement with a non-US investor to finance and produce movie in the U.S. investor contributes funds to the project. Rights to exploit the film is allocated to the partners according to their respective territories or according to mutual agreement.

- U.S. LLC structure – Concern for non-US investor is whether there is ECI if taxed as a partnership. Engaged in trade or business? 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.

- U.S. Corporation structure: US corporate tax and withholding tax on dividends to non U.S. investor.

International Film Financing/Structuring

Co-Production

- Foreign corporation: issues for the US investor – CFC / PFIC issues

- Cost sharing agreement – U.S. investor would not be treated as engaging in a trade or business in the U.S. Investors would split the production cost in proportion to their respective share of the benefits. Attention to Treas. Reg. 1.482-7 detailing rules governing cost-sharing arrangements.

Source of Foreign Income

Source of Income for Royalties

- Royalty income is sourced to the location or place of use of the property. The country of residence of the payor or recipient of the royalties does not affect the sourcing determination.

- Royalties for the use of property in the U.S. are generally U.S. source income and royalties for the use of property outside the U.S. are generally foreign-source income.

- Need to look at the situs of the economic activity giving rise ot the income.

Foreign Tax Credit Regulations

Final 2021 Foreign Tax Credit Regulations

- On January 4, 2022, the Internal Revenue Service (“IRS”) and the U.S. Treasury Department (“the Treasury”) issued final regulations (“Regulations”) that provided significant guidance on the determination of whether a foreign tax is eligible for the U.S. foreign tax credit (“FTC”).

- These Regulations substantially modify prior regulations issued under Internal Revenue Code (“Code”) sections 901-905, but particularly 901 and 903. The Regulations can preclude certain foreign withholding taxes and other income taxes that have historically been considered creditable from being claimed as a FTC.

- These Regulations apply to foreign taxes paid in tax years beginning on or after December 28, 2021

Foreign Tax Credit Regulations

- The Final 2021 Foreign Tax Credit Regulations ("FTCR") primarily modify section 901 and 903 of the Code.
  - Section 901 – Foreign "income, war profits, and excess profits taxes" directly incurred/paid by the US taxpayer (e.g., foreign wages earned by US citizen/resident or income taxes paid by foreign DRE/PE of US person); and
  - Section 903 - Shall include a foreign tax paid in lieu of a tax on "income, war profits, or excess profits" otherwise generally imposed by any foreign country or by any U.S. possession (e.g., withholding taxes).
- The Final 2021 FTCR maintains much of the existing framework around sections 901 and 903 in that it must be a creditable tax; meaning, that it is an income tax (or in lieu of an income tax) that is compulsory and imposed by a foreign jurisdiction or U.S. possession. Moreover, the 2021 FTCR continues to adopt the net gain requirement, which includes three tests all of which must be met in order to be creditable:

1. ***Realization*** - imposed on certain realization events or pre-realization events;
2. ***Gross Receipts*** - imposed on the basis of gross receipts or a measure of deemed gross receipts that is not likely to exceed actual gross receipts; and
3. ***Cost Recovery-*** allows the recovery of significant costs attributable to the gross receipts or a measure of significant costs that is likely to approximate actual costs. A gross basis tax may meet the cost recovery requirement if, in fact, there are no significant costs and expenses attributable to the gross receipts included in the taxable base.

Foreign Tax Credit Regulations

- However, the 2021 FTCR modifies the net gain requirement such that it now incorporates an "attribution requirement" (i.e., nexus) that must be satisfied. The attribution requirement subjects residents and nonresidents to different rules for foreign country taxation:

  - Resident Attribution - requires the country's transfer pricing rules to allocate income among related parties under the arm's-length principals, and the allocation of income must not "take into account as a significant factor the location of customers, users, or any other destination-based criteria" (i.e., the net gain requirement).

  - Non-Resident Attribution – requires the attribution of income and cost to be attributed under one of the following three principles:

    1. ***Activity-based***: Foreign tax imposed on nonresidents' activities must be limited to the gross receipts and costs attributed under "reasonable principles" to nonresidents' activities within the foreign country imposing the tax. This includes the nonresident's functions within the foreign country and assets and risks located in the country (e.g., section 864). Under the final regulations, no FTC is allowed for foreign taxes that (1) consider the location of customers, users or similar destination-based criteria; (2) the location of a supplier; or (3) the location of a permanent establishment ("PE") where there are activities by people other than the nonresident;
    2. ***Source–based***: To satisfy the source rule, the foreign tax must be based on a sourcing rule that is "reasonably similar" to U.S. sourcing rules. For example, services income taxation must be based on where the services are performed (i.e., sections 861(a)(3)) and royalty/residual income taxation sourced to the place of use of the intangible property ("IP") (i.e., sections 861(a)(4)); and
    3. ***Situs of Property-based***: To satisfy the situs test, a foreign tax based on gains of nonresidents from the sale or disposition of property must be attributable to gross receipts from the disposition of real property located in a foreign country, or an interest in a resident entity that owns the real property, under rules reasonably similar to the U.S. Foreign Investment in U.S. Real Property Tax. In addition, tax may be based on sales from business property located in the foreign jurisdiction (i.e., section 861(a)(6)).

