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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
July 16, 1999

CC:EBEO:4
WTA-N-103085-99
Number: **199936044**
Release Date: 9/10/1999
UILC: 404.04-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) CC:EBEO

SUBJECT: Film Participations and Section 404

This responds to your memorandum of February 2, 1999, in which you request our assistance concerning the proper tax treatment of participation payments made to talent by film and television production companies.

ISSUES:

You have asked us to address the following issues:

- (1) Are participation payments covered under the deferred compensation provisions of section 404(a) and (d) of the Code?
- (2) How does Transamerica Corp. v. United States, 999 F.2d 1362 (9th Cir. 1993), affect the analysis in (1)?
- (3) How does section 404 apply when participation payments are made to a personal service corporation formed by an actor or director (a "loan out" corporation)?
- (4) Does the "2½-month rule" of Treasury Regulation §1.404(b)-1T apply to each contract entered into with a producer, director, actor, or other service provider that provides for payments of participations?
- (5) How does section 404(a)(5) apply to a payor on a fiscal tax year when participation payments are paid to an actor who is a cash-basis calendar year taxpayer?

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CONCLUSIONS:

(1) For taxable years after the effective date of the 1986 amendments to section 404 (which applies to amounts paid or incurred after July 18, 1984), deferred contingent compensation arrangements providing for participation payments are covered by section 404(a)(5) of the Code (or section 404(d) in the case of a service provider that is not an employee). Under section 404(a)(5) or section 404(d), participation payments, if otherwise deductible, are deductible by the payor in the taxable year in which those payments are includible in the gross income of the recipient.

(2) The Transamerica case did not address section 404 and the taxable years in issue in that case were prior to 1984. For years subsequent to the effective date of the 1986 amendments to section 404, section 404 applies to participations.

(3) The applicability of section 404(d) to participation payments made to a personal service corporation would depend upon the particular facts and circumstances surrounding the arrangement. Section 404(d) would apply to a "plain vanilla" personal service corporation-- i.e., a personal service corporation that acts in the nature of a conduit for its owner, the individual service provider, in receiving the participation payments, but does not itself provide services apart from those of its owner.

(4) The "2½-month rule" of Treasury Regulation §1.404(b)-1T provides that section 404(a) applies to an arrangement under which compensation is received after the 15th day of the 3rd month after the end of the employer's taxable year in which the related services are rendered. For purposes of the 2½-month rule, each participation payment is analyzed separately to determine whether it is received within the 2½-month period. Whether the services provided by an actor, director, or other service provider in a particular taxable year were performed pursuant to a single contract or several different ones would not affect the application of that rule.

(5) Under section 404(a)(5), compensation paid after the 2½-month period is not deductible by the payor until the taxable year of the employer in which the payment is included in the recipient's income.

FACTS:

Income Forecast Method

Under the income forecast method, the taxpayer estimates the total net income a film will generate over its entire lifetime. Each year's depreciation deduction is then limited to a portion of the film's total cost that is determined by dividing that year's income by the total projected income of the film. This annual deduction limit may

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be expressed in a formula: the cost of the film multiplied by a fraction, the numerator of which is the income from the film for the taxable year and the denominator of which is the total forecasted income. Net income is defined as the gross receipts from the film, less distribution expenses. Durkin v. Commissioner, 87 T.C. 1329 (1986); see also Rev. Rul. 78-28, 1978-1 C.B. 61. Income and expenses from multiple films may be aggregated each year. Transamerica Corp. v. United States, 999 F.2d 1362 (9th Cir. 1993).

The income forecast method of depreciating motion pictures and television films is described in Rev. Rul. 60-358, 1960-2 C.B. 68. Section 1604 of the Small Business Job Protection Act of 1996 (P.L. 104-108) added section 167(g) of the Code, which codifies many of the pronouncements of the Service regarding the income forecast method and is effective for property placed in service after September 13, 1995.

Participations

In the motion picture industry, the fees paid to producers, directors, actors, and others for their services are commonly comprised of both a flat fee and a percentage of the film's future net profits or gross receipts. These percentage payments are known as "participations." In some cases, the producers, directors, actors, and others receiving participations are not employees of the payor, but rather are independent contractors.¹ Often, a personal service corporation formed by a producer, director, actor or other service provider receives the participations on behalf of that service provider.

LAW AND ANALYSIS:

Application of Section 404

In Transamerica, the Ninth Circuit considered whether the taxpayer, in computing the basis for each film produced, could include estimated participation payments. The Service, citing section 1012 of the Code, argued that the participations were contingent liabilities that could not be taken into account in determining depreciable basis until they became due and payable. The Ninth Circuit ruled that participations are "clearly costs of producing the film and not expenses incurred in the distribution," and that these items are properly included in the cost component of the income forecast formula. Transamerica did not consider the deferred compensation aspects of participations, and therefore did not address the

¹ We are not addressing in this memorandum the issue of when a service provider is an employee or an independent contractor. Rather, we are relying on your statement that in some cases the service providers may be independent contractors.

