

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2007-31, page 769.

This document contains the annual report to the public concerning Advance Pricing Agreements (APAs) and the experience of the APA Program during calendar year 2006. This document does not provide guidance regarding the application of the arm's length standard. Instead, it reports on the structure and activities of the APA Program.

INCOME TAX

Rev. Rul. 2007-14, page 747.

Obsolete revenue rulings. As part of the Service's continuing program of reviewing previously published guidance, this ruling publishes a list of rulings and actions relating to decisions of the Tax Court that are obsolete. Rev. Rul. 54-19 obsoleted in part. Rev. Ruls. 55-132, 56-462, 56-518, 57-505, 58-370, 58-500, 69-212, and 71-477 obsoleted.

T.D. 9312, page 736.

REG-115403-05, page 767.

Temporary and proposed regulations under section 181 of the Code provide rules relating to deductions for the cost of producing film and television productions.

REG-100841-97, page 763.

Proposed regulations under section 6159 of the Code govern the acceptance and rejection of installment agreements, the terms of those agreements and when they may be modified or terminated by the Service, and appeal procedures when the Service makes a rejection or termination decision. The principal purpose of this project is to update the regulations

to reflect various amendments to section 6159 and related statutes.

Notice 2007-17, page 748.

The IRS and Treasury anticipate the launch of a pilot program to solicit greater input from the public in the initial development of certain types of guidance projects. As a model for the pilot program, the IRS and Treasury solicit input from interested parties on whether it is appropriate to amend existing income tax regulations to permit certain modifications to securitized commercial mortgage loans.

Notice 2007-24, page 750.

This notice invites public comments on draft IRS forms to implement a new information reporting requirement for charities and certain other entities with respect to certain structured insurance contracts. The notice also solicits comments with respect to a Congressionally mandated study being conducted by Treasury and the IRS.

Notice 2007-25, page 760.

This notice provides modifications and additions to the adjusted limitations on housing expenses for tax year 2006 published in Notice 2006-87, 2006-43 I.R.B. 766, for purposes of section 911 of the Code. Notice 2006-87 modified and supplemented.

(Continued on the next page)

Finding Lists begin on page ii.



Rev. Proc. 2007–25, page 761.

This procedure provides additional guidance regarding the disclosure of certain penalties under section 6707A(e) of the Code on forms filed with the U.S. Securities and Exchange Commission. Rev. Proc. 2005–51, 2005–2 C.B. 296, provides that a person who files SEC Form 10–K, *Annual Report*, must disclose in Item 3 (Legal Proceedings) of Form 10–K the requirement to pay any penalty specified in section 2.05 of Rev. Proc. 2005–51. This procedure describes how persons who are required to file periodic reports under section 13 or 15(d) of the Securities Exchange Act of 1934, or required to be consolidated with another person for purposes of those reports, but that file these periodic reports on a form other than a Form 10–K, must make the appropriate disclosures on these other reports in order to avoid additional penalties. Rev. Proc. 2005–51 amplified.

ESTATE TAX

REG–100841–97, page 763.

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GIFT TAX

REG–100841–97, page 763.

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EMPLOYMENT TAX

REG–100841–97, page 763.

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Rev. Proc. 2007–25, page 761.

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EXCISE TAX

REG–100841–97, page 763.

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ADMINISTRATIVE

Rev. Proc. 2007-25, page 761.

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The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 181.—Treatment of Certain Qualified Film and Television Productions

26 CFR 1.181-1T: Deduction for qualified film and television production costs (temporary).

T.D. 9312

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Section 181 — Deduction for Qualified Film and Television Production Costs

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulation.

SUMMARY: This document contains temporary regulations relating to deductions for the cost of producing film and television productions under section 181. These temporary regulations reflect changes to the law made by the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005, and affect taxpayers that produce films and television productions within the United States. The text of these temporary regulations also serves as the text of the proposed regulations (REG-115403-05) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective February 9, 2007.

Applicability Dates: For dates of applicability, see §1.181-6T.

FOR FURTHER INFORMATION CONTACT: Bernard P. Harvey, (202) 622-3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Pro-

cedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-2059. Responses to these collections of information are required to obtain a tax benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 to provide regulations under section 181 of the Internal Revenue Code of 1986 (Code). Section 181 was added to the Code by section 244 of the American Jobs Creation Act of 2004, Public Law No. 108-357 (118 Stat. 1418) (Oct. 22, 2004), and was modified by section 403(e) of the Gulf Opportunity Zone Act of 2005, Public Law No. 109-135 (119 Stat. 2577) (Dec. 21, 2005).

Explanation of Provisions

For several years, independent filmmakers and television producers have moved production activities from the United States to other countries. Frequently, this has been motivated by credits and other incentives offered by foreign governments to attract the economic benefits gained by hosting these productions.

Congress enacted section 181 to make domestic production more attractive to these taxpayers.

Section 181 permits the owner of a qualified film or television production to elect to deduct production costs in the year the costs are paid or incurred in lieu of capitalizing the costs and recovering them through depreciation allowances if the aggregate costs do not exceed \$15 million for each qualifying production (\$20 million if a significant amount of the production costs are incurred in certain designated areas) (the “production cost limit”). A film or television production is a qualified film or television production if 75 percent of the total compensation of the production is compensation for services performed in the United States by actors, directors, producers, and other relevant production personnel (the “75 percent test”).

Allowance of Deduction

The deduction under section 181 is allowed for the cost of producing qualified film and television productions for which principal photography begins after October 22, 2004, and before January 1, 2009. Production costs incurred before or after this period may be deducted so long as principal photography commences during the period.

Section 181 refers to “the taxpayer” who makes the election and takes the deduction. The temporary regulations provide that only the owner of the film or television production may elect to deduct production costs under section 181. Under the regulations, the owner of the production is deemed to be the person or persons otherwise required to capitalize production costs into the basis of the film or television production under section 263A (or the person or persons that would be required to capitalize production costs if subject to section 263A).

The production costs that must be taken into account (for both the amount of the deduction and for the production cost limit) are the amounts that, absent section 181, are required to be capitalized under section 263A (or the amounts that would be required to be capitalized if the taxpayer

was subject to section 263A). Although a film's budget might be evidence that the production costs will not exceed the production cost limit, the budget is not the same as production costs for purposes of section 181. All production costs eligible to be deducted under section 181 are subject to the production cost limit. Under the temporary regulations, distribution costs are specifically excluded from the definition of production costs under section 181, consistent with the exclusion of distribution costs under section 263A.

Section 181 does not require the production to be placed in service in order for the producer to begin deducting production costs, and there is no requirement that the production ever be placed in service or completed. However, the temporary regulations require that, at the time the election is made and in any year that a deduction is claimed, a taxpayer must have a reasonable basis for believing that the production will be set for production (as defined in American Institute of Certified Public Accountants Statement of Position 00-2), will be a qualified film or television production upon completion, and will not exceed the production cost limit. For example, a taxpayer that has developed a shooting script, has a well-documented budget, and has obtained financing on the basis of these facts is in a good position to determine whether it has a reasonable basis to claim the deduction.

