Investors´ Deductions And Allowances In Film Funds

German And South African Income Tax Laws Compared

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Declaration of the author:

I, the undersigned, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in parts submitted it at any university for a degree.

Berlin, 11 February 2003

Signature:

Signed by candidate

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I. Chapter One: Introduction

As Gal Batsri, NFVF[1] council member and entertainment lawyer with Webber Wentzel Bowens, put it recently:

"Outside Hollywood without government intervention a local film industry won't be able to get off the ground. It's a simple precondition that government has to come on board to develop a viable film industry that is seen as an investment brand."[2]

In 1993 at the peak of a dispute between a large number of taxpayers and the South African Inland Revenue one could read in the "Taxpayer" (a specialist journal on South African Tax Law):

"Unfortunately quite a number of professionals have gone beyond advice and been active in the marketing of schemes [film schemes – supplied by the author]."[3] The same goes for Germany in the last two years[4].

These statements illustrate the dilemma of what can be called "indirect film promotion". This Thesis is concerned primarily with public indirect promotion of film production in the Republic of South Africa (RSA) and the Federal Republic of Germany (FRG) by income tax incentives.

By comparing the income tax allowances and deductions for private investors in film production funds in Germany and in South Africa, the author aims to show how the governments of these two countries are taxing private individuals who invest in film funds, ie what incentives are offered to such venturesome investors. The tax incentives examined here provide the taxpayer with a deferment of his tax payments. By making the comparison the

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[1] "National Film and Video Foundation".

[2] Quoted from Andrew Worsdale, in: ZA@Play, August 23, 2001.

[3] Taxpayer, March, 1993, p 50.

[4] Cf Henning Kruse, "Goldgräberstimmung bei Filmfonds zieht "schwarze Schafe" an - Fehlende Kenntnisse könnten zu bösen Überraschungen für Anleger führen - Experten: Nicht von Hochglanzprospekten blenden lassen" in: Die Welt am Sonntag, Finanzen, Finanzen, dated 27th of July 2001.

author intends examine what role a domestic film fund can play as an instrument for financing domestic[5] and export films and how the government can promote film production in this way.

Also examined are the present practices of the Inland Revenue towards film funds, that is to say, how the tax authorities actually deal with film funds in their instruments. Over and above that, however, as an academic approach, practice notes by South African and "Anwendungserlasse" by German tax authorities respectively, as well as the courts decisions are discussed from a perspective of a coherent income tax system. Especially the current "Anwendungserlasse" and the "Übergangsregelungen" of the German ministry of finance are closely examined which are giving grounds for serious negative consequences for German film funds[6]. As a consequence, this work should not be used in isolation as an investor's guide. Unfortunately due to temporal requirements for submission of this Thesis the author was not able to consider the interpretation note of the South African Inland Revenue on s24F[7] of the Income Tax Act which is expected to be released in the beginning of 2003 and the draft of a supplementary decree on the BMF-decree dated 24.10.2000[8].

In both countries film funds are not only tax saving schemes for investors but also work as a vehicle for the transfer of private money to film producers. The role of film funds in financing a film project can range from the sole financier of a film to one source of finance in the amount of about 20 % of the budget[9] along side other typical modes of finance such as pre-sales,

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[5] "Domestic" here means a film which is produced and sold in the same country. In South Africa "domestic" can be seen as an antonym to "export film" as defined in s24F of the Income Tax Act and the amendment bill thereof).

[6] Cf Leo Fischer, „Dem Steuersparmodell Filmfonds droht das Aus", in: Die Welt am Sonntag, Finanzen, Finanzen, dated 22nd of April 2002; Leo Fischer, „Endzeitstimmung erfasst Steuer sparende Anlageformen", ibid, dated 12th of November 2002; Katja Tamchina, „Eichel-Erlass gefährdet TV-Produktionen", ibid, dated 25th of May 2002; Leo Fischer, „Zukunft der Filmfonds liegt im Dunkeln", ibid, dated 3rd of August 2002.

[7] All sections without description or with the one "of the Act" (in headlines) are such sections of the Income Tax Act No 58 of 1962 as amended and up to and including Act 60 of 2001.

[8] As the author was informed on the 9. of December 2002 by the German ministry of finance, Mr. Hensel, the discussion on the draft (!) of a supplement decree on the BMF-decree dated 24.10.2000, BStBl. I 2001, 780, is still going on. An interims arrangement will be released before a new decree.

[9] The amount of an average budget of a South African cinema feature film for local release with local finance is about Rand 3 million to 12 million; for such film for export the budget can go up to Rand 15 million. The

public funding, bank loans etc.. It is necessary to mention at this stage that the funds, especially the German funds, are used to transfer domestic moneys to foreign film industries, such as Hollywood. These funds nevertheless should be considered as investors and the domestic industry is always a partner to them as long as they meet sound standards of commercial film production[10].

Standards of commercial film production contain the range of factors including:

- A serious and reliable producer who can provide stable business alliances and contacts.
- An international and multi-media exploitable film, whose potential will be proofed best by pre-sales, a reputable distributor and other reliable financial sources and collaterals.
- A business plan, which characterizes the participating artists but also the legal and financial consultants, which shows a realistic evaluation of the market, secures controlling like "in time in budget" production, the cash-flow situation and finally is flexible enough to bear unforeseen incidents.
- A convincing marketing plan about the exploitation of the rights in the territories and merchandising to secure the return on the investment.
- A chain of title regarding all underlying works like the screenplay etc, provided by the producer, to prevent later problems but also to make sure that the fund can acquire the rights.

Note that "commercial" does not mean that the film is of low cultural or artistic value. 10 to 15 % of the demand in the world market refers to so called „art films". There are funds in Germany investing in such films, too[11].

The above mentioned list shows all the requirements a producer has to meet to get a bank loan in the US[12]. But in most cases the bank loan is more expensive than the fund money even

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corresponding numbers for German films are about Euro 1 to 5 million.

[10] Cf Hubert et. alt., in: Cashing In. As the author experienced it at the conference on film financing on the occasion of the Sithengi Film Festival 2002 in Cape Town, this is also true of the South African funds. E.g. Uwe Boll, producer and director, produces his films with the money from his own fund "Dritte Boll Kino Beteiligungs GmbH & Co. KG", cf Ulrich Reitz, „Der Zorro der Filmbranche - Filmemacher Uwe Boll finanziert seine Streifen über eigene Fonds", in: Die Welt am Sonntag, Finanzen, Finanzen, dated 21st of October 2001.

[11] Cf Dr. Kitzler, TransFilm Berlin, in: Cashing In, p 47.

though some funds demand a share of profit equalling their share of the production costs, a top recoupment-position, their operating costs to be paid and sometimes collaterals for their first or second instalment (the latter is true at least for German funds and bank loans).

Since the finance structure of a film production varies from project to project each producer has to check individually if the fund is a proper financier from his perspective and not least of all almost every parameter in a financing scheme is a matter of negotiation between the producer and his partner.

The experiences of the early 90s in South Africa and the present situation in Germany reveals how governments are struggling with the dilemma of promoting the film sector on the one hand and preventing tax evasion on the other hand. This thesis aims to show how the governments in both countries are faring in this regard at present and what they are offering to investors in film production funds.

As already indicated, the approach here is a comparative one. The international setting of film financing and the fact that film production funds in Germany and South Africa are structured in a strikingly similar fashion (as *en commandite* partnerships) makes film funds very suitable for the purpose of a comparative thesis. Accordingly only film production funds are chosen as the object of this research[13]. In order to give a full picture of what the deductions and allowances mean to the taxpayer, an introduction and explanation of the taxable income in both income tax systems is given (the reader may allow the author a short excursus to a problem which arises with partnerships in the newly incorporated residence-based system of taxation in South Africa). In order to avoid repetitions and to draw a clear picture of the similarities and differences between the tax incentives for a German investor in a German film production fund and the ones of a South African investor in a South African fund, the author will limit the

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[12] Cf Josh Kramer, An introduction to film financing published in "produced by" under http://www.producersguild.org/producedby/filmfinancing.html

[13] Another reason to choose production film funds is the fact that in Germany due to the straight-line depreciation leasing funds are not attractive enough for investors (Cf Hans-Joachim Beck, Presiding Judge at the Fiscal Court Berlin, in: Die Welt am Sonntag - online, Immobilien, Recht & Steuern, dated 11th of July 2000).

comparison to the results found in the conclusions of the two parts of this thesis. The detailed differences and similarities are to be found in the corresponding chapters of the said parts.

II. Chapter Two: Deductions and Allowances for film owners in the Republic of South Africa (RSA)

1. The type of company of a film production fund in the RSA

According to s24F(1) a film owner is a person who owns a film, whether solely or jointly[14]. Despite or because of the fact that the partnership does not exist as a legal entity, which means it does not form a *persona* distinct from its members, legal assets like intellectual property rights in a film can be held by the partners in joint and undivided shares[15]. But even if there is no *persona* constituted by the *en commandite* partnership in corporate law, in tax law the partnership can do so with regard to the "film owner". The ruling of s24H(2) shows this different approach in tax law by attributing a legal quality of a partnership to a single partner. Hence there is more than a "questionable need"[16] for this provision, but a clarifying purpose[17]. Consequently the "film owner" under s24F(1) also includes a partner in an *en commandite* partnership[18] which is of some importance, because investors as limited or commanditarian partners of the fund have a great interest to hold a copyright ownership in the film in order to secure the benefit of the applicable allowances in the Income Tax Act, ie s24F[19]. But not only for this reason the *en commandite* partnership is the suitable business entity for a film fund[20]. Moreover it allows to limit the liability of the investors as commanditarian partners to the creditors of the partnership, provided they are not disclosed to the creditors and the debts were

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[14] S24F(1) of the Income Tax Act No 58 of 1962 (as amended up to and including Act 60 of 2001)

[15] *Sacks v CIR* 1946 AD 31, 13 SATC 343; *Strydom v Protea Eisendomsagente* 1979 (2) SA 206 (T), p 209; Silke, Vol. 2, § 11.4.

[16] Cf Meyerowitz, §16.78.

[17] Silke, Vol. 2, § 11.4B.

[18] Meyerowitz, § 12.209.

[19] The Law of South Africa, Vol. 8 Part 2, par425, p249.

[20] If the fund is formed for the production of only one certain film, one speaks of a particular partnership

incurred in the name of the partnership and with its authority[21]. These partners may not represent the partnership and do not participate actively in the business affairs of the partnership. They are also not liable to the creditors of the partnership and to the disclosed partners only to the extent of the capital they agreed to contribute or actually contributed[22]. But on the other hand they cannot claim back any capital contributed or share of the partnership profits in competition with the creditors of the partnership[23]. Therefore the disclosed or managing partner is fully liable to third parties for the partnership debts[24]. Since a company can also become a partner in a partnership with natural persons[25] and it is generally only liable to its creditors for its own debts (the company is a juristic person), it is suitable to act as the disclosed or managing partner of the *en commandite* partnership as a film fund. In an "industry otherwise characterised by notorious uncertainty and instability"[26] this limitation of liability of the investor is obviously as strong as the one of getting access to the advantages of s24F.

2. The determination of the taxable income of the investor

The "taxable income" is already the outcome of a calculation that includes the central concern of this thesis: the deductions and allowances. However these issues can not be examined divorced from the context of their direct effect: the taxable income. To find it there is to be determined the "gross income" of a taxpayer according to s1[27]. From this the "exempt income" according to s10 is to be subtracted[28]. The result is called the "income". From this "income"

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[21] Dorsten, J L van, chapter 4.1, p 332.

[22] Dorsten, J L van, ibid.

[23] *Venter v Naude NO* 1951 (1) SA 156, p 163.

[24] Dorsten, J L van, ibid.

[25] *SA Leather Co (Pty) Ltd v Main Clothing Manufacturers (Pty) Ltd.* 1958 2 SA 118 (O) 119; *CIR v Epstein* 1954 3 SA 689 (A) 700.

[26] Cf The Law of South Africa, Vol. 8 Part 2, par 424, p 248.

[27] s1, „gross income".

[28] The only exemption of interest is s10(1)(zG) read with s24F. But a closer look at this sections, especially the cross reference between them which excludes any scheme of subsidies not mentioned in s24F shows that there is no exempt income available for film producers. This interpretation also meets the statement of Eddie Mbalo (CEO of the National Film And Video Foundation (NFVF), explained at a conference on film financing on the occasion of the 2002 Sithengi Film Festival in Cape Town), that in South Africa there are no subsidies for film producers available at present. Not even any funding by the NFVF.

again the general and special "deductions" are subtracted and finally the "taxable capital gains" according to s26A are added. The result then is called the "taxable income"[29]. It has to be noted however, that the taxable income (including the gross income) is basically an artificial concept and can differ materially from the amount of the income calculated according to accounting principles[30]. It also refers time wise only to the year of assessment, called the „tax year", which is for a natural person a period of twelve months from first of March of one year to the last day of February of the following year[31].

Regarding the tax returns, under s66(15) persons carrying on any business in partnership shall make a joint return as partners and each of the partners shall be separately and individually liable for the rendering of it. But still, as s77(7) stipulates, separate assessments shall be made upon each partner.

2.1 Gross income, s1 of the Act

In fact the income of a film owner who is an investor in films and a natural private person can be derived from all kinds of sources. Not least of all from the business of the fund itself as dividends equal to the share of the partner. Only the abstract definition given by the Income Tax Act under s1 is suitable to embrace all possible sources of income. Accordingly the taxable income consists of the

1. total amount
2. in cash or otherwise
3. received by or accrued to, or in favour of, a person
4. from anywhere in the case of a person who is a resident (2.2.1.1)
5. from a South African source (or deemed source) in the case of a non-resident (2.2.2.2)
6. other than receipts or accruals of a capital nature.

All these provisions have to be met cumulatively in order to speak of income in a legal sense and to make deductions thereof.

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[29] Huxham/Haupt, chapter 1.3.1, p 4.

[30] Silke, Vol. 1, § 1.11.

[31] Silke, Vol. 1, § 1.16.

Since the deductions are the central issue here, there shall be no further examinations made on the income. Only two elements of the gross income are of special interest for funds in regard to the partnership nature of the funds and their investors contributing to it:

2.1.1 The provision "from anywhere in the case of a person who is a resident" of s1 of the Act

The residence-based (or world wide) system of taxation was newly incorporated in the Income Tax Act for the years of assessment commencing on or after 1 January 2001. Now there is a mixed residence/ source basis of tax in this country. Before that time a source basis of tax was applied. The latter is still existing by being component of the new system. In view of that there are no further explanations to be made regarding the past.

A natural person is basically deemed to be a resident when he or she

1. is ordinarily resident or
2. if not so, is physically present in the Republic for certain periods[32].

2.1.1.1 The „ordinary resident"

S1 does not give a clear definition of what is meant by a „resident"[33] and there is no further definition within the Act of what is meant by „ordinarily resident"[34]. Basically the question whether a person is resident or not is merely one of fact[35] and the term has no special or technical meaning[36]. Nevertheless the courts have already defined the term. In the words of Schreiner JA in *Cohen's* case[37]:

> "...his [a man] ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and it would be

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[32] s1(a).

[33] s1.

[34] s1(a)(i) "resident".

[35] Silke, Vol. 1, § 5.2A.

[36] Silke, Vol. 1 § 5.2A.

[37] *CIR v Cohen* 1946 AD 174, 13 SATC 362.

described more aptly than other countries as his real home. If this suggested meaning were given to „ordinarily" it would not, I think, be logically permissible to hold that a person could not be „ordinarily resident" in more than one country at the same time..."

The *onus* is resting on the taxpayer regarding the location of his real home. This *onus* of establishing that he is not ordinarily resident in the Republic, can only be discharged by the taxpayer when his mode of life is such that it cannot be said that he has something like a real home anywhere[38]. But even besides establishing a real home in South Africa a person can be deemed as resident by physical presence in the Republic of South Africa:

2.1.1.2 The physical presence test

According to the detailed regulation under s1 „resident" (a)(ii)[39], a person can become taxable as a resident only in the forth tax year (year of assessment) when the named requirements of the definition are fulfilled. If he misses out being present for more than 91 days in any of the three years as a consecutive period or in the year of assessment, the chain is broken and the non-resident has avoided to become a resident. A person ceases to be a resident when satisfying the provisions under s1(a)(B)[40], which does not release a person from residency for ever, but makes it necessary to restart the aforementioned cycle of becoming a resident.

2.1.2 The provision "from a South African source (or deemed source) in the case of a non-resident" of s1 of the Act

While „residency" is more or less described in the Act, there is no definition of the term „source". Centlivres CJ, in the majority judgement of the Appellate Division in CIR v *Epstein*[41], pointed out that the legislature was probably aware of the difficulty in defining the words „source within the Republic" and consequently gave no definition. The courts have to decide on the particular facts of each case whether income has or has not been received from a

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[38] Meyerowitz, § 5.17.

[39] s1(a)(ii) „resident".

[40] s1(a)(B) „resident".

[41] *CIR* v *Epstein* 1954 (3) SA 689 (A), 19 SATC 221 at 231.

source within the Republic. Still there has been generated some kinds of tests, considerations or factors by the courts in regard to the source of income. There are mainly two factors:

1. the *originating cause or causa causans* of the income, ie what gives rise to the income; and
2. the location of the originating cause

As Watermeyer CJ turned it in *CIR v Lever Brothers and Unilever Ltd*[42] with regard to the originating cause:

> "... the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work that he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he is engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is a combination of these."

As far as the location of the originating cause is concerned Centlivres CJ in the above mentioned case *CIR v Epstein*[43] interestingly held, *obiter*, that when there is a partnership the members of which carry on their business activities in two different countries, the income of the partnership is derived from two sources. When one of the partners carries on his business activities within the Republic his income from the partnership is derived from a source within the Republic, while the income of the other partner is derived from a source outside of the Republic. The income of the former partner is the *quid pro quo* for the services he renders to the partnership in the Republic[44]. The above mentioned cases and others[45] applied what has

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[42] *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441 at 449-50, 14 SATC 1.

[43] Cf The Law of South Africa, Vol. 8 Part 2, par 424, p 221.

[44] Silke, Vol. 1, § 5.11.

[45] *Millin v CIR* 1928 AD 207, 3 SATC 170; *Rhodesia Metals Ltd (in Liquidation) v CoT* 1938 AD 282, 9 SATC 363 and 1940 AD 432, 11 SATC 244; *CIR v Black* 1957 (3) SA 536 (A), 1957 Taxpayer 172, 21 SATC 226 .

been called the „activities test". The deficits of this test become obvious by the following subsumption:

Inferred from these explanations, if an investor and partner gave money to the film fund in form of a South African *en commandite* partnership, the answer to the question where his income from this investment will be taxed would depend where the partner carries on his business activities. The „activity" of an investor is giving money to work with, ie letting the use of his capital to the fund. To locate this kind of activity there is only one place possible: the place from which the investor pays his money. If he did not pay his money, ie render his services to the fund, from South Africa he would not receive his income from a South African source. This result shows, "that it would be wrong to assume that this test can always be resorted to"[46].

The fact that the investors are only contributing money to the fund compared to what the fund is doing with this money shows that one can not talk of a business activity of the single investor without looking to what the fund does. It is the fund, ie its management, that decides in which film project the money will be invested and it is only the successful use of the investment by the fund management that actually gives rise to the shared profit in the hands of the partners. The investment itself is only precondition of any business activity of the fund and it is by nature not of any use to describe a business at all. The actual business of the partner is therefore the one of the fund. S24H(2) supports this argument by its mere language:

> "where any trade or business is carried on in partnership, each member of such partnership shall...be deemed for the purposes of this Act to be carrying on such trade or business".

There is no reason discernible that the „purposes of this Act" are not including the determination of the source of income[47].

Consequently, if the fund is a South African partnership with its management located in South Africa, the *causa causans* of each share of profit is the business of the fund operating in South

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[46] Meyerowitz, § 7.9.

[47] The mentioned problem shows another need for this provision; cf footnote 3.

Africa. The income arising from the fund in the hands of each partner is therefore from a South African source. This is also in accordance with the findings of Schreiner JA dissenting in *CIR v Epstein*[48] where was held by him[49]:

> "1. Since a business may be carried on through partners or other agents, the place where the taxpayer's income originates is not where he personally exerts himself, assuming that he does so, but where the business profits are realised."

Finally it can be said that the „activity test" with respect to film funds as *en commandite* partnerships is not a proper means to determine the source of income arising from the fund in the hands of each partner; especially not as long as the crucial „activity" is deemed to be the one of the limited partner and not the one of the partnership or the general partner respectively.

It has to be borne in mind however that non-residents can escape South African tax by means of a double taxation agreement like the one between South Africa and Germany. An international investment however is not subject to this thesis.

3. Deductions and allowances for the investor

Having established the investor's income by determining his gross income and then deducting all exempt income, the next step in the calculation of taxable income is to deduct all amounts allowed as tax deductions in terms of the Act. All deductions are deductible from any income of the taxpayer subject to tax[50]. S24H(5) provides in subsection (a) that any income which has been received by or accrued to the partners in common, ie to the partnership, is deemed to accrue to the partners in their profit-sharing ration on the same date on which it is received by or accrues to the partnership. According to subsection (b) expenses and allowances relating to such amounts are also deemed to be those of the individual partners[51]. This is one of the

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[48] 1954 (3) SA 689 (A), 19 SATC 221.

[49] *CIR v Epstein* in: Income Tax, Cases & Materials, Emslie/Davis/Hutton/Olivier, 3rd ed. April 2001, Taxpayer, p 118, chapter 4.5.

[50] *SBI v Olifantsrivierse Ko-op Wynkelders* 1976 (3) SA 261 (A), 1976 Taxpayer 229, 38 SATC 79 as cited in Meyerowitz, § 11.2.

[51] Cf s24H. Before s24H was in force it was common cause that in principle the partner was entitled to deduct his share of the loss from his personal income (*Sacks v CIR* 1946 AD 31; *Burgess v CIR* 1993 (4) SA 161 (A), 55 SATC 185, 1993 Taxpayer 153).

central incentives for a private investor to spend money on films: he can reduce the amount of his taxable income derived from his actual profession or other sources by the said deductions.

The Income Tax Act offers, or rather offered, a film owner three deductions:

1. the „film allowance"
2. the „print cost" and
3. the „marketing expenditure".

All of these terms are defined in s24F(1) aside from other terms used within the section[52]. It needs mentioning already at this stage that the marketing allowance of s24F and s11*bis* is no longer available in respect of marketing expenditure incurred after 31 March 1992[53]. However for recent and future film production not only the film allowance and the print costs are of real interest, but also the deduction of the advertising expenses under the general deduction formula as "expenditure incurred for purposes of trade". If the amendment of s24F becomes the law, a new marketing allowance will be available. All this is dealt with in details at a later stage. Before examining the special deductions for film owners, the relationship between these special deductions and general deductions has to be clarified.

3.1 General, special and double deductions, s23B of the Act

The main or general deductions are laid down in s11(a) and (b) and relate to the deduction of expenditure incurred in the course of trade from income derived from trade[54]. The special, specific or particular deductions are contained in s11(c) - (x) to s19 mainly, but also in s24F.

The general deductions relate to special deductions as follows:
S23B[55] introduced into the Income Tax Act in 1991[56] prohibits an expense from being claimed under more than one section of the Income Tax Act, and prevents allowances on an asset from being claimed under more than one section or provision, if there is no deduction or allowance specifically and expressly granted in addition to a deduction under some other section.

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[52] s24F(1).

[53] As s11*bis*(9) provides.

[54] Meyerowitz, §11.2.

[55] s23B.

[56] With retrospective effect to 1 July 1962.

Subsection (3) of s23B rules that where an amount may be deducted under a specific provision just as well as under the general s11(a) or (b) provision the taxpayer is bound to deduct it under the specific provision, ie only the special deduction is applicable. And if in addition to that, the specific provision imposes a limitation on the deduction the non-deductible excess may not be deducted under s11(a)[57] (but may be carried forward to the next year of assessment under s24F(7)).

Subsection (3) of s23B came into operation as from the commencement of years of assessment ending on or after 1 January 1990[58]. In the explanatory memorandum to the Income Tax Bill it was held, that it was never the intention of the legislature and has never been allowed in practice to claim the excess not allowed to deduct under the specific provision to be deducted under the general provisions of s11 (a) or (b)[59].

Subsection (3) reads as follows:

> "No deduction shall be allowed under s11(a) or (b) in respect of any expenditure or loss of a type for which a deduction or allowance may be granted under any other provision of this Act, notwithstanding that such other provision may impose any limitation on the amount of such deduction or allowance."

Before subsection (3) of s23B was added, the Appellate Division found in the instructive case *L. Feldman Ltd.* v *Secretary for Inland Revenue*, 1969 (3) S.A. 424 (A.D.) on the general issue of the relationship between „general" and „special" deductions, that the general deduction under s11(*a*) was applicable aside from the special deduction under s11(*m*), as it was then. Having the situation where any comparable language to subsection (3) was missing, the court held:

> "It is not readily apparent why the Legislature should have desired and intended to cut down, in relations to payments by employers to their former employees or the latter's dependants, the generality of sec. 11 (*a*). Had the Legislature indeed so intended, as is now contended by the Secretary, it would have been a relatively simple matter to have expressed that intention by unequivocal language. That is

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[57] Huxham/ Haupt, 17.2.11, p313; s23B.

[58] Explanatory Memorandum to the Income Tax Bill as cited in: Taxpayer November 1994, p205pp, 205.

[59] Loc cit

certainly not done by the wording of sec. 11 (*m*); and, in the absence of any clearly expressed intention in that behalf, the Court should not, in my opinion, readily construe sec. 11 (*m*) as wholly excluding, in relation to the field which it covers, the operation of sec. 11 (*a*)."[60]

What the court did in this case was finding an answer from the construction of the provisions themselves not by giving a general answer that covers all cases. Obviously the named amendment negated this approach to the relationship of the general formula in section 11(*a*) or (*b*) to (all) other provisions of the Act[61]. In general terms, it results from the amendment what can be called „legal security" or „certainty of justice", but the price to pay for this is a fine tuning to the application of the law to do justice to each single case which again can only be provided by the judicature.

The introduction of s23B(3) has experienced some profound criticism. It was shown by the above mentioned case that it was not „never the intention of the legislature"[62] to allow the excess not so claimable under such specific provision to be claimed in terms of the general deduction formula. There was apparently just no ruling of this problem. The amendment was looked upon as „ill-conceived"[63] and the following illustrative example was given[64]:

„If one assumes that a taxpayer acquires a copyright for the purpose of resale its value, if held and not disposed of at the end of the tax year, must be included in his income, but he cannot deduct the purchase price except to the extent and subject of all the conditions of section 11(*gA*)".

