

Message From The Firm

Our business and tax attorneys frequently assist entertainment industry advisors and their clients on complex transactional and tax planning matters. This special edition of our newsletter focuses on some of the unique issues faced by sports and entertainment clients.

Abandonment of copyrights remains a complicated matter. David Schwartz's article sheds light on the new IRS rules and the lack of sufficient guidance on how to abandon creative properties. Planning to achieve the deduction for the asset loss may end up being more creative than the asset itself.

Rich Luftman's article highlights a portion of the 2004 Jobs Creation Act that provides incentives for low budget film and television producers. Under the new law, producers can now amortize production costs up front. There is a short window in which to take advantage of this powerful deduction, since the new law sunsets in three to four years.

Kalyani Chirra addresses recent tax law changes that limit the initial deduction for charitable patent and copyright contributions. However, donors can now benefit from post-contribution deductions over the next 12 years for patents and copyrights that are exploited by the charity.

Lastly, James Chapman's article discusses how the new federal tax rules will substantially restrict the amount that a business can deduct for the use, acquisition or charter of private aircraft for employees.

If you have a question about an article, please contact the author or one of us.

Brad Cohen and Mike Foster

IRS Guidance on Abandonment of Creative Properties

By David Schwartz (DavidSchwartz@Reish.com)



In 2004, the IRS issued a revenue ruling and a revenue procedure which provide guidance regarding the treatment of costs incurred in acquiring "creative property"—such as screenplays, scripts, treatments, or story outlines; motion picture production rights to books, plays or other literary works; and similar property for purposes of potential development, production and exploitation. The guidance attempts to clarify when a loss for abandonment or worthlessness may be claimed for tax purposes with respect to creative property, and when costs incurred in acquiring creative property may be recovered if the project is ultimately not scheduled for production.

Revenue Ruling 2004-58 does not change existing law regarding the situations in which a taxpayer may deduct the costs of creative property as a loss for worthlessness or abandonment under Section 165(a). In general, the Ruling provides that, unless there is a "closed and completed transaction fixed by an identifiable event," the taxpayer cannot claim a loss deduction for abandonment or worthlessness.

Revenue Procedure 2004-36 provides a safe harbor that permits taxpayers to amortize creative property costs ratably over a 15-year period for properties that are written off for financial accounting pur-

poses. As a general rule, taxpayers are required to capitalize creative property costs, and that unless, e.g., a film, is produced from the creative property, are not permitted to recover those costs through deductions for depreciation or amortization. As a measure of relief to taxpayers who comply with the Revenue Procedure, the IRS will allow a taxpayer to use a 15 year safe harbor amortization method.

Revenue Ruling 2004-58

The IRS examined three different situations under which rights to a script, screenplay, and novel were purchased, but not set for production, and the factual circumstances that caused each situation to result or to not result in a deductible loss. The IRS cited a number of cases for the proposition that, in the context of an abandonment loss, some identifiable act is required that evidences a taxpayer's intent to permanently discard or discontinue use of the property abandoned, and that such act "must be observable to outsiders and constitute some step which irrevocably cuts ties to the asset." However, the IRS did not shed any new light on what constitutes an "identifiable event" that evidences the taxpayer's intent to permanently discard or discontinue use of the property.

The IRS did note that the taxpayer need not relinquish legal title to property in all cases to establish abandonment, as long

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2004 Tax Law Provides Incentives to Television and Film Producers



By Richard Luftman (RichardLuftman@Reish.com)

When Congress passed the American Jobs Creation Act of 2004, it amended Internal Revenue Code Section 181 to allow taxpayers to deduct the full cost of certain qualified television or film productions in the year expended. Under prior law, the taxpayer was allowed to depreciate the cost of the production using the income forecast method (over a period of years corresponding to when the income was expected to be received). Un-

der the revised law, a taxpayer is allowed an immediate deduction in the first year for all of the expenses associated with the qualified production.

What types of productions qualify for this deduction?

The taxpayer must be careful to determine whether the production qualifies for this deduction. The following are the criteria:

- 1) the production must be a motion picture film or video tape,
- 2) if the production is a television series, only the first 44 episodes are taken into account,
- 3) at least 75 percent of the total compensation of the production must be paid for services performed in the United States by actors, directors, producers, and other relevant production personnel (participations and residuals are excluded from this calculation),
- 4) the production must have expenses that *do not exceed* \$15 million, or \$20 million "for certain productions the expenses of which are significantly incurred in a low-income community, or a distressed county or isolated area of distress as designated by the Delta Regional Authority,"

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Charitable Contributions of Patents and Copyrights



By Kalyani Chirra (KalyaniChirra@Reish.com)

In response to donors who contributed copyrights and patents to charities and deducted amounts far above what the intellectual property was really worth, the Jobs Creation Act revised the rules with respect to such donations, effective for gifts made after June 3, 2004.

