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AN ACTOR, A PRODUCER AND A DIRECTOR WALK INTO A BAR…AND THEY"RE ALL THE SAME PERSON; HOW THE LACK OF CLEAR DEFINITIONS IN SECTION 199A CREATES CONFUSION

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[1] The comments contained in this paper are the individual views of the author and do not represent the position of the California Lawyers Association.

[2] Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper, and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this project.

EXECUTIVE SUMMARY

The passage of the Tax Cuts and Jobs Act in December 2017 ushered in a multitude of changes to the Tax Code, but few of them garnered the attention of the media and the public quite like the Qualified Business Income (QBI) deduction. Thanks to dozens of articles highlighting the upcoming changes, the ink of the President's signature was barely dry before various advisors began circulating ways small business owners could capitalize on this new feature. However, not every small business benefits from the new deduction: since one of the objects of the Act was to provide tax savings to small business, only those businesses which meet certain income requirements can take full advantage of the QBI deduction. Furthermore, those professions commonly associated with personal service corporations (PSC)—including accountants, lawyers, and performing artists—faced more restrictions than other industries.

Professionals who advise small, single-owner businesses often find themselves parsing facts to determine whether the business is a PSC. The determination is important, because while corporations always been respected by the IRS and the courts, personal service corporations frequently, single-shareholder corporations whose sole purpose is to provide the services of its shareholder upon demand—have not, resulting in the loss of significant deductions for the taxpayer.[3]

For advisors who work with clients in the entertainment industry, the analysis is further complicated by the addition of the phrase "participation in the creation of the performing arts" in the Tax Cuts and Jobs Act without a clear definition of "participation," "creation" or "performing arts." In the early days of the Tax Code, "performing arts" generally referred to professions music and theater. Over time, as the public has been introduced to new forms of entertainment—including movies, television, animation and virtual reality—the lines defining the roles within performing arts have expanded and blurred. An actor is no longer just an actor, they are an actor/director/producer. Other roles—such as producers—have become hyper-specialists, focusing on a narrow range of skills. A producer may focus only on financing or talent, and the focus may change by project—financing on one, talent on another.

[3] Cases against personal service corporations date back to the early days of the Tax Code, with the IRS frequently taking the position that the PSC is nothing more than a mechanism for avoiding tax.

Rather than regulate the industry as it exists today, the Tax Code seeks to regulate the industry as it existed in 1986.

This paper focuses on how the lack of a clear, consistent definition of the term “performing arts,” coupled with social changes, can cause confusion when trying to advise clients.

DISCUSSION

I. INTRODUCTION.

The performing arts have existed for centuries. The oldest surviving play, "The Persians," dates to 472 B.C.E.[4], and the oldest surviving complete musical composition, the Seikilos epitaph, traces its origins to sometime between the first and second centuries.[5]

Meanwhile the personal service corporation has its beginnings in the associations of certain professions (including doctors and lawyers) who would form to provide them protection from liability (and were often legally and ethically prohibited from incorporating). Eventually, states began allowing these professions to incorporate, giving rise to what would be known as the personal service corporation.

II. THE PERSONAL SERVICE CORPORATION.

A. The Early Days of the Personal Service Corporation.

Congress first addressed Personal Service Corporations (PSCs) in Section 200 of the Revenue Act of 1918, defining them as

> A corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Section 218(e) of the Act provided that:

> Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same

[4] www.pbs.org/empires/thegreeks/background/24b_p1.html
[5] https://en.m.wikipedia.org/wiki/seikilos_epitaph

> manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: Provided, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.
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> 40 Stat. 1062, 1070 (1918).

It is interesting to note that while the Revenue Act of 1918 recognized the entities as corporations, for tax purposes the Revenue Act of 1918 treated them as partnerships. Not surprising, considering the origins of the personal service corporation in the guilds and professional associations of the time. By 1921, however, things had changed. Although corporations had existed since the founding of the country, there were still some restrictions that limited their popularity (including, but not limited to, the lack of liability protection, the at-will right to revocation of corporate charters by states, and limited life spans).

As these limitations peeled away, and with Progressives openly attacking the then-common forms of ownership—corporate trusts and holding companies—interest in corporations increased. At the same time, worker-oriented movements (such as the then-independent Congress of Industrial Organizations and the American Federation of Labor) pushed for more rights and benefits for workers.