Consequently it was held that section 23B as it stood meant that where two or more provisions of the Act were applicable to expenditure or the allowance claimed the taxpayer was entitled to claim it under only one, but under any one of them best suited to him. Behind this reasoning

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[60] *L. Feldman Ltd.* v *Secretary for Inland Revenue,* 1969 (3) S.A. 424 (A.D.) as cited in: Taxpayer August 1969, p145pp, p147/148.

[61] S11(b) was meanwhile deleted by s15(b) of Act 59 of 2000.

[62] Explanatory Memorandum to the Income Tax Bill as cited in: Taxpayer November 1994, p205pp, 205.

[63] Taxpayer November 1994, p205pp, 206.

[64] Loc cit.

stands the opinion that the only purpose of section 23B was to prevent a double deduction of the same amount[65].

Now s23B obviously puts up a hierarchy regarding deductions. This is admittedly something different from what the heading of s23B indicates.

The language of s24F(2)(*b*) clearly rules that regarding the „film allowance" consisting of the „production cost" and „post-production cost" of a film (as defined in subsection (1) of s24F), this allowance shall be in lieu of any deduction[66] or allowance in respect of such production cost or post-production cost which may otherwise be allowable in terms of the provisions of this Act[67]. Thus the legislature did not raise any doubt about its intention.

3.2. The „film allowance"

The film allowance as the characteristic of s24F was introduced into the Income Tax Act in 1987[68] to react to some „innovative financing of expenditure relating to the production, marketing and distribution of films"[69]. In general terms this „film allowance" excluded the possibility of deducting production expenditure incurred under s11(*a*) or depreciation in terms of s11(*e*) and finally repealed the marketing allowance of s11*bis* which then depended upon the amount deducted under s11 and s17 (repealed by now) in respect of marketing expenditure[70]. The former allowance under s11*bis* ranged from 75% to 100% of the marketing expenditure and the wear and tear provisions of s11(e) allowed the costs of the film to be written off over three years in the percentage of 70:20:10[71]. As mentioned above, after the repeal of s11*bis*

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[65] Loc cit.

[66] The words "in lieu of any deduction" mean that this exclusion applies only to the production and post-production cost and no other costs like print or marketing costs; cf Juta's Income Tax, Vol. One, Notes, p 24F-8.

[67] s24F(2)(*b*).

[68] With effect from the commencement of years of assessment ended or ending on or after 7 April 1987, but not in respect of a film acquired under written agreement formally and finally signed by every party before that date.

[69] Taxpayer September 1987, p170 pp, 170.

[70] Taxpayer September 1987, p170 pp, 170, 173.

[71] Taxpayer April 1987, 61 pp, p 61.

(marketing expenditure), the marketing expenditure is currently deductible under s11(a) as "expenditure incurred for the purpose of trade". The deduction of the marketing expenditure was just recently brought back to s24F in a latest amendment bill 2002. This deduction and the amendment is dealt with in detail below.

3.2.1 The investor as a film owner

As a first prerequisite of s24F the investor and partner of the fund must become the film owner. To become a film owner the partner must own the copyright on the film to be produced. In respect of a cinematograph film the Copyright Act No. 98 of 1978 the "author" of a film does not mean that the film owner *in spe* has to be the person through whose technical skills and ability the film is achieved. In the setting of the commercial exploitation of the film it is crucial that the 'author' of the film undertakes the arrangements necessary for the making of the film[72]. Even if the partnership commissions another producer and pays for it or agrees to pay for it in money, the partners of it can become film owners. As section 21(1)(c) of the Copyright Act of 1978 provides, the copyright vests in the person commissioning the film. This legal situation makes it quite easy for the fund in South Africa to meet the precondition to be the film owner. The fund does not even has to have a partner (general or limited) who has certain special knowledge of film production.

3.2.2 The „at-risk" rules and their background

The introduction of the two at-risk rules in s24F[73] is the first time that such provision has been introduced into the Income Tax Act. The „Margo Commission" recommended that such a clause be introduced as a general provision into South African tax law, so that deductible losses from an activity be limited to the amount which the taxpayer has at risk in the activity[74]. As set out in the Explanatory Memorandum of the Income Tax Bill, 1987[75],

> "the purpose of the provision regarding "at risk" is to prevent the deduction from income of expenditure which although incurred, does not have to be paid unless

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[72] Cf Copeling, Copyright, p 27; see section 1(1)(d) of the Copyright Act No. 98 of 1978 as amended.

[73] These rules are dealt with below in detail.

[74] Cf Taxpayer September 1987, p170pp, p172.

[75] Explanatory Memorandum of the Income Tax Bill, 1987, W.P3- '87, p11 (e)

income is derived, and to achieve a measure of matching income and expenditure."

What stands behind the words "expenditure which although incurred, does not have to be paid unless income is derived" is a certain kind of loan, called "non-recourse loan". This term has become notorious in connection with film financing:

3.2.3 The British case Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)

The facts[76] of the British case *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* (1992) 2 WLR 469 (HL) are representing the pattern of a widespread scheme of film financing, also applied in South Africa:

The taxpayer was a company which became partner in two limited partnerships which had been set up to finance the production of two films. The company had been encouraged to become partner as a result of first year tax allowances in respect of capital expenditure incurred in the acquisition of master negatives of the film. It became the limited partner within the partnerships. The films were acquired by the partnerships which utilised its own funds to pay for approximately twenty-five per cent of the purchase price and borrowed the balance from the production company (referred to as "lender") repayable with interest out of the receipts from the films[77]. Another company was founded which became general partner within the partnerships and was as a wholly owned subsidiary of the production company. The loans freed the partnership and all the partners from any liability to repay the loan (so called "non-recourse loans"[78]). The net receipts out of the sale of the films by two distributors which were also wholly owned subsidiaries of the production company were to be split twenty-five per cent to the partners and seventy-five per cent to the lender until such time as the lender had been repaid his loan (which amounted to seventy-five per cent of the partnership capital), the lender was to receive a hundred per cent of the partnership profits. Thereafter the profits were to be

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[76] As cited from: Taxpayer November 1991, 208pp, p 208.

[77] The money borrowed from the production company originally stems from a bank loan in favour of the production company on the basis of a "revolving loan credit" in the amount of $ 11 million.

[78] As *Millet* J turns it in *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1989 1 WLR 1222, p 1227 D: "..they [the non-recourse loans – added by the author] were repayable exclusively out of the receipts of the film without recourse to Victory Partnership or its general or limited partners or their other assets."

divided on the basis of twenty-five per cent to the lender. It was also agreed to make any further loans to the partnership of amounts needed to complete the film should it overrun its budget. The effect of the agreements which had been entered into was that the partners were able to claim tax deductions of four times (!) the amount of the capital which they injected into the partnership. The partners did not involve themselves in any way with the films[79] but appointed agents to act exclusively for them in distributing and exploiting the film. On completion of production both films ran over the estimated budgets and neither proved to be financially successful.

3.2.4 The situation in South Africa before 1987

Before the introduction of s24F South African investors were attracted to film schemes revolving around the write-off of the cost of the film under s11(e) and the marketing expenditure allowance under s11(*bis*). They were assured of recouping their outlays (and even more, as mentioned above) because of tax savings (about R 3,5 for every Rand invested) flowing from the combined operation of the named provisions. Just as in the schemes dealt with in the English case, the South African investor had no liability beyond the amount paid in and were able to claim tax losses far in excess of their equity contribution. The amount invested by the South African investors was only a small part of the total costs, and covered about half of the costs of the production. The balance of the costs, including marketing expenditure, was financed by off-shore loans to the partnership procured by the overseas distributor who guaranteed a minimum gross receipts sufficient to cover the loans and who ultimately took the risk of their repayment, but reduced his risk in the whole venture by the amount invested by the partnership[80]. Another effect of those schemes was that the taxpayer had in addition to his tax savings the chance to earn money if the film turned out to be a success and recouped. This was the only moment when South Africa began to benefit from foreign currency[81]. In South Africa there were not less than 38000 taxpayers involved in these

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[79] The general partner, a subsidiary of the production firm and lender, alone had the conduct and management of the business of the partnership, cf *Millet* J in: *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1989 1 WLR 1222, p1226 H.

[80] Taxpayer April 1987, 61pp, p62.

[81] Taxpayer, Ibid..

kind of schemes until 1992. An estimated number of more than 100 000 assessments had to be completed at the end of 1992[82].

3.2.5 The settlement conference of 1993

In 1993 according to *The Budget Review*[83] assessments in respect of film schemes were outstanding in most cases since 1986, not least of all because the Commissioner for Inland Revenue was still awaiting judgement from Special Income Tax Court of Appeal on tax deductions for film schemes. Judgement then has been given in favour of the Commissioner[84]. Nevertheless after being announced in a press release concerning the named schemes an amendment was introduced to the Income Tax Act in 1993[85]. The provision of s61 introduced by this amendment empowered the Minister of Finance to make regulations authorising the Commissioner to enter into agreements with taxpayers for the settlement of disputes arising out of the legitimacy of tax avoidance schemes in general[86]. The Minister made use of it and the Commissioner made a form available to all taxpayers in which they could apply for a settlement providing an assessment final and conclusive in respect of any year of assessment[87]. S61 had only permitted an agreement to be entered into before 1 March 1994[88].

3.3 The film allowance in detail as it stands now

The „film allowance" is defined under s24F(2)(a) read with subsection (3). It consists of the „production cost" and „post-production cost", the latter terms are defined under s24F(1)[89]. This allowance refers to a film as defined in s24F(1)[90].

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[82] Taxpayer April 1990, 65pp, p 66; Taxpayer November 1992, 207pp, p 207; Taxpayer November 1991, 208pp, p208.

[83] As cited from: Taxpayer March 1993, 49pp, p49.

[84] Taxpayer March 1993, 49pp, p 49. According to *Silke*, Vol. 3, §19.26, p 19-51, the judgement itself was never reported.

[85] S61 of the Income Tax Act 113 of 1993.

[86] Clegg & Stretch, § 26.7; for the detailed regulations set out by the Commissioner on the basis of s61, resp the Minister's regulation see: Taxpayer November 1993, 202pp

[87] Taxpayer November 1993, 202pp, 202; Clegg & Stretch, § 26.7.

[88] Ibid.

[89] s24F(1) „production cost", „post-production cost".

3.3.1 The scale of the production cost

In a list of definitions § 24 F(1) sets out the scale of the "production cost", ie which positions are included in that term, as follows:

> **"production cost",** in relation to a film, means the total expenditure incurred by a film owner in respect of the acquisition or production of such film, excluding the expenditure incurred in the erection, construction of any buildings or other structures or works of a permanent nature, but including, without in any way limiting the scope of this definition -
>
> (a) any remuneration, salary, legal, accounting or other fee, commission or other amount, paid or payable to any person for the purposes of or in connection with the production of the film;
>
> (b) the cost of acquiring the story rights, script, screen play, copyright or other rights in relation to the film;
>
> (c) insurance premiums in respect of insurance against injury or death of persons, or loss or damage to property employed or used, as the case may be, in the production of the film;
>
> (d) premiums or commission payable in order to secure a guarantee that the cost of the film will not exceed a specified amount;
>
> (e) interest, finance charges and raising fees incurred for the purposes of or in connection with the production of the film;
>
> (f) the cost of acquiring or creating music, sound and other effects which will form part of the film;
>
> (g) any allowance which but for the provisions of this section would be allowed under s 11(e) or (o) or s 12C in respect of any machinery, implements, utensils or articles used in the production of a film: Provided that–
>
> 1. any such allowance shall be deemed to be an amount of expenditure incurred.
> 2. an amount equal to the total amount of any such allowance which may be granted in respect of any year of assessment divided by

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[90] s24F(1) "film".

the number of days in that year shall be deemed to have been incurred on each day of that year;

3. such expenditure shall be deemed to have been incurred in the country in which the asset in respect of which the allowance may be granted was acquired; and

4. no deduction or allowance shall be granted in respect of the cost of acquisition of any such machinery, implements, utensils or articles otherwise than as provided in this paragraph or paragraph (h); and

(h) expenditure incurred in respect of–

(i) the purchase, hire or construction of sets, and

(ii) the hire of any machinery, implements, utensils or articles used in the production of the film,

but excluding any such expenditure incurred after the completion date and any expenditure incurred in the marketing or promotion of, or soliciting of orders for, the film;"

As s24F(1)(a) "production cost" provides, so called "soft costs" of the fund like commissions for the finding of equity, outside capital or the concept and fees for auditing and counselling are included in the production cost. The words *"in connection with"* within subsection (1)(a) of the definition of "production cost" mean that a direct causal link (to the production) must exist, although this may be indirect[91].

It needs mentioning in this context that „post-production cost" *expressis verbis* does not include „print cost"[92]. Finally, as mentioned above, the amount of this allowance is in lieu of any deduction or allowance in respect of such production cost or post-production cost which may otherwise be allowable in terms of the provisions of this Act[93].

[91] Juta's Income Tax, Vol. One, 24F-7, 2000.

[92] s24F(1) „post-production cost".

[93] Cf fn 66.

3.3.2 The quantum of the film allowance as such

The film allowance as such is according to s24F(2)(*a*) to be determined under s24F(3)[94]. This subsection sets out the amount of allowance that may be granted on any one film, not necessarily an "export film". Its quantum is the sum of the production costs and any post-production costs of the film incurred during the year of assessment in which the completion date[95] of the film falls (s24F(3)(a)), plus any post-production costs in respect of the film incurred in any subsequent year of assessment (s24F(3)(b)), plus the certain amount of any film allowance disallowed in the preceding year of assessment (s24F(3)(b), s24F(4))[96]. It follows from this, that the film owner can immediately deduct the production costs in the year in which he completes the film. If he incurs post-production costs in that year, he can deduct them as he incurs them[97].

3.3.2.1 The „annual cap" of s24F(2b), s24F(4) and s24F(8) of the Act

The annual cap[98] refers to any single film as the allowance does to its costs. The latter may not exceed the sum of the production and post-production cost of the film paid by the film owner plus the total of the film allowances the film has already generated in preceding years of assessment, s24f(2)(b) read with s24F(4)(a).

3.3.2.2 The (first) „at-risk" rule of s24F(4) read with s24F(8) of the Act

If the film owner has used a loan or credit for the payment or financing of the whole or any portion of the above mentioned costs and a portion of the loan or credit is still owed by him on the last day of the year of assessment, the first „at-risk" rule as set out in s24F(8) read with

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[94] Effective as from the commencement of years of assessment ended or ending on or after 15 May 1989 and applies to any film whose production commenced on or after that date.

[95] s24F(1) „completion date"

[96] Silke, Vol. 2, § 8.54AA, p8-119; The Law of South Africa, Butterworths Durban 2001, Vol. 8 Part 2, par 428 p251. A certain amount of expenditure may not be allowed to be deducted due to the application of the „at risk" rules in s24F which are dealt with below.

[97] Silke, Vol. 2, § 8.54AA, p 8-119

[98] This striking term is used by Silke, Vol. 2 § 8.54AA, p8-119 (it is not used by the law); Silke also talks of a „film-lifetime cap" determined by the total production and post-production costs, ibid.

s24F(4) applies. The consequence of this will be, if the film owner has already paid the named costs but is not deemed to be „at risk" with a loan or credit used for the payments according to subsection (8) of s24F, he will only enjoy the deduction of the money paid by him up to the amount he is deemed to be at risk with the loan or credit on the last day of the year of assessment. According to s24F(8) the film owner is deemed to be „at-risk" to the extent the payment incurred by him would result in an „economic loss" due to no income from the exploitation of the film in future years[99].

If the film owner wants to deduct an amount not yet paid by him, he can only do so to an extent to which he is deemed to be at risk on the last day of the year of assessment under the provisions of subsection (8) of s24F, s24F(4)(b). This is the case only, if the debts incurred by him „would result in an economic loss to him were no income to be received by or accrue to him in future years from the exploitation by him of the film", s24F(8).

In both cases, where the film owner either has already paid (and used a loan or credit to finance the payment) or has incurred debts for the named costs he only enjoys the deduction in the amount of these costs, if he would suffer an „economic loss" by not recouping these costs from the film.

There are two approaches to determine the „economic loss":

3.3.2.2.1 The "worse-off financially" test

It is contended that the legal hypothesise that the film owner will suffer an economic loss is to be verified by a "worse-off financially" test[100]. In case the film owner is „worse off financially"[101] if the film does not recoup, he will be deemed at risk in relation to the expenditure to the extent that he is financially worse-off [102]. This test is taken from the case *Refrigerated Trucking (Pty) Ltd v Zive* 1996 2 SA 361 (T) where the court had to decide

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[99] s24F(8)

[100] The Law of South Africa, Vol. 8 Part 2, Butterworths, Durban 2001, para 429, p252.

[101] Cf *Refrigerated Trucking (Pty) Ltd v Zive* 1996 2 SA 361 (T) cited from: The Law of South Africa, Vol. 8 Part 2, para 429, p252.

[102] The Law of South Africa, Vol. 8 Part 2, para 429, p252

whether a third party had to indemnify the defendant for the total amount of the judgement to be entered against it or only 50 % thereof. The third party was an insurance company liable beside the defendant to the plaintiff. The third party limited its liability towards its policy holder in its general terms to the amount of its rateable proportion if there was any other insurance covering the same liability. Hartzenberg J held on the question if there was an insurable interest for the insured or not, as follows[103]:

> "An insurable interest must be the economic interest of the insured. It can range from the full value of the property (in the case of the owner) to a very small percentage thereof (where in the case of destruction the insured stands to lose a small percentage of the value of the property)."

Some lines further down he held[104]:

> "It seems that in our law of indemnity insurance an insurable interest is an economic interest which relates to the risk which a person runs in respect of a thing which, if damaged or destroyed, will cause him to suffer an economic loss or, in respect of an event, which if it happens will likewise cause him to suffer an economic loss. It does not matter whether he personally has rights in respect of that article, or whether the event happens to him personally, or whether the rights are those of someone to whom he stands in such a relationship that, despite the fact that he has no personal right in respect of the article, or that the event does not affect him personally, he will nevertheless be worse off if the object is damaged or destroyed, or the event happens."

It is contended that the film owner is only deemed to be "at-risk" where no income will be received by or accrue to him in future years from the "exportation" (which probably should be "exploitation") of the (export) film[105]. This means even in the case where the film does recoup only a small part of the expenditure, the film owner would not be "at-risk" because more than "no income" is received by him. This rigid rule is in contradiction to the rule from the case the authors are referring to. As Hartzenberg J explains, as cited above, that an economic interest

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[103] *Refrigerated Trucking (Pty) Ltd v Zive* 1996 2 SA 361 (T), 372 A

[104] *Refrigerated Trucking (Pty) Ltd v Zive* 1996 2 SA 361 (T), 372 F-H

[105] Cf The Law of South Africa, Vol. 8 Part 2, para 429, p252

(and in consequence of which the economic loss suffered by the loss of the property) can also be a very small percentage of the value of the lost property. Applied to the "at-risk" rule of s24F a small recoupment just partly covering the expenditure of the film owner would mean an economic loss to him and consequently he would be "worse-off financially". It is doubtful, whether this approach does justice to the meaning and purpose of the at-risk rule.

3.3.2.2.2 The "absolute liability" test

Another test to proof if the film owner is at risk or not in the meaning of s24F is to ask, if the film owner is absolute liable for the expenditure incurred as production or postproduction cost. An "absolute liability" for this purpose means that this liability will not be waived or otherwise expunged if, for instance, certain minimum sales targets are not met[106]. In other words there must be an unconditional liability for the full amount of expenditure incurred. This test seems to have the advantage that one only has to look at the contracts and agreements of the film owner to find, if he is at risk or not. To illustrate this test a suitable example is given by the legislature[107]:

> "should the film owner be granted such a loan [as set out in subsection (8) of s24F] subject to the condition that he could be called upon to repay the loan only out of the income derived from the film, he would not be at risk in respect of the relevant expenditure."

That it is far more difficult to answer this question, shows the following example given by Clegg and Stretch[108]: If an actual liability is covered by a sales agreement, in terms of which a distributor will pay an amount in excess of the liability, the film owner will be at risk in respect of the liability, if an economic loss will be sustained where the distributor fails to comply with the sales agreement. The fact that the banks as lenders are very carefully checking a sales agreement before they accept it as a collateral, and even then not discounting it, if the

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[106] Clegg & Stretch, § 23.2, p 23-7.

[107] Explanatory Memorandum of the Income Tax Bill, 1987, W.P3- '87, p11 (e)

[108] Clegg & Stretch, ibid

distributor is not trustable or "bankable" enough, shows how much a film owner is at risk in respect of any payment expecting from a distributor[109].

The above mentioned test have to be seen in the light of vexed issues in practice, eg, if the film owner who procures some form of insurance in respect of the return on his investment may rely on the film allowance. Typical of film production is to contract to obtain a revenue shortfall guarantee[110]. The insurers of such insurances are underwriting the difference or shortfall or any part of the shortfall between what an investor invests in a film product and returns received from exploitation. There are two forms of this kind of insurance[111]:

1. It can be a "guarantee policy" provided for in terms of the Short-term Insurance Act according to s1 of the Short-term Insurance Act No. 53 of 1998. In special terms regarding a film production this guarantee may be used to guarantee the debt of the distributor who provides a minimum revenue guarantee as part of the grant of rights in consideration for the right to distribute the film. It covers the minimum revenues guaranteed or part thereof in the event of default by the distributor as an existing debtor[112].
2. In most cases it is a form of professional indemnity, in terms of which a distributor or sales agent makes a sales forecast in respect of a film project prior to production or completion of the film and the insurer underwrites the distributor's or sales agent's professional judgement and commercial assessment of the exploitation potential of the film. This form of the guarantee gives the investor the possibility to insure the returns on the film and cover the shortfall, or part thereof, between the initial investment and the return[113].

Both kinds of insurance policies contain conditions which the insured is required to fulfill before a claim will be entertained by the insurance company. How problematic these conditions are shows the fact that insurers, reinsurers, banks and production companies are battling out

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[109] Josh Kramer, An introduction to film financing published in "produced by" under http://www.producersguild.org/producedby/filmfinancing.html

[110] Ibid.

[111] The Law of South Africa, Vol. 8 Part 2, para 435, p255

[112] Ibid.

[113] Ibid.

the question in the courts who of them will finally bear the costs of some films failing in the 1990s[114]. Consequently the insured always runs the risk of the insurance company refusing the claim and in consequence of which can be deemed to be at risk under s24F; at least until he has fulfilled the conditions of the insurance[115]. The Government in its recommendation to Parliament regarding the introduction of s24F exempted recognised insurers under an insurance policy relating to the completion of the film and effected at arm's length from the consequences of the then recommended and later introduced at-risk rule[116]. Another unanswered question is, how the tax and revenue authorities would look upon an economic loss in form of a diminution of a producer's reputation, ie an indirect monetary loss. It is held that the loss has to be quantifiable and directly flow from the lack of income generated from the exploitation of the film[117]. The wide term of an "economic loss" does actually not give grounds for such an interpretation. In contrast to that vague term the fact that a limited partner of an *en commandite* only is liable up to the amount of what he has contributed to the partnership, gives a clear answer to the maximum amount of the economic loss of such partner. Finally, irrespective of the named insurances and sales agreements, there is no doubt that the film owner can not be considered at-risk in case of the above mentioned "non-recourse loans".[118]

3.4 The "marketing expenditure" and the "print cost"

As mentioned above the marketing allowance under s24F(7), (8) and (9)(b) is not available anymore for marketing expenditure incurred after 31 March 1992. The reason why it is still dealt with here is the provisions of s24F(10) and (11), which give this allowance a further reaching application: The Commissioner shall under s24F(10) and (11) make a revised

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[114]Cf Freshfield Bruckhaus Deringer, March 2002: Film Financing. Who bears the risk?; published under www.freshfields.com/practice/finance/publications/pdfs/2860.pdf

[115] Cf The Law of South Africa, Vol. 8 Part 2, para 430, p253

[116] Cf Taxpayer April 1987, 61pp, p 61.

[117] Juta's Income Tax, Vol. One, Notes, "economic loss", p 24F-8.

[118] Interestingly *Millet* J in *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1989 1 WLR 1222, 1230 A, states: "The non-recourse nature of the borrowing and the use of a limited partnership (either of which would have been sufficient without the other) provided a desirable degree of protection for the participants but

assessment, if the prerequisites of these subsections are satisfied[119]. But also the exclusion from the at-risk rules of certain insurance contracts by the former s11*bis*(3A) gives an impetus to the interpretation of the said rules in s24F.

Whether the marketing expenditure could be deducted or not was to be tested in three steps as follows[120]:

1. It has to qualify and be deductible under s11(a) read with 23(g) (the general deduction formula),
2. it has to qualify under s11*bis* and finally
3. take the hurdle of s24F(7).

Silke refers in this test only to the marketing expenditure in the sense of s24F[121]. But it can be grammatically derived from the wording of s24F(7), that the relative pronoun "which" not only refers to the marketing expenditure, but also to the print cost[122]. S24F(7) reads as follows:

> "The amount of any print cost or any marketing expenditure contemplated in section 11*bis* which may be allowed under section 11 shall not in aggregate exceed the total of – ..."

Systematically the provisions of s24F are located after the general deduction provisions of s11 and as in respect of the explicit reference in s24F to s11 it can be held that the provisions of both sections have to be met cumulative. The wide meaning of the terms "expenditure"[123] and "losses" in the sense of s11(a) indicates once more the inclusion of the "print cost" under s24F to the regime of the said section. Therefore it is held here that the print costs has to qualify

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were not necessary to the securing of the tax advantages sought to be obtained." This – nota bene – refers to the English legal situation in 1989.

[119] s24F(10) and (11); the revised assessments are not dealt with here in detail.

[120] Silke, Vol.2, § 8.54.AA, p8-122.

[121] Silke, Vol. 2, § 8.54AA, p 8-122.

[122] ""which", a pronoun, used in any grammatical relation except that of a possessive; used especially in reference to animals, inanimate objects, groups or ideas (bonds which represents the debt – G.B. Robinson)" – Merriam-Webster's Collegiate Dictionnary, Electronic Edition, Version 1.5, 1994

[123] Cf as Meyerowitz, § 11.32, turns it: "The expenditure may take any form which has a value in money or money's worth".

under s11 just as the marketing expenditure under s24F had to and still has under s11(a) as "expenditure incurred for purposes of trade". For purposes of explaining the effect of the case law on a film fund it is suitable to start with the provisions of s24F and s11*bis*.