Gifts of Copyrights: Under prior law, contributions of copyrights created through personal efforts were deductible only to the extent of the lower of (a) fair market value or (b) basis. Copyrights treated as capital gain property, such as those acquired by purchase or inheritance, were the exception and were deductible at the full fair market value. Under the new law, the deduction is now limited to the lower of (a) fair market value or (b) basis.

Gifts of Patents: Under prior law, because a patent was considered a capital asset, contributions of patents were deductible at full fair market value. The 2004 Act adds patents to the class of contributions for which deductions are limited to the lower of (a) fair market value or (b) basis.

However, until the end of the legal life of the patent or copyright or after the 12th anniversary of the date the contribution was made, the donor may deduct on a sliding scale, as a charitable contribution, amounts of income received by the charity from the use of the patent or copyright (in excess of the amount claimed as a deduction), starting with 100 percent in the first and second years, to 10 percent in the twelfth year.

Example: A donor contributes a copyright to a university. The lower of basis

or value of the copyright is \$50,000 at the time of contribution. In the first year, the copyright earns \$80,000 in royalties. Because the donor has deducted \$50,000, the deduction is limited to \$30,000. In the second year, the copyright earns \$70,000 in royalties and the donor deducts the full amount.

Despite the reduction in the initial charitable deduction for copyrights and patents, the post-contribution deductions might still encourage donations of patents and copyrights. Under prior law, patent/copyright owners who expected large future royalties may have delayed their patent gifts until a later year. Now, the donor patent/copyright owner will still benefit even after the year of contribution of the patent/copyright.

In order to take advantage of the post-contribution benefit, donors should confirm prior to contribution that the donee has the resources to exploit the copyright or patent, otherwise, it could end up costing the donor valuable charitable income tax deductions. ❖

New Rules Limit Employer Deductions for Personal Use of Aircraft



By James Chapman (JamesChapman@Reish.com)

The federal tax rules applicable to personal use of a business aircraft changed on October 22, 2004, with the enactment of the American Jobs Creation Act of 2004, or "AJCA." As a result of this change, employers have three choices: (1) treat the full cost of the personal use of the aircraft as wages to the executive using the aircraft; (2) forego an income tax deduction to the extent the cost of the personal use of the aircraft is not treated as wages to the executive, or (3) limit personal use of the employer's aircraft.

The AJCA limits an employer's deductions attributable to the personal use (as opposed to business use) by "specified individuals" of an aircraft owned by the employer. The deduction is limited to the amount that is included in income as wages by a "specified individual."

These individuals generally include, for both private and publicly-held companies: (a) the president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions; (b) directors; and (c) 10%-or-greater owners.

The AJCA was specifically intended to overturn the deduction previously allowed by *Sutherland Lumber-Southwest, Inc. v. Commissioner*. According to *Sutherland Lumber-Southwest*, an employer could deduct all expenses attributable to the personal use of an aircraft so long as the fair market value of the employee's personal use of the aircraft was treated as wages to the employee. Under generally allowed methodology,

the fair market value of a personal flight is typically much smaller than the cost of the flight to the employer. However, even after the AJCA, the *Sutherland Lumber-Southwest* rule continues to apply with respect to the expenses associated with the personal use of aircraft by employees and persons who are not "specified individuals."

For example, assume that an employer allows its president to use the employer's aircraft to fly the president and his or her family to a vacation destination. Under the applicable valuation rules, the value of the flight is \$1,000, but its cost to the employer is \$10,000. Assume that the employer treats that \$1,000 as wage compensation to the president. Unless the employer proves that the expenditure is directly related to, or associated with, the employer's trade or business, the employer may deduct no more than \$1,000 of the cost of the flight provided to the president.

The IRS has provided guidance, in the form of Notice 2005-45 (issued on May 27, 2005) which contains detailed rules for allocating aircraft expenses between personal and business use. ❖

New IRS Rules Impact on Tax Advice

On June 20, 2005, new IRS rules became effective that will have a significant impact on written tax advice communicated from tax practitioners to taxpayers.

