

# CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 306

August 25, 1966

## CORPORATIONS: DETERMINATION OF INCOME FROM MOTION PICTURES

### Syllabus:

Taxpayer, an independent producer of motion pictures, produced two feature length motion pictures during 1958 and 1959. The first picture was released in September, 1958, and taxpayer's share of the gross receipts ("producer's share") through October, 1962, amounted to less than the production and completion loans which it obtained. The second picture was released in March, 1959, and taxpayer's share of the receipts through October, 1962, exceeded the production and completion loans thereon and the amounts due to others under profit sharing arrangements.

Production of both pictures was financed through loans from the distributing company and third parties pursuant to an agreement dated January, 1958. The loans were secured by mortgages on the pictures. Repayment of the loans was to be made out of the "producer's share." The agreement authorized the distributing company to retain the amount distributable to taxpayer (producer's share of net profits") as security for repayment of the loans. The agreement specifically provided that the net profits from one picture shall in no event be cross-collateralized as security for the repayment of the loans on the other picture.

The agreement of January, 1958, was modified on December 29, 1960, to provide for the production of a third picture and the retroactive cross-collateralization of taxpayer's net profits from all three pictures. Through 1963, taxpayer had not produced the third picture.

Although cross-collateralization was not provided for until the agreement of December 29, 1960, the first question posed is based on the assumption that the provision was in force under the original agreement.

(1) Whether the cross-collateralization agreement requires the offsetting of the loss from one picture against the profit of another picture after both pictures have been released for exhibition before any taxable income can result to the production company.

(2) Whether the cross-collateralization provision in the agreement of December 29, 1960, is entitled to retroactive application for tax purposes.

(1) The question, as phrased, presupposes that the results of the two

pictures are determined separately for each picture. Resolution of the question appears to depend upon whether it is proper to determine the results of the two pictures in such a manner or whether cross-collateralization requires that the results be viewed from the standpoint of the aggregate of both pictures.

Cross-collateralization is a means by which the lenders seek to minimize their risk against losses on the loans made to the production company. The risk is minimized by making the profit from the profitable picture available to repay the deficiency remaining on the advances made for the production of the loss picture. In a non-cross-collateralization situation the lenders would not entirely recover their loans on the loss picture despite the fact that the production company derived a profit from the other picture. Also in such a situation the negative costs on the loss picture are not entirely recovered through the production company's share of the receipts.

The effect of cross-collateralization with respect to the distribution company and third party lenders is the unitization of the two pictures as a single unit in that the profit from one picture, which otherwise is distributable to the production company, is made available to repay the deficiency remaining on loans made for the other picture. Cross-collateralization has a similar effect upon the production company in that the application of the profit from the profitable picture against the loan deficiency remaining on the loss picture increases its equity in the lost picture and to that extent represents a recovery of that part of the negative costs not recovered through its share of the receipts from the loss picture.

In view of the fact that under a cross-collateralization agreement the production company's recovery of the negative costs on one picture is directly dependent upon the result of the other picture, it is our opinion that cross-collateralization requires that the two pictures be viewed as a single unit. Thus, where the production company's share of the aggregate receipts from both pictures, based upon the facts known at the end of the year, are not expected to exceed the aggregate negative costs of both pictures, no taxable income can result to the production company. Cf. Appeal of Pickford-Ladky Production, Inc., SBE, decided April 1, 1948. The conclusion applies only after the two pictures are released for exhibition. For the year or years preceding the release of the second picture, the profit or loss on the first picture is determined on the facts applicable to it notwithstanding the cross-collateralization agreement.

(2) The general rule is that amendments to an agreement cannot have retroactive effect upon tax consequences. Gaylor v. Commissioner, 153 F.2d 408, Appeal of Walter L. Schott, SBE, decided December 11, 1963. Thus, the modification in the agreement of December 29, 1960, providing for retroactive cross-collateralization cannot be applied retroactively so as to change the tax consequences of prior years.