BYE BYE TAX SHELTER

by Michael N. Bergman

The morning after the announcement of the White Paper on Tax Reform most Canadian daily newspapers had hidden away, in the mass of reporting on the new proposed tax regime, one or two lines about the changes to the Canadian Film Tax Shelter. Those one or two lines have no doubt riveted the attention of the entire Canadian film community. Tax reform will affect dramatic changes to the way in which Canadian producers obtain private Canadian film financing.

Tax matters are invariably a wealth of incomprehensible, convoluted sentences which, at first blush, have little technical meaning for the lay person. It will not take much ability though for the average filmmaker to appreciate the significance of the reduction of the Capital Cost Allowance (CCA) for a certified film from 100 percent to 30 percent. Nevertheless, the technical data surrounding the new film CCA policy is vital for both producer and investor decisions about the industry.

The concept of CCA is not unique to the film industry. It is a notion that has been around in fiscal legislation for a long time. It essentially provides a means by which the cost of capital assets used to earn income can be written off over a period of time. Since the costs of capital assets are not an expense *per se* as is (the costs are incurred not to earn income but to create it), these costs cannot be written off as an expense. In most cases CCA permits the taxpayer to write off over a period of years so much of the capital cost incurred to purchase a capital asset. This write-off is not a form of tax reduction but rather a form of tax deferral since when the object is subsequently sold an amount equal to the depreciated capital cost, that is the amount already written off against taxes, is recaptured as income and becomes taxable. The unique feature of the current CCA scheme for certified Canadian films is that it permitted the capital cost of these films to be written off in their entirety immediately and not on the declining balance. Up until a few years ago this CCA could be taken at a rate of 100 percent in the taxation year during which some units were purchased. In recent years with the so-called half year rule, although the deduction remained 100 percent of the cost of the film unit, only up to half that could be taken in the first year and the balance in the next year.

Tax reform changes all this. The CCA for Canadian certified films is reduced from 100 percent to 30 percent on the declining balance. The significance of this is immediate. In each taxation year the investor of units in a certified Canadian film may only write off 30 percent of the undepreciated capital cost of a film unit. In other words, if an investor purchases a $10,000 film unit he may (without taking into account the half year rule in this example which still applies and is discussed below) deduct of the cost of the unit from his taxable income in the first year, 30 percent of $7,000 (the remaining undeducted or undepreciated capital cost) in the second year, 30 percent of $4,900 in the third year and so on on a declining basis.

The above example does not take into account the half year rule which incredibly still remains in effect. Under this rule although the taxpayer is entitled to write off up to 30 per cent of the capital cost of the film unit in the first year the actual use of this deduction must be spread over two years such that in the first year only half of the thirty percent may actually be used and the balance in the second year. In consequence in our above example in the first year of the purchase of a $10,000 film unit the taxpayer would only be able to deduct $1,500 of the capital cost of such a unit. He will then be able to deduct a further $1,500. in the second year as well as 30 percent of the declining undepreciated capital cost of the unit for the second year and following in subsequent years.

There is another wrinkle in the new CCA deductions for film and that is the applicability of a new put-in-use rule which will apply to CCA generally. Under this rule a taxpayer may only start deducting the CCA permissible when the capital assets on which the Allowance is claimed is put in use or where the construction of the asset is completed and thus ready for use whichever is earlier. Since generally film units purchased in one calendar year are in fact equity units in a film which is only completed in the subsequent year it would appear that there is some doubt as to whether a taxpayer may deduct any CCA for the taxation year in which the film unit is actually purchased unless the film is in fact completed in that taxation year. This put-in-use rule does not apply to the Allowance against film income.With this application though, it is clear that it may be possible that a taxpayer receives zero benefit from the purchase of a film unit for the taxation year in which the unit is purchased.

The minister of Finance has tried to offset this dramatic change in the CCA rules by supplementing the new regime with an additional allowance which would allow the taxpayer to write off the undepreciated capital cost of a film unit against any income received in that taxation year from any certified Canadian production net of expenses and net of capital cost already taken. The usefulness of this new allowance in terms of industry practices and realities may be doubtful. On a preliminary basis this allowance seems to operate as follows.

The 30 percent for certified Canadian films may be deducted from any of the taxpayer's income. As such it is of general application regardless of how the taxpayer earns his income. The allowance deduction of the undepreciated capital cost of a film unit against all film income for that year is only applicable against film income for that year. In other words, if a taxpayer does not have any income from any film units in a taxation year he cannot avail himself of this additional allowance. Furthermore, this new allowance is only useful against film income for a particular year. The new allowance is not subject to the half year rule and consequently, if it can be taken, will not be divided as the 30 percent CCA.

