PRIVATE MOTION PICTURE INVESTMENT AND THE INCOME TAX INCENTIVES IN CANADA

by

ANDREW J. DUFFUS

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Department of Commerce and Business Administration

The University of British Columbia
2075 Wesbrook Place
Vancouver, Canada
V6T 1W5

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ABSTRACT

Private investment in motion pictures is a popular form of tax shelter in Canada for high income earners. This thesis attempts to determine if the tax shelter facilitated by motion picture investment adequately compensates the investor for the high risk of the investment. This is an investigation therefore, of the motion picture investment environment in Canada and an appraisal of the legal the financial implications of employing a motion picture tax shelter.

A thorough unbiased examination of the consequences of private motion picture investment is needed because of the importance to the motion picture industry of this source of financing. From the point of view of the investor it is important to determine if motion picture investment is a viable tax shelter. If motion picture investment is a viable shelter, it is necessary to determine the minimum marginal tax bracket an investor must be in before considering such an investment. It must be determined what form of financial arrangement the investment must take. An evaluation must be made to determine the type of motion pictures that are most likely to earn a profit. It is also necessary to determine the value of leveraging the initial capital investment vis-a-vis the incremental future investor liability incurred by the private investor. Does the immediate tax shelter benefit offset the future liability of the promissory notes?

The method used to answer the questions posed is to examine the current literature on motion picture investments, examine the legal framework of the investments and examine the relevant income tax legislation. Actual motion picture investments are reviewed and a quantitative financial analysis is undertaken to determine the net

outcomes to investors under various circumstances.

National Revenue, Taxation is the body of the federal government which interprets and administers the Income Tax Act and Regulations. The terminology of the Act is not always precise therefore the tax department must interpret the legislation in accordance with its mandate which is to collect as much income taxes as possible. If a taxpayer disagrees with National Revenue, Taxation's interpretation he has the right of appeal to the Canadian judicial system. At the present time the courts have upheld National Revenue, Taxation's position that a taxpayer is not entitled to claim a capital cost allowance deduction for any amount that he has not personally committed to the motion picture investment.

This study evaluates through quantitative analytical techniques the financial outcomes to an investor who invests in a motion picture with and without the leveraged tax shelter facilitated by the signing of promissory notes. A motion picture investment model is designed which generates the net present value of a motion picture investment over a seven year time horizon. Two hypothetical investor income levels are used to evaluate investment in educational video tape programs and theatrical feature length motion pictures. Assumptions are made about the distribution receipts of the two types of motion pictures.

The net present value of the investments are found. The outcomes are compared and contrasted and conclusions are drawn. The primary conclusions are that an investor must have a marginal income tax rate greater than fifty percent of his taxable earnings. The motion picture investment must have a structure which facilitates leverage of the investor's initial capital investment for income tax purposes. The future liability necessary for leverage must be at least partially offset by a minimum distribution revenue guarantee. The leverage will reduce the investor's potential loss through the reduction of income taxes. However, the investor will not realize a net gain unless the motion picture earns revenue exclusive of the minimum revenue guarantee. If the motion picture does not generate any net distribution revenue for the investor he will be liable in the future for the promissory notes that facilitated the tax shelter. Therefore, motion picture investment decisions must be based upon careful and detailed examination of the international commercial merits of the motion picture property.

TABLE OF CONTENTS

LIST OF TABLES

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CHAPTER I

INTRODUCTION

Since 1970, motion pictures have been a popular tax shelter investment in Canada. This study is an attempt to analyze the income tax incentives and to evaluate how they affect the private motion picture investor.

A thorough investigation of motion picture investment tax shelters is warranted. Many articles have been published about the immediate attraction of motion picture investment - the glamour, the tax shelter, the possibility of earning millions! Yet no serious attempt has been made to evaluate Canadian motion picture investment proposals over their entire time horizon. Such an attempt must employ modern financial theory in order to evaluate the final consequences to the investor.

Few motion pictures have earned a return for the investor. Many of the capital cost allowance deductions which facilitate the income tax shelter aspect of the investment have been challenged by National Revenue, Taxation. A number of those deductions challenged have eventually been disallowed. The investment not only failed to earn investment income, but it also failed to avoid or defer taxes payable on other sources of taxpayer income.

The study will examine the motion picture investment environment. The study will use quantitative techniques and a motion picture investment model to analyze several investments under various investor circumstances.

A premise of this study is that motion picture investments are a high risk venture. The study will therefore attempt to determine whether or not that risk can be reduced.

A number of questions will be posed. The answers to these questions will be used to draw conclusions and suggest recommendations aimed at improving motion picture investment in Canada. The questions are:

1. What is the value to the investor of the income tax shelter facilitated through the initial capital investment leverage?
2. What is the optimum type of motion picture investment and the optimum investment structure? This is, what characteristics are required of both the investor and the investment?
3. How can the risks inherent in motion picture investment be reduced through positive action by the federal government, the motion picture industry and the investor?

1. LIMITATIONS

This study focuses on a narrow but extremely important aspect of the motion picture industry. The focus is on the financing of motion picture production in Canada by private investors. Many elements of the industry are taken as given. The industry functions of production, distribution and exhibition are examined only to the extent necessary to provide the reader with a basic understanding of the motion picture industry.

Perimeters to the study are for two reasons. The first reason is the limitations of time and resources of the writer. The second reason is that aspects of the motion picture industry not included in this study are available from other sources. For example, the many books on the industry and the numerous trade publications on production, distribution and exhibition.

The study is limited to the period from 1960 to the latest federal budget of March 31, 1977. The major emphasis is on the years from 1970 to 1977.

Investment by chartered banks and finance companies are not included. Except for a few isolated cases traditional lending institutions have not been active in motion picture finance in Canada. Motion picture financing through stocks or debentures issued by production companies is not considered. Foreign investment in Canada also is excluded.

The motion picture production of the National Film Board and the Canadian Broadcasting Corporation is not included because private investment is not involved in these government organizations. The activities of the private commercial broadcasting and cablecasting television networks are excluded.

The quantitative analysis of private motion picture investment (Chapter VII) is limited to several hypothetical investment situations. These hypothetical investments are typical of the motion picture investments currently offered in Canada. The hypothetical investments do not represent every type of motion picture investment package that could be offered. The quantitative analysis is limited to the computing capabilities available to the writer. A computer program could be devised to vastly increase the scope and depth of the motion picture investment model.

No attempt is made to prove correlations between the number of dollar amounts of motion picture production vis-a-vis the development of government production incentives. The current methods used by Statistics Canada to gather and analyze production statistics result in inaccurate data. All producers in Canada are asked to report their annual production. Producers traditionally sub-contract various phases of a motion picture production to other producers. The Statistics Canada questionnaire and evaluation methods do not distinguish that fact, consequently the amount of annual production is overstated.

Note. The Department of National Revenue, Taxation is the branch of the Federal Government of Canada which administers the Income Tax Act and Regulations. "There is no "income tax department as such".[2] It is common to refer to the Department of National Revenue, Taxation as "the income tax department", "the tax department" or simply "the department". The writer uses these expressions throughout this paper.

The motion picture industry produces, distributes and exhibits artistic and dramatic photoplays on motion picture film and magnetic video recording tape. In this paper the expression "motion picture" includes both film and video tape. When it is necessary to distinguish between the two motion picture formats the words "film" or "video tape" are used.

2. THE CANADIAN MOTION PICTURE INDUSTRY - A BRIEF DESCRIPTION

A. Production, Distribution and Exhibition

Production, distribution and exhibition, are the three major activities of the motion picture industry. These activities are parallel to manufacturing, wholesaling and retailing in many other industries which market a product to a large number of consumers in diverse geographical locations.

Production

Production begins with the inception of an idea which will ultimately be made into a motion picture through a complex creative, technical process. The first step involves obtaining the rights to a novel, a research paper or a script. The necessary pre-production steps are threefold:

1. securing the financing;
2. hiring creative personnel and technicians;
3. leasing filming equipment, shooting locations and/or studios.

The next stage is the most exciting and creative. It involves the recording of images and sounds. The visual ideas are dramatized or animated and the dialogue and sound effects are simultaneously recorded.

Post production consists of editing the original "elements" (exposed film and recorded sound tape) according to the intention of the script.

The final stage is the legal process undertaken to protect the rights of the final product (a motion picture film or a video tape) for its owners. The artistic and dramatic contents of the "photoplay" must be copyrighted for protection against unauthorized duplication.

Distribution

Distribution is the activity of marketing the motion picture product.

Feature length motion pictures are rented to exhibitors (owners of motion picture theatres or drive-ins). Educational films are sold directly to audio-visual resource personnel of school boards, post-secondary institutions or hospitals.

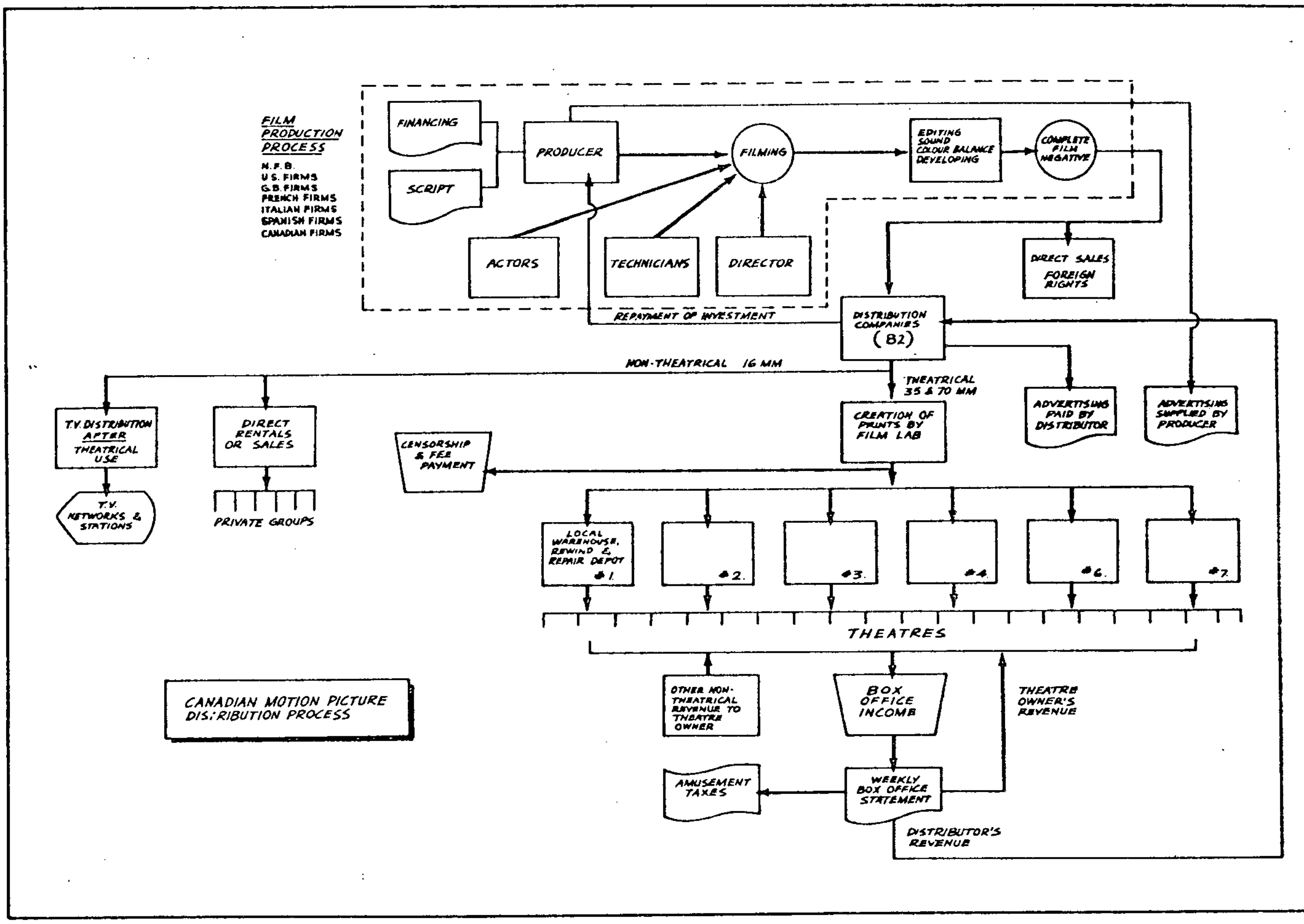
Distributors ship copies of the motion picture directly to their customers. Distributors are responsible for the duplicating, cleaning and repairing of the copies. They coordinate advertising and promotional campaigns directed at educators and the movie going public.

Exhibition

Exhibition is the promotion and screening of motion pictures to the public and exhibitors are the owners or operators of theatres and drive-ins. Through payment of a rental feel, the exhibitor obtains the right to play the motion picture for a specific period of time. The rental fee is subject to the expected "box office" (gross ticket sales) of the particular motion picture as well as the size and location of the theatre.

TABLE I-I

Motion Picture Production, Distribution and Exhibition Process



Source:

Canadian Motion Picture Distributors' Association, "Position Paper Concerning the Motion Picture Distribution Industry in Canada". 1976. Figure 1.

B. The Canadian Motion Picture Industry

In 1975, Canada's motion picture market represented $211 million - over 7% of the total world wide gross motion picture sales.[3] Eleven million dollars of Canada's total was spent on educational motion pictures and $200 million on theatrical feature films.[4] Today, Canada is the second largest market for motion pictures in the world. The United States occupies first place.

The Canadian market is very important to English and American production, distribution and exhibition companies because of its size and language. The appeal of Canada's sizable market and the historical ease with which foreign firms have entered Canada has resulted in a Canadian industry dominated by foreign interests. Foreign interests are particularly overwhelming in the areas of distribution and exhibition. The motion picture product generally is not obtained from Canadian producers but is imported from the United Kingdom and the United States.

Production in Canada

Until 10 years ago there was almost no theatrical film production in Canada. Even recently, statistics indicated that the number of Canadian productions is small relative to the size of the total Canadian market for theatrical films.[5] The production that does take place in Canada is undertaken by two main groups: the major foreign producers and the independent Canadian producers. One of the main reasons foreign producers like to work in Canada is because of this country's relatively unexposed geographical background.

Independent Canadian producers as a rule, work either on speculation or under subcontract arrangement for a major foreign producer. Resident independent Canadian producers, with few exceptions, do not enjoy a particularly good reputation in the United States or abroad. Therefore subcontracting arrangements are uncommon.

Production of a high quality theatrical product requires film making expertise and adequate financing. Unfortunately the absence of financing and expertise have severely inhibited the production capabilities of the independent motion picture producers. Canadian script writers and directors who do not have the necessary experience often choose themes that do not sell. Themes which lack adventure, excitement and international thrust have not enjoyed great popularity with the North American movie going public.

Paul Morton, President, Odeon-Morton Theatres Ltd. described Canadian theatrical motion pictures as "depressing downbeat little pictures that nobody wants to see in our country or anywhere else".[6] The Canadian Motion Picture Distributors' Association stated that "the cultural or educational aspects of the story will not attract viewers if the product is not primarily entertaining and of good technical quality."[7] Most independently produced Canadian theatrical motion pictures lack the necessary craftsmanship and entertainment value. Canadian theatrical films therefore, are suitable for neither Canada's nor the world's commercial motion picture market.

Educational motion picture producers have a marginal commercial existence in Canada because the North American market is highly competative. If the producers expect their motion pictures to be widely distributed and earn a profit, their product must be compatible with educational curriculums throughout North America. The slightest fluctuation in government spending on audio-visual teaching aids can jeopardize the profitabilityof an educational motion picture.

Sources of finance have been reluctant to commit large amounts of money in Canadian motion picture production, given the infancy of the Canadian industry, the non-commercial attitude of Canadian film makers and the inherent investment risk. Consequently there is a shortage of commercial Canadian made product.

Distribution in Canada

Most theatrical distribution in Canada is undertaken by foreign controlled distributors. The most important of these distributors are the American subsidiaries of Walt Disney, Avco Embassy, 20th Century Fox, United Artists Corp., Universal Films, Warner Brothers, Columbia Pictures, Paramount Pictures Corporation and Metro-Goldwyn-Mayer. In 1974 these companies, or their Canadian representatives earned most of the $59,860,000 paid for the rental of feature length motion pictures in Canada.[8]

There are approximately 70 other film distributors in Canada, none of which are very large and whose product is of limited commercial value. Several of these are also owned or controlled by foreign interests. They are called "independents" to distinguish them from the "majors" (Walt Disney et al).

The educational distributors are largely owned by Canadians but several, such as McGraw-Hill, Ryerson Ltd., Encyclopedia Britannica Educational Films and B.F.A. Educational Media are owned by American controlled publishing or media interests. Canadian educational distributors often form agreements with American distributors to carry their product lines on an exclusive basis.

The Draft Film Policy commissioned by the Secretary of State stated that

> about two-thirds of the market for films and other educational material are occupied by imports mostly from the United States.[9]

Once again, through indirect means, the American interest makes itself manifest in the Canadian market.

Exhibition In Canada

Theatrical exhibition is dominated by two companies: Famous Players Theatres Limited and Odeon Theatres (Canada) Ltd. who together own 60% of the 1,116 theatres and 307 drive-ins in Canada.[10] The remaining 40% of Canadian exhibition outlets are owned and operated by the "independents". Some independents may operate as many as ten theatres or drive-ins.

Famous Players and Odeon, the two national chains, because of their high profiles, are the target of much criticism from Canadian film makers, particularly the Canadian Council of Film Makers. The C.C.F.M., a highly vocal group, makes the accusation that "secret" agreements exist between certain major distributors and the two chains. This accusation has further fueled the arguments for foreign motion picture quotas, additional box office levies or possible nationalization of the theatre chains.

The major distributors and exhibitors are represented by the Canadian Motion Picture Distributors' Association. The C.M.P.D.A.

responds to the C.C.F.M.'s criticism by stating that the distributors and exhibitors need product as there is a world wide shortage of motion pictures with a high degree of public appeal. They state in their brief entitled "Position Paper Concerning the Motion Picture Industry in Canada" that "with regard to exploitation and distribution"[11] of Canadian product:

> contrary to some opinion, no particular problem is envisaged provided the right product is there. The only yard stick that governs the number of play dates and attendant box office grosses is public support. Failing public support, the theatre exhibitor, regardless of his business relationships, will refuse to book a picture.[12]

The C.M.P.D.A. claims that:

> The shortage of successful Canadian films is due to the absence of significant economic organization with the capacity of correctly packaging an appropriate property that has the right artistic bias and a very specific international thrust.[13]

The arguments go back and forth with both sides accusing the other of incompetence, dishonesty and ignorance. However, the fact remains that only ten Canadian feature films have ever earned over $1 million in box office gross ticket sales in Canada.[14] Of these ten, only three or four have had any significant public appeal in other English language markets in the world.

In conclusion, motion picture production in Canada of both features and educational films is very unstable. The amount of Canadian production rises and falls with the flow of government aid in the form of loans, grants, and tax incentives. The Canadian motion picture industry is dominated by foreign interests which effectively control the product from production to exhibition.

3. PROGRAMS TO ENCOURAGE MOTION PICTURE PRODUCTION IN CANADA

The federal government for the past ten years has attempted to encourage the development of a viable Canadian film industry. Unfortunately the various incentives to attain this goal have not been very well coordinated with each other or with the true needs of the industry. The lack of a clearly stated government film policy for Canada and the uncertain nature of the incentive programs, are seriously hampering long-term industry development. Incentive programs are devised, announced and implemented, but there is evidence that these are merely "stop-gap" measures responding to pressure from various sectors of the industry and the general public. Clearly what is needed is a coordinated study of the industry, including a serious appraisal of what Canada can offer not only to the Canadian movie-going public but also, and most important, to the world market. It is known that the government has commissioned studies of the film industry through the Secretary of State Department but as yet no conclusions have been announced. For the past four years the response from both the former and current Secretaries of State has been that a concrete film policy for Canada is "under review".

Meanwhile the various incentive programs limp along on a piece meal basis with one government department often seriously thwarting the efforts of another government agency, e.g. Secretary of State's co-production agreements with foreign countries versus the Department of Manpower and Immigration's policies regarding work permits and immigration visas. Superimposed upon these factors is the competition to the private independent film/video tape production companies from the totally government funded agencies: The National Film Board and Canadian Broadcasting Corporation.

Why encourage development of a viable Canadian film industry? First there are two economic reasons.

1. The monetary value of production and distribution contribute to the gross national product. Production is labour intensive and is a stimulus to the national employment level. For example, in 1975, production was estimated at $150 million. In the same year distribution and exhibition in the theatrical and non-theatrical market (educational and television) was $251 million.[15]

2. The monetary value of exportation of Canadian motion pictures contribute to the balance of payments. The export market for Canadian productions has great potential considering the size of the English speaking motion picture markets and their proximity to Canada.[16]

Second, there are the national cultural reasons for a viable Canadian film industry:

1. Films act as a medium of cultural exchange within the various subcultures of our national profile.

2. International release of Canadian productions in world theatrical and television markets is a natural outlet for expressing this multi-faced Canadian culture, leading to a greater world recognition of Canada.

The government programs to encourage and aid motion picture production in Canada will be reviewed under the Canadian Film Development

Corporation, the Canada Council, the Major Exhibitor's investment Program the Co-Production Agreements with Foreign Countries and the Income Tax Incentive Program.

A. Canadian Film Development Corporation

The Canadian Film Development Corporation (C.F.D.C.) was created by a federal cabinet decision in August, 1964. The cabinet approved in principle the establishment of a loan fund to aid in the development of a Canadian feature film industry.

In the 1965 Speech from the Throne, the federal government stated its intentions to aid the motion picture industry. In October of that same year, the Secretary of State announced that a Crown Corporation responsible for administering a $10 million revolving fund would be established. The purpose of the crown corporation would be to financially assist Canadian motion picture productions. The C.F.D.C. would invest in productions that have a theme that fosters the development of a national cultural awareness of Canada and promotes the awareness at home and abroad.

The corporation would be a financing institution similar to the Canadian Industrial Development Bank and the National Film Finance Corporation in the United Kingdom. The corporation would have the power to allot grants, and awards and to lend production funds to Canadian producers. The proposed legislation would require the disbursement of administrative costs and other non-recoverable expenses from the $10 million fund. The corporation would be credited with earnings on its loans and profits from its investments in feature film productions.[17]

In June, 1966 legislation to establish the corporation was introduced in the House of Commons. The debate which followed indicated general support by Parliament for a film development fund. The Members of Parliament were concerned that the bill satisfy the requirements of their constituents. They also voiced their general concern over the problems of distribution of Canadian motion pictures.

The legislation, Bill C-204, was given third reading in Parliament on February 3, 1967. The Senate subsequently passed the Bill, without amendment, on March 3, 1967. (Canadian Film Development Act SC 1966-67 c.78 now RSC 1970 C C-8).

In February, 1968, the chairman and the five members were appointed and the Corporation came into existence as an agency of Her Majesty the Queen. On April 2, 1968, the members met for the first time. Their adoption of the by-laws completed the formal establishment of the Canadian Film Development Corporation. The objects and powers of the corporation are contained in Section 10 of the Canadian Film Development Corporation Act. They are as follows:

(1) The objects of the Corporation are to foster and promote the development of a feature film industry in Canada, and without limiting the generality of the foregoing, the Corporation may, in furtherance of its objects,

(a) invest in individual Canadian feature film productions in return for a share in the proceeds from any such production;
(b) make loans to producers of individual Canadian feature film productions and charge interest thereon;
(c) make awards for outstanding accomplishments in the production of Canadian feature films;
(d) make grants to film-makers and film technicians resident in Canada to assist them in improving their craft; and
(e) advise and assist the producer of Canadian feature films in the distribution of such films and in the administrative functions of feature film production.

(2) For the purposes of this Act, a "Canadian feature film" or "Canadian feature film production" is a feature film or feature film production in respect of which the Corporation has determined

(a) that the completed film will, in the judgement of the Corporation have a significant Canadian creative, artistic and technical content, and that arrangements have been made to ensure that the copyright in the completed film will be beneficially owned by an individual resident in Canada, by a corporation incorporated under the laws of Canada or a province or by any combination of such persons; or

(b) That provision has been made for the production of the film under a co-production agreement entered into between Canada and another country.

(3) The Corporation shall not be regarded as a partner in any film production in which it may invest and its liability shall be limited to the amount of its investment in the production.

(4) The Corporation shall, to the greatest possible extent consistent with the performance of its duties under this Act, consult and co-operate with departments, branches and agencies of the Government of Canada and of the governments of the provinces having duties related to, or having aims or objects related to those of the Corporation.[18]

Since its inception, the C.F.D.C. has been refinanced twice - once in 1972 for an additional $10 million and again in 1976 for $5 million. The C.F.D.C. has invested most of these funds in two motion picture investment programs: the Feature Film Investment Program and the Special Investment Program.

In the Feature Film Investment Program, the corporation could invest up to 50% of the production costs of the completed film with a maximum in 1976 of $250,000.[19]

When the C.F.D.C. invests in a film it will participate in 50% of the profit, in proportion to its share of the original financing. The other 50% of the profits traditionally goes to the producer to be shared with the writer, director, actors and others involved in the production of the film. When the

C.F.D.C. makes a loan, it does not take a share in the profits but it does request security other than the film itself. The rate of interest is subject to negotiation.[20]

A further condition for C.F.D.C. funding was that the producer secure guaranteed distribution in Canada. This was to be ensured by the requirement that a distributor contribute to the production costs and/or advertising and promotion expenses. However, this rule was not always enforced and the C.F.D.C. did participate in productions which did not have a distributor prior to commencement of production.

The Special Investment Program was designed to permit young film-makers to develop and demonstrate their talent through production of a low budget feature. The maximum budgets permitted in this program were between $100,000 and $135,000. The C.F.D.C. could provide up to 60% of the production budget costs. The balance of the budget was to be provided by private investors or by voluntary deferal of the salaries of those working on the film. The C.F.D.C. was to receive 25% of any revenue earned by the film after the private sector or deferals had been repaid. Guaranteed distribution was not necessary.

Initially the Corporation's main concern was to get as many features into production as possible. However, in the early 1970's the C.F.D.C. became increasingly concerned with distribution of the Canadian product. In 1971 a policy was adopted that investment would be made only in films that had been accepted for distribution by a distributor. This policy was somewhat hollow because unconditional binding acceptance of an uncompleted film by a distributor is impossible to legally enforce. The policy was later rescinded and the C.F.D.C. continues to invest in low budget features without a prior distribution agreement.

In 1973 the C.F.D.C. extended its financial assistance so that investment funds could be used for promotion during and following production. Thus better marketing and wider distribution of Canadian features was ensured. In 1975 the Corporation added to its staff an experienced Distribution Officer to work with Canadian distribution companies to enable them to expand their activities both nationally and abroad.

In its 1975-76 fiscal year the C.F.D.C. put greater emphasis than it had previously on its script writing assistance program. The C.F.D.C. recognized that "it is virtually impossible to produce a viable motion picture without a creative, commercial script."[21] To assist in developing good Canadian script writers, the Corporation, in addition to supporting promising writers, created the position of English Script Consultant who was to provide detailed, constructive feedback to script writers. The Corporation allowed that one of its most vital objectives would be "the combination of creative freedom with realistic commercial potential".[22] Executive Secretary Michael Spencer, declared that the corporation had, in the past, invested in the production of "films that had no chance of ever getting off the ground"[23]. It has been proposed by Corporation management that the C.F.D.C. discontinue its practice of investing in low budget features. None of these low budget features have ever earned any returns because very few have even been shown to a paying audience as their themes are not popular and the production value low.

In 1976 the mandate of the C.F.D.C. was expanded to include responsibility for administering and assisting in negotiations of co-production agreements with foreign countries. The corporation scrutinizes all proposed co-productions to see if they comply with the regulations regarding Canadian content and investment,and artistic and commercial potential. "Eligible projects of high merit"[24] are recommended by the C.F.D.C. to the Secretary of State. The Secretary of State makes the final decision to allow financial assistance to the co-productions.

The C.F.D.C.'s expanded mandate also includes co-ordinating the activities of the various government agencies concerned with the film industry in Canada. Some government agencies are: The Film Festival's Bureau - Secretary of State Department, Canada Council for Arts, National Film Board, National Archives and the Department of External Affairs. A further responsibility of the C.F.D.C. is to monitor the voluntary quote agreements with the two national theatre chains - Famous Players Ltd. and Odeon Theatres (Canada) Ltd. These two predominant chains have voluntarily agreed with the Secretary of State to show Canadian-made features at each of their theatres for a minimum of four weeks each year.

In 1977 the C.F.D.C. further increased its responsibilities and broadened its mandate. The C.F.D.C. is now involved in almost every area of the Canadian motion picture industry, including television.

B. Canada Council

The Canada Council was established in 1957 by the passing of the Canada Council Act. The Council's mandate is to "foster and promote the study and enjoyment of, and the production of works in the arts, humanities and social sciences".[25] This mandate is to be accomplished through the distribution of fellowships and grants to creative persons.

The Council has two programs which affect the film industry: the Film Production Grant Program and the Video Production Grant Program. Applicants who have previously established a professional reputation in the visual arts can apply for grants of up to $25,000 for a film production and of up to $10,000 for a video tape production.[26] The intention of these programs is to support the film-maker who has demonstrated a degree of professionalism but who needs further opportunity to demonstrate his creative and technical ability before embarking on a more sophisticated and costly commercial project.

C. Major Exhibitors' Investment Program

A growing lobby made up mostly of nationalistic Canadian film-makers has been pressuring both the federal and provincial governments to force the two major theatrical exhibitors to invest a greater portion of their box office profits directly in film production. Famous Players Limited and Odeon Theatres (Canada) Ltd. are financially controlled either partially or completely by foreign interests. A large amount of their profits flows out of Canada to their parent companies. Various parties including the Canadian Council of Film Makers, the Secretary of State Department and the C.F.D.C. have been seeking ways in which this flow of funds out of Canada could be reduced. Faced with the threat of Canadian content quotas, additional box office levies or outright nationalization, the two major chains have consented to invest a portion of their earnings in Canadian film production.

Famous Players invested some money in motion picture production in the late 1960s and early 1970s but it was not until the possibility of strong government action became likely that the two major chains agreed to provide production financing in any substantial way. Secretary of State, Mr. J. High Faulkner, announced on August 5, 1975 that:

> the two largest theatre chains in Canada...have voluntarily agreed to a quota of four weeks per theatre per year and an investment program of at least $1.7 million to aid the exhibition and production of Canadian feature films.[27]

The announcement noted that Famous Players and Odeon would contribute $1.2 million and $500,000 respectively in the first year of the program.

Attempts by the writer to ascertain the requirements for investment by the two major chains were frustrating. The two chains do invest but it seems they do so reluctantly. They are reticent about specific information regarding their program and do not encourage the submission of production proposals.

M.J. Lawrence Pilon, Vice President and Secretary of Famous Players Limited stated in a telephone conversation with the writer that Famous Players invests up to $1 million per year in certified Canadian productions. Famous Players will contribute up to $150,000 in any one feature for which they expect a share of the profits (points) in accordance with their percentage of the total budget investment on a parri passu recoupment basis. Projects submitted to an executive committee are evaluated with regard to: commerciality of the script, the budget allocations, the proposed stars and the reputation and experience of the principals and other investors involved in the production company and the project.[28] Mr. Pilon would not say who was on the executive committee and he refused to comment on the criteria used to determine acceptance of script, budget, stars, principles and investors.

D. Co-Production Agreements with Foreign Countries

To develop a film industry, Canadians must first learn the necessary technical and creative skills of the art. One way to do this is to co-produce with film-makers from other countries more experienced than ourselves. To encourage Canadian film-makers to work with foreign filmmakers the government, through the auspices of the Secretary of State Department, has negotiated three co-production treaties since June, 1974. The advantage to Canada, is the opportunity for Canadians to benefit from the experience and expertise of foreign craftsmen by working with them in Canada or abroad. Canadian projects produced under these treaties will be eligible for any quotas or other market protection measures in the participating foreign country. The advantages for the foreign country are:

1. Access to Canadian investment, including C.F.D.C. funding;
2. The opportunity to transfer for production purposes funds otherwise blocked by currency restrictions to Canada;
3. Access to Canada's under-exposed scenery for story backgrounds using experienced foreign crews and cast. The Department of Manpower and Immigration has been instructed to relax its work permit regulations in order to allow foreign film-makers to work on Canadian co-productions;
4. Access to Canadian television markets since motion pictures produced under co-production agreements are deemed as "Canadian content" for broadcast purposes.

The film itself is exempt from any import duties or quotas of either of the co-producing countries and therefore can be freely exploited in the two countries.[29] The profits earned in each country, however, accrue solely to the resident co-producer of the country in which they are earned.

> Each production company will reserve its national territory for the exploitation of the film and will share the net profits from the world in proportion to the amount of capital advanced or credit made available to the production. [30]

In February 1976 the Secretary of State appointed the C.F.D.C. as administrator of all existing co-production agreements.[31] The C.F.D.C. reviews any proposals and makes recommendations to the Secretary for final approval of those projects which the C.F.D.C. considers beneficial to Canada.

Canada has co-production agreements with the United Kingdom, France and Italy. Negotiations are in progress with West Germany and Israel.

<u>Canadian-French Co-Production Agreement</u>

The "Film Relations Agreement" between the governments of Canada and France was signed on June 7, 1974.[32] The Secretary of State in Canada and the Directeur Generale de la Centre Nationale de la Cinematographie approve motion pictures produced under the agreement.

The two officials must approve the contractual arrangements of each motion picture production and market-sharing arrangments for for the completed product. The producers must be professionally competent and adequately funded.[33] The director and principle acting talent must be either French or Canadían and the shooting must take place in either France or Canada.[34] Both a French and English sound track version of the film must be made.[35] The proportion of investment and technical and creative contribution can range between 20% and 80%. Usually the investment and production services contributions are of the same respective proportion.[36]

Canadian-Italian Co-Production Agreement

The "Agreement Relating to the Co-Production of Films" between the Government of Canada and the Republic of Italy was signed on July 4, 1974. The terms of the agreement are similar to the French co-production treaty. The Italian Ministry of Tourism and Entertainment is the body which must approve projects involving the Italian co-producers.[37] Two versions of the motion picture must be made, one in Italian and one in either French or English.[38] The contributions to financing by the two co-producers can vary between 30 and 70 percent. The creative and technical services are to conform to the respective participation percentages.[39]

Canadian-United Kingdom Co-Production Agreement

The Honourable Hugh Faulkner, Secretary of State, signed a three year co-production agreement with the United Kingdom on September 12, 1975.[40] A film qualifies for the benefits of this agreement if it has a co-producer (or co-production company) from each country that are corporately independent of one another. The budget must be over $350,000 or £150,000 whichever is the larger amount at the prevailing rate of exchange.[41] The majority of the persons working on the film must be either citizens or residents of the U.K. or Canada but leading performers can be from a third country.[42] The rules regarding the ratio of cast, technical and craft services, distribution and sharing of net receipts are similar to those included in the other two co-production treaties and the general conditions set out in the introduction of this section.

E. Income Tax Incentive Program

The income tax incentive program is the use of the high depreciation rate for motion picture and video tape programs which is allowed for income tax purposes. An investor-owner can utilize this depreciation rate - "capital cost allowance" - to reduce his gross income for tax purposes and thus reduce his taxes payable.

All assets (property) have been assigned to certain "classes" by way of ammendments to the Income Tax Act Regulations. Each class has been given a maximum rate at which the capital cost of an asset can be amortized. The rate is called the capital cost allowance (c.c.a.).

An owner of property (taxpayer) can deduct up to the maximum c.c.a. from the undepreciated balance of the cost of that property. (For a detailed explanation of c.c.a. see Appendix A to Chapter II).

From time to time the various classes are amended by the government to include or delete certain properties. These amendments may reflect new uses and hence economic life expectancy of the property. The amendments may also reflect government policy that is designed to encourage or discourage ownership by Canadian taxpayers of that particular property.

Motion picture films and video tapes are presently in class 10 (30%) and class 12 (100%) depending on their content and ownership. The programs in class 10 are those which the government does not wish Canadians to invest in or own. The programs in class 12 are those in which the government desires to encourage private Canadian investment, hence the income tax based incentive. It is the value of the income tax incentive that will be addressed in this thesis.

4. FORMAT OF STUDY

A. Method

This is a two pronged study of the capital cost allowance incentive program for motion picture investment. Firstly, the study examines the relevant income tax laws of Canada and their interpretation by the Department of National Revenue, Taxation and the Canadian judicial system. Secondly, the study involves a quantitative analysis of the financial implications to a taxpayer investing in Canadian motion pictures. The intention of this study is to investigate motion picture production in Canada and the consequences of investing in such productions from the point of view of the private investor.

The method used to undertake this study is as follows:

1. The present motion picture industry in Canada is described.
2. The theory of capital cost allowance is explained through the use of examples from motion picture investment proposals.
3. The income tax legislation relating to capital cost allowance and the motion picture investment is scrutinized, described and commented upon.
4. Relevant court cases are examined.
5. An actual motion picture investment package including an income tax reassessment and appeal experience of an investor-owner is described.
6. A motion picture investment model which incorporates both investor-taxpayer and investment characteristics is designed.

7. The model is utilized to arrive at various financial outcomes depending upon such factors as:

- -investor income;
- -motion picture investment type;
  - -educational,
  - -feature,
- -investment format;
  - -leveraged,
  - -non-leveraged.

8. The financial outcomes are compared and contrasted. Conclusions are drawn.

9. Overall conclusions are made based on the results of both the descriptive and analytical parts of the study.

10. Recommendations are offered to investors, the motion picture industry and the government.

In summary, this thesis is an extensive examination of the current state of the Canadian motion picture industry and the relevant income tax legislation, the embodiment of an original experience of the writer in that industry, and the application of modern financial principles to motion picture investment.

5. SOURCES OF DATA AND INFORMATION

The Canadian Income Tax Act and Regulations was a major source of information along with interpretations of the *Act* by the National Revenue, Taxation and the Canadian courts.

Other sources of data and information included the following: Motion picture industry trade journals and magazines such as

<u>Variety</u>

<u>Cinema Canada</u>

<u>The Journal of the Producers Guild of America</u>

Canadian newspapers such as

<u>The Financial Post</u>

<u>The Toronto Globe and Mail</u>

<u>The Vancouver Sun</u>

Books written on the industry by lawyers, producers, directors, and distributors such as

<u>Motion Pictures and the Arts in Canada</u>, Garth H. Drabinsky

<u>The Film Industries</u>, Michael F. Mayer

<u>Producing, Financing and Distributing Film</u>, Paul A. Baumgarten and Donald C. Farber

<u>Motion Picture Distribution</u>, Walter E. Hurst and William S. Hale

Papers and speeches presented by lawyers and chartered accountants involved with motion picture financing such as

"Tax Advantages of Film Investments", Wayne G. Beach L.L.B.

"A Cineramic View of Motion Picture Investments", Richard M. Wise, C.A.

"A Departmental Perspective on Tax Shelters", M.W. Steele.

Personal interviews were conducted in an attempt to assess the validity of what had been written by and about the motion picture industry.

The writer has been involved in the production, financing and distribution of educational/documentary motion pictures for five years.

FOOTNOTES CHAPTER I

[1] n. a.

[2] Thomas M. Ferguson, What To Do When The Taxman Comes (Vancouver: International Self-Counsel Press Ltd., 1976), p.xi.

[3] Statistics in the motion picture industry are unreliable but common assumptions based on a number of sources lead to the market figures quoted. These sources include Variety, The Journal of the Producers Guild of America and The Draft Film Policy presumably prepared by or for the Secretary of State and leaked to the press in the fall of 1976.

[4] Draft Film Policy, leaked to the press, author unknown, Cinema Canada, November, 1976, p.22.

[5] See various Canadian Film Development Corporation Annual Reports 1968 to 1976.

[6] Paul Morton, "Reflections on Our Home Movies", Cinema Canada, April, 1976, p.37.

[7] "A 'Major' Offense Against Nationalism", Cinema Canada, February, 1977, p.20.

[8] Canadian Motion Picture Distributors Association Canadian Film Digest, December, 1976, p.17.

[9] "Draft Film Policy", op.cit., p.25.

[10] Dennis H. Diebel "The Role of the Federal Government in the Commercial Feature Film Industry in Canada: An Introduction" (unpublished Masters of Business Administration thesis, University of British Columbia, 1976), pp.26-27,

[11] "A'Major' Offensive Against Nationalism," op.cit., p.21.

[12] Ibid.

[13] Ibid.

[14] "Canadian Films Grosses," Variety, November 24, 1976, p.32.

[15] "Draft Film Policy," op.cit., p.22.