There is no dissent here however from the assertion[124] that the numerical limitation by the words of s24F(7): *"as does not exceed the amount of such marketing expenditure"*, is only referred to the marketing expenditure and not to the aggregate of the marketing expenditure and the print cost. Thus there is no numerical limitation on the print costs.

3.4.1 The (second) „at-risk" rule of s24F(7) read with s24F(8) of the Act

The at-risk rule referred to here in connection with the print costs and marketing expenditure can be called the "second" at-risk rule of s24F. It is operating the same as the first at-risk rule discussed in detail above[125]. The only difference to the first at-risk rule is that it refers to print costs and marketing expenditure.

3.4.2 The independent cap[126] of s24F(7) of the Act on the amount of the "print cost" (and the "marketing expenditure")

The print cost as defined in s24F(1) includes any expenditure incurred by the film owner in the making of copies of the film[127]. Even though they incur in the post-production process, they are not included in "post-production cost" under s24F(1). This is due to the nature of these costs as an outstanding budget item[128].

Section 24F(7) of the Act provides that print cost or marketing expenditure may be deducted in the year in which they were incurred, subject to a maximum allowance calculated according

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[124] Cf Juta's Income Tax, Volume One, Notes on s24F, subsection (7), p 24F-8.

[125] Cf II., 3.2.2, page 22.

[126] As Silke, Vol. 2, § 8.54AA, p 8-120, appropriately summarizes s24F(7).

[127] s24F(1) "print cost"

[128] Cf Bastian Clevé, Investoren, Anlage Nr. 5, p 239. The given example shows a calculation of the break even point of a typical US major studio production, where the production cost are estimated US $ 50 million plus another US $ 27 million P&A (print and advertising expenditure) for the US market and the rest of the world.

to a formula set out in the said section. The formula provides that the deduction cannot exceed the total of:

the amount of the print costs or marketing expenditure which have been paid by the film owner (provided that where a loan or credit has been used by the film owner for the payment or financing of any portion of the print cost, and any portion of the loan or credit is owed by the film owner on the last day of the year of assessment, the amount allowed falls to be reduced by any portion of the loan or credit in respect of which the film owner is not at risk on the last day of the year of assessment),[129] and

the amount of any print cost or marketing expenditure which has not been paid by the film owner and for which he is deemed to be at risk under s24F(b) on the last day of the year of assessment. Print costs or marketing expenditure not allowable in terms of section 24F(7) of the Act must be carried forward and are then deemed to be print costs or marketing expenditure incurred in the succeeding year of assessment.

However in respect of the marketing expenditure this cap only can refer to the expenditure deductible under s24F, ie the marketing expenditure for a South African export film read with *s11bis* until 1992. It would not be covered anymore by the wording of s24F to expand the cap on marketing expenditure to the deduction of advertising expenditure under the general deduction formula as "expenditure incurred for purposes of trade". As a fact it can be recorded that with abolishing the marketing expenditure for export films in s24F an even more attractive deduction under the general deduction formula for advertising expenditure was opened up. This will be changing again, if the amendment bill will become promulgated law. The cap of s24F(7) then will apply to the new marketing allowance for "export films" as defined in the bill.

3.4.2.1 The limitation of s24F(9)(a) of the Act on the amount of the "marketing expenditure"

Until 31 March 1992 there was no allowance in respect of marketing expenditure granted under s24F(9)(a), if the film was not qualifying as a South African export film in the year of assessment. The film qualifies as an export film under s24F(1) only, if a certain percentage of

[129] s24F(7)(a). Cf S24F(4), in relation to the production and post-production costs of a film.

its costs are paid, incurred or payable in the Republic of South Africa[130]. If the film had qualified for certain former subsidies as described in subsection (a), the marketing allowance was not granted at all.

3.4.2.2 The limitation of s24F(9)(b) of the Act on the amount of the "marketing expenditure"

S24F(9)(b)[131] limited the total amount of the marketing allowance as set out in s11*bis*(4)[132]. A formula is given in the said section which reads as follows:

Y = (2,5 x A) – B ;

"Y" represents the amount to be determined ;

"A" represents the sum of the amount of the production and post-production costs incurred in the current and any previous years of assessment and which may be taken into account in the calculation of the film allowance, to the extent that these costs were incurred and paid or are payable in the Republic; and

"B" represents the sum of the production and post-production costs described above to the extent that these were incurred outside the Republic.

3.4.2.3 Qualification of the marketing cost under s11*bis* of the Act

Due to its limited application until 1992 no detailed examination of s11*bis* shall be made here. But even if the marketing allowance is not available anymore for recent and future film productions, there were problems occurring in the past which are still of interest when examining the taxation of the film owner. S11*bis*(3A) contained an at-risk rule which in broad terms provides, that an exporter was deemed to be at risk to the extent that the payment of the amount owed in respect of any loan or credit would, having regard to any transaction,

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[130] s24F(1) "South African export film"- with detailed particulars.

[131] s24F(9).

[132] With effect as from the commencement of years of assessment ended or ending on or after 23 February 1988, and applies in respect of any film acquired by a film owner otherwise than under a written agreement formally and finally signed by every party to it before that date.

understanding or scheme entered into by him, result in an economic loss to him, where no income received by him in future years. A *bona fide* contract of insurance concluded at arm's length with an insurer in the ordinary course of the insurer's business was expressly excluded in this provision from the named transactions. S24F does not provide this exclusion and the problems arising from this are discussed above. The annulment of s11*bis* also in connection with s24F later than 1992 indicates that the legislature intended to give a wide range to the at-risk rules in s24F. Nevertheless, as shown above, it is possible to avoid the negative repercussions of the at-risk rules in s24F; eg by standard insurance contracts in the ordinary course of the insurer's business.

For the sake of completeness, it needs to be mentioned that in the period between 9 March 1989 and 31 March 1993 the allowance may not has exceeded 20 % of the export turnover which accrued to the exporter within this period[133].

3.5 The general deduction formula, ss11, 11(a), 23(g) of the Act

As mentioned above, for explanatory purposes this test is only mentioned at this stage and refers to the deduction of the print costs (as explained above) and advertising expenditure as "expenditure incurred for purposes of trade". Due to the high budget of these costs, the deductibility of the expenditure of which is a crucial point[134]. In numerous cases the courts found that s11(a), also referred to as "the positive test" and s23(g), correspondingly referred to as "the negative test", have to be read together when one considers whether an amount is capable of deduction[135]. The general introduction to s11 prefacing s11(a) again can be said to be a component of the latter section. It reads as follows[136]:

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[133] As s11*bis*(3B)(b) provided.

[134] Cf fn 128.

[135] *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13 at 16; *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381 at 389; ITC 1058 (1963) 26H SATC 305 at 307; *CIR v Nemojim Pty (Ltd)* 1983 (4) SA 935 (A), 45 SATC 241 at 245-5; *CIR v De Beers Holdings (Pty) Ltd* 1984 (3) SA 286 (T), 46 SATC 47 at 53.

[136] s11.

"For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from income of such person so derived - ..."

The general deduction formula derived from the preamble of s11, ss11(a) and 23(g) can be regarded as to consist of the following elements:

1. The expenditure and losses
2. must be actually incurred
3. during the year of assessment
4. in the production of income:
5. They must not constitute expenditure and losses of a capital nature, and
6. if they are claimed as a deduction against income derived from trade, they must either in part or in full, constitute moneys that are laid out or expended for the purpose of trade.

The last requirement is the most problematic in respect of the investment of a private person in films (*via* a partnership) and the tax incentives thereof. This trade requirement has traditionally been applied as set out in s23(g) without reference to s11(a) with "good reason: s23(g) was the more onerous provision, and there was consequence of which no need to examine the trade requirement embodied in s11(a) separately. A taxpayer passing the test of s23(g) simultaneously passed the test of s11(a)"[137]. Thus this requirement has to be satisfied before an amount qualifies as a deduction in terms of ss11(a), 23(g), 24F[138]. S23(g) containing the said requirement reads as follows:

"No deductions shall in any case be made in respect of the following matters, namely-

any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purpose of trade;"

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[137] Emslie/Davis/Hutton/Olivier, 9.1, p 406.

[138] It has to be mentioned that there are special provisions providing that one or the other need not apply, eg s11(n).

It needs mentioning that prior to its amendment in 1992, s23(g) prohibited the deduction of expenditure which was not laid out wholly or exclusively for the purpose of trade[139]. Now s23(g) prohibits only moneys as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade[140]. Obviously for many years the negative test was much more restrictive than it presently is. Nevertheless even now the taxpayer does not want to lose a part of the possible deductions and thus the question, whether the expenditure was for the purpose of trade is still crucial. Besides this, the inter-relationship between s11(a) and s23(g) was not affected by the amendment.

The term `trade´ is defined in s1 and includes in general every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of, or the grant of permission to use any patent, or any design, or trade mark, or any copyright, or any other property which is of similar nature[141]. As s1 shows the term `trade´ is given a very wide meaning and the principle that this definition should be given a wide interpretation was described as being well established in *Burgess v CIR*[142] and it was pointed out that this definition is not necessarily exhaustive.

In respect of a film fund investing into film production as a "a highly speculative adventure, conditioned in its form and motivated by the desire to secure a tax advantage"[143] the said requirement becomes a crucial issue. For a latest interpretation of the "trade requirement" in respect of the print costs and the advertising expenditure of a film fund the following cases may deliver some indication of how the judicature will treat these expenditures; especially in

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[139] The judgements cited above in connection with s23(g) are all referring to the old version of the section which was obviously very strict and therefore harder to satisfy. Not to mention that the old version as an all-or-nothing rule got much more attention by the courts and was the crucial hurdle to take.

[140] s23(g).

[141] s1 "trade".

[142] 1993 (4) SA 161 (A), 55 SATC 185pp, p 196 and 197. Dowling J in *ITC 770* (1953) 19 SATC 216pp, p217 as cited in *Burgess v CIR* said dealing with a similar definiton of trade that it was "obviously intended to embrace every profitable activity and...I think should be given the widest possible interpretation".

[143] As Millet J turns it in: *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1989 1 WLR 1222, 1243 F-G.

case the film turns out as a complete financial failure which happens to 50 % of all films produced in the US with a budget between 25 and 60 million US $[144]:

3.5.1 De Beers Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (AD)[145]

Corbett JA delivering the courts judgement of this case held that "of course, the attainment of a profit is not necessarily the hallmark of a trading transaction"[146] and furthermore " the absence of a profit does not necessarily exclude a transaction from being part of the taxpayers trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purpose of trade within the terms of s23(g)..."[147]. But "were a trader normally carrying on business by buying goods and selling them at a profit then as a general rule a transaction entered into for the purpose of not making a profit, or in fact registering a loss must in order to satisfy s23(g), be shown to have been so connected with the pursuit of the taxpayer's trade, eg on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the monies paid out under the transaction were wholly and exclusively expended for the purpose of trade. Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer"[148].

This test was held to be an objective one[149]. So, if a film production that has prospects of success due to a professional production and distribution of the film, this would deliver facts speaking for a trade according to the film business. As the last cited sentence of the judgement indicates the Revenue is entitled to analyse the motive or intention of the taxpayer where the set of transactions entered into between the parties are such that they raise questions as to their true nature. This remedy of the Revenue under s103 arising from such transactions is dealt with below.

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[144] Cf Clevé, Batian/ Clevé, Investoren, Einführung, p 13. Films with budgets over US $50 million are doomed to success because of their tremendous advertising budgets.

[145]Taxpayer 1986, 8; Emslie et al., Income Tax, p414pp

[146]*De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A) in: Emslie et. al., p 415.

[147]*De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (AD) in: Taxpayer January 1986, 8pp, p9 -Editorial Note

[148]Ibid..

[149]Taxpayer 1991, 208pp, p 210; Emslie et. al., p 414.

3.5.2 Solaglass Finance Company (Pty) Ltd v CIR 1991 (2) SA 257 (A)[150]

Botha JA held in this case that "...the distinction between "motive" and "purpose" in this context [ie the meaning of the words "exclusively laid out or expended for the purpose of trade" – comment supplied] seems to me to be a nebulous one: it may sometimes be found to be helpful, but at other times it may be conducive more to confusion than to clarity...In general one can say no more than that the issue is to be resolved by examining the particular facts of each individual case."[151]

In this judgement the court does not want to commit itself to any single criterion for the trade requirement like the objective purpose, the result, effect or object of the transaction or the subjective motive for so entering into the respective transaction. If eg accountants show practices on behalf of the taxpayer that indicate that there is no future recovering of the outlay expected, such behaviour according to the above mentioned judgement can easily thwart a claim for deductions[152]. Thus this judgement provides quite some insecurity for the film owner regarding the tax deductibility of his expenses. It may be useful to give justice to any specific case but on the other hand it invalidates or even abolishes legal security for any investor in any risky venture comparable to film productions.

3.6 The trade requirement under s23(g) of the Act and the "test of normality" under s103 of the Act

Another obstacle the taxpayer might have to overcome is s103(1)[153] which gives the Commissioner remedies against the avoidance of tax at which it is directed. In order to apply s103(1), the Commissioner must be satisfied with the cumulative fulfilment of the following four prerequisites[154]:

1. A "transaction, operation or scheme" as been entered into or carried out, s103(1).

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[150] Taxpayer 1991, 5.

[151] *Solaglass Finance Company (Pty) Ltd v CIR* 1991 (2) SA 257 (A), p 281.

[152] This example was given with regard to pre-section 24F film partnerships in: Taxpayer Aptil 1990, 65pp, p 68.

[153] s103(1).

[154] Silke, Vol. 3, § 19.2, p 19-4, 19-5.

2. The transaction entered into or carried out had the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act or of reducing the amount of such liability, s103(1)(a).
3. The circumstances under which the transaction was entered into or carried out must be like –

   (a) in the case of a transaction in the context of business, was entered into or carried out in a manner that would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit, s103(1)(b)(i)(aa); and

   in the case of any other transaction was entered into or carried out in a manner that would not normally be employed in the entering or carrying our of a transaction of the nature of the transaction in question, s103(1)(b)(i)(bb); or

   (b) the transaction created rights or obligations that would not normally be created between persons dealing at arm's length und a transaction of the nature of the transaction in question, s103(1)(b)(ii).

It has to be mentioned however, that any decision of the Commissioner under the said section is subject to objection and appeal by the taxpayer, as provided under s103(4), and if the taxpayer can show that any one of the circumstances named above is not of application, his liability for tax may not be determined under s103(1)[155].

Subject to the application of s103(1) is the so called "test of normality". This test is no universally applicable test and there is only one particular type of transaction expressly assumed to be abnormal, namely the one example given in s103(3)[156]. Nevertheless there are a couple of cases which had been discussed in relation to partnerships investing in film production. Aside from the two cases mentioned and discussed above (*Solaglass Finance Company (Pty) Ltd v CIR* and *De Beers Holdings (Pty) Ltd v CIR*) the cases ITC 1496[157],

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[155] Silke, Vol. 3, § 19.2, p 19-3.

[156] Silke, Vol. 3, § 19.13, 19-28-14; s103.

[157] 53 SATC 229 – so called "plantation-case".

Hicklin v CIR[158] and *CIR v Louw*[159] have to be reviewed in the context of the funds and were applied to the said type of partnerships[160].

3.6.1 ITC 1496[161] – the so called "plantation case"

In this case the taxpayer purportedly entered into a farming partnership as part of a "plantation scheme". The central idea of the scheme was that interest due over a lengthy period lying in the future could, by being settled immediately by way of promissory notes, be deducted immediately. The court did not tolerate this in favour of the taxpayer. Another incentive of the scheme was the hope it held out that each participant would benefit by claiming a deduction a proportionate share of a management fee that was payable in advance for the management of the farming activities necessary to the operation of the scheme. To succeed with this claim, the taxpayer had to show that it was a partner in a farming venture. The question was whether the transaction was entered into or carried out in an abnormal manner.

Melamet J considered the partnership to be an "investment vehicle" and the investors were held to "camouflaging themselves as partners"[162]. On the grounds of the timing, the extent of the deductions claimed and the deferment of the receipt of taxable income that the scheme promised, the sole purpose of the scheme was considered to avoid or postpone taxation. The Commissioner was therefore held to be fully justified in applying s103(1)[163].

There are two arguments to question this approach in respect of film funds: Provided that like in the *Ensign Tankers* case the general partner of the partnership is a professional film producer, there is no camouflage at least regarding this partner. And the second one (connected to the first) is that, if one treats a partnership for a number of purposes as a separate legal entity, eg in matters of practice and procedure[164] or in rule 14 of the Uniform

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[158] 1980 (1) SA 481 (A).

[159] 1983 (3) SA 551 (A).

[160] Taxpayer 1990, 65pp and November 1992, 207pp

[161] Loc cit.

[162] 53 SATC 229, 250-251.

[163] As summarised by Silke, Vol. 3, § 19.12C, p 19-28.

[164] Cf *Standard Bank of SA Limited v Lombard and another* 1977 (2) SA 808, p 813;

Rules of the Provincial and Local Divisions of the Supreme Court and Magistrates' Court Rules 40 and 54, this indicates that one has to look at the partnership as a whole to determine, if it is trading or not and not to the individual motives of the partners themselves; especially not only to those motives of the limited partners. In addition to that, if a film fund is structured like in the *Ensign Tankers* case containing a general partner as an original and experienced film producer and the transactions are of merchantable quality, it should be without difficulty for the taxpayer to proof that the transactions are not in an "abnormal manner". Furthermore due to the nature of the general partner, his motive can not be deemed to be of pure tax avoiding nature.

In the face of these arguments the approach of Melamet J in the mentioned case can be looked upon with justification as a "fundamental flaw"[165] compared to the one in the *British* case *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)*[166].

3.6.2 Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)

This case the facts of which has been mentioned above[167] received great attention in `The Taxpayer' journal. It shows how the English judicature deals with film funds and its investments. The case went through all instances in England. At the beginning stands the judgement delivered by the Chancery Division of the United Kingdom[168], then a judgement followed on appeal by the Court of Appeal[169], in which the matter was referred back to the Revenue before it was brought before the House of Lords[170] where it received its final judgement delivered on 12 March 1992. The main judgement delivered by Lord Templeman turned on two issues, namely, the entitlement of the partnership to deduct $ 14 million and the question of whether the partnership was engaged in trading in the form of production and distribution of the film.

Du Toit en andere v Barclays Nasionale Bank Bpk 1985 (1) SA 563 (A), p 575.

[165] Taxpayer 1992, 207pp, p 210.

[166] Finally decided by the House of Lords, 1992 WLR 469 (HL).

[167] Cf II. 3.2.3., page 23.

[168] *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1989 1 WLR 1222.

[169] *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1991 STC 136 (CA).

[170] *Ensign Tankers (Leasing) Limited v Stokes* 1992 WLR 469 (HL).

"... It [the actual loss] was what it purported to be, a loss sustained in a highly speculative adventure, conditioned in its form and motivated by the desire to secure a tax advantage but on commercial terms and in the nature of trade".

The Court of Appeal held that[175]

"the question whether a transaction is a trading transaction will be answered by looking objectively at what was done in order to see if it is similar to transactions of the same nature in the commercial world and carried out in a similar way ... it is established that a transaction which has all the features of a trade must also have a commercial purpose."

With this finding the Court of Appeal decided to remit the case to the Commissioners and confirmed *Millet* J findings in the first instance. Interestingly the Court did that by following the criticism by British tax commentators. One of whom submitted that the only distinction the Court [the Chancery Division as the first instance] was required to draw was that between the purpose or motive of the taxpayer in investing with others and the purpose of that group or partnership or company engaging in the relevant activity[176]. (Obviously the criticism referred to the approach not to the result.) It was further submitted that only in case the partnership was a mere sham there would have been no basis for a distinction between the purpose of the taxpayer and that of the partnership[177]. In this case the Court of Appeal found that where there is some uncertainty to the purpose of the transaction the objective intention of the taxpayer can become relevant in determination thereof. In such case the intention could well be decisive[178].

The House of Lords delivered the final judgement on the said case, ie on the question whether the partnership was engaged in trading. Lord Templeman delivering the judgement found that the production and exploitation of a film was a trading activity and the expenditure of capital for the purpose of a commercial film was a trading purpose. He further found that a trading transaction could plainly be identified in the case, that it was not a sham and the expenditure

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[175] *Ensign Tankers (Leasing) Limited v Stokes (Inspector of Taxes)* 1991 STC 136 (CA), p 144.

[176] Shrubsall 1990 *British Tax Review* 52.

[177] Loc.cit..

[178] Taxpayer 1991, 208pp, p 209.

incurred by the taxpayer was real and not magical[179]. He did that on the basis of his interpretation of the relevant s41(1) of the Finance Act of 1971 (a British statute) finding that this section was not concerned with the purpose of the transaction but with the one of the expenditure[180], which was, as mentioned above, not a magical expenditure.[181]

Here the courts indicated that there is a chance for the objective intention of the taxpayer to become decisive. But, and this is of vital interest for any film fund, if the fund in form of a partnership is dealing in transactions of a merchantable quality as customary in the film business, there is no reason to look at the intention of the taxpayer at all.

It was found rightly on the grounds of this judgement that the taxpayer in South Africa had nothing to fear in respect of his expected deductions with regard to "a Revenue attack on the basis of s103(1)"[182]. Regarding the prohibition of deductions in determination of income under s23(g) it was found that there was not much difference between the approach of *Corbett* JA in *De Beers Holdings (PTY) Ltd v CIR*[183] and that of *Millet* J in the said case. In South Africa a taxpayer who could show that a partnership of which he was a partner was engaged, objectively considered, in a commercial activity of producing the film with a view of making a profit would be able to discharge the onus of proving that he was trading[184].

3.6.3 Hicklin v CIR[185]

The case dealt with a sale of a dormant company to a dividend-stripping company. The idea of the sale was to use the dividend-stripper to take over the dormant company, declare the distributable reserves as a dividend and deregister the company thereafter. Because the

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[179] *Ensign Tankers (Leasing) Limited v Stokes* 1992 WLR 469 (HL), p 490, p487.

[180] *Ensign Tankers (Leasing) Limited v Stokes* 1992 WLR 469 (HL), p487.

[181] Interestingly Lord Templeman held the transaction of the partnership to be a joint venture and not a loan. Consequently each partner was precluded from claiming that he incurred expenditure beyond the quantum of his contribution to the partnership

[182] Taxpayer 1990, 65pp, p 69.

[183] *De Beers Holdings (PTY) Ltd v CIR* 1986 (1) SA 8 (A); Taxpayer, 1986, p 8; cfII. 3.5.1, page 42.

[184] Taxpayer 1990, 65pp, p68.

[185] 1980 (1) SA 481 (A).

dividend-stripper was a company, and therefore not liable for tax on the dividend, the Secretary applied s103(1) and taxed the shareholders of the former dormant company (one was "Hicklin") on the dividend, as if they had liquidated or deregistered the company themselves. The shareholders were not able to discharge the onus of showing that tax avoidance was not one of the main purposes of the sale. However the agreement between the sellers and the dividend-stripper was an arm's length transaction in which each party was striving to obtain the maximum possible advantage for itself. For this reason the court felt that the abnormality requirement was not satisfied and therefore s103(1) not applicable.[186]

Here again the court indicates that, if there are transactions comparable to ones or itself being at arm's length, the abnormality requirement of s103(1) is not satisfied. In case of a film production the taxpayer would always be able to proof that he expected a profit from the exploitation of the film as long as he can provide evidence showing he was engaged in a professional and legitimate production.

3.6.4 CIR v Louw[187]

The court in this case had to apply s103(1) to two schemes, as it found on the facts of the case. One was the incorporation of a company to accrue to it the salary and drawings from a partnership in order to take it later from the company by way of loan and salary. Thereby the tax was reduced because the company was tax on a lower rate than the individuals as partners of the partnership. Here, in line with the decision in *SIR v Geustyn, Forsyth & Joubert*[188] where the facts were similar, the court held that the incorporation in itself was not an abnormal transaction. More interesting though in regard to film schemes including the above mentioned non-recourse loans is the courts finding on the loans the company made to its directors (the than partners of the ex partnership). The company did neither ensure the repayment of the loans nor ask for security thereof. The court considered this loans as abnormal and only constituted for tax avoiding effects and consequently applied s103(3) to the scheme of the loans.

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[186] It needs mentioning here, that in *SIR v Geustyn, Forsyth & Joubert* (1971 AD) 33 SATC 113 the court held that all four of the main criteria listed in section 103(1) must apply before the section can be applied.

[187] 1983 (3) SA 551 (A).

[188] Loc cit.

The court findings in this case also alleviate the ones of Melamet J in ITC 1946. Here the court determined the nature of the transaction by looking at the transaction itself. Regarding the loans, s24F provides all tests. There is no room for this case to be applied to film funds after the introduction of s24F. Any film fund though preceding the application of s24F would be in danger of an attack by Revenue on the grounds of s103(1), if not, like the British courts, the South African would determine the non-recourse loan agreement as a joint venture. The latter is not very likely as the judgment given by E M Grosskopf JA in *Burgess v CIR* indicates:

3.6.5 Burgess v CIR[189]

Of all the cases mentioned here, this case is the applicable to the taxation of a film investor. The question in issue in the Appellate Division was whether the deduction of interest claimed by the appellant was permissible in terms of the general deduction formula laid down in s11(a) and the first main issue on appeal was whether the Special Court had been correct in its view that appellant had not shown that the expenditure had been incurred in the production of income derived by him from "carrying on any trade" within the meaning of s11(a).[190]

The facts in broad terms were as follows:
The taxpayer was approached by an insurance broker who advised him that "over a year period we could make you a considerable amount of money" and that all the taxpayer had to do was to put up a guarantee of R 425 000. The essence of the scheme was that money would be borrowed from a bank and invested for a short period of one or two years in assets such as shares which were expected to appreciate in value. The investment would be made, not by purchasing the assets themselves, but by entering into a single-premium pure endowment policy. The insurance company would then manage the money contributed by the investors by way of premiums in the most advantageous way. At the end of the period the assets would be realised, the bank repaid, and the balance pocketed. This type of investment normally carried

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[189] 1993 (4) SA 161 (A), 55 SATC 185.

