Revised film investment scheme promises tax benefits

The changes to the tax arrangements for film investment in Belgium provide significant advantages for both investors and producers, declare Marc Quaghebeur and Ruth De Baere of Vandendijk & Partners

In 2002, Belgium introduced a tax concession for investments in Belgian audio-visual work. This tax shelter has just been made more attractive by a law of May 17 2004.

The tax shelter offers a 150% income tax exemption for investments in the production of Belgian film and documentaries. The provisions of the new article 194ter of the *Income Tax Code* came into effect in the 2004 tax year, but they failed to convince investors. To reassure potential investors that they would not lose their entitlement to the tax exemption all too easily, eight members of Parliament introduced a draft bill adapting the legislation. The following is a description of the concession.

Investment agreement

The tax shelter offers investors an exemption from corporate income tax of up to 150% of the funds which they have invested – or which they have undertaken to invest – in the production of Belgian films and documentaries. To benefit from the tax shelter, a corporate investor needs to sign a framework agreement with a Belgian producer for the production of a certified Belgian audio-visual work.

The production house

The tax concession is limited to productions by a Belgian production company which mostly develops and produces films, documentaries or animated films for the cinema or for television. The producer cannot be related to a Belgian or foreign television broadcasting company, as television broadcasters are excluded.

The production

The Belgian production company must propose an investment in a feature film, a documentary film (more than 52 minutes) or an animated film for the cinema, or even an animation series or documentary for television. Feature films for television will only qualify as of 2006. Investments in TV entertainment, news and sports, advertising films, short films and soaps do not qualify for the tax shelter.

External investors

Any Belgian corporation and any Belgian permanent establishment of a foreign corporation that pays Belgian corporate income tax can take advantage of the tax concession.

Belgian production companies and television broadcasting companies cannot invest in a Belgian production. This exclusion does not apply to companies related to a Belgian or a foreign television broadcasting company, even if they cannot qualify as a production company.

Television broadcasters and production companies can, however, intervene at a later stage, as secondary investors, to take over the equity rights from the investors.

The investors can finance at most half the budget of the production, in the form of

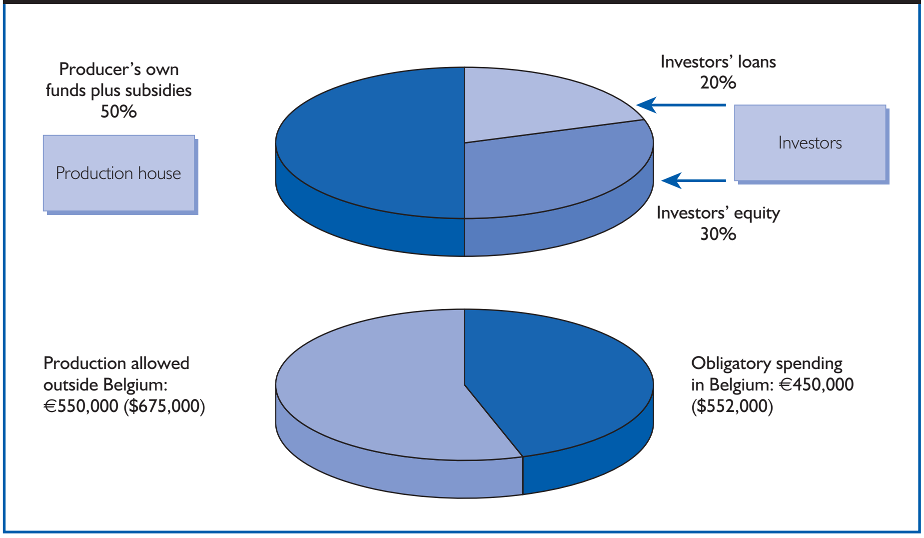
Equity – Venture capital must be the major part of the external investment. In practice this means that the investor will take a participation in a joint venture and acquire rights related to the production and exploitation of the film.

Advances – External investors can limit their risk by financing their production by way of loans granted to the production company. This part of the investment is limited to 40% of the total investment. Bank loans do not, however, give the bank any entitlement to the tax concession.

Marc Quaghebeur: Tax shelter is tax-effective and limits the risk for the investor

Ruth De Baere: Combine it with the tax-efficient regime for paying actors

Diagram 1: Structuring investment in the film



The agreement

The investment agreement will lay down the details of the production and the investment, and in particular the budget, the amount invested by each investor and the form of the investment (equity or advances), the remuneration due to each investor (for example, interest or percentage of ticket sales).