[16] Reliable motion picture export figures are unavailable from Statistics Canada. The writer suspects these figures are unreliable due to the design of Statistics Canada's questionnaire and their survey methods. The writer's company has exported over $100,000 worth of

motion picture product to the United States and Europe. The company has never been asked to report this fact on the annual Statistics Canada Questionnaire for Motion Picture Production, Video Tape Production, Laboratory Operations.

[17] Secretary of State Press Release, October 17, 1965.

[18] Canadian Film Development Corporation Act, Subsection 10, 14-15-16 Elizabeth II, Chapter 78, pp.863-864.

[19] Dennis Diebel, op.cit., p.53.

[20] Ibid.

[21] Canadian Film Development Corporation, Annual Report 1975-76,

[22] Ibid.

[23] Les Wedman, "The C.F.D.C. finally promises to smarten up", Vancouver Sun, July, 1976, p.?

[24] Canadian Film Development Corporation, op.cit., p.7.

[25] The Organization of the Government of Canada (Information Canada, 1975, Catalogue No. 1 C 41-1/1975), p.750.

[26] The Canada Council Aid to Artists (The Canada Council, July, 1976), pp. 10-11.

[27] Honourable J. Hugh Faulkner, Secretary of State News Release, August 5, 1975, p.1.

[28] Statement by J. Lawrence Pilon, Vice President and Secretary, Famous Players Limited. Speaking from Toronto, Ontario, March 16, 1977.

[29] Dennis Diebel, op.cit., p.59.

[30] Garth H. Drabinsky, Motion Pictures and the Arts in Canada, the Business and the Law, (Toronto: McGraw-Hill Ryerson Limited, 1976), p.134.

[31] Canadian Film Development Corporation, op.cit., p.7.

[32] Agreement between the Government of Canada and the Government of France concerning Films and Film Production, into effect June 7, 1974, Article I(i) and Article XI.

[33] Ibid., Article II(i).

[34] Ibid., Article II(ii) and Article II(i) and (ii).

[35] Ibid., Article IX.

[36] Ibid., Article IV(i) and (ii).

[37] Agreement between the Government of Canada and the Government of the Republic of Italy Relating to the Co-Production of Films, signed July 4, 1974, Article I.

[38] Ibid., Article VIII.

[39] Ibid., Article IV and Article V.

[40] Co-Production Agreement between the Governments of the United Kingdom of Great Britian and Norther Ireland and the Government of Canada, signed September 12, 1975.

[41] Secretary of State, News Release, September 12, 1975, p.1.

[42] Ibid.

CHAPTER II

INCOME TAX INCENTIVE PROGRAM

1. MOTION PICTURE INVESTMENT FOR THE PRIVATE INVESTOR

The federal government has stated that it would like a viable motion picture industry to develop in Canada. However for the industry to develop money must be invested in the production of motion pictures.

Motion pictures are a high risk investment. The odds of a motion picture investment earning a reasonable rate of return are very low. The attendant risk is very high that the production phase will exceed the production budget or that the production of the motion picture will not even be completed. The private investment community is unlikely to consider such an investment unless there are additional incentives other than the remote possibility of earning revenue from the motion picture. The federal government is aware of the handicaps to the investor due to high risk of motion picture investment in Canada. Tax legislation has been enacted that is designed to stimulate the growth of the industry through investment by the private sector in "government approved" motion pictures. The tax incentives offer a safe income tax deferral if certain criteria are met by both the investment itself, (i.e. motion picture film or video-tape program) and the technical rules upon which the investment is founded.

The income tax incentives are created by rules and regulations in the Income Tax Act that permit a generous capital cost allowance on motion pictures. Taxpayers can use this c.c.a. to avoid or defer taxes on income earned from other sources.

A. Theory of Income Tax Incentive

Martin O'Brien, a Canadian tax expert, once described taxation in the following terms:

> Taxation is expropriation of property; wealth acquired by the sweat of one's brow is taken away and used for the purposes of the State, some laudatory, some laughable. (See the Auditor-General's Report of any Year). [1]

Numerous taxpayers would readily agree with O'Brien's definition even though it might not be found in conventional, accredited dictionaries of the English language, or even in accountants' handbooks. Taxpayers are reluctant to be "expropriated" of their "hard earned" wealth. Since the advent of personal income taxes, taxpayers have been seeking sophisticated schemes to reduce the amount they must remit to the government's tax collectors. Commonly known as "tax shelters", such properly structured schemes to minimize tax have been approved by the courts over the years.

> As is well known a taxpayer's rights are somewhat safeguarded by the courts, which are not loath to dismiss the Crown's claim for tax where the claimed tax is not specifically imposed by the legislation. [2]

Lord Tomlin said in his decision in the Duke of Westminster case:

> Every man is entitled if he can so order his affairs so that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, however unappreciative the commissioners of Internal Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay increased tax. [3]

A tax shelter, one of the methods used to reduce income taxes, has been defined as:

> ...a transaction whereby tax otherwise eligible is deferred or avoided. This is done by utilizing a loss which does not require an outflow of dollars as a deduction against income. [4]

The use of tax shelters:

> by taxpayers is an attempt to defer the payment to a later date of taxes presently exigible under the enabling legislation or to avoid them entirely, thereby minimizing interference with the individual's civil rights. [5]

Accountants and financial advisors recommend that both the taxpayer (investor) and the investment have certain basic characteristics in order for a tax shelter to be effective. First, the accountants and financial advisors recommend that the taxpayer:

1. Should be in a position to reinvest the cash savings from the capital cost allowance in activities that will earn additional income;
2. Should be well advised not only as to the high risk of tax shelter investments but must have a long term plan to deal with the ultimate termination of the shelter devise provisions and the possible recapture of capital cost allowance previously utilized;
3. Should be in an overall income and tax position such that he can fully utilize the high deduction to offset the inherent high risk. [6]

Second, the accountants and financial advisors recommend that the investment have the following characteristics:

1. Be a property that qualifies for a high rate of capital cost allowance, preferably higher than 30%;
2. Have a rate of return which is sufficient to produce a "reasonable expectation of profit";
3. Be structured in such a way that the investor is protected against further or unexpected liabilities attached to the investment other than those that he is prepared to accept at the outset. [7]

B. Basis of a Tax Shelter

If the reader requires a detailed explanation of the mechanism of a capital cost allowance tax shelter he is advised to turn to the explanation and example in Appendix A to Chapter II.

The following are tax shelter examples of two motion picture investments in a feature length motion picture film and an educational video tape production. The information in the examples is taken from various prospectuses issued by the promoters of the motion picture investments. The purpose of the examples is to familiarize the reader with the basics of motion picture tax shelter investment and to demonstrate the investment and investor characteristics.

Example of a Non-Leveraged Motion Picture Investment

The hypothetical investor in this example has a marginal tax rate of 66% (marginal tax rate is the rate on which the next dollar of income is taxed). The investor has the funds readily available to invest in a motion picture film that will be certified by the Secretary of State as a "Canadian feature film". Ownership of the motion picture film will entitle the taxpayer to a 100% rate of capital cost allowance that may be used for tax purposes to reduce other income. The motion picture film will be copyrighted in the names of the investors as proof of ownership of a property purchased to earn income.

The investor and his financial advisors have analyzed the prospectus of the feature film investment and have agreed that the producer, director, and lead stars are of such calibre that the film is expected to have a box office draw that could yield a "reasonable rate of profit".

The producers have secured a completion guarantee bond. The issuers of the bond will pay any over-budget expenses of production.

Therefore the investor is protected against additional liabilities and can be assured that the project will be completed. The producers have also negotiated an agreement for theatrical distribution in Canada and an option for American and world distribution.

The budget of the motion picture film is $750,000. Minimum investment units of $25,000 are being offered. Each minimum investment unit entitles the owner to 1/30th of the net profits of the distribution revenue of the motion picture film.

The exhibition agreement for the motion picture film specifies that the exhibitors' share and their expenses will be paid on a priority basis. The balance of the distribution revenue, after deduction of advertising, promotion and print costs, will be divided pro rata and pari passu among each of the other entities listed below. If $10,000,000 was the world wide box office gross revenue of the feature film, the gross will be divided among the investor-owner, production, distribution, and exhibition entities as follows:

Expected box office gross (3 years)	$10,000,000
Less:	
Exhibitors' share	4,000,000
Advertising, promotion and prints	500,000
Lead stars' share	500,000
Distributor's share	3,000,000
Producer's share	750,000
Initial capital investment	750,000
Total: Profit to investor-owners	$ 500,000

The film will earn no income during the first year of the investment because it will be in production that year. Therefore, the investor-owner of a 1/30 undivided interest will then compute his taxable income (loss) from the investment as follows:

Income from distribution	$ nil
Less:	
Capital cost allowance on investment @ 100%	$25,000
Income (loss) for tax purposes	($25,000)

As the investor's marginal income tax rate is 66% he will have saved $16,500 in taxes otherwise payable. This saving can be considered a $16,500 indirect recovery on the investment and means that his actual incremental cash investment is only $8,500 (ie. $25,000 original investment minus the $16,500 income tax saving). Revenue in subsequent years will be taxable at his marginal rate.

Example of a Leveraged Motion Picture Investment

In this example, the investor, also at the 66% marginal tax rate, will be investing in a Canadian video tape production that will be marketed to education institutions throughout North America. The initial tax saving attraction will be further enhanced by the use of leverage in the form of a fourteen year full recourse promissory note bearing 6% interest calculated on the outstanding balance at each year end. This promissory note will be signed by the investor-owner and will be payable to the producer. The purchase contracts will allow for the promissory note to be paid out of earnings generated by the program, if any. As this is a full recourse promissory note it must be paid off by the investor-owner at the end of the fourteen years regardless of the fortune of the program.

The full purchase price of the video tape program is $75,000. The investor's cash down payment is $25,000 and the promissory note is $50,000. The leveraged ratio of the cash investment is three to one.

Educational Video Tape Program

Cash down payment	$25,000
Fourteen year promissory note	50,000
Total: Purchase price (Capital cost)	$75,000

A taxpayer whose marginal income tax rate is 66% pays $49,500 taxes on $75,000 income taxed at that rate. (ie. The $75,000 income is over and above income taxed at a lower marginal rate.)

Net Cash Position After Taxes - No Investment

Income taxable at marginal rate	$75,000
Taxes payable at 66%	49,500
Equals: Net cash after taxes	$25,500

If the taxpayer invests in a motion picture investment which is eligible for a 100% capital cost allowance deduction he can avoid income taxes on the c.c.a. deduction. (ie. $75,000)

Income taxable at marginal rate	$75,000
Less:	
Capital cost allowance deduction (100%)	75,000
Equals: Marginal taxable income	nil

The taxpayer-investor-owner has improved his net cash flow by $24,500 because he has avoided paying $49,550 income taxes on the $75,000 earnings, yet his initial cash investment has been only $25,000.

Taxes payable if no capital cost allowance deduction available	$49,500
Less:	
Cash down payment for video tape program	25,000
Equals: Net cash saving	$24,500

The net cash saving of $24,500 through the tax recovery mechanism can then be reinvested at say, an average of 10% interest compounded over fourteen years. If the video tape is not a commercial success, and the promissory note is not retired from the video tape earnings at the end of the fourteen years, the $24,500 cash saving, plus accumulated compound interest of $68,541, will be sufficient to meet the note obligation and its accumulated interest of $42,000 and still return a small profit of $1,041 to the investor-owner.

Note that this example does not consider the time value of money (present value). If a net present value was computed it could be demonstrated that the investment would not have earned a profit and the investor would have, in fact, lost money. The concept of net present value will be fully explained in Chapter VII which explores the quantitative implications of a motion picture investment.

The above two examples, although highly simplified, demonstrate the basis of the "tax shelter" aspect of motion picture investment in Canada.

2. PRIVATE MOTION PICTURE INVESTMENT ARRANGEMENTS

There are several arrangements which private investors have used for investing in motion pictures in Canada since 1970. The arrangements are: limited partnership, joint venture, undivided ownership, and a syndicate-guarantee. Each of these arrangements has advantages and disadvantages in terms of liability, possible reassessment by the tax department, financial risk, potential earnings, complexity of the contracts, the number of investors involved, and the position of the producer.

The objects of film investment are to minimize exposure to both financial liability and tax reassessment while maximizing profit potential and the basis for capital cost allowance (and hence income tax savings). To devise such an ideal framework is not an easy task. If the investor's liability is limited so is his base for c.c.a. If his liability is not limited he may achieve a greater initial tax deferral but usually his profit potential is reduced even if the film is successful. The following is an examination of the various schemes that have been developed. In each examination an attempt will be made to define the structure. The advantages and disadvantages from the investor's point of view will be discussed.

A. Limited Partnership

A limited partnership is defined in Black's Law Dictionary as:

> A partnership consisting of one or more general partners, jointly and severally responsible as ordinary partners, and by whom the business is conducted, and one or more special (limited) partners, contributing in cash payment a specific sum as capital to the common stock (or property), and who are not liable for the debts of the partnership beyond the funds so contributed. [8]

In Canada, such entities are registered provincially. Federal tax law does not deal specifically with the legal effects of business activities carried out by partnerships. Limited partnerships were the usual arrangement for organizing a group of individual investors between 1970 and 1973 for the purpose of investing in motion pictures.

The advantage of the limited partnership was that the individual private investors (limited partners), had no financial liability beyond the amount of money invested by each partner. Their liability was limited with respect to possible cause of action from a third party such as suing for damages for infringement of copyright, defamation of character, invasion of privacy, breach of contract, etc. The general partner was liable for all such liabilities. However, the general partner (usually newly incorporated for the specific production) had minimal assets and simply declared bankruptcy in the event of an unsuccessful film or a major suit.

The major disadvantage of the limited partnership structure stems directly from the limited liability aspect. The tax department will not accept the claim for c.c.a. on an amount owed by the partnership but not directly owing by the individual limited partners. The tax department will not allow non-recourse investment supplied by the C.F.D.C. or by a distributor to be included in the capital cost. Nor will the tax department allow non-recourse promissory notes to be included in capital cost.

The possibility exists that the tax department could apply the short fiscal year rule. The rule could be applied only if the partnership was deemed a "business". A partnership must have a year-end which may not necessarily coincide with the individual partners' year-end or the completion of the motion picture production. If the short fiscal year rule was applied the c.c.a. would be pro-rated and restricted to the number of days the partnership business had been active. The attractiveness of the partnership method is diminished if the c.c.a. is restricted in the initial year of the investment.

The partnership must be liable for additional sums of money over and above that which is invested by the partners to incorporate the leveraged capital cost feature. The additional sums of money must be paid if and when the motion picture generates revenue from distribution. A major portion of the revenue must be directed toward retiring the the partnership's liability. However, since c.c.a. on the leveraged amounts has already been claimed in the initial years of the investment, the limited partners will be required to pay tax on revenue which is not being received by them but which is being applied to the previously incurred liabilities. This often means that if the investors find themselves with a commercially successful motion picture they will not receive any cash income -- yet must pay taxes on monies being paid toward repayment of the C.F.D.C. investment or to the vendor of the film for retirement of the promissory note.

B. Joint Venture

A joint venture, legally know ás a joint adventure, is very similar to a limited partnership but the joint venture is usually not registered or given any corporate designation. A joint venture is usually set up for the purpose of undertaking a specific business project or transaction, and it is terminated upon completion of that undertaking:

> The proportion in which the resultant profit or loss will be shared will be mutually agreed between the partners of the venture according to the financial risk run by them, or according to the value of the services which will be contributed by them.[9]

In the motion picture business the individual private investors supply the cash and the producer and his associates (distributor, etc.) supply the services.

Joint ventures have been abandoned as a method of motion picture financing. The reason joint ventures did not work is because by definition of a joint venture the investors' contribution is a financial contribution only. They are therefore, not true owners of the motion picture, entitled to claim c.c.a. The tax authorities contended that the investors in a joint venture are in "business" and any income would be considered business income not investment income. Therefore capital cost would be pro-rated according to the short fiscal year rule.

C. Investor-Owner of an Undivided Interest

The undivided interest investment structure is similar to limited partnerships and joint ventures methods in many respects. There are trade-offs between the undivided interest and the other two methods with regard to tax advantages, investor liability, and potential minimum and maximum profit and loss.

An undivided interest or undivided right, as it is sometimes called, is similar in law to co- or joint tenancy. Black's Law Dictionary defines undivided right in the following terms:

> An undivided right or title, or a title to an undivided portion of an estate, is that owned by one or more tenants in common or joint tenants before partition. Held by the same title by two or more persons, whether their rights are equal as to value of quantity or unequal. [10]

Interest is defined as:

> Any right in the nature of property but less than title; a partial or undivided right; a title to a share. [11]

The primary objective of the undivided interest arrangement is to avoid the negative tax consequences of a partnership. Accordingly, many purchase and distribution contracts specifically include a denial of any intent to be considered a partnership (or joint venture). However, for income tax purposes the Department of National Revenue, Taxation has indicated that it does not necessarily accept a denial phrase as meaningful, and it may declare that the relationship is a partnership for the purposes of c.c.a.

The purchasers of an undivided interest intend that they be considered co-owners of a property acquired for the purpose of gaining or producing income. The purchasers do not want to be considered engaged in a business because their claim for c.c.a. expense would be subject to the short fiscal year rule.

If individuals owning an undivided interestin a motion picture are not considered to be in a partnership or a joint venture (and it appears that the tax department is not prepared to go out of its way to prove either a partnership or a joint venture exists), then the claim for capital cost allowance on the investor-owners' share of the motion picture is stronger than in the partnership or joint venture arrangement. A straight-forward bill of sale is exchanged which, included with copyright registration, is accepted as adequate proof of ownership.

If it is intended that leverage be used, then the investor-owner signs a full recourse promissory note for which he is personally liable regardless of the fortunes of the film. Again, his case for c.c.a. on this amount is strong. However, according to the terms of the note he will have to pay the holder of the note its face value at some future predetermined date if the distribution receipts have been insufficient. (Notes are usually payable in five to fourteen years and bear interest from zero to ten percent). The promissory note liability will have to be met with his personal resources and, (depending on the investor's tax position and the degree of leverage), can completely eliminate any overall cash saving through tax reduction. If the film is successful, the investor-owner must pay taxes on his full share of the net revenue, a portion of which will be directed toward retiring the promissory note. If he has claimed his full c.c.a. in previous years, he will probably have to find an additional source of cash to meet his tax obligation.

D. Syndicate-Guarantee

The weaknesses of the three arrangements discussed above have induced the motion picture industry to devise more sophisticated methods of financing. The latest financing arrangement involves formation of a syndicate of investors who purchase undivided interests in a film for a small cash down-payment and the syndicate members agree to pay additional amounts to the vendor on definite dates for a number of years. The installment payments are in turn guaranteed to the investor-owner by a third party (the distributor) in the form of minimum distribution receipts. This guarantee of the syndicate's liability by the distributor is often further assured by the purchase of a bank guarantee by the syndicate.

The syndicate-guarantee arrangement does not require investment participation in the actual production by the C.F.D.C. distributors or exhibitors in order to build in the leverage factor and increase the investor-owner's c.c.a. The leverage is created by the vendor (producer) selling the motion picture to the investor-owner at a considerable mark-up over actual production costs.

A syndicate is defined in The Dictionary of English Law as:

> A body of persons taking part jointly in some venture or undertaking, a body of persons associated temporarily for the purpose of buying a private business or other property and selling it at a profit, usually to a limited company. Sometimes a syndicate is formed by persons who are individually possessed of property of the same description (generally shares or the like), and wish to subject it to a common management, with a view to its realisation, after which each member takes the profit or loss accruing in respect of his proportion. [12]

The syndicate-guarantee arrangement appears attractive to the investor at first glance. He is able to write off a very large amount of depreciation against other income in the initial year of the investment. The tax department is unlikely to disallow the investor's c.c.a. deduction for two reasons.

Firstly, the leveraged amount is fully repayable by the investor. His funds are "at risk", even though the leveraged funds are guaranteed by the distributor and a bank guarantor. Secondly, the existence of a distribution agreement with a distributor:

> appears to favourably impress the tax department; such an agreement gives the department some assurance that the film will be distributed. [13]

The possibility does exist that guaranteed distribution receipt schemes could be labelled a financing arrangement rather than the outright purchase of an asset. The tax department might argue that the investors' funds are not "at risk" since they are guaranteed by the distributor. If the motion picture investment is held to be a financing arrangement, c.c.a. will not be allowed.

Another potential problem may exist if the distributor is a resident of the United States or some other country which imposes withholding taxes on revenue earned by non-residents (e.g. Canadians). The guaranteed distribution receipts would be subject to withholding taxes or the receipts would be considered income earned by a non-resident. Thus the investor would be required to make up the difference between the net receipts received from the distributor and his liability to the vendor of the motion picture. Foreign withholding tax can be avoided or minimized by channeling the funds through a foreign country that has a favourable tax treaty with Canada, ie. a country that imposes minimal or no withholding tax.

Schemes involving guaranteed rentals and an inflated purchase price are at best only a deferral of income taxes because the investor-owner is subject to tax at his marginal rate on the flow of guaranteed funds from the distributor. The investor-owner must use his own funds to pay the difference between the amount he receives from the distributor after income taxes and the amount that he must pay to the vendor of the motion picture.

Richard Wise made the following comment concerning the tax effect of the distributor's guarantee in a syndicate-guarantee arrangement in his article in the Canadian Tax Journal:

> There is an absolute guarantee of income by the distributor which would be used to discharge the investors' liability but would constitute taxable income to him.[14]

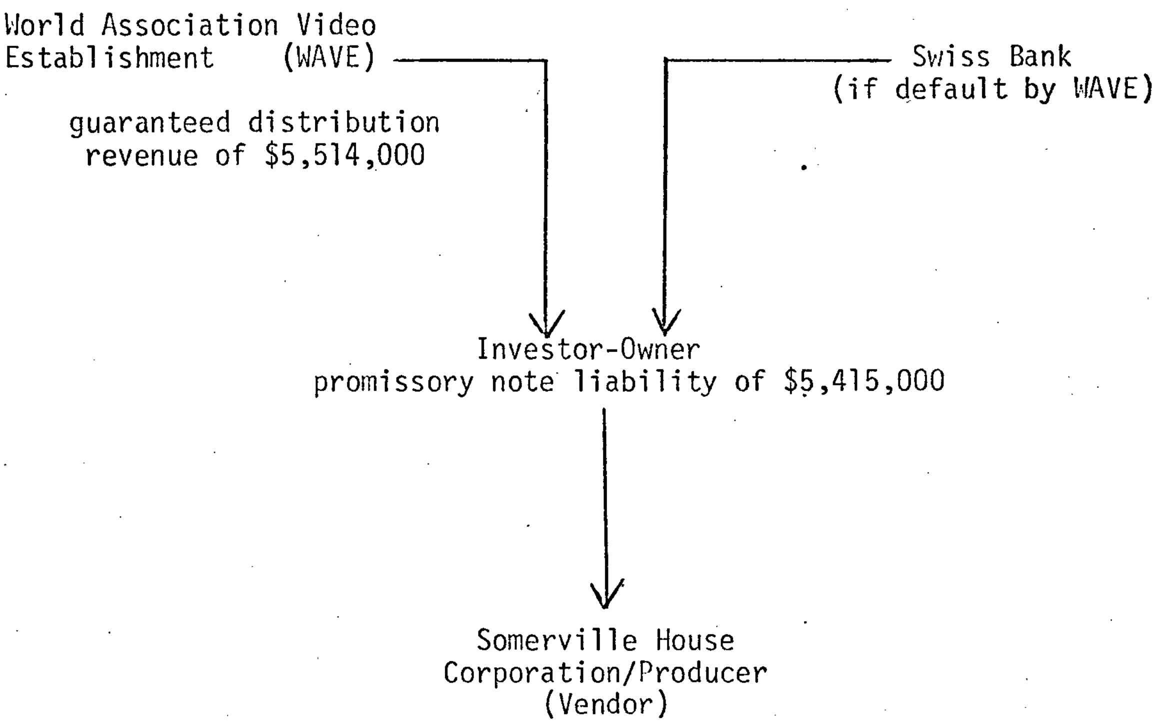
Wise further commented on the effects of the inflated purchase if the film did earn bona fide distribution revenue:

> Admittedly, an inflated sales price will reduce the investor's ultimate profits should the film prove to be a success; however, it appears that most investors are more concerned with immediate tax benefits or deferrals rather than with what is often the dubious possibility of eventual profits in the future - most films being a bust.[15]

The full effects of the tax liability are often omitted in the prospectus issued by the promoters of syndicate motion picture investment. The quantitative analysis of a syndicate-guarantee investment in Chapter VII will consider the effect of the incurred liability by payment of the inflated purchase price.

TABLE II-I

Schematic of Cash Flow in Syndicate-Guarantee
Feature Film Financing Arrangement



The solid lines represent the flow of distribution revenue from the distributor to investor-owner and in turn to the producer. The Swiss bank on the right hand side would only pay the investor-owner if WAVE defaults.

Source:
Somerville House Corporation, The ZerrO Syndicate, (October 3, 1975)

The Flow of Funds Schematic in Table II-I shows the flow of funds between the investor-owner, vendor and distributor or bank guarantor. It appears that there must be some facility that permits the vendor (producer) to reimburse the distributor if the motion picture is unsuccessful and the distributor does not earn any revenue from bona fide distribution activities. However the writer has not been able to prove that there is an arrangement for reimbursement between the distributor and the producer. The promoters of such investment arrangements are understandably reluctant to confirm this theory.

Summary. The four principal financing arrangements have been used by private investors in Canada during the last seven years. The first two arrangements, the limited partnership and the joint venture are no longer used because the Department of National Revenue, Taxation and the Canadian judicial system disallowed part or all of the investors' capital cost allowance deductions. The circumstances for abanding these two financing arrangements will be explained in greater detail in Chapter IV.

The other two private investor motion picture financing arrangements, the undivided interest and the syndicate-guarantee, are still being used. The undivided interest arrangement is usually used by a small number of investors who are financing either a low budget feature film or an educational film or video tape program. This arrangement is enhanced if the initial investor cash down payment is leveraged for capital cost allowance purposes by the use of a promissory note. The syndicate-guarantee arrangement is presently the most widely used method for financing feature films in Canada. The feature film investment is often sold as a package consisting of two or more feature films. The production budgets are usually over $1,000,000 and the productions are often co-productions with nationals of another country. The investor's cash down payment is leveraged because the purchase price is inflated over the production cost. The investor signs a promissory note or notes for the balance of the inflated purchase price. The investor's liability is guaranteed by a distributor. The syndicate-guarantee financing arrangement will be fully explored in Chapter VII.

FOOTNOTES CHAPTER II

[1] Martin L. O'Brien, "An Overview of the Income Tax Law as it applies to Tax Shelters" (Canadian Tax Foundation Twenty Fifth Tax Conference, 1973), p. 485.

[2] Ibid., p. 486.

[3] Lord Tomlin, Commissioner of Inland Revenue v. Duke of Westminster (1936) Appeals Court 1, p. 19.

[4] Canadian Current Tax, Vol. 14, November 23, 1973, Issue 47, (Butterworth & Co. (Canada) Ltd.), p. 2.

[5] O'Brien, op. cit.

[6] Ibid., p. 491.

[7] Ibid., p. 492.

[8] Henry Campbell Black, Black's Law Dictionary (West Publishing Co. 1968), p. 1277.

[9] Francis W. Pixley (ed.), The Accountants' Dictionary, Vol.II (Sir Isaac Pitman & Sons, Ltd., 1926), p. 615.

[10] Black, op. cit., p. 1697.

[11] Ibid., p. 950.

[12] Earl Jowitt (ed.), The Dictionary of English Law (Sweet & Maxwell Limited, 1959), p. 1717.

[13] Wayne G. Beach, "Tax Advantages of Film Investments", CIT Tax Planning and Management 18 (Butterworth and Co. (Canada) Ltd., 1976), p. 18-10.

[14] Richard M. Wise, "A Cineramic View of Motion Picture Film Investment", Canadian Tax Journal, March-April, 1976, p. 162.

[15] Ibid.

APPENDIX A TO CHAPTER II

HOW CAPITAL COST ALLOWANCE SHELTERS TAXABLE INCOME

The following is a basic explanation of capital cost allowance. An asset or property has a cost to the taxpayer (owner). That is, he must either invest capital upon purchase of the asset or promise to pay cash to the vendor at some future date. The aggregate of this down payment and the future payments is the capital cost to the taxpayer. The Income Tax Act and Regulations allow a taxpayer to expense, or deduct, a certain portion of this cost from the taxpayer's income each year. Net Taxable income is the balance of income remaining after all capital cost deductions and other deductible expenses.

Each class of assets has a different rate at which this depreciation expense may be deducted. The rate is usually, but not always, tied into the historic useful economic life of the asset, thus assets which can be used for a long time have a low depreciation rate and assets with a short economic lifespan have a high rate. For example if the asset is a brick building 5% of the undepreciated capital cost may be deducted per year. If the building had a cost to the taxpayer (owner) of $100,000 he would be entitled to deduct $5,000 from his income and would pay no taxes on that $5,000. The following year the undepreciated capital cost would be $95,000 and the taxpayer could deduct $4,750 from his income. If, to cite an unusual case as an example, the building had been expressly erected by the taxpayer on the site of the 1967 World Exhibition (Expo) for a concession or other use, it would be depreciable at 100%. That is, if it cost the taxpayer $100,000 he could deduct that full amount from his income in that year and he would pay no taxes on that $100,000, if he had that much income. The undepreciated capital cost in the following year would be zero, hence no deduction allowed in the second year.

All assets (property) have been assigned to certain classes by way of amendments to the <u>Income Tax Act Regulations</u>. Each class has been given a maximum capital amortization rate, meaning the taxpayer can deduct from the undepreciated capital cost balance up to that rate each year.

CHAPTER III

INCOME TAX ACT LEGISLATION AND REGULATIONS

I. INTRODUCTION

The primary section of the Income Tax Act which facilitates tax shelters through the financing by a tax payer of certain investments is subsection 20(1). Subsection 20(1) provided that a taxpayer may deduct from his income his capital cost of property. The subsection is written as follows:

> Notwithstanding paragraphs 18(1) (a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducated such of the following amounts as are wholly applicable to that source or such part of the following amounts as may be reasonably be regarded as applicable thereto: (a) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation.[1]

Subsection 13(21)(b) defines depreciable property as property on which the taxpayer can deduct the cost of the property as provided in subsection 20(1)(a). Subsection 13(21)(b) states:

> Depreciable property of a taxpayer as of any time in a taxation year means property in respect of which the taxpayer has been allowed, or is entitled to, a deduction under regulations made under paragraph 20(1)(a) in computing income for that or a previous taxation year.[2]

Subsection 18(1) states that the capital cost deduction of depreciable property must relate to property that is owned for the purpose of gaining or producing income. Subsection 18(1) is written as follows:

> In computing the income of a taxpayer from a business or property no deduction shall be made in respect of (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property; (b) an outlay, loss or replacement of capital, a payment on account of capital on an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this part.[3]

2. LEGISLATION AND REGULATIONS - 1960

Part XI of the Regulations states the maximum rate of capital cost allowance deductions for depreciable property that may be taken each year by a taxpayer. The first provision in the Income Tax Act that allowed a capital cost deduction for motion picture film was Order in Council P.C. 1960-225. Order in Council P.C. 1960-225 was published on March 9, 1960 and was applicable to 1959 and subsequent taxation years. The Order added class 18 to Part XI, Section 1100, Schedule B of the Income Tax Regulations, thus allowing a 60% capital cost allowance for "property that is a motion picture film."[4]

A motion picture film has been defined by Revenue Canada, Taxation as "a photographic film on which a useable motion picture has been produced".[5] The "master film" of a motion picture film is defined as:

> The original production of a film (usually in the form of a photographic negative) from which are produced the copies that will be used for performance purposes, each of which is referred to...as a "copy".[6]

3. LEGISLATION AND REGULATIONS - 1966

On March 23, 1966, Order in Council P.C. 1966-431 was published which amended class 18 to add the words "other than a television commercial message"[7]; and the phrase "a motion picture film that is a television commercial message"[8] was added to class 12 of Schedule B which allowed the taxpayer to deduct 100% of the undepreciated capital cost of the property of the class. Television commercial messages were thus made eligible for 100% capital cost allowance in the year they were made.

Video tapes were being used more frequently for television commercials and programs. A Revenue Canada, Taxation's Internal Assessing Guide, dated June 16, 1969 made the following comments regarding the justification for deducting the entire video-tape production expense in the year it was incurred.

> Generally speaking, video tape is little used for long-term storage of the material recorded on it, as there will be gradual deterioration of the recorded images. Accordingly, there is no class in Schedule B to the Regulations that specifically includes the capital cost of such material.
>
> The kind of material recorded on video tape frequently is of short-term use only, because either it is merely of topical interest and will have value just for a little while or, by the production arrangement with the Canadian Council of Authors and Artists, it is intended to be shown only once (although possibly by means of separate showings in different time zones). The production and recording or purchase costs of material of these kinds normally can be written off as expenses of the year. [9]

The Assessing Guide stated "there is no class...that specifically includes the capital cost" of video tape. The Assessing Guide is incorrect. Order in Council P.C. 1961-24 S.O.R./61-22, published January 25, 1961 amended class 12 with the addition of paragraph "(l) video tape."[10] The amendment qualified video tape for 100% capital cost allowance.

4. LEGISLATION AND REGULATIONS - 1972

The "new" Income Tax Act which became law on January 1, 1972 did not directly change any of the reguations for motion picture film or video tape. The Act did, however, make changes in the capital cost allowance deduction for rental real-estate property. Capital cost deductions for rental properties (e.g. apartment buildings) could no longer be deducted from a taxpayer's other sources of income. The c.c.a. deduction could only be taken against the rental income from the property.[11] Prior to the passage of the new Act, rental property has been the most common and conventional type of tax shelter for high income taxpayers.

Thus tax reform increased the interest in other tax shelter investments - motion picture being one of these.

The new Act also featured amendments to the computation of a partner's share of the income or loss from a partnership. Under the "old" Act, the income of a partnership was allocated to the partners before any deduction for capital cost allowance. A partnership was not a "taxpayer" as defined by the old Act, therefore the partnership did not claim capital cost allowance. The partners individually claimed capital cost allowances on their share of assets used by the partnership. If an individual partner wished, he could claim as much or as little capital cost allowance as he required and as was available to him (i.e. undepreciated) to minimize his taxable income.

After December 31, 1971 the new Act required that the partnership itself claim capital cost allowance (up to the maximum allowed on the depreciable property owned by the partnership) prior to allocation of each partner's share of the profit or loss.[12] Few partners have identical amounts of taxable income. A partner with a low amount of taxable income in a particular year may find that he has more deductions (loss) than taxable income. Because he could no longer carry that loss to a subsequent year an attractive income tax consideration was eliminated for many motion picture partnerships.

A third feature of the new Income Tax Act was the provision for income averaging annuities.[13]

> Designed to let an individual taxpayer spread unusually large receipts of specified types of income (including substantial capital gains or recaptured depreciation) over current and future years, an I.A.A. Contract provides deferral of most of the tax on this special income while restricting the use of the income to a fixed yield.[14]

Income averaging annuities are important to a motion picture investor. If he decides to sell his motion picture investment the proceeds from the sale would become taxable income if they exceeded c.c.a. previously claimed for income tax purposes. Under the new Act the investor could now invest the amount of depreciation claimed but not suffered in an Income Averaging Annuity Contract to spread the recaptured depreciation over a number of future income tax years.

5. LEGISLATION AND REGULATIONS - 1974

On July 29, 1975, the federal cabinet passed P.C. 1975-1822. Subsection 1104(2)(h) was thereby added to the Income Tax Regulations effective November 18, 1974 and created the provisions for 100% capital cost allowance of a "certified feature film". The word "or" at the end of paragraph (l) was deleted and added at the end of paragraph (m) and paragraph (n): "a certified feature film" was added to the description of class 12 in Schedule B.[15] The description of class 18 was revoked and thereafter defined as:

> Property that is a motion picture film other than
> (a) a television commercial message and
> (b) a certified feature film[16]

The cabinet's initiative was expressly designed to "increase private sector support of the Canadian feature film industry".[17] The legislation was enacted as follows in Section 1104(2) of the Income Tax Act:

> (h) "certified feature film" means a motion picture film certified by the Secretary of State to be a film of not less than 75 minutes running time in respect of which all photography or art work specifically required for the production thereof and all film editing thereof was commenced after November 18, 1974, and certified by him to be
>
> (i) a film the production of which is contemplated in a co-production agreement entered into between Canada and another country, or
> (ii) a film in respect of which
> (A) the person who performed the duties of producer was a Canadian,
> (B) no fewer than 2/3 in number of all the persons of whom
> (I) was a person who performed the duties of director, screenwriter, music composer, art director, picture editor or director of photography, or
> (II) was the individual in respect of whose services as an actor or actress in respect of the film the highest remuneration or the second highest remuneration was paid or payable, were Canadians,
> (C) not less than 75% of the aggregate of the remuneration paid or payable to persons for services provided in respect of the film (other than remuneration paid or payable to or in respect of the persons referred to in clauses (A) and (B) or remuneration paid or payable for processing and final preparation of the film) was paid or payable to Canadians.
> (D) not less than 75% of the aggregate of costs incurred for processing the final preparation of the film including laboratory work, sound recording, sound editing and picture editing (other than remuneration paid or payable to or in respect of persons referred to in clauses (A), (B) and (C) was incurred in respect of services rendered in Canada, and
> (E) the copyright protecting its use in Canada is beneficially owned
> (I) by a person who is either a Canadian or a corporation incorporated under the laws of Canada or a province, or
> (II) jointly or otherwise by two or more persons described in subclause (I),
>
> other than a motion picture film in respect of which certification under this paragraph has been revoked by the Secretary of State as provided in paragraph (10) (b).[18]

Subsection 1104 (10) of the Income Tax Regulations, also made law on July 29, 1975, described a "Canadian" for the purposes of paragraph (2)(h) as :

(a) a "Canadian" is an individual who was, at all relevant times, a Canadian citizen as defined in the Canadian Citizenship Act or an immigrant whose landing has been authorized under the Immigration Act;[19]

Subsection 1104 (10) (b) provided a certificate revocation clause:

> (b) a certificate issued under that paragraph may be revoked by the Secretary of State
> (i) if an incorrect statement was made in the furnishing of information for the purpose of that paragraph, or
> (ii) if, at any time within four years after the date that the certificate becomes effective, the copyright referred to in clause (2)(h)(ii)(E) was not owned as required by that clause, and a certificate that has been revoked shall be null and void from the time of its issue;[19a]

6. LEGISLATION AND REGULATIONS - 1976

In the May 25, 1976 Budget Speech, Finance Minister, Donald S. Macdonald announced a surprising number of capital cost allowance amendments significantly affecting investments in film and video-tape production both indirectly and directly.

Indirectly, motion picture investment was affected because the capital cost allowance for aircraft, once a popular tax shelter investment, was reduced from 40% to 25%. The amendment removed aircraft from class 16 and placed them in class 9.[20] the government also proposed that capital cost allowances, with respect to leased property, could not be used to create a loss to shelter non-leasing income. Finance Minister Macdonald pronounced that:

> The Government does not intend that capital cost allowances be available for unwarranted use by taxpayers as a means of sheltering income from its fair burden of taxation. With this objective in mind, I am proposing that a new limit be introduced to prevent the creation of tax losses by claiming capital cost allowance on the leasing of moveable property.[21]

The amendment restricting c.c.a. on leased movable property such as aircraft, reduced the interest in that type of tax shelter and increased the interest in other types of tax shelters such as motion pictures.

Macdonald further increased the interest in motion picture investment as a tax shelter when he reiterated that it is "the government's policy to encourage Canadian Productions".[22] He went on to say that motion picture "productions would be specifically excluded from the so-called 'anti-sheltering rule'"[23] affecting aircraft. The Department of Finance issued a press release on June 29, 1976 that read:

> Finance Minister Donald S. Macdonald confirmed that the 100% write-off for certified Canadian Film and video-tape productions will not be affected by the capital cost allowance limitation for leased properties announced in the budget of May 25, 1976.[24]

The new budget amendments directly encouraged private motion picture financing in Canada because the amendments provided that the distinction between productions shot on ordinary film and video tape would no longer exist and the rate of 100% formerly applicable to video tape would be revoked for non-Canadians productions and replaced by the 30% rate.