[190] Even though the court expressly points out that it is not dealing "with an attack by the Commissioner on an alleged tax avoidance scheme in terms of s103 of the Act" (*Burgess v CIR* 1993 SATC 55, 185pp, p 193) this case is discussed here because it easily could have become a question of the application of s103(1). Otherwise the Court did not have to exclude it so clearly. It may also called to mind that in the same year the settlement conference regarding film schemes took place.

the risk that the assets might not perform as expected, leaving the investor with no profit and an obligation to repay the loan. In the said scheme this risk was reduced by some more complex legal devices. Interestingly according to the film funds the transactions were to be entered into not by the individual investor, but by an *en commandite* partnership of which the taxpayer and the initiator of the scheme would be the members. The investor would be the limited partner, who would not be liable for debts of the partnership except to the extent of the bank guarantee referred to. The promoters of the scheme also considered that it held certain tax advantages. The interest payable to the bank by the partnership would be tax deductible, they considered, and as the liability for such interest would be incurred during the first year, even though it was only payable annually in arrears, and no taxable gain would arise before the end of the first year, the timing difference between the incurral of the interest expense and the accrual of the gain on the insurance policy would give rise to a deferment of liability for income tax.

The court held by EM Grosskopf JA[191]:

1. The argument on behalf of the Commissioner that the scheme was nothing more than a tax engineering device and for this reason did not amount to the carrying on of a trade was rejected. Each part of the scheme was designed for a commercial purpose and could not be described as artificial. There was an expected benefit in the form of a tax deferment, but this arose from the nature of the transaction and was not contrived in an artificial way.
2. The proposition that the purpose of securing a fiscal advantage amounted to a non-trade purpose was unsound in law, even if the facts supported it (which they did not).
3. If a taxpayer pursued a course of conduct which, standing on its own, constituted the carrying on of a trade, he would not have ceased carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he did was to obtain some tax advantage. If he carried on a trade, his motive for doing so was irrelevant. The position might be different if a transaction was so affected or inspired by fiscal considerations that the shape and character of the transaction was no longer that of a trading transaction. The shape and character of the transaction on the facts of the present case were inspired entirely by commercial considerations.

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[191] As cited from *Burgess v CIR* in: Emslie/Hutton/Davis/Olivier, § 9.2, p 435.

4. The argument on behalf of the Commissioner that the transaction amounted to an investment and not the carrying of a trade was also rejected. It was a speculative enterprise *par excellence* and could properly be described as a "venture" as envisaged in the definition of "trade".

5. ... 7. ...

As the above mentioned facts of this case show, there is only one fundamental (if at all) difference in the facts between *Burgess v CIR* and *Ensign Tankers v Stokes* and this is the "non-recourse loans" in the latter case. E M Grosskopf JA distinguishes the two cases on the grounds that they are "not the same type"[192]. What is meant by this is most likely the "non-recourse loans". No coincidence that the House of Lords qualified the transactions including the "non-recourse loans" within the film scheme as a joint venture[193]. But still Grosskopf JA refers to Lord *Goff*'s statement, that "unacceptable tax avoidance typically involves the creation of artificial structures, by which, as though by wave of a magic wand, the taxpayer conjures out of the air a loss, or a gain, or expenditure, or whatever it may be, which otherwise would never have existed"[194]. He hereby approves the objective approach to the trade requirement determined by "the course of conduct which, standing on its own, constitutes the carrying on of a trade"[195]. Apart from these "non-recourse loans" which are not permissible anymore under s24F, as shown above, the court at this point clearly states and thereby approves the approach in *De Beers Holding*[196] that the appearance of the transaction itself is decisive in the first place. Only if it is "so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer that of a trading transaction", the motives of the taxpayer can become relevant[197]. Another aspect of the case worth noticing is that by this judgement another one by Melamet J was overruled. This might also invalidate the approach in the "plantation case" with regard to film schemes. Again it can be concluded from this case that a film fund and therefore each single partner has nothing to fear regarding the tax advantages if there is a financing of a legitimate film production and exploitation, even the film

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[192] *Burgess v CIR* 55 SATC 185, 193.

[193] See fn 181.

[194] Ibid..

[195] Cf the *ratio decidendi* in 3. above.

[196] Loc cit.

[197] *Burgess v CIR* 55 SATC 185, 194 with reference to the British case *FA & AB Ltd v Lupton (Inspector of Taxes)* [1972] AC 634, 647 G.

turns out to be a financial failure. Regarding point 4. mentioned above, the judgement confirms the wide definition of trade, which unproblematicly includes the production and exploitation of films[198] .

3.7 Advertising and print costs (P&A) and the provision "in the production of income", s11(a) of the Act

The expression "in the production of income" in s11(a) has been interpreted by the courts in *Port Elizabeth Electric Tramway Co Ltd v CIR*[199] where Watermeyer AJP, as he then was, held[200]:

> "The purpose of the act entailing expenditure must be looked at. If it is performed for the purpose of earning income then the expenditure attendant upon it is deductible[...]
>
> [...] what attendant expenses can be deducted? How closely must they be linked to the business operations? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purposes of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or *bona fide* incurred for the more efficient performance of such operation, provided they are so closely connected with it that they may be regarded[201] as part of the cost performing it."

The UK Film Distribution Guide[202] gives the answer to the question how close the advertising expenditure is connected to the performance of the income from a film:

> "The creative process of planning and executing a film marketing campaign, designing the posters and placing the advertisements, can have a huge impact on how a film performs. The film marketing task is essentially to build visibility, awareness and interest in a new release, peaking at its opening weekend

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[198] Cf II. 3.5, page 41.

[199] *Port Elizabeth Electric Tramway Co Ltd v CIR* 8 SATC 13.

[200] Ibid., at p16.

[201] "may be regarded" can be considered to be "can properly or reasonably be regarded" , cf *CIR v Genn* 1955 (3) SA 293 (A).

[202] httpwww.launchingfilms.com/uk_film_distribution_guide/

(Friday/Saturday/Sunday). After this, a combination of word-of-mouth and further promotion will sustain the film ('give it legs') during its theatrical run, which normally lasts up to four months, although usually most of its money is taken early in the run.

Blockbusters with top stars need heavy marketing spends to back up their wide releases. As advertising costs soar, and the market gets more crowded, marketing decisions become crucial. Whilst inspired marketing cannot save a film for which the public has no appetite, a fine film can be lost in the melee if it is not clearly, distinctly promoted.

The best form of publicity is word of mouth - a positive talking point among the core target audience which ideally expands, via personal recommendations, to other groups. Distributors hire external research companies to track levels of awareness week by week as a film's release date approaches. With a month to go there may be very low awareness: each film is effectively a new product launch, often completed within just a few intense weeks. Distributors are competing for a significant share of voice not just against all other distributors but also against other leisure activities, trying to entice the same audience."

The printing of the copies of the master copy is the *conditio sine qua non* for any release of a film. Thus it is obvious that the costs thereof are the basis of the income from the film; such expenses are more than linked to the business operations. Another citation from the UK Film Distribution Guide will illustrate this argument[203]:

"A wide release, 'at cinemas everywhere', may in practice open at 300 or more sites UK-wide, sometimes playing at two or more screens per cinema. This helps to accommodate mass audiences who, motivated by the distributor's campaign, are eager to see a big new film as early as possible. Distributors pay the print duplication costs: one 35mm print of a two-hour film costs approximately £1,000, so the print cost alone of wide releases is substantial. In due course, digital projection may reduce the physical print cost; digital systems are presently on trial in a small number of UK cinemas.

[203] www.launchingfilms.com/uk_film_distribution_guide/

> Different films are naturally handled in different ways. An 'art house' release may consist of a dozen prints or fewer, booked initially into selected screens in London (which, with the largest population, accounts for about 26% of all annual UK cinema visits) and some university towns, before hopefully touring more widely over the weeks and months to follow."

Finally it needs mentioning that "income" here means income as defined in s1 and the deduction must not be prohibited by s23(f), ie the amounts received or accrued the expenses refer to must constitute income under the term defined in s1.

As the example given above reveals, an 'art house' release does not require too many copies for its distribution, because it serves a different market and a different audience than a 'blockbuster film'. According to this, if too many copies are made just to inflate the budget for purposes of deduction the expenses are not incurred "in the production of income". In such case it will be difficult for the fund to prove that the expenses were *bona fide* incurred for the more efficient performance of such operation, ie selling an 'art house' film.

3.8 Advertising and print costs (P&A) and the provision "not of a capital nature", s11(a) of the Act

There was also no definition laid down in the Income Tax Act regarding the expression "not of a capital nature". However Watermeyer CJ provided the "pre-eminent and principal test"[204] in *New State Areas Ltd v CIR*[205] which was deemed to "hold good in most cases"[206]. This test focuses on the question whether the expenditure or loss should properly be regarded as part of the cost of performing the income-earning operations, then it is of revenue nature (and deductible), or as part of the cost of establishing, enhancing or adding to the income-earning structure or plant or machinery, in which case it is of a capital nature and not deductible[207].

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[204] As Emslie/Davis/Hutton/Olivier, 8.1, p 349 characterize it.

[205] *New State Areas Ltd v CIR* 1946 AD 610, approved in numerous cases since, cf Meyerowitz § 11.48, p 11-19.

[206] Meyerowitz, § 11.48, p11-18.

[207] Emslie/Davis/Hutton/Olivier, 8.1, p 349.

There are two subsidiary tests which are only used in case the named test proves equivocal[208]. As Watermeyer CJ held in *New State Areas Ltd v CIR*[209]:

> "[...]The expenditure of a capital nature, the deduction of which is prohibited under s11(2), is expenditure of a fixed capital nature [emphasis supplied], not expenditure of a floating capital nature, because expenditure which constitutes the use of floating capital for the purpose of earning a profit, such as the purchase price of stock in trade, must necessarily be deducted from the proceeds of the sale of stock in trade in order to arrive at the taxable income derived by the taxpayer from that trade. The problem which arises when deductions are claimed is therefore usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery.[...]"

One could say, regarding the print cost, that the copies of the master negative constitute the income-earning plant or machinery or structure of the film owner. It is the copies which go to the cinemas, in many cases not only once on the release of the film but a second or third time as the classics prove it. The consequence would be that the deduction of the print cost already fails at the stage of the general deduction formula, because the expenditure for the copies would have to be regarded as of capital nature. This approach however does not take into consideration that the fixed capital is the film as such, only embodied in the master negative. The making of the copies and the expenditure for it is nothing but making the film marketable. The print cost are incurred by the film owner for no other reason than converting the film as fixed capital in floating capital. With the film only being fixed on the master negative it could not be used for the purpose of earning a profit. Finally it can be said that providing copies of the master negative the cost incurred for it is the not only part but the major part of the cost of performing the income-earning operations of the film owner. The budget of the print cost substantiates this interpretation.

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[208] Emslie/Davis/Hutton/Olivier, 8.1, p 350.

[209] 14 SATC 155; 1946 AD 610, p 619/620.

Nothing else can be said about the advertising expenditure. This expenditure is exclusively linked to each screening of the film and its effect is gone once the screening took place. An advertisement is not establishing a source of new income like it is the nature of a fixed asset. An advertising measure is exhausted in the moment it is done. Therefore cost incurred for it can not be regarded as part of the income-earning structure, machinery or plant.

4. The limitation of the deduction by s24H(3) read with (4) of the Act

The heart of s24H lies in subsection (3)[210] which – notwithstanding anything to the contrary in this Act other than s11*bis* – restricts any allowance or deduction which a limited partner may claim to the amount of his contribution to the partnership or for which he is or may be held liable to creditors, plus any income received by him from the partnership. But like in s24F(7) provides, any allowance or deduction disallowed under s24H(3) shall be carried forward and is deemed to be an allowance or deduction the taxpayer is entitled to in the following year of assessment, s24H(4).

5. The limitation of the deduction by s23H(1) of the Act

S23H is operative in respect of expenditure incurred on or after the 23. of February 2000[211] and in respect of a film fund, it only affects advertising expenditure as being deductible under s11(a). Even though the author found by interpretation of the wording of s24F that the deduction of the print costs also has to pass the test of the general deduction formula, it is not contradictious to limit the field of application of s23H to the deduction of the advertising expenditure. Section 23H(1) was introduced into the Income Tax Act to give the Revenue another instrument to combat certain tax avoidance schemes[212]. For the same purpose s24F was introduced to the Act. Since s24F specifically deals with the print costs it would be going to far beyond the wording of s23H if one would extend the field of application of this section to the print costs already dealt with in and covered by s24F.

S23H(1) reads as follows:

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[210] s24H.

[211] According to the Taxation Laws Amendment Act 30 of 2000, sec 31(2).

[212] Meyerowitz, § 11.23A, p 11-8.

1) Where any person has during any year of assessment actually incurred any expenditure (other than expenditure incurred in respect of the acquisition of any trading stock)--

a) which is allowable as a deduction in terms of the provisions of section 11(a), (c) or (d) or section 28(2)(a) and (c); and

b) in respect of-

i) goods or services, all of which will not be supplied or rendered to such person, during such year of assessment; or

ii) any other benefit, the period to which the expenditure relates extends beyond such year as assessment;

the amount of the expenditure which shall be allowable as a deduction in terms of such section in the said year and any subsequent year of assessment, shall be limited to, in the case of expenditure incurred in respect of--

goods to be supplied, so much of the expenditure as relates to the goods actually supplied to such person in such year of assessment; or

services to be rendered, an amount which bears to the total amount of such expenditure the same ratio as the number of months in such year during which such services are rendered bears to the total number of months during which such services will be rendered; or

iii) any other benefit to which such expenditure relates, an amount which bears to the total amount of such expenditure the same ratio as the number of months in such year during which such person will enjoy such benefit bears to the total number of months during which such person will enjoy such benefit or where the period of such benefit is not determinable; such period over which the benefit is likely to be enjoyed:

Provided that the provisions of this section shall not apply--

aa) where all the goods or services are to be supplied or rendered within six months after the end of the year of assessment during

which the expenditure was incurred, or such person will have the full benefit in respect of which the expenditure was incurred within such period; or

bb) where the aggregate of all amounts of expenditure incurred by such person, which would otherwise be limited by this section, does not exceed R50 000; or

cc) to any expenditure to which the provisions of section 24I, 24J, 24K or 24L apply; or

dd) to any expenditure actually paid in respect of any unconditional liability to pay an amount imposed by legislation.

2) If the Commissioner is in any case satisfied that the apportionment of the expenditure in accordance with subsection (1) does not reasonably represent a fair apportionment of such expenditure in respect of the goods, services or benefits to which it relates, he may direct that such apportionment be made in such other manner as to him appears fair and reasonable.

3) Notwithstanding the provisions of subsections (1) and (2), where it is during any year of assessment shown by any person that--

a) the goods or services in respect of which the expenditure is incurred will never be received by or be rendered to such person; or

b) such person will never enjoy such other benefit in respect of which any expenditure is incurred,

such expenditure shall be allowed in such year, to the extent that such expenditure has been actually paid by such person.

4) The exercise by the Commissioner of his discretion contemplated in subsection (2) shall be subject to objection and appeal.

This section which is basically self-explaining limits the deductible amount of eg the advertising expenditure to the amount paid for services already received within the year of assessment. So it can be the case, that the advertising expenditure which is quite a relevant position within the budget of a film production is not totally deductible in the year of assessment in which it was paid. It needs mentioning however that the deduction of the advertising expenditure is not numerically limited but maybe deferred, at latest to the year of assessment when the last service is rendered. The question of whether the advertising expenditure was appropriate to the chances of the film in the market is immaterial[213]. Nevertheless an inflated marketing budget can come into conflict with the provision that the expenditure must be incurred "in the production of income" (provided the expenditure is not of a capital nature, see above). As far as the film business has a long tradition on an international basis, it should not be a problem for the taxpayer to discharge the *onus* of proving that the amount spent on advertisement is reasonable and appropriate to the film in question and thus prove that the money was spend "in the production of income"; provided the costs were not inflated to optimise the deductions for the investor.

6. Excursus: VAT included in any of the above mentioned costs

Where the cost of any asset acquired by the film owner or any expenditure incurred by him in respect of the abovementioned costs includes value-added tax, the amount of the latter is to be excluded from the cost of the asset or the amount of expenditure for purposes of calculating a deduction or allowance permitted in terms of the Income Tax Act[214]. The film owner must however be a "vendor" as defined in s1 of the Value-Added Tax Act 89 of 1991 and be entitled, in respect of the current or any previous year of assessment, to claim an input tax credit in terms of that Act[215]. Where an input tax deduction is allowable in respect of a lease[216], each lease payment must be reduced by a proportionate amount of the input tax, ie the input

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[213] Meyerowitz, §11.133, p11-51; ITC 152 4 SATC 299.

[214] s23C(1); effective in respect of years of assessment ending on or after 30 September 1991.

[215] s16(3) of Value-Added Tax Act 89 of 1991, read with the definition of "input tax" in s1.

[216] A lease for this purpose means a lease as contemplated in para (b) of the definition of "instalment credit agreement" in s1 of the Value-Added tax Act 89 of 1991.

tax excluded from the lease payment is the amount which bears to the input tax, the same ratio as the lease payment bears to the total lease payment in terms of the lease[217].

7. The amendment of s24F and s24H of the Act in the Income Tax Amendment Bill 2002

A planned amendment of s24f and s 24H has to be mentioned here because of its considerable effects.

The amendment reads as follows:

> **Amendment of section 24F of Act 58 of 1962, as inserted by section 17 of Act 85 of 1987 and amended by section 19 of Act 90 of 1988, section 24 of Act 101 of 1990, section 26 of Act 129 of 1991 and section 30 of Act 59 of 2000**
>
> **25. Section 24F of the Income Tax Act, 1962, is hereby amended—**
>
> (a) by the insertion in subsection (1) after the definition of " completion date" of the following definition:
>
> " ' export', in relation to a film, means sell and consign or sell and deliver to any purchaser at any address in any export country, or the exploitation of the film by the film owner in an export country and any derivative of 'export' shall be construed accordingly;" ;
>
> (b) by the insertion in subsection (1) after the definition of " exported" of the following definition:
>
> " ' export country' means any country other than the Republic or a neighbouring country;" ;
>
> (c) by the insertion in subsection (1) after the definition of " production cost" of the following definition:
>
> " ' marketing expenditure' means so much of the expenditure incurred by the film owner during the year of assessment to market a South African export film and allowed to be deducted from his income under section 11 as is proved to the satisfaction of the Commissioner to have been incurred directly—

[217] Provision to s23C(1); effective as from 30 September 1991.

Thus the expenditure of such kind for domestic films can be deemed to be deductible under the general deduction formula. The announced interpretation note will hopefully shed some light on this, too. This problem of the deduction of advertising expenses becomes crucial again with the annual cap on the mentioned deductions in s24F(7) and the loss carried forward, after the losses have reached up to this cap. As held here this cap (and the loss carried forward) only applies to the print costs and to the marketing allowance under s24F and s11*bis*, the latter meanwhile repealed. But there is not only an annual cap to the deductions. The Income Tax Act allows the taxpayer to carry forward the losses which go beyond this cap to the next year of assessment. This is a compromise an investor can live with. Another two limitations which can be deemed to be bearable for the taxpayer are the ones in s24H(3), (4) and s23H. s24H(3) more or less limits the deduction in relation to the amount the investor is contributing to the fund, ie his share. In subsection (4), s24H again offers a loss carry forward. So the Income Tax Act is compromising again. Another gradual deduction of the expenditure deductible under the general deduction formula, ie the advertising expenses, is stipulated in s23H(1). Since it refers to expenditure for services not already rendered at the time of the payment, this limitation is very likely to apply to the advertising expenses. Nevertheless the taxpayer has it in his hands to control the expenses to make them be deductible, just by making sure that the services are rendered in the time of the payment. Again this limitation is not a serious obstacle to a film fund.

Due to the history of tax avoidance by film schemes in the early 1990s there is still a test contained in the general deduction formula which can be located with the „trade requirement" of that formula. If the fund shows a "lack of profit motive" it is in danger to loose the loss deduction regarding at least the advertising and print costs. But as it was shown above, by a well founded film production showing all parameters of a professional financing, such as a profound business plan and realistic prognoses of independent experts like sales agents or distributors on the recoupment from the film, it should be no problem to prove the trade requirement and to gain the trust of the tax authorities.

A production of the said quality should also not come into conflict with the „at-risk" rules of s24F and the „test of normality" under s103. An investment into a reasonable and professional film production can not be deemed a pure investment vehicle and as a consequence such

investment can not be deemed as an "abnormal transaction". As the author showed above, special insurances like shortfall guarantees and completion bonds can not trigger of the lethal effect of the said rules. The announced interpretation note on s24F is most likely dealing with this questions to the benefit of the film owner. These rules and tests are historically caused by film schemes which contained so called „non-recourse loans" by which the investor in such a scheme was made not even liable for the loss of the borrowed part of his investment. Despite the fact that these rules caused some confusion and insecurity with film investors, the Income Tax Act offers still viable incentives. The situation will be even better for the funds when the announced practice note is released. Just the fact that the SARS[219] is giving such note shows that there is no prejudice against the funds anymore on the side of the tax authorities.

Finally it can be concluded from this examination of the deductions and allowances for film funds offered by the South African Income Tax Act that the time when the tax authorities and the legislature fought against tax avoidance schemes revolving around film funds is over. The present tax incentives to invest into film production for South African funds are lucrative and may be even more in the future. The announced interpretation note will most likely bring even more legal security. The South African tax system is in this regard on its way to become a remarkable instrument of indirect public film promotion.

III. Chapter Three: Deductions and allowances for film owners in the Federal Republic of Germany (FRG)

1. The type of company of a film production fund in the FRG

The objects of the fund, as it is subject to this work, are the production of films, the distribution, exploitation and marketing thereof. In this way the fund can generate income from trade in the sense of § 15 I Nr. 1[220]. If it does so or not is part of the tax law considerations below.

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[219] "South African Revenue Services".

[220] All paragraphs without description or with the one "of the Act" (in headlines) are such sections of the German Income Tax Act (Einkommenssteuergesetz) dated 16. April 1997, BStBl. I 1997, 415 amended up to and including the Steuerentlastungsgesetz 1999/2000/2002 vom 24.03.1999, BGBl. I 1999 S. 402.

The Income Tax Act (EStG[221]) is only applied to natural persons, cf. § 1 I. Thus only partnerships not companies (joint-stock companies) are of interest when it comes to the taxation of the investor. The proportionate profit or loss of the partnership is allocated to the single partner, if he is a co-partner in the sense of § 15 I Nr. 2. Co-partner in the sense of § 15 I Nr. 2 can only be the partner of a partnership in a civil law meaning and in accordance with § 1 only a natural person. Considering this, the partnership is the only "type of company" suitable for a film fund.

The question which form of partnership is best for the investor can again only be determined against the background of tax law. In the sense of § 15 III Nr. 2 a partnership is deemed to generate income from trade, if its unlimited (personally liable) partner is exclusively a joint-stock company and. this company, ie its manager, is the only authorized manager of the partnership. An *en commandite* partnership in form of a so called "GmbH[222] & Co. KG[223]" provides this legal presumption and the possibility of a sufficient limitation of liability[224]. The "GmbH & Co. KG" is an *en commandite* partnership with a joint-stock company as an unlimited partner. It is – as a juristic person – only liable with the company assets in accordance to § 13 II GmbHG, which can be left at an amount of Euro 25.000,00, see § 5 I GmbHG. In this way the non-member liability of the unlimited partner is also factual limited. If, as usual with the most funds, the company (GmbH) and limited partners are not identical, one

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[221] "Einkommenssteuergesetz".

[222] "Gesellschaft mit beschränkter Haftung".

[223] "Kommanditgesellschaft"

[224] This is the main difference in contrast to the OHG („open trade partnership") which does not include any limitaion of liability of the partners. On the other hand this type of partnership is more attractive from taxation point of view, because under § 15a I the loss adjustment is limited to the amount of the share of the partner of an *en commandite* partnership Less attractive than the en commandite partnership is the „atypical partnership *in commendam*" (atypisch stille Gesellschaft). It´s true that the investor is deemed to be a co-partner under 15 I Nr. 2 EStG, but the enhanced loss adjustment (erweiterte Verlustausgleich) under § 15a EStG is not available for him, cf BFH dated 14.12.1995, BStBl. II 1996, 226. The shared profits are, should the occasion arise, taxable under § 15a III if a negative capital account occurs or raises. The withdrawals are treated as taxable profit of the limited partner. The advantage of such kind of partnership is however that the investor stays anonymous because he needs not to be registered in the Register of Companies (Handelsregister) and in addition to that the possibility of an advanced limitation of liability.

speaks of a "non-personal identical GmbH & Co. KG" (nicht personengleichen GmbH & Co. KG).

1.1 The fiduciary limited partner (Treuhandkommanditist)

Owing to their huge financial budget film funds have a large number of investors. To reduce the complex administration[225] a trustee is often placed between the investor and the fund[226]. But not only for this reason the role of the fiduciary limited partner needs mentioning here. His intervention is also relevant in terms of taxation of the investor, which is dealt with at a later stage.

Trusteeship is not defined by law. Nevertheless characteristics of it has been established in daily legal practice[227]. There are two kinds of trusteeship: the "real" and the "fictitous" trusteeship (echte und unechte Treuhand). Either the trustor transfers certain proprietary rights to the trustee ("real" trusteeship) or he provides him with a power of disposition over his rights ("fictitous" trusteeship), which the trustee may only make use of in accordance with a contractual agreement[228].

1.1.1 The "real" trusteeship

This trusteeship (also called "fiduciary trusteeship" (fiduziarische Treuhand)) is characterized by the fact that the trustor transfers the trust property in full to the trustee. The trustee owns the rights but is contractually bound to the directions of the trustor; he is in consequence of which acting economically on account of the trustor[229]. From the perspective of company law

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[225] Under § 12 I HGB all limited partners must be registered in the Register of Companies (Handelsregister) in a certified form by a notary public which is expensive and complicated.

[226] Von Have/ Pense, Filmfonds, ZUM 11/1998, 890, 892.

[227] Gieseke, Besondere Probleme, DB, Heft 18, 1984, 970, 970.

[228] Machunsky, Immobilienfonds 1997, 7.

[229] Gieseke, loc.cit., 970; Cf BFH dated 23.08.1956, BStBl. III 1956, 302.

in case of a fund only the trustee is involved in the fund (as a registered fiduciary limited partner), not so the investor[230].

