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Preface

KPMG LLP’s (KPMG) Film Financing and Television Programming: A Taxation Guide, now in its sixth edition, is a fundamental resource for film and television producers, attorneys, tax, and finance executives involved with the commercial side of film and television production. The guide is recognized as a valued reference tool for motion picture and television industry professionals. Its primary focus is on the tax and business needs of the film and television industry with information drawn from the knowledge of KPMG International’s global network of media and entertainment Tax professionals.

KPMG published the first guide more than 15 years ago as a resource for global coverage of incentives and tax updates as they apply to the film and television industry. Subsequent editions expanded into coverage of financing techniques, credits/incentives, and a thorough appendix of withholding tax rates—a valuable reference tool for all finance and tax professionals.

Each chapter of the sixth edition focuses on a single country and provides a description of commonly used financing structures in film and television, as well as their potential commercial and tax implications for the parties involved. Additionally, the United States chapter focuses on both federal and state incentives, highlighting the states that offer the more popular and generous tax and financial incentives. Key sections in each chapter include:

Introduction
A thumbnail description of the country’s film and television industry contacts, regulatory bodies, and financing developments and trends.

Key Tax Facts
At-a-glance tables of corporate, personal, and VAT tax rates; normal non-treaty withholding tax rates; and tax year-end information for companies and individuals.

Financing Structures
Descriptions of commonly used financing structures in film and television in the country and the potential commercial and tax implications for the parties involved. The section covers rules surrounding co-productions, partnerships, equity tracking shares, sales and leaseback, subsidiaries, and other tax-effective structures.

Tax and Financial Incentives
Details regarding the tax and financial incentives available from central and local governments as they apply to investors, producers, distributors, and actors, as well as other types of incentives offered.

Corporate Tax
Explanations of the corporate tax in the country, including definitions, rates, and how they are applied.
Personal Tax
Personal tax rules from the perspective of investors, producers, distributors, artists, and employees.

Appendices
Additionally, withholding tax tables setting forth the non-treaty and treaty-based dividend, interest, and film royalty withholding tax rates for the countries surveyed are included as an appendix and can be used as a preliminary source for locating the applicable withholding rates between countries.

KPMG and Member Firm Contacts
References to KPMG and KPMG International member firm contacts at the end of each chapter are provided as a resource for additional detailed information.

The sixth edition of KPMG’s Film and Television Tax Guide is available in an online PDF format at www.kpmg.com/filmtax and on CD. The guide is searchable by country.

Please note: While every effort has been made to provide up-to-date information, tax laws around the world are constantly changing. Accordingly, the material contained in this book should be viewed as a general guide only and should not be relied upon without consulting your KPMG or KPMG International member firm Tax advisor.

Finally, we would sincerely like to thank all of the KPMG International member firm Tax professionals from around the world who contributed their time and effort in compiling the information contained in this book and assisting with its publication. Production opportunities are not limited to the 35 countries contained in this guide. KPMG and the other KPMG International member firms are in the business of identifying early-stage emerging trends to assist clients in navigating new business opportunities. We encourage you to consult a KPMG or KPMG International member firm Tax professional to continue the conversation about potential approaches to critical tax and business issues facing the media and entertainment industry.

Thank you and we look forward to helping you with any questions you may have.

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January 2012
**Introduction**

The United States is the world’s leader in film production, distribution, and technology. The United States film industry should continue to maintain its role as the international center of film production in the 21st century.

**Key Tax Facts**

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<th>Tax Category</th>
<th>Rate</th>
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<tbody>
<tr>
<td>Highest effective corporate personal income tax rate</td>
<td>35% *</td>
</tr>
<tr>
<td>Highest personal income tax rate</td>
<td>35% *</td>
</tr>
<tr>
<td>Normal non-treaty withholding tax rates: Dividends</td>
<td>30%</td>
</tr>
<tr>
<td>Interest</td>
<td>30%</td>
</tr>
<tr>
<td>Royalties</td>
<td>30%</td>
</tr>
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</table>

**Tax year-end:**

Companies may choose their own tax year-end subject to certain limitations; Individuals utilize a calendar year unless they maintain appropriate books and records for a fiscal year.

* In addition to the above federal tax rates, state and municipal taxes may be imposed ranging from 0 to 12 percent.

**Film Financing**

**Financing Structures**

**Co-Production**

A U.S. resident investor may enter into a joint arrangement with a non-U.S. investor to finance and produce a film in the U.S. Under a co-production structure, each investor contributes funds to the project commensurate with its anticipated benefits from the exploitation of the film. The rights to exploit the film may be allocated to the partners according to their respective territories, with the remaining territories being divided or held jointly among the parties according to mutual agreement.

Where the investors contribute funds to, and share in the profits of, the project, the co-production will generally be characterized as a partnership for U.S. tax purposes. Generally, a partnership itself is not subject to federal income tax. In addition, many co-productions are carried on through a limited liability company (LLC), which can elect to be taxed as either a corporation or a partnership, the latter being the more common choice. Certain state and municipalities,
however, may levy a tax on the partnership. For example, California levies an annual tax of US$800 on limited partnerships and LLC’s. California also assesses an annual fee based on an LLC’s gross receipts up to maximum of US$11,790. The discussion below regarding partnerships and the taxation of partners applies where the co-production is characterized as a partnership.

A significant concern in a co-production that is characterized as a partnership is whether the non-U.S. investor is considered to be engaged in a trade or business in the U.S. A 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. Such a non-U.S. investor generally must file a U.S. income tax return reporting his distributive share of such income and pay the tax due on that amount. If considered engaged in a U.S. trade or business a non-U.S. investor is required to file a federal income tax return even though the non-U.S. investor may have no income effectively connected to the U.S. trade or business or the income is exempt under the terms of a tax treaty. In such cases the federal tax return may be limited in scope. If the non-U.S. investor is resident in a treaty country, the co-production partnership must be engaged in a trade or business through a permanent establishment before the partner is subject to federal income tax on his distributive share of the partnership’s income that is attributed to the permanent establishment. Non-U.S. corporate investors may be subject to a branch profits tax and branch tax on interest at a statutory rate of 30 percent. These taxes can be reduced or eliminated by treaty in many cases.

Under certain circumstances, the co-production may not constitute a partnership for U.S. tax purposes. For example, if the co-production is conducted by a U.S. corporation, the corporation itself is subject to federal income tax, and the investors are subject to tax on dividends received (subject to potential treaty relief for non-U.S. investors) from the U.S. corporation. If the co-production is conducted by a non-U.S. corporation, U.S. investors will be concerned with an assortment of U.S. tax provisions, including, for example, the subpart F rules and the passive non-U.S. investment company rules, which may require a U.S. shareholder to report and pay tax on certain income of the non-U.S. corporation in the year that the income is earned (rather than, in a later year, when it is distributed to the shareholder as a dividend). Double taxation of the activity’s income also is a risk if the foreign tax authority does not view the arrangement as a partnership.

A co-production also may be structured as a “cost-sharing arrangement.” Under such an arrangement, the co-production is not treated as a partnership for U.S. tax purposes, and a non-U.S. investor is not treated as engaged in a U.S. trade or business solely by reason of its participation in the cost sharing arrangement. Under a cost-sharing arrangement, the U.S. and
non-U.S. investors split the production cost in proportion to their respective share of the reasonably anticipated benefits from the film rights developed under the cost sharing arrangement. Temporary Treasury Regulation Section 1.482-7T issued in January 2009 provides detailed rules governing cost sharing arrangements.