> The government concluded that the present 60% capital cost allowance rate for motion picture films other than Canadian was too high and their capital cost allowance would be reduced to 30% to more accurately reflect the average useful life of such films.[25]

The government proposal was enacted into law by P.C. 1976-2763 SOR/76-748, effective after May 25, 1975, by adding paragraph "(q) a motion picture film or video tape acquired after May 25, 1976"[26] to class 10 (30%) of Schedule B of the Income Tax Regulations. The reduced c.c.a. greatly decreased the attractiveness of investment in non-Canadian productions regardless of their ultimate chances of commercial distribution success vis-a-vis Canadian certified films.

A proposal by the federal cabinet to increase the capital cost for short motion picture films was made in 1975 (previously only films over 75 minutes qualified for the 100% c.c.a.). This proposal was greeted enthusiastically by the Canadian motion picture industry because it meant that education films and documentaries would also be given the preferential write-off. The government's proposal was enacted by an amendment to Section 1104(2) and through Order in Council P.C. 1976-2763 SOR/76-748, effective after May 25, 1976. Section 1104(2)(h) was amended to include the phrase "and either the film was completed before May 26, 1976, or the photography or art work was commenced before May 26, 1976,".[27] The amendment permitted the owners of previously produced motion pictures and productions currently in progress to continue to be eligible to claim either a 60% or 100% c.c.a. deduction. The amendment eliminated the use of the "certified feature film" category for any future Canadian motion picture productions. Certification of a motion picture by the Secretary of State was now to depend on the number of Canadians performing key functions on the production and the percentage of total budget money paid to those Canadians. Subsection 1104(2)(i) and 1104(2)(j) were added to section 1104.

Subsection 1104(2)(i) defined a unit of production system that would be used to determine if a feature length film or video tape production could be certified by the Secretary of State as a "certified feature production" and hence eligible for a 100% capital cost allowance. Units of production were allotted according to the number of Canadians who performed services for the production and according to the aggregate percentage of the total production budget spent on the motion picture production in Canada. Feature length film or video tape co-productions between Canada and one of the countries with which Canada has a co-production treaty, would continue to be eligible for certification by the Secretary of State and eligible for 100% c.c.a. Subsection 1104(2)(i) reads as follows:

(i) "certified feature production" means a motion picture film or video tape certified by the Secretary of State to be a film or tape of not less than 75 minutes running time in respect of which all photography, taping or art work specifically required for the production thereof and all film or tape editing therefor were commenced after May 25, 1976, and certified by him to be

(i) a film or tape the production of which is contemplated in a co-production agreement entered into between Canada and another country, or

(ii) a film or tape in respect of which

(A) the individual who performed the duties of producer was a Canadian,

(B) the Secretary of State has allotted not less than an aggregate of 6 units of production for individuals who provided services in respect of the film or tape, in the following manner:

(I) for the director, two units of production,

(II) for the screenwriter, two units of production,

(III) for the actor or actress in respect of whose services for the film or tape the highest remuneration was paid or payable, one unit of production,

(IV) for the actor oractress in respect of whose services for the film or tape the second highest remuneration was paid or payable, one unit of production.

(V) for the art director, one unit of production,

(VI) for the director of photography, one unit production,

(VII) for the music composer, one unit of production, and

(VIII) for the picture editor, one unit of production, shall be allotted, provided the individual in respect of such allotment was a Canadian,

(C) not less than 75% of the aggregate of the remuneration paid or payable to persons for services provided in respect of the film or tape (other than remuneration paid or payable to, or in respect of, the individuals referred to in clauses (A) and (B) or remuneration paid or payable for processing and final preparation of the film or tape) was paid or payable to, or in respect of services provided by Canadians, and

(D) not less than 75% of the aggregate of all costs incurred for processing and final preparation of the film or tape, including laboratory work, sound recording, sound editing and picture editing (other than remuneration paid or payable to, or in respect of, the individuals referred to in clauses (A), (B) and (C)) was incurred in respect of services provided in Canada,

other than a film or tape in respect of which certification under this paragraph has been revoked by the Secretary of State as provided in paragraph 10(b);[28]

Subsection 1104 (2)(j) defined short motion picture films and video tape productions that could be certified by the Secretary of State as "certified short productions". Subsection 1104(2)(j) reads as follows:

(j) "certified short production" means a motion picture film or video tape certified by the Secretary of State to be a film or tape of less than 75 minutes running time in respect of which all photography, taping or art work specifically required for the production thereof and all film or tape editing therefor were commenced after May 25, 1976, and certified by him to be
(i) a film or tape that would be certifiable under paragraph (i) if that paragraph were read without reference to the words "of not less than 75 minutes running time", or
(ii) a film or tape in respect of which
(A) the individual who performed the duties of producer was a Canadian, and
(B) not less than 75% of the aggregate of all costs incurred in respect of producing the film or tape, including remuneration and processing, was paid or payable to, or in respect of services provided by, Canadians,
other than a film or tape in respect of which certification under this paragraph has been revoked by the Secretary of State as provided in paragraph (10)(b); and [29]

Section 1104(10) was also amended by Order in Council P.C. 1976-2763 SOR/76-748, effective after May 25, 1976 since it was consequental upon the amendments to Section 1104(2). Section 1104(10) now reads as follows:

(10) For the purposes of paragraphs 2(h) to (j),
(a) "Canadian" means an individual who was, at all relevant times, a Canadian citizen as defined in the Canadian Citizenship Act or an immigrant whose landing has been authorized under the Immigration Act;
(b) a certificate issued under paragraph (2)(h), (i) or (j) may be revoked by the Secretary of State if an incorrect statement was made in the furnishing of information for the purpose of that paragraph and a certificate that has been revoked shall be null and void from the time of its issue;
(c) "remuneration" does not include amounts determined by reference to the amount of income from a motion picture film video tape; and
(d) "unit of production" means a measure used by the Secretary of State in determining the weight to be given for each individual Canadian referred to in clause (2)(i)(ii)(B) who provides services in respect of a motion picture film or video tape.[30]

Class 12 ~~(l)~~ to (n) 100% of Schedule B was amended by Order in Council P.C. 1976-2969 on December 2, 1976 to read:

(l) a video tape acquired before May 26, 1976
(m) a motion picture film or video tape that is a television commercial message,
(n) a certified feature film, certified feature production or certified short production, or [31]

Stripped of the legalese, this means that any video-tape or motion picture, regardless of length, but meeting the Canadian content and ownership requirements, is eligible for 100% c.c.a. All foreign productions (e.g. American), with the exception of co-production treaty productions, will only be eligible for an annual capital cost allowance of 30% on a declining balance basis.

FOOTNOTES CHAPTER III

[1] Canadian Income Tax Act. S.C. 1970-72 c.63, as amended with Income Tax Regulations, 47th edition 1975-76, Consolidated to February 15, 1976 (C.C.H., Canadian Limited, Don Mills, Ontario M3C 1S5, 1976), p.53.

[2] Ibid.,pp.34-35.

[3] Ibid., pp.43-44.

[4] Income Tax Act. R.S.C. c.148, Consolidated with Amendments to 1960, (Richard DeBoo Limited, Toronto, Ontario, 1961), p. 515.

[5] Revenue Canada, Taxation, Assessing Guide 16-6-69, p.4-128.

[6] Ibid., p.4-126.

[7] Canadian Income Tax Act, Chap. 148, R.S.C. 1952 as amended to March 31, 1967, with Regulations Consolidated to March 31, 1967, 36th Edition 1966-67 (C.C.H. Canadian Limited, Don Mills, Ontario, 1967), p. 11,374.

[8] Ibid., p. 11,373.

[9] Assessing Guide. op.cit., p. 4-128.

[10] Income Tax Act. Annotated R.S.C. 1952, c. 148 Consolidated with Amendments to 1961 (Richard DeBoo Limited, Toronto, Ontario, 1962), p. 512.

[11] (11) Notwithstanding subsection (1), in no case shall the aggregate of deductions, each of which is a deduction in respect of property of a prescribed class owned by a taxpayer that includes rental property owned by him, otherwise allowed to the taxpayer by virtue of subsection (1) in computing his income for a taxation year, exceed the amount, if any, by which,

(a) the aggregate of amounts each of which is
(i) his income for the year from renting or leasing a rental property owned by him, computed without regard to paragraph 20(1)(a) or the act, or
(ii) the income of a partnership for the year from renting or leasing a rental property of the partnership, to the extent of the taxpayer's share of such income

exceeds

(b) the aggregate of amounts each of which is
(i) his loss for the year from renting or leasing a rental property owned by him, computed without regard to paragraph 20(1)(a) of the Act, or
(ii) the loss of a partnership for the year from renting or leasing a rental property of the partnership, to the extent of the taxpayer's share of such loss.

Regulation 1100(11) added by P.C. 1972-1612, July 27, 1972, Canada Gazette, Part II, August 9, 1972 effective January 1, 1972, Canadian Income Tax Act with Regulations, 47th Edition (C.C.H. Canadian Limited), pp. 37,174-37,175.

[12] 96.(1) Where a taxpayer is a member of a partnership, his income, net capital loss, non-capital loss and restricted farm loss, if any, for a taxation year, as the case may be, shall be computed as if

(a) the partnership were a separate person resident in Canada

Canadian Income Tax Act with Regulations, 47th Edition (C.C.H. Canadian Limited), p. 267.

[13] Ibid., Section 61 to subsection 61 (4)(b) 1973-74 s.c.c. 14 s.17(1), pp. 132.

[14] Beatrice Riddell, "How To Treat Unaveraged Incomes", Financial Post, February 14, 1976, p.35.

[15] Canadian Income Tax Act, op.cit.,Schedule B, p. 38,006.

[16] Ibid., p. 38,009.

[17] Secretary of State, News Release, August 5, 1975.

[18] Canadian Income Tax Act, op.cit., Regulation 1104(2)(h), pp. 37,195-37,196.

[19] Ibid., pp. 37,198-37,199. [19a] Ibid.

[20] Order in Council P.C. 1976-2969 dated December 2, 1976, effective after May 25, 1976 to provide for new capital cost allowance on various classes of depreciable property.

[21] The Honorable Donald S. Macdonald, Finance Minister, May 25, 1976, Budget Speech (Richard DeBoo Limited, Toronto, Ontario, Special Release, May 25, 1976), p.1.

[22] The Honorable Donald S. Macdonald, Finance Minister, Department of Finance, Press Release, June 29, 1976.

[23] Ibid.

[24] Ibid.

[25] Touche-Ross & Co. Chartered Accountants, Budget Letter, May 25, 1976, p.5.

[26] Canadian Income Tax Act, op.cit., Consolidated to December, 1976, p. 38,007.

[27] Ibid. p. 37,195.

[28] Ibid. pp. 37,195-37,197.

[29] Ibid., p. 37,197.

[30] Ibid.,p. 37,198.

[31] Ibid., p. 38,008.

CHAPTER IV

NATIONAL REVENUE, TAXATION AND THE CANADIAN COURTS VIS-A-VIS PRIVATE MOTION PICTURE INVESTMENT

1. NATIONAL REVENUE, TAXATION AND MOTION PICTURE INVESTMENT

A. Interpretation Bulletins

The widespread use of leveraged investments in high rate capital cost allowance properties prompted National Revenue, Taxation to publish a number of interpretation bulletins on capital cost allowance.

> As their name implies the purpose of these Bulletins is to give, from time to time, the Department's interpretation of sections of the laws it administers: an equally important purpose is to announce significant changes in departmental interpretations and the effective dates of any such changes.
>
> Interpretation Bulletins are not law: that is contained in the Acts themselves and in the Regulations made under them. Through the Bulletins the Department's assessors and auditors are told how to interpret the law and the public is able to know what to expect.[1]

If a taxpayer believes that the tax department's interpretation of the law is incorrect he has the alternative of challenging that interpretation in federal court. The courts have ruled in favour of the taxpayer on occasion. Most tax lawyers and accountants advise their clients to follow the departmental interpretations in order to avoid a reassessment from Revenue Canada.[2] Therefore "the Interpretation Bulletins take on an aura of law".[3]

Since 1970 when the bulletins were introduced, there have been eleven interpretations issued by the tax department that can be applied to motion picture investments. The eleven interpretation bulletins pertaining to motion picture investments will be discussed under the following four headings:

1. capital cost allowance;
2. government assistance to industry;
3. sale, lease-back agreements;
4. partnerships.

National Revenue, Taxation prepares and publishes an interpretation bulletin when it feels that there has been abuse of a tax "loop-hole" or when the department has received a number of enquiries from taxpayers or requests for an advance ruling on certain income tax matters.

Capital Cost Allowance

The practice of leveraging the investment in high rate capital cost allowance properties such as motion pictures and aircraft had become widespread in Canada. Private sector investment accounted for as much as 20% of the total budgets of productions which the C.F.D.C. invested in between the years 1971 and 1973.[4] Private funding was attracted to motion picture investment because a tax shelter could be structured when C.F.D.C. funding was available. The C.F.D.C. is a Crown corporation which does not claim c.c.a. Private investors had assumed they could include the C.F.D.C. funding in their capital cost base.

The first public pronouncement that this practice was not acceptable to the tax department was made by M.W. Steele in a speech at the Canadian Tax Foundation Conference in November, 1973. Steele was Section Chief in the tax department's Rulings Division, Legislation Branch, Ottawa. In his speech to the conference he stated that the department was prepared to allow as cost for the purposes of capital cost allowance in motion pictures:

> Only that amount which has been put at risk by the private investor, either through investment of cash or borrowed funds which he is unconditionally obliged to repay, whatever the fortunes of the film in question might be....Under existing law no degree of leverage can be recognized for purposes of computing capital cost of assets which is not represented by a binding commitment to repay borrowed capital, notwithstanding the fortunes of the film...[5]

The essence of Steele's comments were contained in IT-164 issued by National Revenue, Taxation on June 5, 1974. This bulletin outlined the department's position regarding capital cost allowance on certain leveraged investments, including motion pictures. The bulletin, (which is reporduced in its entirety in Appendix A to Chapter IV) made the following points:

> "Leveraged Investment" means an arrangement whereby an... investor acquires a capital property at a stated purchase price substantially in excess of the amount actually invested or put at risk by him. One of the main objects of the arrangement is to secure the right to capital cost allowance on the total stated purchse price. Generally the investor intends to use the additional capital cost allowance to reduce other income.
>
> The leveraged investment is generally property which qualifies for a high rate of capital cost allowance...for example, a motion picture film...
>
> When a film is acquired the purchase agreement generally provides for an immediate cash outlay substantially less than the total stated purchase price with the balance to be repaid only out of earnings from the distribution of the film. Generally the only recourse by the vendor of the film for non-payment is repossession of the film after a specified number of years.
>
> The Department takes the position that the capital cost of the film to the investor for the purpose of paragraph 20(1)(a) is only that cost which has been laid out or in fact put at risk by the investor, either through investment of cash or borrowed funds unconditionally repayable whatever the fortunes of the film in question may be.
>
> Where, as a result of earnings from the distribution of the film, additional amounts are paid by the investor toward its stated purchase price, such amounts constitute additional capital cost of that film, except in cases described in the next paragraph.

> In certain cases the capital cost of a film for the purpose of its inclusion in Class 18 of Schedule B of the Regulations is NIL, since:
>
> (a) the film is not considered to have been acquired by the taxpayer for the purpose of gaining or producing income therefrom, or
>
> (b) the film is not in fact a Class 18 property; for example, where the investor does not acquire a motion picture film but only the rights to its distribution in a specified territory.[6]

IT-164 also dealt with the subject of leveraged equipment leases. It is the department's contention that the purchase of an asset by an investor and subsequent leasing of that property back to the original vendor (user) is actually a financing arrangement rather than a purchase. No c.c.a. is permitted. The bulletin reads in part:

> The investor arranges for the issuance of notes or certificates by a trustee to other parties supplying 80 percent of the equipment cost. The other parties agree to look only to the equipment and the user for the security of their funds. Accordingly, the investor has no liability for the 80 per cent of the equipment cost... The investor pays his 20 percent to the trustee and the trustee then pays the manufacturer in full for the equipment and receives title.
>
> The trustee then sells the equipment to the investor under a conditional sale agreement which permits title to remain with the trustee as security for the notes or certificates issued to the other parties. However, the terms of the conditional sale agreement specify that the investor is required to make payments to the trustee only to the extent of rentals to be received from the user.
>
> It may be claimed that under such an arrangement this investor is entitled to capital cost allowances on the full cost of the property by virtue of being the sole owner of the equipment once the amounts owing to the other parties have been discharged... However the Department's view is that, the capital cost of the leased equipment to the investor cannot include any part of the cost in respect of which there is no recourse against him in the event of a default. In the above example the capital cost would not include the 80 percent of that cost financed through the other parties.[7]

The tax department could use this interpretation to attempt to disallow capital cost allowance in syndicate-guarantee motion picture investment arrangements. These sophisticated syndicate schemes offset future investor payments with guaranteed minimum distribution receipts. The department could argue that this is a financing arrangement and that c.c.a. is not available to the private investor. This potential arguement by the tax department will be examined in greater detail in the discussion of IT-17 and IT-233.

The publication of IT-164 had a disastrous effect on the Canadian motion picture industry. Private investors were no longer interested in investing in motion pictures if the tax shelter facility was not available. Private sector funding in English language motion picture productions that had C.F.D.C. investment dropped to 12% or $410,000 in the C.F.D.C.'s fiscal year of 1974-75.[8]

Interpretation Bulletin IT-283 issued January 19, 1976 sets out guidelines pertaining to c.c.a. of films and video tapes. The bulletin outlines departmental policy distinctions between cost and capital cost of video tapes and films. According to the bulletin video tapes and films may be capitalized under class 12 or class 18 if the property was produced by the taxpayer himself or purchased for the purpose of earning income. The costs for the purposes of determination of capital cost of a property under paragraph 20(1)(a) will ordinarily include:

> The costs of scripts, musical arrangements, and materials, the remuneration of writers, directors, performers, musicians, technicians and stagehands, and the rental or other costs of studio and properties and of photographic lighting, sound recording and other equipment and overhead costs that can reasonably be attributed to the property but nothing in respect of profit which might have been earned had the asset been sold.[9]

Government Assistance to Industry

The tax department issued four interpretation bulletins that outlined the tax implications of government financial assistance to industry. The bulletins suggested two methods which were to be used to treat government assistance. These methods depended upon the type of grant and the type of industry. Either the government grants were to be used to reduce the taxpayer's expenses including the capital cost base of certain specified types of property or the government grants were to be added to the taxpayer's income.

The first two bulletins IT-49 and IT-53, were issued in late 1971 and in mid-1972 respectively. The tax department advised that financial assistance grants or subsides made by the government or its agencies to enable a taxpayer to acquire property that is of a capital nature[10] would reduce the capital cost base of that property by the amount of such government assistance or investment. These two interpretation bulletins did not mention the C.F.D.C. assistance to the motion picture industry. However, it was generally acquiesced that amounts of money granted outright, loaned, or invested by the C.F.D.C. would have to be excluded from the capital cost base of a motion picture. Prior to this interpretation, the practise among motion picture investors was to include the C.F.D.C. assistance in the capital cost base. The investors had been treating the C.F.D.C. investment as a liability, but repayment was contingent upon the distribution profits of the motion picture.

In December 1975 and January, 1976 the tax department issued two additional bulletins onthe subject of government assistance. The former IT-273 was to replace IT-49.[11] The other IT-276 specifically advised the department's position regarding C.F.D.C. funding: IT-276 reads, in part, that:

> The basic purpose of the Canadian Film Development Corporation is to foster and promote the development of a feature film industry in Canada. The corporation supports the production of Canadian feature films by

> (a) investing in individual Canadian feature film productions in return for a share in any proceeds from them, and
>
> (b) making loans to producers of individual Canadian feature film productions.
>
> The Department considers that amounts paid as described in (a) above are income subject to tax in the hands of the recipient when the amount is received. Payments the recipient must pay to the C.F.D.C. out of the proceeds from the production of a film are a deductible expense at that time.[12]

IT-276 says that C.F.D.C. monies must be included in the recipient's taxable income in the year in which the funds are received.

A Case Against National Revenue, Taxation's Interpretations IT-164 and IT-276

Several income tax advisors believe that IT-164 and IT-276 are incorrect and contradictory.[13] These advisors believe that National Revenue, Taxation is misinterpreting the basis of investment by the Canadian Film Development Corporation in a motion picture. IT-164, issued in 1974, states that the tax department will not accept the C.F.D.C. investment in the capital cost base of the motion picture for purposes of a capital cost allowance deduction by private investors.[14] IT-276 issued in 1976, states that an investment by the C.F.D.C. is "income subject to tax in the hands of the recipient"[15]. IT-276 is not a replacement interpretation bulletin for IT-164.

The position of the investor in a motion picture investment which has C.F.D.C. funding is certainly unclear and perhaps unfair. The investor must exclude the C.F.D.C. financial assistance from the capital cost base (IT-164) yet the C.F.D.C. financial assistance must be reported by the recipient as income (IT-276). If the producer of the motion picture is the recipient, and the producer is not the investor(s), there is no confusion. The financial assistance from the C.F.D.C. is income but the producer's production costs are expenses deductable from that (his) income. If the investors are considered as producers then there is a dilemma. Whether the producer and investor(s) are one and the same depends on the structure of the motion picture production investment. In some motion picture production-purchase contracts the investors are contractually considered the producers. Therefore, the investors would be the recipients of the C.F.D.C. financial assistance.

The writer believes that the tax department did not foresee this dilemma. The dilemma is that funding received from the C.F.D.C. would be taxable in the hands of the investor, and that the investor would not be entitled to claim c.c.a. on the amount of investment the C.F.D.C. contributes toward the production costs of the motion picture, if both interpretations are adhered to by the investor.

Income tax lawyers such as Beach and Sheppard point to the powers of the C.F.D.C. as set out in the Canadian Film Development Corporation Act. Paragraph 10(1)(a) of the Act states that the C.F.D.C. can "<u>invest</u> in Canadian feature film productions in return for a share in the proceeds from any such production".[16] This investment is "made on the same basis as the investments made by other non-equity investors...terms similar to those which the private sector invests".[17] Beach concludes that amounts <u>invested</u> by the C.F.D.C. are not taxable in the hands of the recipient.[18]

The tax department bases its contention that the C.F.D.C. <u>investment</u> is taxable income to the recipient on Subsection 13(7.1) of the <u>Income Tax Act</u>. Subsection 13(7.1) states that:

> ...where a taxpayer has received assistance from a government, municipality or other public authority...as a grant, subsidy, forgivable loan, deduction from tax, investment allowance...[19]

then that amount shall be deducted from the capital cost of the asset.

Beach, writing in Butterworth's CIT Tax Planning and Management, rebuts the tax department's argument on the grounds that funds provided under paragraph 10(1)(a) of the C.F.D.C. Act are investments not loans, awards or grants.[20] The C.F.D.C. does make loans, awards and grants under other powers granted to it in Section 10 of the C.F.D.C. Act but Beach is concerned with the tax department's treatment of investments made by the C.F.D.C.

Beach points out that the C.F.D.C. is a Crown Corporation, not a government or municipality or public authority, and therefore Subsection 13(7.1) of the Income Tax Act does not apply.[21] That the C.F.D.C. does not fall into the category of government, municipality or other public authority was argued by John F. Sheppard at the Canadian Tax Foundation Conference in November, 1973. Sheppard, a lawyer with the Toronto law firm of Miller, Thomson, Sedgewick, Lewis and Healy, bases his argument on British and Canadian tax cases that involved government assistance to industry.[22] These cases considered the nature of government bodies' and authorities' (e.g. Ontario Hydro Authority) financial assistance to industry. Sheppard concluded that these cases defined public authority and that:

> the C.F.D.C. in light of its independence and the previously established commercial nature of its operations...was not a 'public authority' within the meaning of paragraph 13(7.1) of the Income Tax Act.[23]

Sheppard presented an argument that the non-recourse investment and loans made by the C.F.D.C. are to be included in the taxpayer's cost of the motion picture for the purpose of c.c.a. despite the tax department's interpretation of the Income Tax Act in IT-164. Sheppard points out tax court cases that support his argument, e.g. Birmingham Corporation

v. Barnes.[24] This case was concluded in the taxpayer's favour before the House of Lords in England in 1935. Lord Atkin stated in the final decision that "the actual cost (capital cost of property to the taxpayer) has no relation to the source from which that person received the money".[25] Sheppard pronounced that:

> It is a fact that a film is so different from our ordinary thinking of what constitutes an investment that perhaps the Minister has, in reacting to the tax benefits, overlooked the principle of law established in the Birmingham case, and developed the approach that "non-recourse" money cannot be subject to capital cost allowance.
>
> I think we all know of examples where "non-recourse" money has been accepted by the Minister for capital cost allowance purposes. For example, take the case where a corporation borrows money from a traditional lender to construct an income-producing building on lands which it owns, and the terms of the mortgage security provide that the mortgagee will look only to the property as security for its loan and not to the corporation on the usual covenant to pay. Would anyone question the corporation's right to claim capital cost allowance on the borrowed money?[26]

A case could be made then, that there is a basis for including the C.F.D.C. financing in the capital cost of a motion picture. The argument could be based on a section of the tax department's own interpretation bulletin IT-283 which states that:

> If the producer...chooses to follow a consistent practice of including in Class 12 or 18 such films...he thinks will be of continuing value to him...the capital cost of (the) property under paragraph 20(1)(a) will ordinarily include costs of scripts ...the renumeration of writers...and the rental or other costs of studio...[27]

A case could also be made for excluding C.F.D.C. investment from the recipient's income. The taxpayer would have to be prepared to justify these actions in federal court given the Department of National Revenue, Taxation's published positions. The taxpayer could use the cases cited from English and Canadian tax decisions; the tax department would rely heavily on the jurisprudence established in Lawrence H. Mandel v. Her Majesty the Queen (MAHONEY'S ESTATE).[28]

Sale, Lease-Back Agreements

The syndicate-guarantee motion picture investment arrangement features the minimum guarantee of distribution receipts which offset a schedule of future investor payments (i.e. promissory notes.) The syndicates-guarantee arrangements have been used to finance motion pictures in Canada since late 1974. The investors have been including in the capital cost the sum of their initial down payment plus the future payments for which they are liable. The tax department may consider this to be a financing arrangement, thus no c.c.a. would be available to the investor. The department's position would be based on interpretation bulletins IT-17 and IT-233 which consider c.c.a. in sale, lease-back transactions.

IT-17 was replaced and cancelled by IT-233 issued on July 14, 1975. IT-233 states in its opening preamble:

> It is necessary to determine, with regard to leasing agreements, whether payments in respect of those agreements are in substance payments of rent or payments on account of the purchase price of property or, in the case of sale - lease-back agreements, repayments of a loan.[29]

The interpretation bulletin stated further:

> Where it is apparent that the true intent of the parties is that the lessee borrow money on the security of property, the agreement is in substance a loan arrangement. Such an intent is strongly indicated where the sale price of the property is substantially different from its fair market value.[30]

In a syndicate arrangement the producer sells the motion picture to the investor at a price substantially greater than the actual cost to produce the motion picture. Subsequently the producer usually acts as the distributor when the motion picture is completed. The investor and producer sign a conditional sales contract for purchase and production of the motion picture. The investor and producer cum distributor sign a distribution contract. Regardless of the form of the documentation, the tax department might argue that the syndicate-guarantee motion picture investment method is a financing arrangement and not a purchase. The investor-owner must act as a bona fide owner to counter the possible contention of the tax department that the syndicate-guarantee method is analogous to a loan. The owner must exercise a degree of control over the motion picture. He must be entitled to more than just the recoupment of his investment. In other words, he must be entitled to a share of the profits proportionate to his degree of ownership in the motion picture.[31]

To date, the tax department has not said that the syndicate-guarantee arrangement is a financing arrangement and not the purchase of a motion picture. It is certain that National Revenue, Taxation's legal advisors will be closely examining the syndicate-guarantee arrangement. The department will undoubtedly make a specific interpretation statement soon.

Partnerships

Interpretation bulletins IT-90 and IT-138 consider partnerships and joint ventures. Partnerships were used in the early 1970's to invest in motion picture films. Today it is no longer desirable for investors to form a partnership. Investors take steps to avoid their motion picture investments being deemed partnerships by the tax department. One reason partnerships and joint ventures are no longer desirable is that the short fiscal rule can be applied by the tax department for the purpose of calculating the c.c.a. claim. Contracts for recent motion picture investment arrangements, such as the syndicate-guarantee arrangement, expressly deny existence of a partnership or a joint venture.

IT-90, dated February 9, 1973, asks "What is a partnership?" and answers:

> A partnership is the relation that subsists between persons carrying on business in common with a view to profit. However, co-ownership of one or more properties not associated with a business, (which under Common Law might be a joint tenancy or a tenancy in common), does not of itself create a partnership, and this is so regardless of an arrangement to share profits and losses. For guidance on whether a particular arrangement at a particular time constitutes a partnership, reference should be made to the relevant provincial law on the subject, and such law will be viewed as persuasive by the Department of National Revenue.[32]

It is important that a syndicate investing in a motion picture not be considered a partnership for income tax purposes. If the syndicate was deemed a partnership the capital cost allowance may be pro-rated over the portion of the year the syndicate had been in business. If the syndicate (deemed partnership) had not been in business a full year the short fiscal year rule would reduce the amount of loss that the individual investors could use to reduce their taxable income.

IT-90 makes the following comment with regard to joint ventures:

> A joint venture agreement, whereby two or more persons agree that each provides his own property to perform a specific task and receives a specific division of profits from such a task, may be considered a partnership as regards such profits; but as long as the property is not held under joint tenancy or tenancy in common, it is not considered to be partnership property. Thus the capital cost allowance provisions relating to partnership property do not apply.[33]

The tax department could take the approach that the producer-distributor is contributing production-distribution services and the syndicate of investors are contributing financial services, therefore the arrangement is a joint venture. If the arrangement between the producer cum distributor and the investors is a joint venture, the short fiscal year rule could be applied because the income derived, if any, is business income, not investment income. There is a second reason that deeming the arrangement a joint venture would have undesirable tax consequences to the motion picture investors. The reason is that if the tax department contended that:

> the debt held by the (producer) distributor in substance constitutes equity; there (would be) no shift of the depreciable base from the 'vendor' to the taxpayer.[34]

The investors could not deduct any capital cost allowance from other income.

IT-90 makes the following comment on the liability arrangements between syndicate members:

> Where several persons form an association for the purpose of carrying out particular business transactions in which they are mutually interested, the association has the characteristic of partnership. However, such persons may associate without each accepting total liability for the association's debts. In these circumstances, contracts may indicate that the associated persons will be liable only for their respective agreed portions of the debts. The existence of such an arrangement is viewed as an indication that a partnership does not exist. Syndicates often are in this category.[35]

A motion picture investment syndicate could use the above quotation from IT-90 to demonstrate that the association between the members (persons) constitute a syndicate not a partnership. The syndicate members are only liable for their respective agreed portions of the debts.

IT-138, published on December 18, 1973, was National Revenue, Taxation's advice of computation of partnership income under the rules of the new Income Tax Act. The tax department advised that Subsection

96(1)(f) and (g) of the Act provide that:

> In determining income or loss at the partnership level, capital cost allowance on property owned by the partnership ...are claimed by the partnership and not the partners individually.[36]

This bulletin reinforced the changes between the old Income Tax Act and the new Act which became law on January 1, 1972. The effect of the amendment in the method of computing partnership income or losses has been discussed earlier in Chapter III and has implications in the tax appeals considered in the next section of this chapter.

B. Ruling Decision on a Motion Picture Film Investment

On October 18, 1976 Revenue Canada, Taxation published the first formal advance ruling decision on investment in a motion picture film.[37]

The implications of advance ruling decisions are considered in National Revenue, Taxation's Information Circular No. 74-8 which states:

> A published ruling will indicate the position of the Department of National Revenue at the time the actual ruling was given. However, it is not intended that published rulings will subsequently be revised to reflect later changes in Departmental interpretations. Any such change in interpretation will be announced in an appropriate Interpretation Bulletin. Consequently, a published ruling must not be relied upon as being a binding ruling even in circumstances where a particular situation seems to be the same as that in respect of which the actual ruling was given.[38]

The circumstances of the proposed motion picture investment were presented in TR-38. The investor was to purchase an undivided interest in a motion picture for $80,000. The investor was to make a downpayment of $20,000 cash and sign an unconditional promissory note for $60,000, the balance of the full price. The leverage factor of the cash investment would be four to one.

The tax department's advance ruling was a disappointment to the motion picture investment community. The department ruled that the investor would be acquiring an undivided ownership in the motion picture but they did not rule what rate of capital cost he would be entitled to. Nor did the department rule what amount would constitute his capital cost base, \$20,000; \$60,000; or \$80,000. The ruling (which is reproduced in Appendix B to Chapter IV) did not offer further insight into the attitude of National Revenue, Taxation concerning motion picture investment in Canada.

Summary. The Department of Finance writes the Income Tax Act and Regulations and Revenue Canada, Taxation administers the tax laws as contained in the Act. Revenue Canada, Taxation must apply their interpretations of the law as the Act is not always clear even to those who administer it. The tax department attempts to set out their interpretation in interpretation bulletins, information circulars and tax ruling decisions. These publications by the tax department are studied closely by those financial advisors, lawyers and accountants involved with advising Canadians in tax matters. Although the tax department's publications are not law they are generally accepted as such. Therefore the prevailing practice by Canadian taxpayers is to adhere to these interpretations of the Income Tax Act by structuring any tax shelter schemes according to the tax department's interpretations. The interpretations discussed have had a pronounced effect on investment in motion pictures in Canada, some financing arrangements have been abandoned and others have been developed in order to work within Revenue Canada, Taxation's interpretations of the Income Tax Act.

2. THE TAX REVIEW BOARD, THE CANADIAN COURTS AND MOTION PICTURE INVESTMENT

The Federal Parliament has passed increasingly generous tax incentive legislation to encourage investment in Canadian motion picture production. One may speculate that Parliament's incentives are a direct counter-measure to the attempts by Revenue Canada, Taxation and the courts to reduce the amount of tax dollars invested in motion picture shelter investments. The contrariety within the federal government is not surprising. Parliament is committed to the goal of the development of a self-supporting Canadian motion picture industry. Revenue Canada, Taxation is committed to its mandate to maximize income tax revenue within the terms of the Income Tax Act and the process afforded by the courts.

In 1970, Donald J. Johnston, a partner in the Montreal law firm of Johnston, Heenan & Blaikie, recognized that motion pictures would be a good investment for tax write-offs. This resulted in a proliferation of "tax shelter" motion picture production in Canada from 1970 to 1973. Many of these investments were high leverage (up to ten to one) which were made solely for the purpose of reducing, if not altogether eliminating income tax. There was little emphasis placed on expectations of commercial success. Many investments in the early 1970's were structured so that the:

> tax saving would be greatest if the films earned no income and none of the investment recovered, in fact, there would be little tax advantage to the individual investors if the film proved to be very successful.[39]

Most earlier tax shelter arrangements centered around the formation of a limited partnership in which the liability of the individual partners would be limited to the extent of each partner's capital contribution. The available capital cost allowance would flow through to the individual partners.

In 1972, the Department of National Revenue, Taxation began questioning the validity of certain capital cost claims made in previous years. A number of reassessment notices were issued. The Tax Department took the position that the investor's capital cost was the actual cash the investor had personally invested or was unconditionally committed to pay to the vendor (producer) of the motion picture. The capital cost allowance deduction for the investor was based on the amount of investor's money which was "at risk".

The tax authorities contested the practice of private investors claiming capital cost allowance on Canadian Film Development Corporation funds invested or loaned, or on non-recourse promissory notes which would be payable only if the film was successful. Many reassessed investors accepted the department's arguments and paid back-taxes owing, plus interest. Several investors decided to file notices of objection to the reassessments and a few of these cases have gone before the Tax Review Board and the Federal Court-Trial Division.

A. Jacques Y. Paquin Appeal

The first reassessment appeal was the case of Jacques Y. Paquin v. The Minister of National Revenue.[40] The appeal was heard by the Tax Review Board on June 3, 1974.

Paquin and fifty-four others were limited partners in a limited partnership set up in 1971 to acquire motion picture film rights at prices far in excess of their production cost. The limited partners registered the limited partnership under the name Cheverny. They invested $605,000 with the partnership to purchase what they claimed to be $3,821,000 worth of motion pictures. The partners submitted that their personal capital cost was the total purchase price and accordingly claimed a c.c.a. of 60% of that amount in the initial year of the investment.

The limited partnership, Cheverny, purchased rights to certain films with down payments in the amount mentioned, but the purchase contracts stated that the balance of the purchase price was to be paid at the purchaser's discretion and those outstanding amounts bore no interest. Cheverny itself had no obligation to pay the balance and the individual limited partners were personally protected from the liability by the legal nature of the limited partnership. The only recourse offered the vendor in default of payment by Cheverny was that the purchaser would restore the film rights to the seller. If this occurred Cheverny would be absolved of all obligations as per the terms of the contract between the parties.

Tax Review Board Assistant Chairman, Lucien Cardin, Q.C. objected to the arrangement. He commented:

> In my view, the Board is here confronted with a well-organized scheme which enabled the participants to make unjustified claims to tax deductions on income from other sources by means of an abuse of the capital cost depreciation system.[41]

The Tax Review Board took the position that the limited partnership did not have a capital cost allowance loss based on the full (and inflated) purchase price for 1971, the year in question, because the partnership had no legal obligation to pay the balance of the purchase price. Chairman Cardin did allow that the partnership would have been entitled to deduct a capital cost allowance on the basis of the actual cash outlay under Section 11(1)(a) of the Act. However, the partnership had not claimed any c.c.a. because it was intended that the c.c.a. be made available to each of the limited partners personally.

Cardin ruled that the individual partners had no claim to c.c.a. whatsoever. His argument was that "the result of the partnership's operations must, however, be determined before profits can be distributed or the losses claimed."[42] He further stated that the resulting loss to the partnership when pro-rated among the partners would not be "a deduction...for capital cost allowance under Section 11(1)(a), but a deduction for a business loss pursuant to Section 27(1)(e) of the Act."[43] Because Cheverny had not claimed c.c.a. that year, it had not incurred a loss on its operations. Therefore, even the business deduction was unavailable to the limited partners personally.

Lucien Cardin's ruling was unusual because the appeal was for Pacquin's 1971 income tax return. Under the old <u>Act</u>, c.c.a. was not claimed at the partnership level but by individual partners. Cardin seems to have been influenced by the new <u>Act</u> which required the partnership to deduct the c.c.a. expense before distributing the profit or loss to the partners.[44]

The Paquin appeal was unsuccessful due to technical deficiencies in the operation of the limited partnership's accounting practices and the mis-interpretation of the <u>Income Tax Act</u> by the partnership's accountants. The partnership did not refile its claims nor appeal the ruling and the case is now considered by many as precedence. The reassessment had sufficient effect on future motion picture tax shelter projects to cause the promoters to abandon the limited partnership concept of financing in 1973.

B. Wayne F. Currie Appeal

The second motion picture capital cost allowance reassessment appeal case to be heard by the Tax Review Board was Wayne F. Currie v. The Minister of National Revenue.[45] In 1972, the investor, Wayne Currie, purchased a video tape program for a total purchase price of $10,000. He paid a down-payment of $2,500 and agreed to pay the balance on or before November 30, 1979. Curried signed a seven year non-interest bearing promissory note. The appellant then claimed a capital cost allowance deduction on his 1972 income tax return of $10,000. The video tape, being of class 12, Schedule B, was an asset depreciable at a rate of 100%.

In addition to the purchase agreement there existed a separate distribution agreement which Currie signed with the vendors and intended distributors of the video tape. The distribution agreement provided that one-half of any net revenue due to Currie be applied to the promissory note retirement.

The Minister of National Revenue took a different stance on this motion picture investment than he took in the Cheverny investment. The minister contended that the transaction was not a "bona fide" purchase of an asset acquired for the purpose of gaining or producing income, but was entered into solely for the purpose of reducing income taxes. The appeal was dismissed on the grounds that this transaction was a sham, prohibited under Section 245 of the Income Tax Act. Section 245(1), which is couched in very broad all-encompassing terms, reads as follows:

> In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.[46]

The writer and others, including Wayne Beach[47], are of the opinion that the Currie appeal was ruled unfairly. It is true that this video tape investment failed to earn any income between 1972 when it was purchased and February 19, 1975 when the case was heard by the Tax Review Board. The fact that the video tape investment had not earned any income does not mean that the prospects to earn income did not appear promising to both the vendors and the purchaser given the original circumstances surrounding the inital transaction. No one, even those in the motion picture industry can predict with certainty whether a motion picture will earn income or not. Directors, producers, distributors and exhibitors can be quoted as stating unconditionally that a certain motion picture will be a commercial failure, yet the movie-going public has queued for blocks to gain admission to the theatre to see the film. Of course, the opposite has occurred even more frequently.