1.1.2 The "fictitious" trusteeship (unechte Treuhand)

In case of an "fictitous" trusteeship the investor and trustor keeps the full ownership of his proprietary rights, becomes unlimited partner himself and, as a consequence of that, he is registered in the Register of Companies (Handelsregister). The trustee only exercises the trustor's rights in the latter name (also called „power-of-authority trust" (Vollmachtstreuhand))[231]. The "fictitous" trusteeship enables the trustor to have his rights at his solely disposal – contractual and *in rem*. Since it does not make a difference from a tax law point of view which form of trusteeship is chosen, the latter form is preferable, because it is the safest legal position for the trustor.

Procedural both trusteeships are treated like sub-partnerships (Unterbeteiligungsverhältnisse)[232]. For the trusteeship there has to be made a second net income determination procedure (Gewinnfeststellungsverfahren) analogue § 179 II S. 3 AO. With "undisclosed trusteeships" (offene Treuhandverhältnisse) both determinations can be combined[233].

As mentioned in the general introduction, basis of this thesis is a fund with the investor as a registered limited partner. The trusteeship is only introduced here because it is also often used with film funds in Germany. Therefore its effects in connection with other tax law provisions is shown below.

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[230] Cf BFH dated 21.04.1988, BStBl. II 1989, 722; BFH BStBl. II 1995, 714. The trustor is only mentioned in the trustor register, but not in the Register of Companies. Hereby he stays anonymous. In addition to that the intervention of a trustee, if he is a specialist, enables the fund to gain further competence for the investors and safeguard the investment.

[231] Spindler, Einkünfteberechnung, WPg, Heft 6, 1995, 203-207, 203.

[232] Schmidt/Schmidt, EStG, § 15 Rn. 299.

[233] BFH BFH/NV 1995, 565.

2. The system of German Income Tax and the taxation of the investor

The income tax is a "personal tax" (Personensteuer), which means it takes into consideration the personal situation of the taxpayer with the determination of the tax, eg the taxpayer's age, marital status, amount of children and state of health. It is also a "direct tax" (direkte Steuer), ie taxpayer and tax debtor are identical. It is a withholding tax with the income tax on wages and salaries, capital gains tax and interest discount tax. It is levied on seven different types of income listed under § 2 I:

1. from farming and forestry (§§13-14a),
2. from freelancing (§ 18),
3. from trade (§§ 15-17),
4. from employment (§19),
5. from capital stock (§ 20),
6. from letting and leasing (§21),
7. from any other income (§§ 22, 23).

Income tax is assessed tax, ie it is determined by a tax assessment note after the end of an assessment period, cf. § 25. It is also a yearly tax (Jahressteuer), § 2 VII sentence 1, and covers periodically and gradual the income of each calendar year. Consequently one talks of the "periodic principle" (Periodizitätsprinzip) or "section principle" (Abschnittsprinzip)[234]. The assessment period is the calendar year, cf. § 25 I[235].

The tax peculiarity of partnerships is that they are not subject of taxation (only the partners are taxed) but subject of the determination of income (Gewinnermittlung). Under the ruling of the

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[234] Tipke/Lang, Steuerrecht, § 9 Rn. 44.

[235] One has to distinguish between the income determination period and the profit determination period. The former is the one for which the basis of taxation is established. It usually covers the calendar year, § 2 VII sentence 2. The domestic income received while submitted to a limited tax liability (beschränkte Steuerpflicht) is to be included in the assessment for the unlimited tax liability, § 2 VII sentence 3. The profit determination period can differ from the income determination period with regard to income from trade. If the trader is registered with his company in the Register of Companies, the financial year complies with the period for which annual accounts are made regularly, § 4a I sentence 2 Nr. 2. If the trader is not register with his company the financial year is the calendar year, § 4a I sentence 2 Nr. 3. According to § 4a II Nr. 2 with a trader it is irrefutably deemed by law that his profit within a financial year which is not the calendar year accrues to him in the calendar year in which the financial year ends.

Federal Fiscal Court[236] a partnership is partially subject of taxation inasmuch as it realizes by the entirety of its partners a certain type of income. A partnership is „interimistic, ie for purposes of determination of the shares of income of the co-partners [...] it is subject of the determination of income (Gewinnermittlungssubjekt)"[237]. The type of income (of the partnership) is again attributable to the partners for purposes of taxation of each partner. The determination of the income from trade and the attribution of the shares of profit to each partner is carried out in the "procedure of the uniform and individual net income determination" (einheitliche und gesonderte Gewinnfeststellung) in the sense of § 180 I Nr. 2a AO[238]. This procedure provides the even taxation of each partner and serves the economy of the procedure. Consequently the profit and the losses respectively of the partnership are taxed at the partners proportionately. This way of taxation of the investor is another good reason to choose the partnership as the corporate form of a film fund.

The legal basis for income tax is the Income Tax Act (EStG) of April 16th, 1997[239] including later amendments until 2002, the income tax implementing order (EstDV[240]) of June 18th, 1997[241] including later amendments until 2002, income tax on wages and salaries implementing order (LStDV[242]) and other additional orders. It also includes other acts like the "Foreign Investment Act" (Auslandsinvestitionsgesetz) of July 28th, 1969[243]. In the practice of the tax and revenue authorities regulatory provisions (Verwaltungsvorschriften) of the federal government with the approval of the Upper House of Parliament (Bundesrat) according to Art. 108 VII GG play an important role.

The taxation of film funds, ie the investors, has become even more interesting by two events within the last three years:

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[236] BFH BStBl. II 1984, 751.

[237] BFH BStBl. II 1986, 10 as translated by the author.

[238] "Abgabenordnung".

[239] BStBl. I 1997, 415.

[240] Einkommenssteuer-Durchführungsverordnung"

[241] BStBl. I 1997, 655.

[242] "Lohnsteuerverordnung".

[243] BStBl. I 1969, 986.

1. The „Tax Relief Act 1999/2000/2002“[244] (Steuerentlastungsgesetz 1999/2000/2002)[245] and
2. the „BMF[246]-letter dated 02/23/2001“ (BMF-Schreiben vom 23.02.2001) to the regional tax authorities (Obersten Finanzbehörden der Länder), the so called „media decree“ (Medienerlass)[247].

The Tax Relief Act has brought along quite some changes, especially in regard to the "offset of losses" (Verlustverrechnung) for the investor in film production funds; in detail see below.

In the media decree the German ministry of finance has „expressed its view“[248] on the taxation of film and TV funds towards the regional tax authorities. A closed fund which is structured as a „co-partnership“ and as a result generates income from trade forms the basis of this release[249]. Legally dogmatic this release is a regulatory provision (Verwaltungsvorschrift) and therefore has its only effect beyond administration in the constitutional principle of equal treatment. The release is no source of law and due to that only attributable to the field of legal enforcement (Normvollzug)[250]. It can be understood as a "norm-interpreting provision of administration" (norminterpretierende Verwaltungsregelung), which serves the uniform interpretation of tax law. The Federal Fiscal Court infers from this that these provisions are not binding for the fiscal courts, because the latter are only bound to the law[251]. The Federal Constitutional Court[252] also basically rules that the courts are not bound to these provisions of administration when ruling over the administration. But the Constitutional Court also states, that the courts are free to join these provisions in their independent power of interpreting the

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[244] Special German legal terms are translated directly with the original term following in brackets. Hereafter referred to as "Tax Relief Act".

[245] Steuerentlastungsgesetz 1999/2000/2002 vom 24.03.1999, BGBl. I 1999 P 402.

[246] „Bundesfinanzministerium“

[247] BMF-Schreiben dated 23.02.2001, Az. IV A 6 - S 2241 - 8/01 ("Media decree"); hereafter referred to as "media decree".

[248] The wording of the media decree, loc cit.

[249] Lüdicke/Arndt, Medienerlass, 2001, p 2.

[250] Birk, Steuerrecht I, § 5 Rn. 3.

[251] BFH BStBl. II 1986, 856.

[252] BVerfGE 78, P 214.

law[253]. For exactly this reason the media decree becomes relevant for the taxation of film funds and the investors respectively.

Even if the court's judgement in a specific case is not binding in general – cf. § 110 FGO[254] – however by continuous dispensation of justice the courts can develop legal institutions and rules for legal interpretation which are not laid down expressly in any Act[255]. As a consequence this work pays more attention to the court rulings and the wording of the Income Tax Act (EStG) than to the media decree. Nevertheless the latter plays an important role when dealing with the tax and revenue authorities and therefore will be named and discussed at each stage of this work.

3. The determination of the taxable income of the investor

§ 2 II stipulates the determination of the taxable income in a "dualistic" way:

1. by determining the profit or
2. the surplus over "advertising expenses" (Werbungskosten).

Income is made in form of a profit from income derived from farming and forestry (§§13-14a), from freelancing (§ 18) and from trade (§§ 15-17). It is made in form of a surplus over the "advertising expenses" according to §§ 8-9a from the other types of income. "Profit" is legally defined under § 4 I sentence 1 as:

> "the difference between the assets of the company at the end of the financial year and the end of the previous financial year, increased by the value of the withdrawals and reduced by the value of the deposit."

The background to this "dual system of the determination of the income" is the historical reasoning of the legislator[256]. It was held that farmers, traders and self-employees usually would not pursue their business without assets dedicated to it. Therefore the assets at the

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[253] BVerfG, loc cit.

[254] „Finanzgerichtsordnung".

[255] Birk, Steuerrecht I, § 5 Rn. 4. A proper example for this judge made case law is the legal institution of the *„culpa in contrahendo"* which just recently found its way into the German civil code by the latest amendment of the law of obligations in 2002.

[256] Gesetzesbegründung zum EStG 1925, RT-Drucksache 3/796.

beginning and at the end of the year of assessment are crucial for taxation of them. With the other types of income such assets are missing, the change in the value of such assets is not crucial respectively, but the proceeds of it. Therefore with this group the income is to be determined as the surplus of the receipts over the expenses[257].

As already set out above, a film fund is usually planned as a "trade minted partnership" (gewerblich geprägte Personengesellschaft) in the sense of § 15 III Nr. 2. This again is done in order to be able to allocate the proportionate profit or loss of the partnership to the single partner (provided he is a co-partner in the meaning of § 15 I Nr. 2). According to § 15 I Nr. 2 the income of the partners of such partnership is deemed to be income from trade. As a consequence the income of such partnership, ie the partners thereof, is determined under § 5 I read with § 4 I (including the crucial exceptions of § 5 II, referred to in details below)[258]. This determination is called a "balance sheet comparison". § 5 I refers in sentence 1 to the "trade law principles of orderly accounting" (handelsrechtliche Grundsätze ordnungsgemäßer Buchführung). Only an application of the principles not a direct application of trade law provisions (§§ of the HGB[259]) is meant by this reference[260]. Nevertheless the corresponding provisions of the HGB are quoted here with the ones of the tax law.

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[257] Ibid.

[258] § 5 I stipulates that, if a trader voluntarily submits himself to accounting/ bookkeeping, he will be submitted to the determination of income according to § 4 I. Not only for this effect film funds usually do bookkeeping, if they are not obliged to do so by § 141 AO. Inferred from § 5 I, the film fund as a partnership as provided here can choose, if he wants to determine its income according to § 4 I. If the taxpayer has established an opening balance sheet and a bookkeeping he is deemed to have chosen the determination of his profits according to § 4 I (BFH BStBl. II 1982, 593).

[259] „Handelsgesetzbuch".

[260] Schmidt/Weber-Grellet, EStG, § 5 Rn. 26f..

The taxable income of the investor under § 2 IV basically consists of:

The total amount of income from all types of income (Summe der Einkünfte)
+ "additional amount" (Hinzurechungsbetrag) (§ 2 I 3, II Auslandsinvestitionsgesetz)
- amount of old age relief (Altersentlastungsbetrag, § 24a)
- allowance for farmers and foresters (§ 13 III)
= "income" under § 2 III (Einkommen) submitted to
- "loss adjustment" (Verlustausgleich))
- "loss relief" (Verlustabzug) (§§ 10d, 2a III 2)
- extras (Sonderausgaben) (§§ 10, 10a, 10b, 10c)
- extraordinary burdens (außergewöhnliche Belastungen) (§§ 33-33c)
- tax concessions (Steuerbegünstigung) (§§ 10e, 10f, 10h, 10i)
- tax allowances (§§ 31, 32)
= "taxable income" (zu versteuerndes Einkommen)

Income (Einkünfte) is the profit or the "surplus of the income" over the "expenses of occupation" (Erwerbsaufwendungen) (the so called "objective netto-principle" (objektives Nettoprinzip))[261]. The latter contains "advertising expenses" (Werbungskosten) or "operating expenditure" (Betriebsausgaben) in the sense of § 4 IV[262]. The total amount of income under § 2 III consists of the sum of the above mentioned seven possible types of income. Since the income (Einkünfte) can be positive and negative (ie "expenses of occupation"), the income is the balance of the two figures. If the "expenses of occupation" are higher than the (positive) income, losses are arising. Even before positive income is generated, or after the lapse of such income, negative income can arise[263].

The so called „off-set of losses" (Verlustverrechnung) basically offers the possibility, to set off arising losses against profits from the same assessment period ("loss adjustment"

[261] Schmidt/Seeger, EStG, § 2 Rn. 10.

[262] The term "advertising expenses" is used with the determination of income as a surplus over such costs; the term "operating expenditure" is used with income as a profit, cf above.

[263] BFH BStBl. II 82, 495.

(Verlustausgleich)) or to set off arising losses against profits of other periods of assessment ("loss deduction" (Verlustabzug)).

Losses which are arising from sources of income within one type of income can be set off against income from the same type of income. This is the so called "horizontal loss adjustment" (horizontaler Verlustausgleich). Generally remaining losses from one type of income can be set off against income from another type of income. This is the so called „vertical loss adjustment" (vertikaler Verlustausgleich). The result from this is the "income". This principle can lead to hardship, if the income is subject to strong variation. Therefore the Income Tax Act provides not only the "loss adjustment" (Verlustausgleich), but also the "loss relief" (Verlustabzug). Are there still losses left after the "loss adjustment" (Verlustausgleich), than the "loss relief" (Verlustabzug) under § 10d may apply[264]. Regarding the "loss relief" (Verlustabzug) in the sense of § 10d, there is a distinction between the "loss carryback" (Verlustrücktrag) into the previous period of assessment and the loss "carried forward" (Verlustvortrag) into the subsequent period of assessment. The procedure of "loss adjustment" and "loss deduction" can be summarized under the generic term of the „off-set of losses" (Verlustverrechnung).

3.1 The "unlimited tax liability" (unbeschränkte Steuerpflicht) under § 1 I

Subject to German income tax is the income of all seven types arising from any source worldwide (the "world income" ("Welteinkommen")), if the taxpayer is subject to "unlimited tax liability" according to § 1 I. This is the case only, if the taxpayer has his "domicile" (Wohnsitz) or his "ordinary place of residence" (gewöhnlicher Aufenthalt) within Germany, cf. § 1I sentence 1. The taxpayer has his "domicile" where he has a lodging under circumstances which allow the conclusion that he uses and keeps that place, cf. § 8 AO[265]. The courts use the period of 6 months given by § 9 AO as an indication for the founding of a domicile[266]. There is

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[264] The legislator has recently unnecessarily complicated this system by the Tax Relief Act 1999/2000/2002 to such an extent that unconstitutional circumstances are expected, especially in the field of legal enforcement [Sch/Seeger § 2 Rdnr. 52; and: Risthaus/Plenker, Steuerentlastungsgesetz, DB 1999, 605; Herzig/Briesemeister, Zusammenwirken, DB 1999, 1470].

[265] Schmidt/Heinicke, EStG, § 1 Rn. 20.

[266] BFH BStBl. II 1989, 956.

a wide meaning to the term of the lodging, but the taxpayer must have it at his free disposal. So a delinquent in a prison can not found a "domicile". But he can found an "ordinary place of residence". The latter is established where the person stays under circumstances which show that he or she is not only temporarily there. For this an unlawful or compulsory stay is enough[267]. The difference between "domicile" and "ordinary place of residence" is, that for the latter the person does not have to have a fixed lodging. It is possible to have two "domiciles" in two countries at the same time. It is also possible to have an "ordinary place of residence" besides a "domicile" in two countries or the same country, ie Germany. In the latter case, the more difficult test of the founding of a "domicile" can be avoided[268].

3.2 The „limited tax liability" (beschränkte Steuerpflicht) under § 1 IV

Under § 1 IV

> „natural persons who have neither their domicile nor their ordinary place of residence within Germany are [...] subject to limited tax liability, if they receive domestic income in the sense § 49."

The limited tax liability implies an internationally operating German taxpayer, who is not subject to this examination. It just needs mentioning, that § 1 IV read with § 49 interestingly leads away from a "personal tax" system closer to a "tax deducted at source" kind of system. Thus it is held that the "personal tax" is also determined by "object-tax kind of characteristics" (objekt-steuerartige Züge)[269].

3.3 The "extended limited tax liability" under § 2 EStG

This paradox is nothing more than a legal term with quite some importance. Since 1972, Germans who gave up their "domicile" and "ordinary place of residence" in Germany after a minimum of 5 years of unlimited tax liability, can be taxed over 10 years after they left with income from other sources than the ones listed in § 49. They are getting taxed in Germany with

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[267] If he lost the unlimited tax liability in Germany, Jürgen Harksen can "regain" it, by an imprisonment there...

[268] E.g. to find the tax and revenue office in charge under § 19 AO; to all above cf Schmidt/Heinicke, EStG, § 1 Rn. 20f..

[269] Schmidt/Heinicke, EStG, § 49 Rn.1.

all consequences as if they were subject to unlimited liability. Precondition to that is however that they are residing in a "low-tax country" and have major economic interests in Germany[270].

4. The loss deductions

4.1 Income from "trade co-partnership" (gewerblicher Mitunternehmerschaft) under § 15 I Nr. 2 read with II, III

A "co-partnership" (Mitunternehmerschaft) in the sense of § 15 I Nr. 2 requires at first a trade (gewerbliches Unternehmen) in the sense of § 15 I Nr. 1, II[271]. As set out above not only the purpose of the fund is generating income from trade, but just the GmbH & Co. KG as such is deemed under § 15 III Nr. 2 to generate income from trade.

Furthermore the "co-partnership" requires as the central constituent fact under § 15 I Nr. 2 that the investor

1. can develop an "entrepreneurial initiative" (Unternehmerinitiative) and
2. and carry an "entrepreneurial risk" (Unternehmerrisiko)[272].

In the opinion of the of the courts the term „co-partnership" is a so called „type-term" (Typusbegriff), ie not a strictly defined term. The characteristics of this terms need not be met cumulative in each case; the overall picture is decisive[273]. Hence in a concrete case a less "entrepreneurial risk" can be balanced with a stronger "entrepreneurial initiative and vice versa[274]. However to meet the requirements of a "co-partnership" both characteristics have to be met more or less strong each[275].

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[270] Schmidt/Heinicke, EStG § 1, Rn 81; for further details see § 2 AstG („Außensteuergesetz") in: BStBl. I 1995, SonderNr. 1.

[271] BFH BStBl. II 1996, 264.

[272] BFH GrS BStBl. II 1984, 751.

[273] Tipke/Lang, Steuerrecht, § 5 Rn. 45.

[274] Schmidt/Schmidt, EStG, § 15 Rn. 262f.; Schulze zur Wiesche, Mitunternehmerschaft, DB, Heft 5, 1997, 244.

An "entrepreneurial initiative" can be developed by someone who has the right to influence the entrepreneurial decisions in an enterprise. At the same time, it is not decisive that the investor in fact develops the initiative[276]. Referred to a limited partner of an *en commandite* partnership the following applies:

Since § 15 I Nr. 2 expressly names the *en commandite* partnership as the typical form of a „co-partnership", the participatory rights of a limited partner under § 161 pp. HGB are enough to assume a certain and sufficient "entrepreneurial initiative"[277]. It is sufficient for that purpose, if the partner has the following rights under the partnership agreement[278]:

1. The investor has the right to join any company meeting and is invited in due course.
2. The investor has the right of inspection of books and the year-end accounts.
3. The investor has all rights to vote equalling his capital share.
4. Decisions reaching beyond the ordinary conduct of business or affecting sustainable the destiny of the fund require the approval of the investor.

The media decree also takes a stand on this. It assumes that the investor as a partner has a right of information under §§ 118 HGB and 716 BGB, ie as a partner of a partnership in commerce (OHG[279]-Gesellschafter) and as a partner of a partnership according to the German Civil Code (BGB[280]-Gesellschafter) respectively [281]. As shown above, in most cases the right of information of an investor turns out to be ruled by § 166 HGB, because mostly he is a partner of an *en commandite* partnership. These rights of information under § 166 HGB are of lower quality than the ones under §§ 118 HGB and 716 BGB. This just results from the wording of § 166 II HGB which expressly stipulates that the unlimited partner of an *en commandite* partnership is not entitled to the rights under § 118 HGB. This discrepancy between the media decree and the courts' opinion provides some insecurity in legal practice. For the reason of the stronger authority of the courts, as set out in the introduction, one should orientate towards

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[275] BFH GrS, loc cit; BFH BStBl. II 1994, 282.

[276] BFH BStBl. II 1987, 54; 1995, 241; 1995, 714.

[277] BFH GrS, loc.cit..

[278] Grasses, Kapitalanlagen, 1997, p 42.

[279] "Offene Handelsgesellschaft"

[280] „Bürgerliches Gesetzbuch".

[281] Media decree, loc cit, Rz.22.

the judicature. Especially in the face of the fact that the media decree is referring in this aspect to the leasing like structured funds[282].

An investor bears an "entrepreneurial risk" every time he is participating in the gains and losses of the partnership. This risk is established by the aforementioned parameters and by the participation in the hidden reserves including the goodwill of the partnership, ie the share[283]. A limited partner who rendered his entire share to the partnership is participating in the losses of the partnership only up to the amount of his limited partner's share, cf. § 167 III HGB. He is then also not liable for any obligations of the partnership, cf. § 171 HGB. Nonetheless his legal position is one of a „co-partnership"[284]. Even a shareholder who is not participating in the losses of the partnership and does not hold any share of the hidden reserves or the goodwill can be a co-partner, if he makes the typical entrepreneurial decisions in an enterprise and is affected by the success or failure of this decision as a result of it[285]. As a consequence for the investor that means that he has to participate in the chances (eg royalties, sale of the rights, net profit sharing) and in the risks (eg a film is not finished or exploitable) of the enterprise[286]. With a film fund the investors have a share in the losses and gains of the partnership and are participating considerably in the hidden reserves when it comes to the sale of the film rights. In this way even with so called Low-Risk-Funds, the exploitation of which is entirely secured, the investor carries an "entrepreneurial risk" in principle[287].

The media decree again takes a stand on this issue of „co-partnership". However it takes only in consideration the so called "concealed co-partnership" (verdeckte Mitunternehmerschaft) which results from so called "formal only-in-gains-participating contractual obligation" (formal partiarisches Schuldverhältnis). In case the investor is a limited partner the media decree is talking of a "joint owner"[288]. This chapter of the media decree is for this reason only relevant

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[282] Lüdicke/Arndt, Medienerlass, 2001, p 14.

[283] BFH BStBl. II 1984, 751; 1995, 241.

[284] BFH BStBl. II 1975, 818.

[285] BFH BStBl. II 1996, 66; Schmidt/Schmidt, EStG, § 15 Rn. 266f..

[286] Von Have/ Pense, Filmfonds, 1998, p 895.

[287] Zur Problematik der Low-Risk-Fonds als Leasingfonds siehe Einleitung.

[288] Media decree, Rz. 26-28.

to investors who are not partners of the fund. This could be the case where the investor is only participating through a fiduciary limited partner.

In case of a trusteeship the investor as trustor and the fiduciary limited partner must qualify for the „co-partnership", ie the fiduciary limited partner places the trustor with the „co-partnership"[289]. In analogue application of the "trusteeship decree"[290] the investor has to be in a position as if he was a direct participating limited partner in order to be also deemed a "co-partner. To meet this requirement the trusteeship agreement must endow the trustor with the right to direct the trustee in a binding commitment. Thereby the investor holds the exclusive and definite managerial powers and the trustee acts only in relationship with third parties in his own name. Thus the investor can be deemed to be a "co-partner"[291]. Where in a fund the trustee is the only limited partner and associate, the investors can only qualify as "co-partners", if they all have the same influence through their controlling rights irrespective of their direct or indirect participation in the fund[292]. The influence of an indirect participating investor is only equal to that of a direct participating partner, if the trustee is capable on the basis of the partnership agreement to put every single direction of the trustor to practice[293]. Since the trustee only holds one integrated share in the partnership, he must be able to exercise his voting rights split in accordance with any direction of any trustor in order to meet this requirement[294]. Otherwise it is likely that, if the shares are partly held direct and partly indirect by a trustee, a minority imposes its opinion over the majority[295]. In such a case it must be possible for the trustee to split his voting rights. This however is a suspect matter[296]. In the face of that the investors should either entirely participate directly or indirectly. In the latter

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[289] Spindler, Treuhänder, 1995, p 204.

[290] BMF-Schreiben dated 01.09.1994, BStBl. I 1994, 604. This decree is only referring to income from letting and leasing.

[291] BFH BStBl. II 1984, 751; 1991, 691

[292] Fleischmann, Treuhandverhältnisse, 1994, p 1304; Kapitzka, Treugeber, 1996, p 172f..

[293] Fleischmann, ibid, p 1304; Söffing, Mitunternehmer, 1994, p 63.

[294] Lüdicke, Mobilienfonds,1996, p 33.

[295] An example is given by Lüdicke, Mobilienfonds, 1996, p 33.

[296] Cf BFH BStBl. II 1997, 535.

case the "co-partner" and in consequence of which the trustor is the subject of accountability of the income from trade of a „co-partnership". This results from § 39 II Nr. 1 S. 2 AO[297].

4.2 The "intent to realize a profit" (Gewinnerzielungsabsicht)

§ 15 III stipulates that the fund must be in entrepreneurial practice with the "intent to realize a profit" (Gewinnerzielungsabsicht). The latter is been received only if the taxpayer has the intention to increase his company assets „in the form of a total profit" (Totalgewinn)[298]. The "total profit" (Totalgewinn) is – in contrast to the "periodical gain" (Periodengewinn) in the sense of §§ 4 I, 5 – the total outcome of the enterprise from the establishment of it until its sale or liquidation. It is sufficient however that the intent of the taxpayer to realize a profit (Gewinnerzielungsabsicht) is only an additional or collateral purpose, cf. § 15 II sentence 3[299]. No such intent is given in case the taxpayer only seeks to reduce his income tax burden, cf. § 15 II sentence 2. Is this intent missing, one speaks of a "charitable activity" or a "hobby".

