shelter in a changing climate

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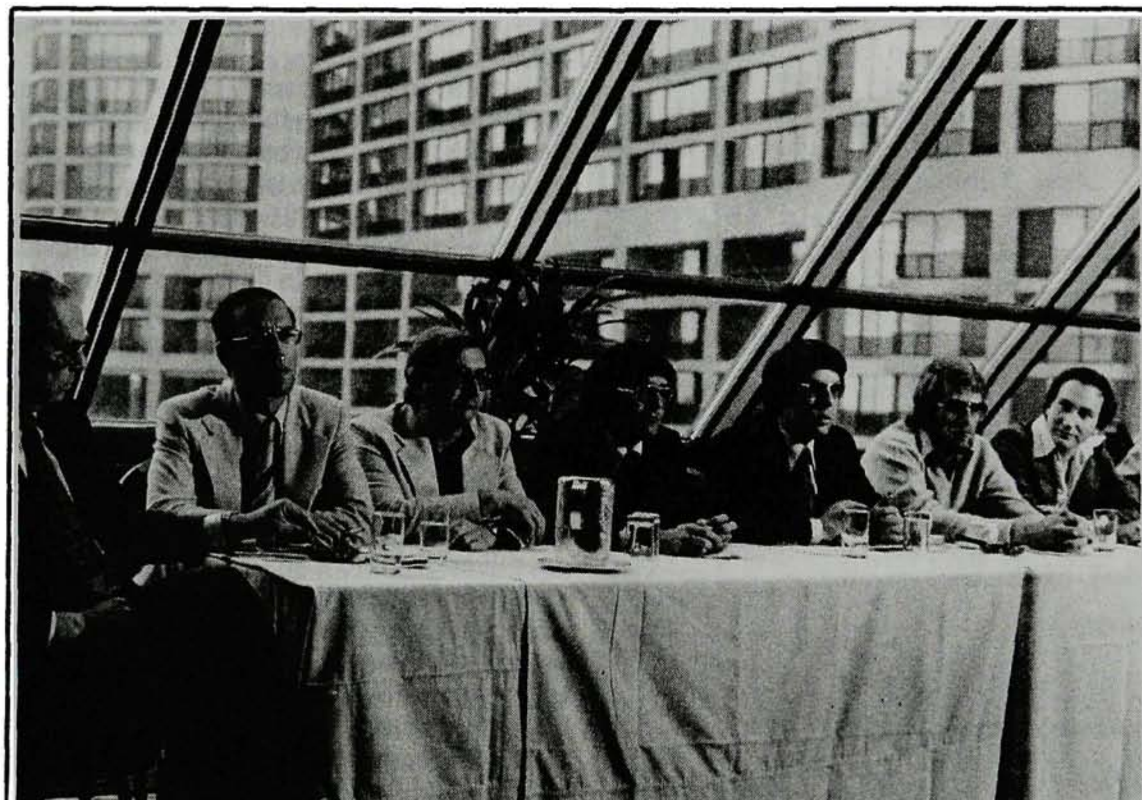

In 1977, producers were already worried about the climate. Above, in a press conference at the Festival of Festivals, labour problems and the hiring of non-Canadians were discussed by (from left to right) J.R. Learn of Nesbitt-Thomson, Richard Wise, C.A., Claude Chabrol, Denis Héroux, Julian Melzack, Peter Collinson and lawyer Charles Smiley.

Investment forecasting in the feature film industry is no easy task — especially when it's blowing hot and cold. Recent conditions have prompted investors and brokers alike to suddenly patch up their shelters.

With the start of the fall production season, the time is ripe to outline the current attitude of Canadian taxpayer/investors and their professional advisors toward investment in Canadian certified film productions acquired as a "tax shelter". The Canadian Securities Commissions have just issued a National Policy Statement outlining a number of requirements and restrictions concerning public financing of certified film productions, and the federal taxation authorities are actively reviewing the existing structure of the 100% capital cost allowance (CCA) deduction available to investors in feature and short productions. Moreover, after Labour Day, major efforts will commence on the part of investment dealers to market units in certified feature and short productions to investors across the country.

Before the federal government enacted regulations in December, 1978 — effective for 1979 and subsequent years — concerning the tax deductibility of investment by Canadian taxpayers in certified films, various structures of vehicles existed which attempted to afford a taxpayer an income tax deduction which often exceeded the true cost of the investment, i.e., the amount the investor had at risk. As a result, the most significant changes to the tax legislation now require the restriction of, or limitation on, an investor's CCA tax deduction where (a) there are certain types of revenue guarantees, (b) principal photography is not completed by March 1 of the year following investment, or (c) where the method of payment for the film investment is other than that described below.