Roland St. Onge, Q.C. of the Tax Review Board, dwelled on the fact that the video tape program had not earned any income and it appears that this was a major influence in his final decision. If the lack of revenue was an influence then he based his decision not on the original circumstances of the investment but on the lack of positive results from the investment three years later. This decision is unfair.

Currie is appealing the decision to the Federal Court-Trial Division. When the case comes to trial, Currie has a chance of having his appeal upheld, given the previous unwillingness of the courts to apply the rather harsh and stringent Section 245.[48]

> It would appear likely that this provision will be applied only in the most blatant cases; for example, highly leveraged,

> non-recourse situations where it is obvious that the film had no chance of success and no serious attempts were made to distribute the film or transactions in which the purchase price of the film was clearly inflated.[49]

Currie signed a full recourse promissory note for $7,500 payable in 1979. No one could say at the inception of the transaction whether the video tape was likely to earn income or not. The producers did make serious attempts to distribute the program. (The Dominion Tax Case report of the appeal is reproduced in Appendix C to Chapter IV.)

C. Lawrence H. Mandel Appeal

The third case in Canada involving motion picture investment is the Lawrence H. Mandel (Plaintiff) v. Her Majesty the Queen (Defendant)[50] which was concluded in Federal Court-Trail Division, August 9, 1976. This is the first motion picture tax case to reach Federal Courts, originating from an appeal by the plaintiff of a reassessment of his 1971 income tax return. The plaintiff had become a limited partner in a limited partnership. The partnership, which was registered in late 1971, was to acquire a feature length motion picture film entitled MAHONEY'S ESTATE.

The limited partners, through the partnership, invested $150,000. Other investors were the Canadian Film Development Corporation, the Bank of Montreal, and the various producers and creative persons involved in the production. In addition to the cash invested, the producers, director, writer, leading actors and others agreed to defer portions of their fees. These fees would be paid "contingent" upon the film earning money from distribution (The word "contingent" plays a major role in the final decision of the Mandel trial).

By December 31, 1971, the income tax year in question, the auditors for the production stated that the cost of the film thus far had been "$577,892, although the payment of some portions of this amount was deferred".[51] The term "deferred" meant that the payments would be met by the various production, distribution and investment entities involved (and by this time there were many!) if and when certain events took place, including but not limited to the release of the film and subsequent earnings, if any. Due to the limited partnership arrangement, none of the limited partners were personally liable beyond their initial $150,000 commitment unless the film generated revenue. If the film did generate revenue, the liabilities were to be met from that revenue, not by the limited partners.

The production became more and more complicated as time went on. Several times the film was refinanced during the five years of production. Some entities including the C.F.D.C. withdrew from the project. A prolonged and irreconcilable dispute between the creative personnel occurred.

It was 1976 when the project was finally finished. At that time the case was being heard in federal trial court. Witnesses testified at great length as to the artistic and commercial merits of the film. The plaintiff found many "expert" witnesses who said that MAHONEY'S ESTATE was a creative masterpiece. The defendents presented just as many "experts" who said the film was totally "lacking in commercial or artistic value."[52]

The tax department accepted in the court case that the treatment of the capital cost allowance and expenses was correct, technically. The loss of $577,982 incurred by the partnership in the year 1971 was attributed to the partnership first. Each individual partner then correctly claimed his share of the loss from the partnership.

At first blush the case appears rather lengthy and complicated due to the number of entities involved and the problems associated with production and financing during the exceptionally long time it took to complete the film. The Minister of National Revenue presented a barage of reasons why the c.c.a. deduction should be disallowed and the individual limited partners reassessed. However, as Justice Walsh astutely pointed out in his disposal of the preliminary issues, (decided in favour of the plaintiff), the case rests on the meaning of the phrase "contingent liability" and how it should be interpreted by the legal and accounting profession and, in turn, in the Income Tax Act.

The disposal of the preliminary issues by Walsh, J. is important because he ruled in favour of the plaintiff on the preliminary issues. Walsh, J.'s findings appear to be opposite to those Roland St. Onge used to dismiss the Wayne Currie appeal. The observations of Walsh, J. could be used as precedence by several motion picture investment cases yet to come to trial, including the Currie appeal to the Federal Court-Trial Division.

In the Statement of Defense to the taxpayer's Notice of Objection, the Minister of National Revenue presented several reasons why the c.c.a. deduction from the taxpayer's income should not be allowed. The reasons for challenging the c.c.a. deduction fall under three headings as follows:

1. Partnership and ownership

   a. The limited partnership was not in business in 1971 and it had not acquired the film in 1971. If the partnership was not in business it could not own an asset, therefore no c.c.a. would be permitted.

b. If the partnership was in business in 1971 the partnership had acquired only the rights to distribute the film, not ownership of the property (film). Distribution rights are not a property and are not eligible for c.c.a.

2. Business operating less than 12 months

a. The partnership was a business. The c.c.a. deduction for a business is limited to the portion of the taxation year it has been in operation under the terms of Regulation 1100(3) and 1104 of the Income Tax Act. (i.e. the short fiscal year rule.)

3. Acquisition of the property not made to earn income

a. The interest in the film did not gain or produce income. The partnership did not acquire the film for any bona fide business purpose. Therefore, the acquisition was a sham with no legitimate business purpose other than to minimize tax. If the interest in the motion picture film was not acquired to earn or produce income it can not be included in class 18 of the regulations because the c.c.a. would unduly or artifically reduce income.[53]

Walsh, J. reviewed the Minister's defense arguments. He realized that the taxpayers would be in a more favourable net-after-tax position if the motion picture investment failed to earn any revenue at all and the full leveraged purchase price was upheld as the basis for capital cost. Walsh, J. commented:

> This does not, however, justify a conclusion that this was in any way improper nor that their motivation has the consequence of depriving them of whatever tax advantages resulted from the purchase, since it is a fundamental principle in taxation law that a businessman may so arrange his affairs in the frame of the relevant taxing statute and regulations as to minimize his tax liability.[54]

Walsh, J. ruled on each of the Minister's preliminary contentions as follows:

1. Partnership and ownership

a. The partnership was duly registered and in business in 1971. The partnership's operating charter set out that the partnership was to purchase ownership in motion picture films. The purchase contracts for MAHONEY'S ESTATE clearly stated that the partnership was the "owner" of a property which was acquired to be distributed and exploited throughout the world.

2. Business operating less than 12 months

    a. The facts were that the plaintiffs were principally lawyers, and were not in the film business. Therefore any income derived from the property (film) would be investment income not income from a business. The short fiscal year rule would not apply.

3. Acquisition not made to earn income

    a. Although the limited partners recognized that film investment is a risky investment, the circumstances at the time of purchasing the property did not indicate that the film did not have potential to earn income. The potential to earn income from the property was among the reasons the C.F.D.C. and the Bank of Montreal invested in the film. When the plaintiffs bought the film in 1971 there was no evidence that the plaintiffs anticipated the film would not be a commercial success. Evidence was presented in the 1976 court trial that arrangements had been made to exhibit the film in several Canadian cities later that year. The possibility existed that the film might earn income even at this late date.[55]

Walsh, J. ruled that the transaction was not a sham as the Minister of National Revenue contended. The film, MAHONEY'S ESTATE was a property owned by an active partnership for the purpose of gaining or producing income. The partnership was entitled to claim a capital cost allowance deduction.

Walsh, J. then addressed the important question, what amount of the purchase price of the film was eligible for a capital cost allowance deduction by the limited partnership? The individual partners had invested $150,000 and the partnership had a limited liability for $427,892 "contingent" upon the revenue earned by the film in distribution.

Once again, witnesses were summoned. These witnesses, tax accountants from reputable Canadian acounting firms, offered their opinions as to whether or not a contingent liability should be included in the capital cost base. The accountants referred to accounting textbooks, terminology publications and previous tax cases to support their opinions. In the final decision Walsh, J. recognized that the taxpayers did not, in 1971, have an unconditional liability for the entire amount of $577,892 including the leveraged amount of $427,892. He ruled that c.c.a. could only be claimed on the actual investment by the limited partners of $150,000. He concluded that:

> When and if the film generates profits and additional payments are made on account of the liability, as now appears possible in view of the distribution of the film which is now commencing, the partnership can at that time set up these further payments as part of the capital cost and Plaintiff can benefit by claiming capital cost allowance against same in the year or years in which such additional capital cost is created.[56]

Summary. The three reassessment cases to be appealed to the Tax Review Board and the Federal Court-Trial Division have been ruled in favour of the Department of National Revenue, Taxation. The tax department's interpretation of the Income Tax Act is being reinforced. In the Wayne Currie case, which is to be appealed, the capital cost deduction was denied on the full purchase price of the video tape program, including both the leveraged amount and Currie's cash investment. In all cases the capital cost allowance deduction has been denied on any amount for which the investors were not personally liable, regardless of the fortunes of the motion picture in distribution.

FOOTNOTES CHAPTER IV

[1] Department of National Revenue, Information Circular, No. 70-1, August 25, 1970, pp.1-2.

[2] Arthur Drache, "Interest Free Loans Gone at Revenue's Whim," Financial Post, May 7, 1977, p.1.

[3] Ibid.

[4] Canadian Film Development Corporation, Annual Reports, for years 1971 to 1973.

[5] M.W. Steels, "A Departmental Perspective on Tax Shelters", 1973 Conference Report (Canadian Tax Foundation, 1974), p. 526.

[6] Department of National Revenue, Taxation, Interpretation Bulletin, IT-164 (June 5, 1974), pp.1-3.

[7] Ibid., p.4.

[8] Canadian Film Development, Annual Report 1974-75, June 30, 1975, p. 4.

[9] Department of National Revenue, Taxation, Interpretation Bulletin, IT-283 (January 19, 1976), pp.1-2.

[10] Department of National Revenue, Taxation, Interpretation Bulletin, IT-49 (December 29, 1971), p.1.

[11] Department of National Revenue, Taxation, Interpretation Bulletin, IT-273 (December 22,1975).

[12] Department of National Revenue, Taxation, Interpretation Bulletin, IT-276 (January 5, 1976), p.6.

[13] John E. Sheppard, "An Overview of the Income Tax Law as It Relates to Investing In Motion Picture Films," 1973 Conference Report (Canadian Tax Foundation, 1974), pp.497-515; and Wayne G. Beach, "Tax Advantages of Film Investment," CIT Tax Planning and Management 18 (Butterworth & Co. (Canada) Ltd., 1976), pp. 18-1 - 18-15.

[14] Department of National Revenue, Taxation, Interpretation Bulletin IT-164, op.cit., paragraph 9, p.3.

[15] Department of National Revenue, Taxation, Interpretation Bulletin IT-276, op.cit. paragraph 30a, p.7.

[16] Canadian Film Development Corporation Act, Subsection 10(1)(a), 14-15-16 Elizabeth II, Chapter 78, p.863.

[17] Wayne G. Beach, "Tax Advantages of Film Investment", CIT Tax Planning and Management 18 (Butterworth & Co. (Canada) Ltd., 1976), p. 18-8.

[18] Ibid., pp. 18-7 - 18-8.

[19] Canadian Income Tax Act with Regulations, 47th Edition C.C.H. Canadian Limited), p.29.

[20] Wayne Beach, op.cit.,p.18-7.

[21] Ibid.

[22] Birmingham Corporation v. Barnes, (1934) 1 K.B. 484 (C.A.); (1935) A.C. 292 (H. of L.) and Ottawa Valley Power Co. v M.N.R., 69 DTC 5166.

[23] John E. Sheppard, "An Overview of the Income Tax Law as It Relates to Investing in Motion Picture Films," 1973 Conference Report (Canadian Tax Foundation, 1974), p.512.

[24] Birmingham Corporation v. Barnes (H.M. Inspector of Taxes) (1935), 1 K. B. 484 (C.A.); (1935) A.C. 292 (H. of L.).

[25] Ibid.

[26] John Sheppard, op.cit., p. 507.

[27] Department of National Revenue, Taxation, Interpretation Bulletin, IT-283, op,cit., p.2.

[28] Lawrence H. Mandel (Plaintiff) v. Her Majesty The Queen (Defendent), Federal Court-Trail Division, August 9, 1976, Dominion Tax Cases (CCH Canadian Limited, September 9, 1976), pp.6316-6331.

[29] Department of National Revenue, Taxation Interpretation Bulletin, IT-233 (July 14, 1975), p.1.

[30] Ibid.,p.3.

[31] Richard M. Wise, "A Cineramic View of Motion Picture Film Investments", Canadian Tax Journal, March/April 1976, (Canadian Tax Foundation, 1976), pp.162-163.

[32] Department of National Revenue, Taxation, Interpretation Bulletin, IT-90 (February 9, 1973), p.1.

[33] Ibid.

[34] Richard Wise, op.cit., p.164.

[35] Department of National Revenue, Taxation, Interpretation Bulletin, IT-90, op.cit., pp.1-2.

[36] Department of National Revenue, Taxation, Interpretation Bulletin IT-138 (December 18, 1973), p.1.

[37] Revenue Canada, Taxation, Ruling Decision, TR-38, October 18, 1976, pp.1-3.

[38] Department of National Revenue, Taxation Information Circular No. 74-8, March 4, 1974, p.1.

[39] Walsh, J., Mandel v. H.M., op.cit., p. 6322.

[40] Jacques Y. Paquin v. Minister of National Revenue, Tax Review Board, June 3, 1974, Dominion Tax Cases (C.C.H. Canadian Limited, June 1974), pp.1142-1145.

[41] Ibid., p.1143.

[42] Ibid., p. 1145.

[43] Ibid.

[44] Martin L. O'Brien, C.I.T. Canadian Current Tax, June 28, 1974, Issue 26 (Butterworth & Co. (Canada) Ltd., 1974) p.2.

[45] Wayne F. Currie (Appellant) v. The Minister of National Revenue (Respondent), Tax Review Board, February 19, 1975, Dominion Tax Cases, (C.C.H. Canadian Limited, April 11, 1975), pp.57-59.

[46] Canadian Income Tax Act with Regulations, 47th Edition, 1975-76 (C.C.H. Canadian Limited, 1976) p.604.

[47] Wayne Beach, op.cit., pp. 18-6 - 18-8.

[48] For a detailed discussion of the meaning and application of section 245 see DesRosiers v. The Queen, 75 Dominion Tax Cases 5298.

[49] Wayne Beach, op.cit., p. 18-8.

[50] Mandel v. H.M., op.cit., pp. 6316-6331.

[51] Ibid., Delorthe, Hoskins and Sells, Chartered Accountants, p.6319.

[52] Ibid., Don Owen, p.6321.

[53] Mandel v. H.M., op.cit., p.6317.

[54] Ibid., Walsh, J. p.6322.

[55] Ibid.

[56] Ibid., p.6331.

DEPARTMENT OF NATIONAL REVENUE, TAXATION

MINISTÈRE DU REVENU NATIONAL, IMPÔT

INTERPRETATION BULLETIN D'INTERPRÉTATION

SUBJECT: INCOME TAX ACT
Capital Cost Allowance on Certain Leveraged Investments

OBJET: LOI DE L'IMPÔT SUR LE REVENU
Déduction pour amortissement à l'égard de certains placements spéculatifs

SERIAL NO: IT–164 DATE: June 5, 1974
REFERENCE: Paragraph 20(1)(a)

NO DE SÉRIE: IT–164 DATE: le 5 juin 1974
RENVOI: Alinéa 20(1)a)

1. This bulletin presents the Department's views in the determination of the capital cost of certain "leveraged investments" for the purpose of calculating capital cost allowance under paragraph 20(1)(a) of the Act.

2. In this bulletin "leveraged investment" means an arrangement whereby a person (or persons) (hereinafter called "the investor") acquires an equity interest in capital property ("the investment") at a stated purchase price substantially in excess of the amount actually invested or put at risk by him. One of the main objects of the arrangement is for the investor to secure the right to capital cost allowance on the total stated purchase price. Generally the investor intends to use the additional capital cost allowance to reduce other income.

3. The leveraged investment is generally property which qualifies for a high rate of capital cost allowance as provided by the Income Tax Regulations, for example, an aircraft (40 per cent), a motion picture film other than a television commercial (60 per cent), videotape or a motion picture film that is a television commercial message (100 per cent), and certain manufacturing and processing equipment (50 per cent). A leveraged investment may also form part of a leasing arrangement where the user of equipment is tax-exempt (for example, a municipality) or non-taxable, or where the capital cost allowance claim by the investor can be greater than that by the user on the same equipment; for example, railway rolling stock that is part of a railway system is Class 4 (6 per cent) but to the investor is Class 8 (20 per cent).

4. The general nature and form of such investments are described below under the headings "Motion Picture Films" and "Leveraged Equipment Leases".

Motion Picture Films

5. A leveraged investment in a motion picture film may generally be categorized according to whether the investment is made:

(a) prior to the completion of production, or

1. Le présent bulletin expose les vues du Ministère à l'égard de la détermination du coût en capital de certains "placements spéculatifs" aux fins du calcul de la déduction pour amortissement en vertu de l'alinéa 20(1)a) de la Loi.

2. Dans le présent bulletin, l'expression "placement spéculatif" signifie un arrangement en vertu duquel une personne (ou plusieurs personnes) (appelée(s) ci-après l'"investisseur") acquièrt une participation à des biens d'investissement ("le placement") à un prix d'achat indiqué excédant de beaucoup le montant effectivement investi ou mis en jeu par l'investisseur. L'un des buts principaux de l'arrangement est d'assurer à l'investisseur le droit à la déduction pour amortissement sur le prix d'achat global indiqué. L'investisseur désire généralement utiliser la déduction pour amortissement supplémentaire afin de réduire d'autres revenus.

3. Le placement spéculatif est ordinairement un bien donnant droit à un taux élevé de déduction pour amortissement tel que prévu par les Règlements de l'impôt sur le revenu, par exemple, un aéronef (40 pour cent), un film cinématographique autre qu'une annonce publicitaire télévisée (60 pour cent), une bande magnétoscopique ou un film cinématographique qui est un message publicitaire télévisé (100 pour cent) et certain matériel de fabrication et de transformation (50 pour cent). Un placement spéculatif peut aussi faire partie d'un arrangement de location à bail en vertu duquel l'usager du matériel est exempté d'impôt (par exemple, une municipalité) ou non imposable, ou en vertu duquel la déduction pour amortissement réclamée par l'investisseur peut être plus élevée que celle réclamée par l'usager à l'égard du même matériel; ainsi, le matériel roulant qui fait partie d'un réseau ferroviaire est classé dans la catégorie 4 (6 pour cent) mais, en ce qui concerne l'investisseur, il entre dans la catégorie 8 (20 pour cent).

4. Les rubriques "Films cinématographiques" et "Locations à bail spéculatives de matériel" traitent ci-dessous de la nature et de la forme générales de ces placements.

Films cinématographiques

5. Un placement spéculatif dans un film cinématographique peut généralement être classé selon que le placement est fait

a) avant la fin de la production, ou

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(b) after the completion of production and perhaps after varying degrees of distribution.

6. The following example illustrates the general features of a leveraged investment made prior to the completion of the film:

(a) The film has a budgeted cost of $500,000.

(b) Financing of the film is as follows:

(i) $180,000 obtained through loans and advances by other parties involved in producing, exhibiting and distributing the film;

(ii) an investment of $200,000 by the Canadian Film Development Corporation (CFDC) pursuant to paragraph 10(1)(a) of the CFDC Act (the CFDC is a Crown corporation established to invest in Canadian feature films to assist the Canadian film industry);

(iii) a cash investment of $120,000 by the investor.

(c) All monies advanced will only be recouped from earnings from the distribution of the film. In addition, all parties share, in a specified manner, in the earnings in excess of those used to repay the advances.

(d) For his investment the investor purports to obtain title to the film upon its completion. None of the other parties have any effective recourse against the investor for monies advanced since their rights to repayment are limited to their participation in the earnings of the film.

(e) The film is property of the investor described in Class 18 of Schedule B of the Income Tax Regulations and as such is subject to a capital cost allowance rate of 60 per cent.

7. The investor described above is often a limited partnership with a group of individual investors as limited partners and a newly incorporated company as a general partner with the limited partners as shareholders of the corporation. Each of the limited partners contributes a share of the investment (in the above example, $120,000) and the limited partnership obtains title to the film.

8. Where a film is acquired after production is completed, the purchase agreement generally provides for an immediate cash outlay (say $120,000) substantially less than the total stated purchase price (say $500,000) with the balance to be repaid only out of earnings from the distribution of the film. Generally the only recourse by the vendor of the film for non-payment is repossession of the film after a specified number of years. Where a limited partnership is the investment vehicle, recourse other than repossession may be indicated by the agreement but generally the only effective action against non-payment is still the repossession of the film.

b) après la fin de la production, et peut-être après diverses étapes de la distribution.

6. L'exemple suivant illustre les modalités générales d'un placement spéculatif fait avant la fin de la production d'un film:

a) Le coût prévu du film s'élève à $500,000.

b) Le film est financé de la façon suivante:

(i) $180,000 sont obtenus au moyen d'emprunts et d'avances par d'autres parties se livrant à la production, à la présentation et à la distribution du film;

(ii) La Société de développement de l'industrie cinématographique canadienne (SDICC) investit $200,000 conformément à l'alinéa 10(1)a) de la Loi sur la SDICC (La SDICC est une société de la Couronne établie pour investir dans des longs métrages canadiens afin d'aider l'industrie cinématographique canadienne);

(iii) L'investisseur fait un placement en espèces de $120,000.

c) Toutes les sommes avancées ne seront recouvrées que des recettes découlant de la distribution du film. En outre, toutes les parties se partagent, d'une façon précise, les gains excédant ceux qui servent à rembourser les avances.

d) En contrepartie de son placement, l'investisseur vise à obtenir le titre de propriété du film une fois qu'il sera terminé. Aucune des autres parties n'a de recours efficace contre l'investisseur à l'égard des sommes avancées, puisque leurs droits au remboursement se trouvent limités à leur participation aux gains découlant du film.

e) Le film constitue le bien de l'investisseur, comme le mentionne la Catégorie 18 de l'Annexe B des Règlements de l'impôt sur le revenu, et il fait, à ce titre, l'objet d'un taux de déduction pour amortissement de 60 pour cent.

7. L'investisseur mentionné ci-dessus est souvent une société à responsabilité limitée composée d'un groupe d'investisseurs particuliers agissant à titre de commanditaires et d'une compagnie nouvellement constituée qui est l'associée en nom collectif, les commanditaires étant les actionnaires de la corporation. Chaque commanditaire contribue une partie du placement (dans l'exemple ci-dessus, $120,000) et la société en nom collectif obtient le droit de propriété du film.

8. Lorsqu'un film est acquis après la fin de la production, le contrat d'achat prévoit généralement des débours immédiats en espèces (par exemple $120,000) considérablement inférieurs au prix d'achat total indiqué (par exemple $500,000) et le solde doit être remboursé seulement sur les gains découlant de la distribution du film. Généralement, le seul recours qu'a le vendeur du film en cas de non-paiement est de reprendre possession du film après un nombre déterminé d'années. Lorsque les placements se font par l'entremise d'une société en nom collectif, le contrat peut stipuler un autre moyen que la repossession, mais, en règle générale, la seule mesure efficace en cas de non-paiement reste encore la reprise de possession du film.

9. Under the types of financial arrangements outlined above the Department takes the position that the capital cost of the film to the investor for the purpose of paragraph 20(1)(a) is only that cost which has been laid out or in fact put at risk by the investor, either through investment of cash or borrowed funds unconditionally repayable whatever the fortunes of the film in question may be. Subject to the remarks in paragraph 11, in either case noted above that capital cost is $120,000.

10. Where, as a result of earnings from the distribution of the film, additional amounts are paid by the investor toward its stated purchase price, such amounts constitute additional capital cost of that film, except in cases described in paragraph 11.

11. In certain cases the capital cost of a film for the purpose of its inclusion in Class 18 of Schedule B of the Regulations is NIL, since:

(a) the film is not considered to have been acquired by the taxpayer for the purpose of gaining or producing income therefrom, or

(b) the film is not in fact a Class 18 property; for example, where the investor does not acquire a motion picture film but only the rights to its distribution in a specified territory.

Leveraged Equipment Leases

12. It is necessary to determine whether payments made in respect of leasing agreements where there is an option to acquire the leased property are in substance payment of rent or payment on account of the purchase price of property or, in the case of sale-leaseback agreements, repayment of a loan. This determination must be made on the basis of general law and the provisions of the agreement itself. Departmental policy in this area is expressed in the Interpretation Bulletin entitled "Lease-Option and Similar Agreements, Sale and Leaseback Agreements". The following comments assume that the lease referred to is in substance a lease.

13. A typical leveraged equipment-leasing arrangement is as follows:

(a) A taxpayer (called "the user") arranges with a manufacturer for certain equipment.

(b) The user (or in some cases the manufacturer) invites various financial institutions to submit tenders for the financing of the equipment.

(c) A financial institution may submit a tender which calls for one of its clients ("the investor") to put up approximately 20 per cent of the asset cost with the remaining 80 per cent to be supplied by other parties (e.g., insurance companies, banks and pension funds) whose participation is also arranged for by the financial institution. The financial institution may itself take the position of the investor.

(d) The tender showing the lowest financing cost to the user generally is awarded the financing contract.

9. Dans le cadre des genres d'arrangements financiers mentionnés ci-dessus, le Ministère considère que le coût en capital du film pour l'investisseur aux fins de l'alinéa 20(1)a) est seulement le coût qui a été établi ou mis en jeu par l'investisseur, soit au moyen de placement de sommes en espèces ou de fonds empruntés inconditionnellement remboursables, quoi qu'il advienne du film concerné. Sous réserve des cas mentionnés au paragraphe 11, ce coût en capital est de $120,000 dans chacun des cas mentionnés ci-dessus.

10. Lorsqu'en raison des gains découlant de la distribution du film, l'investisseur verse des sommes additionnelles en vue de payer le prix d'achat indiqué, ces sommes constituent le coût en capital supplémentaire de ce film, sauf dans les cas mentionnés dans le paragraphe 11 ci-dessous.

11. Dans certains cas, le coût en capital du film aux fins de son incorporation dans la Catégorie 18 de l'Annexe B des Règlements est NEANT pour les raisons suivantes:

a) le film n'est pas considéré avoir été acquis par le contribuable dans le but d'en tirer un revenu ou de lui en faire produire un; ou

b) le film n'est pas réellement un bien de la Catégorie 18; par exemple, lorsque l'investisseur n'acquiert pas un film cinématographique mais seulement les droits à sa distribution dans un territoire indiqué.

Locations à bail spéculatives de matériel

12. Il faut déterminer si les versements effectués dans le cadre de conventions de bail offrant la possibilité d'acquérir les biens loués sont en substance des paiements de loyers ou bien des versements à valoir sur le prix d'achat des biens ou, dans le cas de conventions de vente et de relocation, des remboursements d'emprunts. La question se tranchera à la lumière des dispositions générales de la loi et des stipulations de la convention. La politique du Ministère à cet égard est définie dans le Bulletin d'interprétation intitulé "Conventions de bail avec option et conventions semblables, conventions de vente et de relocation." Dans les notes qui suivent, il est présumé que le bail mentionné est en substance un bail.

13. Voici un example typique de location à bail spéculative de matériel:

a) Un contribuable (appelé "l'usager") s'entend avec un fabricant au sujet d'un matériel.

b) L'usager (ou dans certains cas le fabricant) invite diverses institutions financières à faire des soumissions pour le financement du matériel.

c) Une institution financière peut faire une soumission prévoyant qu'un de ses clients ("l'investisseur") fournira environ 20 pour cent du coût du bien, les 80 pour cent restants étant apportés par d'autres parties (par exemple, des compagnies d'assurance, des banques et des caisses de pensions) dont l'institution financière arrange aussi la participation. L'institution financière peut assumer elle-même le rôle de l'investisseur.

d) La soumission prévoyant le coût de financement le plus faible pour l'usager décroche ordinairement le contrat de financement.

(e) The investor arranges with a trustee (usually a trust company) for the issuance of notes or certificates by the trustee to the other parties supplying 80 per cent of the equipment cost. The other parties purchasing these notes or certificates agree to look only to the equipment and the user for the security of the funds they invest. Accordingly, the investor has no liability for the 80 per cent of the equipment cost financed by the issue of the notes or certificates. The investor pays his 20 per cent to the trustee and the trustee then pays the manufacturer in full for the equipment and receives title.

(f) The trustee then sells the equipment to the investor under a conditional sale agreement which permits title to remain with the trustee as security for the notes or certificates issued to the other parties. However, the terms of the conditional sale agreement specify that the investor is required to make payments to the trustee only to the extent of rentals to be received from the user under a lease arrangement between the user and the investor.

(g) The lease between the investor and the user calls for a lease term approximately the same as the equipment's useful life. The lease rentals, which are calculated to yield sufficient rental revenue to pay only principal and interest on the notes or certificates plus a fair market yield on the 20 per cent invested by the investor, are assigned to the trustee as payments due under the conditional sale agreement. The proceeds are used by the trustee to pay the principal and interest on the notes or certificates issued by the trustee with the balance payable to the investor.

14. All the written agreements evidencing the above-listed sequence of events generally are dated the same day and the purchase, sale and lease are integral parts of the whole financing arrangement. Accordingly, any review of the arrangement cannot be based on the terms of any single document.

15. It may be claimed by the investor that under a typical arrangement as described above he is entitled to capital cost allowances on the full cost of the property by virtue of being the sole owner of the equipment once the amounts owing to the other parties have been discharged and the initial term of the lease has ended. However the Department's view is that, for the purpose of paragraph 20(1)(a), the capital cost of the leased equipment to the investor cannot include any part of the cost in respect of which there is no recourse against him in the event of a default. In the above example the capital cost would not include the 80 per cent of that cost financed through the other parties.

e) L'investisseur s'arrange avec un fiduciaire (ordinairement une compagnie de fiducie) pour que ce dernier émette des billets ou des certificats aux autres parties qui fournissent 80 pour cent du coût du matériel. Les autres parties qui achètent ces billets ou ces certificats conviennent de s'en tenir uniquement au matériel et à l'usager pour ce qui est de la garantie des fonds qu'elles ont investis. En conséquence, l'investisseur n'est pas responsable à l'égard des 80 pour cent du coût du matériel financés par l'émission des billets et des certificats. L'investisseur verse ses 20 pour cent au fiduciaire et le fiduciaire paie alors tout le matériel au fabricant et reçoit le titre de propriété.

f) Le fiduciaire vend alors le matériel à l'investisseur en vertu d'un contrat de vente conditionnelle, ce qui permet au fiduciaire de conserver le titre comme garantie en contre-partie des billets et des certificats émis aux autres parties. Cependant, les termes du contrat de vente conditionnelle précisent que l'investisseur n'est tenu de verser des paiements au fiduciaire que jusqu'à concurrence des loyers à recevoir de l'usager en vertu d'une convention de bail entre l'usager et l'investisseur.

g) Le bail entre l'investisseur et l'usager doit avoir une durée à peu près équivalente à celle pendant laquelle le matériel sera utile. Les loyers du bail, calculés pour produire un revenu locatif suffisant pour payer seulement le principal et les intérêts sur les billets ou les certificats, plus un rendement à la juste valeur marchande sur les 20 pour cent placés par l'investisseur, sont confiés au fiduciaire à titre de paiements dus en vertu du contrat de vente conditionnelle. Le fiduciaire utilise le produit pour payer le principal et les intérêts sur les billets et les certificats qu'il a émis, le solde étant à payer à l'investisseur.

14. Tous les accords écrits ponctuant les différentes phases exposées ci-dessus sont généralement datés le même jour; l'achat, la vente et le bail font intégralement partie de l'arrangement de financement. C'est pourquoi, aucune révision de l'arrangement ne peut se faire sur la base d'un seul document.

15. Il se peut que l'investisseur réclame, en vertu d'une arrangement typique comme celui exposé ci-dessus, le droit à la déduction pour amortissement sur le coût total des biens, en se prévalant du fait qu'il est le propriétaire unique du matériel après l'acquittement des montants dus aux autres parties et l'expiration de la durée initiale du bail. Le Ministère considère, cependant, qu'aux fins de l'alinéa 20(1)a), le coût en capital du matériel loué pour l'investisseur ne peut inclure aucune fraction du coût à l'égard de laquelle il n'existe aucune possibilité de recours contre lui en cas de manquement à ses obligations. Dans l'exemple ci-dessus, le coût en capital n'inclura pas les 80 pour cent du coût financés par l'intermédiaire des autres parties.

APPENDIX B TO CHAPTER IV

INCOME TAX RULING
DÉCISION EN MATIÈRE D'IMPÔT SUR LE REVENU

No TR-38 DATE PUBLISHED: October 18, 1976

SUBJECT: Investment in a motion picture film

REFERENCE: Paragraph 20(1)(a)

This is in reply to your request for an advance income tax ruling on behalf of Mr. *Z*

Proposed transaction

Our understanding of the relevant facts is as follows:

1. Mr. *Z* proposed to purchase not less that 20% of all right, title and interest in and to the copyright protecting its use in Canada and 10% of all right, title and interest in and to the master negative of a film provisionally entitled the "Film" to be produced in 1975 by B.C. Inc. or a wholly owned subsidiary of that company. The company producing the Film and selling an interest therein to Mr. *Z* is hereinafter called the "Vendor".

2. Mr. *Z* will make a written offer to purchase from the Vendor an undivided 10% interest in the Film as stated in paragraph 1 above.

3. The purchase price for the 10% interest will be used by the Vendor to finance to the extent of 10% the production of the Film, which will have an estimated cost of $800,000.

4. The purchase price of the said 10% interest will be approximately $80,000 to be paid by means of a cash down-payment of not less than $20,000 and the balance of price by the delivery of a promissory note in an amount not exceeding $60,000 payable on December 31, 1979. The promissory note will bear interest at the rate of 8% per annum on the amount thereof from time to time outstanding from the date of its acceptance by the Vendor to the date of payment in full. The balance of the purchase price may be prepaid, in whole or in part, without penalty. The promissory note will be fully negotiable and the obligation of Mr. *Z* to pay the balance outstanding thereon will be unconditional and personal.

No TR-38 DATE DE PUBLICATION: le 18 octobre 1976

OBJET: Investissement dans un film cinématographique

RENVOI: Alinéa 20(1)a)

La présente fait suite à votre demande de décision anticipée en matière d'impôt sur le revenu à l'égard de M. *Z*

Transaction projetée

Voici notre interprétation des faits pertinents:

1. M. *Z* se propose d'acheter, à l'égard d'un film provisoirement intitulé le "film" et devant être produit en 1975 par B.C. Inc. ou une filiale à cent pour cent de cette corporation, non moins de 20% de tout droit, titre et participation reliés aux droits d'auteur qui protègent l'utilisation de ce film au Canada, et de 10% de tout droit, titre et participation reliés à la copie originale du film. La compagnie qui doit produire le film et vendre à M. *Z* une participation dans celui-ci sera désignée ci-après comme le "vendeur".

2. M. *Z* adressera au vendeur une offre d'achat écrite en vue d'acquérir une participation indivise de 10% dans le film, tel qu'énoncé au numéro 1 ci-dessus.

3. Le prix d'achat de ladite participation de 10% sera utilisé par le vendeur pour financer jusqu'à 10% la production du film, dont le coût prévu est de $800,000.

4. Le prix d'achat de ladite participation de 10% sera d'environ $80,000. Il devra être payé à raison d'un acompte d'au moins $20,000 et, pour le reste, d'un billet à ordre de $60,000 au plus, payable le 31 décembre 1979; ce billet produira un intérêt annuel de 8%, lequel sera exigible de temps à autre depuis la date où le vendeur aura accepté ces conditions jusqu'à la date où le montant en question aura été entièrement réglé. Le reste du prix d'achat peut être payé d'avance, en totalité ou en partie; aucune pénalité ne sera alors imposée. Le billet à ordre sera entièrement négociable, et l'obligation qu'aura M. *Z* d'en payer le solde sera inconditionnelle et personnelle.

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PUBLIÉ AVEC L'AUTORISATION DU SOUS-MINISTRE DU REVENU NATIONAL POUR L'IMPÔT

5. The written offer to purchase (referred to hereafter as the "Agreement") will contain inter alia the following terms and conditions:

(a) The master negative of the FIlm will remain in possession of the Vendor as security for the balance of the price and other obligations set forth in the Agreement but it shall be made available to authorized distributors at all reasonable times for the purpose of making prints.

(b) Should Mr. *Z* default on any obligations set forth in the Agreement and should such default continue for a period of 15 days after the Vendor gives him written notice by registered mail thereof, then the Vendor shall have the right to set aside the Agreement by a further notice to Mr. *Z* by registered mail and to obtain immediate repossession of all his right, title and interest in and to the Film. The Vendor shall also have the right to retain all payments then made pursuant to the provisions of the Agreement as liquidated damages, without prejudice to whatever rights he may have against Mr. *Z* under the Agreement and/or under the promissory note referred to in paragraph (4) of this letter, provided, however, that nothing contained in this clause shall limit or in any way restrict Mr. *Z's* right to set up such defences (including compensation) as may be available to him. Termination of the Agreement as aforesaid shall not carry with it the termination of any distribution agreement but the Vendor shall be automatically subrogated in Mr. *Z's* rights (if any) thereunder and the same will remain in full force and effect.

(c) Mr. *Z* shall be entitled to receive not less than 7% of net film rentals received from the date of the Vendor's acceptance of the offer, until such time as he shall have received the sum of $80,000; thereafter he shall receive not less than 3½% of net film rentals from the Film; for the purposes of this clause, "net film rentals" means the net amount returned to the Vendor or to a disbursing agent acting on behalf of all investors by distributors of the Film.

(d) Until such time as the balance of price shall have been paid in full by Mr. *Z*, he assigns and transfers to the Vendor all his right, title and interest in and to all amounts to which he is entitled pursuant to paragraph (c) above. In the event the balance of price has not been paid in full through the foregoing assignment, or otherwise prepaid by Mr. *Z*, then the amount remaining unpaid thereof shall be paid in full on December 31, 1979.

(e) A clause whereby the Vendor represents and warrants that the Film does or will qualify under the provisions of paragraph 1104(2)(h) of the "Income Tax Regulations" as a "certified feature film".

6. The funds paid by Mr. *Z* as aforesaid will not be expended in the production of the Film until at least $600,000 has been received by or unconditionally committed to the Vendor for such production costs.

5. L'offre d'achat écrite (désignée ci-après comme la "convention") comprendra notamment les conditions suivantes:

a) La copie originale du film restera en la possession du vendeur en guise de garantie pour la fraction exigible du prix d'achat et des autres obligations précisées par la convention, mais elle sera mise à la disposition des distributeurs autorisés en tout temps raisonnable pour permettre à ceux-ci d'en faire des contre-types.

b) Si M. *Z* manque à l'une quelconque des obligations énoncées dans la convention et si cet état de choses persiste 15 jours après que le vendeur a envoyé à M. *Z* un avis par la poste recommandée, le vendeur aura le droit d'annuler la convention, en envoyant à M. *Z* un nouvel avis à cet effet par la poste recommandée, et de reprendre immédiatement possession de tout droit, titre et participation reliés au film. Le vendeur aura également le droit de conserver à titre de dommages-intérêts toutes les sommes versées aux termes de la convention et ce, sans qu'atteinte ne soit portée aux droits qu'il pourrait avoir vis-à-vis M. *Z* en vertu de la convention et (ou) du billet à ordre dont il est question au numéro 4 des présentes, à condition toutefois que rien dans cette disposition ne limite ou ne restreigne d'une façon quelconque le droit de M. *Z* de recourir aux moyens de défense (y comprise des dédommagements) auxquels il a accès. L'annulation de la convention comme il est dit ci-dessus n'entrainera pas la résiliation de toute convention de distribution qui aurait pu être conclue mais, plutôt, les droits de M. *Z*, s'il en est, seront immédiatement transférés au vendeur aux termes de cette convention, laquelle restera pleinement en vigueur.

c) M. *Z* aura droit à non moins de 7% des redevances nettes reçues pour la location du film depuis la date à laquelle le vendeur aura accepté l'offre d'achat jusqu'à la date à laquelle celui-ci aura reçu la somme de $80,000, après quoi M. *Z* ne recevra pas moins de 3½% des redevances nettes perçues pour la location du film; aux fins de cette disposition, "redevances nettes pour la location du film" désigne la somme nette qui est remise par les distributeurs du film au vendeur ou à un agent payeur agissant pour le compte de tous les investisseurs.

d) Tant que M. *Z* n'aura pas entièrement réglé ce qu'il doit, il attribue et transfère au vendeur tous ses droits, titres et participations reliés aux montants qui lui reviennent d'après le numéro 5 c) ci-dessus. Si le prix n'est pas payé entièrement par le biais de cette cession et s'il n'est pas non plus payé d'avance d'une façon quelconque par M. *Z*, le solde exigible doit être réglé en entier le 31 décembre 1979.

e) Une dispoistion établissant que le vendeur déclare et certifie que le film constitue ou constituera un "long métrage portant visa" en vertu de l'alinéa 1104(2)h) des Règlements de l'impôt sur le revenu.

