Tax Legislative Update for the Entertainment Industry

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Agenda

- 20% Deduction on “Qualified Business Income”
- Choice of Entity
- International Tax Considerations
- Bonus Depreciation / Section 181
- California Tax Considerations
- Other Considerations
  - e.g., meals and entertainment, sexual harassment settlements, alimony, loss limitations

QBI Deduction

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QBI Deduction – In General

- New deduction for “qualified business income” from pass-through entities and sole proprietorships.
- Maximum federal tax deduction is 20% of the taxpayer’s QBI.
- Non-corporate taxpayers (including estates and trusts) are eligible to claim the deduction.
- Effectively reduces the federal tax rate on pass-through income to eligible taxpayers to 29.6%.

QBI Deduction – In General

- Items excluded from QBI:
  - taxpayer's wages (or reasonable compensation)
  - guaranteed payments
  - investment-type income (capital gains, interest, dividends)

QBI Deduction – Calculation

- Subject to certain limits and thresholds, the deduction generally is the sum of:

a) The **lesser of**:
  - 20% of the taxpayer's QBI; or
  - The **greater of**:
    - 50% of the W-2 wages with respect to the business, or
    - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property.

b) Plus 20% of REIT dividends and distributions from publicly traded partnerships.

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QBI Deduction – Who Qualifies?

- Applies to any trade or business **other than**:
  - The trade or business of performing services as an employee; and
  - Any “specified service trade or business” (subject to taxable income threshold exception)

“Specified Service T/B” is any trade or business in the fields of:	
Health	Law
Accounting	Actuarial Science
Performing Arts	Consulting
Athletics	Financial Services
Brokerage Services	Services for investing, investment management, trading, dealing in securities/partnership interests/commodities
Any T/B where the principal asset is the reputation or skill of one ore more employees or owners	

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QBI Deduction – Limits

Total Taxable Income	Not Exceeding Threshold • Single - $157.5k • Joint - $315k	Service Business Phase-Out / W-2 Phase-in • Single: $157,501 to $207.5k • Joint: $315,001 to $415k	Over Threshold • Single - $207,501 • Joint $415,001
Specified Service Business • Front-of-Camera Loanout • Behind-the-Camera Loanout • Athlete Loanout	Full 20% deduction No W-2 / basis limit	20% deduction phased-out	No deduction permitted
Non-Specified Service Business	Full 20% deduction No W-2 basis limit	20% deduction subject to phase-in of W-2 / basis limit	20% deduction permitted, but fully subject to W-2 / basis limit

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QBI Deduction – Meaning of Reputation or Skill?

- Any business where the principal asset of the business is the reputation or skill of one or more employees or owners is considered a "specified service" business and is **not** eligible for the QBI deduction **unless** the taxpayer / partner / shareholder is under the specified income threshold.
- This test is incorporated by reference to IRC § 1202 (exclusion on gain from small business stock).
  - No Treasury Regulations
  - Legislative history is limited

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QBI Deduction – Meaning of Reputation or Skill? PLR 201436001

- Pharmaceutical company that specialized in commercialization of experimental drugs was engaged in QTB despite proximity of its business activities to field of health.
- Used its physical and intangible assets (manufacturing/clinical facilities, intellectual property) to (i) research drug formulation and effectiveness, (ii) conduct pre-commercial testing procedures such as clinical testing, and (iii) manufacture drugs.
- Company's successful performance of these activities in the past earned the company several valuable relationships in the pharmaceutical industry.

QBI Deduction – Meaning of Reputation or Skill?

- QTBs cannot be **primarily** within the specified service industries (e.g., health, law, performing arts).
- Thrust of IRC § 1202(e)(3) is that businesses are not QTBs if they **offer value to customers** primarily in the form of (i) **services** (providing hotel rooms) or (ii) **individual expertise** (law firm partners).
- Company found **not** to be in the business of offering service in the form of individual expertise.
- Instead, Company's activities involved the deployment of specific manufacturing assets and **intellectual property assets** to **create value for customers**.
- Although Company worked primarily in a component of the health industry (pharmaceuticals), it neither performed services in health industry, nor conducted any business activities within any other prohibited categories (including the principal asset / reputation or skill test).

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QBI Deduction – Who may qualify?