The Revenue Act of 1921 marked the confluence of these two interests: Congress, seeking to improve the welfare of employees, for the first time allowed corporations to deduct contributions to retirement plans when computing taxable income. But Congress's effort to help employees, left another class out in the cold: there was no similar provision made for self-employed individuals.[6] As a result, self-employed individuals were incentivized to incorporate, and the personal service corporation increased in popularity.

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[6] See J. Timothy Philipps; James S. McNider, III; and Daniel E. Riley, Origins Of Tax Law: The History Of The Personal Service Corporation, 40 Wash. & Lee L. Rev. 433 (1983), https://scholarlycommons.law.wlu.edu/wlulr/vol40/iss2/4,

It did not take long for Hollywood actors and other entertainers to adopt the idea of self-incorporation. Although legendary agent Lew Wasserman is closely associated with the so called "loan-out" corporation, others, including Charles K. Feldman and Myron Selznick (older brother of famed producer-director David O. Selznick) were incorporating actors as early as the late 1930"s.[7] By contrast, athletes were not as quick to adopt the loan-out form of business,[8] and not as successful.[9] One of the earliest athlete loan-outs (formed on April 27, 1956) belonged to boxer Floyd Patterson. Unfortunately for Patterson, the IRS was able to convince the Tax Court that Floyd Patterson Enterprises, Ltd. should not be recognized for tax purposes and that Patterson, not the company, should have recognized various items of income for 1957 and 1958.[10]

B. Personal Service Corporations Today and Why Clarity is Needed.

Despite Patterson's loss and several subsequent cases challenging loan-outs[11] (generally by invoking either the sham corporation doctrine[12] or assignment of income doctrine[13] and reassigning the income under 26 U.S.C. §482) loan-outs continued to increase in popularity through the early 1980s. Two factors were behind this growth: the ability to recoup some expenses via tax deductions, and the ability to defer more income via pension plans. Although top performing artists and athletes can earn income at rates significantly higher than the average taxpayer, they also have costs that the average taxpayer does not have, such as agents, attorneys, managers, business managers and publicists, all of whom generally take a percentage of

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[7] https://en.wikipedia.org/wiki/Lew_Wasserman (retrieved March 1, 2019).

[8] This was partially due to differences in the industries. Actors are not bound to one studio for an extended length of time, while athletes are. Moreover, some leagues prohibited teams from contracting with loan-outs. See Bret M. Kanis, *Utility of Personal Service Corporations for Athletes*, 22 Pepp. L. Rev. 2, 635 (1995)

[9] *Patterson v. Commissioner*, 25 T.C.M. 1230 (1966).

[10] Id., p. 1236.

[11] See, *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991) (discussing the 197 formation of personal service corporations by two professional hockey players, Gary Sargent and Steve Christoff); *Johnson v. United States*, 698 F.2d 372 (9th Cir. 1982) (discussing the formation of a personal service corporation in 1974 by Charles Johnson, a professional basketball player); *Kenyatta Corp. v. Commissioner*, 86 T.C. 171 (1986) (discussing the formation of a personal service corporation in 1973 by a former professional basketball player, Bill Russell), affd, 812 F.2d 577 (9th Cir. 1987). *Kanis*, 22 Pepp. L. Rev. 2, 630-31.

[12] For the origin of the sham transaction and substance-over-form doctrines, see *Gregory v. Helvering*, 293 U.S. 465 (1935) and *Helvering v. Minn. Tea Co.*, 296 U.S. 378, 385 (1935). For a discussion of these cases, and the accompanying doctrines, see *CNT Investors, LLC v. Commissioner*, 144 T.C. 161, 194-197 (2015).

[13] *Lucas v. Earl*, 281 U.S. 111 (1930).

the individual's earnings as fees. When added up, the agent (usually 10% of gross earnings), business manager (5%), lawyer (5%), manager (520%) and publicist (up to 5%) can take as much as 45% of an individual's earnings before the individual even gets paid. A vehicle that allows the taxpayer to take those costs into account *before* paying taxes is an attractive one indeed. Add to that the ability to defer more income via a pension plan than one could via an IRA, SEP-IRA or SIMPLE plan, and the attraction becomes almost irresistible. It also did not hurt that the corporate tax rate was, for most of the Twentieth Century, far below the highest individual tax rates that top athletes and performers were generally paying.[14]

The growth in loan-outs was not to last, however. Beginning with the Economic Recovery Tax Act of 1981, which slashed the top individual rate from 70% to 50%, Congress, with the encouragement of actor-turned-President Reagan would take actions that limited the usefulness of the loan-out corporation, and for a time reduce its popularity.