The December 1978 amendments even provided restrictions as to how an investment could be made by a taxpayer if his purchase of film units was not paid for entirely in cash, but rather by promissory note.

As a result of these important income tax amendments, practically all film investment currently being offered to the public are on a relatively uniform and consistent income tax basis. For example, most investments being offered involve the downpayment of 20% cash and the issuance by the taxpayer/investor of a personal promissory note equal to the balance (80%) of the purchase price — such note being of a "full-recourse" nature and payable in four years (or earlier out of any revenues from the exploitation of the film). The cash portion is 20% because this is the minimum requirement under the Income Tax Regulations; and the four-year limitation is also a rule. (Note that the various restrictions, etc. relating to revenue guarantees, principal photography completion dates, the mode of payment for film units and the four-year rule relate only to "certified" films, i.e., films in which the government is supposedly trying to encourage investment. A non-"Canadian" — non-certified — film does not have these restrictive "rules," but the CCA rate is only 30% with certain limitations.)

Investors are therefore at risk with respect to the cost of their units in a film, in that the aggregate of the cash plus the promissory note (which is unconditionally payable and for which the investor is personally liable) represents the true "hard" cost of his units. That is, an investor who acquires, for example, a $10,000 film unit is actually at risk for the full amount. In fact, the amount to which he is exposed could be even larger because his promissory note bears interest which, over a four-year period at current rates, could amount to a fair sum, even after tax. For this reason, and because of the historical track record of motion picture films on a worldwide industry basis, it is not likely that a taxpayer would invest in a film as opposed to stocks, bonds, real estate, art, postage stamps, rare coins, etc. However, it is specifically because of the generous tax incentives given to Canadian investors that many of them have been prepared to take the risk. An investor who, for example, pays tax at the rate of 60% on his top earnings would really have an economic exposure or "downside" of only forty cents on the dollar (ignoring interest).

Strictly because of the tax incentive, Canadians have not been too reluctant to invest their hard-earned funds in motion pictures. However, to their dismay, they are only beginning to realize that "you don't spend a dollar to save sixty cents!" Now, more than ever before, investors are looking at the investment and business aspects of the particular film offering, and not just blindly at the reduction of taxes. As the date approaches for repayment of their promissory note — for which they are fully liable — they will begin to realize that if there are no (further) revenues from their film investment, they will be required

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to dig into their pockets to repay their note. They are also seeing that even if there are revenues which can be applied toward reducing the balance of the note, these revenues are taxable (at their top marginal rate), which of course means that they must still dig into their pockets.

For example, assume that an investor in the 60% marginal tax bracket acquires an interest in 1980 in a certified feature production for $10,000, payable as follows: $2,000 cash downpayment and $8,000 by way of a four-year personal promissory note bearing interest at prime plus 1%. Assume further that to the extent that there are revenues available to the investor from the exploitation of the film, such revenues will (must) be used to reduce the outstanding balance of the above-mentioned promissory note.

In the year of investment, 1980, the tax deferral (or saving, to the extent the film is unsuccessful) will be $6,000 (60% of $10,000). To achieve this benefit the investor had to initially part with the downpayment of $2,000. Therefore, the "cash flow" or net cash benefit is $4,000 ($6,000 – $2,000). This is what stands out in the investor's mind — unfortunately to the exclusion of everything else: an immediate 200% cash return. He fails to appreciate at that point that he is in debt for $8,000 plus interest and that, at a 60% marginal tax rate, must receive $10,000 in film revenues to repay the $8,000 note. That is, if $8,000 are owing by the investor, the $4,000 cash flow from the original tax deferment can serve to reduce the note to $4,000; the balance payable of $4,000 ($8,000 – $4,000) will require $10,000 of film revenues, so that after tax (at 60%) there will remain sufficient funds to pay off the balance of $4,000. If we ignore interest, only if the investor receives $10,000 will he be able to repay his promissory note — hence today's apparent reluctance on the part of many investors to purchase film units, unless there is some evidence of anticipation of reasonable revenues.

