Trends in the Motion Picture Industry Provide Opportunities and Challenges for Accountants: Tax Credits, Crowd Funding and Global Partnerships

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EXECUTIVE SUMMARY

Accountants are faced with an expanding knowledge base including tax credits, crowd funding, and specialized revenue and cost recognition, as filmmakers continue to find innovative ways to produce, finance, and distribute films in the global motion picture industry. They must stay abreast of various tax incentives targeting the industry and of the financial implications of crowd funding. International joint ventures require accountants to understand how unique revenue arrangements, production costs, and other expenses are recognized and reported. These trends provide challenges and opportunities for accounting firms and clients who want to maintain competitiveness in their respective industries and global markets.

Keywords: Film tax credits, Crowd funding, Jobs Act, ASC 926, Motion Picture Industry

INTRODUCTION

Public accountants with an interest or a client base in the motion picture or other entertainment-related industries are well aware of the various business and financial structures and the complicated accounting, reporting and planning for these entities. Complexities exist in utilizing tax incentives designed specifically for the entertainment industry, in using crowd funding as a source of financing production costs, in the accounting for diversified revenue sources and contractual arrangements, and in reporting under Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). Practitioners must be aware of recent and in some cases subtle changes in US accounting standards, as well as the impact of international standards on accounting and reporting in a global entertainment industry in the wake of the Financial Accounting Standards Board's (FASB) and International Accounting Standards Board's (IASB) final version of their revenue recognition standard. In this evolving global industry, public accountants and clients have ultimate loyalty to the bottom line rather than any individual nation's accounting rules. All of these factors contribute to an interwoven industry that provides opportunities and challenges for accountants.

Underlying the complexities of accounting and financing in the motion picture industry is that there is no longer a "typical movie." A movie begins with a story and can end up in a movie theatre, on a television network, on an on-demand service, as a distributed video, or all of the above and more, during which time the ownership of the intellectual property evolves depending on the route the movie takes. The group that wrote or adapted the story does not usually sell the story, and the group that sells the story is not usually responsible for the funding, actors, production and distribution network (Young et al., 2008, 2008). It is during each step of this process that a different type of business structure and/or taxable entity is created and often solely for that individual phase of a project.

Larger accounting firms, specifically, KPMG, Price Waterhouse Coopers, Deloitte, Ernst & Young and Grant Thornton, continually publish detailed interpretive guidance on the complex accounting issues facing the motion picture industry (Deloitte, 2013; Ernst & Young, 2011; Grant Thornton, 2010; KPMG International, 2010; Price Waterhouse Coopers, 2014, 2010, 2009). Smaller regional Certified Public Accounting (CPA) firms and individual CPAs procuring new clients in the movie production or distribution industry may find themselves not only addressing accounting and tax treatment of complex

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contracts and transactions but serving as advisors for appropriate terms of contracts in order to maximize clients' after-tax profits. For example, producers may operate as limited liability company (LLC) to permit tax refunds or any incentives to flow through to individual taxpayers, while at the same time the relevant financing institutions may not prefer to loan funds to LLCs. Additionally, due to differences in state partnership laws in the US, some state tax credits offered may only be applicable to corporations, and thus corporations may then create various LLCs so that the tax credits can be utilized. While non-public production and distribution companies in the entertainment industry may not be required to follow GAAP, presenting financial information necessary for obtaining financing is critical. Experienced accounting professionals are essential in guiding clients through this maze at every turn. This paper addresses three areas of particular interest to accountants: tax incentives and credits in the film industry, the recent financing trend of crowd funding and industry-specific issues in accounting and reporting.

TAX INCENTIVES FOR FILM PRODUCTION

According to the Motion Picture Association of America, the movies and TV industry generates $16.7 billion annually in public revenues, exporting $14.3 billion and involving 108,000 businesses across the US (Motion Picture Association of America, Inc., 2015). The US industry creates more than $104 billion annually in total wages. This has spurred a number of states to offer powerful incentives in the form of state income tax credits in order to persuade production companies to film in their states.

Income tax credits are regional economic tools being used at a global level (Bloomberg BNA, 2013; Screen Daily, 2010). Some states require a minimum qualifying expenditure, limit the annual credit, or impose annual funding caps that make eligibility more competitive (National Conference of State Legislatures, 2014). Production credits are designed to bring non-local spending into a region, provide jobs and spark economic development. In addition to short-run economic and fiscal benefits of employment and spending with an economic multiplier effect, long-run benefits may include increased tourism and development of film and related industry infrastructure (Phillips et al., 2012).

Louisiana was the first US state to offer a film tax credit in 1992 (Henchman, 2010), with three more states participating in 2002, and culminating in at least 39 states offering credits by 2014. Incentives include income tax credits, lodging and sales tax exemptions, employment rebates and free services such as use of municipal property and police protection. It is not just states that are offering incentives; larger cities are piggybacking on state credits to sweeten the offer. While receiving her first Emmy for *30 Rock*, Tina Fey exclaimed in her acceptance speech telecasted world-wide: *"I want to thank the City of New York for the giant tax cuts that make our show possible"*(Atkinson, 2014).

