

Entertainment, Media and Communications Tax Newsletter*

A summary of selected tax developments for clients of the firm

Technical topics in this issue:

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State film tax incentive environment remains positive

The difficult economy of the past year has put a huge strain on budgets in many states. The budgetary pressure has caused some of them to consider whether they can afford their tax credit and incentive programs, including film and television production incentives. Furthermore, the weak financial position of many states has made funding independent film production more problematic, as many conventional banks either do not want to risk financing a production where the state incentive might be pulled or are mitigating their financing risk by charging high fees and interest rates.

Despite widespread publicity about several states considering either eliminating or curtailing their film production tax incentive programs, the state tax incentive environment for film production remains positive, with limited exceptions.

Of the 43 states (plus the District of Columbia) that offer film production tax incentives, two (Iowa and Kansas) have suspended their programs within the past year. Most other states are standing by their programs and making concerted efforts at increasing the efficiency of their tax incentives. Some states are expanding incentives.

Two film program suspensions:

In a well-publicized development, Iowa suspended its film production incentive program in September 2009 amid claims of mismanagement and abuse of the program. The state attorney general opened a criminal investigation, which is ongoing. The suspension was lifted in November 2009, and companies who had projects in process were given the option to continue in the program. However, no new projects are being registered until the governor and Legislature have the opportunity to review and re-evaluate the program this year.

In January 2010, a seven-member Tax Credit Review Panel, appointed by the Iowa governor, issued a report on its in-depth review of existing tax credits, including the film tax incentive program. The report recommends that the state eliminate its film production tax credit, citing improper management among its reasons. While the report made recommendations for increased transparency, a capping of benefits, and a five-year sunset provision to provide for greater accountability of the other tax credits, it also acknowledged that tax credits can be an effective tool when properly administered with full accountability.¹

The other state that suspended its film tax credit in the past year is Kansas. In May 2009, Kansas enacted a two-year suspension of its film production tax credit program for tax years 2009 and 2010. Any film production credits that were earned prior to tax year 2009 may be carried forward to 2011, but none of the film production credits will be allowed against tax years 2009 and 2010 tax liabilities. This suspension was imposed as part of a broader legislation that temporarily reduced many other tax credits to enable the state to meet its budgetary needs.²

But many more continuations and expansions of film programs:

Other states, however, after considering their budgetary needs and, in some cases, evaluating the effectiveness of film tax incentives, lauded the benefits of their programs, and some even increased their incentives despite the difficult economy.

A few examples:

- Michigan, which provides some of most generous state film tax incentives with a refundable, assignable tax credit of up to 42 percent of qualifying direct production expenses, retained its film production incentive program in its 2009 budget after the Legislature debated about the program's advisability. The Michigan Film Office in its 2008 report on the effectiveness of the program claims that the completed projects as of February 3, 2009, generated \$125 million of Michigan expenditures.
- In 2009, Louisiana increased its film production tax credit from 25 percent to 30 percent and eliminated the phase-down of its tax credit program.
- In California, despite that the California Film Commission has run through its limited allocated funding through June 2010, Governor Arnold Schwarzenegger has announced that the state's film program has generated more than \$710 million of additional production spending this fiscal year.

¹ State of Iowa Tax Credit Review Report, January 10, 2010

² Kansas Department of Revenue, Office of Policy and Research, Notice 09-09, 2009 HB 2365

- In his 2010 budget, Governor David Paterson of New York has called for expanding the state's film tax credit funding to \$420 million from \$350 million and extending the program through 2014.
- In New Jersey, Governor Chris Christie's Transition Team, Subcommittee on Economic Development & Job Growth, has recommended an expansion of the state's tax credit caps to \$50 million for film and \$10 million for digital media.
- In New Mexico, despite recent failed legislative initiatives to curtail the state's film incentives, Governor Bill Richardson continues to tout the state's film incentive program, indicating that since 2003, the program has generated an estimated \$3 billion in economic benefits for the state and 10,000 direct and indirect film-related jobs.