The IRS revised these rules primarily in response to taxpayers and their advisors who were participating in, and promoting, tax shelters. The new rules, however, cover a much broader spectrum of written advice that includes any written advice that addresses federal tax issues, where the principal or significant purpose of the transaction is the avoidance of tax.

The IRS did not adopt the revised rules to discourage legitimate tax planning that is employed within the spirit and purpose of the law. Therefore, the legitimate tax planning employed by our firm and many other

firms may continue to be considered and implemented. However, the impact of the revised rules is to make any practitioner who practices before the IRS—attorneys, accountants, enrolled agents and enrolled actuaries—adopt more stringent standards within their tax practices, even if the tax practice deals only in legitimate tax-saving planning.

The effect on you is that you will begin to see disclaimers in written advice that you receive from this firm and from other tax practitioners. The IRS rules require such a disclaimer.

We wanted to make sure you were aware of this change in the rules so that such a disclaimer does not take you by surprise or alarm you. We will continue to render written tax advice. However, based on the revised rules, we will not be able to give you explicit protection

against potential penalties associated with a potential tax audit.

The best protection against penalties is to have strong tax arguments under the law. If you prefer to have a written legal opinion on which you can rely in connection with a potential tax audit, we will be able to render such an opinion; however, such an opinion will be much more thorough than in the past, will require more time to prepare, and will necessitate additional fees.

If you have any questions about these revised rules, please contact Michael Luftman or the attorney at the firm with whom you normally communicate.

Be on the lookout for our disclaimer in letters and emails!

Creative Properties

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as there is an intent to abandon and an affirmative act of abandonment. The IRS also noted that, where the taxpayer retains creative properties for potential future exercise of ownership or other contractual rights, or retains the ability to enforce those rights by preventing competitors from using the property, a loss under Section 165(a) will not be allowed solely because (i) the development or production of the property is not actively pursued; (ii) the property is not set for production within a certain period of time after acquiring it; or (iii) the costs of developing or acquiring the property are written off for financial accounting purposes. The IRS also noted that unsuccessful attempts to find a distributor for a motion picture is not sufficient evidence of worthlessness, where the possibility of commercially exploiting the motion picture remains viable. In such a case, while there might have been a diminution in the value of the picture, there is no worthlessness.

Based on the foregoing, it would be extremely difficult to claim a loss under Section 165(a) with respect to a copyright, as long as ownership of the copyright remains vested in the taxpayer.

Revenue Procedure 2004-3

In addition to the difficulty in claiming a loss for abandonment or worthlessness of creative property where exclusive or limited legal ownership rights in the creative property remain vested by the taxpayer, taxpayers are generally required to capitalize creative property costs. Under current law, unless a film is produced from the creative property, taxpayers are not permitted to recover those costs through deductions for depreciation or amortization.

The Revenue Procedure grants relief to taxpayers who ultimately will not exploit

the creative property, and have written off the property for financial accounting purposes. The definition of "creative property" is substantially similar for purposes of the Revenue Ruling and the Revenue Procedure. The Revenue Procedure generally provides that a taxpayer who complies with the requirements of the Revenue Procedure may amortize creative property costs over 15 years beginning on the first day of the second half of the taxable year in which the taxpayer properly writes off the costs under "Statement of Position" (SOP) 00-2, which was issued by the American Institute of Certified Public Accountants in June 2000.

Under the safe harbor method in Revenue Procedure 2004-36, taxpayers must amortize creative property costs properly written off by the taxpayer under SOP 00-2 ratably over an amortization period of 15 years, beginning on the first day of the second half of the taxable year in which the taxpayer properly writes off the costs under SOP 00-2. For any creative property costs that are (a) associated with a particular creative property that has not been set for production and (b) paid or incurred by the taxpayer subsequent to the initial write-off, those costs must be amortized by the taxpayer under the same schedule as provided above, beginning on the first day of the second half of the taxable year in which the taxpayer pays or incurs those costs. If creative property is set for production subsequent to the initial write-off, and the creative property costs are paid or incurred by the taxpayer after the property is set for production, those costs must be capitalized by the taxpayer from the time the property is set for production, and depreciated using an allowable depreciation method for produced films (for example, the income forecast method) at the time the property is placed in service.

If the taxpayer disposes of the creative property during the 15 year amortization period, the taxpayer must nevertheless

continue to amortize the creative property costs over the remainder of the 15 year period. For this purpose, a "disposition" includes the sale, exchange, abandonment or destruction of creative property or rights relating thereto. A disposition also occurs upon the expiration of a taxpayer's rights to a particular creative property, similar to the second situation in Revenue Ruling 2004-58.