Foreign Tax Credit Regulations

- Thus, to determine if a particular foreign tax will be a creditable FTC, a U.S. taxpayer or its US tax advisor will now have to:
  - Determine the character of the transaction (i.e., income from copyright, royalty/residual income, or service income) under the Code and whether it's arm's length;
  - Determine the source of the income (i.e., U.S. or foreign) under the Code;
  - Determine the character of the transaction under foreign law; and
  - Determine if the tax is creditable under sections 901 or 903 by applying the tests described under each Code section.

  Note: the complexity of the Regulations will require all taxpayers, but particularly, small to mid-size taxpayers, to spend additional time and resources to determine if a FTC is available for foreign taxes paid or may force taxpayers to forego a valuable tax credit; either alternative is a costly decision!
- Who in particular are affected by the 2021 FTCR in the Entertainment industry?
  - US taxpayers that earn certain cross-border royalty/residual withholding tax payments (e.g., Film/TV distribution rights) may not be creditable under section 903 even if earned from a treaty country, unless a certain exception applies (i.e., single country license and documentation requirements).
  - US taxpayers that directly earn foreign source income from a non-treaty country that does not adopt the OECD transfer pricing principles will likely be subject to double taxation and disallowed to credit withholding taxes under section 903.
  - US taxpayers that own an interest in a foreign partnership or disregarded entity production company in a non-treaty country (e.g., Brazil or Hungary) will likely be subject to double taxation due to the inability to credit foreign taxes under section 901

Foreign Tax Credit Regulations

2022 Proposed Foreign Tax Credit Regulations

- On November 18, 2022, the Treasury Department released proposed foreign tax credit regulations ("PFTCR") that provide additional guidance on several key areas of the 2022 Final FTCR, most notably the cost recovery requirement, the attribution requirement for withholding tax on royalty payments, and the definition of a reattribution asset for purposes of allocating and apportioning foreign taxes.

- The 2022 PFTCR have varying applicability dates, but in all events, and subject to consistency rules, they provide taxpayers the option to apply the 2022 PFTC regulations, once finalized, to all foreign taxes that were subject to the modified provisions of the regulations finalized on January 4, 2022.

- The 2022 PFTCR would relax the stringent creditability requirements of the 2021 Final FTCR, following a more modest relaxation in the correcting amendments that were published last summer. Although Treasury and the IRS have not agreed with calls to withdraw the final regulations or defer their applicability, the proposed changes should insert needed flexibility into the FTC regime to account for the wide variety in countries' income tax laws.

Foreign Tax Credit Regulations

- Most relevant to the Entertainment industry is:
  1. The 2021 FTCR added an attribution or nexus requirement as an element of the net gain requirement to allow a credit for a foreign tax only if the country imposing the tax has sufficient nexus to the taxpayer's activities or investment of capital that generates the income included in the tax base.
  2. However, the 2022 PFTCR would provide a limited exception to the source-based attribution requirement of the 2021 FTCR when qualifying a foreign tax as a covered withholding tax under section 903 whereby the taxpayer can substantiate that a withholding tax is imposed on royalties/residuals received in exchange for the right to use IP solely within the territory of the taxing jurisdiction. This limited exception would generally apply **only if the taxpayer has a written license agreement** that provides for the payment of the royalty, and that limits the use of the intangible property giving rise to the royalty payment to the territory of the foreign country imposing the tax, or otherwise specifies the portion of the payment related attributable to such foreign country ("single-country license").
  3. A US taxpayer must satisfy certain documentation requirements in that it must provide the license agreement within 30 days of a request by the IRS, or another period as agreed between the IRS and the taxpayer. Except as provided, the required agreement pursuant to which the royalty is paid must be executed no later than the date of payment that gives rise to the gross royalty income that is subject to the tested foreign tax. In the case of a royalty that is paid before the date on which the required agreement is executed, in order to meet the requirement of this rule, the required agreement must be executed no later than May 17, 2023, and the agreement must state that royalties paid on or before the date of execution of the agreement are considered paid pursuant to the terms of the agreement.
  4. Requires US taxpayer to carefully work with your CPA and legal counsel to draft licensing agreements to comport with the single-country license and separately stated portion agreements as well as satisfy certain documentation requirements in order to the credit the foreign taxes under the new 2021 FTCR/2022 PFTCR.