The temporary regulations treat the cost of acquiring a production as a production cost. This rule is premised upon the understanding that under section 1245, the seller would recapture upon the sale of the production any section 181 deduction that the seller had claimed. In the case of a sale between related parties, the purchaser must treat the greater of the acquisition cost or the seller's production cost as the purchaser's production cost for purposes of the production cost limit, notwithstanding that the purchaser's deduction under section 181 is based on the purchaser's actual acquisition cost.

In the film industry, once a prospective producer has determined the estimated budget for a production, it usually must obtain financing from a bank or other lender to cover at least part of the production cost. The producer may incur up-front costs in obtaining such financing. The producer's pre-sale agreements with distributors may

be used as collateral for this financing. Generally, the financier will be repaid directly by these distributors upon delivery of the finished production. In addition, the financier will usually require that the producer obtain a completion guarantee (often referred to as a completion bond) as a condition of the loan. The completion guarantee is a guarantee that, if the production costs exceed the budgeted costs or the loan proceeds are mishandled, the film will still be completed and/or the financier will be made whole. A completion guarantee can be satisfied in a number of ways. For example, the guarantor may loan funds to the producer to finish the production, may finish the production itself (although this is rare), or may reimburse the financier for the amount loaned to the producer (plus interest and other charges). Generally, the producer must pay an up-front amount in order to obtain a completion guarantee.

The temporary regulations provide that the costs of obtaining financing, including premium costs for completion guarantees, are production costs that are subject to the production cost limit and are deductible under section 181. In addition, if the completion guarantor loans additional funds to the producer and the funds are expended by the producer to complete the production, or if the completion guarantor incurs additional production costs on its own behalf, the additional funds are production costs under section 181.

Participations and residuals (P&R) are defined in section 167(g)(7)(B), as costs with respect to an item of property described in section 167(g)(6), the amount of which by contract varies with the amount of income earned in connection with the property. In the context of film and television production, participations are payments to actors, directors, and other talent based on a contractually-defined measure of future income from the production. Residuals are payments made pursuant to collective-bargaining agreements, such as those of the directors' and actors' guilds, based upon non-theatrical sales, under terms that differ between video, free television, and pay television sales. Participations are generally paid by the producer but may be assumed by a third-party distributor. On the other hand, residuals are generally paid by a distributor out of its gross receipts from the production. Industry accounting generally

treats participation payments made by distributors as a reduction in the producer's profit rather than a production cost, and generally treats residual payments made by distributors as a distribution cost.

Various comments were received with respect to the treatment of P&R under section 181. Some comments suggested that taxpayers be permitted to elect to deduct participation payments (rather than capitalizing those payments into the basis of the production) under the income forecast method rather than section 181. Other comments suggested that Congress, by specifically excluding P&R costs paid or incurred by the taxpayer from the definition of "qualified compensation" in section 181(d)(3), intended these costs to be excluded from the production cost limit in section 181(a)(2). Comments received also suggested that P&R costs should be excluded for purposes of determining whether the production cost limit is exceeded, but nonetheless should be deductible production costs under section 181.

In addition, various comments expressed concerns about productions being subsequently disqualified if P&R costs are included in determining if the production cost limit is exceeded. For example, a taxpayer forecasts its production costs (including a reasonable amount of P&R costs based upon projected income from the production) and based upon this forecast the taxpayer determines it has a reasonable basis for making an election under section 181. However, if an unexpectedly large amount of P&R is later paid as a result of production earnings being much greater than was initially expected, with the result that the total production cost exceeds the production cost limit, the production would become disqualified from treatment under section 181.

The temporary regulations provide that P&R costs are considered production costs for purposes of the production cost limit. The IRS and Treasury Department recognize that P&R costs are costs that are generally subject to capitalization under section 263A (see §1.263A-1(e)(2) and §1.263A-1(e)(3)). Nonetheless, an explicit reference to P&R costs is provided in the temporary regulations in order to avoid any uncertainty with respect to these costs.

The IRS and Treasury Department believe that the statute requires P&R costs

to be included in the production cost limit. For example, the statute specifically provides that participations and residuals are excluded from the definition of compensation for purposes of determining whether the production was a qualified film or television production, as defined in section 181(d)(1). This explicit exclusion is not found in the production cost limit of section 181(a)(2) or elsewhere in section 181.

In addition, the IRS and Treasury Department are concerned that if P&R costs were excluded from the definition of production costs under section 181, section 181(b) could cause them to be nondeductible under any provision of the Internal Revenue Code. Specifically, section 181(b) states that no depreciation or amortization deduction other than the deduction provided under section 181 is allowed for the basis of a qualified film or television production for which an election has been made. Therefore, if P&R costs were excluded from the definition of production costs under section 181, a taxpayer wishing to expense P&R costs under the holding of *Associated Patentees*, 4 T.C. 979 (1945), may be barred from doing so under section 181(b), as the holding in that case is explicit that a deduction under *Associated Patentees* is a depreciation deduction of basis.

Additionally, the IRS and Treasury Department are concerned that a blanket exclusion of participations from the definition of production costs would allow taxpayers to manipulate the total production cost (and avoid the production cost limit) by structuring compensation as participation payments. Commentators argued that this potential abuse could be mitigated with an anti-abuse rule that treats only those participations that are disguised non-contingent or guaranteed payments, where the talent incurs minimal risk of non-payment (for example, participations with a payment priority over distribution cost repayment and/or production financing cost repayment) as production costs subject to the production cost limit, but does not treat other participation costs as production costs.

The IRS and Treasury Department considered excluding from the amount to be taken into consideration as production costs any residuals (payments to actors' or directors' guilds based on gross income from exploitation in secondary markets)

that are paid by the distributor or other third party, under the theory that these payments are costs of exploiting the finished production. However, the same argument could be advanced for participations contingent on income, notwithstanding that most participations are taken in lieu of compensation for services (normally a production cost). In addition, a payment of residuals by a third party is still made on the producer's behalf, and the producer remains the party with ultimate liability for the payment. Thus, the temporary regulations provide that P&R costs are production costs that are deductible under section 181 and are included in the production cost limit.

