Profit, Glamour and Glitter

by Mark Medicoff

Jamie Brown felt like a criminal. He was seeking investment funds for a film he was co-producing with Robin Spry called **Keeping Track.**

The atmosphere was always heavy with mistrust when he met with businessmen who had in earlier years invested in motion-pictures. There was almost open hostility.

"It wasn't pleasant," Brown, an accomplished screenwriter for over 17 years, recalls.

During the heyday of the Canadian film tax-shelter in the 1970s, the majority of investors lost small fortunes. Brown was now experiencing their pent-up frustation.

For many businessmen who took advantage of the income tax laws at the time, the desire to avoid taxes was more important than the motive to generate profit. Seasoned businessmen lost sight of the profit objective and when the time came to pay the bills for their films – many of which had never even graced the inside of a theatre – they swore never to become involved again.

"And the greed, the greed was intolerable," says Brown. "Producers were pocketing upwards of 30 percent of the budget as finder's fees. There was never any concern about distribution or guaranteed returns for the investor. These guys really put a spike into the Canadian film business," Brown states.

With **Keeping Track** completed and distributed, and new projects underway, Brown is at the forefront of a new breed of successful Canadian film producers where integrity is as important as the product itself.

Over the last two years new investors have been enticed back to the film industry. They no longer walk to the back of the bus in their financial dealings with producers, but are protected by pre-sale guarantees, and priority payment rights.

The Canadian film industry has evolved to a new level of maturity.

The "new" Canadian film industry was launched in the fall of 1985 with the introduction of more intelligent government tax rulings. Telefilm Canada, named and reorganized in 1983 from the Canadian Film Development Corporation, has also played a significant role.

These two factors have played a pivotal role in attracting high-bracket earners back to film tax-shelters.

The new tax provision sanctions pre-sale guarantees without prohibiting their inclusion as part of the tax shelter.

In the past such assurances could not be declared part of the taxpayer's film shelter deferral, although pre-sales reduced the at-risk portion of the investment dollar appreciably.

As a tax deduction, film tax shelters offer as much sanctuary as a pup tent in a summer tempest. But as a tax deferral – and even potential profit maker – film investments can be an alluring opportunity.

The government obligingly delays acquisition of its tax in the hope profits will be generated for the businessman from a film investment.

"Being successful in film shelters means using taxable dollars with the potential of earning more dollars, rather than just paying the income tax and being done with it," explains Robert Hecht, a tax shelter expert with the Montreal accounting firm of Ferstman Rapp Hecht.

For those inclined to pursue the matter in depth, film tax shelters provide a fascinating glimpse into the Canadian culture industry. But the objective is strictly profit, and any ideas about the glamour and glitter of the film business should quickly be squelched. The business side of entertainment is like any other, with rate of return and downside risk the measure of success.

The lure continues to be a provision in the tax code which permits capital cost allowances, or write-offs, for investments in Canadian certified television or theatrical releases.

Federally, a 100 percent write-off of the investment spread 50-50 over two years is permitted. In addition to the federal advantage, residents of Quebec can invest in Quebec certified productions and be allowed to write-off 150 percent in one year.

Certification is vital. Only those films and television projects which follow the Canadian – or Quebec – content regulations are applicable under this tax ruling.

Based on a $10,000 investment in the 1986 taxation year, an Ontario resident in the 55 percent tax bracket can defer $2,750 a year for two years.

Quebec residents investing in a Quebec certified production fair better in 1986. In the first year they can defer $4,080 on their provincial returns and $1,590 on their federal returns. In the second year only $1,590 is permitted on the federal return and none of the provincial since the Quebec certification program allows for the tax benefits to be taken in one year.

If the cash poor taxpayer needs to borrow the money to pay his tax bill, he can lever his investment for as little as $500 down and a letter of credit to pay the balance of the $9,500 loan within five years. Using film tax shelters annually, a taxpayer can defer his taxes year after year or pay them in years when gross earnings can better absorb additional income. Interest on the loan is also tax deductible.

"Of course the possibility also exists, depending on cash flow status, that you could reinvest those deferred dollars into more conservative plans," explains Robert Dostie, a Montreal entertainment lawyer and financial consultant who has directed over $4 million of client funds into film shelters.