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application of section 404. The taxable years at issue in Transamerica were 1971-1973. Section 404 states, in pertinent part:

(a) General Rule. --If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

[Paragraphs 1 through 4 refer to specific types of plans and trusts and provide specific rules for deductions.]

(5) Other Plans -- If the plan is not one included in paragraph (1), (2), or (3), in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan....

(b) Method of Contributions, Etc., Having the Effect of a Plan; Certain Deferred Benefits.

(1) Method of contributions, etc., having the effect of a plan. -- If --

(A) there is no plan, but

(B) there is a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation...

subsection (a) shall apply as if there were such a plan.

...

(d) Deductibility of Payments of Deferred Compensation, Etc. to Independent Contractors. If a plan would be described in so much of subsection (a) as precedes paragraph (1) thereof (as modified by subsection (b)) but for the fact that there is no employer-employee relationship, the contributions or compensation --

(1) shall not be deductible by the payor thereof under this chapter, but

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(2) shall (if they would be deductible under this chapter but for paragraph (1)), be deductible under this subsection for the taxable year in which an amount attributable to the contribution or compensation is includible in the gross income of the persons participating in the plan.

Regulation § 1.404(b)-1T, Q&A-1 explains that under section 404(a)(5) and (b), if otherwise deductible under section 162 and 212,² a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is included in the gross income of the employee (without regard to any applicable exclusion under Chapter 1, Subtitle A, of the Code).

Regulation § 1.404(b)-1T, Q&A-2(a) provides that, for purposes of section 404(a), a plan, method or arrangement defers receipt of compensation to the extent it is one under which an employee receives compensation more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation are performed. Q&A-2(b) of that regulation further provides that a plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the third month after the end of the employer's taxable year in which the related services are rendered.

There appear to be two reasons why section 404 was not raised in Transamerica. First, prior to the addition of section 404(d) by the Revenue Act of 1978, section 404 applied only to deferred compensation of employees. Second, prior to amendment of section 404 in 1986, section 404 was limited to "expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income)...." Reg. § 1.404(a)-1(b). A motion picture is a capital asset, and the costs of its production are capital expenditures generally recovered under the income forecast method over the useful life of the film. Accordingly, production costs, including compensation paid to actors, directors, writers, etc., represent capital expenditures recoverable by depreciation deductions under section 167 rather than expenses deductible under section 162. Thus, prior to the 1986 amendment, it appears that section 404 was

² The regulations refer to deductibility under sections 162 and 212 (rather than "otherwise deductibility") because they were published before technical corrections of section 404 were enacted in 1986. The technical corrections apply retroactively to amounts paid or incurred after July 18, 1984, in taxable years ending after that date.

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irrelevant to compensation included in film production costs for depreciation under the income forecast method.

Participations are a form of compensation, because they are payment to the actor, director, or other service provider for rendering a service to the payor.³

For years prior to the effective date of the 1986 amendments to section 404 of the Code, the language of section 404 appears to have precluded its application to participations.⁴ For years after the effective date of the 1986 amendments, it is clear that section 404 would apply.⁵

The Senate Committee Report on the 1986 amendment of section 404 states:

The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction of such deferred compensation. [Emphasis added].

S. Rep. No. 313, 99th Cong., 2d Sess. 1013 (1986).

Thus, for tax years after the effective date of the 1986 amendments, participations that are paid directly to employees would generally be governed by section 404(a)(5). Under section 404(a) and (b), a contribution paid or incurred with

³ We understand that participations in films may sometimes be paid to a person for property rights rather than for services. For example, participations may be paid to a writer of a book in exchange for movie licensing rights. To the extent that participations in films are not granted in exchange for services, they are not compensation for services and so are not subject to the section 404 rules for deferred compensation.

⁴ GCM 36590 (February 12, 1976) states that participations are not deductible under Code section 404(a)(5), but rather are a capital cost that are included in basis for purposes of the income forecast method of computing depreciation under section 167.

⁵ We are not addressing here the effect of the 1986 amendments upon participation agreements that span years both prior to and subsequent to the effective date of the 1986 amendments.

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respect to a nonqualified plan, or method or arrangement, is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusion under chapter I, subtitle A, of the Code).

Deduction for payment of participations to individual independent contractors would generally be governed by section 404(d), so the result is the same as for participations paid to employees.