Section 181(a)(2)(B) provides a higher production cost limit for a qualified film or television production "the aggregate cost of which is significantly incurred" in a designated area. Designated areas include areas eligible for designation as low-income communities or certain distressed counties and isolated areas. However, neither the statute nor its legislative history provides a definition for "significantly incurred," nor do they explain how the standard should be applied. However, Congress' stated intent in enacting section 181 was to encourage economic activity in these designated areas. Accordingly, the temporary regulations provide two different tests for establishing when production costs have been significantly incurred in a designated area. One test is based upon production costs while the other is based upon days of production. Under the first of these tests, the temporary regulations establish a 20 percent threshold for the "significantly incurred" standard (similar to the rules of §1.199-3(g)(3)). This test compares production costs incurred in first-unit principal photography that takes place in a designated area to all production costs incurred for first-unit principal photography. First-unit principal photography typically films the primary actors, whereas second-unit principal photography typically films shots that establish location or context (exteriors of buildings, crowds, cars passing). Production costs of principal photography include, for example, compensation to actors, directors and other production personnel, location costs, camera rental and insurance, and catering. This 20 percent test is based upon production costs incurred in first-unit principal

photography and ignores all other production costs such as preproduction, editing, and postproduction costs for purposes of the "significantly incurred" requirement. These other production costs often greatly exceed principal photography costs, and must be incurred where adequate production facilities exist (and it is likely that few such facilities are available in the designated areas). The IRS and Treasury Department believe that if all production costs were taken into consideration in determining whether the 20 percent "significantly incurred" threshold had been met, very few films would qualify for the higher production cost limit, even if a substantial amount of principal photography occurred in a designated area. However, we request comments regarding whether the exclusion of preproduction, editing, and postproduction costs will unfairly impact taxpayers.

Comments were received requesting that consideration be given to developing a "significantly incurred" test based upon the number of days of principal photography. The temporary regulations adopt this suggestion and provide, as an alternative to the 20 percent cost-based test, a "significantly incurred" test based upon the total number of days of principal photography. Under this test, if at least 50 percent of the total days of principal photography take place in a designated area, the production will be deemed to have satisfied the "significantly incurred" requirement of section 181(a)(2)(B). This 50 percent test may provide a simpler computation than the 20 percent cost-based test and avoids issues such as the allocation of salaries to specific days of principal photography.

A taxpayer intending to utilize the \$20 million production cost limit under section 181(a)(2)(B) must maintain records adequate to demonstrate that it has a reasonable basis under the "significantly incurred" standard to support reliance on the higher dollar limitation.

Election

The Conference report underlying section 181 provides that, until the Secretary publishes specific guidance, taxpayers may make a valid election under section 181 by claiming the deduction on the taxpayer's return for the year that production costs are first incurred. H.R. Conf.

Rep. 108-755. The IRS published the section 181 election requirements in Notice 2006-47, 2006-20 I.R.B. 892, May 15, 2006. See §601.601(d)(2)(ii)(b). The notice also includes transition rules for taxpayers that incurred costs during the period prior to October 22, 2004 (the enactment of section 181) for productions that qualify under section 181 (that is, productions for which principal photography began on or after October 22, 2004). The temporary regulations provide the same election requirements and transition rules, along with a requirement that the taxpayer have a reasonable basis for claiming the deduction.

Many films are owned by a passthrough entity with more than one owner. The temporary regulations provide that if the production is owned by a partnership, the election is made at the partnership level.

Section 181(c)(2) provides that an election under section 181 may not be revoked without the consent of the Secretary. However, the election is effectively revoked if the production costs exceed the production cost limit or if the production fails to be a qualified film or television production. In recognition of the concerns expressed by commentators over the inclusion of P&R costs in the definition of production costs under section 181, and the fact that the requirements of section 181 may ultimately not be met notwithstanding a prior reasonable basis for believing otherwise, the temporary regulations permit taxpayers to revoke a section 181 election by filing a statement with the return for the taxable year in which the revocation is effective identifying the production for which the election is revoked. The return for that taxable year must also report compliance with the recapture provisions discussed in "Special Rules" in this preamble.

Qualified Film or Television Production (definitions)

Both the Senate report and the Conference report underlying section 181 state that "the provision defines a qualified film or television production as any production of a motion picture (whether released theatrically or directly to video cassette or any other format); miniseries; scripted, dramatic television episode; or movie of the week" that satisfies the 75 percent test. The definition provided in the Senate

report and the Conference report arguably would exclude productions that do not fall within these delineated categories, such as reality programming, documentaries, sports programs, news programs, variety shows, game shows, live performances, interview and talk shows, commercials and "infomercials," religious/inspirational programming, educational programming, exercise shows, training videos, and others. Comments were received noting that it appeared from the legislative history that Congress intended for the provision to apply only to a motion picture, miniseries, scripted dramatic television episode, or movie of the week. Notwithstanding the legislative history, section 181(d)(2) itself defines a production as "property described in section 168(f)(3)." Section 168(f)(3) property is "any film or video tape." Accordingly, the temporary regulations adopt the broader statutory definition provided in section 168(f)(3) and specifically define a production under section 181 to include any film or video tape production the production cost of which is subject to capitalization under section 263A.

Once a film or television production is released or broadcast, the taxpayer may face additional costs to prepare the production for foreign distribution, rebroadcast (for example, editing a theatrical film for television), or release to the home video market. Consistent with the approach taken under the income forecast method (see section 167(g)(5)(A)(ii)), these costs are not treated as production costs of the film or television production for purposes of the production cost limit under section 181(a)(2), and no deduction may be taken under section 181 for such costs.

Section 181(d)(1) compares qualified compensation to total compensation in applying the 75 percent test. Although qualified compensation is defined by section 181(d)(3)(A) as compensation for services performed in the United States by actors, directors, producers, and other relevant production personnel, the 75 percent test compares this amount to the "total compensation of the production." In order to be consistent with the definition provided for in section 181(d)(3)(A), the temporary regulations define "total compensation of the production" as the total amount of compensation paid for services performed anywhere by actors, directors,

producers, and other relevant production personnel in the production of the film or television production. In addition, the temporary regulations specifically provide that the terms compensation and qualified compensation include compensation paid to persons who are not directly employed by the producer.

The term *qualified compensation* is defined as compensation for services by various participants performed "in the United States." The definition of "United States" in section 7701(a)(9) includes the 50 states and the District of Columbia. Although the goal of section 181 is to encourage economic activity within the United States as defined in section 7701(a)(9), the use of a standard based upon principal photography requires the use of a slightly broader definition that takes into account that the physical act of principal photography may take place on land, at sea, or in the air. Consequently, the temporary regulations provide that a service is performed in the United States for purposes of the 75 percent test if the principal photography to which the service relates occurs within the fifty states, the District of Columbia, the territorial waters of the continental United States, or the airspace or space above the continental United States and its territorial waters.

There are some services related to a production that may physically take place at a variety of places outside the control and knowledge of the producer (for example, training, rehearsal, and pre- and post-production). However, the producer has direct or indirect control and knowledge of the shooting location of principal photography with which these other services are associated. Therefore, the IRS and Treasury Department believe that as a general rule the 75 percent test should be based upon the locations where principal photography occurs.

In this regard, the temporary regulations provide a special rule for animated productions. Although these productions may have a "principal photography" analogue, the production process is completely different and the majority of the work of the "talent" is performed independent of the actual frame photography. Computer-generated animation is not photographed at all. Hand-drawn animated films involve the creation of a storyboard (sketches of the story action) by

the principal artists. Once the storyboards are approved, individual frames showing important moments in the action called “keyframes” are created by the principal artists, after which the frames in between these frames (the “in-betweens”) are produced by assistant animators. These in-betweens are frequently outsourced overseas. Background art is created separately. The animation frames are transferred to plastic cels with a copier or, in some cases, are hand painted on the cels (or both). The cels are then photographed against the background art. Voice acting, music, and Foley (sound effects) are recorded independently. All of these elements are then combined into the finished film.