A partnership which is in practice without such "intent to realize a profit" and the only aim of which is to place losses with its partners, is not trading. The achieved losses of such partnership are not relevant to income tax.

Even if the partnership has the said intent, it can be missing for the partners, eg because of a limited duration of the participation in the partnership[300]. The media decree therefore only declares that this intent has to be shown by the partner as well as by the partnership[301].

To proof this intent the external and objective characteristics are crucial[302]. The law does not provide any definition of the "intent to realize a profit". The Federal Fiscal Court[303] understands this criteria as the intention to increase the company's assets in form of a "total

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[297] Cf BFH BStBl. II 1993, 538.

[298] BFH GrS BStBl. II 1984, 751, 766.

[299] Kohlhaas, Gewinnerzielungsabsicht, 1996, P 947.

[300] Schmidt/Schmidt, EStG, § 15 Rn. 183.

[301] Media decree, Rz.33.

[302] Cf BFH BStBl. II 1991, 564.

[303] BFH BStBl. II 1984, 751.

profit". In this context the term "total profit" is a positive, the "equity capital" (Eigenkapital) exceeding total result of the trade activity from the beginning of the enterprise until its sale or liquidation[304]. This "total profit" is established by a comparison between the company's assets at the beginning and those at the end of entrepreneurial activity[305]. Thereby the taxable gain of sale or disposal which each partner is realizing is taken into consideration[306]. This is of considerable relevance, because with many funds a "total profit" is only occurring, if the prognosticated proceeds are coming true[307]. In consequence the "total profit" of a film fund is determined by summing up all tax results during the term of the fund. The exterminating judgement of the revenue authorities or the fiscal court, that the fund was missing the necessary intent to gain a profit, can be avoided by planning the participation structure of the fund. Thus a "total profit" of the fund must be predictable from the all objective circumstances at the time of the entry of the investor for the whole period of his participation including possible proceeds at the end of the term of the fund[308]. To get there the brochure of the fund must present a detailed prognosis calculation of the proceeds and the portfolio of the productions and co-productions respectively must be able to legitimate a prognosis of returns which shows a "total profit" in the opinion of an honest businessman of ordinary prudence[309]. This is not at last dependent on the competence and reputation of the management of the fund[310]. An exact prognosis on the returns of a film is not possible due to the unpredictable exploitation of it. The latter again depends on the success of the film which is always linked to the uncertain acceptance of the audience. But a valid prognosis of an independent and acknowledged distributor will help to get over this problem. The courts[311] have already conceded, that „ a minimum sum is not necessary for planned total profit, especially not a minimum interest payment on the inserted equity capital..."[312]. One has to bear in mind however that the "special property" (Sonderbetriebsvermögen) of the investor is included in

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[304] Groh, Gewinnerzielung, 1984, P 2424.

[305] Groh, ibid., P 2425.

[306] Pferdmenges, Totalerfolg, 1990, P 701; cf also Abschnitt 138 (6) EstR; von Have/Pense, Filmfonds, P 895.

[307] Lüdicke, Liebhaberei 1994, P 110.

[308] Cf Von Have/ Pense, Filmfonds, P 895.

[309] Von Have/ Pense, Filmfonds, P 895 ; Lüdicke, Mobilienfonds, 1996, P 36.

[310] Von Have/ Pense, Filmfonds, P 895.

[311] BFH BStBl. II 1985, 549.

[312] BFH, loc cit.

the calculation of the "total profit". In the opinion of the courts[313] "special property" is a commodity which belongs to a partner and is suitable and meant to serve the business of the fund or the share of the partner in the fund. Hence investors who finance their share (beyond the measures of the prospectus) with borrowed money and consequently show high extraordinary operating expenditure (Sonderbetriebsausgaben) are in danger of loosing a "total profit". The other investors' "intent to realize a profit" is thereby generally not in danger[314].

There are also film funds which initially do not show the "intent to realize a profit" but are satisfied with any possible future profit[315]. The courts[316] speak in such case – not only in view of film funds – of so called "loss-allocating companies" (Verlustzuweisungsgesellschaften):

4.3 The „typical" „loss-allocating company" (Verlustzuweisungsgesellschaft)

The term „loss-allocating company" (Verlustzuweisungsgesellschaft) is not legally defined, though it has become a common tax law term[317]. The courts[318] and the tax and revenue authorities[319] have generated a legal definition of that term as follows[320]:

1. The raising of capital is reached by a large number of investors,
2. the entire capital only consists of a limited scale of own resources,
3. advertisement is made with the allocation of losses,
4. the company has a certain company law structure, that guarantees a limited liability of the investors[321],
5. the rendered capital investment can be financed wholly or partly by tax savings,

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[313] BFH BStBl. II 1988, 667; 1989, 890; 1993, 328; 1995, 452.

[314] On that and the exception to it: Lüdicke, Mobilienfonds, 1996, P 36.

[315] Siegwart, Film-Verlustzuweisungsgesellschaften, 1981, P 685f..

[316] BFH BStBl. II 1991, 564; 1992, 328; 1996, 219; each judgement in connection with the legal presumption of the missing intent to realize a profit.

[317] Cf BFH BStBl. II 1996, 219, where the Federal Fiscal Court uses the term „typical" loss-allocating company (Verlustzuweisungsgesellschaft).

[318] Supra.

[319] BMF-Schreiben dated 13.07.1992, BStBl. I 1992, 404.

[320] Kohlhaas, § 2b EstG, 1999, P 511f.; ders. Gewinnerzielungsabsicht, 1996, P 947f..

[321] For this reason the partnership according to the German Civil Code (GbR) and the partnership in commerce (OHG) can not be a loss-allocating company, cf Kohlhaas, Verlustzuweisungsgesellschaften, 1998, P 403.

6. there is no real economical, but only a book keeping burden on the investor by the losses of the company.

Are these prerequisites met, there is a *prima facie* evidence for a loss-allocating company[322]. But if the investor, and the fund respectively, can proof an "intent of realizing a profit", in spite of advertising with the allocation of losses this *prima facie* evidence can be fend off. This is called a "distress counterevidence" (Erschütterungsbeweis)[323].

The historical background to the development of this figure (the „loss-allocating company") was the legal situation until the introduction of § 15a. Before § 15a was introduced, the investor could almost only because of tax savings join this now called "loss-allocating companies". A definitive loss of his share in the company due to a complete failure of the film was overcompensated just by the allocation of losses and the later "rate of relief" (tarifermäßigte Besteuerung)[324].

Additionally and unnecessarily complicated becomes the understanding of this term by the wording of the recently introduced § 2b[325]. Here the legislator does not refer to the term in its meaning given by the judicature, but explains it in § 2b itself[326]. The intention of the introduction of § 2b was to knock the bottom out of all tax saving schemes which enabled the very well-off of taxpayer to get completely away from taxation just by participating in such schemes[327]. The ruling of § 2b was meant to be an alternative to the "minimum taxation concept" which is referred to later and which together with § 15a already sets a limit to tax advantages of any participation in such schemes[328]. As a consequence § 2b can only limit

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[322] BFH BStBl. II 1996, 219.

[323] Kohlhaas, Modellhaftigkeit, 2001, P 1139.

[324] Kohlhaas, Modellhaftigkeit, 2001, P 1138; ders. in FR 1999, 504.

[325] § 2b introduced by the Tax Relief Act (Steuerentlastungsgesetz) 1999/2000/2002 dated 24.03.1999, BGBl. I 1999 P 402; coming into force: 01.01.1999.

[326] Cf Kohlhaas, § 2b EStG, 1999, 511f..

[327] Kohlhaas, Modellhaftigkeit, 2001, 1137f., 1138.

[328] Kohlhaas, Modellhaftigkeit, 2001, P 1138 und P 1143. Only the part of the share which is financed by own resources can be covered by tax savings, ibid.

temporary tax advantages[329]. The German ministry of finance takes a stand regarding this in its "decree of application" (Anwendungsschreiben) regarding § 2b dated 2.7.2000[330]:

4.3.1 § 2b and its interpretation on the basis of the "decree of application" of the BMF dated 2.7.2000

To force back "loss-allocating companies" and similar schemes the legislator has excluded the "adjustment of losses" in its "Tax Relief Act 1999/2000/2002"[331] by the new regulation of § 2b. This provision stipulates that it is not possible to adjust the losses, ie negative income, from shares in "loss-allocating companies" or similar schemes with other (positive) income[332].

"Loss-allocating companies" in the sense of § 2b are companies which have an "intent of realizing a profit" and income, but their business concept is aligned to tax advantages of their partners or shareholders. As a consequence § 2b includes also the „typical" loss-allocating schemes, with which the *prima facie* evidence of the missing "intent of realizing a profit" was refuted[333].

According to this a fund and the investors of which who have an "intent to realize a profit" are to be treated as follows:

4.3.1.1 The "exemplary arrangement" (modellhafte Gestaltung) in the sense of § 2b

An "exemplary arrangement" in the sense of § 2b is given if there is:

1. a "prefabricated concept" (vorgefertigtes Konzept),
2. "contractual relations of similar kind" (gleichgerichtete Leistungsbeziehungen), which are substantially identical,
3. the "provision of a bundle of services" (Bereitstellung des Leistungsbündels)
4. a "minimized risk for the investor" (Minimierung des Risikos des Anlegers) and
5. the "safeguarding of a tax saving effect" (Sicherung des Steuerspareffekts).

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[329] Kohlhaas, Modellhaftigkeit, 2001, ibid.

[330] BStBl. I 2000, 1148; DStR 2000, 1373.

[331] Loc.cit..

[332] For the temporal scope of the law, see § 52 IV sentence 1.

[333] Cf Kohlhaas, Modellhaftigkeit, 2001, P 1139.

The "prefabricated concept" requires that it has been established by a third party in order to offer it to the public. The "contractual relations of similar kind" mean that the tenderer of the scheme is offering all potential investors contracts (sale contracts, financing contracts, trusts etc.) of the same kind and form. The "prefabricated concept" must include a bundle of main, additional and peripheral services, which are inflating the losses or negative income of the potential investor. This criteria is also usually met by media funds[334].

Regarding this issue it is held that there has to be made a distinction in analogue application of the so called "construction client decree" (Bauherrenerlass) dated 31.08.1990[335] between the "exemplary arrangement" of the fund and the one of the financing of the share in the fund[336]. The former is only given, if the "provision of the contractual relations of similar kind" according to Rz. 19 of the named decree are "minimizing the risk of the investor" and at the same time "safeguarding the tax saving effect". This is not possible inasmuch as the investor is always carrying the financial risk of his decisions and the tenderer never can guarantee the return of the raised outside capital. Only if the return of this raised outside capital is the basis of the business concept, a "minimized risk" is given[337].

Regarding the "exemplary arrangement" of the financing of the share it is used as an argument in view of the "construction client decree"[338], that the finding of a financing through the tenderer is not "exemplary". The reason for that is because every economically reasonable thinking investor would prefer this financing due to the favourable conditions. Provided that the initiator and tenderer does not raise higher commissions as usual charged, the found financing is not "exemplary" in spite of an extra remuneration of the initiator. So the reason why the investor enters into this offer is not the tax advantage[339].

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[334] Zacher/Müller, Medienfonds, 2001, P1191; Kohlhaas, Modellhaftigkeit, 2001, 1140.

[335] BMF-Schreiben dated 31.08.1999, BStBl. I 1990, 366.

[336] Kohlhaas, Modellhaftigkeit, 2001, P 1140.

[337] Kohlhaas, Modellhaftigkeit, 2001, P 1142.

[338] BMF-Schreiben dated 31.08.1990, loc cit.

[339] Kohlhaas, Modellhaftigkeit, 2001, P 1141.

This recourse of the tax and revenue authorities to the named decree has not been criticised without sound reason[340]. The objection is made that the named decree with its reference to buildings was not applicable to funds producing films. The nature of the objects of the funds was not comparable. Films did not show the "necessity of approval" (Genehmigungserfordernis) in the contrast to a finished building. They needed planning too, but the latter is upset daily even in the phase of the shooting[341]. Since the media decree refers to the above mentioned decree the former has to be judged by the latter.

A „§ 2b EStG-figure"[342] is also only given, if the investor is not encumbered by the outside capital; ie if the tenderer can in fact guarantee the investor the return of such capital on the basis of the contractual concept. Then – *nota bene* – the "loss offset" (the "loss adjustment" as well as the "loss relief") is absolutely impossible.

4.3.1.2 The „not pick up limit" (Nichtaufgriffsgrenze) of § 2b

A "loss-allocating company" or an "exemplary arrangement" under § 2b is regularly not given, if after the prognosis of the results the difference between the accumulated losses in the phase of losses and the amount of the share and the money to be raised in accordance with the business concept does not exceed 50 %, the so called „not pick up limit" (Nichtaufgriffsgrenze).

Due to the already mentioned specifics of media funds these funds are mostly withstanding this negative selection so that other criteria have to be examined[343].

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[340] Lüdicke/Arndt, Medienerlass, 2001, P 8.

[341] Cf Lüdicke/Arndt, Medienerlass, 2001, ibid. The same problem occurs at the determining of the beginning and the end of the production of a film and the question, how long the fund can influence the production process; regarding this see below.

[342] That is how Söffing, DB 2000, 2340f., calls the "loss-allocating companies" and the "model-kind of arrangements" under § 2b.

[343] Cf Zacher/Müller, Medienfonds, 2001, P1191.

4.3.1.3 The tax advantage as the central motivation under § 2b

The test has to be made on the basis of two legal examples given by § 2b sentence 3 (Regelbeispiele) and interpreted in the media decree.

4.3.1.3.1 The first example of § 2b

This example is dealing with cases of the company, community of part-owners or the similar „exemplary arrangement" in which, according to the business concept, the return on the invested capital after tax (= after tax return) exceeds the double amount of this return before tax (= pre-tax return) and the management predominantly is based on this fact. Referred to this the media decree gives a detailed example for a registered share in a media fund with 100 % losses in the beginning and 20 % refinancing of the equity capital. The screening of the after tax return in the example leads under the given premises to no application of § 2b. This example can be regarded as representative for many of the recently offered media funds. Therefore § 2b should not be applied for media funds through this criteria. A planned more precise example which is supposed to deal with actual paid capital (not only the number of the registered share) could become of a problem for concepts with stretched obligation of payment[344]. It is furthermore not sufficient that a "total profit" arises on the mere basis of the inclusion of a participation in the surplus of a slim chance[345]. Finally a fund which can proof its „intent of realizing a profit" by a realistic and economically comprehensible prognosis of the results will always be able to refute the requirement of this example of § 2b the management was only based on the tax advantage.

4.3.1.3.2 The second example of § 2b (zweites Regelbeispiel)

The achievement of a tax advantage is also deemed to be the predominant motive, if the investor is promised such advantage through loss allocation. This is the case, if including the duty of information arising from the prospectus liability there is an extra hint, especially of advertising nature, that tax relief owed to the participation is possible. The mere naming of such tax effects and after tax return is not deemed to be such a hint.

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[344] Zacher/ Müller, loc cit, P 1191.

[345] Zacher/Müller, ibid.

This tax relating advertising ban is mainly observed by the tenderers. Problems only can occur in view of the examples given by § 2b, if for purposes of tax optimization concepts are offered which include the repayment of life insurances or share fund saving plans. Such concepts are regularly due to their orientation to tax optimization categorized by the tax and revenue authorities as tax injurious[346].

4.3.1.3.3 The "collecting" (Auffang-) or "basic" requirements (Grundtatbestand) respectively of § 2b

Closing after the „especially" introduced and therefore priority requirements (the two examples given by § 2b), the "basic" requirements of § 2b have to be tested. In the opinion contained in the media decree this requirements are met and consequently a loss allocating company is assumed, if the accumulated allocation of losses in the beginning are amounting more than 100 % of the not borrowed equity capital which has to be paid accordingly to the concept. In practice these prerequisites are presumably only met with funds having a large proportion of outside money. Who however optimises the leverage-effect too much to optimise the return of the invested own money runs the risk of getting into the range of § 2b in the opinion of the tax and revenue authorities[347]. It is worth considering to avert such an attack of the tax and revenue authorities on the grounds that this interpretation, ie the definition of the basic requirements by the given examples of the named authorities, is not covered by the wording of § 2b anymore[348]. Even though it is not advisable to base a fund on such a risk of litigation it is just possible that the Federal Constitutional Court will find § 2b to be unconstitutional and therefore null and void.

4.4 The "generating of losses" (Verlustentstehung) and the deductible costs

According to § 248 II HGB, § 5 II intangible assets of the fixed assets, which are not acquired against payment, are not allowed to be activated in the balance sheet as an asset. This prohibited inclusion as assets is based on the idea, that self created intangible objects of an investment have not experienced an appropriation of value in the market and in consequence of

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[346] Zacher/Müller, loc cit, P 1192.

[347] Zacher/Müller, ibid.

[348] Söffing, DB 2000, P 2345.

which are not allowed to be activated in the balance sheet[349]. This is of great importance for the utilization of film rights as objects of funds. All costs in connection with the production can be deducted as operating expenditures, so that losses can be allocated to the investors at maximum. The prerequisites for the deductibility of such costs are the following. There must be, cf. § 248 II HGB:

1. intangible assets
2. of the fixed assets
3. which are not acquired against payment.

The fund and the investors respectively must be not only owner of the assets in a civil law meaning but also in a tax law meaning. That means they must hold the factual power of disposition over the assets in the sense of § 39 II Nr. 1 AO. This requirement however is only problematic with leasing funds, which are not subject to this thesis.

4.4.1 Film rights as intangible assets

Before the question can be answered whether film rights are intangible assets, it has to be asked whether a film right can be activated in the balance sheet at all. This is always the case, if a commodity can be assessed independently and can be part of trade[350]. A film right is independently assessable if made expenditure is attributable to it. With a production fund this would be the production costs. A film is part of trade, if it is saleable and disposable independently. This criteria is met, if the legal practice has found ways for an economical circulation of such rights[351]. With the self-created film rights the fund has the ability to transfer them, cf. § 94 II UrhG[352]. In how far the investors are able to reduce their tax burden depends on balance-sheet and tax regulations regarding the "generating of losses".

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[349] Wriedt/Witten, Behandlung von Filmrechten, 1991, P 1293. It is a principle of making up a balance sheet that the evaluation of the commodities has to be made carefully, cf § 252 I Nr. 4 HGB.

[350] Baetge/Kirsch, Grundsätze,1995, P 163f..

[351] BFH BStBl. II 1978, 521; 1992, 977.

[352] "Urheberrechtsgesetz". If the rights are derivatively acquired by a licence agreement the transferability is judged by the said agreement.

§§ 240 I, 252 I Nr. 3 HGB and § 6 I are setting out the "principle of single assessment" (Grundsatz der Einzelbewertung). According to this each commodity has to be assessed separately. The right in a film can be qualified as a bundle of many single rights. It is questionable whether all these rights are to be assessed separately. The Federal Fiscal Court[353] has already indicated in a court order which dealt with the question whether a commodity is to be assessed separately or together with others within a unified assessment, that the crucial issue is, whether the commodity is linked to the use in the business, and its function to the business. Usually the single rights (eg the rights in the screenplay or the film music) are transferred to the producer only for the making of the film itself and melt together with the latter to one unit, so that the producer can only make use of them for the production of the film[354]. That means, that an exploitation of these single rights beyond the screening of the film (eg selling the film music on a CD) is not possible[355]. The film as a synthesis of arts legally consisting of a bundle of single rights evokes the presumption to be one single commodity. However the film producer and so the fund is generally striving for an exploitation of the film at any stage of the exploitation, ie from cinema to free-TV (1. cinema→ 2. video rental→ 3. video sale→ 4. pay-TV→ 5. free-TV, not mentioned: internet video on demand, music, merchandising etc.). Because each of this exploitation rights creates a source of income for the producer, ie the fund, all of these rights must be treated as different commodities and therefore be assessed separately.

The distinction between a tangible and intangible asset is not clear regarding the right to produce the film and the one to exploit it, insofar as the film right is linked to a physical object, namely the film negative. This linkage is also the precondition for the granting of the rights of the film producer under § 94 UrhG. However an intangible asset is still an object, even if it is not tangible[356]. For the classification as a tangible or intangible asset it is crucial which component of the asset is representing the actual value of it[357]. In the opinion of the

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[353] BFH BStBl. II 1974, 132.

[354] Wriedt/Fischer, Filmvermögen,1993, P 1683; Schwarz/Schwarz, Filmherstellungsrecht, 1988, P 434.

[355] Of course the filmproducer can acquire further rights on a contractual basis. These are then to be assessed independently with the producer, cf Wriedt/Fischer, Filmvermögen, 1993, P 1683.

[356] Cf Baetge, Bilanzen,1996, P 158.

[357] Pfeiffer, Bilanzfähigkeit, 1984, P 334.

literature[358] and the courts[359] films are a matter of intangible assets, because the physicality of the film negative plays a quite unimportant role for the added value to the film. As a reason for that, it is argued that § 94 UrhG only protects the organisational and economical accomplishments of the producer[360]. Finally, all intangible assets are not balanced the same. Such of the circulating assets are generally to be balanced, while the ones of the fixed assets are only allowed to be balanced, if they where acquired against payment.

4.4.2 Intangible assets of the fixed assets

According to § 247 II HGB assets as fixed assets are only acknowledgeable, if they are deemed to serve the business permanently. For the distinction between fixed and circulating assets it has to be determined what the asset is used for. This again is to be determined by the nature of the asset and the intention of the merchant[361]. So the sole intention of the merchant is not decisive. It is rather the legal and economic possibility of use which must be in accordance with the merchant's intention[362]. Besides the named requirements, the requirement of „endurance of the asset" has to be met. That means, the asset must not be envisaged to be sold or consumed within a short time[363]. If this is case, the asset is regarded as belonging to the circulating assets[364]. The business object of the fund customarily is the development, production, exploitation, merchandising and distribution of films. As a consequence of that the use of the film right as an asset is determined in accordance with the intention of the merchant, ie the fund. So the first requirement is met. For the approval of the criteria of endurance it has to be distinguished by the frequency of exploitation of the film. An asset belongs to the fixed assets, if a multiple exploitation is planned and legally and economically possible[365]. It is held that high production costs already indicate that there is a multiple exploitation, because

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[358] Depping, Werbespots, 1991, P 2048; Forster, Ansatz, 1988, P 321.

[359] BFH BStBl. II 1971, 186; 1997, 320.

[360] Herzig/Söffing, Bilanzierung (Teil I), 1994, P 603.

[361] Cf Gräfer/Sorgenfrei, Rechungslegung, 1997, P 126.

[362] Wriedt/Fischer, Filmrechte, 1991, P 1293.

[363] Gräfer/Sorgenfrei, Rechungslegung, 1997, P 126.

[364] BFH BStBl. II 1977, 684.

[365] Cf Wriedt/Fischer, Filmrechte, 1991, P 1293.

otherwise the film would never recoup the costs[366]. However it is pointed out that a multiple screening decisively depends on whether film was a success or failure at his première[367]. The courts already decided in 1955, that film rights are belonging to the fixed assets, if they are deemed to be licensed to a distributor for a limited time and territory[368]. Hence a film right is only belonging to the circulating assets, if at the time of its production the owner has already decided to sell it soon or use it only for a single exploitation[369]. The tax and revenue authorities are also coming to this conclusion in the media decree[370] with reference to the courts[371].

4.4.3 „Original" and „derivative" acquisition

To fall under the prohibition of being balanced, the rights must not be acquired against money, ie "derivative". The fund can only acquire the film rights "originally" if it is a producer in the sense of § 94 UrhG[372]. The courts[373], which the media decree[374] refers to, equate the term of a producer in copyright law with the one in tax law[375]. According to the courts it is decisive for the quality of a producer, that he makes the final and basic decisions in the production process and carries the economical responsibility[376]. What the tax and revenue authorities connect to this term with regard to the content is explicitly laid down in the media decree and follows partly word-for-word the named court decisions[377]:

„A film- or TV-producer fund is deemed to be the producer of a film, if he

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[366] Forster, Ansatz, 1988, P 324.

[367] Wriedt/Fischer, Filmrechte, 1991, ibid.

[368] BFH BStBl. III 1955, 96.

[369] Cf Herzig/Söffing, Bilanzierung (Teil I), 1994, P 606.

[370] BMF-Schreiben, loc cit, Rz. 20.

[371] BFH BStBl. II 1997, 320.

[372] Due to the „creator-principle" (Schöpferprinzips) under § 7 UrhG and its preconditions, the film producer is not an originator (Urheber) of a protected work under § 2 I Nr. 6 read with II UrhG. However he is entitled to protection of his accomplishments (he is a so called "Leistungsschutzberechtigter") under § 94 I UrhG.

[373] BFH BStBl. II 1997, 320.

[374] Media decree Rz. 7.

[375] To this dogmatic inaccuracy, cf Lüdicke/Arndt, Medienerlass, 2001, 2.

[376] BFH BStBl. II 1997, 320.

[377] Media decree, Rz. 9 und 10.

1. carries the whole risk of the production as a contractor ("fictitous service production" by using service producers (unechte Auftragsproduktion durch Einschaltung von Dienstleistern)) or
2. he carries out a flim project by means of co-production on his own (co-)responsibility and by taking over (partially) the risks and chances resulting from the project.

Has the initiator of the fund (usually a distributor, an investment consultant or a leasing firm) developed completely the comprehensive contract of the fund (including basic agreements with service producers or/and co-producers), the design of that is crucial to be deemed a producer, insofar as the fund still must have basic means of intervention in the film production and carry the (shared) responsibility for the financial consequences of this. This is especially the case, when the intervention of the fund directly results in the destiny of the film (eg the approval of the over all budget (Gesamtbudgets), the contracting with actors and other participators and the implementation of changes in the organisation); the means of intervention must not be *de facto* limited."

4.4.3.1 Forms of production to acquire the "quality of a producer" (Filmherstellereigenschaft)

For the original acquisition of the film rights as intangible assets there are three forms of production for the fund:

1. The "self- made production" (Eigenproduktion),
2. the "co-production" (Koproduktion) and
3. the so called "fictitous contractual production" (unechte Auftragsproduktion).