Under the Revenue Procedure, any amounts received by the taxpayer in connection with a disposition would generally be required to be recognized as ordinary income, notwithstanding any other provisions of the Internal Revenue Code (except as a result of a sale of the entire related business).

Conclusion

Taxpayers will need to determine if, in the event they write off creative property for accounting purposes, they intend to ultimately abandon or destroy such property for tax purposes. While a loss for income tax purposes would otherwise be allowed under Revenue Ruling 2004-58 upon the expiration of a taxpayer's rights to the property, or otherwise upon the abandonment or destruction of the property, the Revenue Procedure limits the taxpayer's deduction.

As a result, if the taxpayer anticipates that it will not exploit the creative property and the taxpayer's contractual rights in the property will expire, or otherwise the taxpayer will abandon (if abandonment is even possible) or destroy such property, then, depending on the date those rights expire, it could be more beneficial for the taxpayer to wait until the rights expire. This will allow the taxpayer to claim a loss for the entire cost of the property at that time. Otherwise, the taxpayer could be required to continue to amortize those costs over a much longer period of time. ❖

2004 Tax Law*continued from page 2*

- 5) the basis of any qualified production may *not* also be otherwise depreciated or amortized, and
- 6) the production must have commenced *after* October 22, 2004 and *prior to* December 31, 2008.

How does a taxpayer elect to take the deduction?

An election to take the deduction must be made by the due date (including extensions) for the tax year in which the qualified production activities are first incurred. However, once made, an election can only be revoked with the consent of the Secretary of the Treasury.

Caution!

The IRS rule that treats controlled groups as a single taxpayer also applies to this deduction. For example, if two corporations or partnerships have quali-

fied production expenses, and those corporations would be considered a controlled group under the relevant rules, then the expenses of both entities must be taken into account when considering the maximum expense of the qualified production.

With respect to deceased taxpayers, the rules applicable to apportionment between the income beneficiary and fiduciary of an estate apply with respect to this deduction.

If the production is subject to the rules covering productions with sexually explicit conduct, then it *does not* qualify for this deduction.

As you can see, Congress has provided a large incentive to taxpayers who produce relatively inexpensive film and television productions. Assuming the production qualifies, the tax benefit should be considerable, since the revised law provides an immediate deduction rather than spreading the tax relief over many years.

This deduction may be short lived, since the law is due to sunset as of December 31, 2008. Additionally, the IRS has designated this deduction as a priority for which it intends to issue further clarification and/or guidance during 2005 and 2006. Commentators also expect Congress to amend the law to make technical corrections to the statute, which could have a dramatic impact on the way the deduction operates and its potential benefits.

With all of these uncertainties, you should stay tuned and remember that we will be on the verge of having a new President, and possibly a very different Congress, by the time this law is due to sunset. ❖

Around the Firm

Fred Reish was quoted in the June issue of *HR Magazine* in the article "Take a Closer Look" about hidden weaknesses in 401(k) plans. Nick White was quoted in the July issue of *California CPA* in the article "Pension Attention." David Schwartz gave a presentation to the Wells Fargo Private Client Services Group in Los Angeles on June 20th on "Current Issues in Transfer Tax Laws." Jon Karp spoke in July at the California CPA Education Foundation's Pass-Through Entities Conference on "Post Mortem Planning: What To Do When Your Client Dies Owning Interests in Pass Through Entities?"

On August 4th, Mark Terman presented "Technology and Privacy in Today's Workplace: Protecting Confidentiality and Trade Secrets" for a Professionals in Human Resources Association (PIHRA) seminar in Los Angeles. Jon Karp taught an all day course in Monterey on August 8th for the California CPA Education Foundation on the subject of "Succession Planning for the CPA Firm." Jeff Lewis spoke on "Private Annuities" to the Merrill Lynch Estate Planning Services Group in Los Angeles on August 25th.

Several of our attorneys are involved in upcoming conferences for the California CPA Education Foundation. Nick White will be a speaker on "Compliance and Regulatory Issues" at the Retirement Plan Conference in Los Angeles on September 21st and in San Francisco on September 22nd. Brad Cohen and Michael Foster will co-present "Tax Update - Talent" at the Entertainment Industry Conference in Century City on September 29th. Jon Karp will speak on "Structuring the Deal" at the Succession Planning for the CPA Firm Conference in Burbank on September 29th and in San Francisco on September 30th.

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