Assuming a U.S. participant in a cost sharing arrangement is entitled to only the U.S. distribution rights under the terms of the cost sharing arrangement, the U.S. participant is subject to federal income tax on profits arising from the exploitation of the film in the U.S. Assuming a non-U.S. participant in a cost sharing arrangement retains only the non-U.S. distribution rights and has no U.S. trade or business, such investor should not be subject to U.S. federal income tax upon distribution of the film outside the U.S.

The following are examples of relief available under selected treaties (assuming business profits are attributable to a U.S. permanent establishment and interest, dividends and royalties are not attributable to a U.S. permanent establishment):

<table>
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<tr>
<th>Country</th>
<th>Description</th>
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<tbody>
<tr>
<td>U.K.</td>
<td>Branch profits tax rate generally is 5% and some U.K. companies are exempt. (Article 10). Interest withholding tax eliminated (Article 11). U.S. income tax on business profits creditable against U.K. tax (Article 24); Royalty withholding tax eliminated. (Article 12)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Branch profits tax rate generally is 5% and some Dutch companies are exempt (Article 11). Interest withholding tax eliminated (Article 12). Business profits exempted from tax where already taxed in the U.S. (Article 25); Royalty withholding tax eliminated. (reduction not applicable to film and television royalties; instead such royalties are treated as business profits under the treaty). (Article 13)</td>
</tr>
<tr>
<td>Australia</td>
<td>Branch profits tax rate generally is 5% and some Australian companies are exempt (Article 10). Interest withholding tax rate reduced to 10% (Article 11). U.S. tax on business profits creditable against Australian tax (Article 22); Royalty withholding tax reduced to 5%. (Article 12)</td>
</tr>
<tr>
<td>Japan</td>
<td>Branch profits tax generally is 5% and some Japanese companies are exempt. (Article 10). Interest withholding tax rate reduced to 10% (Article 11). U.S. tax on business profits creditable against Japanese tax (Article 23). Royalty withholding tax eliminated. (Article 12)</td>
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**Partnership**

Financial investors from several territories and film producers may become limited and general partners, respectively, in a U.S. limited partnership formed to produce a film and contract with independent distributors to distribute the film for a fee. Each partner under this arrangement contributes funds to the partnership in return for a share of the partnership profits; the partnership may receive royalties under distribution agreements from residents of both treaty and non-treaty countries and proceeds from the sale of any rights remaining after exploitation.

Sometimes a partner in a partnership will contribute a promise to perform services in the future instead of property. If by reason of the promise, the partner is allocated a portion of the partnership capital, the partner will recognize income in an amount equal to the capital allocated, and the partner will have a basis in the partnership for the same amount. If, on the other hand, the partner receives an interest in the partnership profits only, the partner will generally not recognize any income and the partner will not have any basis in the partnership, except to the extent that in the future the partnership has undistributed profits.

Generally, a partnership itself is not subject to federal income tax. The partners in the partnership take into account their distributive share of the partnership’s profits and losses when determining their tax liability. Partnership profits and losses may be allocated by the partnership agreement, but such allocations must reflect the economic substance of the partnership arrangement. Complex regulations determine the amount of partnership losses that a partner may deduct in a taxable year, but generally these losses cannot exceed a partner’s capital account plus third-party loans to the partnership for which the partner is at risk (i.e., the amount the partner is personally liable to pay the creditors of the partnership). A U.S. partner’s tax base for the purposes of calculating tax includes its worldwide income. A non-resident partner’s taxable base, however, includes only income that is “effectively connected” with a U.S. trade or business and certain U.S. source income.

U.S. tax law requires that any partnership, whether non-U.S. or domestic, having effectively connected income that is allocable to a non-U.S. partner withhold federal taxes from that income (section 1446). The partner takes the withheld taxes into account as a credit when determining his tax liability. The amount of withholding is based on the “applicable percentage” of the effectively connected income of the partnership that is allocable to the non-U.S. partners. The applicable percentage is the highest U.S. marginal tax rate for the partner, and is dependent on the tax status (i.e., individual or corporation) of the partner. If the business profits are attributable to a U.S.
permanent establishment there is no practical treaty relief for the section 1446 tax. Certain states, such as California, also impose a similar withholding requirement on partnerships with non-U.S. partners. Tax treaty benefits generally cannot be claimed where the LLC is treated as a partnership for U.S. federal income tax purposes and a U.S. corporation under the tax law of the applicable tax treaty country and not otherwise taxed as a resident of the treaty country under the treaty country’s tax laws.

**Limited Liability Company**

The joint venture may also take the form of a limited liability company (LLC). An LLC provides limited liability to its members while being treated as a partnership for federal income tax purposes and most state income tax statutes. Although the body of law surrounding LLCs is not as developed as corporate or partnership law, the LLC has quickly become the entity of choice in many industries due to its partnership-type flexibility with regard to distributions and its corporate-type liability limitations. For federal income tax purposes, the LLC itself generally is not considered a taxable entity (although it is possible to elect to have the LLC treated as an entity taxable as a corporation), but rather the LLC’s members are taxed as partners on their share of the LLC’s income. Since the LLC is generally treated as a partnership and its members treated as partners for tax purposes, the preceding discussion regarding partnerships applies to LLCs as well.

**Yield Adjusted Debt**

A film production company may finance its films using loans obtained from financial institutions or other third parties. The loans may be secured by pre-sale contracts with respect to the film or by the general assets of the production company.

A film production company may sometimes issue a security with a yield linked to revenues from specific films. The principal amount of such a security is typically due at maturity, and the security may have a low (or even nil) rate of stated interest. The security also usually provides for a supplemental (and perhaps increasing) interest payment that becomes due when a pre-determined financial target (such as revenues or net cash proceeds) is reached or exceeded.

For U.S. tax purposes, this security might be characterized as equity because the periodic payments are dependent on the profitability of specific films. In this event, such periodic payments would be recharacterized as dividend distributions taxable to the recipient to the extent of the corporation’s earnings and profits. Such distributions are not deductible in determining the corporation’s taxable income for the year. The repayment of the principal amount of the security typically would be characterized as a return of capital.
However, if the security carries both a stated interest rate that closely approximates a market rate of interest and a contingent payment, the security would be more akin to a debt instrument. In this case, all or a portion of the periodic payments would likely be deductible as interest by the production company. Various rules affect the amount and timing of such deduction (e.g., the OID rules, the earnings stripping rules, the applicable high-yield discount obligations rules, etc.).

Regardless of the characterization of a periodic payment as dividend or interest, if the payment is made to a non-U.S. person, withholding tax will be levied on the U.S. source portion of the payment, unless the payment is effectively connected with a U.S. trade or business of the payee. In addition, a treaty may reduce or eliminate the withholding tax.

**Equity Tracking Shares**

These shares provide for dividend returns dependent on the profitability of a film production company’s business. These shares typically have the same voting rights as the production company’s ordinary (i.e., common) shares, except that dividends are profit-linked and have preferential rights to assets on liquidation of the company.

If the production company is a U.S. corporation, dividends on such stock would generally be treated in the same manner as dividends on ordinary shares.

If the tracking shares are acquired by a U.S. investor and the production company is incorporated outside of the U.S., any tracking dividends received would be income to the U.S. investor in the same manner as dividends received on ordinary shares. Generally, a direct non-U.S. tax credit is allowed for withholding taxes paid on the dividend, and “deemed paid” non-U.S. tax credits may be allowed to a 10 percent or greater U.S. corporate shareholder for the amount of tax paid by the non-U.S. corporation with respect to the earning and profits out of which the dividend is paid.

