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Tax-Motivated German Financing of the U.S. Film Industry

William T. Bardeen MBA '04

Claude Shaw MBA '04

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1. Introduction

Film production companies have long looked for creative ways to finance their projects. Most recently, international tax policies have emerged as a significant consideration in U.S. film financing. Nowhere has this trend been more clear than in Germany. In fact, Merrill Lynch estimates that German film funds cofinanced 15 to 20 percent of all major Hollywood movies in 2001. Twenty-two large German film funds closed or were in the process of closing in 2000 and 2001, raising nearly \$3 billion in capital to finance approximately 150 projects (Tubeleh and Seip 2001, 5). Studios, including Paramount, Universal, Fox and New Line, have used German funds to help produce such blockbuster movies as *Mission: Impossible 2*, *The Lord of the Rings* trilogy and *Shallow Hal* (Gorman 2002, 1). According to *Variety* (2003), this trend continued in 2002, with Germans investing more than \$2.3 billion in U.S. films. An analysis of the tax benefits, financing structures, German requirements and U.S. issues associated with this film financing technique demonstrates why international tax factors have become so important to the U.S. film industry.

2. The History: Film Financing Goes International

At the most basic level, studios can finance films either with the retained earnings from previous films or with capital from external sources. External sources range from pure debt provided by banks and insurance companies to pure equity provided by individuals, private funds and the public markets. In order to mitigate risk, financing structures have evolved to include presales, securitization, step deals, coproductions and limited partnerships rather than just straight debt, private placements or common stock offerings.¹

Through the 1940s, Hollywood studios controlled exhibition and talent, which helped limit production costs and provided some financial stability. Even after the 1948 Paramount consent decree that separated film production and distribution from exhibition and marked the end of the old studio system, the financial situation changed little for most studios. In this environment, retained earnings and bank debt were the most common financing sources. However, changes in the industry, including increasing costs and higher interest rates, put financial pressure on studios, forcing them to look elsewhere for external capital.

The first wave of change occurred in the early 1970s when the U.S. government responded to the industry's troubles with tax-related incentives. Tax shelters and a practice called *gearing* allowed investors to write off more than their invested capital. Abuse of these incentives led the U.S. government in 1976 to require that investors' money be *at risk*, though additional tax incentives were created that benefited the film industry. As a result, a proliferation of limited partnerships, motivated both by tax and profit

¹ For a full discussion of film financing, see Vogel (2001) and Desai, Loeb and Veblen (2002).

considerations, began to finance films from the 1970s to the mid-1980s. However, the 1986 Tax Reform Act effectively ended tax-motivated financing of films in the United States, and the stock market crash of 1987 had a similar effect on the profit motivation.

With the curtailing of U.S. financing sources, Hollywood was forced to look abroad in the late 1980s and early 1990s. While studios had always practiced coproduction through the use of foreign production facilities, foreign countries became much more heavily involved in U.S. film financing throughout the 1990s due to international tax policies. Seeing an opportunity for economic benefit, many foreign countries began marketing existing tax incentives as well as creating new ones. In some cases these tax incentives led to injections of capital into the U.S. film industry, while in other cases countries attempted to use tax incentives to attract the large capital and labor investments made by U.S. studios for film production.

Japan was one of the first major sources of financing, though by 2002 many more countries had supplanted Japan to become the most prominent players. Currently, countries offering attractive film-based tax incentives include Australia, Canada, Germany, Ireland, the Netherlands and the United Kingdom. Some of these countries provide direct tax credits or rebates, while others use tax deductions to encourage investment in film production. By 2002, several foreign countries were providing more than \$100 million in tax credits and spurring more than \$4 billion in film investments annually (figure 1). Germany led the way, with \$2.3 billion invested by its citizens in Hollywood due to favorable tax treatments (*Variety* 2003).

Figure 1. Tax-Related International Film Financing, 2002

Country	Dollars Involved (U.S. Million)	Description of Amount
Germany	2,330	Tax-advantaged investment in film production
United Kingdom	1,600	Budgets of films certified as British
Ireland	86	Tax-advantaged investment in Irish film production
Netherlands	84	Tax-advantaged investment in Dutch film production
Luxembourg	47	Rebate for foreign film production in Luxembourg
Canada	44	Tax credit for foreign film production in Canada
France	40	Tax-advantaged investment in French film production
Australia	20	Tax credit for foreign film production in Australia
Brazil	19	Various tax benefits for investment in Brazilian production
Iceland	1	Rebate for foreign film production in Iceland

Source: *Variety* (2003).

3. The Theory: Foreign Tax Incentives as a U.S. Benefit

At first glance, it may be understandable that tax credits for film production help film producers but also appear strange that tax breaks for German investors could be such a boon for Hollywood. The answer lies in understanding that cross-border tax arbitrage is common throughout many industries and that tax benefits are often *priced in* to a transaction, distributing benefits of a tax advantage to both parties.