In summary, while many states are facing budget problems, few have been cutting back on their film tax incentives as a way to close the budget gap. To the contrary, many governors and legislatures are viewing the film industry as a growth business in their state and have used the continuation or expansion of state film tax credits as a mechanism that they hope will create local jobs. However, as pressure builds in some states to balance budgets, entertainment, media and communications (EMC) companies will need to continue to monitor whether film tax credit incentives will survive intact.

Will recent IRS guidance require EMC companies to reconsider tax deduction for year-end accrual of bonuses?

A recent IRS chief counsel advice memorandum (CCA) illustrates issues that can arise as to whether, and to what extent, bonuses may be accrued for tax purposes.

In CCA 200949040, the IRS ruled that a taxpayer could not take into account employee bonuses accrued at year-end because the employees were required to be employed in the following year when the bonuses were paid. The IRS concluded that this requirement prevented the liability from being established before year-end.

Background

EMC companies that offer bonuses to employees generally accrue the bonuses during the year the related services are performed even though they anticipate paying the bonuses the following year. For tax purposes, an accrual-method taxpayer generally may take bonuses into account in the year accrued if two requirements are met:

- First, the taxpayer's liability for the accrued bonuses must satisfy the requirements of section 461, which generally allows a liability to be taken into account to the extent all of the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy (the "all-events test"), and economic performance (in this case the provision of services) has occurred with respect to the liability.
- Second, the accrued bonuses must be paid within 2.5 months after year-end (the "2.5-month rule") to avoid being characterized as deferred compensation under section 404.

When determining the amount of the deduction for accrued bonuses, EMC companies may focus on the 2.5-month rule and may place less emphasis on the all-events test, even though the latter is a threshold determination that must be met regardless of whether the bonuses are paid within 2.5 months. In particular, companies should ensure that their liability for the accrued bonuses is fixed at year-end before considering the application of the 2.5-month rule.

The CCA

The facts in the CCA state that the taxpayer accrued bonuses during the year the related services were provided. Under the taxpayer's bonus plan, in order to receive the bonuses, employees were required to be employed on the date the bonuses were paid, which occurred after year-end. The CCA states that any amount not paid to an individual because he or she was not employed at the payment date was forfeited and reverted back to the taxpayer.

The taxpayer filed a Form 3115, Application for Change in Accounting Method, requesting to change its method of accounting for accrued bonuses effective in year 1.

Consistent with section 461, the taxpayer proposed to take accrued bonuses into account in the year that the related services were provided to the extent that all events occurred to fix the liability, the amount of the liability could be determinable with reasonable accuracy, and economic performance had occurred with respect to the liability.

Under the proposed method, the all-events test would not be met and economic performance would not occur until the bonuses were deemed paid under section 404 (relating to the 2.5-month rule). In its response to Form 3115, the IRS granted the taxpayer's request. Accordingly, the taxpayer implemented the new method of accounting in year 1. In addition, the taxpayer also formally obligated itself to pay 90 percent of the accrued bonus amount for financial statement purposes to employees within 2.5 months of year-end. Any amount not paid to employees would be paid to a charity as a contribution. However, according to the IRS, no such charitable contribution was made.

IRS analysis

The IRS determined that the taxpayer's bonus plan did not fix its liability at the end of year 1 under the all-events test as a result of the requirement that employees be employed by the taxpayer on the payment date. According to the IRS, this requirement created a contingency — services were required to be performed after year-end — and the taxpayer's liability to pay the bonuses could not be considered fixed until the contingency was satisfied, which occurred if the individual was employed on the date the bonus was paid.

Moreover, the IRS stated that while the bonuses may be based on the taxpayer's performance in year 1, economic performance does not occur and the liability is not fixed until the date that the bonuses are paid because service must continue until that time. The IRS also determined the taxpayer was not entitled to a charitable contribution under its bonus plan because the taxpayer did not make any charitable contribution pursuant to such plan.

(Note: Under section 170, a taxpayer may take a charitable contribution into account for a year if the board of directors authorizes such contribution during that year and the contribution is made within 2.5 months of year-end.)

IRS conclusion

The IRS concluded that the taxpayer's obligation at the end of year 1 to pay 90 percent of the amount accrued to employees, with any amount not going to an employee being paid to a charity, did not sufficiently fix the taxpayer's liability for purposes of the all-events test. According to the IRS, the timing rules for taking into account accrued bonuses and charitable contributions differ, and, in any event, the IRS stated that no forgone bonuses were contributed to a charity.