**Tax and Financial Incentives**

**Federal Incentives**

The **Emergency Economic Stabilization Act of 2008 (the “2008 Act”)** was enacted on October 3, 2008, and expanded federal tax incentives applicable to the film and television industry in the U.S.

The Act modified rules with respect to “qualified production activities” which originally stemmed from provisions originally enacted under the American Jobs Creation Act of 2004 (the AJCA). The Domestic Production Activities
Deduction under section 199 allows for a deduction in an amount equal to 9 percent (for taxable years beginning in 2010 and later) of “qualified production activities income.” “Qualified production activities income” is equal to “domestic production gross receipts” reduced by the sum of (1) allocable cost of goods sold and (2) other expenses, losses, or deductions that are properly allocable to such receipts. While the eligibility of receipts must be determined on an item-by-item basis, the final regulations clarify that allocation of expenses, for example, may be performed on an aggregate basis. Two limitations apply: the deduction is the applicable percentage of the lesser of qualified production activities income or taxable income, and the deduction may not exceed 50 percent of W-2 wages. The wage limit is based on wage expense, which may include such items as stock options and designated contributions to a Roth IRA. Note that, for taxable years beginning after May 17, 2006, W-2 wages are limited to those attributable to domestic production activities. The definition of “W-2 wages” also includes any compensation paid for services performed in the United States by actors, production personnel, directors, and producers incurred in the production of “qualified film.” “Qualified film” includes any motion picture film, videotape, television program, copyrights, trademarks, or other intangibles with respect to such film if 50 percent or more of the total compensation relating to the production of such property (including participations and residuals) constitutes services performed in the U.S. by actors, production personnel, directors and producers. A recent ruling holds that licensing of a programming package (a group of programs that includes programs produced by the taxpayer, programs produced by third parties, commercial advertisements, and interstitials) to customers in the normal course of business can give rise to “domestic production gross receipts.”

“Domestic production gross receipts” include gross receipts derived from any lease, rental, license, sale, exchange, or other disposition to an unrelated person of a “qualified film” produced by the taxpayer. According to the Act, the deduction is not to be affected by the means and methods of distributing such “qualified film.” The distribution of such film via digital distribution is thus considered to be a disposition of the film for purposes of determining domestic production gross receipts (DPGR). If the film is viewed online or downloaded, and whether or not a fee is charged, there is still considered to be a disposition of the film for purposes of calculating the deduction; this scenario is most likely distinguishable from theater showings, which the regulations indicate do not constitute dispositions.
The 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Act”) was enacted on December 15, 2010, and expanded federal tax incentives applicable to the film and television industry in the U.S.

The 2010 Act further expanded upon a provision under section 181 that allows a taxpayer to elect to deduct the costs of any qualified film or television production in the year the expenditure is incurred. Under pre-2010 Act law, taxpayers could elect to expense the cost of qualified film and television productions rather than capitalizing those costs for productions commencing before January 1, 2010. The 2010 Act extended Section 181 for two years, to qualified film and television productions beginning before January 1, 2012.

For qualified film and television productions commencing after December 31, 2009, the first $15 million of costs ($20 million for costs incurred in certain designated low-income or distressed areas) are eligible for the election under Section 181. For purposes of this provision, a qualified film or television production is one for which at least 75 percent of the total compensation is for services performed within the United States by production personnel (not including participations and residuals). For purposes of a television series, only the first 44 episodes of the series are taken into account, and the $15 million production cost limitation and the 75 percent qualified compensation requirement are to be determined on an episode-by-episode basis.

The final regulations under Section 181 became generally effective September 29, 2011 and further clarify that (1) distribution costs are specifically excluded from the definition of production costs, (2) costs associated with acquiring a production are treated as a production costs, (3) costs associated with obtaining financing are production costs, and (4) participations and residuals costs are considered production costs, all for purposes of the production cost limitation. In addition, the final regulations further define “initial release or broadcast” as the first commercial exhibition or broadcast to an audience. Initial release or broadcast does not include certain limited exhibitions primarily for purposes of publicity, marketing to potential purchasers or distributors, determining the need for further production activity, or raising funds for the completion of production.

The final regulations apply to productions for which the first day of principal photography occurs on or after September 29, 2011. A qualified film or television production that commenced on or after October 22, 2004 and before February 9, 2007, or on or after January 1, 2009 and before September 29, 2011, may generally apply the proposed and temporary
regulations published February 9, 2007. An owner of any production commenced on or after February 9, 2007 and before September 29, 2011 may apply the final regulations.

On October 18, 2011, temporary regulations under section 181 were issued for film and television productions commencing on or after January 1, 2008 (post-amendment) and clarifies that section 181 permits a deduction for the first $15 million (or $20 million) of aggregate production costs, regardless of the total cost of the production.

The temporary regulations also state that in determining whether a production qualifies for the $20 million deduction limit, compensation to actors, directors, producers, and other relevant production personnel is allocated entirely to first-unit principal photography. The temporary regulations also clarify that the costs of a post-amendment production that are not allowable as a deduction under section 181 may be deducted under any other applicable provision of the Code.

The temporary regulations apply to qualified film and television productions for which principal photography (or if animated production, in-between animation) began on or after October 18, 2011. A taxpayer may choose to apply the temporary regulations to qualified film or television productions beginning on or after January 1, 2008, and before October 18, 2011.

The AJCA enacted on October 22, 2004, repealed the extraterritorial income exclusion (EIE), under which U.S. film producers and distributors could exclude a portion of the gross income generated from the sale or license of qualifying films or television programs for exploitation outside the U.S. However, it should be noted that EIE remains in full effect for “transactions” entered into on or before December 31, 2004. The income from these transactions should be eligible for full EIE benefits even if it is received after December 31, 2004 (for example, in the case of a long term license arrangement entered into on or before December 31, 2004, but with rights and associated revenues extending beyond this date.)

**State Incentives**

Approximately 40 states offer tax or financial incentives, most notably California, Georgia, Louisiana, Michigan, New Mexico, New York and Pennsylvania.

In February 2009 legislation was signed into law in California creating the state’s first film and television production credit. The credits can be applied in tax years beginning on or after January 1, 2011. Although the California
Film Commission (CFC) will not issue credit certificates prior to January 1, 2011, the CFC will begin allocating tax credits to applicants beginning fiscal year 2009/2010 through fiscal year 2013/2014 on a first come first served basis. For each fiscal year from 2009 through 2013 credits in the amount of $100 million annually will be issued and any unallocated credits or credits that were previously allocated but not certified may be carried forward to the next fiscal year. Taxpayers may assign any portion of the credit to one or more affiliated corporations for each taxable year in which the credit is allowed. This credit will be 20 percent of the qualified expenditures attributable to the production of a “qualified motion picture” in California or 25 percent where the “qualified motion picture” is a television series that relocated to California or an “independent film”. Taxpayers are allowed a credit against income and/or sales and use taxes, based on qualified expenditures, for taxable years beginning on or after January 1, 2011. Credits applied to income tax liability are not refundable. Only tax credits issued to an “independent film” may be transferred or sold to an unrelated party. Other taxpayers may carryover tax credits for 5 years and transfer tax credits to an affiliate.

A “qualified motion picture” is defined as a motion picture that is produced for distribution to the general public, regardless of the medium, that is one of the following:

1) A feature with a minimum production budget of $1 million and a maximum production budget of $75 million.

2) A movie of the week or miniseries with a minimum production budget of $500,000.

3) A new television series produced in California with a minimum production budget of $1 million licensed for original distribution on basic cable.

4) An independent film.

5) A television series that relocated to California.