For example, a taxpayer purchases a $10,000 film unit in a certified Canadian production. In the first year of his purchase he deducts the CCA for such a project which is $1,500, (one-half of 30 percent under the half year rule). He is thus left with $8,500 of unused or undepreciated CCA. In the same taxation year he earns income from all of his film units from any projects of $7,000. Since he has $8,500 of undepreciated capital cost on his film unit purchase he may deduct this against his $7,00 of film income for that year leaving $1,500 of undepreciated capital cost in his original film unit which may be deducted on a 30 percent declining basis for subsequent years. It is to be noted that the allowance against film income must equal the lesser of the undepreciated capital cost of a film unit for that taxation year or the income from all films for that year.

These new rules for the tax film shelter come into effect for all films made after December 31, 1987 unless a film produced after December 31, 1987 was produced according to an agreement in writing entered into by the taxpayer before June 18, 1987 or in accordance with a prospectus or offering memorandum filed before June 18, 1987 with the Securities Commission.

Getting a handle on all of this and the new structures' reorienting effect on the film industry requires the recognition of certain basic principles of the film tax shelter as a financing device in the industry. The Canadian film tax shelter has had a checkered history of success and failure in the industry. Nevertheless it has been, and in its pre-June 18, 1987 format, continued to be, a pillar for private financing of Canadian films. In the '70s the tax shelter was primarily responsible for a veritable boom in Canadian film production. Although in the early '80s this particular tax shelter lost both its popularity and credibility with most investors, it nevertheless was still a part of virtually every offering made to obtain private film investment. In 1985 and particularly 1986 the film tax shelter made somewhat of a comeback with private investors and in fact 1986 saw a considerable resurgence of private offerings filed with the various securities commissions in this country, all invariably offering the tax shelter as an advantage to the investment.

The film tax shelter, as any tax shelter, costs the government revenue. It is a tampering with the fiscal system to create a fiscal incentive for investors to put their money into a particular industry. In perhaps a utopian outlook, it is designed to encourage investor interest in a particular industry so that perhaps investors will ultimitely invest in that industry because of its own merits and rate of return. While there may have been some private Canadian investors for whom the film tax shelter stimulated such a result, particularly in the years '85 and '86, there seems very little doubt that the main reason why private Canadian investors purchased feature film units was to obtain immediate tax relief. For the private Canadian investor a tax shelter is a front-end system. For a small amount of cash down plus a promissory note payable later on, the investor obtains substantial immediate income tax relief. This was the rub of the whole system which has now disappeared.

Under the new system the attraction of the Canadian film tax shelter is not immediate fiscal relief but relief from income tax on film income. The attraction is that a portion of income from film units may be sheltered from tax. The emphasis therefore is on successful income-generating film projects – income-generating to the investor and not just the producer. Here is the rub of the new system.

The film business is a high-risk enterprise. It is difficult to say what project will earn income to the producer let alone to the investor. Consider the example of Steven Spielberg's **E.T.** which bounced around from studio to studio because nobody believed in it. In the film business there is very little assurance that a film will earn income to the investor. Consequently an allowance which permits the write-off of the cost of a film unit against film income is of doubtful use. In order to make it work as an incentive for weary investors larger and larger revenue guarantees will become necessary to assure that there is some income to the investor against

Michael N. Bergman is a Barrister & Solicitor, member of the Bars of Quebec, Ontario and Alberta, with offices in Montreal and Toronto.

which he can apply the allowance. Even if such large revenue guarantees were possible (they would probably have to exceed 75 percent of the cost of the unit) it will still not alleviate what will surely be a problem in most cases of the investor having very little film income to apply the Allowance against in the first year of his purchase of film units. This is because most revenue guarantees are only payable in the second or subsequent years following the purchase of a film unit. Since most investors purchase film units in the last quarter of the calendar year it is unlikely that in most cases a producer could organize a structure by which a revenue guarantee is paid in the same year as the unit is purchased.

Another interesting problem of the new CCA scheme for films is the effect on buy-backs. Buy-backs are a growing phenomenon of film financing. Under the buy-back system an investor has the option, within a certain limited number of years, of either continuing to keep his unit and subsequently earning income, if any, or selling his unit back to the production company for a price determined by an independent evaluator. An investor who takes advantage of this option and makes the producer buy back the unit will pay tax on the sale price of that unit to the extent that that price is equal to the CCA which the taxpayer has already taken, this is known as recapture.