C. The Tax Reform Act of 1986 and Section 448.

The Tax Reform Act of 1986 represented the first major rewrite of the tax code since 1954. Income which was taxed at rates as high as 50% (income over $367,120) was now taxed at 28% (income under $57,738 was taxed at 15%). While that provided a positive gloss which won public approval, there were a number of provisions that were directly aimed at professionals, including performing artists.

The first was a temporary increase in the corporate tax rate. In 1985, the top corporate rate increased to 51% on corporations with income between $1.0 and $1.4 million, but dropped back down to 46% for corporations with income over $1.4 million. Even though the rate dropped down to a maximum of 39% in 1987, that rate was still eleven percentage points above the highest individual rate.

The second was the addition of Section 448(d)(2). For decades the definition of personal service corporation had remained unchanged. But Section 448(d)(2) introduced the "qualified" personal service corporation, defined as a corporation:

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[14] See, https://corporatetax.procon.org/view.resource.php?resourceID=005129 for a listing of corporate tax rates from 1909-2018. The highest corporate tax rate was 52% in 1968-69. By contrast, the highest individual rate in 1968-69 was 70%.

> (A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and
>
> (B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by—
>
> > (i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),
> >
> > (ii) retired employees who had performed such services for such corporation,
> >
> > (iii) the estate of any individual described in clause (i) or (ii), or
> >
> > (iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

For the first time, specific industries were named as personal service corporations. Of these industries, the broadest and least clear was performing arts. The regulations—specifically, Treas. Reg. 1.448-1t(e)(4)(iii)—attempted to clarify what Congress meant:

> Meaning of services performed in the field of performing arts. For purposes of paragraph (e)(4)(i)(G) of this section, the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (e.g., persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise

> disseminate the performances of such artists to members of the public (e.g., employees of a radio station that broadcasts the performances of musicians and singers). Finally, the performance of services in the field of the performing arts does not include the provision of services by athletes.

The effect was to limit the term "performing arts" to essentially four specific professions: actors, musicians, entertainers and "similar artists," with the latter two being vaguely defined and not further clarified, except by exclusion.

D. Omnibus Budget Reconciliation Act of 1993 and Section 1202.

By 1992, the country was in the midst of a recession. The Presidential election of 1992 focused largely on the economy, and—after Ross Perot entered the race—the looming budget deficit and the national debt.[15] The Omnibus Budget Reconciliation Act of 1993 (also called the Revenue Reconciliation Act of 1993) was an attempt to begin reducing the national debt and budget deficits.

As part of that attempt, Congress introduced Section 1202, which partially excluded the gain from the sale of small business stock from capital gains tax. However, Section 1202 limited the exclusion to the stock of a "qualified" trade or business, which it then defined as:

> any trade or business other than—
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> (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
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> (B) any banking, insurance, financing, leasing, investing, or similar business,

[15] http://bancroft.berkeley.edu/ROHO/projects/debt/1993reconciliationact.html. The 1992 campaign was also the origin of James Carville"s famous statement "the economy, stupid" (often misquoted as "it"s the economy, stupid") which he coined as a campaign strategy for President Bill Clinton"s campaign.

> (C) any farming business (including the business of raising or harvesting trees),
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> (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
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> (E) any business of operating a hotel, motel, restaurant, or similar business.

Despite including “performing arts” in the list of disqualified trades or businesses, neither Congress nor the Treasury Department provided any guidance as to what “performing arts” included for purposes of Section 1202: there are no definitions in the regulations for Section 1202, leaving the definitions under Treas. Reg. 1.448-1T(e)(4)(iii) as the only guidance.

E. The Tax Cuts and Jobs Act of 2017 and Section 199A.

2016 brought another presidential campaign where tax reform, the national debt and the budget deficit were key issues. However, it was not until December of 2017 that President Trump and Congress were able to pass the Tax Cuts and Jobs Act.

Unlike the Tax Reform Act of 1986 (which was developed over a two-year period), this legislation was written, passed and implemented in a mere 60 days. In addition, there were a significant number of additions to the code—among them, the qualified business income deduction—as well as a number of significant deletions, including the elimination of the miscellaneous itemized deduction subject to 2% of AGI.