- Is a production company eligible for the QBI deduction?
  - If it owns the resulting produced content?
  - If it is engaged by a studio to produce content?
  - If eligible, consider payroll considerations for W-2 wage limit.
- Management companies?
- Agencies?
- Music Bands?
- Endorsement deals?
- Book authors?

QBI Deduction: Exception for Performing Services as an Employee

- A taxpayer that is in the trade or business of performing services as an employee is not a qualified trade or business and not eligible for the deduction.
- No clear guidance in legislation as to meaning of exception.
- Will lower income talent who form S-corporation loanouts to mitigate loss of itemized deductions be eligible for the 20% QBI deduction?

Choice of Entity

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Choice of Entity – Current Effective Tax Rates

As a result of the new lower corporate rate, should taxpayers reconsider their choice of entity?

	C-Corporation	Pass-Through w/o QBI*	Pass-Through w/QBI*
Federal Tax Rate	21%	37%	29.6% (effective)
California Tax Rate	8.84%	13.3%	13.3%
Dividend / Exit Tax Rate			
Federal	20% + 3.8% = 23.8%	0%	0%
California	13.3%	0%	0%
State/Local Tax Deduction	100%	Property taxes deductible, SALT income taxes not deductible	
Aggregate Effective Tax Rate (incl. state tax deduction)	65.08%	50.3%	42.9%

*Ignores entity level California tax rates (e.g., 1.5% net income tax for S-corporations and gross receipts tax for LLCs).

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Choice of Entity – Other Considerations

- Unavailability of employee deduction for unreimbursed business expenses
  - Lower-income talent considerations, past and present
  - Athlete considerations, past and present
- Rethinking use of a loanout
  - Generate business deductions otherwise denied under new law
  - QBI exception for trade or business of being an employee
- Executive loanouts
  - Section 269A considerations
  - Per se employee considerations

International Tax Considerations

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Tax Rate Changes

	Individual	Corporate
Tax Rates	37%	21%

Transition Tax

US Taxpayer

- Owns 10% of specified foreign corporations
  - Controlled Foreign Corporation (CFC), or
  - Foreign corporations with at least one C Corporation shareholder owning 10% or more
- Has accumulated deferred foreign income (net of deficits)
- Pay transition tax at the rate of:

	Individuals	Corporations
Cash	17.54%	15.5%
Other	9.05%	8%

Note: Individual rate is a presumption but not provided in the statute

- Installment payments available over 8 years:
  - Years 1 - 5: 18%
    Year 6: 15%
  - Year 7: 20%
  - Year 8: 25%

S corporations have a special exclusion from this tax unless have a liquidation event.

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Base Erosion and Anti-Abuse Tax (BEAT)

Individual

N/A

Corporate

- $500M of annual gross receipts (including affiliates)
- Essentially a minimum tax on the amount by which 10% of *modified taxable income* exceeds regular tax liability less some credits such as R&D.
- Modified taxable income is computed without taking into account certain related party payments which are considered base erosion payments.

Foreign Derived Intangible Income (FDII)

Applies **only** to Corporations

- A domestic corporation's FDII is 37.5% deductible in determining its taxable income, which results in a 13.125% effective tax rate. If deemed intangible income is zero or less, there is no benefit.

- Total Net Income of Domestic Corporation
  - Less:
    - Dividends or deemed dividends of a CFC
    - Income attributed to a foreign branch
    - 10% of corporation's tangible personal and real property
  - Equals Deemed Intangible Income

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Foreign Derived Intangible Income (Cont.)

- Foreign derived portion of deemed intangible income is income
  - From property (including intangible) sold, leased or licensed to a non US person for foreign use, or
  - From services provided by the taxpayer to any person or with respect to any property not in the US, even if services are provided in the US
- FDII = Deemed Intangible Income x Foreign-Derived Deduction Eligible Income/Deduction Eligible Income
- Taxed at 13.125% through 2025, and at 16.4% thereafter

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Global Intangible Low-Taxed Income (GILTI)

Applies to corporations **and** individuals

- Total Income of the CFC
- Less:
    - Effectively connected US trade or business income (already taxed)
    - Subpart F income of the CFC
    - Income taxed in foreign jurisdictions of at least 18.9%
    - 10% of corporation's adjusted basis of tangible and intangible property
- Equals GILTI

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Global Intangible Low-Taxed Income (Cont.)