The IRS maintained its position that the bonuses could not be fixed because of the employment contingency. According to the IRS, the taxpayer did not know at the end of year 1 whether it owed a bonus to any employee. As a result, the IRS concluded the taxpayer's liability for accrued bonuses must be taken into account for tax purposes in the year the bonuses are paid rather than the year accrued.

Observations

Case law provides that if a taxpayer has a legal obligation to pay an amount at year-end, the liability is fixed at year-end regardless of whether the taxpayer has identified the payee of that amount. Second, case law also suggests that a company can meet the all-events test at year-end by committing itself before year-end (e.g., by a board resolution) to pay a bonus that is fixed in amount or is determinable under a fixed formula.

However, the application of the case law must be carefully applied to the specific facts and circumstances of each bonus program to determine the proper timing of the deduction.

The issuance of this CCA highlights the issue of whether accrued bonus liabilities are fixed at year-end, and may prompt IRS agents to begin focusing on this issue during examinations. As a result, EMC companies should consider mitigating any potential exposure relating to bonus plans for prior years by filing a request for an accounting method change, which generally would qualify for automatic consent under Rev. Proc. 2008-52.

Moreover, a change in method of accounting generally would provide an EMC company with audit protection for erroneously accrued bonus amounts in prior years, and allow the company to spread the unfavorable section 481(a) adjustment into income ratably over four tax years. By contrast, if the issue is raised and sustained by the IRS, an unfavorable section 481(a) adjustment generally would be taken into account entirely in the earliest open year.

Additionally, EMC companies also may be able to take into account a liability for accrued bonuses by changing the terms of their bonus plans to meet the all-events test by year-end.

State tax issues related to extended federal NOL carryback rules

The Worker, Homeownership, and Business Assistance Act of 2009 (H.B. 3548, enacted November 6, 2009) allows qualifying taxpayers to elect to carry back net operating losses (NOLs) incurred in 2008 or 2009 for up to five tax years. The extended carryback provisions are not available to all companies (such as Troubled Asset Relief Program (TARP) recipients or members of a TARP recipient's affiliated group). However, most EMC companies should be able to take advantage of the extended NOL carryback rule. The carryback election must be made by the due date of the return for the taxpayer's last year beginning in 2009, and is irrevocable.

While the extended carryback period may provide significant benefits at the federal level, EMC companies should be aware of the state tax implications.

EMC companies with a multistate presence should determine how an extended federal NOL carryback election may affect state tax liabilities. That determination should consider potential state nonconformity to the extended federal NOL carryback period that may result from differences in Internal Revenue Code conformity dates or state-specific legislation regarding the utilization of NOLs. In addition, differences in federal and state return filing methods may limit the benefit of NOL carrybacks.

Nonconformity — the norm for NOLs

States face unique challenges deciding whether to conform to federal provisions intended to stimulate the economy. Unlike the federal government, which can run deficits, nearly all states must maintain balanced budgets. Accordingly, states often choose not to conform to changes in the Internal

Revenue Code (the code) that have the potential to reduce tax revenue. Bonus depreciation and more generous NOL utilizations are a few recent examples of tax benefits created by the federal government to stimulate the economy to which many states do not conform.

The most common way for states to limit the impact of federal tax changes on state revenue is to adopt the code, in whole or in part, as of a fixed date. This "fixed date" conformity may eliminate some or all of the costs associated with federal provisions intended to reduce taxes, especially where the benefit is tied to transactions that occur in a specific year. Another common method is to "decouple" selectively from newly enacted provisions.

For the minority of states that allow NOL carrybacks, EMC companies should be aware of states that make adjustments to federal taxable income. These adjustments may transform a federal loss into state taxable income, eliminating the state carryback opportunity. Alternatively, there may be state adjustments that transform federal taxable income into a loss for state purposes, creating a state refund and carryback opportunity.