The first form of production is the one of a „native" film producer, ie an indvidual producer[378], who also could be called an insider of the film business. He has not only the typical know-how and necessary film business creativity of a film producer, but also the business connections to actors, writers and directors and other participators in a film[379]. A fund can not show these abilities and connections and therefore this form of production is not realizable for it.

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[378] To this term, cf Lüdicke/Arndt, Medienerlass, 2001, P 5.

[379] The „commandatore" as Fellini portraits him in "Otto e mezzo".

The second form, also usually called in the trade a „joint production"[380], serves to shoulder mutually the financial risk of expensive productions[381]. So there are at least two producers to this kind of production, who are producing the film. They also make the decisions together and, as a precondition to that, they are sharing all rights in the film and the film negative (so called "zero-copy" (Null-Kopie)) of the joint film[382]. While doing this it is has to be taken care of, that not one of the co-producers becomes the responsible producer or the producer in charge, at which the rights of § 94 I UrhG are exclusively arising. As a possible consequence the fund would receive only a derivative right under § 94 II UrhG[383]. To prevent this, the fund needs to be granted in the co-production agreement all rights which allow him *de facto* to intervene in the production in the above mentioned extent. The media decree basically demands this, too[384]. This form of production is very attractive to funds usually lacking the necessary know-how and connections needed for a film production.

The third form of production which can provide the fund with the producer quality is the „fictitous contractual production" (unechte Auftragsproduktion). Here the fund commissions a producer, ie a so called "service producer", to technically produce the film not as an independent entrepreneur, but entirely dependent on the fund. This means that all contracts are entered into by the service producer are entered into by the name of and on account of the fund. Thereby the original rights under § 94 I UrhG arising with the fund. The legal nature of the „fictitous contractual production" is a service contract and not a contract of work, because the service is predominating the obligations[385].

The "real contractual production" (echte Auftragsproduktion) leads to an intangible asset of the circulating capital[386]. In such case the producer produces the film in his own name and on his account. He therefore acquires the film rights originally according to § 94 I UrhG and then

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[380] Hartlieb, Filmrecht, 1991, P 250.

[381] Cf Eggers, Filmfinanzierung, 1995, P 55.

[382] Cf Gundelach, Filmfinanzierung, 1994, P 72.

[383] Hertin, § 94 UrhG, 1998, P 630.

[384] Media decree, Rz. 13, 13a-f.

[385] Cf Hartlieb, Filmrecht, 1991, P254; Schack, Urheber- und Urhebervertragsrecht, p 477 Rz. 1087.

[386] BFH BStBl. II 1997, 320.

transfers them to the fund. The latter acquires them derivatively and therefore "against payment". The fund can never be deemed a producer with such kind of production.

To be deemed the producer in tax law the fund has to meet certain requirements. These demands are basically the ones which the media decree places on the fund to be deemed the producer of the film in case of an intervention of a service provider[387]; here in case of an "fictitious contractual production", but also in case of a co-production[388]:

1. The contracts the fund enters into have to provide the fund with all rights needed for the production and exploitation of the film (possibly proportional in case of a co-production).
2. Are there rights only arising within the phase of production (even abroad!), it has to be guaranteed, that they are completely transferred to the fund.
3. All substantial moves within a film production, especially the choice of the story, the screenplay, the casting, the planning of the budget, the shooting plan and the financing are in the disposition of the fund. With this it is important to decide on the basis of facts of the situation. A contractual right to issue instructions is irrelevant, if the fund does *de facto* not make use of it or is *de facto* not able to do so. An example for this is the case in which the decisions of the fund are controlled by the service provider or any entity connected to the latter, or the fund, its management respectively, is not able due to other circumstances to make the said decisions; eg because of insufficient know-how of the management or its representatives.
4. The service producer (within the „fictitious contractual production") should receive a flat-rate. He can be reimbursed for expenses beyond this flat-rate if such costs occurring with him and are paid on account of the fund.
5. If the risks of the production are covered by an insurance (eg a completion bond or shortfall guarantee (PLI)), which is common nowadays, the fund must be the policy holder.
6. Does the fund take over an already started production (it joins such a production at a later stage as a co-producer respectively), he still can become a producer, as long as there are remaining basic means of intervention to him. The tax and revenue authorities

[387] Cf Media decree, Rz. 12, 12a-12f.

[388] Zacher/Müller, Medienfonds, 2001, P 1186.

shall assume this as long as the shooting has not started. But even later the wording of the media decree[389] does not exclude the possibility for the fund to become a producer. This again mainly depends on its means of intervention.

7. Is the service provider also a shareholder of the fund, this does not touch the quality of a producer of the fund, if the service production agreements for the „fictitous contractual agreement" (unechte Auftragsproduktion) are entered into at arm's length, ie as if they would be entered in between third parties[390].

To sum it up with regard to the „fictitious contractual agreement", it is crucial that the fund has the right and *de facto* the possibility to instruct the service producer in the typical field of a film production. It therefore needs not at least of all a sufficiently qualified management. This again does not mean, that the management has to take influence or intervene in the creative and artistic field, since the right of the producer under § 94 I UrhG arises from a economical and organisational accomplishment and not from an artistic performance. In the media decree[391] there is also only mentioning of film-"technical" knowledge.

The media decree assumes another form of production, which is also a co-production, legally however not on a company law, but on a contractual law basis.
From a tax law point of view nothing else applies to such form of production than to the co-production on a company law basis.

4.4.3.2 Interim result regarding the producer quality of the fund

It applies to all forms of production which provide the producer quality for the fund, that the fund must be *de facto* able to intervene in and influence the production economically and

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[389] Rz. 12 e of the media decree reads as follows [as translated by the author]: "In case of a take over of a started film project by the fund the quality of a producer can be assumed, if the fund has still basic means of influence and intervention. Due to reasons of simplification, this can be assumed, if at the moment of the take over the shooting has not yet started. Are there no means of intervention and influence remaining for the fund, it is deemed to be a purchaser; all expenses are treated as the purchase price." This means the film is acquired derivatively.

[390] Media decree, Rz. 12 f.

[391] Media decree, Rz. 12 b.

organizationally, carry a financial risk and the film rights must under § 94 I UrhG are originally at least "co-arising" with the fund, ie must not transferred to it.

The question of the producer quality is only an issue of the fund, ie the „co-partnership". Only the fund, the „co-partnership" respectively, is subject to the determination of income and so relevant for the application of the accounting ban of § 5 II. The fund places this quality with the investor who has to and subsequently does qualify as a producer in the sense of § 94 I UrhG, too[392].

4.4.3.3 The producer quality of the fund and the investor in connection with the process of the film production

As the last mentioned requirement to reach the quality of a producer indicates, it is of great importance from the tax law point of view, that the fund, and even more important the investor[393], enters into the production at such a time which still allows them to become a (co-)producer. This is a matter of considerable importance for a film fund, because the fund often takes over a production before all investors are recruited. The fund can generally provide the investor with the producer quality. It can easily happen however, that the investor obtains the „co-partnership" quality from the found, but due to his late entry in the fund he can not be placed with the producer quality anymore. The consequence of which is, that the investor as a not qualified producer can only derivatively acquire the film rights anymore and therefore the expenses of this investor are categorized as a purchase price and not as production costs. Correspondingly the immediate "loss relief" does not apply to him anymore.

The media decree[394] differentiates as a consequence of this regarding the producer quality between two types of investors:

1. the ones who joined the fund after the beginning of the shooting but before the finishing of the film and
2. investors who joined the fund after the film was finished.

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[392] See above; Lüdicke/Arndt, Medienerlass, 2001, P 7.

[393] Regarding the investor, see below.

[394] Media decree Rz. 11, 12 e, 9.

At the same time the media decree still assumes the producer quality of the fund[395]. The media decree considers the conclusion of the contracts by which the rights in the underlying works of the film (eg the copyrights in novel to form a screenplay) are acquired to be the beginning of the production[396]. The courts consider the beginning of the production of a commodity generally to be the point of time, when expenses are occurring which are directly and factual connected to the commodity[397]. It is held however that the beginning of a film production from a trade law perspective is only after the finishing of the shooting plan[398]. The media decree further assumes that the next steps of a production (eg contracting with the actors, director etc.) following the acquisition of the underlying rights are taking place within the next three months after acquiring the first rights. If this is not the case, the beginning of the production is deemed to be the point of time of the later act or step of the film production[399]. Background to this is the avoidance of funds which are only stocking up on film rights without producing any film[400]. The end of the production is reached when the film negative (Null-Kopie) of which all other copies for the distribution of the film are made is produced[401]. The media decree is giving the following examples in which the beginning of the production is considerably postponed[402]:

1. Just before the shooting a new actor or director has to be found.
2. The screenplay has to be rewritten.
3. Copyright disputes or legal disputes about personal rights are arising.
4. One of the co-producers has problems with the financing.
5. The film subsidies are paid with delay.

So if an investor joins the fund at a time when the fund can not become a producer anymore, the investor also lacks the producer quality. Because of the prohibition of retroactive effects in tax law the expenses which incurred before the entry of the investor can not be allocated to

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[395] Lüdicke/Arndt, Medienerlass, 2001, P 7.

[396] Media decree, Rz. 11.

[397] BFH BStBl. II 1978, 620.

[398] Wriedt/Fischer, Filmvermögen, 1993, P 1684.

[399] Media decree, Rz. 11.

[400] Lüdicke/Arndt, Medienerlass, 2001, P 9.

[401] Media decree Rz. 11.

[402] Cf Zacher/Müller, Medienfonds, 2001, P 1188.

him with retrospective effect[403]. Only future losses can be allocated with an *a priori* effect to such an investor by a so called "equality clause" (Gleichstellungsklausel)[404]. For this however he must have been again a co-producer (besides the other partners and the fund) at the time of his entry[405]. As long as there are still significant steps of production following his entry, the accounting ban of § 5 II covers the derivative acquired (fictional) part of the developing commodity of the investor at the time of his entry in the supplementary statement. The balancing of accounts here is as it was in the case of a derivative acquisition of film rights which are not carried as an asset in the balance sheet, if they are taken up in the production process following[406]. At a stage where the fund can not become a producer anymore, the investor would never become one. For this case the media decree provides that the accounting ban of § 5 II reaches until the beginning of the shooting[407]. With an entry at a later stage the evidence of the decline of the acquired partial rights has to be provided. Nevertheless the media decree can not be interpreted in the way that with an entry after the beginning of the shooting the rights are obligatorily to be carried as an asset[408]. These decisive points of time the media decree borrows from the „construction client decree"[409], as mentioned above under 3.5.1.1. The criticism of that was also mentioned above. In practice many film funds move on to build so called "blind pools", which means that the films to be produced are not yet chosen and defined. On the one hand the investor does not know when entering the fund what film will be paid by him. This is somehow obscure from the protection of the investors point of view. The latter only can trust the fund´s management to find a profitable project. On the other hand the fund can safeguard that the investor can play his role as a producer as set out above.[410]

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[403] Cf Lüdicke/Arndt, Medienerlass, 2001, P 7.

[404] The loss allocation is only of use for the investor, if there are still enough losses after his entry in the fund which then can be allocated with him, cf Zacher, Medienfonds, 1999, P 1842.

[405] Media decree, Rz. 11, Satz 6; with reference to H 138 Abs. 3 EStH - Vorabanteile.

[406] Cf Media decree, Rz. 11 und 37.

[407] Media decree, Rz. 11 iVm. 12 e.

[408] Lüdicke/Arndt, Medienerlass, 2001, P 7.

[409] Loc cit.

[410] Leo Fischer, "Zukunft der Filmfonds liegt im Dunkeln", in: Die Welt am Sonntag– online, Finanzen, Finanzen, dated 3rd of August 2002.

4.4.3.4 Interim result regarding the producer quality of the investor:

The fact has to be recorded that the presumption in favour of the co-producer quality of the investor is not really laid out in favour of him. However the investor has still the possibility (especially on the grounds of a concrete situation of the production of a concrete film) to provide evidence that the fund and therefore he himself has considerable influence on the production; especially if one considers the court's general definition of the beginning of the production of a trade commodity. Given this the investor is not *a priori* excluded from the tax advantages of the loss relief[411].

4.4.4 The scale of the production costs

With the fund being the producer of the film, and so the film rights arising with the fund, these rights are assessed according to § 6 I Nr. 1 read with § 255 II HGB as the production costs. § 255 II HGB defines the production costs as follows:

> „Production costs are the expenses which are arising from the consumption of goods, the demand of services for the production of an asset its enhancement or its improvement beyond its original state. To this it belongs the costs of material, the production costs and the special costs of production. The calculation of the production costs may include reasonable parts of the overhead material costs, of the necessary overhead production costs and of the consumption of the fixed assets, insofar as the latter is induced by the production. Costs of the general administration as well as expenses for welfare institutions of the company, for voluntary welfare payments and for a company pension plan need not to be included. Expenses according to sentence 3 and 4 must not be taken into consideration, as far as they are allotted to the period of production. Marketing or distribution costs must not be included."

As explicitly stipulated in § 255 II sentence 6 HGB, distribution costs are not included in the production costs. Just by the wording of § 255 II sentence 6 HGB one should think that the print costs for the production of the copies for the distribution of the film are not included and

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[411] The same mechanism applies to the change of partners regarding the new partner, to this, cf media decree, Rz. 11 and Lüdicke/Arndt, Medienerlass, 2001, P 8.

consequently the film right is not assessed as such costs. But even packaging costs can be deemed to be production costs, if the packaging is of such nature that it is obligatory to put the product on the market, eg the packaging of milk, cigarettes or oil[412]. A film on the first film negative ("zero-copy" (Null-Kopie)) is as such not a marketable commodity, because it is economically inconceivable to sell a film by having one copy. No purchaser would ever be able to recoup the purchase price from one copy. In other words: the costs for the copies and the launching of the film, so called "P&A" (print and advertising costs), borne by the fund are deemed "production-related expenditure" and therefore included in the production costs[413].

Also included in the production costs is the so called „budget exceeding reserve" (Budgetüberschreitungsreserve). The purpose thereof is already explained by its name. It is subject however to the immediate deduction of operating costs only if it is demanded for sure, ie the film production costs are exceeding the budget[414].

For the assessment of the production costs it is also necessary to define the period of production. Regarding this it can be referred to the chapter above. According to § 255 II HGB all single costs, ie all costs which are attributed to the asset directly or indirectly, have to be obligatorily included in the trade law meaning of production costs. For the inclusion of the material costs, administration costs as well as production costs the trade law offers the right to choose. In tax law this right to choose however only exists according to R 33 EStR[415] for the administration costs. As a consequence the overheads have to be assessed besides the single costs. With a film production there are almost exclusively single costs[416] which again melt together and become the film. Inferred from this the trade law meaning of production costs and the tax law meaning of production costs are matching to the greatest possible extent. The actually capitalized costs of the fund are therefore attributed to the prevailing film rights as

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[412] Schmidt/Glanegger, EStG, § 6 Rn. 186.

[413] This finding was also confirmed by Dr. Stefan Lütje, Linklaters & Alliance, Berlin, attorney at law and specialist in film funds.

[414] BFH BStBl. II 1989, 830. Therefore it is common practice in the service production agreements that this reserve is not paid back even if it is not demanded. By doing this no reclaims are to be activated in the balance sheet.

[415] "Einkommenssteuerrichtlinien".

[416] E.g. the expenses for the screenplay, the actors, the director and the music.

purchase price, in case of a production fund as production costs respectively, and are as a consequence of which not to be activated in the balance sheet. Hence all costs of the fund are immediately deductible operating costs[417]. The fund costs however should not be inflated artificially, because saved costs are always more economical than deductible ones[418]. These costs which are also called "soft", „substance creating" or just „costs of the fund", are consisting of:

1. The "placing-guarantee" (Platzierungsgarantie),
2. the equity capital finding commission (Eigenkapitalvermittlungsprovision),
3. the outside capital finding commission (Fremdkapitalvermittlungsprovision),
4. the costs for the concept of the fund (Konzeptionskosten),
5. the fees for auditing and counselling (Prüfungs- und Beratungshonorare).

4.4.4.1 The deductibility of the costs of the "placing-guarantee" (Platzierungsgarantie)

With this guarantee the initiator guarantees the fund that in case of missing equity capital due to lacking investors the fund can be placed, if necessary by taking over the rest of the unsold shares. Is there equity capital missing and does it has to be replaced by a loan, the return of the investor declines, which can possibly lead to a so called "negative leverage-effect"[419]. The costs for such a guarantee with regard to a property fund has already been subject to a suspension order and were not accepted as immediately deductible advertising expenses[420]. With regard to a film fund this would mean that this costs can not be considered as immediately deductible production or operating expenditure respectively.

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[417] Cf BMF-Schreiben dated 31.08.1990, BStBl. I 1990, 366.

[418] Cf Fleischmann, Steuern, 1984, P 33.

[419] Cf Kammerl, Leverage-Effekt, 1993, P 1532f.; The leverage-effect ("Financial-Leverage-Effect", "trading on the equity", "income gearing") is dealing with the ideal composition of equity capital and outside capital. The leverage describes the interdependence between the profitability of the equity capital and the proportion of the outside capital. A positive leverage-effect occurs, if the profitability of the entire capital is higher than the interest on the outside capital. By this effect, the profitability of the equity capital increases the profitability of the equity capital with increasing debts. At certain disproportion of equity and outside capital, this calculation can reverse the effect and the investment ends with a loss – which is the so called negative leverage-effect; cf Encyclopaedia Britannica, Vol. 15, p427.

[420] BFH BStBl. II 1987, 212.

4.4.4.2 Deductibility of the "equity capital finding commission" (Eigenkapitalvermittlungsprovision)

This commission is owed to a party who recruits the investors who again provide the fund with equity capital. This obligation to recruit the investors usually assumes a major bank with the corresponding regular clientele. The amount of the commission depends on the amount of the recruited capital. According to § 248 I HGB expenses for the finding of equity capital are not allowed to be balanced in the balance sheet as assets. With the balance of trade being decisive for the tax balance sheet, the entire amount should be completely deductible as operating expenditure. This opinion was confirmed by the tax and revenue authorities[421]. Nevertheless the said authorities were basically keeping their word but limiting the amount deductible in analogue application of Rz. 7.1 of the „construction client decree"[422] to 6 % of the found equity capital. The question of deductibility of the commission for the finding of capital for the fund was already subject to a court order of the IX. Senate of the Federal Fiscal Court. This Senate ruled that these costs are not immediately deductible advertising expenses[423]. Against this the IV. Senate of the Federal Fiscal Court ruled that these commissions are deductible as operating expenditure[424]. Due to this divergent opinions of the two Senates the IV. Senate presented the matter according to § 11 II and IV FGO to the Great Senate of the Federal Fiscal Court. This order to refer the matter to the Great Senate was annulled by the IV. Senate in its decision dated June 28th, 2001 when this Senate joined the opinion of the IX. Senate[425]. This Senate also ruled that this commission is not deductible and went on to say that the 6 % of the commission which the tax and revenue authorities allowed to be deducted are not in accordance with the law[426]. The German ministry of finance used this judgement as an opportunity to release the decree dated 24.10.2001[427]. According to the decree the tax and revenue offices were ordered to not allow any deduction of the said commission. The latter decree and the draft of a supplementary decree to the latter received profound criticism: it was held that the two mentioned judgments were dealing with unusual cases not suitable for

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[421] BMF-Schreiben dated 12.02.1988, BStBl. I 1988, 98.

[422] Loc cit.

[423] BFH BStBl. II 1995, 166; cf Also the BMF-Schreiben dated 24.10.2001, BStBl. I 2001, 780.

[424] BFH BStBl. II 1999, 828, also already BFH dated 23.11.1993 in NV 1994, 370.

[425] BFH, Urt. v. 28.6.2001 - IV R 40/97.

[426] BFH, Urt. v. 28.6.2001 - IV R 40/97; cf Also the BMF-Schreiben dated 24.10.2001, BStBl. I 2001, 780.

[427] BMF-Schreiben dated 24.10.2001, BStBl. I 2001, 780.

generalization, quite apart from the fact that they were referring to closed property funds[428]. The decree dated 24.10.2001 already contained an interim arrangement for (film) funds selling their shares before 1st of January 2002 and taxpayers joining the fund before 1st of January 2003. This interim arrangement was just extended by a latest decree to the 1st of September 2002 and the 1st of January 2004 respectively[429]. Nevertheless the said decree is still in force and declared the judgments applicable to all closed funds (including film production funds) which started selling shares after the 1st of September 2002. The courts in the mentioned cases were not wrong since the courts decision was not based on § 5 I EStG but on § 42 AO. This makes a big difference, because § 42 AO is dealing with the misuse of the legal possibilities of tax planning (Missbrauch von rechtlichen Gestaltungsmöglichkeiten) and § 5 I is a special provision abstractly setting out the determination of income of traders. These cases are not comparable in a sense that a ruling on a case of misuse can be transferred to any case of an immediate deduction due to a determination of income by a balance sheet comparison. As a result, it is necessary at present to overrule the tax authorities with a decision of the fiscal court in order to deduct the costs for the "equity capital finding commission". However, under this circumstances a film fund can not find an investor. Thus the "equity capital finding commission" can be regarded as not deductible in practice at any rate. This means a loss of tax advantages in the amount of 10 %[430]. Maybe the tax authorities change their opinion in the present process of discussions.

4.4.4.3 The deductibility of the "outside capital finding commission" (Fremdkapitalvermittlungsprovision)

Such a commission arises for the finding of outside capital for the fund in form of a bank loan. In the opinion of the tax and revenue authorities such commission can be deducted as advertising expenses or operating expenditure respectively in the amount of the merchantable conditions of such a commission[431]. The merchantable conditions are established at 2 % of the found bank loan[432].

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[428] Statement of the „Institut der Wirtschaftsprüfer" on the draft of a supplement decree on the BMF decree, BMF-Schreiben dated 24.10.2001, BStBl. I 2001, 780, under: www.idw.de/download/Fondsgesllsch.pdf

[429] BMF-Schreiben dated 29. November 2002, not yet published under BStBl. I.

[430] Leo Fischer, „Endzeitstimmung erfasst Steuer sparende Anlageformen", in: Die Welt am Sonntag – online, Finanzen, Finanzen, dated 12th of November 2002.

[431] BMF-Schreiben dated 31.08.1990, BStBl. I 1990.

4.4.4.4 The deductibility of the costs for the concept, the fees for auditing and counselling (Konzeptionskosten, Prüfungs- und Beratungshonorare).

Usually the fund buys a ready made and complete legal concept from the initiator which provides the basis of the fund's commercial activity and includes the drafting of all necessary contracts. In the opinion of the tax and revenue authorities[433] and the courts[434] such costs can be activated in the balance sheet as the intangible asset "conception" besides the purchase price. These costs are immediately deductible operating expenditure. Single services received on the basis of service agreements are only forming a concept and therefore they are not the purchase price for the acquisition of a tangible asset[435].

The costs of external consulting services referred to the care and conception of the participation offer, the auditing of the annual account and the fund's prospectus by an accountant are also immediately deductible operating expenditure.

5. The limitations of the „loss deductions " (Verlustabzugsbeschränkungen)

As mentioned above, the participation in a fund serves the investor mostly to reduce his tax burden with the allocated losses from the fund. As the cherry on top the investor is looking for a return on his investment. The regulations limiting this „off-set of losses" are therefore of central of the investor.

5.1 The „minimum tax concept" (Mindestbesteuerungskonzept)

With the introduction of the „Tax Relief Act 1999/2000/2002" on March 19th, 1999 (Steuerentlastungsgesetz 1999/2000/2002)[436] the legislator has made a major amendment regarding the general tax law relevance of losses[437]. Especially the newly regulated „off-set of losses" of §§ 2 III and 10d influences the advantages of a participation of an investor in a film

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[432] BMF-Schreiben ibid.

[433] Cf BMF-Schreiben dated 30.03.1976, BStBl. I 1976, 283.

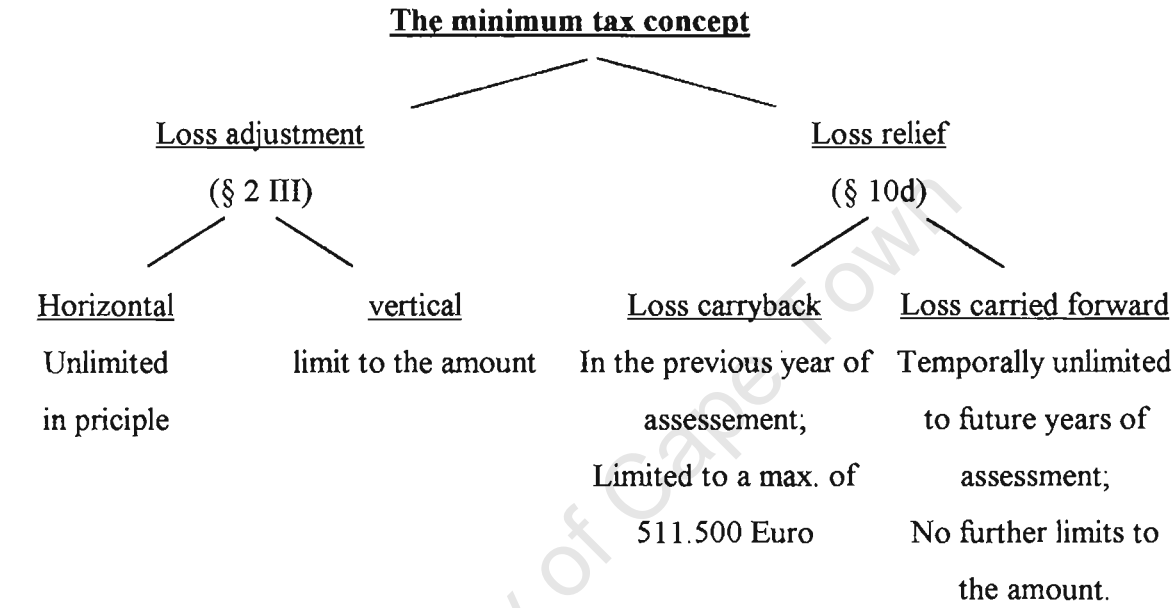
[434] Cf BFH BStBl. II 1993, 538.

[435] Gondert/Schimmelschmidt, Konzeption, 1996, P 1747; Lüdicke, Mobilienfonds, 1996, P 52f..

[436] Loc cit.

