

PUBLIC NOTICE–CAVCO 2005-001

I. Introduction

On November 14, 2003, the Minister of Finance and the Minister of Canadian Heritage announced modifications to the Canadian Film or Video Production Tax Credit (CPTC) designed to simplify the credit and ensure that tax assistance is appropriately targeted. Draft amendments to the *Income Tax Act* (Act) accompanied the announcement.

Of particular importance are modifications that have an impact on the policies of the Department of Canadian Heritage with respect to (i) copyright ownership of certified productions, (ii) acceptable revenues from the exploitation of the production in non-Canadian markets, (iii) control of the initial licensing of the commercial exploitation of the production, and (iv) producer control guidelines.

The Canadian Audio-Visual Certification Office (CAVCO) of the Department of Canadian Heritage wishes to consult Canadians on the guidelines it should adopt in light of the proposed 2003 amendments to the Act.

The following provides some background on the issues we are raising for consultation purposes. This is followed by a number of related questions and detailed procedures to file comments. A draft guidelines proposal is included in annex. Respondents are invited to comment on the proposal and the questions, and to add any further pertinent information.

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II. Background

1. As a result of the draft amendments to section 125.4 of the Act, the definition of “investor” in subsection 125.4(1) was repealed and the revised “investor rule” in subsection 125.4(4) will only disqualify a production where the production, or a person or a partnership holding an interest in the production, is a tax shelter. In addition, there is no longer a property ownership requirement in the definition of “labour expenditure” in subsection 125.4(1).
2. Even though the Act contemplates that persons other than the production corporation can now “hold an interest” in the production, the backgrounder accompanying the release of the draft Income Tax amendments states that *“...it remains a requirement ...that the production corporation have ownership of copyright. This latter provision is currently under review by the Department of Canadian Heritage.”*
3. Among the issues to be examined in this consultation process is the need to clarify the notions of “holding an interest” and “owning the copyright” in the production. Draft interpretive positions issued by the Canada Revenue Agency (CRA) have posited that, at some point, copyright ownership can be affected by the degree to which other entities may have acquired “beneficial ownership” of all or a portion of the copyright, with the potential to disallow a tax credit claim by the legitimate copyright owner.
4. In the view of the CRA, for example, where profit participation is granted to investors in the production, the investment could be deemed to represent a “beneficial ownership” position in the production’s copyright. If this is so, then the production becomes an “excluded production” as the production corporation is required, under the draft Income Tax Regulations, to be *“the exclusive worldwide copyright owner in the production for all commercial exploitation purposes for the 25-year period that begins at the first time the production had been completed and is commercially exploitable.”*
5. Replacing the investor rules by a new rule that specifically targets tax shelters is a useful first step in preventing interpretations that may potentially deny the tax credit to production corporations that rely on normal commercial arrangements by distributors, broadcasters and interim financiers in return for sharing some of the benefits of exploitation (e.g. through profit participation). However, there still exists the potential for the CRA to apply its “beneficial ownership” position, for instance, for the purpose of determining who, among eligible investors, can claim the additional available Capital Cost Allowance in the property. In determining who the actual “owner(s)” is (are), the CRA’s position still has the potential to render ineligible otherwise legitimate investments and deny a tax credit claim.

6. For its part, the Department of Canadian Heritage also seeks to ensure that allowing investors to “hold an interest” in the production does not give rise to unintended results such that, for example, non-Canadian entities can take equity positions that may affect the Canadian producer’s ownership and control of the production.
7. Through this consultation process, the Department of Canadian Heritage seeks to consult Canadians on the guidelines it should adopt in light of the proposed 2003 amendments to the Act. We propose to frame the notion of ownership within the current draft regulatory requirements with respect to “copyright ownership” and “initial control of the commercial exploitation of the production,” as well as the new draft legislative requirement for the production corporation to demonstrate “an acceptable share of revenues from the exploitation of the production in non-Canadian markets.” By clearly identifying the requirements under each of these headings, we aim to provide greater certainty in the administration of the CPTC.