Many of the additions were made in vaguely defined terms, and initial requests for clarification were greeted with a response akin to the ubiquitous “player to be named later” in a story about a major trade in baseball. Not surprisingly tax planners, prognosticators and other interested parties immediately set about dissecting the plan and offering their opinions and tax-advantaged strategies to the public; the government, on the other hand, moved far more slowly, with no official guidance until August, nearly nine months after the bill was passed.

1. ***Proposed Regulations.***

The proposed regulations issued August 8, 2018 looked to Section 1202 and the definition of "qualified trade or business" for guidance as to what would constitute "qualified business income" and what would constitute a "specified service trade or business." The regulations noted that "the guidance under sections 1202(e)(3)(A) and 448(d)(2) is not an appropriate substitute for clear and distinct guidance governing what constitutes an SSTB under section 199A"[16] because "some SSTBs are listed in section 1202(e)(3)(A), but not listed in section 448(d)(2), such as athletics, financial services, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. In addition, some activities are mentioned only in 199A, such as investment management, trading, and dealing."[17]

The proposed regulations noted that "[t]he definition of an SSTB under section 199A is substantially similar to the list of service trades or businesses provided in section 448(d)(2)(A) and §1.448-1T(e)(4)(i)."[18] Although this seemed to indicate that the IRS would adopt the definitions of §448, that is not exactly what happened with the definition of performing arts:

> "Proposed §1.199A-5(b)(2)(vi) is informed by the definition of "performing arts" under section 448 and provides that the term "performance of services in the field of the performing arts" means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such,"

Although the language is similar to §448, it is not identical, as it actually adds directors—which are not mentioned in §448—-to the list. In addition, the proposed regulation deviates from §448 further by stating that the "performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts," while §1.448-1T(e)(4)(iii) "does not include the provision

[16] Proposed Regulations, p. 54
[17] Id., p. 55.
[18] Id., pp. 58-59. It should be noted that the Commissioner's cite to the temporary regulation is incorrect here; the actual language is in §1.448-1T(e)(4)(iii).

of services by persons who themselves are not performing artists (e.g., persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts).” Thus, the proposed regulations for Section 199A significantly changes the scope of the term “performing arts” and expands the reach of the exclusion beyond what is contemplated by §448.

2. *Final Regulations.*

The proposed regulations made it clear that there was still a lot of work to be done to finalize the meanings behind and scope of §199A. To that end, the IRS invited interested parties to submit comments for consideration.

On January 25, 2019 the final regulations were released. Although the IRS noted that “[s]everal commenters argued that the meaning of performance of services in the various fields should be limited to the definitions provided in §1.448-1(T)(e)(4),”[19] the IRS and Treasury declined to adopt this suggestion, arguing “nothing in the language of the report limits the definitions for purposes of section 199A to those provided in §1.448-1T(e)(4).”[20] The IRS”s reasoning behind this was that “[t]he intent of section 448 and the intent of section 199A are different. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting,” while “section 199A provides a deduction based on QBI from a qualified trade or business. Accordingly, it is both necessary and consistent with the statute and the legislative history to expand the definitions of the fields of services listed in section 199A(d)(1) and (2) and §1.199A-5 beyond those provided in §1.448-1T(e)(4).” [21]

3. *The Need for Consistency and Clarity.*

Taxpayers and their advisors rely upon consistent definitions to accurately determine and forecast their tax liability. Most taxpayers are—

[19] Final Regulations, p. 73. The IRS continued, “A few commenters noted that any expansion beyond these definitions is contrary to legislative intent as expressed in “Tax Cuts and Jobs Act,” Statement of Managers to the Conference Report to Accompany H.R. 1, H.R. Rept. 115-466 (Dec. 15, 2017), p. 216-222. These commenters argue that the Statement of Managers notes that the committee adopted the Senate Amendment and described the section 448 regulations as an indicator of the meaning of services in the health, performing arts, and consulting fields referenced in section 1202(e)(3)(A) as incorporated by section 199A. The Treasury Department and the IRS decline to adopt these comments.”

[20] Id. p. 74.

[21] Id. pp. 74-75.

contrary to what might seem to be the case—happy to pay taxes when the tax appears to be fair in its application, and when the law is clear on what is being taxed and what is expected of the taxpayer. When the law is inconsistent or vague, however, planning becomes difficult, because it forces taxpayers to make choices in a vacuum. Clarity is key to compliance.