The production company will have to give undertakings that:

- it will finance at least half of the total budget;
- it will use the investments exclusively for the production of the film;
- the equity investment will be at least 60% of the financing by external investors; and
- an amount equal to 150% of the equity investments will be used in Belgium within 18 months.

The agreement will normally provide that the investor advances the funds lent at the time of the signature of the agreement, and that the equity will be released on the demand of the producer or at the time of completion of the film.

Tax concession

Investors are entitled to a tax exemption of 150% of the funds which they have invested – or have undertaken to invest – in the Belgian film production.

Tax exemption

The tax exemption is limited to 50% of their taxable profits, with an overall maximum of €750,000 ($921,000). Only companies with a profit before tax of €1.5 million or more will be able to maximize the tax exemption by investing €500,000 in that year.

If the investor does not have enough taxable profits, or invests more than €500,000, he can carry forward the tax exemption until the year before the certificates mentioned below are provided.

Conditions

Apart from monitoring the producer's compliance with the framework agreement, the investors must record the tax-exempt profit on a separate account on the liabilities side of their balance sheet. The reserve must be maintained there for a period of about four years, and during that time the corporate investor cannot divide out this tax-exempt reserve until he can provide the certificates mentioned below.

The investor will have to attach a copy of the framework agreement to his tax returns with proof of certification as a European audio-visual work in the sense of article 6 of *Council Directive 89/552/EEC* of October 3 1989 (Television without Frontiers).

Moreover, within four years he has to provide a certificate issued by the producer's tax office confirming that all the conditions have been met, as well as a certificate by the Flemish or French Community confirming that the production is completed and that the budget has been used as anticipated.

At that time the tax exemption becomes final and the tax-exempt profits are available for distribution.

Penalties

Failure to comply with these conditions – and in particular failure to produce these certificates – will result in a clawback of the tax write-off for the future, and interest will be due.

Considerations for the external investors

The corporate investor can limit his risk by splitting his investment in a loan for 40% and equity for the rest.

The interest of the investment for the investor is, of course, the tax exemption of 150% of the funds invested, whether by way of equity or by way of advance. This is a tax saving equal to 51% of the investment, that is, 33.99% corporate income tax of the exempted profit.

The part of the investment that is advanced by way of a loan will normally be paid back over a period of time. Nothing prevents the corporate investor from asking for securities or guarantees from the producer. The reimbursement of advances is not taxable profit for the investor.

This means that, if the investor has maximized the part of his investment that he can give in the form of a loan, he can recover another 40%, and he will effectively recover 91% of this investment.

Other jurisdictions have a preferential tax treatment for costs incurred in connection with the production or acquisition of qualifying films

The producer can find different forms of remuneration that will, however, be liable to corporate income tax.

- Interest. This will, however, never cover the shortfall of 9%.
- The investor can also ask for a percentage of the ticket sales.
- To entice potential investors, the producer may undertake to buy back the investor's equity rights in the film at a guaranteed price. The only limitation is that the producer may not use the equity investment for this purchase. The investments received must be used entirely for the production of the film.
- Finally, the investor may want to sell on his rights to the equity or the receivable resulting from the advance to a third party. The only limitation is that the investor must keep full ownership of the receivables and ownership rights until the film is completed. The loan cannot be paid off and the equity rights cannot be assigned for a period of 18 months after the date of the signing of the framework agreement.

Interest for the investor

Tax exemption 33.99 % of 150 % of the funds invested
40% investment in the form of a loan
Interest
Percentage of ticket sales
Sale of the equity
Possibility to divideout the tax exemption after four years.

This may be an opportunity for a second (foreign) producer or a television broadcasting company who are excluded as initial investors in the investment agreement.

Any profit the investor makes from the investment will be liable to corporate income tax. However, capital losses on the advance invested or on the equity cannot be set off against taxable profits.

An investor is free to pay the production house for other services, sponsoring or advertising contracts. These remain tax-deductible under the ordinary rules relating to allowed expenses.

Considerations for the production house

The producer has to finance at least half the budget. He can do this by using his own funds, but subsidies and income from sponsoring and advertising will also be taken into account.

The producer must spend at least 45% of the budget in Belgium for the production and exploitation of the film. This is calculated as 150% of the investors' equity. There is a timeframe of 18 months from the date of the signing of the framework agreement for this spending. The criterion of spending in Belgium means that these exploitation costs and financial expenses are liable to Belgian income tax in the hands of the beneficiaries and are not disallowed expenses for the production company.