Under the new system the following problem could arise. A taxpayer purchases a $10,000 film unit from Company B. The taxpayer takes his CCA of $1,500 under the half year rule against his Company B film income. He has now written off the entire capital cost of Company A's film units. Company A's film units offer a buy-back. In the year following the purchase of Company A's film units the taxpayer takes advantage of this buy-back and sells his film units to Company A for $8,000. Under ordinary taxation rules this $8,000 obtained from Company A would be a recapture of income and become taxable. The question now becomes what income tax effect if any does the buy-back of Company A's film units have on the cost of an income from Company B's film units? Another question which is raised is can capital losses on buy-backs of film units be applied against income generally or only film income?

Seeing that the film tax shelter has been considered so vital to private financing in the Canadian film industry, it is surprising that the government undertook these changes without any advance consultation. Certainly the changes to the film tax shelter did not have to form part of tax reform generally. More properly they should have formed part of the general reform film policy. This would have allowed the matter to be debated by all concerned in the industry well in advance of the implementation of any changes. It is surprising that a government that feels the need to provide direct subsidies to the film industry in the form of Telefilm Funding would announce such a jolting change to the principal vehicle for private financing in the film industry. Arguably all bets are off with respect to new projects looking for private financing since they can no longer plan beyond the end of 1987.

As the new regime is more likely to detract investment, the film industry will be required to lobby for alternate means of support if changes to the new regime cannot be secured. In the past this lobbying has generally been directed towards increased direct government subsidy by making more money available to Telefilm Canada. Certainly this will be unfortunate if the government intends to encourage a weaning away of the industry from government support to private financing. In the absence of increased direct government subsidy or changes which will continue to attract the private Canadian investor, many established Canadian producers will draw on an increasing trend for film financing in this country – American participation.

This participation in itself has its drawbacks since it tends to promote the development of a filmmaking industry in Canada rather than a Canadian film industry. It is only a source of financing participation to the extent that the costs of filmmaking in Canada continue to be substantially less than in the United States.

The new tax shelter regime continues some of the worst aspects of the former regime – it encourages film financing on a project-by-project basis and discourages the capitalization of production corporations. As such I would have suggested that the government, in consultation with the industry, scrap the existing regime in favour of one which provides one form of government assistance for the capitalization of production houses and another towards the financing of film budgets for unestablished producers. It is unfortunate that the new regime will probably hit the unestablished or single venture producer the hardest since, having no track record and unable to provide the same degree of assurances or revenue guarantees as the established producer, he will not be able to use the shelter to the same advantage. Ironically the producers with the best track record of continuing success, whose investors are continually earning income from their units, may obtain a "rear end" benefit from the newest regime. The more income an investor obtains from his film units the more taxes he will pay on that income. Under the new regime one of the best ways to shelter that film income is to buy more film units, the capital cost of which can be deducted from film income.

Whatever the rules for the film tax shelter they must be looked upon in a framework of the overall tax reform. If the minister is as good as his word, then the top Federal Tax Rate will drop from 34 per cent to 29 per cent. This drop may have the effect of decreasing the incentive to invest in a film unit for tax purposes, considering the high-risk nature of the film industry. After all there is less income that needs sheltering.

While the government can be blamed for proceeding unilaterally and without advance consultation on a law which will affect a major change in the method of financing in an industry highly dependent on government initiatives, producers cannot escape some blame for lack of foresight. The film tax shelter has been periodically examined and in fact a short few years ago the government wanted to reduce the 100 percent deductibility. The Australian federal government is looking to abolish a similar program. It is therefore unfortunate that the industry did not propose well in advance some alternative which could have been secured against tax reform changes.

The new CCA system for Canadian-certified films must also be placed in the context of events in the industry generally. Such matters as the delay, if not failure, to bring forward legislation to assist Canadian film distributors, the effect of free trade on the cultural industry, the failure to include provisions dealing with broadcast and satel–lite transmission and retransmission in the Bill to Amend the Copyright Act, increased taxation of Cable services, all suggest that the Canadian film industry may be on the verge of a real downer. •

INDUSTRIALS COM-
MERCIALS ROCK
DRAMA VIDEO
Sony and Ikegami Broadcast Equipment/Professional Crews
Sim Video Productions, Inc., 58 Third Street, Toronto 416-255-9914