An “independent film” is defined as a motion picture with a budget between $1 million and $10 million that is produced by a company that is not publicly traded or more than 25 percent owned directly or indirectly by a publicly traded company. The CFC will set aside up to $10 million of motion picture tax credits each year for independent films. To qualify as a “qualified motion picture” several conditions must be met, including the requirement that “at least 75 percent of the production days occur wholly in California or 75 percent of the production budget is incurred for payment for services performed within the state and the purchase or rental of property used within the state.”
“Qualified expenditures” are amounts paid or incurred to purchase or lease tangible personal property used within California in the production of a qualified motion picture and payments, including qualified wages, for services performed in California in the production of a qualified motion picture. The following expenses are not allowed as qualified expenditures – state and federal income taxes, CPA expenses for Section 5506 reports, expenditure for services performed out-of-state and expenditures for exhibiting the qualified motion picture.

Georgia offers a tax credit to commercial, video, movie, and television production companies and their affiliates for qualified production activities in Georgia. The production company must invest at least $500,000 in a state-certified production approved by the Department of Economic Development. Projects over a single tax year may be aggregated to meet the $500,000 threshold. The production company and/or affiliate(s) must not be in default on any tax obligation of the state or have a loan made or guaranteed by the state.

The credit computation is based on the amount of total production expenditures in the current year (“base investment”) over the production expenditure incurred during 2002, 2003 and 2004 as follows:

1. If annual total production expenditures in 2002, 2003, and 2004 were $30 million or less, a credit of 20% of the base investment in Georgia. An additional 10% of the excess base investment may be claimed if the production activities include a qualified Georgia promotion.

2. If annual total production expenditures in 2002, 2003, and 2004 were $30 million or greater, a credit of 20% of the base investment in Georgia. An additional 10% of the excess base investment may be claimed if the production activities include a qualified Georgia promotion.

“Base investment” is the amount actually invested or expended as production expenditures. The “excess base investment” is defined as the current year production expenditures minus the average of the annual total production expenditures for 2002, 2003, and 2004.

Qualified production expenditures include new film, video and digital projects produced in Georgia (in whole or in part) such as feature films, series, pilots, movies for television, commercial advertisements, music videos, interactive entertainment, or sound recording projects. The projects recorded in Georgia can be in short or long form, animation or music, or fixed on a delivery system and must be intended for multarket commercial distribution via theatres, licensing for exhibition by individual television stations, corporations, live
venues, the internet, or any other channel of exhibition. Television coverage of news and athletic events do not qualify. Pre-production, production, and post-production costs incurred in Georgia and used directly in a qualified activity are eligible.

The credit is first taken in the year the production company meets the investment requirement. The credit may be claimed against 100% of the company’s Georgia corporate income tax liability and any excess credit may be taken against Georgia payroll tax withholding. Any unused credit may be carried forward for 5 years. Further, unused film credits may be sold or transferred, in whole or part, to another Georgia taxpayer, subject to certain conditions.

Georgia also provides a sales and use tax exemption to film, video, broadcast and music production companies working in the state on immediate point-of-purchase savings on most materials and service purchases, leases and rentals. The exemptions applies to both Georgia state and local sales taxes, resulting in up to an 8% exemption per purchase. The production company must apply to the Georgia Film, Video and Music Office for an exemption certificate, which is presented at the time of purchase to the seller.

**Louisiana** offers a motion picture investor tax credit which has two components as follows:

1. **Motion Pictures** – For the investment in a state-certified production approved by the Governor’s Office of Film and Television Development, the taxpayer is entitled to an *income* tax credit as follows:
   a) For state certified productions approved on or after January 1, 2006, but before July 1, 2009, if the investment is greater than $300,000, a credit of 25 percent of the actual base investment made in the state of Louisiana may be granted.
   b) For state certified productions approved on or after July 1, 2009 - for investments of $300,000 or more in a state-certified production a credit of 30 percent of the investment may be granted.

2. **Employment of Louisiana Residents** – To the extent that the base investment is expended on payroll for Louisiana residents employed in connection with a state-certified production:
   a) That is approved on or after January 1, 2006 but before July 1, 2009, each investor may be eligible for an *income* tax credit of 10 percent of the Louisiana payroll (excluding salary of any one person exceeding $1 million).
b) That is approved on or after July 1, 2009, each investor may be eligible for an income tax credit of 5 percent of the Louisiana payroll (excluding salary of any one person exceeding $1 million).

Note that the credits are fully transferable and may be sold to another Louisiana taxpayer subject to certain conditions.

**New Mexico** offers four incentive programs. First, a film production tax refundable credit is available for up to 25 percent of all production expenditures (including New Mexico labor) incurred within the state. Note that the credit amount is limited to 20 percent if the taxpayer also receives a credit pursuant to the federal new markets tax credit program. Second, a production company can receive a gross receipts tax (i.e., sales tax) exemption at point of purchase by presenting the vendor with a “nontaxable transaction certificate.” Production companies intending to take the film production tax refundable credit may not use the gross receipts tax exemption. Third, New Mexico offers fixed rate (National Prime Rate plus 1.5%) production loans capped at $15 million provided certain criteria are met. Fourth, New Mexico offers a 50 percent wage reimbursement to production companies that hire and provide on-the-job training for upgrading crew members and new trainees.

To encourage the production of motion pictures, television programs, music videos, and other similar ventures in **Michigan**, the Michigan Business Tax Act was amended to provide additional tax incentives to encourage film and television production within the state.

For qualified eligible production companies, a film production company “certified” tax credit equal to 40 percent (42 percent if the qualifying expenditures are made in a designated Core Community) of direct production expenditures is allowed for payments to Michigan vendors related to the production or distribution of the production and for payments and compensation made to certain production personnel that are residents of Michigan. In addition, for personnel expenditures related to nonresidents of Michigan an eligible production company may claim a credit equal to 30 percent of such qualified personnel expenditures. Qualified personnel expenditures relate only to payments and compensation made to nonresidents of Michigan. For direct production and personnel expenditures made on and after May 26, 2011, an agreement with the Michigan film office should be made in concurrence with the State Treasurer.

A film infrastructure credit is also available under Michigan law. The Michigan Film Office may grant an eligible taxpayer a nonrefundable “certified” tax
credit equal to 25 percent of the taxpayer’s base investment in a qualified film and digital media infrastructure project in Michigan. In addition, the Michigan Film Office may grant an eligible production company a nonrefundable tax credit equal to 50 percent of the qualified job training expenditures, subject to certain requirements. This credit may not be claimed for any direct expenditure or qualified personnel expenditure for which the production company is also claiming a credit under the Film Production Credit. This nonrefundable credit may be carried forward up to 10 tax years against the MBT.

The Michigan corporate income tax, which is effective January 1, 2012, does not provide for Michigan film production company and film infrastructure credits. Taxpayers who wish to continue claiming these “certified” credits may elect to continue to file under the MBT instead of the CIT. The election must be made for the first tax year ending after Dec. 31, 2011. The taxpayer must continue to file under the MBT until that certified credit and all carryforwards expire. Taxpayers can continue to claim a credit for film/television job training expenditures against the MBT until all “certified” credits are used up that were the basis for filing the MBT instead of the CIT.

**New York** State offers a refundable production tax credit equal to 30 percent of the qualified production costs incurred for a qualified film or television production. The amount of the credit is allocated annually by the New York State Governor’s Office for Motion Picture and Television Development. Applications must be submitted to that agency within certain strict time limits, prior to starting principal and ongoing photography. A meeting is then held with the agency, prior to the start of photography. A final application is then submitted no more than 60 days after the completion of the project.