The equity investment constitutes the net amount of funds that are available to the producer. In practice, he will have to discount the interest due on investors' loans and the percentage on ticket sales, as well as the price he has guaranteed to the investor for buying back his equity. Production houses are, therefore, well advised to work out:

- a financing structure via a financial institution where they can draw advances guaranteed by the equity investment so that the investor can delay effectively paying the equity until the production is completed.
- a structure that can reassure the investor that he will be able to realize his equity investment by selling it to a secondary investor, be it another producer or a television broadcasting company.

The producer

Increase of available funds = equity investment minus interest, percentage on ticket sales and guaranteed buy back.
Obligation to spend at least 45% of the budget in Belgium.
Producers and television broadcasters cannot invest directly but they can be a secondary investor.

The international perspective

Roughly speaking, national incentives in the major film-producing jurisdictions take one of the following forms.

France, Italy and Spain levy box office rebates on films; these are returned to the producer, usually to allow him to reinvest in future film productions.

Investors are entitled to a tax exemption of 150% of the funds which they have invested – or have undertaken to invest – in the Belgian film production

Some jurisdictions, such as Luxembourg and Canada, operate a tax credit system whereby a producer is entitled to reclaim a percentage of costs incurred in the jurisdiction in relation to qualifying films.

Other jurisdictions have a preferential tax treatment for costs incurred in connection with the production or acquisition of qualifying films. This tax write-off can be set up in two ways. Either a taxpayer is allowed to defer his tax liability by producing or acquiring a film and then leasing, licensing or selling it on or back to the producer (UK, Germany). Alternatively, the taxpayer can be entitled to offset his investment in a film production company (Ireland) or in a specialized finance vehicle (France) against his taxable income.

Combining the benefits from different jurisdictions may be possible, but requires a good understanding of the criteria for qualification to ensure the compatibility of the structures.

UK: sale and leaseback

The UK grants a 100% write-off for the expenditure of production or acquisition for qualifying British films in the year of completion or acquisition.

A typical structure for a production company seeking to refinance a film is to sell it. The purchaser then leases the film and the distribution rights back to the production company for a period of 10 years to 15 years. The purchaser usually is a partnership; this is a transparent vehicle for tax purposes so that tax losses can be passed on to the partners.

The relief is given for qualifying British films with a total production budget of less than £15 million ($27.5 million). For films with a budget more than £15 million, the production and acquisition expenditure can be written off over three years.

A film will be certified as British if the production company is established within the European Economic Area (EEA), if 70% of the production cost is spent in the UK and at least 70% of the labour costs are paid to residents of the Commonwealth or the EEA. Also eligible for relief are films produced under the European Convention on Cinematographic Co-Production or under a bilateral co-production treaty with Australia, Canada, France, Germany, Italy, New Zealand or Norway.

The lessor can set off the total acquisition cost in the year of acquisition, while he will pay tax on the rentals from the lease of the film.

As of July 1 2005, the system is to be replaced by a new relief for production expenditure that will go directly to the filmmaker with the exclusion of third parties.

German film funds

The German tax write-off is granted upfront to a partnership investing in the production of a film, enabling the partners to defer their tax liability.

German film funds (*Medienfonds*) are usually structured as German limited partnerships (GmbH & Co KG). Investors are partners with limited liability. The fund enters into a production services agreement with a production services company or participates in a co-production. The fund must acquire all rights to the screenplay and keep all copyrights to the film. It will enter into a worldwide distribution agreement with one distributor for a period of between seven years and 10 years.

There are no nationality or minimum requirements in respect of spending or

Table 1: Film investment in the EU

	UK	Germany	Ireland	France	Belgium
Legal basis	Section 48 *Finance (No 2) Act 1997*	General legislation on partnership loss allocation	Section 481 *Taxes Consolidation Act, 1997*	Section 238 bis HE CGI	Section 194ter *Income Tax Code*
Structure favoured	Sale leaseback	Film funds (*Medienfonds*)	Investment in special film production vehicle	Sofica – investment fund for financing the production of films	Joint venture : investors invest 60% in equity and 40% in the form of advances
Conditions	• 70% spend in the UK. • 70% of labour costs paid to residents of EEA or Commonwealth	• the filom fund must make sure it obtains and maintains producer status	• 10% - 75% spend in Ireland • the film must contribute to Irish film industry or culture	• French-language films • production in France or another member state of the European Community.	• 150% of equity investment must be invested in Belgium (in practice 45%)
Co-productions	Allowed	Allowed	Allowed	Allowed	Allowed
Film budget / percentage of investments allowed	<£15 million 100%	-	Under €5.08 million: 66% Between €5.08 million and €6.35 million: 55% – 66% More than €6.35 million: 55%, limited to €10.48 million*	-	No limitation 50%
Tax relief					
Individuals	100% first-year relief*	Losses allocated from the film fund can be set off against trading income. Carry-forward for any losses over €51,500 per year (€103,000 for spouses assessed jointly).	80% tax deduction (limited to €31,750 per year)	100% set off against total taxable income (limited to 25% or €18,000 per year).	N/A
Companies	100% first-year relief*	Losses allocated from the film fund can be set off against profits	80% write-off of their investment (limited to €10,160,000 per year)	50% write-off	50% of taxable profits, with an overall maximum of €750,000
Notes	** As of 1 July 2005: tax credit of 20% of the production budget*		** €15 million as of 2005*		