Ideal candidates for the tax shelter regulations are businessmen or professionals earning at least $60,000 a year. "You may have a businessmen who wants to minimize his corporate income tax and instead pays a large bonus to himself," explains Hecht.

"He then looks to shelter that income in the form of films, oils, mines etc. Professionals or other high-income earners often have cash-flow problems at the end of the year, so being able to deduct the taxes without having to put up all the $10,000 investment immediately becomes very attractive."

Mitchell Kobernick, a 31-year-old Quebec real-estate investor, made his first plunge into film tax shelters in 1985. In the past Kobernick limited his tax planning measures to Quebec Stock Saving Plans and a RRSP. "I was hesitant to get into film tax shelters because of its history," he explains, "but **Keeping Track** was structured with a minimal amount of risk and good tax deferral benefits."

Working closely with his accountant, Mitchell calculated that his investment would earn a 10 percent return because of his 59 percent tax bracket.

"That would be my earnings standard for any future involvement in films," he maintains. "When you consider getting 10 percent and some hope of future profits or giving it all away in taxes and no potential, the shelter became very attractive."

Mitchell admits the "sizzle" of Hollywood North attracted him. And he's not disappointed. But it was the strong "comfort zone" that he felt about writer-producer Jamie Brown and director-producer Robin Spry, as well as the facts, that finalized his commitment. "You have to trust your instincts about people too," Kobernick advises.

Kobernick secured a bank loan to finance his investment in order to keep his capital free, and because the interest was tax deductable.

At worst, the film business consists of gambling 45 cent dollars for the Ontario resident and 27.4 cent dollars for the Quebec resident. "But it took a while for it to dawn on investors that it doesn't make any sense to spend $1 to save 55 cents," says accountant Richard Wise, managing partner with Richter, Wise and Associates.

The new industry-wide standard guaranteeing 55 percent to 70 percent in returns on the tax-deferred dollar from pre-sale arragements diffuses the 'lose your shirt' stigma from the early years. But Merritt Goddard, executive vice-president of Equion Securities cautions: "If you're not in a position to lose 15 percent on $10,000, don't get involved.

Telefilm Canada has also renewed investor confidence. Through the Broadcast Program Development Fund the agency invests $60 million dollars annually in partnerships involving up to 49 percent ownership. A production stamped with a Telefilm Canada financial endorsement has passed all standards requirements.

In the past, large brokerage houses dominated the film tax shelter business but lacked the expertise on the production side. "When we went looking for $3 million to finance **Keeping Track**, we found a lot of hostility centered in the brokerage houses," explains Jamie Brown. "A lot of investors were burned in the early years. Ironically, the brokerage houses were the only people to really make money in those days," he adds.

Ron Pearl, a tax partner at Montreal's Clarkson Gordon, hasn't directed client funds into film shelters for over five years. Rosemary Christensen, president of Sommerville House Securities, has few clients interested in films. In the early years Christensen would personally supervise productions. "We were even writing them in our boardroom," she recalls.

The investor must make sure that the producer is associated with professionals in the industry. The distributor must be financially strong and consistently reliable. A non-partisan accounting agent should do the tax shelter paperwork and audit the financial progress of the project. A lawyer should monitor the investment offering and protect the project in contract dealings.

Today, a shrewd and vigorous investment community with expertise in film production spearheads any offering for taxpayer dollars. Three independent financial organizations form the axis of the Canadian video and film industry. They see to it that producers provide high-calibre personnel, performance guarantees and proposals with financial and distribution guarantees.

Equion Securities raises otherwise taxable dollars in a marketing relationship with The Skyld Group, an interim financer, under the trustee umbrella of the accounting firm of Ernst and Winney.

In 1985 Equion Securities raised over

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$16 million dollars from a film tax shelter market estimated at $100 million – making Equion the largest player in the market. Merritt Goddard, executive vice-president of Equion Securities, says his firm won't even look at a project unless there is a guaranteed return of at least 60 percent-70 percent of the investor's tax shelter investment.

The Skyld Group provides the more risky interim-financing through internal resources and commercial banks. It then resells the completed product, including distribution and pre-sales, to Equion Securities.