The Tax Cuts and Jobs Act suffers from a lack of clarity. For example, the proposed regulations added the phrase, "participate in the creation of performing arts" without further discussion of what that means. Even the phrase "performing arts" is unclear. For the average consumer, the term "performing arts" is archaic, replaced by the phrase "entertainment industry," a term that encompasses many fields, including graphic arts, virtual reality, and video games, many of which did not exist (or were in extremely nascent form) in 1986.

To add to the complexity, some areas of law—such as intellectual property—have greatly expanded in scope since 1986. Ownership of intellectual property, once an afterthought, now drives many development decisions. These factors have, in turn, changed how the general public consumes content, have resulted in significant changes in how the industry operates. In 1933 an actor was an actor, and a director was a director. While some people held dual roles, it was far less common. This was still the case in 1986.

Today, a much different environment exists. On the one hand are the "slash" performers—not an actor, but an actor/director/producer—and on the other are the hyperspecialists, the people who only focus on a narrow range of skills—a producer who solely focuses on film financing, or who brings a certain type of actor to a production. In between are those who shift between functions—financing producer on one film, talent producer on another, director on a third, and actor on a fourth—sometimes within the same year.

And then there is distribution. In 1933, that meant putting your film in a theater, where the general public would buy a ticket to watch, as they would a concert or play—true "performing arts." By the late 1960s, television had firmly established itself as an alternative, with the "ticket" being paid not by the general public, but by advertisers. And by the time the Tax Reform Act of 1986 came along, a new(ish) distribution method—cable, paid for by subscribers, not advertisers—was beginning to take hold. Today, the Internet provides yet another distribution channel, or platform, with dozens, even hundreds of sub-platforms within it.

With all the platforms comes noise, and with the noise comes a much more competitive environment. In the so-called "old days," a studio would make a film with the intent of releasing it in theaters, where the general public would buy a ticket. An exception to this general rule was the film in "development hell"—a film that had been gone through so many changes in script, director, talent, etc., that the film would likely never get made. That is no longer the case. Today, there are far more options for consumers, and the payoffs can be far higher (a majority of the highest grossing movies in history have been made in the last 25 years), which in turn has resulted in far more people trying to enter the industry. This influx of talent has made it for more difficult for an individual to get noticed and establish themselves, which has resulted in much more content being made for speculative purposes than for consumption. A person might make a film and upload it to You Tube, not for public consumption, but rather as a proof of concept, or even a demo reel, with the hope of getting hired for an entirely different project.

In short, the environment today is vastly different than what existed 33 years ago. Despite this, the Internal Revenue Code still addresses the industry as it was in 1986, not the industry as it is today. Section 199A in particular fails to recognize these distinctions or to assist taxpayers in determining when, if ever, their activity may be eligible for treatment under Section 199A.[22]

Advisors who work in the entertainment industry struggle with these issues regularly. The difficulty is particularly acute when the client works in multiple media or in performs multiple tasks or roles in a production. Attempting to parse the different roles filled by the client in accordance with relevant provisions of the Tax Code can result in conflicting answers from the advisor depending on the circumstance, which only leads to frustration on the part of the client. It is clear that not only is further guidance needed, but that guidance should be consistent with existing definitions of terms.

[22] There has been some accommodation made, in that parties can bifurcate their books and records in order to qualify for Section 199A to some extent, but that is not always practical.

III. CONCLUSION.

For a taxpayer to be able to comply with the law, the taxpayer needs to have a law that is consistent in its definitions and its application. The taxpayer also needs to have a law that recognizes and accommodates the shifts in industries over time.

Although the term “entertainment industry” has grown to include activities unheard of in 1986, the Tax Code still uses term “performing arts,” a term that is found in only four places in the U.S. Tax Code.[23] With so few points of reference, it is important that the definitions be consistent, and yet the definitions under Section 199A are not consistent with other sections and case law, ostensibly because Section 199A represents a reduction in taxable income, rather than a mere timing difference. Treasury and the IRS need to provide further guidance on Section 199A, and should make the definitions under 199A more consistent with other sections of the code.

[23] 26 U.S.C. §62(b) (definition of qualified performing artist), 26 U.S.C. 199A, 26 U.S.C. §448(d)(2) (definition of personal service corporation), and 26 U.S.C. 1202(e)(3)(a) (definition of qualified trade or business) – and in the regulations for only two of the four sections (§199A and §448).