Corporations:

- 2017-2025 10.5%, afterwards 13.125%
  - Less: 80% of any foreign tax on GILTI paid by CFC

Individuals:

- Taxed at ordinary rates unless elect to be treated as a corporation (watch double taxation)

Summary

C corporation benefits

- 21% tax rate on domestic corporations but less on certain income -
- 13.125% on foreign derived income
  - Includes income from films
  - Services by producer or distributor rendered in US for films produced or distributed outside US
- 100% Dividends Received Deduction for dividends from foreign owned corporations
- 10.5% tax (GILTI) on foreign income received from foreign owned corporations

C corporation risks

- Accumulated earnings tax (if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of 20%)
- Personal holding company tax (the personal holding company tax is imposed on the undistributed income of those C corporations that serve as vehicles to shelter passive income at 20%).
- Does not work if individual shareholder is a party to the contract so most talent will not qualify
- Double taxation on dividend distributions to individual shareholders

Bonus Depreciation / Section 181

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Bonus Depreciation

- Section 181 was not renewed, but may be extended to 2017.

- Under the new tax legislation, qualified film, television, and live theatrical productions are now eligible for 100% bonus depreciation <u>when placed in service</u> (phased out 2023 through 2026).

Bonus Depreciation

- Same definitions as Section 181, but no $15/$20 million limit.
- Qualified film or TV production
  - Any motion picture film or video tape (subject to exceptions) where 75% of the total compensation of the production is for services performed in the U.S. by actors, production personnel, directors, and producers (excluding participations and residuals) ("Qualified Compensation").
- Qualified live theatrical production
  - Any live stage production of a play (with or without music) which is derived from a written book or script and is produced or presented by a taxable entity in any venue which has an audience capacity of not more than 3,000 or a series of venues the majority of which have an audience capacity of not more than 3,000 if 75% of the total compensation of the production is Qualified Compensation.
  - Special rules for touring companies.

Bonus Depreciation: Qualified Property

- "Placed in service"
  - Qualified film / TV production – at the time of initial release or broadcast.
  - Qualified live theatrical production – at the time of initial live staged performance.
- May apply to acquired qualified property if (i) never used by the acquiring taxpayer, and (ii) generally acquired in a taxable transaction from an unrelated party.
- Effective Date
  - Applies to qualified property (i) acquired after September 27, 2017, and (ii) placed in service after such date.

California Tax Considerations

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CA Tax Considerations: Federal Deduction for State Tax

- Federal deduction for state income taxes paid generally capped at $10k.
- College Access Tax Credit
  - 50% tax credit on personal income taxes in exchange for contribution to College Access Tax Credit Fund.
  - Extended through 2022.
- California SB 227 – California Excellence Fund
  - 85% tax credit on personal income taxes in exchange for a contribution to a new California Excellence Fund (fund schools, road repairs, etc.).
  - Original proposal of 100% tax credit was amended amid concerns that a dollar-for-dollar tax break could more easily be challenged by the IRS.
  - Bill introduced in early January 2018, cleared the California Senate 27-7 and now moves to the Assembly.
  - *See http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB227.*

Other Considerations

Other Considerations

- Qualified Personal Service Corporations now subject to flat 21% federal tax (down from 35%)
- Deduction for meals and entertainment
  - Entertainment
  - Client meals
  - Business meals
- Deduction for qualified fringe benefits
- Deduction for transportation expenses
- Deduction for alimony payments
- Sexual harassment settlements

Other Considerations

- Rev. Proc. 2004-34 (advanced payments) is now codified
- $5m gross receipts test under IRC § 448 is increased to $25m
- No longer can carryback NOLs
- Loss Limitations
  - Use of flow-through losses is now limited to $250k (for individuals) and $500k (for married filing jointly).
  - Any disallowed loss is carried forward indefinitely as an NOL.
  - NOL is limited to offsetting 80% of taxable income.
  - Passive loss rules apply first.
- § 1031 is now limited to real estate (no longer applies to artwork, private jets, etc.)
- AMT, § 409A and election for capital gain on music copyrights retained

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Questions?