Differences in federal and state NOL provisions

In an attempt to eliminate the need to adopt one-off provisions to limit the effect of federal tax changes, a number of states permanently decouple from provisions that have the potential to wreak havoc on a budget. The most common example is in the area of NOLs — almost 30 states have state-specific NOL provisions that prohibit the carryback of an NOL, while a number of others cap the amount of NOL that can be deducted in a carryback year. States such as California, Kentucky, Tennessee, and Wisconsin prohibit NOL carrybacks. Other states limit the amount of carryback deduction that can be claimed in a year, such as New York (\$10,000), Delaware (\$30,000), Idaho (\$100,000), West Virginia (\$300,000), and Utah (\$1 million). States also may limit the carryback period as a result of their code conformity date. For example, while Virginia adopts the federal NOL carryback period because it adopted the code as of December 31, 2008, provisions in H.B. 3548 that allow taxpayers to carry back 2008 or 2009 NOLs for a period of up to five tax years do not, absent legislative action, apply for Virginia tax purposes. Accordingly, while a taxpayer could see a refund of tax at the federal level in one of the extended carryback years, it may not see comparable refunds of previously paid state taxes.

Differences in federal and state NOL provisions are likely to create recordkeeping challenges. Taxpayers must run separate calculations regarding the amount of NOL carryover available for federal and state purposes, and the years in which a deduction may be claimed. The NOL carryover issue may be complicated further by the differences in federal and state return filing methods, such as when a group files a consolidated return for federal purposes but is required to file on a separate, combined, or consolidated basis at the state level.

States with unique tax systems

The Michigan Business Tax (MBT) is imposed on two bases — modified gross receipts and business income. The business income portion of the MBT allows taxpayers to claim a "business loss" deduction on a carry-forward basis only, as loss carrybacks are not allowed. The Michigan business loss is in lieu of the federal NOL.

As of January 1, 2008, Texas imposes a margin tax based on modified gross receipts. Texas allows a temporary credit (20 years) against the margin tax for business loss carryovers, not already utilized in computing tax under the prior franchise tax, which was computed in part using taxable income. The margin tax does not consider NOLs in computing the tax base.

Ohio imposes a Commercial Activity Tax (CAT), which was fully phased in for tax years ending in 2009 and later. The CAT is based on receipts from commercial activity conducted in Ohio, rather than net income. Accordingly, NOLs are not considered in computing the CAT base.

Other state considerations

One of the biggest areas of concern for EMC companies is the possibility that a state may view the filing of an amended return to claim an NOL carryback as an opportunity to audit a return for other issues, such as intercompany deductions and apportionment methods. Given their dire fiscal position, some states may try to limit refunds by finding offsets in other areas. Factors such as these should be given strong consideration when amending returns, especially when certain tax positions are taken on a return.

In summary, state and local tax considerations related to the extended federal NOL carryback will differ based on a taxpayer's specific facts. Accordingly, EMC companies are strongly advised to consider differences between state and federal NOL provisions, including state-specific limitations on the number of years an NOL may be carried back. Differences in code conformity dates, return filing methods, apportionment provisions, and NOL deduction caps likely will complicate the analysis of the impact of the extended federal NOL carryback period for some state taxpayers. In addition, taxpayers that file amended returns to claim NOL carrybacks should be cognizant of the potential for state administrators to view the filings as an opportunity to review other return issues. Although the extended NOL carryback may provide federal tax benefits, state and local income tax implications must be examined and factored into the assessment of overall benefits.

LMSB designates "repairs versus capitalization" as a Tier I issue

On January 22, 2010, the IRS Large and Mid-Size Business Division issued two directives elevating the "repairs versus capitalization" change in accounting method issue to Tier I status. The significant rise in the number of companies, especially in the telecommunications industry, filing to change their accounting method for certain expenditures as repairs instead of as capitalized items has led the IRS to scrutinize these expenditures. While these directives are aimed at companies that filed these method changes, they may result in increased audit activity for others as well.

Industry Director's Directive #1 (IDD #1) provides direction to agents in examination of companies that have changed their method of accounting to re-characterize previously capitalized expenditures under section 263(a) as deductible repairs and maintenance expenditures under section 162. Industry Director's Directive #2 (IDD #2) emphasizes that examiners are not prevented from auditing the issue of whether certain expenditures are deductible repairs when a taxpayer has received either automatic consent for such change under Appendix sec. 3.06 of Rev. Proc. 2008-52 or received consent for a change filed under Rev. Proc. 97-27.