In order to qualify, all productions must incur at least 75 percent of its qualified production costs (excluding post-production costs) at a qualified production facility in New York. If such costs are less than $3 million, the production must shoot at least 75 percent of its location days in New York to qualify; if not, the credit is available only for qualified production costs incurred at the qualified production facility. “Qualified production costs” generally means below-the-line costs incurred in the production (including pre-production and post-production) of the qualified film or television production.

August 2010 legislation was signed into law by New York State, authorizing the aggregate funds cap, for all applicants, available for the film production tax credit, in the 2010 through 2014 tax years, to be $420 million annually (i.e., $2.1 billion over that five year period).
Of the total allocation, $35 million in total (i.e., $7 million annually) is devoted to a new “post production” tax credit. Companies that are ineligible for the basic film production credit can still qualify for the post production credit. The post production credit equals 10% of qualified post production costs paid in the production of a qualified film at a qualified post production facility, which is generally a facility in New York State. To be eligible, the costs at such facility must at least equal 75% of the total post production costs at any post production facility.

The basic film production and post production credits are generally claimed on the applicant’s tax return in the later of the tax year in which the production is completed or the tax year immediately following the allocation year from which the taxpayer was awarded credit. Effective for tax years beginning on or after January 1, 2009, a credit that is more than $1 million, but less than $5 million must be claimed over a two year period, with half of the state credit claimed each year, and a credit that is at least $5 million must be claimed pro rata over a three year period, with one-third claimed each year. If the credit is less than $1 million the entire credit can be claimed in the tax year in which the film is completed.

The 2010 legislation extended the film credit to qualified independent film production companies. Requirements are that such company have a maximum budget of $15 million, have control over the film during production, and not be a publicly-traded entity or have no more than 5% beneficial ownership held by a publicly-traded entity. Independent film production companies, and shooting of pilots, will not be required to meet a further eligibility test – that at least 10% of total principal photography shooting days be spent at a qualified production facility.

New York treats the creation of a feature film, television film, commercial and similar film and video production as manufacturing activities that result in the production of tangible personal property. Accordingly, a taxpayer producing a film for sale is afforded the same exemptions available to New York’s manufacturers. In addition to covering purchases of machinery, equipment, parts, tools, and supplies used in production, the exemption also covers services like installing, repairing, and maintaining production equipment. Film and video production receive a sales tax exemption for all production consumables and equipment rentals and purchases as well as related services, so long as such are used directly and predominantly in the actual filming process. Thus, for example, a rented truck used 70% for transporting set props and only 30% during actual film-making would not qualify for the sales tax exemption.
Pennsylvania provides a film production tax credit ("credit") for investments made towards film production expenses. A taxpayer may apply to the Department of Revenue ("Department") for a credit of up to 25% of “qualified film production expenses” that may be applied against personal income tax, corporate net income tax, or capital stock and franchise tax. A taxpayer that has received a film production grant under Pa. Stat. Ann. 12 § 4106 may not claim a film production credit for the same film.

The tax credit must be applied against the taxpayer’s qualified tax liability for the year in which the credit certificate is issued. Any carryover credits from previous years will be applied on a first-in, first-out (FIFO) basis and may be carried forward for up to three tax years. Unused credits may not be carried back. Additionally, a taxpayer claiming the credit who fails to incur the amount of qualified film expense agreed to in the contract must repay the amount of credit to the Commonwealth.

“Qualified film production expenses” for which a credit can be claimed include all Pennsylvania production expenses if Pennsylvania production expenses make up at least 60% of the total production expenses of the film, but may not include more than $15 million in aggregate compensation paid to individuals or to entities representing an individual for services provided in the production of the film. A “Pennsylvania production expense” means a production expense incurred in Pennsylvania. The term includes the following:

1. Compensation paid to an individual on which Pennsylvania personal income tax will be paid;
2. Payment to a personal service corporation representing individual talent if Pennsylvania corporate net income tax will be paid or accrued on the net income of the corporation for the taxable year;
3. Payment to a pass-through entity representing individual talent if Pennsylvania personal income tax will be paid or accrued by all of the partners, members or shareholders of the pass-through entity for the taxable year;
4. The cost of transportation incurred while transporting to or from a train station, bus depot or airport, located in Pennsylvania;
5. The cost of insurance coverage purchased through an insurance agent based in Pennsylvania;
6. The purchase of music or story rights if: (a) the purchase is from a resident of this commonwealth, or (b) the purchase is from an entity subject to tax in Pennsylvania and the transaction is subject to corporate or personal income tax or capital stock and franchise tax in Pennsylvania;

7. The cost of rental of facilities and equipment rented from or through a Pennsylvania resident or an entity subject to tax in Pennsylvania.

A “film” is defined to include a feature film, television film, television talk show or game show series, television commercial, television pilot, or each episode of a television series that is intended as programming. Pennsylvania excludes from the term “film” a production featuring news, current events, weather and market reports, or public programming, sports events, awards shows or other gala events. Additionally, productions that solicit funds, contain obscene material or performances, or productions made primarily for private, political, industrial, corporate or institutional purposes are also excluded from the credit.

To obtain the credit, a qualified taxpayer must file an application for the credit with the Department. Once an application for credit is approved, the Department will enter into a contract with the taxpayer. The contract contains an itemized list of production expenses incurred or to be incurred; an itemized list of Pennsylvania production expenses incurred or to be incurred; a commitment to incur the itemized expenses if the film has not been completed prior to the contract; the start date of production and any other information the Department deems appropriate. The Department will then issue a tax credit certificate to the taxpayer.

Pennsylvania provides grants for a portion of qualified film production expenses incurred while making a motion picture in the state. The amount of the grant may not exceed 20% of a taxpayers qualified film production expenses.

To apply for the grant, the taxpayer must submit an application to the Department of Community and Economic Development at any time within 60 days of the completion of the production of the film. The applicant must sign a contract with the Department upon approval of the grant.

Qualified production expenses include wages and salaries of individuals employed in the production of the film (excluding salaries of individuals who earn $1 million or more), and costs of construction, operations, editing, photography, sound synchronization, lighting, wardrobe, accessories, rental facilities, and equipment.
Other Financing Considerations

Exchange Controls and Regulatory Rules
The U.S. does not have any exchange control regulations.

Corporate Taxation

Recognition of Income

Production Fee Income

U.S. Resident Production Company
A special purpose company may be set up in the U.S. for the limited purpose of producing a film, video, or television program, without acquiring any rights in the product (i.e., a “work for hire” company). Such a special purpose company would be required to disclose transactions with its foreign related parties. Consequently, the Internal Revenue Service (IRS), the U.S. taxing authority, would be notified of income received from a non-U.S. related party and would be able to scrutinize the allocation or attribution of income to the special purpose company.

U.S. tax law requires that payments made pursuant to transactions between the special purpose company and its non-U.S. affiliates be equal to the amount that would have been paid or charged for “the same or similar services in independent transactions with or between unrelated parties under similar circumstances” -the so-called arm’s length standard. Taxpayers ordinarily carry out economic studies to document the arm’s-length nature of their significant intercompany transactions in order to mitigate potential penalties in the event the IRS successfully adjusts the income or deductions arising from such transactions.

It also is possible to obtain an Advance Pricing Agreement (APA), in which the U.S. (or the both the U.S. and another country) agree as to the arm’s length charge due in a particular intercompany transaction, e.g., the amount or percentage of income to be attributed to the special purpose company. The APA process can be costly and time-consuming and may be impractical for a “work for hire” company organized to produce a single film.