6. Les sommes payées par M. *Z* comme il est dit plus haut ne seront pas affectées à la production du film tant qu'au moins $600,000 n'auront pas été versés ou promis inconditionnellement au vendeur en vue de couvrir ces frais de production.

7. The Film will be distributed in Canada by AMN Films Ltd., a Canadian corporation, under a standard distribution agreement between that company and the Vendor.

8. B.C. Inc. is a Canadian corporation incorporated under the laws of Quebec, whose principal object is to produce motion pictures, television series and other theatrical and non-theatrical productions. The company is a subsidiary of RST Ltd., a public Canadian company listed on the Montreal Stock Exchange. RST Ltd., through its various subsidiaries, has previously been involved in a number of feature motion films and has been carrying on business in the industry for many years.

9. We understand that Mr. *Z* will include in his income amounts that represent the share of net film rentals to which he is entitled. For greater certainty, these amounts are those to which reference is made in subparagraph 5(c) of this letter.

Ruling given

Provided that our understanding of the facts as summarized hereinabove is correct and all the relevant aspects of the transaction are carried out in the manner described by you, we donfirm that Mr. *Z* will, upon execution and acceptance of the offer to purchase and completion of the Film, acquire in a motion picture film an undivided interest the cost of which will, on the basis of a cash payment of $20,000 and a promissory note of $60,000 under the terms and conditions outlined above, be $80,000. We are not in a position to confirm whether the Film will be an asset described in Class 12 or Class 18 as set out in Schedule B of the Income Tax Regulations. This is a question of fact that will depend upon whether or not the Film will be a "certified feature film" under the provisions of subparagraph 1104(2)(h) of the Regulations. The date of completion of the Film is also a question of fact upon which we are not able to express an opinion.

This ruling is given subject to the general limitations and qualifications set forth in Information Circular 70–6 dated September 14, 1970, issued by the Department of National Revenue, Taxation, and is binding provided the Agreement is entered into by

Income Tax Rulings are published for the general information of taxpayers but are considered to be binding on the Department only in respect of the taxpayer to whom the ruling was given.

7. Le film sera distribué au Canada par AMN Films Ltée, une corporation canadienne, aux termes d'une convention ordinaire de distribution conclue entre cette corporation et le vendeur.

8. B.C. Inc. est une corporation canadienne qui a été constituée conformément aux lois du Québec et dont l'objectif principal est de produire des films cinématographiques, des émissions télévisées en série et d'autres représentations théâtrales ou non théâtrales. Cette corporation est une filiale de RST Ltée, une corporation publique canadienne inscrite à la bourse de Montréal. Par l'intermédiaire de ses diverses filiales, RST Ltée s'est déjà engagée à l'égard d'un certain nombre de longs métrages cinématographiques et elle fait affaire dans ce domaine depuis de nombreuses années.

9. Nous croyons savoir que M. *Z* inclura dans son revenu des montants représentant la part qui lui revient des redevances nettes pour la location du film. Nous précisions qu'il s'agit des montants mentionnés au numéro 5c) des présentes.

Décision rendue

Si notre interprétation des faits exposés ci-dessus est exacte et que tous les éléments de la transaction soient exécutés de la façon décrite, nous confirmons que suite à l'acceptation de l'offre d'achat, de l'achat et de la réalisation du film, M. *Z* acquerra dans un film cinématographique une participation indivise dont le coût sera de $80,000, dont $20,000 exigibles sous forme d'acompte et $60,000 sous forme de billet à ordre, conformément aux conditions énoncées ci-dessus. Nous ne pouvons confirmer si le film sera un bien de la catégorie 12 ou 18 selon l'annexe B des Règlements de l'impôt sur le revenu. Il s'agit ici d'une question de fait qui sera tranchée selon que le film constituera ou non un "lon métrage portant visa" en vertu du sous-alinéa 1104(2)h) des Règlements. Quant à la date à laquelle le film sera achevé, cela est également un point de fait sur lequel nous ne sommes pas en mesure de nous prononcer.

Cette décision est rendue sous réserve des restrictions et conditions générales énoncées dans la Circulaire d'information 70–6 du 14 septembre 1970 publiée par le ministère du Revenu national, Impôt, et elle s'applique pourvu que la convention soit conclue au plus tard le

Les décisions en matière d'impôt sur le revenu sont publiées pour l'information des contribuables, mais elles n'obligent le Ministère qu'à l'égard du contribuable visé par la décision rendue.

APPENDIX C TO CHAPTER IV

WAYNE F. CURRIE v. THE MINISTER OF NATIONAL REVENUE

Wayne F. Currie (Appellant) v. The Minister of National Revenue (Respondent).

Tax Review Board, February 19, 1975. (Received from the Board, April 2, 1975.)

Deductions—Sham purchase of asset to claim depreciation—Artificial reduction of income—Income Tax Act, S.C. 1970-71-72, c. 63, s. 245.

The appellant taxpayer was a financial adviser and consultant living in Toronto. On November 30, 1972 he purported to buy from a company incorporated in England, a videotape of a motion picture entitled "An Introduction to Dissection", which was only one of a series of six photoplays entitled "Biology", produced by the English company. Of the total purchase price of $10,000 the taxpayer paid only $2,500. The balance was to be paid by applying half the amount due to the taxpayer under the terms of a distribution agreement signed on the same day by which the taxpayer purported to give to the English company the exclusive right to distribute throughout the world all prints, adaptations and derivations of the videotape. Any remaining balance was to be paid by November 30, 1979. The taxpayer never took possession of the tape. This asset, being of Class 12, Schedule B, was depreciable at a rate of 100%. The taxpayer, therefore, claimed a deduction of $10,000 for the 1972 taxation year. The Minister disallowed the deduction on the basis that the videotape was not acquired as an investment for the purpose of gaining or producing income and that the transaction was a sham prohibited by section 245 of the Act. The taxpayer appealed, arguing that he was the owner of the tape in 1972 and that it was an arm's length transaction carried out in a business manner. He admitted that although the tax implications played a certain role in the transaction, he also intended to earn income therefrom. The promissory note which he had signed in the amount of $7,500 showed his commitment to pay the balance of the purchase price.

Held: The appeal was dismissed. The taxpayer was not entitled to the deduction. The transaction was not a *bona fide* purchase for the purpose of claiming a deduction with respect to capital cost allowance. In 1972 the taxpayer was not in any business connected with videotapes, nor did he have possession of the tape. The promissory note had no date of payment, only the year 1979. A taxpayer could so arrange his affairs in order to pay less tax as long as it was legal and not too artificially done. However, the possibility of earning income out of this transaction was so remote that no serious businessman would have contemplated it unless it was to use it as a tax shelter to unduly or artificially reduce his income.

D. C. Nathanson for the appellant; N. Helfield for the respondent.

Before: Roland St-Onge, Q.C.

ROLAND ST-ONGE, Q.C.: This is an appeal from a reassessment dated June 26, 1973, wherein a tax was levied in respect of the 1972 taxation year.

On November 30, 1972, the appellant, a financial adviser and consultant in Toronto, signed as purchaser a document with Seabourne Enterprises Limited, a company incorporated under the laws of England, in order to acquire one videotape recorded motion picture photoplay entitled "An Introduction to Dissection", which videotape was one of a series of six videotape recorded motion picture photoplays entitled "Biology", produced by Seabourne. The total purchase price was $10,000 but the appellant paid only $2,500 in 1972 and the balance was to be paid later.

This asset, being of Class 12, Schedule B, was depreciable at a rate of 100%. So, when the appellant prepared his income tax return for the 1972 taxation year, he claimed therein a deduction of $10,000.

The balance of the purchase price was to be paid as follows:

> the balance remaining of $7,500 of the purchase price by application thereto of one-half (½) of the moneys which the Appellant was entitled to receive on account of net revenues from the distribution of the videotape pursuant to a distribution agreement (described below) and by the payment in any event on the 30th day of November, 1979, of the portion, if any, of the purchase price then remaining unpaid.

By agreement made the same day between the same parties, the appellant as owner granted to Seabourne the exclusive right to distribute to exhibitors for exhibition throughout the world prints and all adaptations and derivations thereof of the videotape on, *inter alia*, the following terms:

(a) The term of the exclusive right to distribute the videotape to be fifteen (15) years from the 30th day of November, 1972, with an automatic renewal of the said term for a further period of fifteen (15) years in the absence of either party to the distribution agreement delivering notice to the other of its intention to terminate the arrangement;

(b) Seabourne as Distributor to devote its best efforts to the proper marketing and distribution of the videotape so as to maximize gross returns;

(c) Seabourne as Distributor to obtain a certificate or certificates of cultural or educational value from appropriate authorities in England regarding the videotape;

(d) Seabourne as Distributor to insure the videotape adequately and to note the interest of the Appellant on any insurance policy in that regard;

(e) Seabourne as Distributor to be entitled to be reimbursed for distribution expenses incurred by it out of gross receipts derived from the distribution of the videotape;

(f) Until $10,000 has been paid to the appellant and Seabourne under the distribution agreement, the appellant to pay to Seabourne 10% of net revenues (gross receipts minus certain distribution costs) derived from distribution of the videotape;

(g) The appellant irrevocably directed Seabourne to pay on its behalf one-half (½) of the moneys required to be paid to the appellant under the distribution agreement to Seabourne until the sum of $7,500 has been paid to Seabourne on account of the purchase price of the videotape;

(h) After $10,000 has been distributed to the appellant and Seabourne under the distribution agreement, the distribution fee payable to Seabourne to be 50% of the net revenues derived from distribution of the videotape.

The Minister disallowed the deduction on the basis that the videotape was not acquired as an investment for the purpose of gaining or producing income and that the transaction was a sham prohibited under section 245 of the *Income Tax Act*.

The appellant testified that before acquiring the videotape he had made some research on Seabourne Enterprises Limited to discover that Mr. John Seabourne was an honest, reputable individual and that his company was in good financial standing. He also stated that he was not in the business of buying, selling or distributing videotapes or in any allied business; that he never entered into possession of the said videotape; that in buying the tape the income tax implication played a certain role and that his intention in buying the said tape was also to earn income therefrom. He filed a Promissory Note (Exhibit A-4) in the amount of $7,500 to show his commitment to pay the balance of the purchase price. This exhibit mentions no date but only the year 1979 for the payment of the said sum or such earlier date for the payment of two-thirds thereof to be paid to the purchaser pursuant to the Agreement between the vendor and the purchaser dated November 30, 1972, already mentioned.

He also filed a document to show that he was the owner of the tape in 1972 and that the said tape was insured for a substantial sum of money.

Counsel for the appellant argued that the appellant's purpose in buying the tape was to earn income and that the said purchase was not a sham because the agreement is still in force; that there was no attempt whatsoever to disguise the nature of the contract or to deceive the Minister of National Revenue; that the appellant had executed a Promissory Note for the balance of the purchase price; that it was an arm's length transaction carried out in a business manner and that in 1972 the appellant was the owner of the tape notwithstanding the fact that he had left the possession of it to the seller. In short, he stated that the Board should look at the contract, the appellant's course of conduct and his intention.

Counsel for the respondent argued that the transaction under discussion was not a *bona fide* purchase and referred the Board among other cases to an American decision in *Marvin M. and Lorraine May v. Commissioner*, T.C. Memo. 1972-70 . . . Dec. 31, 309(M).

In that case a taxpayer

> entered into an arrangement in which he purported to purchase 13 television film episodes for an alleged price of $365,000. His out-of-pocket costs were $35,000 and it was never intended that he pay any more, notwithstanding that he was theoretically obligated to pay the entire purchase price. He attempted to take depreciation deductions aggregating $365,000 over a two-year period. *Held*, in the circumstances of this case, this was not a *bona fide* purchase, and taxpayer was not entitled to the claimed deductions.

In 1972 the appellant was not in possession of the videotape and was not in the business of buying, selling or distributing videotapes or in any business connected therewith. Moreover, the possibility of earning income out of this transaction was so remote that no serious business man would have entered into such a transaction unless it was to use it as a tax shelter to unduly or artificially reduce his income.

A taxpayer is allowed to arrange his affairs to pay less taxes as long as it is legal and not too artificially done.

In the circumstances of this appeal the transaction under discussion is not a *bona fide* purchase for the purpose of claiming a deduction with respect to capital cost allowance.

Consequently the appeal is dismissed.

CHAPTER V

MOTION PICTURE INVESTMENT - A CASE STUDY

1. INTRODUCTION

Chapter V examines in detail an actual motion picture investment in education health video tape and film programs. These programs were produced by Edu-Film Productions Ltd.,[1] a Canadian producer-distributor of education audio-visual programs specializing in health topics. The programs were marketed under the collective title of THE WORLD OF HEALTH. The theme and format of Edu-Film's product will be explained as well as the marketing background. The financial and contractual arrangements between the production-distribution company and the private investors will be explained.

Edu-Film Productions Ltd. was chosen as a case study for five reasons:

1. The writer is employed by the company. The information concerning the company operations was accessible albeit in this paper some details are changed to comply with a request for anonymity from the principals of Edu-Film Productions Ltd.
2. The characteristics of the investment and the investors were suitable to explain and demonstrate some of the points arising from the analysis of the tax court cases and the Department of National Revenue, Taxation's interpretation of the <u>Income Tax Act and Regulations</u>.
3. The company had experience in complete product development

from conception through financing, production and marketing.

4. One of the company's investors experienced an income tax reassessment which the investor appealed. This was brought to a successful conclusion in favour of the investor although the file at the tax department is still considered open. This chapter and the succeeding chapter on the reassessment experience, will demonstrate the many arguments which National Revenue, Taxation's auditors can use to attack a tax shelter investment, even if the tax department auditor's accept the commercial reality of the investment.

5. A final reason for including a case study was to impart upon the reader a further background in the mechanics of leveraged motion picture investment. This background will be important in understanding the motion picture investment model and the quantitative analysis of motion picture investment undertaken in Chapter VII.

2. FINANCIAL FEASIBILITY STUDY

In 1973 Edu-Film Productions Ltd. recognized that there was a need for short educational films on popular health topics such as stress, physical fitness, weight control and nutrition. There was a lack of such up-to-date audio-visual material and the topics were becoming of increasing concern to the medical profession and general public alike. The concept of audio-visual health programs is explained in Edu-Film's brochure introduction quoted below:

THE WORLD OF HEALTH

In recent years man's awareness and comprehension of his world has expanded in two major directions: outwards, to grasp the concept of "Spaceship Earth", and inwards, to focus on his own body - his personal "capsule" - equipped with infinitely complex life support systems, in which he travels through time and space.

Man's pre-occupation with his body and its functions is not new; but his fuller understanding had been blocked for centuries by a mystique that grew up around the knowledge and practice of medicine. Only recently have sweeping changes in attitude and in the techniques of communication started to unlock the door to these secrets of life.

As a result, public demand for medical knowledge has become almost insatiable. This trend - and its potential as a marketing vehicle - is evident in all the communications media.

Curiosity alone does not generate this quest for knowledge. Man's concern for health of his total biosphere duplicates his concern for a healthier life style.

"THE WORLD OF HEALTH" is a series of 10-12 minute filmed programs dealing with the most common and most intriguing aspects of physical and mental health. Each program seeks to accomplish three objectives:

1. To entertain by presenting factual material in a visually fascinating way: through the use of animation; by taking the viewer on an actual voyage of exploration through the body and its organs; by entering into microscopic worlds that reveal the awesome beauty and complexity of the body we inhabit and the micro-organisms that, in turn, inhabit our body.

2. To inform by incorporating the latest medical research available - approved by top experts in each field - and by presenting this material in a manner than can be understood easily by a lay audience.

3. To promote a healthier life style. This is the missing ingredient in many medically-orientated presentations, whatever the medium. These programs will present not only information but practical advice on how to apply that information to achieve a healthier life style. This is an important new dimension in medical communications. It reflects the growing interest in the role each individual can play in preventive medicine - an interest expressed at all levels of the medical world, from governments to private practitioners.[2]

Edu-Film undertook a four month feasibility study which identified the need, the potential markets and the production resources which were available to fill that need. The study indicated that programs costing an average of $25,000 to produce could more than recoup their costs in three major markets over a period of about three to five years. The three markets in North America were:

1. Educational: schools, colleges, universities;
2. Medical: physicians' offices, health clinics and hospitals;
3. Television: education and commercial.

In Appendix A to Chapter V are two letters from international educational/medical film distributors. The letters indicate the distributors' response to Edu-Film's first program, BIRTH CONTROL: FIVE EFFECTIVE METHODS. The letters include an estimate of sales for the program. Edu-Film based its financial feasibility study, in part, on these sales estimates made by the distributors.

The following is another excerpt from Edu-Film's promotional literature. The excerpt explains the three markets and review Edu-Film's progress in penetrating these markets through sub-distributors and sales agents.

EDUCATIONAL MARKET

The first of these markets has been long established. It includes schools, universities, colleges, training hospitals, community organizations etc. The requirements for successful educational programs are well defined and Edu-Film's programs are designed to filfill these requirements to ensure their widespread use. The selection of topics has been based on feedback from both end-users and distributors in the United States and Canada. It is expected that this market will be a major source of revenue as the response from these education distributors has been most encouraging.

MEDICAL MARKET

The second market is physicians' and surgeons' offices and health clinics throughout North America. The largest distributor in this market is Medical Distributors, Inc., a Los Angeles company incorporated six years ago. Presently they have over 5,000 doctors subscribing to their programs. The recent expansion of their sales force and the endorsement of patient education programs by the American and Canadian Medical Associations has resulted in a substantial increase in the number of users. The potential is staggering, as the number of medical doctors in North America exceeds 300,000. Ultimately a large percentage of this number will be serviced by a private cablevision network to individual medical practitioners' offices.

TELEVISION MARKET

Edu-Film's third area of distribution is the entertainment television market. CXYZ television, acting as our television sales agents have made considerable progress in this market. CXYZ produced a video-tape presentation with The Common Cold film demonstrating how it could be expanded into an entertaining yet informative half-hour program with each local station providing the 15 minute wrap-around. This demonstration program was displayed by Four Star Entertainment Corporation, one of the foremost independent television program distributors, at the National Association of Television Program Executives Convention in Los Angeles during February, 1974. The reception was enthusiastic and the health programs series will be syndicated in 1975.[3]

3. PRODUCTION FINANCING

Edu-Film proposed to raise its production financing from the private investment community. An investor would be offered undivided ownership in an audio-visual educational health program. The program would have a capital cost to the investor of $50,000. The investor-owner would pay in cash $25,000 and sign a seven year, full recourse, 5% interest bearing promissory note for $25,000.

The program's capital cost would be eligible for capital cost allowance because it would be a property purchased to gain or produce income. Edu-Film was producing its education health programs on both motion picture film and video tape depending upon the technicalities of production.[4] If the program was a film, the capital cost to the investor of $50,000 would be eligible for 60% c.c.a. on a diminishing balance basis according to the income tax regulations in effect at the time

(1974). If the program was to be produced as a video tape its capital cost of $50,000 would be eligible for a 100% c.c.a.

The inducement to invest was enhanced by the use of 2:1 leverage facilitated through the promissory note. The low leverage ratio was regarded as very conservative vis-a-vis other film investment packages being offered but was less likely to be questioned by the tax department. The low leverage offered an immediate tax advantage but did not expose the investor to an excess liability for which he may have been called upon to settle in the future if the program failed to earn sufficient income to satisfy the note. Edu-Film emphasized the commerciality of the programs and their potential to earn income - not the tax shelter aspect - although all requirements to make the investment a tax shelter were satisfied. No investment was accepted by Edu-film unless the investor had consulted his lawyer and/or accountant and/or financial advisors and the investment met with their approval.

> Ownership in educational film or video tape programs involves complex legal and accounting principles, therefore any person contemplating such an investment is urged to seek competent legal and financial advice.[5]

Table VI-I outlines the Edu-Film video tape program production budget components. The table also shows the structure of the investor purchase payments.

4. INVESTMENT DOCUMENTS

There were three separate documents exchanged between the investor and producer. The first was a production-purchase contract which facilitated the purchase of the investment and advancement of funds by the investor as the production work progressed. The producer in effect was contracting to produce a film or video tape for the investor-owner.

TABLE V-I

Edu-Film Video Tape Program Production and Purchase Costs

Production Costs:

Procuration:		10%	$2,500
Production:	Research and scripting;	15%	3,750
	Preproduction and animation, etc;	30%	7,500
	Principal photography and sound tract	25%	6,250
	Editing, laboratory, etc.	10%	2,500
Overhead:		10%	2,500
Total: Production costs:		100%	$25,000

Purchase Cost:

Cash Down payments:		
	Procuration;	$8,333
	Principal photography;	8,333
	Answer print;	8,334
Sub-total: cash down:		$25,000
Seven year promissory note:		$25,000
Total: Purchase price:		$50,000

Source:

Edu-Film Productions Ltd., Investment Prospectus, The World of Health (1974), p.5.

This contract emphasized that the work had to follow a pre-arranged schedule and to meet acceptable standards of motion picture production. The contract vested complete ownership of the program to the investor-owner in all rights and title to the program including copyright and distribution rights. Two pertinent clauses from the Production-Purchase Contract were:

> The vendor desires to sell and the purchaser desires to purchase the program on the execution date and upon the terms and conditions hereinafter contained.
>
> The term "Program" as used herein shall be deemed to include all written material produced in the research stage, all scripts, all material related to preproduction, production and post-production, the original video-tapes and film negatives, together with all copyrights attached thereto.[6]

Upon completion of the project and final acceptance by the investor-owner, the seven year, full recourse, 5% interest bearing promissory note was signed. The note was for $25,000, the balance of the full $50,000 purchase price. The promissory note read as follows:

> FOR VALUE RECEIVED, (hereinafter called the "Purchaser") hereby acknowledges himself indebted and promises to pay Edu-Film Productions Ltd. (hereinafter called the "Vendor") on , 19 , upon presentation and surrender of this Promissory Note the sum of TWENTY-FIVE THOUSAND DOLLARS ($25,000.00) in lawful money of Canada together with interest at the rate of five percent (5%) per annum calculated on the balance of the principal sum outstanding on the 31st day of December in each year and payable at the principal office of the Vendor in , or at such other place as the Vendor designates in writing provided that the Purchaser may make any payments on the principal of this Note at any time without notice or bonus.
>
> DATED the day of 197 .[7]

The third document was a contract which appointed Edu-Film Productions Ltd. as the distributors of the program for a period of fifteen years. The terms of the contract gave Edu-Film full control over distribution subject to ratification of any sub-distribution contracts by the program investor-owner, limitations on expenses and a best efforts clause. The first clause in the Distribution Contract read:

> The Owner hereby grants to the Distributor subject to the terms and conditions herein set forth and for the term herein provided, and the Distributor hereby accepts, the sole and exclusive right and licence to sell, rent, licence, lease, distribute and otherwise exploit to exhibitors for exhibition throughout the world (hereinafter called the "Territory") prints, video-tape copies, video disk copies or any other adaptation or derivations thereof (hereinafter collectively called "copies") of the video-tape program entitled... .[8]

A. Transfer of Title and Ownership

Steps were taken to avoid the pitfalls that may have exposed the investment and its capital cost allowance deduction to attack from National Revenue, Taxation.

Tax advisors often ask the question, when does a motion picture actually become an asset eligible for c.c.a.? When depreciation starts for tax purposes is a highly technical question. Since production of even a short documentary health program can take as long as a year to complete, it was important, to the investor-owner's tax position, that the asset be eligible for c.c.a. in the first year of the investment. If the program is not considered a completed asset eligible for the full c.c.a. in the first year, the c.c.a. may have to be prorated and limited to the number of days the asset had been in production. Another possibility is that only the cash committed by the investor-owner at year end may be considered eligible for c.c.a. A third possibility is that no c.c.a. be deducted from the investor-owner's taxable income until the program is actually completed and has been delivered to the investor-owner. This delivery may not take place until after year-end if the project was started late in the year.

The high risk of motion picture investment and the fickle nature of investors (taxpayers) has caused many investors to delay committing themselves until very late in their tax year (often mid-December). The taxpayers suddenly realize they are going to be liable for a large amount of income tax unless they do some very fast tax planning. The year-end rush into investments of this kind often precludes a careful examination of the business sense and economics of the various projects due to the "pressure cooker" atmosphere to find a tax shelter.[9] This practice of year-end investment has been questioned in all appeal cases before the tax review board and the courts, but has not yet been directly attacked. The tax department's lawyers felt they could disallow the c.c.a. claim on alternative grounds.

The completion date of the program had to occur prior to the taxpayer's year-end (December 31st) to qualify the investment for maximum c.c.a. Edu-Film took steps to ensure that there be no question about the completion date. The steps Edu-Film took were:

1. No programs would be offered for sale after September 1st.
2. Production schedules were arranged which ensured that at least "principal photography" was finished before December 31st.

The tax department indicated that if principal photography was completed it was prepared to accept a motion picture as eligible for c.c.a. even though it may not be in marketable form. This was a reasonable position on their part because the bulk of production costs are expended upon completion of principal photography.

The committment of funds must also be unequivocally established prior to year-end in order that the investor-owner be entitled to claim c.c.a. The final production payment was not due from the investor-owner until he had viewed and approved the completed program in marketable form.

If the program was not going to be in marketable form until after December 31st, Edu-Film arranged for an escrow holder to hold the balance of the production monies in trust. The promissory note was also signed prior to year-end and held in escrow. The following are relevant clauses from the Escrow Agreement between the vendor and the purchaser. Clause 1 of that agreement reads:

> The expression "the date of completion" and "the time of delivery" wherever they appear in the Purchase Agreement shall mean and be deemed to mean the date of completion of principal photography of the program (hereinafter called the "Completion Date"). [10]

Clause 6 reads:

> The Purchaser shall deliver to the Escrow Holder on the Completion Date the said certified cheque in favour of the Vendor in the amount of Eight Thousand Three Hundred and Thirty-Four ($8,334.00) Dollars and the said Promissory Note in favour of the Vendor in the amount of Twenty-Five Thousand ($25,000.00) Dollars and the Escrow Holder shall hold the same in escrow and undeliverd and shall deliver same upon the following conditions: [11]

The performance required by these clauses was considered sufficient to establish that the investor's funds were committed or "at risk".

The actual moment of transfer of ownership of the program was very important and measures were taken to ensure that there could be no doubt as to when this transfer had occurred. The production-purchase contracts were worded so that the ownership was considered transferred upon execution of the documents. The various production payments were considered conditional installments.

> The Purchaser hereby purchases and the Vendor hereby sells, assigns and transfers to the Purchaser all rights, title and interest in and to the Program and all such copy-rights involved therein as and from the date of execution thereof.[12]

The productions were insured for their full value at the outset and the proceeds were payable to the investor-owners not the producer.

During the production the investor-owners received up-to-date reports on the production of their program including a cost accounting of funds spent. The investor-owners backed up their claim for c.c.a. by submission of the budget reports with their income tax returns.

It was important that the investor-owner be considered in control and acting like an owner and not merely a financier. The advancement of funds upon approval by the investor-owner of the various production stages was emphasized. The production-purchase contract contained the following provision:

> PROVIDED HOWEVER the sums provided in subparagraph (b) and (c) shall only be payable to the Vendor if the Purchaser is satisfied that sums expended to the date of such payments by the Vendor have been expended in an appropriate manner towards the completion of the Program and the Purchaser is satisfied with the quality of the material produced to the date of each such payment.[13]

The distribution contract further emphasized the investor-owner's control. Although the distribution contract was with the producer, the owner had the right to terminate the agreement if specific conditions were not fulfilled.

Physical delivery of the motion picture asset to the investor-owner was a point raised in some of the previous tax reassessment cases. Therefore once Edu-Film had completed the motion picture program it was physically delivered to the investor-owner and the delivery of the program was duly notarized in order to further emphasize the transfer of ownership.

Upon completion of the program it was officially registered in the investor-owner's name with the Copyright Office of the federal Department of Consumer Affairs under the Copyright Act of Canada. Establishing copyright of the program in the investor-owner's name protects the program from being unlawfully duplicated and distributed, and "may be the margin of difference in proving title to a motion picture".[14] All copies of the program (film or video tape prints) remained in the owner-investor's name to further emphasize bona fide ownership of the motion picture investment. The distribution contract stated that:

> Title to Copies and parts thereof ordered by the Distributor and any other accessories and materials delivered to the Distributor hereunder shall be and remain in the Owner's name at all times, subject to the right of the Distributor to use such Copies and other materials in accordance with and subject to the terms of this Contract.[15]

5. DISTRIBUTION

A. Accounting Requirements

When the programs were completed and the distribution contract executed, individual accounting records and bank accounts were set up for each investor-owner and his program. The distributor was merely acting in the capacity of an agent. Gross sales, expenses and net revenue were entered in the appropriate subledgers for each program in the investor-owner's name as per the distribution agreement:

> The Distributor agrees that it will keep and maintain in the name of the owner full and accurate books of accounts and records with reference to the Program and Copies licenced hereunder, which books of account and records shall show

> readily the Gross Receipts of the said Copies together with all deductions applicable thereto...[16]

The necessary accounts and ledgers are listed in Table V-II.

TABLE V-II

Accounts and Ledgers Maintained for Each Video Tape Program

1. Bank Account
2. Gross Sales Subledger
3. Direct Distribution Expenses Subledger
4. Indirect Distribution Expenses Subledger
5. Net Sales Subledger
6. 5% Distribution Fee Subledger
7. Owner's Revenue Subledger
8. Promissory Note Subledger

Source:

Edu-Film Productions Ltd., accounting records.

Gross sales of copies of the education video tapes were subject to a distribution fee by Edu-Film's distributors. The distribution fee ranged between 10% and 75% depending on the market the program copy was sold in. Edu-Film deducted certain expenses to which it was entitled from the amount received from the distributors. The balance, the net revenue, was then credited to the investor-owner's trust account. From this sum was paid the following:

1. 5% distribution agents fee to Edu-Film;
2. 40% promissory note payments;
3. 5% interest due on promissory note, if any;
4. Balance to the investor-owner

The revenue flow schematic and subledgers are shown in Table V-III.

Subledgers were set up to record the various amounts paid and the amounts owing on each investor-owner's promissory note. The multiplicity of subledgers for each film, owner-investor and function was considered necessary to strengthen the owner's claim that he was, in fact, an "owner with respect to his entire interest in both capital and profits".[17] The separation of accounting was also necessary to demonstrate that the individual investor-owners were not merely partaking in a partnership or joint venture either among themselves or with the producer cum distributor. In addition, there was the following denial of partnership and joint venture in the distribution contract:

> Nothing herein contained shall be construed as in any way constituting this a partnership between, or a joint venture by, the parties hereto or be construed to evidence the intention of the parties to constitute such a relationship. Neither of the parties shall hold itself out contrary to the terms of this paragraph by advertising or otherwise, nor become liable or bound by a representation, act or omission whatsoever of the other party contrary to the provisions of this paragraph.[18]

A denial of partnership or joint venture in contracts between two parties does not mean that the tax department or the courts will agree that a partnership or joint venture does not in fact exist. The behaviour of the investor-owners and distributor establishes whether a partnership or joint venture exists for tax purposes.

TABLE V-III

Distribution
Revenue Flow Schematic

Gross Sales of Program

To Distributors	Fees & Expenses
Educational:	
U.S.A.	75%
Canada	62%
Medical:	70%
Television:	10%-50%

Edu-Film — Gross Sales - General Ledger

Program Account — Program Gross Sales - Subledger

Direct & Indirect Expenses - Subledgers

Net Revenue — Investor-owner's Trust Account and Subledger

Distribution Agent's Fee - Subledger

Owner's Revenue — Investor-Owner Taxable Income - Subledger

Promissory Note Payable - General Ledger

CHEQUE TO OWNER

Sources:

Edu-Film Productions Ltd., accounting records and Edu-Film Productions Ltd. Investment Prospectus, The World of Health (1974), p.6.

B. Distribution Reports

The investor-owners were entitled to and received a complete report of the distribution of their audio-visual educational health program every three months. The distribution report included all the information as per the subledgers as well as important information concerning the sales campaign in each of the three major markets. Specific information on major sales, new advertising brochures, program reviews and film festivals was reported. The purpose of issuing a detailed report was twofold: to keep the investor-owner fully informed and to carefully document the distribution efforts to demonstrate a bona fide investment in a property made to gain or produce income.

Summary. This chapter has reviewed a motion picture investment in audio-visual educational health programs. The producer-distributor recognized that there was a need for such programs in North America. Given intensive distribution an investment made in well researched and well produced education health films or video tapes could be a profitable venture. The investor-owner's cash investment was leveraged by the use of a promissory note payable out of program earnings or by the investor-owner in seven years, which ever occurred first.

The chapter also reviews the contractual steps which were taken to ensure that the investor-owner was protected from poor performance by the producer-distributor and that the investor-owner could claim the maximum c.c.a. on his property for income tax purposes. The production-purchase and distribution contracts were quoted to demonstrate how the investment was structured. The contents of the quarterly distribution reports from the distributor to the investor-owner were outlined. Part of a distribution report by Edu-Film to its investor-owner group is included in Appendix B to Chapter V.

FOOTNOTES CHAPTER V

1 Edu-Film Productions Ltd. is not the registered name of the production-distribution company that produced THE WORLD OF HEALTH eduction series. The principals of the actual company requested that the registered name of the company not be used in this thesis.

2 Edu-Film Productions Ltd., Investment Prospectus, The World of Health (1974), p.2.

3 Ibid., pp.3-4.

4 For example, animated audio-visual programs had to be produced on film; live action programs could be shot on film or video tape depending on the previous experience of the director and production crew.

5 Edu-Film Productions Ltd., Investment Prospectus, The World of Health, op.cit., p.1.

6 Edu-Film Productions Ltd., Production-Purchase Contract (1974), p.1.

7 Edu-Film Productions Ltd., Promissory Note (1974).

8 Edu-Film Productions Ltd., Distribution Contract (1974), p.2.

9 "Certified Feature Films Revisited", Tax Bracket, January, 1977 (Thorne Riddell & Co., Chartered Accountants, 1977), p.2.

10 Edu-Film Productions Ltd., Escrow Agreement (1974), p.2.

11 Ibid., p.3.

12 Production-Purchase Contract, op.cit., p.1.

13 Ibid., p.4.

14 Garth H. Drabinsky, Motion Pictures and the Arts in Canada, The Business and the Law (Toronto: McGraw-Hill Ryerson Limited, 1976), p.42.

15 Distribution Contract, op.cit., p.4.

16 Ibid., p.6.

17 Richard M. Wise, "A Cineramic View of Motion Picture Film Investment", Canadian Tax Journal, March, April, 1976 (Canadian Tax Foundation, 1976), p.163.

18 Distribution Contract, op.cit., p.9.

APPENDIX B TO CHAPTER V

PRODUCTIONS LTD.

THE WORLD OF HEALTH

DISTRIBUTION REPORT

4th Quarter - 197

The final quarter of 197 finished strongly for Edu-Film despite the soft educational film market in North America. Gross receipts for THE WORLD OF HEALTH series during the 3 month period from October 1st to December 31st, 197 were half those which were earned in the entire preceding 12 months.* While total sales did not reach this years expectations we are sufficiently encouraged by this final quarter to look toward 197 with optimism.

Previews & Festivals

In the fall, several widely read educational magazines and journals reviewed THE WORLD OF HEALTH series. The reviews appeared in the following magazines and will be a further stimulus to sales.

- Canadian Association for Health, Physical Education and Recreation News
- Lander's Film Reviews (U.S. publication)
- Journal of Nutrition Education (U.S. publication)
- Educational Film Library Association Inc. (U.S. publication)

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* Gross receipts Oct.1 - Dec. 31st 197 : $

Gross receipts Oct.1,197 - Sept.30, 197 : $

The Canadian Dietetic Association Journal reviewed the four nutrition programs and found them "timely...entertaining...credible... and informative". The Nutrition Education Committee concluded its review by stating that these programs "mark a valuable contribution to Canadian Nutrition Education Resources".

STRESS - THE WORLD OF HANS SELYE was entered by the Secretary of State Film Festivals Bureau in the 197 Melbourne Film Festival held in Australia. The film was well received and an article about its festival appearance was published in prominent Australian newspapers.

PHYSICAL FITNESS - THE NEW PERSPECTIVE has been chosen by the Canadian Red Cross Society for entry in the VII International Festival of Red Cross and Health Films to be held in Varna, Bulgaria, June 197 .

The program SNACKING - GARBAGE IN YOUR GUT? won a "Golden Babe" (statuette) award at the Chicago Educational Film Festival. An article about the festival and our creative success is being prepared by the Association for Educational Communications and Technology Journal. (A.E.C.T.)

British Columbia Distribution

Again, Edu-Film's direct distribution efforts generated the most revenue. The B.C. market accounted for over % of the gross revenue earned in the final quarter of 197 . This result was due to the closing of a major video tape sale to the British Columbia Department of Education. Edu-Film entered into a 5 year V.T.R. arrangement with the Provincial Education Media Centre for a total sum of $. This arrangement entitles P.E.M.C. to dub V.T.R. copies of all programs which will be widely circulated throughout B.C. schools, community colleges and universities.

The sale's level the series is currently enjoying in our province is the indication of the trend that will develop when the national distributors have completed initial advertising exposure throughout their larger markets.

Canadian Educational Distribution

Canadian Educational Pictures Ltd. is undertaking an extensive mail out of their promotional literature. They now have four separate sets of information describing the series.

- THE WORLD OF HEALTH (4 page brochure devoted exclusively to the series)
- HEALTH AND CAREER DEVELOPMENT (Breakout from master catalogue for schools)
- HEALTH EDUCATION AND CARE (Breakout from master catalogue for provincial health departments)
- CANADIAN EDUCATIONAL PICTURES LTD. 16mm FILM CATALOGUE

Beginning in September this promotional literature was included in several mass mailings to schools, public health units and hospitals throughout Canada.

American Educational Distribution

American Educational Distributors, Inc. reported total sales of the series has now reached $.

Last month, American Educational completed preparation of study guides to be included with each program. These guides offer suggestions to the teachers as to how they can make optimum use of the programs as an audio-visual teaching aid. The guides include a detailed description of each program's contents and a series of questions to be considered by the student audience.

American Educational is releasing its new catalogue which devotes two full pages to THE WORLD OF HEALTH. The programs are further highlighted by a description of the series in a priority position on the inside front cover of the new American Educational catalogue.

North American Medical Distribution

Medical Distributors Incorporated recently published a brochure that describes THE WORLD OF HEALTH programs. This brochure has been mailed to Medical Distributor's 15,000 subscribers as well as the many potential clients among North America's 350,000 physicians and surgeons.

The first Edu-Film distributed by Medical Distributors, BIRTH CONTROL - FIVE EFFECTIVE METHODS, has sold prints in this market since its release 2 years ago. The gross receipts to the U.S. distributor amounted to $ and have been sufficient to return approximately $ to the owner/investor and in addition reduce his promissory note by $.

Foreign Distribution

Several of the programs were screened at the International Week for Education and Teaching Films, in Antwerp, Belgium and at the Melbourne, Australia Film Festival last summer. To publicize this event Edu-Film contacted over 50 foreign distributors in advance. Enquiries have been received from several European distributors and from one distributor in Japan. It is expected that distribution arrangements will be completed in a number of foreign markets early this year.

STRESS - THE WORLD OF HANS SELYE has now been released in Sweden. The Swedish distributor has placed an order for 10 prints to use in their marketing campaign. A positive review of the film appeared in Dageous Nyheter, the largest Swedish newspaper, coinciding with the release of the Swedish Version.

In Summary

Sales of THE WORLD OF HEALTH series are continuing to build; gross revenues were 41% higher this quarter over the previous quarter, while distribution expenses were 50% lower. It is expected that this trend will continue and that 197 sales forecasts will be met, as the series is being enthusiastically received by those concerned with public health education in North America.