The production process for computer animation is similar, except that the principal artists work directly with computer programmers to create keyframe images in the animation software. In-between work is less likely to be outsourced, as the computer can generate most in-between frames from the keyframes themselves. Background art can be created within the computer program or scanned in from physical artwork. Post-production is generally done completely in the digital realm, and the final product is output to disc.

The temporary regulations apply the 75 percent test to animated productions based upon the production locations for (at least) the keyframe animation, the in-between animation, the animation photography, and the recording of the voice acting performances instead of the location where principal photography takes place. A separate rule is provided for productions that combine animation and live action, taking into account the production locations for the animation functions in addition to the location of principal photography.

Special Rules

The version of the legislation that became section 181 (as originally passed by the Senate) provided a deduction for production costs up to \$15 million, and allowed production costs in excess of \$15 million to be depreciated using the straight-line method over a 36-month period. Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. §321 (2003). The depreciation provision was removed in conference, with the result that the deduction does not apply to qual-

ified film or television productions with an aggregate production cost in excess of \$15 million (\$20 million if a significant amount of the production costs are incurred in designated areas.) Section 181 is silent as to what should happen when a production appears to meet the requirements of section 181 in the year the election is first made, but fails to meet those requirements thereafter (for example, when the production cost exceeds \$15 million, or when the production no longer meets the 75 percent test).

The temporary regulations provide a recapture provision that requires the recapture of any production costs previously deducted under section 181 in the year the election is voluntarily revoked or the production fails to meet the requirements of section 181. For property already placed in service, the taxpayer must include in income the difference between the aggregate amount claimed under section 181 and the depreciation that would have been otherwise allowable with respect to the production in the same years. For a production not yet placed in service, the taxpayer must include in income the aggregate amount claimed under section 181. The structure of the recapture provision is intended in part to alleviate concerns that including P&R in the definition of production costs under section 181 would cause taxpayers to completely forgo the benefits of section 181. Under the temporary regulations, a taxpayer with a reasonable belief that it is producing a qualified film or television production, and that the production cost will not exceed the production cost limit, will be permitted to elect to currently deduct production costs under section 181 with the understanding that a recapture may be required in a later year if circumstances or expectations change. A taxpayer that is required to recapture previously deducted production costs under section 181 will nonetheless be permitted to deduct otherwise allowable depreciation expenses in future years.

Prior to the technical correction enacted in the Gulf Opportunity Zone Act of 2005, a taxpayer could potentially incur production costs, deduct the production costs under section 181 against ordinary income, then sell the film after holding it for one year and report the proceeds (including the gain attributable to the basis reduction from the section 181 deduction) as a

long-term capital gain, effectively converting ordinary income to capital gain. This potential “tax flip,” existed because, as originally enacted, the statute did not specify that the deduction under section 181 is a deduction for depreciation or amortization, or state that it is subject to recapture under section 1245. The technical correction specifically treats a deduction under section 181 as a deduction for depreciation or amortization that is subject to recapture under section 1245, and the temporary regulations follow this rule.

Effective Date

The temporary regulations apply to qualified film and television productions with respect to which principal photography or, in the case of an animated production, in-between animation, commenced on or after February 9, 2007 and before January 1, 2009.

Effect on Other Documents

The following publications are modified as of February 9, 2007:

Notice 2006-47, 2006-20 I.R.B. 892, is modified by removing section B.2. in the INTERIM PROVISIONS of Notice 2006-20.

Rev. Proc. 2002-9, 2002-1 C.B. 327, is modified and amplified to include the automatic changes in methods of accounting in §1.181-2T(d)(2) and (e)(1) in the APPENDIX of Rev. Proc. 2002-9.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), please refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Bernard P. Harvey, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Sections 1.181-0T through 1.181-6T are added to read as follows:

§1.181-0T Table of contents (temporary).

This section lists the table of contents for §§1.181-1T through 1.181-6T.

§1.181-1T Deduction for qualified film and television production costs (temporary).

- (a) Deduction.
 - (1) In general.
 - (2) Owner.
 - (3) Production costs.
- (b) Limit on amount of production costs and amount of deduction.
 - (1) In general.
 - (2) Higher limit for productions in certain areas.
 - (i) In general.
 - (ii) Significantly incurred.
 - (iii) Animated film and television productions.
 - (iv) Productions incorporating both live action and animation.
 - (v) Records required.
 - (c) No other depreciation or amortization deduction allowed.

§1.181-2T Election (temporary).

- (a) Time and manner of making election.
- (b) Election by entity.
- (c) Information required.
 - (1) Initial election.
 - (2) Subsequent taxable years.
 - (3) Deductions by more than one owner.

- (d) Revocation of election.
 - (1) In general.
 - (2) Consent granted.
 - (e) Transition rules.
 - (1) Costs first paid or incurred prior to October 23, 2004.
 - (2) Returns filed after June 14, 2006, and before March 12, 2007.
 - (3) Information required.

§1.181-3T Qualified film or television production (temporary).

- (a) In general.
- (b) Production.
 - (1) In general.
 - (2) Special rules for television productions.
 - (3) Exception for certain sexually explicit productions.
- (c) Compensation.
 - (d) Qualified compensation.
 - (e) Special rule for acquired productions.
 - (f) Other definitions.
 - (1) Actors.
 - (2) Production personnel.
 - (3) United States.

§1.181-4T Special rules (temporary).

- (a) Recapture.
 - (1) Applicability.
 - (2) Principal photography not commencing prior to January 1, 2009.
 - (3) Amount of recapture.
 - (b) Recapture under section 1245.

§1.181-5T Examples (temporary).

§1.181-6T Effective date (temporary).

- (a) In general.
- (b) Application of regulation project REG-115403-05 to pre-effective date productions.
- (c) Special rules for returns filed for prior taxable years.

§1.181-1T Deduction for qualified film and television production costs (temporary).

- (a) *Deduction*—(1) *In general.* The owner (as defined in paragraph (a)(2) of this section) of any film or television production (as defined in §1.181-3T(b)) that the owner reasonably expects will be, upon completion, a qualified film or television production (as defined in §1.181-3T(a))

for which the production costs (as defined in paragraph (a)(3) of this section) will not be in excess of the production cost limit of paragraph (b) of this section may elect to treat all production costs incurred by the owner as an expense that is deductible in the taxable year in which the costs are paid (in the case of a taxpayer who uses the cash method of accounting) or incurred (in the case of a taxpayer who uses the accrual method of accounting). This deduction is subject to recapture if the owner's expectations prove to be inaccurate. This section provides rules for determining who is the owner of a production, what is a production cost, and the maximum production cost that may be incurred for a production for which an election is made under section 181 of the Internal Revenue Code (Code). Section 1.181-2T provides rules for making the election under section 181. Section 1.181-3T provides definitions and rules concerning qualified film and television productions. Section 1.181-4T provides special rules, including rules for recapture of the deduction. Section 1.181-5T provides examples of the application of §§1.181-1T through 1.181-4T, while §1.181-6T provides the effective date of §§1.181-1T through 1.181-5T.