The business world is rife with examples of companies taking advantage of tax regimes that vary from country to country. For example, multinationals have an incentive to shift taxable income from high-tax jurisdictions to low-tax jurisdictions. One way to do this is through transfer pricing: a high-tax operation within a company may undercharge a low-tax operation within a company for the goods it sells them, reducing the company's overall taxes. Corporate inversions represent another form of multinational tax planning. In a corporate inversion, a company incorporates in a country operating under a territorial tax system to avoid having to pay U.S. tax rates on its foreign subsidiaries.

But cross-border arbitrage is not the only tax factor at work in the move to foreign film financing. Pricing also plays a role. Evidence of taxes being priced in to transactions abound. For example, there is a personal tax disadvantage of debt, since debt generates fully taxable interest income for investors. Therefore, investors will bid down the price of debt, driving up yields. On the other hand, municipal bonds, for which interest is tax exempt, will have a higher price and a lower yield.

Equipment is another area in which taxes can affect pricing. If depreciation policies are accelerated, equipment may very well go up in price; the buyer of equipment often shares the depreciation benefit with the seller. Taxes also can affect pricing in mergers and acquisitions. The target company in an acquisition generally prefers a stock acquisition, since it does not have to pay inside capital gains taxes at the time of the transaction. The buyer in the acquisition generally prefers to purchase the assets of the target, since it gets a step-up in tax basis. Therefore, a buyer offering to purchase assets will generally have to pay a higher price to a seller than a buyer offering to purchase stock.

The cross-border tax arbitrage and pricing concepts evident throughout modern business practice also form the basis for how a U.S. film company can benefit from tax incentives in other countries. Pricing dictates that if foreign investors get tax benefits when investing in U.S. films, it should be priced in to the financing costs, making foreign financing attractive relative to other sources. Cross-border tax arbitrage dictates that U.S. studios take advantage of this disparity by accepting the cheaper foreign money. And no one's money has been cheaper in recent years than Germany's.

4. The Evidence: German Film Funds

While the sexiness of the film industry has always played a role in film financing, Germans have had significant additional incentives to invest. In most tax systems, including that of the United States, the standard method for film tax treatment involves amortizing the cost of creating a film either over a number of years or as a percentage of revenues received in order to match deductions with income.

However, German tax law has permitted the immediate deduction of the cost of creating “intangible” assets, including films.² As a result, German film investors can immediately write off the entire cost of producing a film, delaying their tax payments and effectively reducing their tax burden. By getting the tax advantages up front, German investors take clear advantage of *time-shifting*, one of the most basic tax-planning strategies. The benefit can be magnified if the investment is leveraged with debt since the investor can deduct the debt as well. Much like the gearing that occurred in the United States in the early 1970s, this allows German investors to deduct more than their cash outlay, though they are still liable to repay the debt.

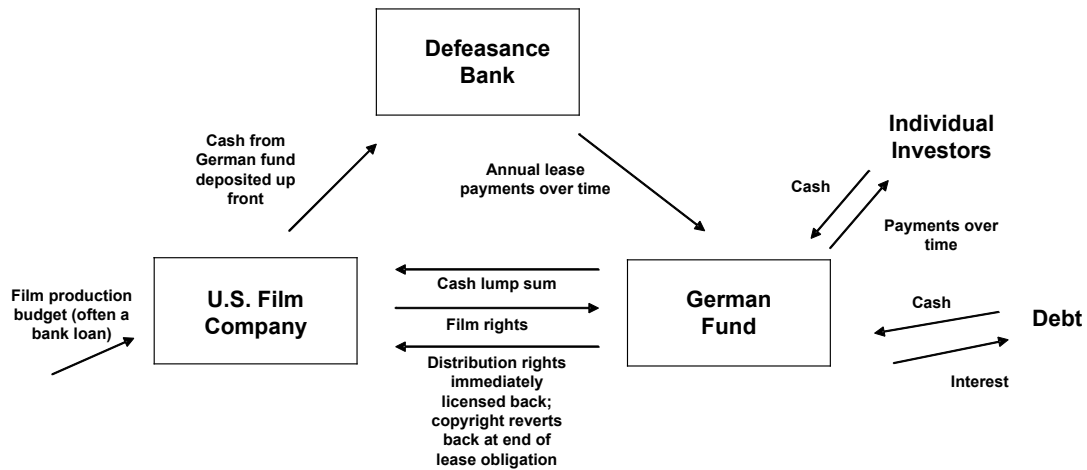
All of this adds up to a significant tax-saving opportunity for wealthy Germans, particularly those attracted to the glamour of Hollywood. An important distinguishing feature of these German tax benefits is that it has not mattered who produces the films or where they are produced. Most countries that have film tax shelters intend them to serve as an indirect subsidy for local production and therefore require that the films be produced in the home country. The German benefits, on the other hand, are based on loopholes in German commercial laws that result in an unintentional subsidy for worldwide production (*Variety* 2003).

