North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

David W. Hoyle
Secretary

March 8, 2011

FEIN: [redacted]

[redacted]

Dear [redacted]

The Department is in receipt of your request for a private letter ruling regarding the application of the credit for qualifying expenses of a production company to transactions between related entities. The request was received by the Department via email on [redacted].

Facts

[redacted], a [redacted] limited liability company ("[redacted]"), intends to undertake two related activities in the State of North Carolina. First, [redacted] will either form a new North Carolina for-profit company or partner or contract with an existing North Carolina-based for-profit company [redacted] to provide production, post-production, editing, visual effects, computer generated imagery and related services ("Services") to the film industry. [redacted] will own or manage a wide array of equipment and services related to its core business of providing the Services. Second, [redacted] will periodically produce motion pictures in the State of North Carolina. Each motion picture will be produced by a new, special-purpose, for-profit entity related to the particular motion picture (each a [redacted]). Each [redacted] will contract for the Services of [redacted]. [redacted] will provide production funding to each [redacted] to pay for the costs of producing the motion picture, including the Services of [redacted]. In some cases, the cost of the Services will account for most, if not all, of the costs of producing the particular motion picture. The funds, once paid to [redacted], may be used by [redacted] to pay its hard costs and the balance may be returned to [redacted] in whole or in part, as [redacted] may direct. Each payment to [redacted] by each [redacted] will be made pursuant to an invoice issued by [redacted]. [redacted]'s cost of providing the Services under the contract will be substantially less than the amount billed to [redacted]. However, [redacted] asserts that in no case will the amount billed by [redacted] to [redacted] be in excess of the fair market value of such Services.

Question Presented

Does the payment made by [redacted] to [redacted] for Services under this factual scenario constitute a "qualifying expense" for which a credit may be claimed under the credit for qualifying expenses of a production company?

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Answer

No. The payments from [redacted] to [redacted] would not be a qualifying expense to the extent that the payments exceeded the direct cost of providing the Services.

Discussion

As a general principle, the Secretary has the authority under various statutes to determine the amount of net income earned by a taxpayer in this State. This authority exists under both the corporate income tax statutes (G.S. 105-130.4, 105-130.6, 105-130.14, and 105-130.16) and the individual income tax statutes (G.S. 105-152). G.S. 105-130.16 and G.S. 105-152, in particular, address the Secretary's authority to correct distortions to income caused by the way a taxpayer conducts a trade or business.

The factual scenario described above would create distortions to the taxpayer's income. Under this scenario, [redacted] would create and fund [redacted] that would contract for Services with [redacted]. [redacted] would then remit some or all of the proceeds of that contract to [redacted]. There is no indication that this arrangement has any economic purpose other than to inflate the amount of credit for which a production may be eligible. Clearly, this produces a distortion. Under either G.S. 105-130.16 or G.S. 105-152, the Secretary may make alternative computations to correct this distortion. In this case, due to the circular nature of this transaction (in which [redacted] is funding [redacted] to pay [redacted], which then remits some or all of the proceeds to [redacted]), the Department would find that the amounts "paid" by [redacted] to [redacted] had not been "spent". It is difficult to see how an amount that is repaid to the original funder has been "spent" in any economic sense. Accordingly, the Department would not allow a credit for the amount of the contract between [redacted] and [redacted] to the extent that the amount paid exceeded the direct cost of [redacted] in providing the Services.

This ruling is based solely on the facts submitted to the Department of Revenue for consideration of the transactions described. If the facts and circumstances given are not accurate, or if they change, then the taxpayer requesting this ruling may not rely on it. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material aspect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that this document is not to be cited as precedent and that a change in statute, a regulation, or case law could void this ruling.

Sincerely,

[redacted]

[redacted]