Non-U.S. Resident Production Company with an Office in the U.S.
A non-U.S. company that has a production office in the U.S. to administer location shooting in the U.S. may be subject to U.S. tax if its activities amount to a U.S. trade or business that produce effectively connected income. In general, operating a production office to oversee U.S. location shooting may constitute a U.S. trade or business. Also, some of the income earned
by the production company may be effectively connected with that trade or business. Whether the income in fact is effectively connected will depend upon the character of the income generated by the production company once the film is complete (e.g., rental or royalty income or gain from the sale of property) and the source of such income (e.g., domestic or non-U.S.). U.S. taxation may turn on whether the production company continues to have an office in the United States at the time the income is realized.

Even if some of the income generated by the non-U.S. production company is effectively connected with a U.S. trade or business, if the company is resident in a treaty country and is eligible to claim the benefits of that treaty, the U.S. may not tax that income unless the activities of the production company create a permanent establishment in the U.S. and the income is attributable to the permanent establishment. Generally, if the production company has a U.S. office through which it carries on business it will have a permanent establishment in the U.S. Whether the income is attributable to the permanent establishment generally will depend upon the same factors that determine whether the income is effectively connected. However, some recent U.S. income tax treaties follow the “authorized OECD approach” for attributing profits and losses to a permanent establishment.

**Non-U.S. Resident Production Company without an Office in the U.S.**

A non-resident company that does not maintain a production office but undertakes location shooting in the U.S. may be considered engaged in a U.S. trade or business and, as discussed above, income generated by the production company may be considered effectively connected with that trade or business. If the company is resident in a country that does not have an income tax treaty with the U.S., the company’s effectively connected business income will be taxed on a net basis at U.S. corporate tax rates. U.S. source fixed or determinable, annual or periodical income (e.g., rents and royalties that are not effectively connected) earned by the production company will be subject to a 30-percent gross-basis withholding tax.

If the company is resident in a country that has an income tax treaty with the U.S., the company’s effectively connected business income will be taxed only if the company has a permanent establishment in the U.S. In general, location shooting should not create a permanent establishment if it takes place at multiple locations for a limited period of time. If, however, the activity is carried on in a single location the risk of such activity creating a permanent establishment would increase as the duration of the activity increases. The factors bearing on whether the income of the production company may be attributable to a permanent establishment are discussed above.
Transfer of Distribution Rights

Income arising from the transfer of all, or substantially all, copyright rights to exploit or distribute a film or television program within a specified geographic area for the remaining life of the copyright is gain from the sale of property under U.S. tax law. As discussed below, the U.S. does not tax gain realized by a non-US person from the sale of intangible property, provided the consideration is not contingent on the productivity or use of the transferred intangible. In determining whether a transfer will be treated as either a sale or a license certain factors are considered, including: whether all or part of the rights to the film or television program are transferred; whether key rights have been reserved by the transferor; whether the transfer covers specific geographic regions; whether the transfer is exclusive or nonexclusive, and whether the rights are transferred for the remaining life of the copyright.

If a transfer of copyright rights by a non-US person is characterized as a license, and not as a sale for U.S. tax purposes, the U.S. will tax the U.S. source royalty generated by the license. In addition, gain realized by a non-U.S. person from the sale or exchange of intangible property for a series of payments contingent on the productivity or use of the property in the U.S. (e.g., based on revenues generated by the property for use in the U.S.), is taxed in the same manner as U.S. source royalty income.

U.S. income tax treaties generally tax transfers of intangible property in a manner consistent with U.S. domestic tax law. Some treaties, however, distinguish the license of film rights from other intangible assets in the royalties article of the treaty for purposes of determining the rate of tax at source, and some treaties consider income from the license of film rights as business profits, not royalties.

Various rules apply to the transfer of intangible assets by a U.S. person to a non-U.S. person. If the transferee is a related party, U.S. transfer pricing rules require the consideration received by the transferor be commensurate with the income derived from the intangible. Under this rule the IRS, under certain conditions, may adjust the income received by the transferor taking into account the income realized from the intangible in years after the transfer. Also, a transfer of an intangible asset to a non-U.S. corporation in a nonrecognition transaction (such as in tax-free exchange for shares or in a tax-free reorganization) generally is treated as a sale of the intangible for payments contingent upon its productivity or use. The consideration received by the transferor also may be adjusted by the IRS.
U.S. Resident Production Company – Transfer of Distribution Rights to Non-U.S. Person

Generally, a transfer of distribution rights is characterized as either a sale or a license for U.S. tax purposes. Whether a sale or a license produces a potentially more favorable tax result depends on various factors, including the non-U.S. tax credit position of the transferor, the terms of any applicable income tax treaty and treatment of the transaction in the transferee’s jurisdiction. Transfers of distribution rights are subject to the rules generally applicable to the transfer of intangible assets described above.

U.S. Resident Distribution Company – Acquisition of Distribution Rights

The timing of the deduction of the payments for tax purposes depends on whether the distribution rights are purchased or licensed and on whether the transferee is a cash or accrual method taxpayer.

Whether the acquisition of the distribution rights is treated as a purchase or license, both cash and accrual method taxpayers must capitalize the payments for the distribution rights. The acquisition costs, then, may be depreciated by one of two methods: the straight-line method (which allows equal amounts of depreciation over the useful life of the intangible right or over a 15-year period if the rights are acquired in connection with the acquisition of a trade or business or substantial portion thereof) or the income-forecast method (which allows as depreciation a percentage of capitalized distribution costs equal to the year’s actual revenues divided by the total projected revenues). See discussion below regarding “Amortization of Expenditure”.

For contingent royalty payments, whether paid under a purchase or license of a film, the timing of the deduction of payments made depends on whether the company uses the cash or accrual method. Generally, the cash method company may deduct payments when paid. Conversely, the accrual method company will be able to deduct only that portion of the license payment that relates to the current tax year.

If the payments constitute advances, the federal tax rules suggest that the payments should be amortized over the term of the license using the straight-line method. However, industry practice has been to amortize the payments over the term of the license using the income forecast method because it provides for much closer matching of deductions with income. An argument also exists for amortizing the payment over the term of the recoupment of the advance.
The type of income arising from exploiting rights in a given country depends on the applicable treaty and the characterization of the acquisition of such rights as either a purchase or a license. Certain treaties characterize income from either the purchase (including contingent payments) or the license of films rights as royalties. Under other treaties, all payments from either a sale or a license of the use or right to use cinematographic films or films used for television broadcasting are excluded from the definition of “royalties” and instead are treated as trading income (business profits).

**Non-U.S. Resident Company**

If the company is resident in a non-treaty country, the analysis is the same. The income from exploiting the distribution rights generally is treated as royalty income or capital gain, depending on the specific facts involved.

**Transfer of Distribution Rights Between Related Parties**

Where a worldwide group of companies holds rights to films and videos, and grants sublicenses for the exploitation of those rights to a U.S. resident company, care needs to be taken to ensure that the profits in the various entities can be justified. Upon examination, the IRS typically will query the level of profit earned by the U.S. sublicensee by examining the payments made to related non-U.S. companies. Generally, the amount of the license fee must be commensurate with the income generated by the intangible, as discussed above.

The IRS may assess substantial penalties if it determines that the transfer of property (e.g. a sale or a license) between related parties was not for arm’s length consideration. However, certain penalties do not apply if the taxpayer attempted to ascertain the appropriate arm’s length charge and contemporaneously documented its transfer pricing methodology in accordance with the regulations.