CHAPTER VI

REASSESSMENT OF A CAPITAL COST ALLOWANCE DEDUCTION AND TAXPAYER APPEAL

I. INTRODUCTION

National Revenue, Taxation has reviewed most motion picture investments made in Canada since 1970. A review is initiated by the assessing division of the tax department. If the assessing division can find reason for denying all or part of the c.c.a. deduction, the department notifies the taxpayer. The notification to the taxpayer is either a Notice of Assessment or a Notice of Reassessment. If the assessing division is reviewing the taxpayer's income tax return at the time of filing, the division sends the taxpayer a Notice of Assessment. If the assessing division's review occurs after the original filing, the division issues a Notice of Reassessment. Either notice states the changes that are being made to the taxpayer's income tax return and the reasons for the changes. The taxpayer has ninety days to respond to the tax department's changes. If the taxpayer queries the reassessment, and the matter can not be settled by the assessing division, the taxpayer's file is forwarded to the audit division of the tax department. Few motion picture capital cost claims are settled by the assessing division.

The audit division begins a detailed investigation of the motion picture investment with a field audit of the producer/vendor company. The auditors analyze the contractual arrangements between the production company and the investor-owner of the motion picture. Upon completion of the investigation the audit supervisor decides whether or not the reassessment is valid. If the auditor decides the reassessment is valid the taxpayer can appeal the notice. The taxpayer begins a formal appeal of the reassessment by filing a Notice of Objection, form T400A.

Normally, straight forward tax disputes can often be settled by a clarification of the facts between the taxpayer and the assessor or an appeals officer at the district office level. However, disputes involving capital cost in motion picture investments are usually forwarded to the regional appeals office. The regional appeals office staff is more experienced and maintain closer contact with the appeals branch head office in Ottawa. National Revenue, Taxation recognizes that there is very little precedence in motion picture investment in Canada. The tax department is attempting to establish jurisprudence in motion picture capital cost deductions. In the interests of maintaining uniformity in application and interpretation of the Income Tax Act, the regional appeals office regularly seeks guidence from the head office in motion picture capital cost appeals.

National Revenue, Taxation's official attitude:

> is neutral with respect to the use of films as subjects for tax shelters. The department does object, however, to the setting aside or misrepresentation of provisions of the Income Tax Act and its Regulations in order to obtain unjustified advantages.[1]

Therefore very few motion picture investments escape close scrutiny by the tax department.

2. INCOME TAX REASSESSMENT AND APPEAL

One of Edu-Film Production Ltd.'s investor-owners was singled out. His refund claim based on the capital cost allowance deduction for his video tape investment in an education health program was challenged. A Notice of Reassessment was issued. The taxpayer contacted the district office and asked for an explanation. The tax department took several stances as to why the c.c.a. was denied during the twelve months it took to review the case. Each stance was progressively more specific than the previous stance. The investor-owner and his financial advisors found it necessary to prepare a rebuttal for each of the tax department's arguments as to why the c.c.a. deduction should be disallowed. Edu-Film cooperated and assisted in the preparation of each rebuttal.

The tax department's auditor asked the following question. Was the video tape program purchased to gain or produce taxable income or was it bought solely to reduce the taxpayer's income taxes? If the video tape was bought only to reduce income taxes otherwise payable, the c.c.a. claim would be denied. The denial would be based on subsection 245(1) of the Income Tax Act. Subsection 245(1) prohibits any transaction which unduly or artificially reduces a taxpayer's income.[2]

The investor-owner answered the auditor's question by presenting the financial feasibility study of the educational health program investment. This study had been prepared by Edu-Film and presented to all prospective investors. The study included minimum and maximum earning projections of an educational health program. The projections were based on the educational audio-visual market conditions of 1973 and sales estimates from various education film distributors throughout North America. Table VI-I is from the financial feasibility study. The table projects expected revenue from a typical educational health program for a six year period. The tax department studied the information submitted and concluded that while the transaction did minimize the investor-owner's taxes, the purchase appeared to have been made for legitimate business reasons and contained elements of "commercial reality".

The tax department conceded that the video tape investment could make economic sense if the product (film or video tape program) met acceptable market standards. In other words, the tax department auditors were questioning the quality and marketability of the product produced by Edu-Film. The auditors had good reasons for asking questions about product quality and marketability.

Firstly, an eastern Canadian company had produced some video tape programs which were considered by audio-visual media experts to lack marketability. In 1973-75 that particular company produced over one hundred programs which had relatively low budgets of $7,000 to $10,000 per program. The eastern Canadian company sold these programs to investors on the very high leveraged basis of $60,000-$75,000. The offering of these video tape programs to investors emphasized the immediate tax shelter aspects of the investment. The sales potential of the video tape programs was secondary. The tax auditors wanted proof that Edu-Film's programs were marketable and that the investment was not solely to shelter income from taxes.

TABLE VI-I

THE WORLD OF HEALTH

Six Year Revenue Forecast for a 15 Minute Program

GROSS SALES OF PROGRAM:			
Educational:			
Canada	(100 x $180)	$ 18,000	
U.S.A.	(500 x $190)	95,000	
Foreign		16,000	
Medical:	(1000 x $300)	300,000	
Television:		4,000	
TOTAL GROSS SALES:			$433,000
Less Distributors' Fees & Expenses:			
Educational:			
Canada	62%	11,160	
U.S.A.	75%	71,250	
Foreign	75%	12,000	
Medical:	70%	210,000	
Television:	10%-70% (Average 30%)	1,200	
Distribution Agent's expenses		6,000	
Total fees & Expenses		$311,610	
TOTAL NET REVENUE OF PROGRAM			$121,390
Less:			
Distribution Agent's Fee *		31,089	
Interest on Promissory Note		4,000	
Program Purchase Price		50,000	
Subtotal		$ 85,089	
SIX YEAR NET INCOME TO INVESTOR			$ 36,301
AVERAGE YEARLY NET INCOME TO INVESTOR BEFORE INCOME TAXES			$ 6,050

*Distribution Agent's Fee Breakdown:
5% up to Net Revenue of $65,789 = $ 3,289
5% thereafter = $ 27,800
Total Fee $ 31,089

Source:
Edu-Film Productions Ltd., Investment Prospectus, The World of Health (1974), p.7.

Secondly, the tax department auditors questioned Edu-Film's production capabilities because the company had only been in the motion picture business a very short time and the principals of the company had little or no film production experience.

Principals of Edu-Film met with officials of National Revenue, Taxation. The purpose of the meetings was to demonstrate the quality and marketability of the product produced by Edu-Film. Edu-Film principals explained that Edu-Film's policy was to engage the services of several of Canada's top motion picture directors. This policy is not a guarantee of artistic and commercial success but it does increase the chances of producing a program which meets market requirements. Edu-Film hired such directors as Jack McGaw and Donald Brittain. McGaw is well known for his investigative journalism on the Canadian Television Network's W-5 INQUIRY program. He is also the winner of numerous awards for his directing, including the 1973 Roland Mitchner Award for Journalism. Brittain was the director of such films as BETHUNE, CANADA AT WAR and MEMORANDUM. Brittain's latest film VOLCANO: AN INQUIRY INTO THE LIFE AND DEATH OF MALCOLM LOWRY was nominated for an Academy Award in early 1977.

The credentials of both directors favourably impressed the tax department auditors. They were more impressed, however, by the exhibit of sizable purchase orders from several provincial health departments and Health and Welfare, Canada. The financial feasibility study of the video tape investment, which was, by definition, theoretical, had been reinforced by proof that the product was of marketable quality.

The tax department was unsuccessful in denying the c.c.a. deduction on the basis of "commercial reality" of the investment.

The tax department lawyers then attacked the legal technicalities of the video tape investment capital cost allowance. Success in the technical aspects of the investment would not have eliminated the capital cost deduction altogether but would have forced the investor-owner to spread the deduction over several years. The tax shelter advantage to the investor-owner may have been reduced in the initial year of the investment and he would have to pay interest on any back taxes owed.

The first question the tax department lawyers asked was, when was the "principal photography" of the video tape completed? To answer the question, copies of invoices for laboratory services, editing rooms and sound transfers were submitted. These invoices were evidence that the investor-owner's funds had been expended in the year for which the c.c.a. deduction was claimed. As further evidence that principle photography had been completed, a notorized letter from the director was presented. The letter, which was on the director's letterhead and bore his company's corporate seal, stated that principal photography and other phases of production had been completed prior to December 31st. The tax department accepted this evidence without further question.

The tax department lawyers investigated the transfer of ownership between Edu-Film and the investor-owner. The purchase contracts between Edu-Film and its investor were examined by National Revenue, Taxation lawyers in Ottawa. The Ottawa lawyers decided that the investor-owner had acquired the video tape program in the first year of the investment even though the programs were not completely finished until the following year. Physical delivery to the investor-owner and copyright registration of the video tape program in the owner's name did not take place until the second year. The tax department accepted that the investor's cash payments had either been expended on the production or, as were the promissory notes, held in escrow by an independent third party pending completion of the programs. Therefore the investor's funds were "at risk" and the c.c.a. deduction requirements satisfied.

A subsequent technical argument arose over whether the asset belonged to class 12, or whether it belonged to class 18 as set out in Schedule B of the Income Tax Regulations. The investor-owners who had purchased the video tapes deducted a c.c.a. of 100% as per class 12.

It must be noted that the technical distinctions between motion picture film and video tape are readily apparent but modern production facilities permit transferring between the two formats. The Department of National Revenue and the Department of Finance belatedly acknowledged the ease of transfer between film and video tape. Accordingly, the federal budget of May, 1976 eliminated the distinction between film and video tape for c.c.a. purposes.

The Edu-Film investment was made in 1974, prior to the 1976 amendment. The tax department officials were trying to prove that the educational health program was in fact a film production, not a video tape production. If the tax department could prove that the program was a film, the c.c.a. deduction would be reduced from 100% to 60% in the first year of the investment. The investor-owner's deduction would have been reduced by $20,000.

Edu-Film used both film and video tape production techniques on all its productions depending on which technique was in the best interests of expedient production and program quality. The final edited version of the product was finished on video tape and a video tape copy delivered to the investor-owner.

The tax deparment's initial approach was to send letters to all Edu-Film's investor-owners stating that National Revenue, Canada considered their programs to be motion picture films which are in class 18 (60% c.c.a. in 1974). The tax department stated in the letters that it was amending the investor-owner's tax return for the first year of the investment and that the investor-owner was to submit the difference in back taxes plus interest. Edu-Film, through an investor-owner, asked the tax department for a list of technical criteria of a video tape production. The tax department declined to supply a list of criteria. The investor-owner reiterated that the "master copy" of the educational health program was a two inch quad master video tape and that the investor-owner had taken delivery of a video tape copy of the master. Therefore the 100% c.c.a. deduction was correct. Given the recent amendment to the Income Tax Act and the difficulties in distinguishing between motion picture film and video tape production techniques, the tax department decided to let the matter rest.

The tax department has indicated that it will monitor the marketing of the educational health programs and the subsequent retirement of the promissory notes held by Edu-Film. The writer is of the opinion that if the programs have failed to recoup the majority of their production costs, additional reassessments may be issued before the four year limitation period has elapsed. Reassessment appeal proceedings can take several years to complete. Before the appeal has been settled, the tax department would be able to observe whether or not Edu-Film demands the balance of any outstanding promissory notes in 1981. If Edu-Film does collect or the notes have been retired previously, the tax department will have the satisfaction of collecting taxes on Edu-Film's net income at the prevailing corporate rate. If Edu-Film fails to collect the promissory notes the tax department may apply Section 80 of the Income Tax Act to the investor-owners. Section 80 states that a taxpayer who realizes any net gain on settlement of a debt must include this amount in computing his income.[3] The investor-owner would then have to pay additional income taxes at his prevailing personal tax rate on the amount of debt forgiven.

FOOTNOTES CHAPTER VI

[1] Rulings Division of Revenue Canada, Taxation, letter, cited by Wayne Beach, "Tax Advantages of Film Investments", CIT Tax Planning and Management 18, March 1, 1976 (Butterworths, 1976), p. 18-13.

[2] Canadian Income Tax Act with Regulations, 47th Edition, 1975-76 (C.C.H. Canadian Limited, 1976), p.604.

[3] Ibid. , p.184.

CHAPTER VII

QUANTITATIVE ANALYSIS OF MOTION PICTURE INVESTMENT

1. INTRODUCTION

This chapter is a quantitative analysis to determine the investor's after-tax position in two motion picture investments. The two motion picture investments are an educational health video tape program and a feature length theatrical motion picture film. A seven year model is developed that incorporates characteristics of the two types of motion pictures both leveraged and non-leveraged and the characteristics of hypothetical investors at two arbitrary annual income levels ($30,000 and $100,000).

The educational health video tape program is based on the Edu-Film Productions Ltd. investment package which was described in Chapter V. The feature film investment package is based on an investment offering by the Somerville House Corporation. (Some of the details, of the two investment packages however, have been altered and some assumptions made for the purpose of this analysis.) Somerville's project consists of two feature length motion picture films and is typical of the structure of syndicated film investment packages offered in Canada. The investor makes a down payment and a series of six annual payments to Somerville, the vendor of the two motion picture films. The series of future payments is guaranteed to be paid to the investor by a third party, the foreign distributor of the films. The arrangement is called a syndicate-guarantee motion picture investment.

A motion picture investment model will be developed that incor-porates the financial arrangements of the educational health video tape program and the feature film syndicate-guarantee investments. Sixteen after-tax outcomes will be generated through the model by application of a present value factor to the annual incremental cash flow from the motion picture investments. Pessimistic and optimistic distribution revenue forecasts will be made. Net present value (N.P.V.) financial outcomes will be calculated for the two motion picture investment pack-ages when no income is generated by the motion picture (pessimistic fore-cast) and when "moderate" income is generated (optimistic forecast). If no income is generated in the leveraged investments the investor-owner is called upon to pay the promissory notes to the vendor (or produc-er) of the motion picture.

The investor-owner's after-tax financial position will be computed for both leveraged and non-leveraged motion picture investments. (The leveraged investments permit the investor-owner to claim a capital cost allowance deduction which is based on the sum of the initial cash down payment and the future payments to the vendor of the motion picture. The investor-owner's capital cost deduction in the first year of the invest-ment can exceed his initial cash outlay, thereby reducing his taxes pay-able and increasing his cash flow in that year.) To determine the value of leverage to the investor-owner a number of assumptions will be made and the leveraging aspect of the motion picture investment eliminated from the model. Then the investor-owner's after-tax financial position in the non-leveraged investment will be computed. The non-leveraged financial outcomes will be compared to the after-tax financial outcomes in the leveraged motion picture investment. The value of the tax shelter aspect of motion picture investment to the hypothetical investor-owners can then be evaluated.

The four variables in the motion picture investment model are:

1. The motion picture investment type, either:
   a. educational health video tape program
   b. feature length theatrical films.

2. The motion picture's distribution earnings, either:
   a. no distribution revenue (pessimistic forecast)
   b. moderate distribution revenue (optimistic forecast).

3. The motion picture investment's financial structure, either:
   a. leveraged
   b. non-leveraged.

4. The motion picture investor-owner's annual basic income, either:
   a. $30,000
   b. $100,000.

These variables are combined to obtain sixteen after-tax financial outcomes for the motion picture investor-owner. The sixteen combinations of variables are as follows:

<u>Edu-Films Video Tape-Program Investment</u>

<u>$30,000 income level</u>

1. Leveraged - no motion picture revenue
2. Leveraged - moderated motion picture revenue
3. Non-leveraged - no motion picture revenue
4. Non-leveraged - moderate motion picture revenue

<u>$100,000 income level</u>

5. Leveraged - no motion picture revenue
6. Leveraged - moderate motion picture revenue
7. Non-leveraged - no motion picture revenue
8. Non-leveraged - moderate motion picture revenue

<u>Somerville House Corporation Feature Films Investment</u>

<u>$30,000 income level</u>

9. Leveraged - no motion picture revenue

10. Leveraged - moderate motion picture revenue

11. Non-leveraged - no motion picture revenue

12. Non-leveraged - moderate motion picture revenue

$100,000 income level

13. Leveraged - no motion picture revenue

14. Leveraged - moderate motion picture revenue

15. Non-leveraged - no motion picture revenue

16. Non-leveraged - moderate motion picture revenue

2. MOTION PICTURE INVESTMENT MODEL LIMITATIONS

Model limitations are determined not only by the finite number of variables which can be included in the model's design but also by the specific computing capabilities of the (particular) user of the model. The model developed in this study considers only two motion picture investments, the educational video tape program offered by Edu-Film Production and the feature films offered by Somerville House. It can not therefore be used without modification for a quantitative analysis of all motion picture investment packages.

The model is used to calculate the outcome for investors at only two levels of annual income. The model does not take into account the general averaging provision available to Canadian taxpayers. (General averaging bases the taxes payable on the taxpayer's annual income on an average of the past five years. General averaging is applied to a taxpayer's income which has increased over the previous year's income.)

The model considers the motion picture revenue when it is nil and when it is a moderate amount. The model does not consider the probability factor of these revenue levels being reached. Nor does the model consider the effect of foreign withholding taxes on the motion picture investment revenue earned outside of Canada.

The different outcomes of the video tape program and the feature films will be compared and contrasted. However, comparisons are not truly valid. The characteristics of the two investments are not exactly the same and the model is not sophisticated enough to account for the differences between them. An educational video tape program and a feature film have very different risks and potential earning factors. A well produced and effectively distributed video tape program usually generates revenue but a well produced and effectively distributed feature film can fail to earn any money if the movie going public is unreceptive. An educational video tape has an upper limit of approximately 3,000 print sales (assuming a selling price of $250 per print, 3,000 prints would gross $750,000) but a feature film can gross over $200 million (eg JAWS). The down payments for each investment are similar but the future liabilities are different in the leveraged situations. In the video tape program, the investor-owner's future liability is $25,000 plus interest. In the feature film the investor-owner's future liability is $82,045 which is guaranteed by the foreign distributor. In the leveraged investments the initial income tax shelter in the feature films investment is larger than in the video tape program investment.

In the quantitative analysis of the non-leveraged investments the hypothetical investor-owner's cash investment is $25,000 for a 1/66th share in the feature films and $35,000 for a video tape program. (See Appendices A and C to Chapter VII.)

3. GENERAL ASSUMPTIONS

A number of general assumptions are made for the motion picture investment model input. The investor-owner's annual professional, business or salary income is assumed to be constant over the seven year model horizon. There is no provision for cost of living increases or the possibility of income decrease because of retirement, loss of job, etc. The assumption is made that the Canadian income tax rates remain constant over the seven years. The rates are the prevailing 1976 income tax rates without the 10% federal surtax on taxes payable over $8,000 in 1976. The model assumes that no other tax shelter investments are made during the seven years. Realistically, an investor could shelter his basic annual income and any motion picture revenue in other tax shelter investments, e.g.gas and oil exploration investments.

The assumption is made that the investor-owner's annual income and any revenue generated from the motion picture investment is spread evenly throughout any given year of the model.

The present value discount factor is 10% because the writer believes that the investment risk dictates that an investor should require an after-tax return of 10% on a motion picture investment. The rationale of the derivation of the 10% after-tax return is based on the required pre-tax return. The required pre-tax return is derived from the total of the annual inflation rate plus the real return on a risk free investment plus the required risk premium for the investment.

Annual inflation rate	6%
Plus:	
Real return on risk free investment	3%
Required risk premium return	10%
Total:	
Required pre-tax return of motion picture investment	19%

The 19% pre-tax return is realistic if the return of alternative investments is considered and an allowance is made for the higher risks of motion picture investments. An opportunity cost approach is taken to further rationalize the required pre-tax return of 19%.

Yield on a risk free long term investment (e.g. Canadian Government savings bond)	9.0%
Plus:	
Apparent risk premium required on high quality, marketable Canadian utility stocks	4.3%[1]
Risk premium for incremental risk of motion picture investments (subjective)	5.7%
Total:	
Required pre-tax return of motion picture investment.	19.0%

The pre-tax investment return of the motion picture investment is subject to income taxes at the investor's personal tax rate. The income taxes are subtracted from the pre-tax investment return to determine the required after-tax return. Assuming the investor pays income tax of 47.4% of his investment earnings the required after-tax must be 10%.

Required pre-tax return of motion picture investment	19%
Less:	
Income taxes payable (19% x 47.4% = 9%)	9%
Equals:	
Required after-tax return of motion picture investment	10%

If an equivalent investment return were earned, for example, from a "risky" common stock, the tax rate would be the same as if the earning were from the motion picture investment. The current tax rate can be applied to the pre-tax opportunity cost to determine the after-tax opportunity cost. The after-tax opportunity cost therefore, is assumed to be 10%. This 10% discount factor is applied to the annual incremental cash flows in order to calculate the net present value outcomes in the motion picture investment model.

4. THE MOTION PICTURE INVESTMENT PACKAGES

A. Edu-Film Video Tape Program Leveraged[2]

Video Tape Program Cost

Production cost	$25,000
Producer's profit	$25,000
Total: Program purchase price	$50,000

Payment Plan

Cash down payment	$25,000
Seven year 6% interest promissory note	$25,000
Total: Payments	$50,000

The 6% simple interest is calculated on the outstanding promissory note balance on December 31st of each year-end.

Revenue Sharing Arrangement

Gross revenues (after distribution expenses)	100%
Less:	
Distribution agent's fee	5%
Equals: Net revenue	95%
Less:	
Promissory note payment	2/5ths of 95%
Equals: Cash to investor	3/5ths of 95%

When the promissory note is fully retired the distribution agent's fee is increased to 50% of the gross revenues and the investor-owner is paid the remaining 50% of the gross. The note is fully retired when total net revenue has reached $65,789.

B. Edu-Film Video Tape Program Non-leveraged

Video Tape Program Cost

Production cost	$25,000
Producer's profit	10,000
Total: Program purchase price	$35,000

For the rationale of the $35,000 program purchase price see Appendix A to Chapter VII.

Payment Plan

Total: Cash payment	$35,000

Revenue Sharing Arrangement

Gross Revenues (after distribution expenses)	100%
Less:	
Distribution agent's fee	50%
Equals: Cash to investor	50%

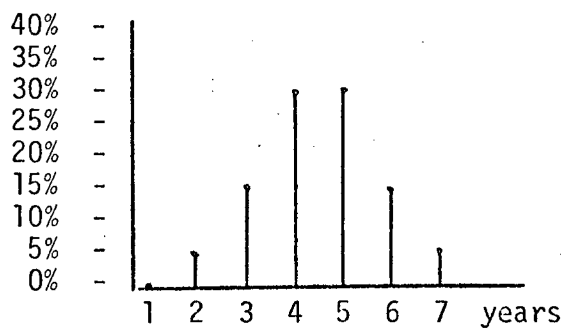
C. Educational Video Tape Program Earning Pattern

The assumption is made that if the video tape program generates revenue, the revenue is earned between the second to seventh year of the investment. The percentages of gross revenue, after distribution expenses, are shown in Table VII-I.

TABLE VII-I

Video Tape Distribution Earning Pattern

Annual Percentages of Total Distribution Revenue of Video Tape Program



Source:

General assumptions by the educational film industry in North America.

For the video tape program earning a moderate income after distribution expenses, the amount is assumed to be $100,000 per program.

In the leveraged investment, the investor-owner's share of the $100,000 moderate income is $79,606 after the distribution agent's fee is deducted. The promissory note payments and interest are deducted from the $79,606. In the non-leveraged investment situation, the distribution agent's fee is a constant 50%. Therefore, the investor-owner's share is $50,000 after deduction of the distribution agent's fee.

D. The Somerville House Corporation Feature Films Leveraged

The Somerville investment package consists of two motion pictures, ZORRO and THE STORY OF O. These two films are offered to investors at a total capital cost of $7,000,000 in the leveraged investment situation.[3] The Somerville prospectus for the ZorrO Syndicate is reproduced in its entirety in Appendix B to Chapter VII. This investment package was offered prior to the amendment in the capital cost allowance provision which was increased to 100%. Consequently the capital cost allowance at the time of offering was 60% per year. For the purposes of this investment analysis it is assumed that the two motion picture films would qualify for the 100% capital cost allowance, that is, Canadian certified feature films or Canadian co-productions.

Feature Films Cost

Production cost: expended	$1,585,000
deferred	? ?
Portion guaranteed by distributor	5,415,000
Total: Purchase price of films	$7,000,000
Cost of bank guarantee	65,000
Total: Capital cost	$7,065,000

For the purpose of the quantitative investment analysis it is assumed that an investor wants to invest $25,000 cash in the leveraged motion picture films investment. A 1/66th share of the motion picture investment can be purchased for an initial outlay of $25,000.

Payment Plan (for 1/66th share of motion picture films)

Cash down payment	$24,015
Cost of bank guarantee	985
Total: Cash payments 1st year	25,000
Promissory Notes	82,045
Total: Payments	$107,045

The investor signs five full recourse non-interest-bearing promissory notes. A promissory note for $15,152 is payable each year in years two to five of the investment. A final note of $21,439 is due and payable in the sixth year.

In the syndicate financing arrangement, the investor buys an undivided interest in the two motion pictures. The investor-owner is responsible for marketing the film but in practice, the investor-owner turns this function over to the producer cum distributor. The producer-distributor in turn puts the films in the hands of professional international theatrical motion picture distributors.

Revenue Sharing Arrangement

The ZorrO Syndicate will receive 30% of the gross distribution receipts from the distribution of ZORRO and 10% of the gross distribution receipts from the distribution of THE STORY OF O in the United States and Canada. The North American distributor is Allied Artists of Los Angeles. The two films will be distributed in the foreign markets by World Association Video Establishment (WAVE). The ZorrO Syndicate is guaranteed to receive $5,415,000 in distribution receipts from WAVE. These guaranteed receipts are to be paid by WAVE to the investor-owners on or before the promissory notes are to be paid by the investor-owners to the vendor of the films. The syndicate will not receive any additional distribution receipts from distribution of the films in the foreign markets. It is assumed that the syndicate's expenses are deducted from the revenues received from the North American markets.

E. The Somerville House Corporation Feature Films Non-Leveraged

The Somerville feature films investment package will be analysed without the tax shelter leverage facilitated by the promissory notes. It is assumed that the 1/66th share of the motion picture films will be purchased for $25,000. The assumption is made that the syndicate will only receive distribution receipts from the North American motion picture markets. The vendor (or producer) of the films will receive any distribution revenue earned in the foreign motion picture markets. These assumptions are based on the theory concerning the flow of funds between the producer and the distributor advanced by the writer in the Chapter IV discussion of the syndicate-guarantee financing arrangements. A more detailed discussion of the rationale behind the $25,000 purchase price for a 1/66th share of the feature films investment package is given in Appendix C to Chapter VII.

F. Feature Film Earning Pattern

The promoters of the ZorrO Syndicate have projected minimum earnings of the two films in the North American markets at $2,350,000. The foreign distributor, WAVE, has guaranteed $5,415,000 distribution revenue.

Motion picture producers (promoters) overestimate the potential of their projects. A.H. Howe, Vice President of the Bank of America in Los Angeles stated:

> I can only repeat that over the years I have talked to hundreds of producers, each with the world's best picture, a project where it was impossible to miss, where a hit was absolutely certain...The difficulty is, proved over and over again, that these certain hits, when made, are usually lost in the shuffle and more often than not, fail to return their costs.[4]

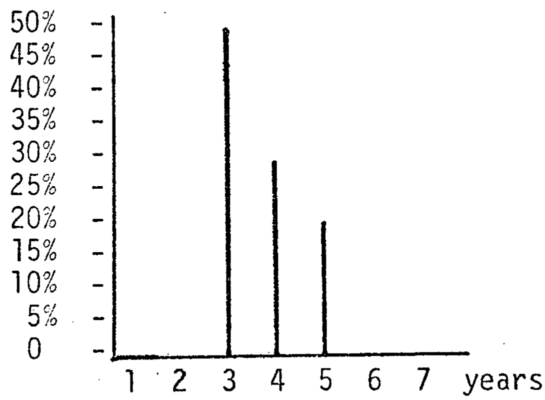
For the purposes of the analysis of both the leveraged and non-leveraged feature films investments, the North American earnings projected by Somerville are reduced by approximately 50% to arrive at the "moderate" revenue figure. The foreign receipts are taken as given because those receipts are guaranteed by WAVE in the leveraged feature films investment. (If WAVE fails to honour its commitment, the Swiss bank will pay the investor-owners the guaranteed amount.) In the non-leveraged feature films investment, the earnings in the foreign market, if there are any earnings, will be considered the vendor's (producer's) profit.

The assumption is made that if the feature films generate revenue in the North American markets, the revenue is earned between the third and fifth years of the investment. The annual percentage of total revenue occurring to the ZorrO Syndicate is shown below in Table VII-II.

TABLE VII-II

Feature Film Distribution Earning Pattern

Annual percentages of Total Distribution Revenue of Feature Films in North American Markets



Source:

General assumptions by the theatrical film industry.

The moderate earnings of the two feature films will be assumed to be $1,185,030 after syndicate expenses. The share attributable to each 1/66th of the motion picture will be $17,955 in leveraged feature films investment. In addition, guaranteed distribution receipts from WAVE of $82,046 will be earned by each 1/66th share. In the non-leveraged investment situation, the investor-owner will only receive $17,955 from North American distribution for each 1/66th share owned. The syndicate will not receive any guaranteed distribution revenue from WAVE nor any earnings from the foreign markets in the non-leveraged feature films investments.

5. THE MOTION PICTURE INVESTMENT MODEL

The model enables the interaction between the financial characteristics of the investor and the motion picture investment to be analyzed. The planning horizon for the investment decision is seven years. Seven years is considered the economic life of the feature films and video tape program motion picture investments. The ZorrO Syndicate promissory notes payments are spread over six years and the Edu-Film promissory note is due in the seventh year. The investor commits his funds for this seven year period and is now hostage to the future consequences.[5] Each year in the model is represented by the vertical columns of numbers labled 1 to 7. The horizontal lines of input and calculations are shown in Table VII-III.

A. Investor-Owner Income Tax Calculations

The first step in utilizing the model is to calculate the investor-owner's annual income taxes. This is done by deducting the capital cost allowance (and cost of the bank guarantee and interest, if any) from the income earned by the investor-owner from all sources including any motion picture investment revenue.

The investor-owner's income from business, professional or salary sources for the purpose of this model is a net amount before

TABLE VII-III

Motion Picture Investment Model Input and Calculations

INVESTOR-OWNER INCOME TAX CALCULATIONS:(Step One)

Income: Business, Professional or Salary:
        Motion Picture Investment Revenue:
Gross Income:
Less:
        Cost of Guarantee:
        Interest Payments:
        Capital Cost Allowance:
Taxable Investor-Owner Income:
Income Taxes Payable:

CASH FLOW WITH INVESTMENT: (Step Two)

Gross Income:
Less:
        Investment Down Payment:
        Interest Payments:
        Cost of Guarantee:
        Promissory Note Payments:
        Income Taxes Payable:
Net Cash:

CASH FLOW NO INVESTMENT: (Step Three)

Income: Business, Professional or Salary:
Less:
        Income Taxes Payable:
Net Cash:

ANNUAL INCREMENTAL CASH FLOW: (Step Four)

ANNUAL PRESENT VALUE @ 10%: (Step Five)

NET PRESENT VALUE OF MOTION PICTURE INVESTMENT: (Step Six)

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income taxes, but is after pension contributions, medical, child, marriage and any other personal deductions have been taken. It is assumed that the deductions either remain constant for the seven year model or any increases or decreases are offset by parallel income changes.

The motion picture revenue, if any, is the amount paid to the investor-owner. Distributor's or syndicator's fees and expenses are not included in the gross amount. The motion picture revenue each year is calculated according to the revenue pattern assumed as characteristic of the type of motion picture under consideration. The guaranteed distribution revenue is included in the leveraged feature motion picture analysis only.

Gross income is the total income earned by the investor-owner from all other sources after personal deductions, plus the motion picture investment revenue.

The cost of the guarantee is the investor's share of the guarantee purchased from a bank in the feature films leveraged investment. The bank guarantor will pay to the investor the yearly amount which the investor-owner must pay the vendor of the feature film motion pictures should the distributor default in his payments to the investor-owner. The guarantee is purchased in the first year of the investment and is an expense for tax purposes deductable against gross income in the first year.

The interest payments are the amount the investor-owner of the Edu-Film video tape program must pay to the holder of the promissory note. The interest rate is 6% calculated on the outstanding balance of the note on December 31st of each year. The interest is not compounded.

The capital cost allowance is the amount the investor-owner deducts for tax purposes from his gross income each year. The available capital cost deduction is deducted during the seven year period of the investment so that the investor-owner optimizes his cash flow position vis a vis the 10% return expected in the net present value calculation.

In almost all of the motion picture investments analyzed the optimal cash flow to the investor-owner is arrived at by utilizing available c.c.a. to bring the investor-owner down one complete marginal tax bracket for as many years as there is a capital deduction available.[6] That is, if the investor-owner is earning $30,000 annually before income taxes he is in the 44.10% marginal tax bracket. (Taxes payable at a rate of 44.10% on any income earned in excess of $23,606 until an annual income level of $31,368 is reached.) The capital cost deduction is then used to bring the investor-owner down to the top of the next bracket which, in this example, begins at $18,298 annual income. Income exceeding $18,298 but less than $23,606 is taxable at a rate of 43.58%.

If the motion picture investment increased the investor-owner's taxable income he may, depending upon the amount of motion picture revenue, move into a higher tax bracket that year. If the investor-owner moves up into a higher bracket because of motion picture revenue any c.c.a. would be applied to bring him down to the top of the next bracket. The c.c.a. is spread from one to six years depending on the investor-owner's total taxable income and the capital cost of the motion picture.

Taxable income is the investor-owner's gross income minus the capital cost allowance deduction taken for the year and interest, if any, (and the cost of the bank guarantee in the first year of the feature films investment). In the latter years of the investment model when no c.c.a. is available, the taxable income is the same amount as the gross income.

Income taxes payable are based on the federal income tax rate and the British Columbia provincial tax rate in effect for 1976. The tax computations do not consider the 10% federal surtax imposed on federal tax payable over $8,000 in effect for 1976. The tax calculations are computed according to the "Federal and Provincial Income Tax Rates For Individuals - 1976" tables published by C.C.H. Canadian Limited.[7]

B. Cash Flow With Investment

The second step to utilize the model is to calculate the net cash flow to the investor-owner after his actual cash investment expenses and taxes payable are deducted from his total income from all sources.

Gross income is the investor-owner's income from all sources including motion picture revenue, if any. This is the same total for each year which is arrived at in the model's first step, the income tax calculations. The investment down payment is the down payment by the investor-owner to the vendor of the motion picture in the first year of the investment. The amount of the down payment is chosen to impart a degree of compatibility between the different types of motion picture investment under analysis. The video tape program investment down payment is $25,000 in the leveraged investment situation. The balance of the full purchase price of $50,000 is the full recourse seven year 6% interest bearing promissory note payable by the purchaser (investor-owner).

In the non-leveraged video tape program investment analysis, the payment in the first year is $35,000. This payment is the full cost of the investment. In the non-leveraged situation the payment to the vendor of an additional $10,000 in the first year represents the discounted value to the vendor (producer) of the seven year promissory note. (See Appendix A to Chapter VII for a full explanation of the assumptions used to arrive at an amount of $10,000.)

In the feature films motion picture investment, the investment payment in year 1 in the leveraged situation is $24,015. The payment of

$24,015 plus the cash payment of $985 for the bank guarantee total $25,000. The $25,000 buys the investor 1/66th of the feature films motion picture investment package. The investor-owner is entitled to 1/66th of all net receipts from the distribution of the feature films.

The cost of 1/66th of the feature films investment package in the non-leveraged situation is assumed to be $25,000. (The rationale behind this price is explained in Appendix C to Chapter VII.)

The interest payments are the annual interest charges on the outstanding balance of the seven year promissory note in the leveraged video tape program investment.

The cost of the guarantee is the investor-owner's portion (1/66th) of the bank guarantee purchased by the feature films motion picture investment syndicate in the leveraged feature films investment. No guarantee purchase is necessary in the non-leveraged feature films investment.

The promissory note payments are the investor-owner's payments to the vendor of the motion picture. These payments are only applicable in the leveraged investments. The feature films' promissory notes are retired at a constant amount of $15,152 per year for years 2 to 5. In the sixth year, a final payment of $21,439 is made. The guaranteed distribution receipts are paid to the investor-owner in an identical pattern if the bona fide distribution receipts are insufficient. In the video tape program investment the promissory notes are retired according to the amount of revenue earned by the video tape program. Forty percent of the motion picture revenue earned each year by the investor-owner is applied against the promissory note until the note is fully retired. If the video tape program fails to earn any revenue for the investor-owner during the seven year period, the investor-owner pays the promissory note in full at the end of the seventh year.

The income taxes payable are the final figure arrived at in the tax calculations for each year in step one.

Net cash is the amount of money remaining each year from the investor-owner's annual gross income after the annual cash expenses of the investment and income taxes have been deducted.

C. Cash Flow No Investment

The third step in the model is to arrive at an annual net cash flow for a hypothetical taxpayer who has the same business, professional or salary income as the taxpayer investing in a motion picture. The annual net cash amounts of the two taxpayers will be compared after calculating the net after-tax amounts.

The taxpayer's income from business, professional or salary sources is assumed to be identical to that of the taxpayer investing in the motion picture, that is, all personal deductions have previously been taken. The taxpayer's income is assumed to remain constant for the seven year time span of the motion picture investment model.

The income taxes payable are based on the federal and British Columbia provincial income tax rates prevailing in 1976.

Net cash is the amount of disposable cash income that the taxpayer has after payment of his income taxes.

D. Annual Incremental Cash Flow From Investment

The annual incremental cash flow is the cash difference between the two taxpayers, the taxpayer who invests in the motion picture investment and the taxpayer who does not invest. The non-investing taxpayer's net cash flow is subtracted from the investing taxpayer's cash flow each year. If the taxpayer who invests has less net cash than the taxpayer who does not invest, the amount is set between parenthesis for that particular year.

E. Annual Present Value

The discounted present value is calculated annually for the difference in cash flow between the motion picture investor and the taxpayer, who has the same basic income but does not participate in the motion picture investment. The annual incremental cash flow is discounted by a present value factor of 10%. Present value is defined as the value today (ie. time equals 0) of a cash payment received sometime in the future after applying a given discount factor.

F. Net Present Value of the Motion Picture Investment

The net present value is the total seven year incremental cash flow from the motion picture investment discounted at 10%. The net present value amount is the final financial outcome of the motion picture investment model. If participation in the motion picture investment reduces the investor-owner's discounted cash flow (ie. creates a financial loss) the net present value amount is set in parenthesis.

6. THE MOTION PICTURE INVESTMENT MODEL OUTCOMES

The net present value outcomes for each hypothetical investor-owner and motion picture investment (leveraged and non-leveraged) are calculated. The available c.c.a. is utilized to reduce the investor-owner's income taxes payable so that the best possible net present value is found for each model outcome given the computing capabilities and time resources of the writer. See Table VII-IV for an example of the actual calculations of one net present value outcome of an investor with a $30,000 basic income purchasing a leveraged educational video tape program which earns moderate distribution revenue.