An effort by the German government to redirect the investment back to Germany through more restrictive requirements has led to evolving financing structures. There have been two major structures used with German tax funds: *net-benefit funds* and *equity funds*. Film companies have traditionally preferred net-benefit funds, which were most common in 1999, though the increasing restrictions in German tax law have made equity funds more common through 2001 and 2002.

Net-benefit funds are structured in a sale-leaseback model (figure 2). A fund is set up to which individual German investors each agree to contribute equity and against which additional funds are borrowed. The U.S. film company sells the underlying film rights to the German fund for a price equal to the film company’s cost of producing the film. The fund immediately leases the distribution rights back to the producer in exchange for a stream of lease payments, starting at the time of the film’s release.

² Unless otherwise noted, the discussion of the tax benefits and structures of German film funds is based upon Moore (2001).

Figure 2. German Net-Benefit Fund Mechanics



Typically the producer will pay the bulk of the lease payments up front to a bank, called the defeasance bank, which then disburses the lease payments to the fund over time. When the lease obligation has been fulfilled, the copyright reverts back to the film company. The total amount of lease payments that the producer pays to the fund is generally less than the amount the fund initially paid the producer for the rights to the film. The difference, or net benefit, which the producer gets to pocket, represents the subsidy to the producer for using a German tax fund to finance his film. In most instances, after transaction costs this benefit equals about 10 percent of the budget of the film. The benefit to the film fund investors is the tax deferral they receive by writing off 100 percent of the cost of the film up front; the net present value of the savings resulting from the tax deferral is the benefit that the fund shares with the producer by offering a discount on the lease payments (UK Film Council US).

An important characteristic of the net-benefit structure is that the German fund is not actually funding the physical production of the film; the production company has to raise those funds itself, usually through a bank loan. The sums paid by the German fund to the producer, which equal the cost of producing the film, are simply a way for the fund to “pretend” that it is financing the film in order to constitute an investment that can be written off immediately. German funds are generally also entitled to share in the overall profits of the film, but such back-end participation is rarely seen.

With German equity funds, in contrast to net-benefit funds, German investors actually provide cash for the film’s budget, taking a real equity position in the economic fate of the film. While they care about the nature of the film and the economics of the deal, these

equity funds can typically accept more risk and the possibility of a lower return than other equity investors that do not have the German tax benefits. Not all of this equity is at risk, however. Typically, German funds insist on minimum guarantees of at least 50 percent of the budget.

One example of a film that was financed through an equity fund is Universal's *The Fast and the Furious*, the success of which allowed German investors to double their money. However, given the erratic nature of film returns, in the long run taking risk positions may be a costly proposition for investors. As one industry observer stated, "All the funds now are being structured so that the investors really are at risk. If there's one industry where you don't want to be at risk, it's the entertainment industry. Most films lose money" (Gorman 2001, 3).

All German tax funds, including net-benefit funds and equity funds, must meet several structural requirements to obtain German tax benefits. First, the German fund must own the copyright to the film, though the fund can license back the distribution rights. The copyright can also be reacquired later through a repurchase option granted up front. Second, the German fund must legally be the "producer" of the film; it must bear the film's financial risk and have substantial input into the creative and business aspects of the film. In practice, however, the fund simply "hires" the U.S. studio to produce the film. Lastly, the fund must prove that it is not purely a tax-avoidance scheme. To meet this requirement, the fund provides investors with a detailed prospectus calculating expected returns and other financial details.

5. The Future: Political Uncertainty as Growth Continues

Due to the tremendous role Germany and other foreign countries have played in U.S. film financing over the last several years, changes are under way both in the United States and abroad, and the future of tax-related international film financing is far from certain. The tax incentives offered by many countries, most notably Canada, mandate that the films be produced in the foreign host country. Therefore, they lure film production—and the jobs that go with them—away from the United States, a trend known as "runaway production." One study estimated that the costs to the United States of runaway production in 1998 totaled \$3 billion in lost spending and tax revenues and 23,500 jobs (DGA 2001). In response, industry labor groups have been lobbying Congress to bring back incentives for U.S. film production and institute countervailing tariffs against films produced using "unfair" foreign subsidies. According to this argument, domestic films produced abroad should be subject to punitive duties, just like steel, lumber or any other import product.³

³ Bernard Simon, "Using tariffs to discourage movie productions outside U.S.," *New York Times*, March 29, 2002.

Because German film funds do not require films to be produced in Germany, they are not a source of the runaway production feared by U.S. labor groups. While this has been ideal for the United States, Germany has seen little of the economic benefit intended by the tax incentives. As a result, the German government is still in the process of tightening its requirements, and there is a sense that the days of easy German money may not last forever. Despite this prospect, both runaway production and the foreign financing of U.S. films continue to grow, suggesting that foreign tax incentives will remain a powerful force in keeping U.S. studios focused abroad.

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