(2) *Owner.* For purposes of this section and §§1.181-2T through 1.181-6T, the owner of a production is any taxpayer that is required under section 263A to capitalize costs paid or incurred in producing the production into the cost basis of the production, or that would be required to do so if section 263A applied to that taxpayer. A taxpayer that obtains only a limited license or right to exploit a production, or receives an interest or profit participation in a production as compensation for services, generally is not an owner of the production for purposes of this section and §§1.181-2T through 1.181-6T.

(3) *Production costs.* (i) The term *production costs* means all costs paid or incurred by the owner in producing or acquiring a production that are required, absent the provisions of section 181, to be capitalized under section 263A, or that would be required to be capitalized if section 263A applied to the owner. These production costs specifically include, but are not limited to, participations and residuals, compensation paid for services, compensation paid for property rights, non-compensation costs, and costs paid

or incurred in connection with obtaining financing for the production (for example, premiums paid or incurred to obtain a completion bond for the production).

(ii) Production costs do not include costs paid or incurred to distribute or exploit a production (including advertising and print costs).

(iii) Production costs do not include the costs to prepare a new release or new broadcast of an existing film or video after the initial release or initial broadcast of the film or video (for instance, the preparation of a DVD release of a theatrically-released film, or the preparation of an edited version of a theatrically-released film for television broadcast). Costs paid or incurred to prepare a new release or a new broadcast of a film or video that has previously been released or broadcast, therefore, are not taken into account for purposes of paragraph (b) of this section, and may not be deducted under this paragraph (a).

(iv) If a production (or any right or interest in a production) is acquired from any person bearing a relationship to the taxpayer described in section 267(b) or section 707(b)(1), and the costs paid or incurred to acquire the production are less than the seller's production cost, the purchaser must treat the seller's production cost as a production cost of the acquired production for purposes of determining whether the aggregate production cost paid or incurred with respect to the production exceeds the applicable production cost limit imposed under paragraphs (b)(1) and (b)(2) of this section. Notwithstanding this paragraph (a)(3)(iv), the taxpayer's deduction under section 181 is limited to the taxpayer's acquisition cost of the production plus any further production costs incurred by the taxpayer.

(v) The provisions of this paragraph (a) apply notwithstanding the provisions of section 167(g)(7)(D).

(b) *Limit on amount of production cost and amount of deduction*—(1) *In general.* Except as provided under paragraph (b)(2) of this section, the deduction permitted under section 181 does not apply in the case of any production, the production cost of which exceeds \$15,000,000.

(2) *Higher limit for productions in certain areas*—(i) *In general.* This section is applied by substituting \$20,000,000 for

\$15,000,000 in the case of any production the aggregate production cost of which is significantly incurred in an area eligible for designation as—

(A) A low income community under section 45D; or

(B) A distressed county or isolated area of distress by the Delta Regional Authority established under 7 U.S.C section 2009aa-1.

(ii) *Significantly incurred.* The aggregate production cost of a production is significantly incurred within one or more areas specified in paragraph (b)(2)(i) of this section if—

(A) At least 20 percent of the total production cost incurred in connection with first-unit principal photography for the production is incurred in connection with first-unit principal photography that takes place in such areas; or

(B) At least 50 percent of the total number of days of first-unit principal photography for the production consists of days during which first-unit principal photography takes place in such areas.

(iii) *Animated film and television productions.* For purposes of an animated film or television production, the aggregate production cost of the production is significantly incurred within one or more areas specified in paragraph (b)(2)(i) of this section if—

(A) At least 20 percent of the total production cost incurred in connection with keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production is incurred in connection with such activities that take place in such areas; or

(B) At least 50 percent of the total number of days of keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production consists of days during which such activities take place in such areas.

(iv) *Productions incorporating both live action and animation.* For purposes of a production incorporating both live action and animation, the aggregate production cost of the production is significantly incurred within one or more areas specified in paragraph (b)(2)(i) of this section if—

(A) At least 20 percent of the total production cost incurred in connection with

first-unit principal photography, keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production is incurred in connection with such activities that take place in such areas; or

(B) At least 50 percent of the total number of days of first unit principal photography, keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production consists of days during which such activities take place in such areas.

(v) *Records required.* A taxpayer intending to utilize the higher production cost limit under paragraph (b)(2)(i) of this section must maintain records adequate to demonstrate qualification under this paragraph (b)(2).

(c) *No other depreciation or amortization deduction allowed.* (1) Except as provided in paragraph (c)(2) of this section, an owner that elects to deduct production costs under section 181 with respect to a production may not deduct production costs for that production under any provision of the Code other than section 181 unless §1.181-4T(a) applies to the production. In addition, except as provided in paragraph (c)(2) of this section, an owner that has, in a previous taxable year, deducted any production cost of a production under a provision of the Code other than section 181 is ineligible to make an election with respect to that production under section 181.

(2) An owner may make an election under section 181 despite prior deductions claimed for amortization of the cost of acquiring or developing screenplays, scripts, story outlines, motion picture production rights to books and plays, and other similar properties for purposes of potential future development or production of a production under any provision of the Code if such costs were incurred before the first taxable year in which an election could be made under §1.181-2T(a). However, the production cost of the production does not include costs that a taxpayer has begun to amortize prior to the time that the production is set for production (for further guidance, see Rev. Proc. 2004-36, 2004-1 C.B. 1063, and §601.601(d)(2)(ii)(b) of this chapter).

§1.181-2T Election (temporary).

(a) *Time and manner of making election.* (1) Except as provided in paragraph (e) of this section, a taxpayer electing to deduct the production cost of a production under section 181 must do so in the time and manner described in this paragraph (a). Except as provided in paragraphs (a)(2) and (e) of this section, the election must be made by the due date (including extensions) for filing the taxpayer's Federal income tax return for the first taxable year in which production costs (as defined in §1.181-1T(a)(3)) have been paid or incurred. See §301.9100-2 of this chapter for a six-month extension of this period in certain circumstances. The election under section 181 is made separately for each production produced by the owner.

(2) An owner may not make an election under paragraph (a)(1) of this section until the first taxable year in which the owner reasonably expects (based on all of the facts and circumstances) that—

(i) The production will be set for production and will, upon completion, be a qualified film or television production; and

(ii) The aggregate production cost paid or incurred with respect to the production will, at no time, exceed the applicable production cost limit set forth under §1.181-1T(b) of the regulations.

(3) If the election under this paragraph (a) is made in a taxable year subsequent to the taxable year in which production costs were first paid or incurred because paragraph (a)(2) of this section was not satisfied until such subsequent taxable year, the election must be made in the first such taxable year, and any production costs incurred prior to the taxable year in which the taxpayer makes the election are treated as production costs (except as provided in §1.181-1T(c)(2)) that are deductible under §1.181-1T(a) in the taxable year paragraph (a)(2) of this section is first satisfied and the election is made.