Those who have purchased film units over the last few years are now starting to ask many more questions, because only a handful of investors have recovered the cost of their investment either on a before, or after-tax basis. This reality is being reflected in the current investment climate. Not only do a number of investors want answers, but the investment dealers — who have an image to safeguard — are attempting to seek further protection for their clients by insisting upon distribution contracts, pre-sales, etc. being in place before agreeing to act as broker. Many 1980 film deals already have good distribution arrangements.

What many investment dealers are now seeing is that, when approaching a potential customer for film units, investors are asking why they should continue to invest if, having bought units for the past two, three or four years, they have not even recouped previous years' investments, and still owe money to the producer on their notes. In effect, they are starting to recognize that in a number of cases they did indeed spend $1.00 to save 60 cents!

Competition is intense among investment dealers and promoters with respect to the marketing of film units during the "tax shelter" selling season (autumn); it is also intense respecting interim or bridge financing earlier in the year. But competition does not run simply among films ; it is also present vis-à-vis other tax shelter products being offered to the investors, such as oil and gas drilling funds. It must be remembered that *if it were not for the tax shelter aspect of the film investment, investors simply would not purchase units in films.*

It was thought that for 1980, the government's reduction of the tremendous incentive for investing in drilling funds would contribute significantly in helping the film industry attract tax shelter dollars. But, unfortunately, the poor track record of films generally, as investments, has so far greatly inhibited investment this year, with many productions being aborted by producers and/or promoters because of the lack of financing. Ironically, the larger, well-established production houses — which have less of a requirement for outside money — will continue to obtain financing, to produce high-level films of international caliber and to strike the most favourable distribution deals. The smaller, independent producer may be the one to suffer if public investor confidence is not restored.

Sophisticated and prudent investors and their advisors are now asking many questions the answers to which were never really followed up heretofore; so are many conservative and knowledgeable investment dealers (and certain lending institutions). For example, they want to know why producers' fees and other benefits and emoluments are often so high in a number of cases. They now question the so-called "development profit" (built into the budget) which enures to the benefit of the producer, executive producer and sometimes the Canadian Film Development Corporation(CFDC). They look at expenses that are not reflected on the screen, i.e., the so-called "soft costs," that do not enhance the quality of the picture and the consequential revenues that would result from having a better quality picture. Such "soft costs" would include, among other things, interest on interim financing (sometimes as high as 30% per annum) ; finders' fees (sometimes as high as 15%) ; issue expenses (often $150,000) ; legal fees for the prospectus (often around $75,000) ; overhead expenses (often bearing no relationship to the particular film) ; certain publicity expenses ; broker's commission (which ranges from 7% to 9%) ; etc. ; as well as "non-productive" producers' fees ; associate producers' fees, and executive producers' fees, to the extent these more than provide compensation/remuneration for services rendered.

Reacting to investor concerns, the Securities Commissions have proposed a general rule that "the promoter will not be permitted to mark up expenses incurred for development of the film rights and screenplay. The total producer fees to be paid to all those with producer titles and those providing producer-like services, except the line producer, shall not exceed 5% of the direct costs, above and below-the-line. The maximum aggregate amount of fees from all sources paid to these persons shall not exceed 10% of direct costs. Any fixed, deferred fees payable to any such person will be included in their fee for the purpose of making the calculation."

Another problem that seems to bother certain investors is that "interim financiers" who have the right to convert their loans (made early in the year) into film ownership units (at the end of the year) and who have been induced by the high rates of interest (ranging from 1 1/2% to 2 1/2% per month) are suddenly realizing that they are the ones bearing the interest because once they convert, they are in effect purchasing units *the cost of which includes those high interest charges* !

Investors now appear to also be questioning the non-arm's-length relationships existing in a number of film deals insofar as commissions, interest, fees for services, trustee fees, etc. are concerned.

Some investors, as well as certain investment dealers, are seriously questioning why, in the case of, say, a multi-film package, various economies of scale are not available so that the resultant savings could be passed on to the investors. For example, where there is a multi-film package, one would assume that as a result of quantity purchasing of supplies and services, where the producer is a "price-setting buyer," an attractive deal could be struck with the various suppliers.

Investors have now begun to understand the royalty/revenue flow with respect to films. They are beginning to, at least in theory, trace the revenue flow from the various media such as theatres, pay-TV, network TV, syndication, video cassettes, in-flight movies, TV serialization, etc. to the distributor and to the producer. Accordingly, investors are calculating in their minds that the box office figures must be very high simply in order to break even, but they are willing to accept that as peculiar to the industry. However, they appear more and more reluctant to accept a high proportion of "soft costs" (above), since it would require that much more film revenue for an investor to get his money back.