II-A. Copyright Ownership

8. We propose (i) to clarify those rights that Canadian producers must retain so as not to give away either “legal” or “beneficial” ownership of the copyright in the production, and (ii) under certain conditions, to allow profit participation by various investors.
9. In this context, it is important to make a clear distinction between the “legal” right of the copyright owner and the rights of certain other entities to a net profit entitlement. In our view, the legal test is simple. Indeed, the *Copyright Act* (Canada) clearly sets out the incidents of copyright ownership. Under that Act, only the owner of the copyright in a production has the right to authorize its exhibition, duplication and exploitation in various media and territories around the world during the term of copyright. A clear chain-of-title is sufficient to demonstrate legal ownership.
10. Difficulties arise, however, when one attempts to define legal ownership in terms of a beneficial interest in the exploitation of the production. In that respect, a useful interpretive approach is to maintain a clear separation between those rights that take the form of an actual equity interest (copyright-like) in the production and those that allow various investors to share in the profits.
11. In structuring the financing for their productions, producers seek to share as much risk as possible with other investors. They look to distributors, broadcasters and interim lenders to provide financing in the form of distribution advances, broadcast pre-sales and loans. It is normal for such entities that advance substantial sums to recoup their investments, as well as seek to participate in net profits. We also recognize the risks that investments such as these may pose where the investors cross a certain threshold and take on the qualities of equity owners, that is, their rights extend far beyond normal recoupment arrangements between copyright owners and their investors.

12. In this context, we are of the view that production financing amounts raised through distributors and broadcasters should be characterized as payments for the “licensing” of the exploitation rights and not as investments in the form of equity which, for various reasons, could also be characterized as conferring a share of copyright ownership. Only certain “prescribed” entities, like Telefilm Canada, private production financing funds set up as a result of Canadian broadcaster commitments to the CRTC, and other qualified corporations should be allowed to have an equity interest in the production.
13. Currently, however, Canadian broadcasters that are licensed by the CRTC are also prescribed entities that can take copyright and equity interests in Canadian certified productions. A question we are raising in this consultation process is whether they should continue to be prescribed.
14. Notwithstanding the point raised in No. 13, in order to set the threshold between licensing rights and equity rights, we propose to rely on the legislative requirement for the producer to demonstrate an “acceptable share of revenues from the exploitation of the production in non-Canadian markets.” An examination of this requirement follows.

II-B. Acceptable Share of Revenues From the Exploitation of the Production in Non-Canadian Markets

15. The November 14, 2003, announcement introduced a legislative amendment with respect to the definition of “Canadian film or video production certificate” to direct the Minister of Canadian Heritage to issue guidelines regarding productions,

*“in respect of which that Minister is satisfied that
(a) except where the production is a prescribed treaty co-production (as defined by regulation), an acceptable share of revenues from the exploitation of the production in non-Canadian markets is, under the terms of any agreement, retained by
(i) a qualified corporation that owns or owned an interest in the production,
(ii) a prescribed taxable Canadian corporation related to the qualified corporation, or
(iii) any combination of corporations described (i) or (ii),... ”*

16. We propose to adopt a number of conditions (as set out in the attached draft guidelines proposal) in order to define what a production corporation must retain from the exploitation of the production so as to satisfy the regulatory definition of “acceptable revenues,” and as a basis for assessing whether all or a portion of the copyright may have been disposed of to non-prescribed entities. These conditions include minimum profit participation for the production corporation, as well as certain limits on distributors’ and broadcasters’ exploitation rights.

17. Although this proposal contemplates that the Canadian production corporation will never have less than a certain percentage of retained benefits in its own production, nothing would prevent it from securing a more beneficial profit position where at all possible given its relative negotiating strength, its actual investment in the production, or where it is determined that investors' profit participation is not warranted.