(b) *Election by entity.* In the case of a production owned by an entity, the election is made by the entity. For example, the election is made for each member of a consolidated group by the common parent of the group, for each partner by the partnership, or for each shareholder by the S corporation. The election must be made by the due date (including extensions) for filing the return for the later of the taxable

year of the entity in which production costs are first paid or incurred or the first taxable year in which §1.181-2T(a)(2) is satisfied.

(c) *Information required—(1) Initial election.* For each production to which the election applies, the taxpayer must attach a statement to the return stating that the taxpayer is making an election under section 181 and providing—

(i) The name (or other unique identifying designation) of the production;

(ii) The date production costs were first paid or incurred with respect to the production;

(iii) The amount of production costs (as defined in §1.181-1T(a)(3)) paid or incurred with respect to the production during the taxable year (including costs described in §1.181-2T(a)(3));

(iv) The aggregate amount of qualified compensation (as defined in §1.181-3T(d)) paid or incurred with respect to the production during the taxable year (including costs described in §1.181-2T(a)(3));

(v) The aggregate amount of compensation (as defined in §1.181-3T(c)) paid or incurred with respect to the production during the taxable year (including costs described in §1.181-2T(a)(3));

(vi) If the owner expects that the total production cost of the production will be significantly paid or incurred in (or, if applicable, if a significant portion of the total number of days of principal photography will occur in) one or more of the areas specified in §1.181-1T(b)(2)(i), the identity of the area or areas, the amount of production costs paid or incurred (or the number of days of principal photography engaged in) for the applicable activities described in §1.181-1T(b)(2)(ii), (iii), or (iv), as applicable, that take place within such areas (including costs described in §1.181-2T(a)(3)), and the total production cost paid or incurred (or the total number of days of principal photography engaged in) for such activities (whether or not they take place in such areas), for the taxable year (including costs described in §1.181-2T(a)(3)); and

(vii) A declaration that the owner reasonably expects (based on all of the facts and circumstances at the time the election was filed) both that the production will be set for production (or has been set for production) and will be a qualified film or television production, and that the aggregate

production cost of the production paid or incurred will not, at any time, exceed the applicable dollar amount set forth under §1.181-1T(b).

(2) *Subsequent taxable years.* If the owner pays or incurs additional production costs in any taxable year subsequent to the taxable year in which production costs are first deducted under section 181, the owner must attach a statement to its Federal income tax return for that subsequent taxable year providing—

(i) The name (or other unique identifying designation) of the production;

(ii) The date the production costs were first paid or incurred;

(iii) The amount of production costs paid or incurred by the owner with respect to the production during the taxable year;

(iv) The amount of qualified compensation paid or incurred with respect to the production during the taxable year;

(v) The aggregate amount of compensation paid or incurred with respect to the production during the taxable year, and the aggregate amount of compensation paid or incurred with respect to the production in all prior taxable years;

(vi) If the owner expects that the total production cost of the production will be significantly paid or incurred in (or, if applicable, if a significant portion of the total number of days of principal photography will occur in) one or more of the areas specified in §1.181-1T(b)(2)(i), the identity of the area or areas, the amount of production costs paid or incurred (or the number of days of principal photography engaged in) for the applicable activities described in §1.181-1T(b)(2)(ii), (iii), or (iv), as applicable, that take place within such areas, and the total production cost paid or incurred (or the number of days of principal photography engaged in) for such activities (whether or not they take place in such areas), for the taxable year; and

(vii) A declaration that the owner continues to reasonably expect (based on all of the facts and circumstances at the time the election was filed) both that the production will be set for production (or has been set for production) and will be a qualified film or television production, and that the aggregate production cost of the production paid or incurred will not, at any time, exceed the applicable dollar amount set forth under §1.181-1T(b).

(3) *Deductions by more than one owner.* If more than one taxpayer will claim deductions under section 181 with respect to the production for the taxable year, each owner (but not the members of an entity who are issued a Schedule K-1 by the entity with respect to their interest in the production) must provide a list of the names and taxpayer identification numbers of all such taxpayers, the dollar amount that each such taxpayer is entitled to deduct under section 181, and the information required by paragraphs (c)(1)(iii) through (vi) and (c)(2)(iii) through (vi) of this section for all owners.

(d) *Revocation of election*—(1) *In general.* An election made under this section may not be revoked without the consent of the Secretary.

(2) *Consent granted.* The Secretary's consent to revoke an election under this section with respect to a particular production will be granted if the owner—

(i) Files a Federal income tax return in which the owner complies with the recapture provisions of §1.181-4T(a) to recapture the amount described in §1.181-4T(a)(3); and

(ii) Attaches a statement to the owner's return clearly indicating the name (or other unique identifying designation) of the production, and stating that the election under section 181 with respect to that production is being revoked pursuant to §1.181-2T(d)(2).

(e) *Transition rules*—(1) *Costs first paid or incurred prior to October 23, 2004.* If a taxpayer begins principal photography of a production after October 22, 2004, but first paid or incurred production costs before October 23, 2004, the taxpayer is entitled to make an election under this section with respect to those costs. If, before June 15, 2006, the taxpayer filed its Federal tax return for the taxable year in which production costs were first paid or incurred, and if the taxpayer wants to make a section 181 election for that taxable year, the taxpayer may make the election either by—

(i) Filing an amended Federal tax return for the taxable year in which production costs were first paid or incurred, and for all subsequent affected taxable year(s), on or before November 15, 2006, provided that all of these years are open under the period of limitations for assessment under section 6501(a); or

(ii) Filing a Form 3115, "Application for Change in Accounting Method," for the first or second taxable year ending on or after December 31, 2005, in accordance with the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9, 2002-1 C.B. 327, and §601.601(d)(2)(ii)(b) of this chapter). This change in method of accounting results in a section 481 adjustment. Further, any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting under this paragraph (e)(1). Moreover, the taxpayer must include on line 1a of the Form 3115 the designated automatic accounting method change number "100".

(2) Returns filed after June 14, 2006, and before March 12, 2007. If, after June 14, 2006, and before March 12, 2007, the owner of a film or television production filed its original Federal income tax return for a taxable year ending after October 22, 2004, without making an election under section 181 for production costs first paid or incurred after October 22, 2004, and if the taxpayer wants to make an election under section 181 for production costs first paid or incurred during that taxable year, the taxpayer must make the election within the time provided by paragraph (a) of this section and in the manner provided in paragraph (c)(1) of this section, except that the election statement attached to the return must include the information required in paragraphs (c)(1)(i) through (vi) of this section.