Sch K-2/K-3 Reporting: Purpose

- Schedules K-2 and K-3 provides a standardized format for reporting items of international relevance with respect to a partnership or pass-through entity (i.e., S Corp, LLC, LP)
  - Items of Relevance is defined as and includes the following:
    - ✔ Foreign tax credit
    - ✔ Interests in foreign entities or distributions from foreign corporations
    - ✔ Foreign partner's U.S.-source income and/or U.S. effectively connected income (ECI)
    - ✔ Investments in foreign entities
    - ✔ Interests in CFCs, global intangible low-taxed income (GILTI), and subpart F income inclusions
    - ✔ Foreign-derived intangible income (FDII)

- Greater clarity for partners and shareholders to calculate their U.S. income tax liability with respect to international tax matters

- Technically, the information required is not different than what was historically required to complete Sch K-1; however, it didn't provide much guidance on reporting the foreign information for the partners to accurately complete their returns until the enactment of Sch K-2/K-3

- Specifically, to ensure US taxpayers have all relevant information to determine their US foreign tax credit limitation amount and ultimate utilization of foreign tax credits

Sch K-2/K-3 Reporting: Who Must File

- Generally, pass-through entities with items of international tax relevance

- For example, filers of Form 1065, Form 1120-S, and Form 8865 that have cross-border activities, investments, owners, or income may have sch K-2/K-3 filing requirements

- Per Sch K-2/K-3 instructions, the reporting can be required when a partner claims a foreign tax credit and needs the information to complete Forms 1116/1118.

  Note: Even a US partnership/pass-through entity with no foreign partners or foreign entities/subsidiaries may still be required to file Sch K-2/K-3 if they have items of international relevance unless they meet an exception.

Sch K-2/K-3 Reporting: Who Must File

Exceptions to filing Sch K-2/K-3:

- Per the 2022 Form 1065 Schedules K-2/K-3 instructions, if a partnership does not meet the domestic filing exception, it may meet the Form 1116 exemption to file the sch K-2/K-3. *See IRC Section 904(j)*
- A domestic partnership is not required to complete Sch K-2/K-3 if:
  - All partners are eligible for the Form 1116 exemption; and
  - The partnership receives notification of the partners' eligibility for such exemption by the 1-month date
- If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership does not need to complete the K-3 for those exempt partners but must complete K-2 and K-3 with respect to the partners to the extent that the partnership does not qualify for the domestic filing exception.

Schedule K-2 and K-3: Form Breakdown

Part No.	Schedule K-2 – Form 1065	Schedule K-3 – Form 1065
I	Partnership's Other Current Year International Information	Same as K-2 but for partner's share
II	Foreign Tax Credit Limitation	Same as K-2 but for partner's share
III	Other Information for Preparation of Form 1116 or 1118	Same as K-2 but for partner's share
IV	Information on Partner's Section 250 Deduction with Respect to FDII	Same as K-2 but for partner's share
V	Distributions form Foreign Corporations to Partnership	Same as K-2 but for partner's share
VI	Information on Partner's Section 951(a)(1) and 951A Inclusions	Same as K-2 but for partner's share
VII	Information to Complete Form 8621	Same as K-2 but for partner's share
VIII	Partnership's Interest in Foreign Corporation Income	Same as K-2 but for partner's share
IX	Partners' Information for Base Erosion and Anti-Abuse Tax	Same as K-2 but for partner's share

Schedule K-2 and K-3: Form Breakdown

Part No.	Schedule K-2 – Form 1065	Schedule K-3 – Form 1065
X	Foreign Partner's Character and Source of Income and Deductions	Same as K-2 but for partner's share
XI	Section 871(m) Covered Partnerships	Same as K-2 but for partner's share
XII	Section 871(m) Tax Liability of a Qualified Derivatives Dealer (QDD)	Same as K-2 but for partner's share
XIII	Reserved	Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

Schedules K-2 and K-3: Transition Penalty Relief

- Per IRS Notice 2021-39, the IRS will provide transition relief for tax years beginning in 2021 with respect to Schedule K-2 and K-3
- Relief is available if the filer establishes, to the IRS' satisfaction, that a good-faith attempt was made to comply with the new reporting requirements
- When determining a filer's good-faith effort, the IRS will consider the extent to which the taxpayer changed its systems, processes, and procedures for collecting and processing information relevant to Schedule K-2 and K-3

QUESTIONS

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