II-C. Control of the Initial Licensing of Commercial Exploitation of the Production

18. In addition to the legal ownership and acceptable revenues tests, a third test is included in the Act as a basis on which to assess true control and ownership of the production by the eligible corporation. This requirement is set out in section 1106(1) of the Regulations, under the definition of "excluded production." The qualified production corporation (or a related prescribed taxable Canadian corporation) must be able to demonstrate that it exercises full control over the initial licensing of its rights as a copyright owner, from the time of the acquisition of the property.
19. Difficulties arise where a certain amount of development occurs, under foreign copyright ownership, before a Canadian producer in turn secures the copyright in a concept or project. In the interest of providing greater clarity, we propose to adopt two simple rules to recognize only those productions whose development originates under the control of Canadians. Productions would be ineligible for the CPTC program to the extent that any meaningful development or exploitation arrangements have been initiated by non-Canadians before copyright ownership has been secured by an eligible Canadian company. In addition, non-Canadian owners of underlying rights in a concept or project would not be permitted to obtain exploitation rights under licence or otherwise once the production has been completed.

II-D. Producer Control Guidelines

20. Comprised of a number of requirements and indicators, the current Producer Control Guidelines were adopted in 1996, following consultation with the industry. They were intended to function as an evaluation mechanism rather than a rigorous set of rules in order to assess true Canadian ownership and control of the production. In many instances, this required a case-by-case examination of the various production, financing and exploitation agreements resulting in uncertainty on the part of producers during the critical development phase of production. While the general principles underpinning the guidelines are still valid, in our view, many of the issues that have arisen in the past will be resolved with the introduction of the new rules mentioned above regarding copyright ownership, acceptable revenues and initial control of commercial exploitation. We propose therefore to replace the current guidelines with a set number of rules as set out in the attached draft guidelines proposal.

21. We also intend to modify CAVCO's Non-Canadian Exemption Policy to allow greater latitude for non-Canadians who provide services to certified productions to be recognized in the screen credits. This is another area that has caused uncertainty. As a replacement for the current policy of allowing only three such credits for non-Canadians, we propose simply that screen credits for non-Canadian executives who render services to the production not exceed the number of Canadian producer-related credits, with certain provisos. Considerations as to the placement and size of various credits will need to be evaluated in applying this policy.
22. In line with CRTC policies, however, courtesy or vanity credits for non-Canadians would be permitted only to the extent that their duties relate to non-creative, non-production-related functions (for example for representatives of distribution, broadcasting or financing companies that do not take an active role in the actual production). With respect to time spent on set, the functions of non-Canadians would continue to be limited to that of observers, not to exceed 25% of principal photography. An exception to this rule would be allowed with respect to lead actors and one supervisory position in the writing department (see paragraph 26).

II-E. Limited Use Rights

23. The appended draft guidelines proposal includes a section on “limited use rights” to permit certification in cases where only limited rights or exploitation territories may be available to, or desired by, the Canadian production corporation (notwithstanding that “exclusive worldwide copyright ownership” must be held for 25 years). In certain cases, rights to a concept, literary property or format may be licensed to a Canadian producer under terms that allow for a limited use of the finished property, while the underlying rights are retained by the original owner.
24. For example, a producer may want to tape a famous stage play for television broadcast under the terms of a licence with the estate of the author which will retain all rights to the original story and may limit the exploitation of the taped property to a certain medium or territory. Another example would be where a Canadian producer may want to exploit a well-known concept only in a certain Canadian territory. The underlying rights owner has no interest in the Canadian version and the producer may not want to exploit the production worldwide. A third example would be where a producer may choose not to purchase world rights from a writer, having no intention to exploit the finished production outside of a specified territory. In any of these cases, there is no question as to the Canadian producer's ownership of the finished production.
25. However, at issue, particularly for productions based on popular formats, is the amount of control over the actual production process retained by underlying rights owners, coupled in some cases with the obligation on the part of the Canadian producer to grant to the original owner all distribution rights outside of Canada. In certain cases, the Canadian production corporation may also specifically be prevented from exploiting the

production outside of Canada, should the opportunity arise. Although the Canadian production corporation may benefit from the exploitation of the production, our inclination is to treat this type of arrangement as a service deal. In this context, the proposed rules outlined at paragraph 19, in conjunction with the established guidelines, would preclude such arrangements from certification under the CPTC. However, they may be eligible for the Film or Video Production Services Tax Credit (PSTC). Final determination would depend on a case-by-case analysis.