In this connection, Securities Commissions now require that producers/promoters must "assist investors in understanding the film industry," and have published guidelines in their National Policy Statement intended to "contribute to prospectuses." Furthermore the Commissions require that the prospectus must highlight the risk factors and speculative nature of the film investment. While this is not new, their Policy Statement is quite specific.

Certain investors have expressed skepticism vis-à-vis expenses being charged to distribution revenues or, indeed, to current film production. For example, certain producers — in order to keep a high visibility with prospective investors in the event of future financial needs — are providing investors with various gimmicks (such as three-ring binders in which investors can file the various despatches coming from the producer). Notwithstanding how relatively inexpensive such gifts are, disgruntled investors are asking "who is really paying for these perks ?"

In early 1979, the Motion Picture Institute of Canada held a major conference on film financing in Toronto. There were many speakers from both Canada and the U.S. who addressed the audience on the subject of financing Canadian films. One of the panelists was a senior official of the Ontario Securities Commission. During the public question period following his address to the audience, it was recommended to him by the author of this article that the Commission issue certain guidelines for purposes of protecting the investors. (This, in turn, would have the effect of minimizing investor losses and thus keeping the level of investor confidence and production of Canadian films high.) The OSC official respectfully dismissed the suggestion as one that would be burdensome and fraught with difficulties and, on the whole, neither convenient nor within the particular scope of the Commission. It is interesting to note that the Ontario Commission is one of the key participants in the development and spearheading of the National Policy Statement on public financing of certified feature and short productions.

While the involvement and interest of the Securities Commissions may have unfortunately appeared a few years late, it is hoped that this will have some effect on regaining investor confidence in the business and financial aspects of investing in Canadian certified films.

It would be unfair to completely exonerate the investors themselves, as well as their advisors. The problem is that investors rarely read the contents of a prospectus or offering circular. The more disclosure — the thicker, heavier and more burdensome the document is — ironically, the less chance there is of an investor reading (let alone understanding) its contents. A current example of the extent to which investors do not read prospectuses or other offering circulars relates to a number of "interim financing" opportunities recently being marketed to investors. Even though the term "second position" is used throughout in connection with such an offering, the investor does not really appreciate the realities of his legal/economic position as lender. He fails to understand that, while his money is "as good" as anyone else's, he stands behind the other lenders. He is "blinded" by an extremely attractive interest rate and perhaps a small "commitment" fee; yet he has taken a back seat with respect to both (a) repayment and (b) security in the event that he does not get repaid. The solution is to coordinate the loans among the various lenders on a negotiated basis. Otherwise such "deals" hurt the Canadian film industry and, as we can see, the effects are just now surfacing. To use the words of the Canadian Securities Administrators, this is a "highly complex industry." And so it is... particularly with respect to financing.

Finally, it may be of interest to briefly outline some of the more relevant items or headings covered by the Securities Commissions' National Policy Statement:

— Accountability of Promoters to Investors
— Structuring of the Offering
— Production (including the identification of interim financiers; the amounts involved and the cost of such financing; profit and mark-ups payable to the promoter, producer or to related parties; etc.)
— Completion Guarantee (For the first time there will be a requirement that any rebate of a portion of the fee must be returned to the *investors*.)
— Distribution (The face page of the prospectus must disclose, if applicable, the fact that distribution agreements are not in place for major markets — in particular the U.S.)
— Risk Factors (Prospectus should clearly indicate that to achieve recoupment from theatrical exhibition alone, a film must generate box office receipts many times its budget within a few years.)
— Management Interests and Conflicts of Interest.

It is quite obvious that investor experience in films over the last few years has compelled the provincial Securities Commission to act. Hopefully, with such "controls" and investors safeguards, the industry will continue to attract tax shelter dollars. The points and issues raised here are real, timely and express widespread views. Those Canadian chartered banks who have, until now, been providing production financing have suddenly begun to express concern because repayment of their production loan will come about only if investors continue to purchase units in certified film productions. If there is a significant decline in investment, the funds that would otherwise be available to repay the bank loan will not be forthcoming — which would mean that the bank will become an (unwilling) investor.

As 1980 appears to be a difficult year in which to finance productions, it is up to the leaders in the Canadian industry and the producers of many years' standing in which direction the industry will head.

Finally, if the CCA rate applicable to certified films (100%) is reduced by the taxation authorities, there will be an even greater need to upgrade the business aspects of the taxpayer's film investment. ■