"We provide the full financial analysis and funding on a project," explains Barry Young, president of Skyld Holdings. "No other firm in Canada provides this kind of underwriting, and naturally our belief in the project must be very strong."

Young emphasizes the strict separation between his company's financial responsibilities and the creative activities of the producing team. "Too close an association sacrifices independent analysis," he stresses.

Ernst and Winney, a world-wide accounting firm to the film and television industry acts as a "watchdog," in representing investor interests. The company is Canada's largest film accounting firm with 25,000 investors participating in 34 productions.

Their Montreal office also provides financial management services to film producers as well as providing evaluations of companies operating in the business.

"We are a revenue dispersing and monitoring agency," explains Ian McCallum, an executive with the company's Entertainment Group. As trustees, Ernst and Winney audit and review production costs and revenues and send investors a summary every six months for a period of ten years. "We hold investor funds until all the conditions of the offering are met. "It puts pressure on the people who control the product to handle it properly," he adds.

"The right to get information and the right to follow it up over a number of years is very important," agrees Hugh Alcorn, branch manager of Wood Gundy.

Like any investment opportunity, succeeding in film tax deferrals means prospecting for the right deal. Motivation is fueled by the enormous profits generated by a successful product.

Alcorn cites two concerns for the taxpayer looking to invest in film – risk ratio and rate of return. The risk is that portion of all costs which are not guaranteed by pre-sales. "The point is to find a product which offers a decent return on investment because it's the profit, as well as the tax deferral benefits the taxpayer should be looking for."

Although pre-sales reduce risk, they also reduce potential profit. Before a movie winds down in its marketing potential it will more than likely pass through a sequential stream, starting with foreign and domestic theatres, home video, pay-TV, network runs, and syndication runs. There is greater potential to realize profit if the pre-sale agreements cover risk but do not include all the possible customers.

"If there's no potential to get you up to zero and some profit, don't buy the deal," advises Goddard.

He also recommends setting up tax deferrals as early in the year as possible to have the widest choice of products. "You have more time to evaluate," he says, "and if you know your financial and tax position then it shouldn't make any difference if you buy in January or in October. At the same time, it's important to have a balanced film tax shelter portfolio because even in entertainment, different products present different risk."

Theatrical releases, made for television films, and television episodes vary in their degree of downside risk and "through the ceiling" profits. Episodes are the 'blue chip' investments in the field because returns are more predictable.

Last winter, a Skyld Group offering consisted of a $3.2 million advance for 13 episodes of **Night Heat**, the commercially successful police series. The offering indicated a minimum gross recoupment to investors of 75.1 percent.

Goddard cautions, however, that the return on investment for a product like **Night Heat** only comes after five years" "unless syndication hits, which means you won't get your bonanza until the 5th or 10th, or 15th year."

And episodes do not mean pilots, Richard Courville, a Montreal trustee and private entertainment investor, won't become involved in a deal to finance a pilot television show. "I shy away from them," he warns "the risk of failure is simply too high."

"An important criterion," says Brown, "is to evaluate the people who are behind the project. What is the producer's track record? Are any fees being paid to the producer initially, or are the fees being retained pending the film's on-budget completion? The contract should state that cost overruns come out of the producer's pocket."

Frank Jacobs, president of Entertainment Financing, was involved in **Quest for Fire** and **Joshua Then and Now**. He stresses the importance of a completion bond in any financial deal. "It guarantees the completion and delivery of the project because if the project goes beyond budget, the insurer will provide the necessary additional funds."

The payment schedule is also a major consideration. In the past, conservative businessmen playing movie moguls found themselves at the end of a long line of creditors. "All the money should go to the investor first, until he gets a recoupment of 100 percent or 110 percent. This puts the onus on the producer, director, and distributor to make the film a success," Goddard points out.

"The deal should be structured in such a fashion that the people who control the destiny of the product will have a common goal with us," he adds.

Deferring the tax bill has become an important factor to deflect the growing tax burden. In sound financial planning, carefully selected film shelters can be a device to make a taxpayer's money work as hard as he/she does.

Films which do well for investors do well for the entire industry.,