II-F. Show Runners and Writers

26. We also propose to adopt a new policy to disallow the use of non-Canadian show runners on certified productions. We are prepared, however, to allow a maximum of one non-Canadian to occupy a supervisory position in the writing department.
27. We are aware that the term “show runner” has many applications in the television sector. Of greater concern to us are the functions generally assigned to producer/writers who act as liaison between a non-Canadian broadcaster and the Canadian producer on large television series principally destined for the US market, and who integrate many of the Canadian producer functions; who in fact run and actually produce the show. It will be useful in this consultation process for respondents to distinguish between the various types of show runner positions to better apply this policy.

II-G. CAVCO Advisory Committee

28. In order to help CAVCO keep abreast of the challenges facing the industry and to act as a sounding board for future policy and process decisions, we are considering creating a CAVCO Advisory Committee. This consultative body could provide feedback to CAVCO on questions of evolving commercial standards, industry practice and market conditions. Respondents are invited to comment as to the mandate and composition of such a committee.

III. The Department of Canadian Heritage Seeks Comments on the Following Questions

29. The issue raised at paragraph 13 of this document suggests that Canadian broadcasters would no longer be “prescribed” entities under the Regulations. Respondents are asked to consider whether the holding of a portion of copyright ownership or equity ownership of Canadian productions by Canadian broadcasters is still desirable, or whether the more important issue is what the production company is allowed to “retain” in terms of production control and exploitation benefits regardless of ownership.

30. Should the current 25-year copyright ownership requirement be maintained? Are there instances where an exception could be made in this regard, for example upon the retirement of a Canadian producer or the wrapping up of the production corporation?
31. For the purpose of the “acceptable revenues” provision in the draft legislation, is a net profit definition the best way to ensure an appropriate share of revenues to the production corporation? Should a definition be based on gross profits instead or other forms of participation in the production’s revenue stream? Could additional guidelines help to set a “breakeven” point (the point at which sales equal production and distribution costs)?
32. Should the Canadian copyright ownership requirements be adapted to take advantage of other tax-based incentives outside Canada that are also based on copyright ownership? How could this be achieved?
33. Given the substantial differences between theatrical and television production, as well as exploitation, does the preceding document raise issues that need to be treated differently for either market?
34. Please provide comments as to the mandate and composition of a CAVCO Advisory Committee.

IV. Procedures for Filing Comments

35. The consultation will be done in two phases. During phase 1, respondents are invited to file their comments in writing no later than **March 31, 2005**. These comments will be posted on the CAVCO Web site (www.pch.gc.ca/cavco), allowing for public viewing. Phase 2 will allow respondents to comment on the initial submissions, no later than **April 22, 2005**. Only those submissions received by the established dates will be accepted.
36. To facilitate the consultation process, we ask that, to the extent possible, all submissions be provided in an electronic format that can be adapted for use on the Internet.
E-mail address: cavco_bcpac@pch.gc.ca.
In paper form, please address to: Director, Canadian Audio-Visual Certification Office, 100 Sparks Street, 4th floor, Ottawa, Ontario, K1A 0M5.
37. Submissions should include the name of the person or organization that provides comments. Submissions longer than five pages should include a summary. Please number each paragraph.