TABLE VII-IV

MOTION PICTURE INVESTMENT MODEL

Educational Video Tape Program
Leveraged Investment
Investor's Basic Income: $30,000
Distribution Revenue: "Moderate"

INVESTOR-OWNER INCOME TAX CALCULATIONS: (Step One)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Totals
Income: Business, Professional or Salary:	$30,000	$30,000	$30,000	$30,000	$30,000	$30,000	$30,000	$210,000
Motion Picture Investment Revenue:	o	4,750	14,250	28,500	22,106	7,500	2,500	79,606
Gross Income:	$30,000	$34,750	$44,250	$58,500	$52,106	$37,500	$32,500	$289,606
Less:								
Cost of Guarantee:	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest Payments:	o	1,155	870	300	o	o	o	2,325
Capital Cost Allowance:	11,702	9,989	19,774	8,535				50,000
Taxable Investor-Owner Income:	18,298	23,606	23,606	49,665	52,106	37,500	32,500	237,281
Income Taxes Payable:	$ 5,468	$ 7,781	$ 7,781	$20,835	$22,156	$14,548	$11,964	$ 90,533
CASH FLOW WITH INVESTMENT: (Step Two)								
Gross Income:	$30,000	$34,750	$44,250	$58,500	$52,106	$37,500	$32,500	$289,606
Less:								
Investment Down Payment:	25,000	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	25,000
Interest Payments:	o	1,155	870	300	o	o	o	2,325
Cost of Guarantee:	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Promissory Note Payments:	o	1,900	5,700	11,400	6,000	o	o	25,000
Income Taxes Payable:	5,468	7,781	7,781	20,835	22,156	14,548	11,986	90,533
Net Cash:	($468)	$23,914	$29,899	$25,965	$23,950	$22,952	$20,535	$146,747
CASH FLOW NO INVESTMENT: (Step Three)								
Income: Business, Professional or Salary	$30,000	$30,000	$30,000	$30,000	$30,000	$30,000	$30,000	$210,000
Less:								
Income Taxes Payable:	10,747	10,747	10,747	10,747	10,747	10,747	10,747	75,229
Net Cash:	$19,253	$19,253	$19,253	$19,253	$19,253	$19,253	$19,253	$134,771
ANNUAL INCREMENTAL CASH FLOW: (Step Four)	($19,721)	$ 4,661	$10,646	$ 6,712	$ 4,697	$ 3,699	$ 1,283	$ 11,977
ANNUAL PRESENT VALUE @ 10%: (Step Five)	($17,928)	$ 3,852	$ 7,998	$ 4,584	$ 2,916	$ 2,088	$ 658	$ 4,168
NET PRESENT VALUE OF MOTION PICTURE INVESTMENT: (Step Six)								$ 4,168

Key: n.a. = not applicable

TABLE VII-IV

The determination of the best possible net present value figure (least discounted loss or greatest discounted profit) for each investor-investment situation can involve calculation of many different outcomes.[8] These different outcomes are dependent on the amount of capital cost allowance deduction which is used in each year of the investment. For example, in the investment situation in which the investor earns $30,000 annually and has the opportunity to buy a $35,000 non-leveraged educational health video tape program, four possible outcomes are calculated. The four outcomes are dependent on how much of the $35,000 capital cost is deducted each year. In this example it is assumed no distribution revenue is earned. Four possible uses of the c.c.a. deductions are as follows:

1. Take maximum c.c.a. in year 1 to reduce the investor-owner's taxable income to nil. ($30,000 c.c.a.) Take the balance of the c.c.a. ($5,000) in year 2. The N.P.V. of the investor's incremental cash flow is then a loss of $20,131.
2. Spread c.c.a. over six years to reduce the investor-owner's taxable income to the top of his present bracket (ie. $23,606). Therefore, he pays a maximum of 41.30% on income exceeding $18,298 instead of 44.10% on income over $23,606. The N.P.V. of investor's incremental cash flow is a loss of $19,781.
3. Spread c.c.a. over two years to bring the investor-owner down to the 43.58% marginal tax bracket (ie. annual income $18,298). Use the balance of the available c.c.a. in year 3. The N.P.V. of the investor's incremental cash flow is a loss of $18,724.
4. Random use of the c.c.a., eg. claim $20,000 in year 1 and $15,000 in year 2. The N.P.V. of incremental cash flow from the investment is a loss of $18,896.

The net present value is a negative in all these situations, but the optimum position of the combinations calculated is to use the c.c.a. to place the investor-owner at the beginning of the next lowest marginal tax bracket assuming his basic $30,000 annual income, ie. as in 2 above.

A. Net Present Value Outcomes

The sixteen net present value outcomes for each motion picture investment model's seven year incremental cash flow are as follows:

Edu-Films Production's Video Tape Program Investment

$30,000 income level

Leveraged	1. No motion picture revenue	($21,000)
	2. Moderate motion picture revenue	$ 4,168
Non-leveraged	3. No motion picture revenue	($18,724)
	4. Moderate motion picture revenue	($ 2,164)

$100,000 income level

Leveraged	5. No motion picture revenue	($10,567)
	6. Moderate motion picture revenue	$ 6,281
Non-leveraged	7. No motion picture revenue	($12,650)
	8. Moderate motion picture revenue	($ 288)

Somerville House Corporation's Feature Films Investment

$30,000 income level

Leveraged	9. No motion picture revenue	($12,921)
	10. Moderate motion picture revenue	($ 5,518)
Non-leveraged	11. No motion picture revenue	($13,008)
	12. Moderate motion picture revenue	($ 6,678)

$100,000 income level

Leveraged	13. No motion picture revenue	($ 2,090)
	14. Moderate motion picture revenue	$ 2,683

Non-leveraged { 15. No motion picture revenue ($ 8,739)
16. Moderate motion picture revenue ($ 3,965) }

7. COMPARISONS AND CONTRASTS

Comparisons and contrasts can be made between the sixteen financial outcomes. (The net present value of the motion picture investments' cash flows using a 10% discount factor.) These comparisons and contrasts are used to support the writer's conclusions and recommendations with regards to motion picture investment.

The reader should refer to Table VII-V while considering the following comparisons and contrasts between the final financial outcomes of the motion picture investment.

1. None of the non-leveraged motion picture investments has a positive net present value at a 10% discount rate.
2. In all the motion picture investments except one, the loss was greater in the non-leveraged investment than the similar leveraged motion picture investment. (The exception was the video tape investment made by the $30,000 income level investor-owner when no distribution revenue was earned.)
3. In all cases the investor-owner in the leveraged investment was better off than if he invested in the non-leveraged investment when the motion picture earned moderate distribution revenue.
4. The investment had a positive net present value only if the motion picture earned a moderate amount of distribution revenue. However, even if moderate revenue was earned, the outcome was negative for the $30,000 investor-owner investing in the feature films.
5. The negative net present value of the incremental cash flow was substantial for the $30,000 investor-owner if the investment

TABLE VII-V

Net Present Value of Incremental Cash Flow
From Motion Picture Investment at a 10% Discount Factor

	VIDEO TAPE PROGRAM			FEATURE FILMS		
	LEVERAGED	NON-LEVERAGED		LEVERAGED	NON-LEVERAGED	
Investor-owner's Basic Income $30,000	($21,001)	($18,724)	MOTION PICTURE REVENUE: NIL	($12,921)	($13,008)	Investor-owner's Basic Income $30,000
	$4,168	($2,164)	MOTION PICTURE REVENUE:"MODERATE"	($5,518)	($6,678)	
	LEVERAGED	NON-LEVERAGED		LEVERAGED	NON-LEVERAGED	
Investor-owner's Basic Income $100,000	($10,567)	($12,650)	MOTION PICTURE REVENUE: NIL	($2,090)	($8,739)	Investor-owner's Basic Income $30,000
	$6,281	($288)	MOTION PICTURE REVENUE:"MODERATE"	$2,683	($3,965)	

failed to generate any revenue in distribution.

6. The $30,000 investor-owner had a loss in all the situations tested except in the leveraged video tape program which generated a moderate amount of distribution revenue.

7. The potential loss to the $30,000 investor-owner is approximately twice the potential loss to the $100,000 investor-owner in the leveraged video tape program. The financial outcome for the $30,000 investor-owner is the highest potential loss of any of the motion picture investment model outcomes. His potential gain, if the leveraged video tape program generates a moderate amount of revenue, is approximately one-half of the potential amount which the $100,000 investor-owner would earn.

8. The video tape program investment offers a greater positive net present value to either the $30,000 or the $100,000 investor-owner than in the feature films investment if moderate revenue is generated. Albeit in all cases the potential loss is greater than the potential loss in the feature films investment which has guaranteed distribution revenue to offset the future liabilities.[9] However, the video tape program has a definite upper limit to its earning potential whereas the feature films could be "blockbusters". If even one of the feature films is a blockbuster the earnings could be very high. The potential box office gross of an exceptional feature length motion picture can be in the $100 millions.

8. CONCLUSIONS

Given the characteristics of the investor-owner and motion picture investments, specific and general conclusions can be drawn about motion picture investment by studying the motion picture investment model outcomes.

1. The attractiveness of a motion picture investment is severely diminished if the investment is not leveraged in order to enhance the tax shelter aspect of the investment. It appears that an investor would be unwise to consider investment in a motion picture unless there is at least a two to one leverage of the initial investment. There must be a minimum distribution revenue guarantee to offset promissory note liability, particularly if the leverage ratio is high.

2. There is no net tax advantage to an investor if the motion picture fails to generate any distribution revenue. Contrary to what motion picture investment promoters maintain, the tax shelter aspect alone is not enough to make motion picture investments attractive. Therefore, a taxpayer should not invest unless the motion picture has a realistic potential to earn distribution revenue.

3. The investor's marginal tax rate has a definite effect on the outcomes of motion picture investments. The higher the taxpayer's marginal tax rate the lower the potential loss on the investment and the greater the potential gain.

4. Given the high potential downside and low potential earnings it appears that a taxpayer with a base income of $30,000 or less would be unwise to consider investing in any kind of motion picture investment.

5. The leveraged video tape program investment returns a greater amount than the leveraged feature film investment given the circumstances outlined in this analysis. However, the probabilities of success or failure of either type of motion picture investment would have to be carefully considered.

This quantitative analysis through the use of a motion picture investment model has determined the final investment cutcomes to an investor-owner given certain financial characteristics and circumstances. The net present value of the incremental cash flow allowed comparisons and contrasts between the investor-owner's after-tax position based on two income levels, two types of motion picture investments and two distribution revenue patterns. Comparisons and contrasts were made between leveraged and non-leveraged motion picture investments. From these comparisons and contrasts conclusions were drawn concerning the income tax incentives of motion picture investment.

It must be remembered that no mechanical rules can be substituted for sound business judgement. The relative risk and financial characteristics of each motion picture investment package must be considered. In the final analysis, the potential investor must weigh the motion picture investment from two angles, the investor's personal tax position and the specific merits of each motion picture investment package.

FOOTNOTES CHAPTER VII

[1] W.B. Wheeler, Investment Analyst, Pemberton Securities Ltd., Vancouver, personal interview, April 24, 1977. Wheeler offered the following example to justify his statement that a marketable Canadian utility stock would in his opinion require an incremental apparent risk premium of 4.3% over a risk free Canadian government savings bond:

> Calgary Power common stock is allowed by government regulation to earn a 15% return on common equity. The yield is 5.8%. The reinvestment rate is 50% so the internal growth rate is 7.5% (15% x .5 = 7.5%). Therefore the investor's apparent total return equals 13.3% (5.8% + 7.5% = 13.3%). To calculate the incremental premium for a utility investment the yield on a risk free investment (e.g. Canadian government savings bond = 9%) is subtracted from the apparent total of the utility investment. The incremental risk premium is 4.3% (13.3% - 9% = 4.3%).

[2] The educational video tape investment is based on Edu-Film Productions Ltd., Investment Prospectus, The World of Health (1974), various pages.

[3] The feature films syndicate investment is based on an investment offered in The Somerville House Corporation, The ZerrO Syndicate (October 3, 1975), various pages.

[4] A.H. Howe, "A Banker Looks at the Picture Business - 1971," The Journal of the Producers Guild of America, Volume 13, Number 2, (1971), page 4.

[5] J. Fred Weston and Eugene F. Brigham, Managerial Finance (2nd Edition, New York: Holt, Rinehart and Winston, Inc., 1966), p.139.

[6] The optimum minimum income tax payable position in reality is not possible by simply deciding to utilize the capital cost allowance deductions to reduce the taxpayer's taxable income to the next lower income tax bracket. There are too many uncertainties in a taxpayer's seven year planning horizon. The optimum minimum income tax position would only be possible if "retroactive or hindsight" tax planning was permitted on a regular basis by National Revenue, Taxation through refiling previous years' income tax returns.

In reality most tax planners advise deducting the maximum c.c.a. available in the initial year or years to reduce taxable income by as much as possible. Any incremental cash flow generated in a tax shelter can then be reinvested in other investments.

[7] Financial Compound Interest and Annuity Tables, Fifth Edition (Boston: Boston Financial Publishing Company).

[8] A multitude of financial outcomes are possible for each set of investor-motion picture investment circumstances. A computer program would be necessary to determine the absolute optimum use of the c.c.a. for each investor-investment combination.

[9] If guaranteed distribution revenue was built into the educational video tape program investments the outcomes to the investor would be quite different. Hence the conclusions and recommendations to the investor would also be different from the ones offered in this chapter. However, educational producers have not offered guaranteed distribution revenue in packages available to Canadian investors.

APPENDIX A TO CHAPTER VII

RATIONALE FOR PURCHASE PRICE IN NON-LEVERAGED VIDEO TAPE PROGRAM INVESTMENT

The pricing decision for the non-leveraged video tape program investment is both objective and subjective. The price at which the producer sells a non-leveraged motion picture investment should relate objectively to the net present value of the cash flow to the producer when he sells a leveraged motion picture investment. A comparison is made of the net present value of the cash flow to the producer when the video tape program earns no distribution revenue and when it earns moderate distribution revenue. The net cash flow to the producer in the four possible combination of variables is discounted by a present value factor of 10%. The variables of distribution revenue and leverage are combined as follows:

1. No distribution revenue - leveraged
2. No distribution revenue - non-leveraged
3. Moderate distribution revenue - leveraged
4. Moderate distribution revenue - non-leveraged

The pricing decision is also based subjectively on the collectibility of the seven year promissory note by the producer.

<u>Discounted Cash Flow to the Producer Assuming No Distribution Revenue</u>

In the leveraged investment the investor-owner would be liable to the producer for $32,500 if no revenue was earned by the video tape program during the seven years.

Promissory note	$25,000
Interest for 5 years @ $1500/yr. [1]	7,500
Total paid by investor to producer assuming no distribution revenue earned-leveraged investment	$32,500

The net present value of the cash flow of $32,500 over seven years is $17,730 when the discount rate for the time value of money is 10%.

The total discounted cash flow to the producer is $42,730.

Investor down payment (production cost)	$25,000
N.P.V. of promissory note and interest	17,730
Total: discounted value to producer assuming no distribution revenue earned-leveraged investment	$42,730

If the producer offers the non-leveraged investment for $35,000 and no distribution revenue is earned, the producer gives up a potential discounted cash flow of $7,730.

Leveraged investment discounted cash flow to the producer	$42,730
Minus: non-leveraged investment cash flow to the producer	35,000
Difference: assuming no distribution revenue earned	$ 7,730

Discounted Cash Flow to the Producer Assuming Moderate Distribution Revenue

The net present value effect on the producer's share of moderate distribution revenue must be considered for the leveraged and non-leveraged investment situations. The annual distribution revenue flow for an education video tape program is shown in Table VII-I.

If the video tape program investment is leveraged, the producer cum distributor is entitled to a 5% distribution fee until the promissory note is retired and a 50% distributor's fee thereafter. Moderate revenue in the amount of $100,000 would earn the producer-distributor $47,719, including the $25,000 promissory note, the interest on the note and the distribution fee. (See Table VII-IV) The net present value of $47,719 spread over the seven year horizon at a 10% discount rate is $31,391. The total discounted cash flow to the producer is $56,391 in the leveraged video tape program investment.

Production costs	$25,000
N.P.V. of promissory note, interest and distribution fee earnings	31,391
Total: discounted cash flow to the producer assuming moderate distribution revenue earned - leveraged investment	$56,391

If the educational video tape program is sold as a non-leveraged investment, the producer cum distributor would receive 50% of the distribution revenue as a distribution agent's fee. If moderate revenue of $100,000 is earned by the non-leveraged video tape program the producer's share is $50,000. Assuming the distribution revenue pattern of Table VII-I, the net present value of $50,000 is $32,777. The total discounted cash flow to the producer is $67,777 if the video tape program investment is sold by the producer to the investor for $35,000.

Production costs	$25,000
Production profit	10,000
SubTotal: Non-leveraged purchase price	$35,000
N.P.V. of producer's share of distribution revenue	32,777
Total: discounted cash flow to producer assuming moderate distribution revenue earned - non-leveraged investment	$67,777

The producer earns additional revenue with a net present value of $11,386 if he sells the video tape program investment at $35,000 and the program earns distribution revenue of $100,000.

Non-leveraged investment discounted cash flow to producer	$67,777
Minus: leveraged investment discounted cash flow to producer	56,391
Difference: assuming moderate distribution revenue earned	$11,386

<u>Comparison of Net Present Value of Cash Flows to Producer</u>

The four net present value cash flows to the producer are as follows:

	Leveraged Investment	Non-leveraged Investment
Distribution Revenue: Nil	$42,730	$35,000
Distribution Revenue: $100,000	$56,391	$67,777

There is a reasonable trade-off between the leveraged and non-leveraged net present value cash flows to the producer (vendor) of an educational video tape program. If the producer sells a video tape program investment which is leveraged, his minimum cash flow ($42,730) is higher than if he sold the program as a non-leveraged investment. However, if the video tape program earns moderate distribution revenue he will receive less of that revenue ($56,391). If the producer sells a video tape program investment which is not leveraged his minimum cash flow ($35,000) is lower but his share ($67,777) of the moderate distribution revenue will be greater. The trade-off is that the producer gives up some of his initial cash flow but is entitled to a greater share of the future profits, if any.

Subjective Discount Factor

There is a subjective factor in selecting the selling price of the non-leveraged video tape program investment. The objective net present value difference between the leveraged and non-leveraged investment - assuming no distribution revenue - is $7,730. That is, the producer is giving up earnings with a net present value of $7,730 if he sells the non-leveraged investment for $35,000.

However, the price of $35,000 can be justified subjectively, because the producer may not be able to collect the promissory note and interest from the investor at the end of the seven years. This absence of collectibility may be due to several reasons.

1. The producer is no longer in business.
2. Either the producer or investor-owner are deceased.

3. The investor-owner is bankrupt or disappears.

4. The investor-owner refuses to pay the promissory note because the investment failed to meet revenue expectations. The producer would be forced to sue the investor-owner in court. The suit may be expensive and may be lost by the producer.

Therefore, it is reasonable that the producer further discount the seven year promissory note objective net present value for subjective factors such as collectibility.

FOOTNOTES APPENDIX A TO CHAPTER VII

[1]There is no interest due for the first year of the investment because the note is signed on the last day of the year. There is no interest due for the seventh year because the note is retired on or before December 31.

The Somerville House Corporation

October 6, 1975

Avenue,
Vancouver, B.C.

re: fall, 1975 film package,
Zorro and *The Story of O*

Dear Mr.

Further to your request, I am pleased to enclose herewith a brochure describing two films which we have acquired the right to purchase and which, we believe, have great potential for commercial success.

Zorro, a commercial production of an old favorite, will return to the owners 30% of gross distributor's rentals in excess of $500,000 (U.S. and Canada only - the rest of the world is subject to a distribution agreement providing guaranteed rentals).

The Story of O, a highly commercial film based upon an extremely popular French novel and presently the subject of much publicity, will return to the owners 10% of gross distributor's rentals from the first dollar on the same basis as for *Zorro* (see above).

The Somerville House Corporation is forming a syndicate to purchase the films and a mid-November closing is anticipated, co-inciding with the North American release of the films.

Minimum contributions to the zorrO syndicate have been set at $25,000, although, as always, consideration will be shown to smaller investors.

Syndicate and Contribution Agreements are presently being prepared, and will be forwarded to you upon request.

As is our policy, we will accept syndicate members' contributions on a "first-come, first-served" basis.

Please do not hesitate to contact me should you wish any further information or explanation with regard to this venture.

Yours sincerely,

:/by
enclosure

The Somerville House Corporation

the zorrO syndicate

OCTOBER 3, 1975

CONTENTS

COPY FOR: ______________________

the zorrO syndicate

PROPOSED TRANSACTIONS

1. The Somerville House Corporation will form and manage a syndicate, to be called "the zorrO syndicate", for the purpose of purchasing the motion picture films known as *Zorro* and *The Story of O*.

2. Members of the Syndicate will initially invest the sum of $1,650,000 U.S. ($1,585,000 U.S. for the down payment in respect of the purchase - see below; $65,000 U.S. to purchase a bank guarantee in respect of the receipt of certain of the film rentals - see page 6) and will share in the profits and losses of the syndicate *pro rata* to their respective investments.

3. The syndicate, for and on behalf of its members, will purchase all right, title and interest in and to the motion picture films, *Zorro* and *The Story of O*, from [illegible], a Swiss corporation, and will own the copyright and original negative thereof.

4. At the time of acquisition of the films, the investors will acquire undivided interests in the ownership of the films. It is not intended or desired that a partnership be formed among the syndicate members. In fact, the express intention is that there be no partnership.

5. The purchase price to be paid for the films will be $7,000,000 U.S., of which $1,585,000 U.S. will be paid on closing and the balance of $5,415,000 U.S. will be paid in the following installments on the dates indicated:

   $1,000,000 U.S. on April 1, 1976
   $1,000,000 U.S. on April 1, 1977
   $1,000,000 U.S. on April 1, 1978
   $1,000,000 U.S. on April 1, 1979
   $1,415,000 U.S. on April 1, 1980

   Each investor shall have the obligation to pay his or her proportionate share of the balance of purchase price. Such obligation shall be with full recourse and must be paid when due.

6. The films are to be distributed in the U.S. and Canada by Allied Artists Picture Corporation and in the rest of the world by World Association Video Establishment (Wave). The agreement with Allied Artists provides for contingent rentals, based on Allied Artists' receipts, and the agreement with Wave provides for guaranteed rentals. The syndicate will purchase a bank guarantee to ensure the receipt of the guaranteed rentals from Wave.

   Page 6 hereof contains further details in respect of the distribution agreements.

7. *The Story of O* has been released in France and has received immense publicity. ("Half of Paris seems to be queuing up to see it - and the other half is talking about it" - *Time*, September 22, 1975)

   North American release of both films has been moved up from January to November in order to capitalize on the publicity being given to *The Story of O*, which will include a feature in the November issue of *Playboy*.

PROPOSED TRANSACTIONS

CONTINUED

8. All transactions of the syndicate will be made in U.S. funds and, accordingly, members will purchase their interest in the films in U.S. dollars and will receive distributions of syndicate funds in the same currency.

9. Allied Artists, Wave, [illegible], the investors and the bank which will provide the guarantee of Wave's obligations under its distribution agreement are not related to each other by family, ownership, control or other than by virtue of the transactions referred to above.

10. The Somerville House Corporation will not receive any fees from the syndicate for the organization or management thereof, but will be entitled to recover its expenses incurred in managing the operations of the syndicate. The Vendor is liable for costs of organizing the syndicate and consummating the purchase of the films.

    The Sommerville House Corporation will, however, receive remuneration from the Vendor and from Allied Artists, as follows:

    a. from the Vendor, as a fee for organizing the venture, the sum of approximately $140,000; and

    b. from Allied Artists, 2½% of gross receipts in excess of $500,000 from the U.S. and Canadian distribution of *Zorro* and 2½% of gross receipts in excess of $2,500,000 from the U.S. and Canadian distribution of *The Story of O*.

11. Persons wishing to purchase an interest in the films should:

    a. sign two (2) copies of a contribution agreement;
    b. sign two (2) copies of a syndicate agreement;

    c. forward both copies of the contribution and syndicate agreements, together with a cheque in U.S. FUNDS for the amount of their investment and payable to "[illegible], in trust", to The Somerville House Corporation.

    One fully-executed copy of the contribution agreement and the syndicate agreement will be returned to you for your files.

the zorrO syndicate

SYNOPSIS - *ZORRO*

STORY LINE: Zorro (Don Diego de Vega), the black garbed Robin Hood of Spanish California originated as the hero of a 1919 strip cartoon by Johnston McCulley and was subsequently featured in a number of films - *The Mark of Zorro*, *Don Q, Son of Zorro*, *The Bold Caballero*, *The Sign of Zorro* and *Zorro and the Three Musketeers*, as well as serializations.

In this 1975 film version, Zorro, the devil-may-care righter of wrongs, assumes the responsibilities of Governor of New Aragon upon the death of his good friend Miguel. In this new position, Zorro adopts the personality of the palace playboy to camouflage his true identity as the restorer of justice to the territory.

PRODUCTION: A Franco-Italian co-production by Mondial TE.FI and Les Productions Artistes Associes, produced by Luciano Martino and directed by Duccio Tessani.

STARS: Alain Delon...French leading man who became an international star through such films as *The Leopard*, *The Yellow Rolls Royce*, *Once a Thief*, *Is Paris Burning* and *Texas Across the River*.

Stanley Baker...tough looking Welshman who has played important roles in *The Cruel Sea*, *Alexander the Great*, *Richard III*, *The Angry Hills*, *The Guns of Navarone* and *Sands of the Kalahari*.

And co-starring the beautiful Italian actress, Ottavia Piccolo.

PURCHASE PRICE: $4,500,000

the zorrO syndicate

SYNOPSIS - *THE STORY OF O*

STORY LINE:	Based on the most widely read contemporary French novel by Pauline Reage.
PRODUCTION:	A Franco-German co-production between S.H. Prodis-Yang Films - A.D. Creation and Terra Filmkunst GmbH.
DIRECTOR:	Just Jaeckin whose last year's success, *Emmanuelle*, became the top grossing film in French history.
STAR:	Corinne Cléry
PURCHASE PRICE:	$2,500,000

the zorrO syndicate

DISTRIBUTION AGREEMENTS

Allied Artists Picture Corporation will distribute the films in the United States and Canada. the zorrO syndicate is to receive percentages of such distrubutor's gross receipts, as follows:

a. in respect of *Zorro*, 30% of gross receipts in excess of $500,000; and

b. in respect of *The Story of O*, 10% of gross receipts from the first dollar.

(Gross receipts are, generally, all monies received by the distributor from the exploitation of the films in all media, before the deduction of any fees, expenses or other amounts due to or paid by the distributor.)

World Association Video Establishment (Wave), a Swiss Corporation, will distribute the films in the rest of the world. the zorrO syndicate is to receive from such distributor guaranteed film rentals of $5,415,000, payable on or before the various dates on which syndicate members will be required to make payments on account of the balance of purchase price of the films. the zorrO syndicate will receive no other film rentals from Wave.

In order to insure the receipt of such guaranteed rentals, the syndicate will purchase, at a cost of approximately $65,000, a guarantee from a major Swiss banking organization that if Wave fails to pay its rentals when due, the bank will make payment in its stead.

the zorrO syndicate

REVENUE CONSIDERATIONS

Zorro and *The Story of O* are of sufficient quality and should have sufficient box office attraction to make them a financial success and to produce a substantial return on the investment therein.

Based on films of similar natures, what we believe to be a conservative cash flow projection is as follows:

RECEIPTS FROM ALLIED ARTISTS - U.S. AND CANADA:		
Zorro, gross receipts estimated at $5,000,000 of which the syndicate will receive 30% of $4,500,000		1,350,000
The Story of O, gross receipts estimated at $10,000,000 of which the syndicate will receive 10%		1,000,000
RECEIPTS FROM WAVE - REST OF THE WORLD:		
Guaranteed rentals		5,415,000
TOTAL ESTIMATED RENTALS		7,765,000
Costs		
Cost of films	7,000,000	
Cost of bank guarantee	65,000	7,065,000
ESTIMATED MINIMUM CASH SURPLUS (before income taxes and expenses of operation)		$ 700,000

Syndicate members will appreciate that the ownership of motion picture films is a high risk investment and no guarantee or representation is made herein.

APPENDIX C TO CHAPTER VII

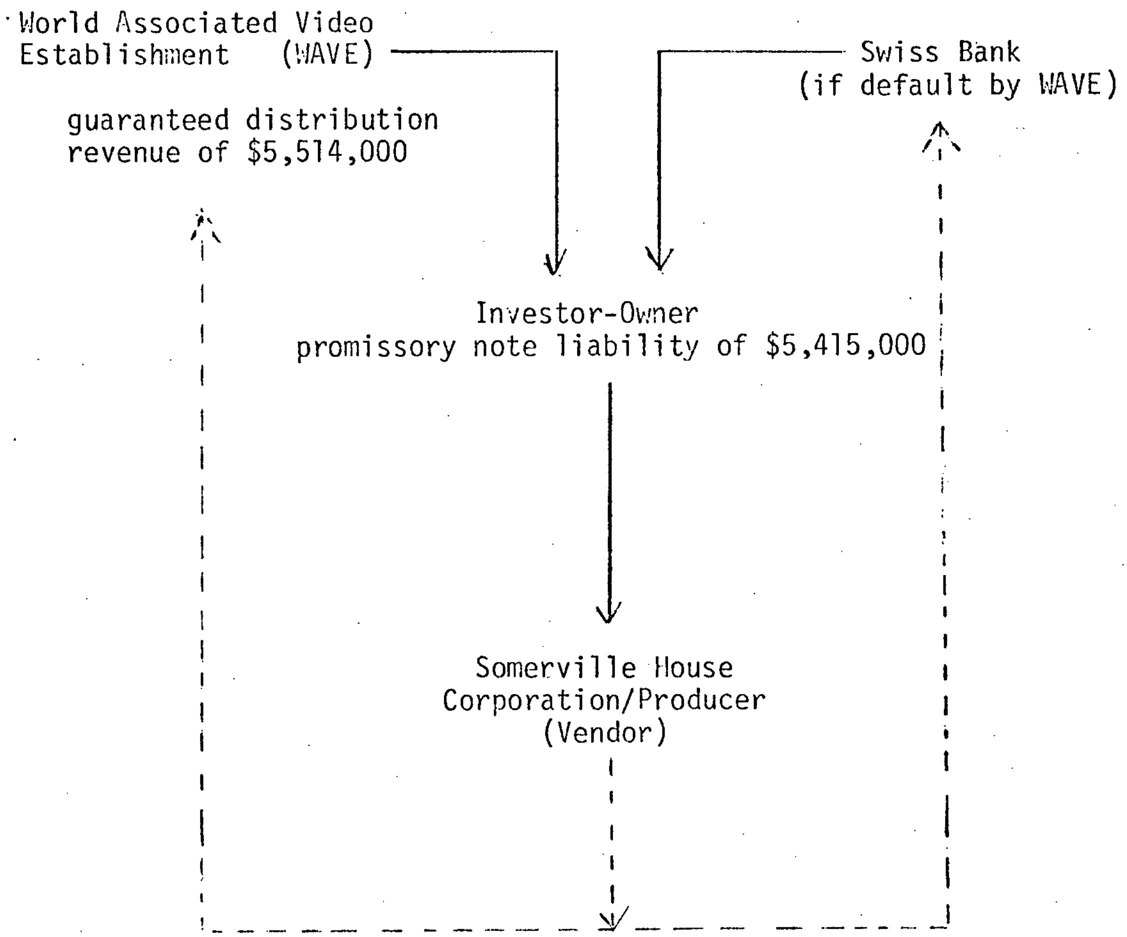
RATIONALE FOR PURCHASE PRICE IN NON-LEVERAGED FEATURE FILMS INVESTMENT

A 1/66th share of the two feature films offered by the Somerville House Corporation is assumed to cost the investor $25,000 if the investment is not leveraged. The assumption is made that in the non-leveraged investment, the syndicate will receive only the distribution revenue earned in the North American theatrical film markets. The vendor (producer) of the two feature films will receive any revenue earned by the films in the foreign theatrical motion picture markets. These assumptions are based on the writer's theory that there must be some arrangement between the vendor of the films and the foreign distributor to reimburse the distributor should the distributor have to pay the investor-owner's promissory note liability. Table VII-VI is a schematic of the cash flow of the syndicate-guarantee financing arrangement. The dotted lines represent the suspected flow of funds between the vendor and the foreign distributor-guarantor or bank guarantor. If this theory is correct the net effect of the flow of money between distributor-investor-vendor-distributor is zero. (This flow of money could be effected by withholding income taxes, however.)

Therefore, if the vendor reimburses the distributor, if the film is a financial failure in the foreign markets, the vendor is primarily concerned with the amount of money initially invested by the investors ($1,585,000). If some money is earned by the films in the foreign markets, that amount would be profit to the vendor because the vendor would not have to reimburse to the distributor that amount received from the syndicate of investors. For example, suppose the films earned $415,000 in the foreign

TABLE VII-VI

Schematic of Cash Flow in Syndicate-Guarantee Feature Film Financing Arrangement (Showing Writer's Reimbursement Theory)



The solid lines represent the flow of distribution revenue from the distributor to Investor-Owner and in turn to the Producer. The Swiss Bank on the right hand side would only pay the investor-owner if WAVE defaults. The broken lines represent the suspected cash reimbursement of any funds paid by the distributor, WAVE or the bank should the feature films fail to earn at least enough for the investors to pay the promissory notes of $5,415,000 to the producer.

Source:
Somerville House Corporation, The ZerrO Syndicate, (October 3, 1975)

markets in bona fide distribution. The distributor, WAVE, would be out-of-pocket $5,000,000 when WAVE was called upon to pay the investors the guaranteed distribution receipts of $5,415,000. The investors would in turn, use the $5,415,000 to pay the promissory notes held by the vendor. And, if the writer's theory is correct, the vendor would reimburse the distributor the $5,000,000 the foreign distributor was out-of-pocket to meet the guaranteed distribution revenue obligation. The vendor would have a profit of $415,000 before income taxes.

It appears that the series of promissory notes and the guaranteed distribution revenues to off-set the promissory notes, is a charade designed soley to offer to investors a tax shelter, or at least a deferment of taxes payable by the investors.

CHAPTER VIII

SUMMARY, RECOMMENDATIONS AND CONCLUSIONS

1. INTRODUCTION

The purpose of this chapter is

1. To summarize the most important points of each chapter while placing particular emphasis on the motion picture industry environment in Canada and on the consequences to the private investor involved in that environment.

2. To offer recommendations as to how the federal government and the motion picture industry together can attract the necessary investment capital for the development of a stable motion picture industry in Canada.

3. To repeat the stern premonition that motion picture investments are likely to be a financial loss.

4. To offer recommendations as to how those investors still interested in investment, may increase their chances of earning a return on their equity.

5. To offer suggestions for futher study of the motion picture industry.

2. SUMMARY OF PREVIOUS CHAPTERS

Chapter I. The marketing activities in the motion picture industry in Canada are foreign dominated. The distribution companies are subsidiaries of several large international American-based companies. Theatrical exhibition is dominated by two national theatre chains which control over 60% of the theatre screens in Canada. The two chains are owned by foreign interests.

The product marketed by the distributors and exhibitors is predominantly foreign produced. Lately, Canada has been producing an average of about 30 feature films each year - an amount which is equivalent to 10% of the annual American production. Commercial Canadian product with mass audience appeal is in short supply.

Educational motion picture production and distribution is American dominated. The product is for the most part, American and the distribution companies are either American subsidiaries or American influenced through exclusive product exchange agreements.

A federal government goal is the development of a motion picture industry in Canada. The first method the government devised to achieve this goal was the founding of the Canadian Film Development Corporation.

The C.F.D.C. is a crown corporation which has a mandate to invest in, or loan money to Canadian motion picture production. The C.F.D.C. has expended over $25 million in its attempt to nuture a Canadian film industry. The direct financial returns on this investment have been disappointing. The benefits to the motion picture industry and to the Canadian economy as a whole are controversial.

The second concession the federal government offered the motion picture industry was the income tax shelter incentive designed to encourage direct private investment in Canadian motion pictures. To date the provision for deducting the capital cost of motion pictures from other sources of income has not worked for the mutual benefit of the industry or the investors. Both avaricious taxpay-investors and rapacious promoter-producers have devised schemes which resulted in very few products that were commercially viable. The result of these schemes was to increase the work load of the already over-burdened National Revenue, Taxation employees, who had to painstakingly prove that the motion picture investments were made for no other purpose than to reduce the investors' income tax liabilities. The long term result was loss of the investment, hence investor dissatisfaction thus supporting the disreputable motion picture investment image.

A third program to encourage the development of a motion picture industry in Canada is the co-production treaties with foreign countries. These treaties offer Canadians the opportunity to become involved in international productions which draw on a much greater corps of technical and creative talent. Properly administered, the co-production program may be the key to reaching the goal of a Canadian motion picture industry which produces a product which can compete in the world market.

Chapter II explores the basics of motion picture investment through the tax shelter approach. The characteristics of the investor and the investment are examined. The advantages and disadvantages of the various financing arrangements are evaluated. The major point of the chapter is that the financing arrangement must be satisfactory to the investor and at the same time adhere to the requirements of the Canadian Income Tax Act and Regulations.

Chapter III describes the relevant sections of the Income Tax Act and Regulations as they pertain to motion picture investment and capital cost allowance. The Income Tax Act and Regulations are written by the Department of Finance under the auspices of Federal Parliament. The purpose of income tax is to provide a means of revenue for the state. The revenue is used to supply the services and facilities expected by Canadian citizens. The Act attempts to tax the profits of Canadians so that the government can directly provide certain services and facilities. The Act also attempts to encourage taxpayers to invest their income (before taxes) in a prescribed manner which will indirectly provide certain services and facilities to Canadians.

The government does not wish to exclusively provide educational and entertainment motion pictures. The government would prefer that taxpayers provide motion pictures for themselves, therefore capital cost incentive for investment in Canadian made or co-produced motion pictures has been devised.

The current Income Tax Regulations state that to be eligible for the 100% capital cost allowance, the motion picture investment must be in a "certified feature production" or a "certified short production". Those productions are either Canadian productions which meet the Canadian production content criteria or co-productions with nationals of a country with which Canada has a co-production treaty. The Secretary of State must approve and certify the motion picture.

Chapter IV. The government's intention is to encourage the use of the capital cost allowance system to aid in the development of the Canadian motion picture industry. National Revenue, Taxation's mandate is to collect as much revenue from the Canadian taxpayer as possible by applying the terms of the Income Tax Act and Regulations. The Act and Regulations is not always written in precise terminology, therefore the tax department has adopted the policy of publishing interpretations - their interpretations - as to the implications of the wording of the Act.

The tax department contends that a taxpayer can only claim a capital cost allowance deduction for an asset if both the taxpayer and the asset unconditionally meet certain requirements. The requirements are:

1. Ownership - which means that the owner behave in the manner of a true owner, exercising control over the asset;
2. Commitment - which means that the asset must have been purchased with the taxpayer's funds or with funds for which the taxpayer is unconditionally liable;
3. Purpose - which means that the asset must have been purchased for the purpose of gaining or producing income.

In Chapter IV National Revenue, Taxation's interpretation of the three requirements for a capital cost allowance deduction in a motion picture investment are reviewed.

If a taxpayer does not agree with National Revenue, Taxation's interpretation of the provisions of the Act and Regulations the taxpayer can submit his income tax return based on his own interpretation. Such action by the taxpayer will almost certainly be contested by the tax department's assessors. The taxpayer can appeal to the Tax Review Board for a ruling and in turn to the Federal Court-Trial Division. The taxpayer can present his case stating the grounds he used to calculate his income tax and why he believes he is entitled to a capital cost allowance deduction. The Minister of National Revenue will present arguments which contend that the taxpayer's income tax calculations are not in accordance with the wording of the Act.

Chapter IV includes the consideration of three tax cases: two appeals to the Tax Review Board and one appeal to the Federal Court-Trial Division. All cases were ruled in favour of the Queen or her representative, the Minister of National Revenue. The principal point in all cases was that the taxpayer is not entitled to deduct from his income, capital cost allowance which includes in the capital cost base, amounts which were not personally committed by him or for which he was not personally liable.

National Revenue, Taxation's interpretation has been upheld. Capital cost allowance in motion picture investment can only be deducted if the taxpayer has personally and unconditionally committed and expended the capital.

Chapter V is a detailed case study of a motion picture investment in an educational video tape program. The purpose of the case study was to demonstrate how the mechanics of a motion picture investment function within the perimeters of the Income Tax Act and Regulations. The emphasis was that the investment be one of commercial reality, and that the legal language of the contractual arrangements between the investor, the vendor-producer and the distributor be carefully designed to avoid the adverse effects of denial by the tax department of the capital cost allowance deduction.

The chapter examines such factors as commitment of investment funds, completion dates, copyright, ownership, and the flow of distribution revenue. All these factors are important to the tax shelter feature of the investment.

Chapter VI explains National Revenue, Taxation's procedures for reassessing and auditing a taxpayer. The chapter reviews the reassessment of the motion picture investment outlined in the case study in the previous chapter. The arguments for reassessment by the tax department and the taxpayer's rebuttal of the arguments are presented. The chapter demonstrates why the technical and legal structure of a motion picture investment must be so thoroughly considered for every possibly contingency.

Chapter VII. In Chapter VII a motion picture investment model was developed. The purpose of the model was to undertake a quantitative analysis of the financial outcomes to hypothetical taxpayers investing in an education video tape program and theatrical feature films. The analysis studied the financial effects of leveraged and non-leveraged investments. The conclusions of this analysis will be considered in the next section of this chapter.

3. PRIVATE MOTION PICTURE INVESTMENT - GENERAL CONCLUSIONS

Private motion picture investment is a complicated, high risk venture. Private financing must be arranged in a sophisticated manner in order to satisfy the requirements of the investor, the investment, the motion picture producer-vendor and the income tax laws of Canada. There is an obvious risk that the motion picture will be an artistic and commercial failure. There is also a risk that the motion picture will fail to qualify for a capital cost allowance deduction from the investor's other sources of income.