Some US states are beginning to allow their tax credit programs to sunset due to the effects of recession and the perceived ineffectiveness of tax credits on economic development and job growth, while others are expanding programs (Henchman, 2011). North Carolina debated reducing their credit by more than half in 2014, while New York opted to increase their credit to an annual $420 million that includes commercial, TV series and post-production. New Jersey has resisted moving their annual credit allotment beyond $10 million, which has resulted in the popular HBO series *Boardwalk Empire* (set in New Jersey) being filmed in New York. Likewise, another New Jersey set movie *Silver Linings Playbook* was filmed in Pennsylvania where the credit stood at $60 million annually (New York Department of Taxation and Finance, 2010). Louisiana led film production countrywide in 2013 surpassing even California.

Government film incentives can be traced to the beginning of the 20th century in Europe as two or more producers from different countries would partner to take advantage of bilateral treaties that incentivized film production. Incentives may be both regional and national. For example, there are provincial as well as national filmmaking incentives in Canada (Canada Film Capital, 2014). Today, Latin America, the Caribbean and Eastern Europe have become more aggressive with film production incentives, trying to unseat Canada, the US and the United Kingdom (Wharton, University of Pennsylvania, 2013).

Some US states permit the sale of tax credits and therefore film tax credit brokers have been established. The procurement and sale of entertainment tax credits is so successful that there are national brokerage firms representing both buyers and sellers throughout the process. For example, Georgia partnerships, LLCs and S-Corporations are able to purchase film tax credits from an approved seller of the earned credits (State Tax Credit Exchange, 2014). The seller recognizes ordinary

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income and the buyer can carry forward the credit for five years. It is imperative to note that purchased credits can be invalidated if the original calculation of the film tax credit earned by the seller is incorrect. CPAs may be called upon to perform agreed upon procedures for clients and potential credit purchasers and must be well-versed in particular states' credit rules.

In addition to tax credits, tax elections have been available whereby all or a significant portion of film costs are deductible in the year of production. Since many films experience tax losses, investors in productions yielding passive losses can use the losses to offset other passive income. CPAs need to advise clients in making the proper elections in a timely manner so as to take advantage of these tax provisions. Firms may consider becoming pre-certified as experts in the area of film tax credits in their respective states.

GLOBAL FINANCING THROUGH CROWD FUNDING

According to Price Waterhouse Coopers, the global filmed entertainment sector is expected to generate revenues of more than $106 billion by 2017, a significant increase from $88.6 billion in 2012 (Price Waterhouse Coopers, 2009). Improvements in digital technology have created new distribution channels and foreign markets such as China, Thailand, India, Venezuela, Russia and Argentina have been experiencing double-digit compound annual growth rates, creating new markets for the American and international film industries (Howse & McLarney, 2006). Technological advancements in the Chinese and Indian film industries are creating increasing opportunities for joint production and investment, such as *Dreamworks and Reliance Entertainment* in India (Motion Picture Distributors' Association India Private Limited, 2014).

While 80 percent of the US film industry is dominated by a handful of mega studios and distributors, many private investors are now considering movies as an investment, especially independent films or those with smaller budgets, to diversify their portfolios. Today new crowd funding platforms are being established globally and the participation of world famous actors are adding credibility. Even the annual Odessa International Film Festival in the Ukraine is being financed by crowd funding due to the loss of funding from the interim government due to political unrest (Holdsworth, 2014).

Such recent development in the film financing environment has made the potential need for the services of professional accountants even more relevant. In July, 2013, the SEC approved Title II of the Jobs Act which allows US-based film makers to advertise their fundraising efforts publicly within the US and seek crowd funding. Independent film makers are increasingly employing crowd funding as a viable financing tool. These smaller producers may look to CPA firms for their statement preparation or attestation services as required by accredited or public investors for credibility purposes.

Clients utilizing crowd funding should understand the different types of funding (equity, debt, or reward-based), and the possibility of generating taxable income. While equity-based and debt-based funding are not a new concept, reward-based crowd funding especially in the entertainment industry involves pre-selling a product or rights without incurring debt or giving up ownership. Perks such as a T-shirt or a DVD signed by the director, dinner with the Associate Producer, or the title of Executive Producer for $500, along with an invitation to a private screening of the movie premiere (Trigonis, 2013) can trigger taxable events for recipients and funders. Since the IRS does not have a long track record with crowd funding, large inflows of funds into clients' bank accounts may trigger an audit. If the client is not subject to income tax, property transfers, rewards, or incentives may be subject to sales or use tax. In some cases, there may be a charitable deduction for the investors if filmmakers partner with not-for-profit organizations such as Fractured Atlas, a 501(c)(3) providing financial and legal oversight for independent films.