(3) *Information required.* If, in accordance with paragraph (e)(1) of this section, the taxpayer is making an election for a prior taxable year by filing amended Federal tax return(s), the statement and information required by paragraphs (c)(1) and (c)(2) of this section must be attached to each amended return. If, in accordance with paragraph (e)(1) of this section, the taxpayer is making a section 181 election for a prior taxable year by filing a Form 3115 for the first or second taxable year ending on or after December 31, 2005, the statement and information required by paragraphs (c)(1) and (c)(2) of this section must be attached to the Form 3115. For purposes of the preceding sentence, the

amount of the cost or compensation paid or incurred for the production must only include the amount paid or incurred in taxable years prior to the year of change (for further guidance on year of change, see section 5.02 of Rev. Proc. 2002-9 and §601.601(d)(2)(ii)(b) of this chapter).

§1.181-3T *Qualified film or television production (temporary).*

(a) *In general.* The term *qualified film or television production* means any production (as defined in paragraph (b) of this section) if not less than 75 percent of the total amount of compensation (as defined in paragraph (c) of this section) paid with respect to the production is qualified compensation (as defined in paragraph (d) of this section).

(b) *Production*—(1) *In general.* Except as provided in paragraph (b)(3) of this section, for purposes of this section and §§1.181-1T, 1.181-2T, 1.181-4T, 1.181-5T, and 1.181-6T, a film or television production (or production) means any film or video (including digital video) production the production cost of which is subject to capitalization under section 263A, or that would be subject to capitalization if section 263A applied to the owner of the production.

(2) *Special rules for television productions.* Each episode of a television series is a separate production to which the rules, limitations, and election requirements of this section and §§1.181-1T, 1.181-2T, 1.181-4T, 1.181-5T, and 1.181-6T apply. A taxpayer may elect to deduct production costs under section 181 only for the first 44 episodes of a television series (including pilot episodes). A television series may include more than one season of programming.

(3) *Exception for certain sexually explicit productions.* A production does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257. Section 2257 of Title 18 requires maintenance of certain records with respect to any book, magazine, periodical, film, videotape, or other matter that—

(i) Contains one or more visual depictions made after November 1, 1990, of active sexually explicit conduct; and

(ii) is produced in whole or in part with materials that have been mailed or shipped

in interstate or foreign commerce, or is shipped or transported or is intended for shipment or transportation in interstate or foreign commerce.

(c) *Compensation.* The term *compensation* means, for purposes of this section and §1.181-2T(c), all payments made by the owner (whether paid directly by the owner or paid indirectly on the owner's behalf) for services performed by actors (as defined in paragraph (f)(1) of this section), directors, producers, and other relevant production personnel (as defined in paragraph (f)(2) of this section) with respect to the production. Indirect payments on the owner's behalf include, for example, payments by a partner on behalf of an owner that is a partnership, payments by a shareholder on behalf of an owner that is a corporation, and payments by a contract producer on behalf of an owner. Payments for services include all elements of compensation as provided for in §1.263A-1(e)(2)(i)(B) and (3)(ii)(D). Compensation is not limited to wages reported on Form W-2, "Wage and Tax Statement," and includes compensation paid to independent contractors. However, solely for purposes of paragraph (a) of this section, the term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)). See §1.181-1T(a)(3) for additional rules concerning participations and residuals.

(d) *Qualified compensation.* The term *qualified compensation* means, for purposes of this section and §1.181-2T(c), all payments made by the owner (whether paid directly by the owner or paid indirectly on the owner's behalf) paid for services performed in the United States (as defined in paragraph (f)(3) of this section) by actors, directors, producers, and other relevant production personnel with respect to the production. A service is performed in the United States for purposes of this paragraph (d) if the principal photography to which the compensated service relates occurs within the United States and the person performing the service is physically present in the United States. For purposes of an animated film or animated television production, the location where production activities such as keyframe animation, in-between animation, animation photography, and the recording of voice acting performances are performed is considered in lieu of the location of

principal photography. For purposes of a production incorporating both live action and animation, the location where production activities such as keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production is considered in addition to the location of principal photography.

(e) *Special rule for acquired productions.* A taxpayer who acquires an unfinished production from a prior owner must take into account all compensation paid by or on behalf of the seller and any previous owners in determining if the production is a qualified film or television production as defined in paragraph (a) of this section. Any owner seeking to deduct as a production cost either the cost of acquiring a production or any subsequent production costs should obtain from the seller detailed records concerning the compensation paid with respect to the production in order to demonstrate the eligibility of the production under section 181.

(f) *Other definitions.* The following definitions apply for purposes of this section and §§1.181-1T, 1.181-2T, 1.181-4T, 1.181-5T, and 1.181-6T:

(1) *Actors.* The term *actors* includes players, newscasters, or any other persons who are compensated for their performance or appearance in a production.

(2) *Production personnel.* The term *production personnel* includes, for example, writers, choreographers, and composers providing services during production, casting agents, camera operators, set designers, lighting technicians, make-up artists, and others who are compensated for providing services directly related to producing the production.

(3) *United States.* The term *United States* includes the 50 states, the District of Columbia, the territorial waters of the continental United States, the airspace or space over the continental United States and its territorial waters, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the continental United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. The term *United States* does not include possessions and territories of the United States (or the airspace or space over these areas).

§1.181-4T *Special rules (temporary).*

(a) *Recapture—(1) Applicability.* The rules of this paragraph (a) apply notwithstanding whether a taxpayer has satisfied the requirements of §1.181-2T(d). A taxpayer that, with respect to a production, claimed a deduction under section 181 in any taxable year in an amount in excess of the amount that would be allowable as a deduction for that year in the absence of section 181 must recapture deductions as provided for in paragraph (a)(3) of this section for the production in the first taxable year in which—

(i) The aggregate production cost of the production exceeds the applicable production cost limit under §1.181-1T(b);

(ii) The owner no longer reasonably expects (based on all of the facts and circumstances at the time the election was filed) both that the production will be set for production (or has been set for production) and will be a qualified film or television production, and that the aggregate production cost of the production paid or incurred will not, at any time, exceed the applicable dollar amount set forth under §1.181-1T(b); or

(iii) the taxpayer revokes the election pursuant to §1.181-2T(d).

(2) *Principal photography not commencing prior to January 1, 2009.* If a taxpayer claims a deduction under section 181 with respect to a production for which principal photography does not commence prior to January 1, 2009, the taxpayer must recapture deductions as provided for in paragraph (a)(3) of this section in the taxpayer's taxable year that includes December 31, 2008.

(3) *Amount of recapture.* A taxpayer subject to recapture under this §1.181-4T must, in the taxable year in which recapture is triggered, include in the taxpayer's gross income and add to the taxpayer's adjusted basis in the property—

(i) For a production that is placed in service in a taxable year prior to the taxable year in which recapture is triggered, the difference between the aggregate amount claimed as a deduction under section 181 with respect to the production in all such prior taxable years and the aggregate depreciation deductions that would have been allowable with respect to the property for such prior taxable years (or that the taxpayer could have elected to deduct

in the taxable year that the property was placed in service) with respect to the production under the taxpayer's method of accounting; or

(ii) For a production that has not been placed in service, the aggregate amount claimed as a deduction under section 181 with respect to the production in all such prior taxable years.