ANNEX

Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

Basic Requirements

Eligibility Criteria

1. Copyright ownership
("excluded production" definition,
Income Tax Regulations)

where the production is not a treaty co-production, neither the corporation nor another prescribed Canadian taxable corporation related to the corporation is, except to the extent of an interest in the production held by a prescribed Canadian taxable corporation as a co-producer of the production or by a prescribed person (within the meaning assigned by subsection 1106(7)), the exclusive worldwide copyright owner in the production for all commercial exploitation purposes for the 25-year period that begins at the first time the production had been completed and is commercially exploitable;

1. Copyright ownership

- a) exclusive worldwide copyright shall be established through a clear chain-of-title;
- b) only prescribed Canadian taxable corporations and prescribed persons can own the copyright, or retain an equity interest, in the production;
- c) distribution advances and broadcasting pre-sales shall take the form of licenses for exploitation rights and shall not confer any copyright or equity ownership in the production;
- d) however, distributors and broadcasters may be entitled to a share of profits as further defined in the *acceptable revenues* provision;
- e) any security interest shall be lifted immediately after acceptance of delivery;
- f) the production shall not be a co-venture as defined by the CRTC.

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Copyright, Revenue and Control Requirements

Basic Requirements

Eligibility Criteria

2. Limited use rights

For the purpose of section 1106 of the Income Tax Regulations, “exclusive worldwide copyright owner in the production for all commercial exploitation purposes for the 25-year period” means a copyright owner whose production meets the adjoining criteria.

2. Limited use rights

- a) it is produced from various components, including from rights related to underlying works that are acquired by the producer under a licence, if the copyright owner retains ownership of the production for a minimum period of 25 years;
- b) for which the commercial exploitation will be in conformity with the rights that have been acquired in order to make the production;
- c) for greater certainty, throughout the 25-year period mentioned in paragraph a), no one other than the worldwide owner of copyright shall be entitled to commercially exploit the production and grant licences there to.

Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

Basic Requirements

Eligibility Criteria

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| <p>3. <u>Acceptable revenues</u> (subsection 125.4(1) <i>Income Tax Act</i>)</p> <p><i>the corporation retains a share of revenues, that is acceptable to the Minister of Canadian Heritage, from the exploitation of the production in non-Canadian markets;</i></p> | <p>3. <u>Acceptable revenues</u></p> <p>a) a beneficial interest in the exploitation of the production in non-Canadian markets shall be retained by the eligible corporation, and in no event shall it be less than 25% of net profits in <u>each</u> of any major foreign territory;</p> <p>b) a beneficial interest in the exploitation of ancillary and subsidiary rights in the production in non-Canadian markets shall be retained by the eligible corporation, and in no event shall it be less than 25% of the worldwide net profits from the exploitation of those rights;</p> <p>c) subject to paragraphs (a) and (b) in this section, profit participation outside an investor's territory shall not exceed its percentage of production financing;</p> <p>d) broadcast licences are not recoupable in any territory and shall be negotiated separately from distribution licenses;</p> <p>e) except where the distribution entity is related to the eligible production entity, the term for the exploitation of the production by a distributor in non-Canadian markets shall be limited to 25 years;</p> <p>f) distribution fees for the exploitation of the production by distributors in non-Canadian markets shall be reasonable and expenses shall be limited to direct, actual and out-of-pocket expenses;</p> |
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Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

| Basic Requirements | Eligibility Criteria |
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| | <p data-bbox="846 243 1385 394">g) the Canadian territory shall not be cross-collateralized with non-Canadian territories, nor shall it constitute a source of revenues for non-Canadian investors;</p> <p data-bbox="846 432 1385 541">h) federal tax credits shall not be included in the revenue stream of other investors.</p> |

Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

| Basic Requirements | Eligibility Criteria |
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| <p data-bbox="228 241 787 357">4. <u>Control over exploitation</u> (“excluded production” definition, Income Tax Regulations)</p> <p data-bbox="228 388 787 472"><i>the corporation controls the initial licensing of commercial exploitation;</i></p> | <p data-bbox="787 241 1383 283">4. <u>Control over exploitation</u></p> <p data-bbox="787 315 1383 577">a) a production in respect of which any meaningful development or exploitation arrangements have been initiated by non-Canadians, before copyright ownership has been secured by the eligible Canadian corporation, is ineligible;</p> <p data-bbox="787 609 1383 871">b) a non-Canadian entity that has held the underlying rights in a concept or project, prior to the eligible corporation’s ownership of copyright in the production, cannot obtain exploitation rights in any territory once the production is completed.</p> |

Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

Basic Requirements

5. Production Control Guidelines

The producer is an individual who controls and is the central decision maker in respect of the production from beginning to end. The producer is normally involved in and is ultimately responsible for:

- the acquisition and/or meaningful development of the story;
- commissioning the writing of the screenplay/series bible;
- selecting, hiring and firing key artists and creative personnel;
- preparing, revising and giving final approval of the budget;
- all overages;
- binding the production company to talent and crew contracts;
- arranging production financing;
- supervising the filming/taping and post-production;
- final creative control, subject to reasonable and customary approvals required by investors, distributors, broadcasters and financiers;
- approving production expenditures;
- controlling production bank accounts (sole and unfettered cheque-signing authority);
- arranging the commercial exploitation of the production.

Eligibility Criteria

5. Production Control Guidelines

a) The producer must not:

- i) be a producer-for-hire of a non-Canadian entity;
- ii) receive less remuneration than the aggregate remuneration (including all fringes, travel, accommodations and gratuities) paid to non-Canadian executives who render services to the production such as facilitating or arranging financing and foreign exploitation of the production;
- iii) be a party to an agreement wherein the producer can be overruled or fired by another person in the case of a dispute (except for a producer hired by the eligible Canadian corporation.)

b) The production corporation must:

have a right of first negotiation or option right for subsequent cycles of a television series, sequels or spin-offs based on the specific rights acquired.

c) Ineligible entities must not:

- i) restrict the authority and responsibilities of the producer or exercise undue control through the receipt of weekly expense statements, daily rushes, rough cuts, etc., or require changes (at a cost or no cost to the producer) save to have the production conform to pre-approved elements or, in the opinion of the producer, enhance the production;

Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

Basic Requirements

Eligibility Criteria

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| | <p>ii) control production expenditures, co-sign cheques, receive under-budgeted amounts or supervise producer functions such as production accountant or production manager;</p> <p>iii) act as a completion guarantor, with take-over rights, unless it is a recognized lending institution normally in the business of lending money and taking security therefor. In the event the production is taken over, it must continue to comply with all legislative, regulatory and guideline requirements.</p> |
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Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

| Basic Requirements | Eligibility Criteria |
|---------------------------|---|
| 6. <u>Show runners</u> | 6. <u>Show runners</u> The participation of non-Canadian show runners will render the production ineligible. |
| 7. <u>Writers</u> | 7. <u>Writers</u> A maximum of one non-Canadian can occupy a supervisory position in the writing department. |

Draft Guidelines Proposal
Copyright, Revenue and Control Requirements

Basic Requirements

Eligibility Criteria

| 8. <u>Screen credits</u> | 8. <u>Screen credits</u> |
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| | <p>a) only Canadians can be accorded producer or co-producer credits, except for official treaty co-productions;</p> <p>b) the number of non-Canadian courtesy or vanity credits, per production or episode of a television series, shall not exceed the number of Canadian producer-related credits;</p> <p>c) a maximum of two screen credits (including “presentation” and “in association with” credits) are allowed for any one non-Canadian company and/or its individual representatives;</p> <p>d) non-Canadians cannot receive an individual presentation credit;</p> <p>e) Canadian producer-related credits must appear no less prominently than non-Canadian courtesy or vanity credits;</p> <p>f) with the exception of a lead actor and <u>one</u> non-Canadian in a supervisory position in the writing department, courtesy or vanity credits may be offered to non-Canadians only to the extent that their duties relate to non-creative, non-production-related functions. For greater certainty, these functions shall be limited to facilitating or arranging financing and exploitation;</p> <p>g) with respect to time spent on set, the functions of non-Canadians shall be limited to that of observers not to exceed 25% of principal photography;</p> <p>h) the Canadian copyright notice must appear in the screen credits.</p> |