**Amortization of Expenditures**

**Treatment of Production Costs**

A film producer who retains film rights may incur substantial costs over a period of several years in connection with the production of a film. Two methods are available to the film producer for the amortization of the production costs of the film—the income forecast method and the straight-line method. As discussed above, a film producer may elect for any “qualifying film and television productions” for which production commences after October 22, 2004 and before January 1, 2012 to deduct as incurred the cost of productions up to $15 million ($20 million incurred in certain low-income or distressed areas), in lieu of capitalizing the cost and recovering it through amortization.
Under Section 263A, all direct and indirect costs of producing property, including films, videotapes, or similar property, must be capitalized. Expenses related to the marketing, selling, advertising, and distributing a film are not required to be capitalized.

**Income Forecast Method**

Typically, the film and television industry claims amortization deductions for production costs under the “income forecast” method. Under this method, taxpayers determine the amortization deduction for a taxable year by multiplying the capitalized production cost of the property by a fraction, the numerator being the current year income and the denominator being the forecasted total income.

For films and television programs released on or before October 22, 2004, “current year income” means the net income generated by the property in the current taxable year (gross income less distribution costs for such year), and “forecasted total income” equals the sum of the current year income for the year the property is released plus all reasonably estimated net income (gross income less distribution costs) from subsequent years up to and including the tenth taxable year after the year the property is released. For films and television programs released after October 22, 2004, gross income, not net income, from the property is used to calculate current year income and forecasted total income for purposes of computing the allowable deduction under the income forecast method.

**Determination of Income (Current Year and Forecasted Total)**

In the case of films, television programs, and other similar property, income (current year and forecasted total) includes, but is not limited to: income from foreign and domestic theatrical, television and other releases and syndications; income from releases, sales, rentals, and syndications of video tape, DVD, and other media; and income from the financial exploitation of characters, designs, titles, scripts and scores earned from ultimate sale to, or use by, unrelated third parties. Examples of this third income category include the sales of toy figurines related to animated films or television programs, or licensing income from the use of an image.

In the case of a television series produced for distribution on television networks, income (current year and forecasted total) need not include income from syndication of the television series before the earlier of the fourth taxable year beginning after the date the first episode in the series is
placed in service, or the earliest taxable year in which the taxpayer has an agreement to syndicate the series.

The forecasted total income from the film or television program for purposes of the income forecast method includes all income expected to be generated by the production up to and including the tenth taxable year after the year of release. Any income expected to be earned after this term is not included in the formula. Forecasted total income is based on the conditions known to exist at the end of the tax year of release (subject to revision in later years). These rules also apply to the “look back” method described below.

Revised Forecasted Total Income
Pursuant to proposed Treasury regulations, if information is discovered in a taxable year following the year in which the property is placed in service that indicates that forecasted total income is inaccurate, a taxpayer must revise the forecasted total income. Under the revised computation, the unrecovered depreciable basis of the property is multiplied by a fraction, the numerator of which is the current year income and the denominator of which is obtained by subtracting from revised forecasted total income the amounts of current year income for prior taxable years.

The revised computation must be used in any taxable year following the year in which the income forecast property is placed in service if forecasted total income (or, if applicable, revised forecasted total income) in the immediately preceding taxable year is either less than 90 percent of the revised forecasted total income for the taxable year, or greater than 110 percent of the revised forecasted total income for the taxable year.

Determination and Treatment of Basis of Property
The basis of the property includes only costs that have been incurred pursuant to section 461 of the Code. For that purpose, the economic performance requirement can be met at different times depending on the facts and circumstances of a transaction. For example, if a taxpayer incurs a non-contingent liability to acquire property, economic performance is deemed to occur when the property is provided to the taxpayer. In addition, the rules of IRC Section 461(h)(3) relating to the recurring item exception may apply.

The following costs incurred after the property is placed in service are treated as a separate piece of property:

- Any costs incurred with respect to any property after the tenth taxable year beginning after the taxable year in which the property was placed in service
Any costs incurred after the property is placed in service and before the close of the aforementioned tenth taxable year if such costs are significant and give rise to a significant increase in the income from the property which was not included in the estimated income from the property. If costs are incurred more than ten years after the property was originally placed in service and no resulting income is expected, such costs are deducted as incurred. At this time there is no comprehensive guidance on what constitutes a “significant” cost or increase in income.

Finally, any adjusted basis of the production not recovered by the tenth taxable year after the property was placed in service can be taken as a depreciation deduction in that year. Presumably, this deduction ignores salvage value.

Look-Back Method
Taxpayers that use the income forecast method for amortization of production costs are required to apply the “look-back” method of accounting. The “look-back” method requires a taxpayer to pay or receive interest by recalculating amortization deductions (and the corresponding increase/decrease in tax) using newly revised forecasted total income from the property. It is applicable to any “recomputation year,” defined generally as the third and tenth taxable year after the taxable year the property was placed into service. This requirement does not apply when forecasted total income or revised forecasted total income for preceding taxable years is within 10 percent of revised forecasted total income for the potential recomputation year. For purposes of applying the look-back method, income from the disposition of the property is taken into account in determining revised forecasted total income.

In applying the “look-back” method, any costs not treated as separate property and taken into account after the property was placed in service can, if so elected, be taken into account by discounting such cost to its value as of the date the property was placed into service. This discounting is based on the Federal mid-term rate determined under IRC Section 1274(d). The “look-back” method does not apply to property with a total capitalized cost basis of $100,000 or less as of the close of a potential recomputation year.

Treatment of Participations and Residuals
For purposes of computing the allowable deduction under the income forecast method, participations and residuals may be included in the adjusted basis of the eligible property beginning in the year such property is placed in service. The provision applies only if such participations and residuals relate to income that would be derived from the property before the close of the
tenth taxable year following the year the property was placed in service. Alternatively, the taxpayer may choose, on a property-by-property basis, to exclude participations and residuals from the adjusted basis of such property and deduct such participations and residuals in the taxable year paid.

**Straight-Line Method**
Under the straight-line method, depreciation for the year is computed by dividing a film’s production costs over the film’s estimated useful life. A film’s useful life for depreciation purposes has been the subject of controversy. A film based on a contemporary theme may have a shorter useful life than one based on a historical event.

If a film right is acquired as a part of the acquisition of assets constituting a trade or business or substantial portion thereof, the cost of such film right must be amortized over a period of 15 years.

**Treatment of Pre-Production Costs of Creative Properties**
The IRS has provided clarification on the treatment by a film producer of costs incurred in acquiring and developing screenplays, scripts, treatments, motion picture production rights to books, plays and other literary works, and other creative properties.

A film producer is generally required to capitalize creative property costs and, unless a film is produced from the creative property, is not permitted to recover those costs through depreciation or amortization deductions. However, a film producer is now permitted to amortize ratably over a 15-year period the costs for creative properties that are not scheduled for production within three years of acquisition.

Additionally, a film producer may not deduct the capitalized costs of acquiring or developing creative properties as a loss under IRC Section 165(a) unless the producer establishes an intention to abandon the property and an affirmative act of abandonment occurs, or identifiable events evidencing a closed and completed transaction establishing worthlessness occur.

**Other Expenditures**
Neither a film distribution company nor a film production company has any special status under U.S. law. Consequently, they are subject to the same rules as any other U.S. company, and are generally allowed to deduct the expenses of running their day-to-day operations to the extent such expenditures are ordinary and necessary and not of a capital nature.

Certain expenditures of U.S. companies can never be deducted. The following are some examples of such non-deductible expenditures: fines, penalties, bribes, certain executive life insurance, a portion of meals and
entertainment, country club membership dues, and certain related party losses. In addition, other expenditures cannot be currently deducted, such as capital expenditures, but must be deducted over the time period of their benefit to the company.