(b) *Recapture under section 1245.* For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as a deduction allowable for amortization.

§1.181-5T Examples (temporary).

The following examples illustrate the application of §§1.181-1T through 1.181-4T:

Example 1. X, a corporation using a calendar taxable year, is a producer of films. X is the owner (within the meaning of §1.181-1T(a)(2)) of film ABC. X incurs production costs in year 1, but does not commence principal photography for film ABC until year 2. In year 1, X reasonably expects, based on all of the facts and circumstances, that film ABC will be set for production and will be a qualified film or television production, and that at no time will the production cost of film ABC exceed the applicable production cost limit of §1.181-1T(b). Provided that X satisfies all other requirements of §§1.181-1T through 1.181-4T and §1.181-6T, X may deduct in year 1 the production costs for film ABC that X incurred in year 1.

Example 2. The facts are the same as in *Example 1.* In year 2, X begins, but does not complete, principal photography for film ABC. Most of the scenes that X films in year 2 are shot outside the United States and, as of December 31, year 2, less than 75 percent of the total compensation paid with respect to film ABC is qualified compensation. Nevertheless, X still reasonably expects, based on all of the facts and circumstances, that film ABC will be a qualified film or television production, and that at no time will the production cost of film ABC exceed the applicable production cost limit of §1.181-1T(b). Provided that X satisfies all other requirements of §§1.181-1T through 1.181-4T and §1.181-6T, X may deduct in year 2 the production costs for film ABC that X incurred in year 2.

Example 3. The facts are the same as in *Example 2.* In year 3, X continues, but does not complete, production of film ABC. Due to changes in the expected production cost of film ABC, X no longer expects film ABC to qualify under section 181. X files a statement with its return for year 3 identifying the film and stating that X revokes its election under section 181. X includes in income in year 3 the deductions claimed in year 1 and in year 2 as provided for in §1.181-4T. X has successfully revoked its election pursuant to §1.181-2T(d).

Example 4. The facts are the same as in *Example 2.* In year 3, X completes production of film ABC at a cost of \$14.5 million and places it into service. ABC is an unexpected success in year 4, causing participation payments to drive the total production cost of film ABC above \$15 million in year 4. X includes in income in year 4 as recapture under §1.181-4T(a) the difference between the deductions claimed in year 1, year 2, and year 3, and the deductions that it would have claimed under the income forecast method described in section 167(g) of the Internal Revenue Code, a method that was allowable for the film in year 3 (the year the film was placed in service). Because X calculated the recapture amount by comparing actual deductions to deductions under the income forecast method, X must use this method to calculate deductions for film ABC for year 4 and in subsequent taxable years.

§1.181-6T Effective date (temporary).

(a) *In general.* (1) Section 181 applies to productions commencing after October 22, 2004, and shall not apply to productions commencing after December 31, 2008. Except as provided in paragraphs (b) and (c) of this section, §§1.181-1T through 1.181-5T apply to productions, the first day of principal photography for which occurs on or after February 9, 2007, and before January 1, 2009. In the case of an animated production, this paragraph (a) should be applied by substituting "in-between animation" in place of "principal photography". Productions involving both animation and live-action photography may use either standard.

(2) The applicability of §§1.181-1T through 1.181-5T expires on February 8, 2010.

(b) *Application of regulation project REG-115403-05 to pre-effective date productions.* A taxpayer may apply §§1.181-1T through 1.181-5T to productions, the first day of principal photography (or "in-between" animation) for which occurs after October 22, 2004, and before February 9, 2007, provided that the taxpayer applies all provisions in §§1.181-1T through 1.181-5T to the productions.

(c) *Special rules for returns filed for prior taxable years.* If before March 12, 2007, an owner of a film or television production began principal photography (or "in-between" animation) for the production after October 22, 2004, and filed its original Federal income tax return for the year such costs were first paid or incurred without making an election under section 181 for the costs of the production, and if the taxpayer wants to make an election under section 181 for such taxable year, see §1.181-2T(e) for the time and manner of making the election.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB Control No.
* * * * *	
1.181-1T and 1.181-2T	1545-2059
* * * * *	

Kevin M. Brown,
Deputy Commissioner for
Services and Enforcement.

Approved February 1, 2007.

Eric Solomon,
Assistant Secretary of
the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on February 8, 2007, 8:45 a.m., and published in the issue of the Federal Register for February 9, 2007, 72 F.R. 6155)

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.

Obsolete revenue rulings. As part of the Service's continuing program of

reviewing previously published guidance, this ruling publishes a list of rulings and actions relating to decisions of the Tax Court that are obsolete. Rev. Rul. 54-19 obsoleted in part. Rev. Ruls. 55-132, 56-462, 56-518, 57-505, 58-370, 58-500, 69-212, and 71-477 obsoleted.

Rev. Rul. 2007-14

The Internal Revenue Service is continuing its program of reviewing guidance (including revenue rulings, revenue procedures, notices, and actions relating to decisions of the Tax Court) published in the Internal Revenue Bulletin to identify items that are obsolete because (1) the applicable statutory provisions have been changed or repealed; (2) the matter is

specifically covered by statute, regulations, or subsequent published position; or (3) the facts on which the position is based no longer occur or are not sufficiently described to permit clear application of the current statute and regulations.

The following revenue ruling is partially obsolete. Rev. Rul. 54-19, 1954-1 C.B. 179, is obsolete with respect to the income tax conclusion, but not with respect to the estate tax conclusion.

In addition, the rulings listed below are obsolete.

<u>Ruling No.</u>	<u>C.B. Citation</u>
Rev. Rul. 55-132	1955-1 C.B. 213
Rev. Rul. 56-462	1956-2 C.B. 20
Rev. Rul. 56-518	1956-2 C.B. 25
Rev. Rul. 57-505	1957-2 C.B. 50
Rev. Rul. 58-370	1958-2 C.B. 14
Rev. Rul. 58-500	1958-2 C.B. 21
Rev. Rul. 69-212	1969-1 C.B. 34
Rev. Rul. 71-477	1971-2 C.B. 479

Furthermore, in light of the amendments to § 104(a)(2) of the Internal Revenue Code under § 1605 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1838 (1996), certain acquiescences to decisions are obsolete. These amendments make clear that Congress intended "that the exclusion from gross income [under § 104(a)(2)] only applies to damages received on account of a personal physical injury or physical sickness", and thus damages received on account of personal nonphysical injuries or nonphysical sickness generally

would be required to be included in gross income. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 301 (1996), 1996-3 C.B. 1041. Consequently, acquiescences to the following decisions are withdrawn:

Hawkins v. Commissioner, 6 B.T.A. 1023 (1927), *acq.*, VII-1 C.B. 14 (1928).

McDonald v. Commissioner, 9 B.T.A. 1340 (1928), *acq.*, VII-2 C.B. 26 (1928).

DRAFTING INFORMATION

The principal author of this revenue ruling is Christina M. Glendening of the Of-

fice of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Glendening at (202) 622-4920 (not a toll-free call).