employment in Germany. This makes a German film fund an ideal candidate for international co-production deals benefiting from tax incentives in two countries.

The film produced is a fixed intangible asset which is not carried as an asset on the balance sheet. The expenses of the film fund incurred in the production and exploitation of films are, therefore, generally deductible in the year they are incurred. German film funds must obtain and keep producer status to be entitled to these tax losses. International co-productions must be structured in such a way that the losses are not allocated to the non-German co-producer.

Investors are allocated part of these losses and they are entitled to offset these losses against other trading income without limitations. For individual taxpayers, the set off is, however, limited to €51,500 ($63,417) per year (€103,000 for spouses assessed jointly). The balance can be carried forward.

Special production vehicles in Ireland

Ireland grants an 80% tax deduction to Irish investors who buy shares in Irish film production companies. The scheme has just been extended until 2008.

These Irish production companies are typically set up to make a single film. They sign a pre-sale agreement to produce a film for an agreed fee, payable on acceptance and delivery. The pre-sale fee is usually set at about 82% of the investor funds raised and an advance of the remainder of the budget. The structure often provides for a further entitlement for the company to either a net profit or adjusted gross position, and possibly a cash flow benefit to the producer.

To qualify for certification by the minister for arts, sport and tourism, the film must either effectively stimulate film-making in Ireland (for example, provide quality employment and training opportunities) and/or be of importance to the promotion, development and enhancement of the national culture. At least 75% of the work on the production of the film must be carried out in Ireland, but this percentage may be reduced in the case of co-productions, but it will never go under 10%. Ireland has signed co-production treaties with Canada and Australia, and is about to sign one with Germany. Ireland has ratified the European Convention on Cinematography.

The relief is given for a percentage of the budget of a qualifying Irish film,

budget under €5.08 million ($6.255 million): 66%

budget between €5.08 million and €6.35 million ($7.82 million): 55% to 66%

budget more than €6.35 million: 55%, limited to €10.48 million ($12.9 million) (€15 million ($18.47 million) as of 2005)

Individual investors are entitled to set off 80% of their investment (limited to €31,750 ($39,100) per year) against their total taxable income.

Companies are entitled to an 80% write-off of their investment which cannot exceed of €10.16 million ($12.5 million) per year companies (limited to €3.81 million ($4.69 million) per production).

The French Sofica

France encourages the collection of investments for the film industry via investment funds. These *sociétés de financement de l'industrie cinématographique et de l'audio-visuel* (Sofica) are set up for a period of 10 years in the form of a *société anonyme*.

A handful of Soficas linked to major groups of the audio-visual industry attract investments from the public, mostly private individuals. Generally, the Sofica invests cash in the production of a film by way of a joint venture for the film production against an entitlement to income from the exploitation of the film.

The relief is given for qualifying French language films approved by the *Centre National de la Cinématographie*. The films must be made in France or another member state of the European Community. Co-productions may qualify as well.

Individual investors are entitled to set off 100% of their cash contribution against their total taxable income. The set-off is limited to 25% of their taxable income or €18,000 ($22,160) per year. Although the individual investor must keep his shareholding for a period of five years, the Sofica usually undertakes to redeem the shares at a price of between 75% and 85% of the initial investment.

Companies are entitled to a 50% write-off of their cash investments in the shares of a Sofica.

Lacking finance

The Belgian audio-visual sector has difficulties financing its productions; production houses are undercapitalized, and advance sales and subsidies are hardly sufficient. The fragmentation of the European film industry in national markets does not help the development of a sector that is dominated by American films.

Nevertheless, Belgium has a reputation for the quality of its film technicians, and its animated films. It is substantially less expensive than the major film production centres. And it has a tax-efficient tax regime for fees paid to actors.

The tax shelter for audio-visual works is a tax-effective way of boosting the Belgian audio-visual sector. A well-advised use of the opportunities will enable the sector to maximize the return for potential investors and the available means for the producer.

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