[437] Cf Herzig/Briesemeister, Verlustnutzung, 1999, P 1377.

fund. Until the introduction of this amendment losses could be set off against other positive results within the same period of assessment either horizontal, ie within one kind of income, or vertical, ie between different kinds of income. The amendment of § 2 III limits the possibility to adjust losses between the different kinds of income. The amendment of § 10d takes up the amendment of § 2 III and limits the possibility of the vertical loss set off for the loss brought forward and the loss carryback[438]. The minimum tax concept generally looks like this:



5.2. The limitation of the "loss deduction" under § 2 III

After the amendment of the minimum tax concept the "horizontal loss adjustment" between the different sources of income within the same kind of income is still admissible without limitation, see above. This amendment has therefore no effect on the "domestic trade minted partnerships" (inländische gewerblich geprägte Personengesellschaften) like film funds, because they generate income from a commercial enterprise, ie trade, in any case[439].

There is however a limitation to the "vertical loss adjustment". After the amendment this adjustment will be made in two steps:

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[438] Cf Stuhrmann, Änderungen, 1999, P 1662.

[439] Cf Dötsch/Pung, Änderungen, 1999, P 935.

1. At the first step losses are only adjustable up to a so called "bagatelle-limit" (Bagatellgrenze) in the amount of 51.500 Euro[440].
2. At the second step the loss adjustment is limited to the effect that losses are only adjustable up to the half of the remaining amount of the positive income[441].

The possibly remaining losses after this adjustment can be put away in the loss deduction under § 10d.

Thus § 2 III sets out the following test[442]:

1. The positive and negative income within one kind of income has to be established and afterwards set off against each other within the bounds of the "horizontal loss adjustment".
2. Then the sum of the positive and the negative income from different kinds of income has to be established.
3. If the sum of the negative income and/or the sum of the positive income amounts from different kinds of income, it has to be connected at first the negative and/or positive balance of the single kind of income to the sum of the positive and/or negative income.
4. The next step is to check, if the sum of the negative income exceeds the „bagatelle-limit" (Bagatellgrenze) of 51.500,00 Euro.
    a) If this is not the case, the losses are to be adjusted in total with the sum of the positive income.
    b) Does the negative income however exceed this limit, the exceeding amount of negative income is only deductible up to the half of the amount of the remaining positive income.

    In this way it is to be safeguarded under § 2 II sentence 4, that the vertical loss adjustment is made in the amount, in which the positive sums of the income from different kinds of income is connected to the total sum of the positive income. Does the sum of the negative income exceed the adjustable amount of 51.500,00 Euro,

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[440] This step is also called "loss adjustment I" or "minimum loss adjustment" (Mindestverlustausgleich); Cf Schneider, Verlustausgleich, 1999, P 328; Grefe, Unternehmenssteuern, 1999, P 164.

[441] This step is also called loss "adjustment II" or "additional loss adjustment".

[442] Cf Brandenberg, Steuerentlastungsgesetz, 1999, P 332; Risthaus/Plenker, Steuerentlastungsgesetz, 1999, P 605; Graf/Obermeier, Steuerrecht, 1999, P 94.

the sum of the negative income from different kinds of income is to be taken into consideration under § 2 III sentence 5 inasmuch as it is connected to the sum of the negative income.

5. Not adjusted negative income is to be put away in the loss deduction under § 10d.

Thus a vertical loss adjustment is only possible up to the amount of 51.500,00 Euro plus the half of the exceeding amount of the positive income. In this way according to § 2 III a minimum taxation is set in the amount of the half of the sum of the positive income exceeding 51.500,00 Euro[443].

This new concept of the „off-set of losses" with the showed differentiation on the basis of the source of the positive income (from trade or otherwise) has significant consequences for private investors, who generate their positive income as freelancers from self-employed work. Such investors must precisely proof their optimum of shares in a film fund in order to have admission to the vertical loss adjustment with their losses[444]. The preference of the taxpayers in the loss relief with income from trade is also problematic in relation to constitutional law. The dependence of the loss adjustment and deduction under § 2 III and § 10d from the kind of income generated, indicates a violation of the constitutional principle of equality under Art. 3 I GG[445]. The Federal Constitutional Court[446] has already indicated in a decision referring to the question of the prohibition of the „set-off of losses" with other income according to § 22 Nr. 3 that an exclusion of the „set-off of losses" between different kinds of income is contravening the principle of equality under Art. 3 I GG[447].

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[443] This is a matter of a minimum taxation with a minimum basis of determination (Mindestbemessungsgrundlage).

[444] Cf Mindermann, Medienfonds, 1999, P 373.

[445] "Grundgesetz der Bundesrepublik Deutschland".

[446] BVerfG dated 30.09.1998 in DStR 1998, 1743.

[447] For further criticism on the amendment of § 2 also with reference to its complicated nature, cf Kossow, Verlustausgleich, 1999, P 584.

5.3 The limitation of loss deduction (Verlustabzugsbeschränkungen) under § 10d

As mentioned above, losses which are not deductible under § 2 III are put away to the "loss deduction" (Verlustabzug) (ie the generic term for "loss carried forward" (Verlustvortrag) and "loss carryback" (Verlustrücktrag)) under § 10d[448]. The „loss carryback" under § 10d was also limited by the „Tax Relief Act 1999/2000/2002"[449]. Thus it is only possible anymore to carry back a loss to the previous year of assessment[450] and the maximum amount is limited to 511.500,00 Euro. The "loss carried forward" is only limited insofar, as it is only possible without limitation within the same kind of income. This again is a consequence of the interaction of § 2 III with § 10d. Inferred from that the "loss deduction" has to be made for each single year of assessment in connection with each single kind of income[451]. It is then only possible, if the amounts named in § 2 III in the corresponding year of assessment are not already consumed by the "loss adjustment". Otherwise the limits set out in § 2 III would be annulled by § 10d[452]. The maximum "vertical loss deduction" under § 10d is therefore only possible up to half of the amount exceeding the "bagatelle limit" of 51.500,00 Euro of the positive income[453].

There is no disadvantage for the taxpayer in respect of the loss carryback resulting from the priority of the loss deduction under § 10d I sentence 1 from the total sum of the income before "extras" (Sonderausgaben), "extraordinary burdens" (außergewöhnliche Belastungen) and other deductible amounts. He can determine the total amount of the carryback[454].

With the "loss carried forward" it is different. Because the "horizontal loss carried forward" is always to be made at a maximum, incurred „extras" or „extraordinary burdens" are not deductible anymore and stay without a tax effect. The same is true for the "vertical loss carried forward", inasmuch as the sum of the positive income falls below the "bagatelle limit"

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[448] Thus §§ 2 III and 10d are meshing.

[449] Loc cit.

[450] Bauer/Eggers, Mindestbesteuerung, 1999, P 400.

[451] Günkel/Frentzl, Fragen, 1999, P 659.

[452] Cf Schneider, Verlustausgleich, 1999, P 398.

[453] Cf Ritzer/Stangl, Zweifelsfragen, 1999, P 887.

[454] Cf Reiff, Verlustabzug, 1998, P 863.

(Bagatellgrenze) of 51.500,00 Euro and is not already balanced by way of "loss adjustment" under § 2 III[455].

5.4 The limitation of deduction (Verlustabzugsbeschränkungen) under § 15a

§ 15a basically limits the "horizontal loss adjustment" (§ 2 III) and the loss deduction (§ 10d) respectively. The provision stipulates that losses with a limited partner are only deductible in the year in which they arise in the amount of the quantum of the capital account (Haftkapital) of the limited partner (ie it has to be a positive capital account)[456]. Background to this is the fact that losses beyond the amount of the capital account of the limited partner, ie his liability, are generally not encumbering him neither legally, nor economically, in the year in which they arise. The burden of such losses is only suspensively conditional, if and insofar as later profits are made[457]. The provision aims at the restriction of "loss allocating companies"[458]. At the same time the regulations of § 15a are not only covering „loss allocating companies", but also any *en commandite* partnership[459]. Furthermore § 15a regulates the deductibility of losses, which are not only consuming the capital in the capital account of a partner, but moreover are leading to a negative capital account. Thus the capital account is the central term of § 15a.

5.4.1 The capital account of the limited partner

The term is again not defined by the law and its meaning was controversial over a long time. For a long time the tax and revenue authorities established the crucial capital account of the limited partner by the balance of the capital accounts in the tax balance sheet, in the possible

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[455] Herzig/Briesmeister, Verlustnutzung, 1999, P 1381.

[456] Under § 171 HGB the commanditarian partners are not directly liable to creditors of the partnership anymore after producing their investment to the partnership They are also not participating in the losses of the partnership according to § 167 III HGB beyond the amount of their share. According to the courts and the majority opinion in the literature § 167 III HGB does not exclude the establishment of a negative capital account, but only defines the limit of the final participating in the losses. Only if on the balance-sheet date it is certain that the negative capital account can not be filled up anymore with later profits, the allocation of losses is not allowed anymore; BFH BStBl. II 1981, 164; LSch/Sch § 15a Rn. 2 f. - with further quotations.

[457] Schmidt/Schmidt, EStG, § 15a, Rn. 30 (17. Aufl. 1998).

[458] Ibid..

[459] BFH BStBl. II 1996, 94; this is one reason why s15a was held to be unconstitutional.

"special-purpose financial statement" (Sonderbilanz) or in the supplementary statement (Ergänzungsbilanz). This definition was based on the reasoning of the draft legislation of § 15a[460]. In the opinion of the courts[461] however the capital account in the sense of § 15a does not include the special property of the partner, because the legal intention of § 15a is to adapt the loss adjustment to the scale of the partners liability. Since the limited partner is not liable with his special property, it can not influence the loss adjustment[462]. Accordingly, the loss adjustment is to be adapted to the extent of liability. On the other hand it is held that it is the purpose of § 15a (covered by the wording of § 15a) to include the result from the supplementary statement provided for him in the establishing of the capital account in the sense of this provision[463]. Thus according to the majority opinion in the literature and of the courts the loss in the share of the *en commandite* partnership includes under § 15a only the losses which are arising from the field of the joint ownership. Inferred from this the capital account in the sense of § 15a comprises the capital account of the partner in the tax balance sheet of the partnership and the capital of his supplementary statement[464]. In sum, an amount beyond the liability of the limited partner to a creditor of the partnership is neither adjustable under § 2 III to, nor deductible under § 10d from other income from trade or other income from other sources inasmuch as a negative capital account is created or increased.

However if a negative capital account emerges, this losses are allowed to be set off under § 15a II against later profits out of the same participation without temporal limits[465].

5.4.2 The expanded loss adjustment (erweiterter Verlustausgleich)

§ 15a I provides the so called „expanded loss adjustment" (erweiterter Verlustausgleich). In case a limited partner has not paid or not fully paid the capital he is liable with on the balance sheet date and therefore is liable to the creditors of the partnership directly and personal under

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[460] Bundesministerium der Finanzen BStBl. I 1981, 308; but also: Biergans, Einkommenssteuer, 1992, P 1219.

[461] BFH BStBl. II 1992, 167; 1993, 706; 1999, 163; L/B/H § 15a Rn. 19a.

[462] Ibid..

[463] BFH BStBl. II 1993, 706.

[464] BFH BStBl. II 1993, 706.

[465] Cf Bohnenblust/Menger, Verlustverrechung, 1991, P 436; one decisive reason why § 15a can be deemed to be constitutional.

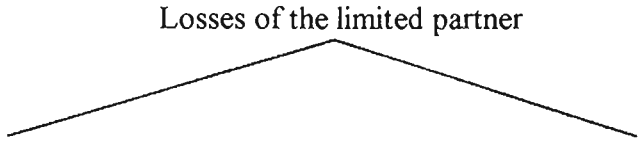
§ 171 I HGB[466], § 15a I sentence 2 and 3 allows – according to its object – the loss adjustment over and above the capital account up to the scale of the personal liability. Precondition to that however is that a decrease in the capital is not contractually excluded or unlikely due to the nature of the business. Such decrease in the capital is unlikely only if the financial situation of the partnership and its present and future financial solvency is so extraordinarily positive, that the actual personal liability of the limited partner seems unrealistic[467]. This is a prognosis which can be deemed difficult with film funds because of the unpredictable nature of the financial success of a film.

Insofar as the taxpayer can influence the amount of the capital account before the balance-sheet date by raising the share or the liability (since § 15a I focuses on that day), such attempts will be stopped by a subsequent taxation. Such taxation will include withdrawals or reductions of the liability in later years as taxable profits. At the same time an adjustable loss arises in the amount of the fictitious profit.

[466] But not in the case of a liability under § 172 II HGB, BFH BStBl. II 1993, 665.

[467] BFH BStBl. II 1992, 164, aber auch BMF-Schreiben dated 20.02.1992, BStBl. I 1992, 123.

5.4.3 Summary of the loss adjustment and loss deduction with limited liability:



Lower than the capital account
→ adjustable
→ deductible under § 10d

higher than the capital account
→ not adjustable
→ not deductible under § 10d
but:
capable to be set off under § 15a II against profits in later years from the same participation

5.5 The concurrence of laws regarding §§ 2 III, 10d, 2b, 15a

As mentioned above, §§ 2 III and 10d are basically meshing, though § 2 III has to be tested first and then § 10d again limits the sum brought forward.

With the relationship between § 2 b and § 15a it is more difficult. § 15a applies only to limited partners with a negative capital account. Therefore it can be looked upon as more specific and had to be tested prior to § 2b. On the other hand, § 2b only aims at investors who participate in a fund for just one reason: the tax advantage. It was held, that § 15a – interpreted concurrent to the constitution – was only applicable to "loss allocating companies"[468]. However the Federal Fiscal Court had no doubt relating to the constitutionality of § 15a[469]. So in the face of the practice an answer to the concurrence of these two provisions has to be found. The latter is delivered by the mere wording of § 2b sentence 1 (as translated by the author):

> „Negative income on the basis of participation in companies or partnerships or similar models ["Beteiligungen an Gesellschaften oder Gemeinschaften oder

[468] Jakob, Wolfgang, § 15a EStG, 887f..

[469] BFH BStBl. II 1988, 5f..

ähnlichen Modellen", – German text supplied] must not be adjusted with other income, if with the acquisition or foundation of the source of income the realization of a tax advantage is in the centre of attention. It also must not be deducted under §10d."

This wording makes clear that no loss adjustment or loss deduction is meant to be available for the taxpayer referred to (positive) income from other sources than such of a "loss allocating company". Inferred from this, if there is income from such company, the application of § 15a is narrowed down by § 2b to the income from such company. Even if a calculation would show, that the taxpayer would stay under the „not pick up limit" of § 2b with the application of § 15a before the test of § 2b is applied, this would not be a juridicial argument for the priority of § 15a[470]. The wording of a provision is the strongest, as it is the first and finally limiting guideline of its meaning. Moreover, the special provision is always to be tested before the general one[471]. In the case of § 2b, it is clear that § 2b is more specific than other provisions limiting the deductions, like § 15a, § 2 III and § 10d. The latter refers to all kinds of partnerships, as mentioned above. Thus § 2b has priority over § 15a and therefore is to be tested first.

6. Conclusion

A German film production fund is in most cases formed as an *en commandite* partnership (in form of a GmbH & Co. KG) which offers the possibility of a limited liability of the investor. A trustee can be placed between the fund and the investor without loosing tax advantages. The intervention of a trustee helps to avoid an obligatory and complex registration of all investors as partners of the fund in form of a GmbH & Co. KG. Such fund still provides all preconditions to fit into the necessities of the Income Tax Act.

The determination of income by a balance sheet comparison under § 5 I and the tax law balancing of film rights with a "GmbH & Co. KG" under §§ 248 II HGB, § 5 II offers the

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[470] Scite: "judex non calculat"!

[471] Within the method of interpretation of a provision, after the wording of a provision, it follows its purpose, than its position within the legal system and finally the historical intention of the legislator. The wording is always the starting and ending point of the interpretation. There is always a core of the meaning of a word as well as a limit of the latter; cf Larenz, Methodenlehre, p 257 f.

possibility for the investor to create losses which are deductible immediately at the beginning of a film production and can be set-off against income from other sources than the fund.

The latest introduction of the Tax Relief Act 1999/2000/2002 followed by the German ministry of finance's so called "media decree" brought some trouble to the German film funds. The introduction of the "minimum tax concept" and the newly regulated „off-set of losses" in §§ 2 III and 10d strongly influences the advantages of a participation of an investor in a film fund. A tax driven fund is not so easy to be constructed as it was before 1999. In Germany the days of the 1970s are over when the investor was able to collect 230% and more of his investment by an allocation of losses. Nowadays the individual gearing of the investment for each investor has become crucial for his tax savings, ie the deferment of payment.

Still all necessary prerequisites the investor has to meet under § 15 I Nr. 2 read with II and III can be satisfied by contractual terms. Basically it has to be safeguarded that the fund is the producer of the film carrying all essential risks and having a fundamental influence on the production. As a consequence, only certain forms of production can be chosen to safeguard this producer quality of the fund. And in addition to that, it is more important ever since that the fund has a qualified management.

To proof the "intent to realize a profit", stipulated under § 15 III as a constituent fact in tax law, the fund has to provide a valid prognosis of the results from the exploitation of the film. For purposes of giving evidence, it would be best, if an independent and acknowledged sales agent or distributor endows the fund with such prognosis.

The introduction of § 2b will be less problematic for film production funds as it seems at first sight. As long as the tenderer of the fund provides such just mentioned prognosis of the results from the exploitation of the film, it will always be able to refute the reproach of § 2b, that the entrepreneurship was only based on the tax advantage. The tenderer must also not guarantee in fact the return of the outside capital of the investor on the basis of the contractual concept. If the investor uses such capital, he must be encumbered by it. Another risk which is also avoidable is the utilization of outside money to optimise the so called leverage-effect. The media decree draws a line which shows a clear and calculable limit. Since this limit is

questionable under aspects of constitutional law, it is just possible that it will be put aside by a court in the near future.

The scale of the deductible production costs ranges quite wide, even though § 255 II HGB stipulates that marketing or distribution costs must not be included in the production costs. By a certain arrangement however the print costs can take part in the immediate deduction of the production costs. Unavoidable however is the fact that the tax and revenue authorities limit the amount of the "soft costs", ie the fund costs, in many cases to a certain percentage. But still, most of these costs can be deducted with one exemption regarding the "equity capital finding commission". In its recent decisions the Federal Fiscal Court found in two cases that these costs were not allowed to be deducted at all. It is highly questionable if these court rulings can be generalized and applied on film funds as the tax authorities did in the latest decree dated 24th of October 2001. A new draft of a supplement decree on this BMF-decree even goes as far as to cut off the producer-quality of the fund from the one of the investor. As a consequence of this all production costs would not fall under the prohibited inclusion as assets and would not be deductible in full in the year in which they were incurred. It is held with good reasons, as showed above, that this would lead to an end of film production funds in Germany[472]. The fact that the discussion about this is still going on and a new interim decree just released on the homepage of the German ministry of finance extending the exclusion from current funds from the application of the criticized decree a second time, shows that the tax authorities are aware of the danger of their policies.

§ 15a was also introduced to curb the so called "loss allocating companies" and shows effect by limiting the loss adjustment under § 2 III in case of a taxpayer as a limited partner of an *en commandite* partnership. If the investor is a limited registered partner of a film production fund, § 15a limits the possibility of a loss deduction on the basis of the capital account of the partner on the one hand, but on the other hand it allows losses to be set off against future profits from the same participation in the partnership. By this the legislator again makes clear that it does not target an investment in a film fund – as long as it is an economically promising enterprise.

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[472] Position of the „Institut der Wirtschaftsprüfer" (IDW) on the draft of a supplement decree on the BMF-decree, BMF-Schreiben dated 24.10.2001, BStBl. I 2001, 780 under www.idw.de.

All in all the film production funds as set out here can still offer attractive deductions to investors. These deductions live on the prohibited inclusion as assets under §§ 248 II HGB read with 5 II. This again shows that the tax advantage from an investment in a film production fund is not arising from a timely or politically related basis even it is affected by a recent commitment of the German government to fill tax loopholes. It is based on general and regular provisions of tax lax and balance sheet law. The attempts of the legislator to stop uneconomical investments just for the sake of a tax advantage by legislation such as the latest "Tax Relief Act 1999/2000/2002" with its "minimum tax concept", the amendment of § 10d and the introduction of § 2b are not really endangering the launching of a film production fund; not just because of the doubtful constitutionality of § 2b. The provisions as such are still providing enough space for a profitable private investment with a proper gearing. Hopefully it becomes true what Hans Eichel, the German minister of finance, promises: the repeal of 20.000 tax laws of 70.000 existing in Germany[473]. This again only can help the situation.

IV. Chapter Four: Comparison and final conclusion

The relating law to film production funds is surprisingly similar in both countries. The legal construct of an *en commandite* partnership is used in both countries to provide for limited liability of investors and open up tax deductions. In Germany it is common for there to be a trustee operating between the fund and the investor. This however does not make any difference to the tax law treatment of the investor.

There are substantial differences relating to the legal possibility of funds to furnish their partners with ownership rights of the film. In both countries the funds themselves have to hold the rights in the films which they produce in order to be able to allocate the losses arising from the production to the investors. It is at this point that fundamental differences between the Anglo-American copyright law system and the German intellectual property law coming to light. As copies are at the centre of copyright law the latter protects the economic investment[474]. The fact that copyright is transferable under South African law and not under

[473] Cf "Der Spiegel", No. 49, dated 2nd of December 2002, p 40.

[474] Cf Breyer, Harvard L.Rev. 84, (1970) p 285f., who states that also with other workers the remuneration does not represent the full value of their work.

German law (with the exception of a disposition *mortis causa*,cf. § 29 UrhG) clearly illustrates this point. But not only the South African copyright law but also the demands of the tax authorities on the funds make it much easier for a South African fund to secure the position of a film owner. In Germany under the "Copyright Act" (Urheberrechtsgesetz) the author of a work has the work exclusively at his disposal. In film the director is the author of the work. The film producer has no "copyright" in the film but only a "right of protection of an industrial property" (Leistungsschutzrecht)[475] which allows him to make use of the film in certain ways and protects him against the interference by the author of the film or by the one of the underlying works. Nevertheless the film producer has to make sure that he contractually acquires all the rights in the film and in the underlying works. The German law only assists him with a certain rule of interpretation of such contracts. Only then does the film producer unite all usufructuary rights within his person. The demands on the funds are not only more onerous under German Copyright law. The tax authorities strictly observe whether the fund really has the factual influence on the production in all its aspects. To be on the save side the German fund has to provide someone who can prove at least some expertise in the field of film production to supervise and direct a commissioned producer or deal at eye level with a co-producer. This requirement only applies to South African funds in so far as it is necessary to prove that they are not acting merely as an investment vehicle for the purpose of tax avoidance.

The actual tax incentives for investors are provided in South Africa for the most part by s24F, a special section dealing with film owners in the Income Tax Act. In contrast to that, German income tax law is open for deductions and allowances for film owners just on a balance sheet law basis, which allows immediate deductions of losses in connexion with intangible assets like any copyrights (as long as they vest directly in the investor which is happening when the investor is deemed the producer of the film). Following from this in Germany each expenditure has to be approved under the general provision of § 255 HGB, which only talks about production costs and excludes marketing and distribution costs *expressis verbis*. The fact that the "P&A" (print and advertising expenditure) of a film can be deducted as "production-related expenditure" seems to be *contra legem*, but is still possible due to the special nature of a film as a commodity. South African law deals easier with this issue, since all "soft-costs" are listed

[475] In Austria for instance a *cessio legis* transfers the rights in the film to the producer.

in a catalogue of the said section. Nevertheless, the distinction in the treatment of a "domestic" and an "export" film also raises problems regarding the question under which section the marketing expenditure can be deducted. The author sought to find an answer to this by distinguishing with regard to the types of films between two different commodities – "export films" and films for domestic release.

With regard to limitations of deductible amounts, the amount of the share of the investor is the numerical limiting factor in both countries. In this regard s24H(3) in South African law has its counterpart in § 15a I in German law. Only if the investor has not paid his share (in full) and therefore is directly and personally liable to the creditors of the partnership, he is allowed under German law to deduct an amount beyond his capital account up to the amount of his personal liability. Otherwise both statutes allow the investor to carry forward the loss not deductible because of the said limitation to the next year of assessment, s24H(4) and § 15a II respectively.

What used to be the attitude in the early 1990s in South Africa is now to be noticed in Germany: due to dubious tax schemes the German Inland Revenue is over-reacting against film funds. However, it would be too simple to blame only the funds for this. The present German government tries with all kinds of instruments to raise taxes because of the poor national budget. Under the pretext to close loopholes in the German Income Tax Act and to fight tax avoidance, the government has created a situation in the last two years in which all funds are struggling to find investors, not only the dubious ones. The intervention of the German tax authorities by their practice notes has created a hostile climate for film funds in Germany, even though the court rulings and the law itself still provides tax incentives to the funds.

With the two due practice notes, the one by the South African and the other by the German tax authorities, the Inland Revenue in both countries can still show its intention to promote well-founded film production as an economic factor and provide an indirect promotion of the cultural asset "film". The regional tax authorities in both countries hold the key position at present when it comes to the point of passing on the investments to the producers[476]. How they

[476] As Ms. Dr. Hendricks, a representative of the Federal Ministry of Finance, explained on occasion of the First Annual Film Finance Forum in Berlin: there was no tax law planned concerning deductions for film funds. The federal government tried to reach an agreement with the regional governments (and their tax

implement the practice notes or "Anwendungserlasse" respectively is crucial for the domestic film production. This again shows how much tax law is ruled by politics. The over-sceptic attitude of South African Inland Revenue towards film funds seems to be a matter of the past. In Germany the film funds and producers are still waiting for a "happy end" in this tax law "thriller"...

authorities) on a unified interpretation of the media decree. This was unavoidable to curb competition between the regions in attracting film funds (!).

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Urheberrechtsgesetz (UrhG). Zuletzt geändert durch Art. 7 G v. 23. 7.2002 I 2850 Amtliche Hinweise des Normgebers auf EG-Recht: Umsetzung der EGRL 9/96 (CELEX Nr: 396L0009) vgl. G v. 2.7.1997 I 1870 Umsetzung der EWGRL 83/93 (CELEX Nr. 393L0083) vgl. G v. 8.5.1998 I 902 Umsetzung der EGRL 55/97 (CELEX Nr. 397L0055) EWGRL 28/92 (CELEX Nr: 392L0028) vgl. G v. 1.9.2000 I 1374 → http://jurcom5.juris.de/bundesrecht/urhg/