During the past 18 months, a significant number of companies in almost all industries, including the telecommunications industry, have filed for repairs accounting method changes. Due to the widespread nature of this issue and the substantial factual component of a repair versus capitalization analysis, the directives and accompanying Tier I status are not a surprise. IDD #1 directs exam agents first to ascertain whether the company's determination of its Unit of Property (UOP) and its application of the UOP to specific expenditures are correct. The focus on UOP also is not a surprise because the UOP determination plays an important role in whether expenditures should be deductible or capitalized.

IDD #1

IDD # 1 observes that a UOP determination is among the first steps that affect the treatment of expenditures. Because the UOP determination varies based on the type of property and industry, the IDD suggests the following groupings:

- UOP issues present in all industries (for example, buildings and structural improvements)
- Regulated industries with network assets such as the utilities, telecommunications, and railroad industries
- Remodeling and renovation issues present in the gaming, retail, restaurant, and hotel industries

In determining whether an expenditure is a deductible repair or must be capitalized, exam agents are directed to apply sections 263(a), 263A, and 162 as well as current case law and IRS rulings. However, agents are directed not

to cite or rely on the proposed tangible asset regulations issued in March 2008 until they are issued in final format. Pursuant to IDD #1, exam agents "must contact the appropriate industry or capitalization technical advisers for assistance in developing the issue." IDD #2, seemingly contrary to IDD #1, provides that "the determination[s] that specific costs qualify for deduction or capitalization under current law are decisions left to field examiners."

Although repairs versus capitalization is now a Tier I issue, indicating control and tracking of the issue by LMSB's issue owner and issue management team, there appears to be room for independent thinking and action by the field. IDD #2 allows field examiners to make decisions. However, based on experience with Tier I issues, it is unclear how much independent decision-making field examiners will have.

Finally, IDD #1 solicits Industry Issue Resolution (IIR) requests for the retail/restaurant, utility, and telecommunications industries. The IIR program was created to resolve frequently disputed or burdensome tax issues that affect a large number of companies within a given industry. This may be a platform for the telecommunications industry to minimize the effect of these directives.

IDD #2

IDD #2 specifically applies to companies that have been granted an accounting method change request under either Appendix sec. 3.06 of Rev. Proc. 2008-52 or Rev. Proc. 97-27, and emphasizes that an examiner may audit the issues discussed above even though the taxpayer may have been granted IRS consent to change its method of accounting.

IDD #2 directs exam agents to ascertain whether the company's determination of its UOP and the application of that UOP to specific expenditures are correct. In addition, examiners may challenge any factual representations made by a company in requesting the method change as well as other matters relevant to a taxpayer's repair versus capitalization method.

Summary

As stated earlier, the IDD's appear to address specifically companies that have changed their methods of accounting to recharacterize previously capitalized expenditures under section 263(a) as deductible repairs and maintenance expenditures under section 162. While the IDD's are not directly applicable to companies that did not change their method of accounting, the Tier I status of this issue may cause examining agents to inquire about the current methods of accounting for repairs for all companies.

Recommended reading:

**Change is in the air
2009 Wireless Industry Survey**

<http://www.pwc.com/us/en/industry/communications/publications/2009-North-American-wireless-industry-survey.jhtml>

Point of View: Wireless Customer Profitability

<http://www.pwc.com/US/en/point-of-view/wireless-customer-profitability.jhtml>

Entertainment & Media M&A insights: Analysis and trends in US M&A activity 2010

<http://www.pwc.com/us/en/transaction-services/publications/ts-insights/entertainment-media-ma-activity-2010.jhtml>

Communications Review: A journal for telecom, cable, satellite, and Internet executives

www.pwc.com/communicationsreview

EMC Perspectives: Technical accounting guidance for entertainment and media companies;

- Film-financing and passive investor arrangements (Volume 1)
- Revenue recognition matters unique to the motion picture industry (Volume 2)
- Filmed entertainment: Cost capitalization, amortization, and impairment (Volume 3)

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