While we conclude that section 404 applies to participations, and that therefore participations are not deductible by the taxpayer prior to the year in which they are includible in the gross income of the recipient, we have not yet determined how section 404 might interact with section 167 in this context. One approach would be that participations are includible in the cost basis of films for purposes of the income forecast method of calculating depreciation deductions under section 167 at the time that they become deductible under section 404. However, we are not prepared at this time to say that such a conclusion is required. Rather, we will be happy to work with Passthroughs and Special Industries in resolving that issue.

Payments To Corporate Service Providers

Whether participations paid to a corporate service provider are governed by section 404 is a more complex issue. In this regard, the legislative history of the addition of section 404(d) by the Revenue Act of 1978, P.L. 95-600, indicates that Congress did not intend to limit section 404(d) to compensation paid to individuals:

The bill adds a new provision (sec. 404(d)) which denies a deduction for deferred compensation provided under a nonqualified plan to non-employee participants, including cash-basis corporations, until that compensation is includible in the gross income of participants.

H. Rept. No. 95-1445 (on H.R. 13511), 95th Cong., 2d Sess. 61 (1978). See also, S. Rept. No. 95-1263 (on H.R. 13511), 95th Cong., 2d Sess. 73-74 (1978); Staff of the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Cong., 2d Sess. 77 (1979)).⁶

⁶ It is not clear why the legislative history refers specifically to cash-basis corporations. Congress may have been less concerned with applying section 404(d) where corporate service providers use the accrual method, because generally the normal rules for accrual of their income would suffice to achieve the matching with service recipient deductions that is the goal of section 404(a)(5).

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In view of the scant authority, the applicability of section 404 to participation payments made to a corporate service provider should be considered in light of the particular facts and circumstances surrounding the arrangement, including the specific contract provisions relating to the participation payments, the nature of the services provided by the corporation and the individual workers, and the extent to which the corporation may be acting in the nature of a conduit for the individuals in receiving the participation payments. Generally, we believe that section 404(d) would apply to a "plain vanilla" personal service corporation -- i.e., a personal service corporation that acts in the nature of a conduit for its owner, the individual service provider, in receiving the participation payments, but does not itself provide services apart from those of its owner.

Application of the "2½-Month Rule"

Pursuant to Regulation § 1.404(b)-1T, Q&A-2, section 404(a) applies to an arrangement under which compensation is received after the 15th day of the 3rd month after the end of the employer's taxable year in which the related services are rendered. (Emphasis added). Thus, the application of the "2½-month rule" is based upon the taxable year in which the services giving rise to the payment of the compensation are rendered, and when the payment is received.

You have asked whether the "2½-month rule" of Treasury Regulation §1.404(b)-1T applies to each contract providing for participation payments. In conversations with this office, you have explained that your question relates to whether, when a series of participation payments are made based upon the same contract, all of those participation payments are considered deferred compensation if one of the payments is paid after the end of the 2½-month period. For purposes of section 404, each participation payment would be analyzed separately to determine whether it is deferred compensation. The determinant factor is when the participation payment is received. For example, if a producer with a calendar taxable year made participation payments to an individual actor on February 28, March 31, and April 30, 1999, for work performed during 1998, the February 28 payment is not treated as deferred compensation and could be deducted as early as 1998, but the March 31 and April 30, 1999, payments are treated as deferred compensation and cannot be deducted by the producer under section 404 until 1999. That result is the same regardless of whether each of the payments is made pursuant to a different contract, or whether all of the payments are made pursuant to the same contract.

You also ask how section 404 applies to a payor on a fiscal tax year. For example, a production company with a fiscal year ending June 30 releases a film on May 1, 1994, that was started and completed during the previous four months. Pursuant to a contract with an actor, participation payments are made on June 15, 1994, August 15, 1994, October 15, 1994, and July 15, 1995. Assuming that the actor is

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a cash-basis calendar year taxpayer, you ask in which fiscal years would the above four payments be deductible by the production company.

In your example, the production company's taxable year in which the services relating to the participations are rendered is the taxable year ending June 30, 1994. The participation payment made on June 15, 1994, is made and is deductible by the production company in that taxable year. The payment made on August 15, 1994, is paid within the 2½-month period, and therefore is not treated as deferred compensation under regulation § 1.404(b)-1T. Accordingly, the August 15, 1994, payment is deductible by the production company in its taxable year ending June 30, 1994. The October 15, 1994, and July 15, 1995, payments are considered deferred compensation subject to section 404(a)(5) (or section 404(d)) because they are paid after the end of the 2½-month period. The October 15, 1994, payment is included in the recipient's income for the calendar year ending December 31, 1994, and is deductible by the production company in its taxable year ending June 30, 1995. Finally, the July 15, 1995, payment is deductible by the production company in its taxable year ending June 30, 1996 because it is included in the recipient's income for the calendar year ending December 31, 1995.

We hope that the above information will be helpful to you. If you have any questions, please call (202) 622-6060.

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