A taxpayer contemplating investment in a motion picture should be prepared to at least satisfy questions which tax department officials will ask concerning the structure of the investment. A taxpayer may have to submit to a tax department audit. The taxpayer should be prepared for the audit and he sould include a financial contingency for additional legal and accounting fees in his consideration of the investment. The audit can be very time consuming:

> ...since the (tax department) auditor has plenty of time to do the job, he/she looks over all the returns in the file... and asks any questions which come to mind based on the information...filed. He/she might as well fill the page as long as he/she is writing to you (the taxpayer) anyway.[1]

A taxpayer should not consider motion picture investment if he can not stand the rigors (mental, physical, financial, emotional and/or spiritual) of a National Revenue, Taxation audit.

The final outcomes of the quantitative analyses of the motion picture investments indicate that the investment must be structured so that the initial capital investment is leveraged and that the capital cost allowance claim in the first year is equal to or greater than the initial capital investment. The liability incurred by the leverage is offset by the minimum distribution revenue guarantee. Therefore the loss to the investor is minimized if the motion picture is a commercial failure. A taxpayer is advised that he should only consider motion picture investment if his basic income exceeds $30,000 annually, that is, his marginal income tax rate is 50% or more.

Many motion picture investment-promoters and even some tax advisors fail to consider the long term implications of the tax shelter feature of motion picture investment. The full long range effect must be evaluated. Many investors see the immediate tax deduction but fail to fully consider the future liabilities attached to the promissory notes. Investors often fail to consider the future tax consequences in syndicate-guarantee arrangements. The guaranteed revenue credited to the investor-owner by the distributor is paid to the producer-vendor, yet the investor-owner must pay taxes on the revenue flow.

Investors enticed by the excitement of motion picture glamour and/or the initial tax deferral make naive statements. For example:

> Who cares (what the prospects of the film are), I only know that for every dollar I put up I receive a two-dollar tax refund.[2]

This line of reasoning is dangerous. If the motion picture does not earn any distribution revenue the net present value of the incremental cash flow is negative. The investor will lose money in the long term. A taxpayer must not consider investment unless the project has elements of commercial reality. Unrealistic projects will fail to generate a return on equity and the c.c.a. claim may be disallowed on the grounds that the investment is a sham made solely for the purpose of reducing tax.

A taxpayer must consider only projects which have a realistic chance of exploitation in the international market. A motion picture will have a realistic chance of commercial exploitation if it will appeal to American audiences. Therefore, an investor should consider only those motion picture projects which are based on a script which has attracted the serious interest of a large United States based international distributor. Ideally, the project would have partial financial backing from an American distributor.

The writer believes educational films and video tapes are not as good an investment as a well packaged theatrical feature films. This belief is based on the motion picture investment model outcomes and the definite restriction to educational audio-visual program earnings. The potential earnings of an educational motion picture are not enough to outweigh the potential losses. A higher leverage ratio than was used in the model (2:1) could be incorporated into an educational motion picture investment. This leverage would reduce the investor's downside. The higher promissory note liability however, would make it impossible for the investor to earn any revenue because of the gross sales ceiling of educational motion pictures. If education producers offered a minimum distribution revenue guarantee to offset the promissory note liability the financial outcomes of an unsuccessful educational motion picture would be improved. Education producers have not offered this financing arrangement in Canada.

The writer recommends that investors consider only feature films. Feature film investments can be more highly leveraged than educational motion picture investments because feature films have a higher revenue ceiling than educational motion pictures. The leverage liability is offset by guaranteed distribution revenue. The high leverage reduces the financial exposure for the high income taxpayer because the avoidance or deferral of income tax is equivalent to a government investment or interest free loan.

The potential investor must realize that very few feature length motion pictures earn money for the investor. Motion picture industry spokesmen are fond of quoting that there is "one chance in seven of earning some money on an investment and one chance in ten of backing a box office smash."[3] The writer disputes these figures. The motion picture industry is notorious for touting statistics which are, at the very least, out of context and, at worst, dishonest. Howard T. Lewis, writing in The Motion Picture Industry, states:

> The industry has made no real attempt to give the public any thorough-going, unbiased discussion of its organization, operation or profits and that such information as has been given has been frankly biased and intended primarily to promote friendly public relations...[4]

The motion picture industry spokesmen who quote figures of one in seven and one in ten are talking about feature films which are actually completed and released in the North American markets. The quoted figures do not include the many pictures which are started but never completed or those that are completed but never released. Motion pictures which are not completed will not be eligible for a capital cost allowance deduction because the tax department does not allow depreciation on an asset which does not exist. Capital cost allowance will likely be denied on unreleased theatrical features. If no serious distribution attempts are made then the tax department could contend that the asset was not purchased to gain or produce income.

The Canadian Film Development Corporation has invested $25 million in feature films. None of those films have been "block busters" and only three or four have earned any revenue for the C.F.D.C. (approximately $4 million in total). These facts confirm the writer's opinion that the commonly quoted industry statistics are false - particularly in Canada.

The corporate strategy of the large American motion picture production-distribution companies further confirms the high risk of motion picture investment. These companies, which are in the best position to evaluate the probability of commercial success and return on investment are currently investing in few motion pictures despite a good cash flow from some exceptional "hits". The companies are investing in other businesses "quite far removed from (motion picture production)... - in areas that promise more stable and predictable earnings."[5]

A Canadian taxpayer contemplating motion picture investment must be fully prepared and able to lose his investment. On the other hand, changes in the movie-going public's habits could make the investment pay off handsomely. Statistics indicate that fewer people are attending fewer motion pictures but when a motion picture with mass appeal is released a greater number of people will attend that particular movie. The reason people are attending fewer films than they once did is that admission prices have steadily increased. The cost of a theatre ticket is as high as $5.00. A person spending that amount of money makes a positive decision to attend much less readily than he did when the admission price was $1.00 or less. George Destounis, president of Famous Players Ltd., stated:

> ...audiences have every right to be selective. They're buying. They're no longer killing time at 95 cents but choosing what they want to see at $3.25, $3.50 or $3.75.[6]

Motion pictures must also compete with television as a form of entertainment.

If, however, a theatrical motion picture is popular, the revenues generated by that movie are greater than ever before :

> From the first days of filmmaking until 1970, only a dozen or so movies ever grossed as much as $25 million. No fewer than 25 films since 1970 have done that well, and that does not count foreign distribution which can sometimes double the take.[7]

Emanual Gerard, executive officer of Warner Communications, Inc. stated in Business Week "the upside payoff has shot up faster than (production) costs, and when you score, you score big."[8]

There are no proven formulas for a successful feature length motion picture either in theme, creative content or budget size. There are elements which a potential investor should insist on in any motion picture investment under consideration. The most important of these elements is that the motion picture have international market appeal. The international appeal factor can be best assured by investing in a Canadian co-production. The co-production must be produced or directed by a filmmaker of international renown. Other elements which should be in a theatrical motion picture investment will be outlined in this chapter in the section entitled "Recommendations to Private Investors".

A potential investor must seek competent tax advice before investing in a motion picture. The investor and his advisors must prepare for the eventuality of either a motion picture "hit" and the subsequent return on the investment, or of a motion picture "bust". The tax planning should include contingencies for either eventuality. Plans must be made which either reduce the future tax liabilities through other tax deferral investments or reduce the promissory note liabilities with income from low risk investments.

Good tax planning takes time and careful consideration. Therefore a taxpayer is advised to investigate motion picture investments early in his tax year. He should avoid any last minute decisions. Decisions which are made in haste cannot include and carefully consider all the factors involved in motion picture investment.

4. RECOMMENDATIONS

A. Recommendations to the Federal Government

The federal government has a goal to encourage the development of a self-supporting motion picture industry. Various policies and incentives have been instituted during the past ten years in an attempt to achieve the government's goal. The policies and incentive programs have not been coordinated and are often initiated on an individual basis in order to appease the most vocal pressure group of the moment. This patch work film policy has resulted in a situation which has certain government departments and agencies working at cross purposes to one another. The situation reduces the positive effect on the motion picture industry.

The first step toward establishing a Canadian film policy and viable motion picture industry should be a comprehensive examination of the potential benefits for Canada of a motion picture industry. The government must determine what the benefits are and then evaluate Canada's production and distribution capabilities to derive these benefits. The evaluation of Canadian capabilities must be based on a realistic appraisal of what can be accomplished immediately and in the future. Canada must decide what is its present strength in motion picture production and distribution and what skills Canadians can develop from the present base.

Canadian Market and Product

Canada's population and hence market is not large enough to support the expense of motion picture production. Canadians must produce products which are commercially acceptable in Canada and in the international markets, particularly the world's English and French speaking markets. It must be accepted that until Canada's technical and creative production skills are developed Canada is best to supply the current needs of the international motion picture markets. Canadian filmmakers must develop a reputation for excellent technical production before they attempt to make statements reflecting Canada's culture in their motion pictures.

Sweden, a country with a population of less than 50% of Canada's population, has a thriving motion picture industry. Their film technicians are among the best in the world. When a country has a reputation for technical excellence it can develop an interest in the country's culture among its world wide audience.

The Canadian federal government must resist the temptation to use the motion picture industry as a political tool. The government's motion picture policy must consider the economic benefits of a self-supporting motion picture industry. The government must put aside the cultural and political benefits until the industry can stand on its own feet.

Production of motion pictures involves millions of dollars. The Canadian Motion Picture Distributors' Association considered the economic versus the nationalistic cultural arguments in their "Position Paper Concerning the Motion Picture Distribution Industry in Canada." The paper stated as a premise that motion pictures have a cultural and educational impact on society. The Association recognized that the Canadian motion picture market can not economically support purely societal objectives and be self-sustaining.[9] "A movie will have limited cultural or educational impact if the movie going public is unwilling to attend."[10] The primary thrust of the government's motion picture policy must be to develop an industry which will provide the type of product demanded by the market place.

What is needed now is a clear declaration of the government's determination to build a motion picture industry - not just a Canadian motion picture industry but a motion picture industry in Canada capable of competing in the world markets. A government study or perhaps a royal commission should look into the activities of the various government bodies concerned with motion pictures. A policy must evolve which coordinates the activities of the public and private production/distribution organizations. A cost benefit analysis of the C.F.D.C. and the National Film Board must be undertaken.

Canadian Film Development Corporation

The government must decide if the C.F.D.C.'s present mandate is correct. The writer believes that the C.F.D.C should be more concerned with earning a return on its financial participation in motion pictures. Les Wedman, the Vancouver Sun movie critic has stated that:

> getting government money (from the C.F.D.C. and Canada Council) has become a national pastime and everybody is playing with film-making.[11]

The writer agrees. Some "film producers" have developed a greater skill for obtaining government financing than they have for making motion pictures. The irresponsible attitude of these producers does not develop the Canadian industry, it simply contributes to the boom or bust cycles. When government money is plentiful many unskilled or untalented persons become involved in film productions. Later, when government assistance is reduced, these non-professional persons swell the ranks of the unemployed, thereby adding to the taxpayer's burden by collecting unemployment insurance benefits. These people list their occupation as "filmmakers" and can legitimately refuse to take other forms of employment. They can continue to collect unemployment insurance cheques until the advent of the next government handout through the C.F.D.C..

The original intention of the government in 1965-66 was to establish a loan fund to foster and promote the development of a feature motion picture industry in Canada. It was expected at that time that the injection of some $10 million would be sufficient to assist the industry and make it self supporting. But the industry has not become self-supporting. The incorporation of the C.F.D.C. created yet another government bureaucracy. The C.F.D.C. in league with the motion picture industry lobby in Canada, seems to have sufficient weight to not only obtain some $15 million more in operating and investment funding from the Federal Treasury Board but to increase its mandate as well. The C.F.D.C. officers argue that:

> It has become increasingly clear that government assistance is fundamental to the successful continuation of a Canadian film industry involved in feature film production and that the Canadian Film Development Corporation, far from being an agency which could launch the industry and leave it to go on its own, must have a continuing role".[12]

The C.F.D.C. can, of course, publish statistics in its annual reports and make presentations to the government which indicate the value of the C.F.D.C. contribution to the industry. It is common knowledge that statistics can be made manipulative. Statistics Canada's production questionnaire is badly designed. The questionnaire leads to overstated production statistics as it does not distinguish between sub-contracted production work among different producers. Therefore, the basis of the statistics which are used by C.F.D.C. are unreliable.

It may be conceded that the C.F.D.C. had to learn by experience during these past nine years. The total return of $4 million[8] on the $25 million investment of the Canadian taxpayer's money is very poor. The writer believes that encouraging tax shelter investment by wealthy taxpayers who can perhaps afford to take a risk is a superior method to that which forces all taxpayers to contribute to an industry which is faced with intense world-wide competition in a declining market.

Foreign Co-Production

Wedman of the Vancouver Sun suggested:

> do away with the entire C.F.D.C. as it currently exists and put film-making under the control of one man who knows how to spend money wisely and how to make money.[13]

The writer believes that the C.F.D.C. should have a different mandate - not to invest in motion pictures directly but to encourage and facilitate production by coordinating all agencies involved. The C.F.D.C. should actively develop more international motion picture co-production treaties.

The C.F.D.C. should offer non-monetary government aid to foreign producers. Part of this aid for example, could be in the form of assisting the foreign producer in obtaining permits and licences necessary to shoot in certain public or restricted locations. The C.F.D.C. could act as a liason with other government bureaucracies. Foreign productions in Canada would help to reduce the present cyclical pattern of motion picture production.

Foreign producers must be made aware that they are expected to contribute to the Canadian industry if they wish to take advantage of

Canada's offer of assistance and encouragement. The foreign filmmakers must agree to partake in apprenticeship training programs for Canadian filmmakers. The editors of Cinema Canada, Connie and Jean-Pierre Tadros, have editorialized:

> Certainly the more films (co-productions) which are made in Canada, the better things will be for the technicians who work and learn, and the stronger the industry will become.[14]

The Department of Manpower and Immigration must be directed to make special work permit concessions to foreign filmmakers working on Canadian co-productions. Most important, streamlined processes must be developed which will permit a foreign producer to get his film crews into Canada in an expeditious manner, with minimal red tape.

A special program to encourage foreigners to work in Canada should have sunset provisions. A time horizon should be determined in advance which would gradually close the door to foreigners. It would be undesirable to allow foreigners to become entrenched in the Canadian motion picture industry resulting ultimately in a competitive situation for Canadian filmmakers.

Income Tax Incentives

The writer believes that the income tax capital cost allowance legislation should be improved so that there is a greater incentive for high income taxpayers to finance motion pictures. The incentive should not be so generous that the taxpayer-investors unfairly take advantage of the situation but that they end up in the same net position as if they had originally paid their taxes. In order to avoid a situation in which every wealthy Canadian invests in motion pictures and there is a prolif-eration of unrealistic motion picture projects, the onus will be on the investors and producers to prove that the unsuccessful motion pictures are honest commercial failures if c.c.a. is to be allowed. That is the picture was a failure because the public was unreceptive to the creative elements, not because the technical elements were poor or the picture was not aggressively marketed. If the motion picture is a success the investors should be entitled to a fair return on their equity. Paul Morton, president of Odeon-Morton Theatres Ltd. says that:

> if there is to be a film industry in Canada, it will have to be done with the co-operation of all segments of the private sector together with government.[15]

Morton believes that "the greatest problem is how to finance a Canadian motion picture".[16] He suggests:

> take the government out of direct financing of commercial pictures, let them provide tax incentives to private capital by extending capital cost allowances past the 100% mark. There is no magic in that figure and there is nothing to preclude capital cost allowance from being at 115% or 125% for a few years as an experiment. This would not cost the government any more than they are currently spending with the C.F.D.C., but it would stimulate private capital, and the ability and creativeness of the people who manage it, and bring them into the field of film production.[17]

A coordinated government policy encouraging private investment would help develop the motion picture industry. Private investors would become sophisticated in assessing motion picture investment proposals. The investors would know what elements to look for. It has been the writer's experience that the private investor attracts the serious motion picture producer who has realistic projects in mind. The private investor is a businessman more concerned with making a return on his investment than the C.F.D.C. is interested in making a return on theirs. Producers should realize that a private investor will not invest solely to avoid income taxes. There is no net saving for the investor if he does. The government has tried in the past to aid the motion picture industry directly through the C.F.D.C. It is time to let the industry build itself through indirect incentives. This suggested approach may eliminate the incompetent filmmakers and the non-commercial projects.

If the government follows the recommendation to ammend the rules for motion picture investment and capital cost allowance, the rules must be clearly spelled out for both the investor and for National Revenue, Taxation. The ammendments to the Income Tax Act and Regulations must be written in clear, concise terminology. Nothing will be accomplished if the federal government adopts certain income tax incentive policies and the tax department auditors disallow the incentives.

Educational films and video tapes provide an excellent medium for young filmmakers to gain experience in motion picture production. Many educational motion pictures are simply short features - the technical and creative processes are similar and the project must work within the economic perimeters of budget and market potential. The writer believes that if the government is serious about a motion picture industry in Canada then the government should encourage the production of short films by the private sector. (The National Film Board is well known for its short motion pictures but that is the public sector).

The market potential of an educational motion picture has a definite upper limit, albeit, the costs and the risk of complete commercial failure are lower. The government should consider special tax incentives to encourage private investment in educational motion pictures.

The educational video tape investment model simulations and the conclusions in Chapter VII demonstrated that educational programs were not as attractive an investment as features because of the educational market's revenue ceiling. Perhaps a structure of tax incentives could be devised, similar to the dividend tax credit scheme which was recently increased in the March, 1977 budget. The scheme could be designed to reduce the taxes which investors pay on income from an educational motion picture investment thereby increasing the after-tax-yield as compensation for the restricted educational audio-visual market. Special tax incentives would stimulate the private investor and the production of educational motion pictures.

Theatrical Quotas

The writer does not agree with the recommendation made to the government by the Canadian Council of Film Makers and others, that a theatrical screen time quota for Canadian motion pictures should be imposed. It is not possible to legislate audiences to see motion pictures made in Canada or anywhere else:

> The main thrust...was that if quotas were enacted in Canada, we would have a viable Motion Picture Industry and the public would automatically go to see every Canadian Film. Of course this is ridiculous, you cannot legislate people to pay $3.50 to see something they have no desire to see.[18]

Audiences will not attend the theatres unless the motion picture is appealling to them.

However, even if Canadian motion pictures were supported by theatre quotas and Canadian content television rules, the motion pictures will still not earn a profit in the Canadian market alone. The market is simply not big enough. In 1974, the average film rental fees earned by motion pictures distributed in Canada was $70,000 per picture.[19] The maximum amount expected "even with the best bookings and a sound exploitation is $400,000".[20]

> Given that film rentals are the sole means by which investors recoup production costs, the Canadian market is obviously not making significant profits for producers from any country.[21]

Quotas on Canadian television would have the same adverse effect. Viewers simply change channels if they are not interested in viewing a particular motion picture.

Motion pictures which cannot compete in the international markets should not be produced. The United States has produced more theatrical length motion pictures than any other country in the world. American motion pictures have been thrust upon most western markets. Canada's market has not been an exception. Nor is it a dumping ground for American products. Other countries with even smaller domestic markets than Canada (e.g. Sweden), have developed thriving motion picture industries. These countries' industries produce products for both national and international consumption, including the American market. The Canadian motion picture industry must strive for the same market goal.

B. Recommendations to the Motion Picture Industry

Canadian filmmakers must ignore the prevalent rumours that taxpayers invest in motion picture production solely for the tax write-offs. The tax shelter is not sufficient to attract serious investors. Canadian film makers must realize that their projects must be designed to earn a profit for the investor.

Promotion in an International Industry

Members of the motion picture industry must recognize that motion pictures are an international industry. If Canada is isolated through the imposing of screen time quotas, import restrictions and other government interference with the free market, retaliation by other countries is likely, notably by the United States. Budge Crawley, one of Canada's most prolific and successful producers commented in Quest magazine:

> you can't make money without world-wide distribution and that means you have to crack the American market. If the Americans don't buy your film, nobody will.[22]

The message is clear that Canadian motion pictures must be distributed internationally. International distribution means not only a picture with international appeal but proper international distribution and promotion. Motion picture producers in Canada have not been spending enough money on promotion of their product before, during and after production. The writer recommends that Canadian producers invest a greater proportion of the production cost of the projects in promotion. Distributors, exhibitors and audiences must be aware of your film - they must anticipate its release. This is a key to commercial success. Francis Mankiewicz, one of Quebec's directors says:

> promotion is crucial. You can have the most beautiful film in the world but if people don't know about it they won't go to see it.[23]

Canadian distributor Len Herberman, of Ambassador Film Distributors says:

> I wish they (Canadian producers)'d get distributors involved right at the beginning of a film, when it's still at the script and screen treatment stage, instead of bringing them in when the picture is already finished.[24]

Herberman points out that a distributor needs time to prepare an effective sales campaign. A motion picture should not "sit on the shelf" when it is completed. The picture must be distributed as soon as it is finished to take advantage of the publicity momentum developed during production.

It is imperative that the producers of educational motion pictures seek distributor guidance prior to commencing an educational production. Distributors receive feedback from their sales force as to the educational market needs. The distributor can provide an educational producer with information about the market requirements for current subjects, content, style and optimal length. An educational distributor is in an excellent position to assist in sales forecasting for a specific educational motion picture topic.

Educational motion picture producers must face the reality of their market. The recent reduction in certain government spending, particularly at the municipal level, has reduced the potential sales for educational audio-visual programs. School boards have been forced to reduce all but essential services. Money that used to be spent on the purchase and rental of audio-visual materials is being diverted to other uses - e.g. teachers' escalating salaries. The educational producer must realistically consider his production costs vis-a-vis the potential gross sales.

A portion of the financing for educational and entertainment motion pictures should be sought by the producer from the distribution branch of the industry:

> Money investment (by a distributor) is inherently the best motivation for effective distribution of product towards recouping such investment and turning a profit.[25]

A distributor is unlikely to invest in a motion picture which, in his view, is non-commerical.

Unions

The members of the motion picture industry must review the film union regulations and practices in the industry. The unions must relax their rules in order to permit foreign filmmakers to work temporarily in Canada. The foreigners will give Canadian motion pictures the necessary international appeal and they will teach Canadian filmmakers. Presently the Canadian unions have applied pressure to the Department of Manpower and Immigration which has effectively prevented many proposed co-productions in Canada. The motion picture co-productions (often involving Canadian investment) are being shot in the co-producing country where the government bureaucracies are more cooperative. The net result has been that instead of learning from the foreigners working in Canada, Canadian filmmakers have not worked at all.

The motion picture unions are going to have to examine the current "feather-bedding" practices. The number of technicians a producer is forced to hire and the high wage scales are increasing the already enormous costs of motion picture production. Canada has an international reputation among many industries, for high wages and low productivity. Canadian filmmakers must not allow a reputation of non-productiveness to become synonymous with the fledgling Canadian motion picture industry. Production costs must be kept low so that the private investors who finance these costs can expect a favourable equity return ratio.

Distributors

Distributors of educational and theatrical motion picture products both in Canada and the United States must examine their operating overhead structure. Presently the percentage of the gross selling price or box office receipts which is returned to the producer is far too low vis-a-vis the producer's (or his investor's) capital investment and risk:

> The terms of distribution are going to have to be enhanced to motivate those who wish to make films to do so and to risk their own capital, or to obtain risk capital from (private investors).[26]

Many motion picture distributors treat independent producers very unfairly. This treatment is surprising because the distributors must rely on the producers for product supply. The distributors take advantage of the producer's relatively weak financial position. Some distributors are slow to remit to the producer his share of the gross receipts. These distributors often use questionable accounting methods, inflate expense accounts or worse simply fail to remit the producer's share at all. Many independent producers are forced to sue a distributor in court in order to obtain money which is rightfully theirs.

Producers

The producers in turn must realize that their reputation and future funding depends on their treatment of their sources of private financing. Producers must prepare the royalty reports to their investors. Most important, they must remit the investor's share of the motion picture receipts on time and in full.

The poor reputation of some Canadian producers' treatment of their financial backers must be rectified if private motion picture investment is to increase. Herberman, of Ambassador Films commented on this problem in Cinema Canada:

> Another of Herberman's pet peeves involves producers who, in spite of everything, do manage to make money on their pictures, but who then proceed to rip off their investors. "The investors," he says, "in some cases never get a dime back on the picture, even when the picture has earned money."[27]

Dishonesty has no place in the motion picture industry in Canada, nor in any other industry.

Dishonesty is only one of the problems which make it difficult for investors to earn a return. Lack of investor knowledge of the industry is also a problem, particularly lack of knowledge concerning the method by which motion picture revenues are shared. Producers must examine their present revenue sharing arrangements. The writer recommends that the producers adopt revenue sharing arrangements which are more generous to the investors. If the investors never recoup their original investment nor receive their fair share of the distribution profits they are unlikely to invest a second time.

Producers would be wise to consider a revenue sharing formula which permits most of the distribution revenue to be paid directly to the investor until the investor has recouped his investment. After the initial investment has been repaid the producer can then receive a greater share of the profits. If investors insisted on the revenue formula suggested, many marginal projects would be eliminated before they were begun. The producers would consider the economics of production and distribution more carefully if they realized that they would be paid only after the investor had recouped his investment.

When Canadian film makers have developed the necessary technical and creative skills to be commercially successful in the international markets, they can then allow themselves the luxury of cultural narcissism. Canadian film makers must prove their commercial ability "to build an export-oriented industry that could eventually serve to reinforce Canadian identity and culture".[28]

Honest and generous treatment of investors by the motion picture industry will build a sound business repore which will greatly aid the development of the motion picture industry in Canada.

C. Recommendations to Private Investors

The first factor that an investor should realize is that other than the Income Tax Act and Regulations motion picture investment is unregulated. There are no government or industry bodies screening or approving motion picture investment packages offered to the public. There is, for example, no motion picture equivalent of a securities and exchange commission. It is not necessary for a producer to issue a prospectus.

Anyone who wants to call himself a producer can do so:

> The entertainment world has more than its share of sharks just waiting for the unwary investor. The rule of thumb in movie investing is: watch out. A lot of this boils down to dealing with reliable people warns Sobol (Daniel Sobol, former chairman of New York's Chelsea National Bank). And (New York lawyer) Lee Steiner cautions that anybody can be a movie producer these days - he can be good at it or a complete novice.[29]

The private investor must demand solid evidence that the motion picture has commercial potential. The investor should insist that the producer supply an uncollaborated gross sales forecast from a reputable distributor. The investor should seriously consider only investments in which a distributor, independent of the producer, is prepared to make either a financial commitment or at the very least guarantee distribution of the completed film.

The writer believes that the best way to ensure distribution of Canadian features would be to arrange a pre-production commitment of financing from distributors and/or exhibitors. A commitment on the part of the distributors or exhibitors would offer some guarantee that an effort would be made to market the film if only to recoup their share of the investment. As a condition of investment the investor should require that the producer raise some financing from the motion picture industry itself, i.e. distributors and/or exhibitors. The distributors and exhibitors know through their marketing experience what types of motion pictures and what themes are likely to appeal to their audiences. The distributors' and exhibitors' opinion of a script would be worthwhile evaluations of the motion picture's chances of commercial success. Their evaluation, while not infallible, would counter-balance the evaluation of the producer and others, e.g. the C.F.D.C. bureaucrats. The C.F.D.C. officers and Canadian independent producers are frequently accused by film critics and the North American motion picture industry of making inaccurate judgements of the economic realities of production and marketing.

The investor should obtain independent sales forecasts from other distributors. This would determine whether or not the sales forecast prepared by the producer-promoter and the producer's distributor is realistic.

The investor, with the help of his accountant and lawyer, must investigate all aspects of the motion picture project thoroughly. The following is a multi-point check list which a prospective investor should use to analyse the potential of a motion picture investment. No one can predict which motion pictures the public will embrace, but the risk of failure is decreased if the packager (producer) stands up to scrutiny.[30] "Investigate everything in sight"[31] warns Steiner.

Motion Picture Investment Check List

The Producer

1. The producer's credentials:
   - How did his latest films do?
   - Did he live up to his promises to his previous investors?
   - Are he and his company financially healthy - will he provide his financial statements?
   - Are his bank references good?
   - Is his reputation among others in the motion picture industry good?
2. Is the producer prepared to defer most of his producer's fee and production profit until the motion picture begins to earn money from distribution?
3. Will the producer stand behind his claims of the potential of his motion picture project? Is he willing to undertake responsibility for the information in his prospectus? Will he issue a prospectus which discloses complete financial details with all parties involved in the production and distribution of the motion picture?

The Motion Picture Project

4. Is it an educational or feature length motion picture which will find a strong market in the United States? The U.S.A. market represents approximately 40% of the world theatrical market for English language films (or films suitable for dubbing into foreign languages). Foreign sales are unlikely to be significant if the motion picture is unsuccessful in the U.S.A.

5. Can a television sale be anticipated in the future? A television sale is important but it is not enough to recoup the budget cost alone. (U.S. television networks pay on average of between $600,000 and $1,000,000[32]. Sales expenses and sales agents' fees are deducted from the gross.) The television market is highly competitive.

6. Have adequate profit forecasts been made and do other producers and distributors agree with these forecasts?

7. Has a clear distinction been drawn between box office gross receipts, distributors' receipts, producer's revenue, investor's net revenue, etc.?

8. Is the investor in a favourable position vis-a-vis the profits?

9. Are the expenses which the producer can deduct from distribution receipts clearly defined and limited?

10. Are the contractual arrangements between the producer and all other parties including the investor acceptable?

11. Has the producer prepared an adequate production budget including a 10% amount for contingencies? Has an independent producer been consulted to ensure that no budget item has been omitted, inflated or underestimated?

12. If the project is a feature length motion picture with a budget exceeding $1 million, has a completion guarantee been arranged? If the budget is less than $1 million or the project is educational the producer should have a strong line of credit with his bank in the event of a budget overrun.

13. Has adequate pre-production been done e.g. research, budget preparation, film scheduling, etc.?

14. Is the budget to be administered by a reputable trustee, preferably a firm of chartered accountants?

15. Will the producer prepare periodic progress reports for the investors during both production and distribution? Will these be verified by the trustee chartered accountants?

16. Is adequate provision made in the budget for pre-production, production and post-production publicity? Is some of the budget set aside for advertising when the picture is finished? The distribution terms can be more favourable if the producer shares some of the distributors' advertising costs.

Distribution

17. If a distribution arrangement has been made or when it is made, what is the distributor's reputation? How has he treated other independent producers in the past?

18. Is the distributor credit worthy?

19. Are the distribution terms fair? How do the fees compare to the range of fees charged by other distributors?

20. Will the distributor offer an advance against future earnings or otherwise commit himself financially to the motion picture?

21. Will the distributor accept a performance clause with certain

guaranteed minimum earnings within a definite period of time?

The final question which the investor should ask is: will the terms of the contracts between the investor, producer and distributor work within the income tax laws of Canada?

An investor cannot expect to have knowledge in all the areas mentioned in the foregoing check list. To educate himself an investor would be wise to examine many motion picture investment proposals. Potential investors are often secretive about the fact that they are interested in motion picture investment. The isolated investor then only gets exposed to the projects offered by the most persistent producer-promoter or the producer who has a personal contact with the investor. This "head-in-the-sand" behaviour is wrong. If an investor is seriously interested in motion picture investment the writer recommends that he let his interest be known to the industry. Undoubtedly the investor will be inundated with proposals but this exposure will give the investor an understanding of the industry. The understanding will enable him to develop the ability to assess the relative merits of motion picture investments. A prudent investor should then submit the most promising projects to an independent producer for a second opinion.

The writer offers a special recommendation to those investors considering feature length motion pictures. Although there is no hard and fast rule, generally films with a budget of less than $1 million will lack the production quality necessary for international audience appeal. Films with budgets of over $3 million will require that up to seven times that amount be earned at the theatre box office just to recoup the initial investment. The writer recommends that investors consider only projects whose budgets are over $1 million and less than $3 million.

5. AREAS OF FURTHER STUDY

Several areas of the motion picture industry in Canada warrant further investigation. The findings of these investigations would be useful to the motion picture industry, to the federal government and to the private investor. The data could be used as input for a coordinated motion picture policy for Canada.

Accurate production and distribution statistics should be collected. The statistics should then be correlated with major events which have influenced the industry in Canada. The motion picture industry itself would benefit most from the correlation and it is the industry that is in the best position to undertake the statistics gathering task.

Motion picture production volumes in Canada should be correlated with:

1. The ammendments to the Income Tax Act and Regulations in order to determine their affect;
2. The motion picture investment reassessment cases. The decisions have had an affect on the attitude of potential investors and their financial advisors. These reassessment decisions have directly influenced the amount of private motion picture investment funds available.
3. The financial participation of the Canadian Film Development Corporation. A study should determine the true effect of the C.F.D.C.'s financial assistance. The study should examine not just production volume but also the short and long term benefits to the motion picture industry and the Canadian economy as a whole.

4. The recent co-production treaties. A study should attempt to determine how beneficial these treaties have been to the Canadian industry, to the private investors and to the balance of export payments.

5. The ammendments to the United States income tax system. Preferential tax treatment is no longer given to investors in motion pictures in the U.S. The major motion picture production-distribution companies have begun looking for ways they can produce in Canada where there still are tax incentives for investment.

Up to date distribution statistics must be gathered to determine the market potential in Canada and in the foreign markets for Canadian made educational motion pictures. Correlations and conclusions could be made with regard to the recent reductions of educational audio-visual purchasing budgets in North America.

The basic theory behind audio-visual education is being questioned by some educators. Originally, educators believed that the audio-visual medium would be a very effective one to reach a generation of students who have been exposed to television all their lives :

> According to television survey-taker A.C. Nielsen, children under five watch an average of 23.5 hours of TV a week. Today's typical high-school graduate has logged at least 15,000 hours before the small screen - more time than he has spent on any other activity except sleep.[33]

Through constant exposure to the television screen children of today's generation have learned to blot out the information, much like older generations do when their radio programs are interrupted by commercials. The demand for educational audio-visual material may not increase even after budget restrictions are removed.

The long range future of feature length theatrical motion picture markets should be studied. The study should include the demographic change affecting the motion picture markets as the children of the "baby boom" mature. The advent of pay television and six foot television screens in private homes should be studied to determine the affect on the future marketing of motion pictures.

A sophisticated computer study should be undertaken which employs a model capable of incorporating a large number of factors affecting motion picture investment. A person or group of persons, familiar with computer programs and the motion picture industry should approach the problem by setting out a premise, developing a motion picture investment model, and running the program for various motion picture investment packages and investors. The computer output should then be analyzed.

The computer program could include such investor factors as:

- age of the investor;
- risk of investor death;
- marginal income tax rate;
- personal income tax deductions;
- type of income: salary, professional, business or investment;
- expected earning pattern which would consider increases and decreases of income over the motion picture investment planning horizon.

Characteristics of the motion picture investment should also be built into the computer program model. These characteristics could include:

- initial cash investment;

- interest on cash investment if the investor is required to borrow the initial investment from conventional lending institutions;
- cost of a distribution revenue guarantee;
- leverage ratio;
- maturity date of promissory notes;
- interest rate on promissory notes;
- repayment pattern of promissory notes;
- expected annual inflation rate;
- expected yield on any income tax savings that are reinvested;
- cost of an insurance policy on the investor's life;
- cost of investor's legal and accounting fees.

The computer program could simulate the net outcomes to the investor at different income levels and under many different distribution revenue patterns. A risk factor, based on historical distribution earnings statistics, could be assigned to the different types of motion pictures. This factor could be incorporated in the motion picture investment model.

A computer program incorporating these and other factors could be extremely valuable to private investors considering investment in specific motion pictures. The program could take some of the guess work out of the investment decision which may lead to wiser investments and a high success factor.

6. CONCLUSION

This paper has been a study of the investment income tax incentives for the motion picture industry in Canada. Alone, the income tax incentives are not enough to attract private investment. The motion picture industry must make an effort to reduce the investor's chances of investment loss.

The motion picture industry throughout the western world has been seeking new methods of financing since 1948 when the Anti-Trust Division of the U.S. Justice Department obtained a Court Order in the Paramount[34] decision forcing the major production-distribution companies to sell their national theatre chains. Television has further eroded the financial stability of the motion picture industry, "an industry that seems perpetually in need of a transfusion,"[35] No country's motion picture industry, not even that of the United States can expect to be self supporting without producing for world consumption.

Canadian filmmakers must improve their motion picture investments if they expect to survive. Canadians must strive to produce economically viable pictures of commercially acceptable technical quality. These pictures must have themes interesting not only to Canadians, but to all English language audiences. Only then will the risk of financial loss be decreased and private investment be encouraged.

The capital cost allowance system compensates a private investor for some of the high risk of motion picture investment, provided the deduction is acceptable to all government departments, including the tax department. "There is nothing reprehensible in seeking to take advantage of a tax benefit allowed by law"[36] particularly if the investment supports a labour intensive, non-polluting industry. The motion picture industry is an industry which could benefit the Canadian economy through employment and product export. The federal government should encourage private investment in motion pictures. The logical government policy to encourage investment, under the present circumstances, is to expand the co-production treaty program and to refine the income tax incentive system.

High income taxpayers should only consider motion picture investments which allow a high degree of leverage on the initial capital investment. The liability incurred by the leverage must be offset by a guaranteed minimum revenue distribution agreement. Investments structured thus, will reduce the investor's potential capital loss through income tax deferment.

Presently, feature films produced under Canadian co-production treaties offer the best chances for investment success. Thoughtfully packaged co-productions can have strong international appeal and hence ready access to important world markets.

Finally, it is important not to become too enamoured by the income tax ramifications and remember that the object is to invest in the production of a marketable product. An investor should never invest in a motion picture solely for the purpose of sheltering income. The investment must be an irreproachable business decision based on a sound investment structure.

FOOTNOTES CHAPTER VIII

[1] Thomas M. Ferguson, What To Do When The Taxman Comes (Vancouver: International Self-Counsel Press Ltd., 1976), p.46.

[2] Gary Mandel, "Feature films: fine tax shelter but loaded with investment traps", Financial Post, January 22, 1977, p.27.

[3] "How to Invest in Movies", Business Week, August 25, 1975, p.73.

[4] quoted from Mae D. Huettig, Economic Control of the Motion Picture Industry (Philadelphia: University of Pennsylvania Press, 1944), p. 54.

[5] The Cash-Rich Movie Companies, Why They Pump Box-Office Profits into other Businesses", Business Week, May 16, 1977, pp.114-115.

[6] Les Wedman, "Boss the C.F.D.C.? - Let's let George do it", Vancouver Sun, November 20, 1974, p.45.

[7] "The Cash-Rich Movie Companies," op.cit., p.115.

[8] "Is it worth making blockbuster films?", Business Week, July 11, 1977, p.36.

[9] " A'major' offensive against nationalism," Cinema Canada, February, 1977, p.23.

[10] Ibid.

[11] Michael Walsh, "Too late for film industry, critic warns nationalists", The Province, August 5, 1975, p.11.

[12] Canadian Film Development Corporation, Annual Report 1973-74, p.4.

[13] Michael Walsh, loc.cit.

[14] Connie and Jean-Pierre Tadros, "Of Financing and Freedom", Cinema Canada, December, 1976/January, 1977, p.21.

[15] Paul Morton, "...depressing downbeat little pictures", Cinema Canada, April, 1976, p.36.

[16] Ibid.

[17] Ibid.

[18] William Soady, president, Universal Films (Canada), "...legislation will do little or nothing," Cinema Canada, April, 1976, p.41.

[19] "A 'major' offensive against nationalism," op.cit. p.22.

[20] Ibid.

[21] Ibid.

[22] James Quig, "Yesterday's Shirt and Last Week's Pants", Quest, May, 1977, p.22.

[23] Alex Angioli, "Quebec films dare," Province, December 21, 1973, p.29.

[24] Jaan Pill, "Feature Distribution - all that glitters," Cinema Canada, February, 1977, p.25.

[25] Burton W. Kanter and Calvin Eisenbert, "What Alice Sees Through the Looking Glass when Movieland Seeks Creative Techniques for Financing Films," The Tax Magazine, February, 1975, p.98.

[26] Ibid., p.99.

[27] Jaan Pill, op.cit., p.25.

[28] "A 'major' offensive against nationalism," Cinema Canada, February, 1977, p.23.

[29] "The new tax shelter: Finance the filming", Business Week, August 25, 1975, p.79.

[30] "How to invest in movies", Business Week, August 25, 1975, p.73.

[31] Ibid., p.74.

[32] Anthony J. Patterson, "Live dangerously; invest in a film," The Province, July 5, 1974, p.6.

[33] "What TV does to Kids", Reader's Digest, July, 1977, p.53, article condensed from Newsweek, February 21, 1977.

34 United States v. Paramount Pictures, Inc. Supreme Court of the U.S., (1948), 334 U.S. 131, 68 S ct 915.

35 Robert Miller, "Sweet smell of excess," Maclean's, June 27, 1977, p.32.

36 Tax Bracket, February 15, 1977, p.10.

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