Films with successful crowd funded projects range from very small, raising hundreds of dollars to larger ones, raising hundreds of thousands of dollars. As crowd funding evolves, depending on the type of project being funded, clients may have an obligation to report to the SEC and prepare financials in accordance with GAAP and/or IFRS. The Jobs Act places limits on the value of securities an issuer may offer and how much individuals can invest through crowd funding platforms. An independent financial statement review and an audit by a CPA firm may be required depending on the amount raised. Investors may need to obtain financial accreditation. The SEC continues to seek comments on these proposed and somewhat controversial rules for crowd funding as currently adopted and proposed laws and regulations under Title II, III, IV, Reg. D and Reg. A+ of the Jobs Act continue to evoke public discussion and debate (Securities and Exchange Commission, 2015, 2013). While it is probable that the final rules and regulations may change, the involvement of CPAs is inevitable.

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ACCOUNTING AND REPORTING UNDER GAAP AND IFRS

Accounting practices followed for the production and distribution of motion pictures have been scrutinized for years, as accountants and other stakeholders often felt that industry leaders were even more creative in their accounting than they were in their productions. Complicated contracts that involved multiple business partners and subcontracts, multi-tiered compensation plans, and multifaceted internal cost allocations, made readers of financial statements wary of whether the statements reflected the true and fair profit or loss earned from films. GAAP specifically addresses accounting issues in this industry (ASC 926), but the complexity of the arrangements among the parties involved and the increasing amount of global interdependence brings together parties which may or may not be subject to IFRS. While GAAP specifically addresses this industry, IFRS does not. Therefore, as in other similar situations, the GAAP treatment is acceptable as long as it does not conflict with broader IFRS reporting of comprehensive income, financial position, and cash flow.

FASB's newly converged revenue recognition standards will impact accounting for most entertainment industry clients, since these standards focus on revenue from contracts. For example, contractual arrangements in the film industry often include some minimum guaranteed contract price with additional potential variable payments such as royalties based on performance. Under the new guidance, there may be significant timing differences in the amounts of revenue recorded, as variable consideration will be allowed to be allocated to performance obligations as long it can be reasonably estimated and is reasonably assured to be achieved. This new standard is in line with IFRS, which allows fees and royalties to be recognized when they are probable of being received and can be reliably measurable (FASB Accounting Standards Codification Professional View and GARS Online, 2015).

Motion picture production requires significant up-front investment. Under current US GAAP, most production costs are capitalized and amortized over the life of the expected revenue run of a film, which can be a relatively short period of time. As estimates of the ultimate revenue to be recognized as well as the timing and extent of a film's productive life are constantly updated and adjusted, the amount of film costs amortized are correspondingly adjusted. The accounting for production costs and the methods for allocating production overhead are not expected to be affected by proposed changes in standards. Under proposed standards, all costs of obtaining a contract and those related to contract inefficiencies, as well as those costs that do not relate to future activity should be expensed immediately. Current IFRS is in agreement with these standards, in that film costs are capitalized as intangible assets, and those not capitalized are expensed as incurred. Some differences may exist in the accounting for pre-contract commissions, which under proposed GAAP would be expensed, while under IFRS may be capitalized if the costs can be separately identified, reliably measured and it is probable that the contract will be obtained (Price Waterhouse Coopers, 2014, 2010, 2009).

Since unamortized film costs are held as intangible assets subject to amortization based on estimates of ultimate revenue streams, the question of whether or not to test for impairment is raised. Under current GAAP (ASC 926) impairment should be recorded when the fair value of a film is less than its unamortized film costs. ASU 201-07 adds that events arising after the measurement date that are deemed to have existed as of the measurement date must be incorporated into the impairment calculation. Effects of events that should be included are those that market participants would have considered. If any such events exist, disclosure is required under ASC 855, even if they do not affect the impairment calculation. The impairment testing of unamortized film costs is not in conflict with IFRS. IFRS does not contain industry-specific standards for impairment assessment; general guidance on impairment is found in IAS 36. The steps in impairment testing may be slightly different than GAAP's at present, but qualitative factors are considered in both GAAP and IFRS, and the definitions of fair value are comparable (Deloitte, 2013; FASB Accounting Standards Codification Professional View and GARS Online, 2015).

CONCLUSION

There is no doubt that public accounting firms with clients in the motion picture and other entertainment-related industries must be well-versed in the various financial structures and the complicated accounting, reporting, and tax planning for these entities. Clients will expect firms to provide guidance and service on all fronts. The local, national and international knowledge base on tax credits, crowd funding, revenue recognition, and accounting for costs is constantly expanding and

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evolving. This combination of trends provides interesting challenges and opportunities public accounting firms and their clients who want to maintain competitiveness in their respective industries and global markets.

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