**Losses**
Net operating losses (i.e., losses from operations) may be carried forward for twenty years to offset future income, or may be carried back for two years and offset against prior year’s income, resulting in a refund of tax. Some states also allow the carryforward and carryback of net operating losses. Losses attributable to the sale of certain assets used in the taxpayer’s trade or business may be currently deducted. Capital losses on investment assets, however, are only deductible to the extent that there are capital gains for the year. An excess capital loss may be carried back three years or forward five years. States generally follow the federal treatment.

**Foreign Tax Relief**
Foreign tax relief is provided to U.S. taxpayers by allowing such taxpayers a foreign tax credit or foreign tax deduction for foreign taxes paid. Generally, the foreign tax credit provides the greatest relief from double taxation. If foreign tax is paid directly by a U.S. taxpayer, a direct credit is allowed, but the credit is generally limited to the amount of U.S. tax that would have been paid had the income been earned in the U.S. If a 10 percent or greater U.S. corporate shareholder receives a dividend from a foreign subsidiary, a “deemed paid” credit may be allowed for the amount of income tax paid by the foreign corporation which is related to the income out of which the dividend is being paid.

**Indirect Taxation**

**Value Added Tax (VAT)**
The U.S. has no VAT on the sale of goods or services.

**Sales/Use Tax**
Sales taxes are generally imposed on sales of tangible personal property and selected services. A complementary use tax is imposed on property purchased for storage, use or other consumption in the state if sales tax was not paid on the purchase. Most states allow for an offsetting credit against the use tax for any sales taxes legally imposed and paid.

All states except Alaska, Delaware, Montana, New Hampshire and Oregon impose sales/use taxes. In addition, many local governments impose sales/use taxes. Rates range from 3 to 10.25 percent.
As a general rule, most states impose sales/use tax on the sale or use of production equipment and supplies. If a production company is providing services and without the sales of tangible personal property, then production services are likely exempt from sales and uses taxes. Production labor is also taxable in many states. Production companies typically are required to register for sales/use tax purposes in states where filming or production work is performed.

**Customs Duties**

For 2011 the following customs duty rates are generally applied for the described goods:

<table>
<thead>
<tr>
<th>Description</th>
<th>Duty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>35 mm or wider positive release prints</td>
<td>Free</td>
</tr>
<tr>
<td>Negatives, 35 mm or wider</td>
<td>Free</td>
</tr>
<tr>
<td>Sound recordings on motion picture film 35 mm or wider suitable for use with motion picture exhibits</td>
<td>1.4% of dutiable value (NAFTA Free)</td>
</tr>
<tr>
<td>Video tape recordings (VHS), between 4 mm and 6.5 mm</td>
<td>33 cents per linear meter</td>
</tr>
<tr>
<td>Video discs</td>
<td>Free</td>
</tr>
<tr>
<td>Publicity materials (e.g., posters, promotional, flyers, etc.)</td>
<td>Free</td>
</tr>
</tbody>
</table>

**Personal Taxation**

**Income Tax Implications**

**Non-Resident Artists**

The U.S. taxes non-resident artists on their income originating in the U.S. An artist’s income “effectively connected” with a U.S. trade or business is taxed at the graduated income tax rates. Effectively connected income includes income earned by a non-resident artist performing or providing services in the U.S. An income tax exception applies for non-residents present in the U.S. for a period of 90 days or less during the taxable year performing services on behalf of a non-U.S. person and earning less than $3,000 in the aggregate. When the non-resident artist performs services within and outside the U.S. during the taxable year, the income received must be allocated between U.S. and foreign sources in a way that most
accurately reflects the proper source of the income based on the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an allocation on the time basis is appropriate.

Generally, U.S.-source income other than effectively connected income – royalties, for example – is subject to withholding and ultimate tax at a 30-percent rate, unless an applicable treaty reduces this rate.

**Self-Employed**

While a self-employed artist’s income effectively connected with a U.S. trade or business is ultimately subject to the U.S. graduated income tax rates when the tax return is filed, initially it is subject to withholding at a rate of 30 percent (absent the application of a more favorable treaty provision). Income from self-employment usually falls under the Independent Personal Services or Business Income provisions of treaties. Under these provisions, income arising from services rendered by a non-resident artist in the U.S. usually will be taxable in the U.S. only if the individual has a fixed base or permanent establishment in the U.S.

**Employees**

Treaty relief may be available for relatively short (generally less than 183 days) periods of presence in the U.S. However, some treaties contain an “artists and athletes” clause that overrides the otherwise applicable treaty protection for both employees and self-employed artists in the U.S. The artists and athletes clauses often preserve the treaty protection only if specific income or physical presence limitations are not exceeded.

**Resident Artists**

Artists resident in the U.S. generally must pay taxes in the same manner as other U.S. residents. Consequently, the resident artist would be subject to U.S. taxation on worldwide income. Double tax relief is provided by allowing U.S. resident taxpayers a foreign tax credit or foreign tax deduction for non-U.S. income taxes paid; however, the foreign tax credit is limited to the U.S. tax attributable to the non-U.S. source income. Under domestic law, residency is determined under the “substantial presence test” or the “lawful permanent residence test.” Under the substantial presence test, an individual will be considered a resident of the U.S. if present in the U.S. for 183 days during a calendar year, or for at least 31 days during the current calendar year and a total of 183 days for the current and 2 preceding calendar years. For purposes of this 183-day requirement, the number of days present in the U.S. is determined by adding the days present in the current year, one-third of the days present in the
immediately preceding year and one-sixth of the days present in the second preceding year. Under the lawful permanent residence test, any foreign citizen who is a lawful permanent resident—a “green card” holder—in the U.S. will be a resident for tax purposes regardless of the time actually spent in the U.S. Many exceptions apply to these rules, and tax treaties may override the resident definition in domestic law.

**Self-Employed**
Self-employed individuals are required to make estimated income tax payments on a quarterly basis if they expect their annual combined income and self-employment tax liability, after credit for withheld taxes, to equal or exceed $1,000.

**Employees**
Employers with employees resident in the U.S. are obliged to make regular, periodic payments to both the federal government and, possibly, state and local governments with respect to the employee’s personal tax liabilities arising from wages paid by the employer. An employer makes these payments to the federal and state governments with moneys withheld from the employee’s wages.

The amount of income tax required to be withheld and remitted to the government is generally set forth in tax schedules provided by the government. Salaries and wages include both cash remuneration and generally the value of fringe benefits. However, reimbursements of deductible employee business expenses are non-taxable as are certain fringe benefits if they are of a de minimis value.

### Social Security Tax Implications

**Employees**
For resident artists working in the U.S. as employees, the Social Security and Medicare taxes are divided equally into employer and employee shares. Employers are required to withhold the employee’s share of Social Security and Medicare taxes from the employee’s salary and to submit this amount along with the employer’s share to the proper tax authorities. For 2011, Social Security tax is computed at 6.2 percent for the employer and 4.2 percent for the employee (10.4 percent total) up to a taxable annual wage base of $106,800. Medicare withholding is computed at 1.45 percent for both the employer and employee (2.9 percent total) with no applicable wage base limitation.

Non-residents working in the U.S. as employees are generally subject to income tax withholding, Social Security withholding, and Medicare withholding in the same manner as U.S. resident employees (discussed above).
Partial or complete relief from U.S. social security taxes may be available to both resident and non-resident artist employees pursuant to a Social Security Totalization Agreement.

Self-Employment
In addition to income taxes, self-employment tax, at a rate of 15.3 percent, is imposed on net earnings from self-employment. The self-employment tax is made up of a 12.4-percent component imposed on earnings within a specified earnings base that is indexed for inflation ($106,800 for 2011), and a 2.9-percent component imposed without limit.

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