

Chapter Seven — Particularized Problems of Small Business Investing In Independent Motion Pictures Through Small Business Investment Companies

After the Tax Reform Act of 1976, a motion picture investment no longer yields large tax deductions. A film must be successful at the box office to be a good investment. Because of the speculative nature of the industry, however, investors must finance a number of films in order to realize a net profit. If investors choose to invest in independent motion picture production and distribution through a small business investment company, the Small Business Administration will provide the investors with the funding they need to diversify their portfolio of film investments. This comment analyzes the advantages and disadvantages of using federal funds to invest in independent motion picture production and distribution.

Between 1973 and 1976, high income taxpayers helped to finance the production of one out of every five films produced in the United States.¹ Attracted to motion pictures as tax shelters, wealthy individuals financed such films as *Funny Lady*, *The Great Gatsby*, and *Shampoo*.² The 1976 Tax Reform Act,³ how-

¹ Hoffman, *Will the Next Robert Redford Have to Be a Canadian?*, N.Y. TIMES, Oct. 23, 1977, at 1, col. 2.

² Grover, *Hollywood, Hurt by a Tax Bill, Starts to Make More Movies in Europe, Canada*, WALL ST. J., March 24, 1977, at 42, col. 1. High income taxpayers often sheltered their income through limited partnerships. The limited partnerships either produced films or purchased completed motion pictures. Distributors then publicized the films and negotiated rental terms with exhibitors. See notes 9-16 and accompanying text *infra*.

The major motion picture companies, such as United Artists and Paramount Pictures Corporation, often distributed the motion pictures. As distributors, the "majors" have historically dominated the motion picture industry because of their nationwide marketing capability, longstanding reputation within the industry and financial resources. See Comment, *Blind Bidding and the Motion Picture Industry*, 92 HARV. L. REV. 1128, 1128-31 (1979); ECONOMIST, Nov. 4, 1978, at 85. See also Kanter & Eisenberg, *What Alice Sees Through the Looking Glass When Movieland Seeks Creative Techniques for Financing Films*, 53 TAXES 94, 97-98 (1975); Beaupre, *Industry*, FILM COMMENT, Jul.-Aug. 1978,

ever, largely eliminated the tax sheltering advantages of motion picture investments. Despite increased consumer demand for motion pictures,⁴ most investors stopped financing the production and distribution of films altogether. Many producers began making films abroad to take advantage of foreign subsidies.⁵

Recently, the Small Business Administration (SBA) established a pilot program under the Small Business Investment Act⁶ to promote independent motion picture production and distribution in the United States. The Small Business Investment Act authorizes the SBA to license, regulate, and finance privately-operated small business investment companies (SBICs). The SBICs, in turn, provide equity capital, long-term loans and management assistance to eligible small businesses.⁷ Under the SBA's motion picture program, SBICs specialize in financing

at 68.

In addition to distributing completed films, most of the major motion picture companies produce films. However, they are no longer as active in film production as they once were. Kanter & Eisenberg, *supra* at 97-98. Independent producers, on the other hand, are becoming a more important part of the motion picture industry. In 1970, less than a third of all films were created and financed outside the major studios. In 1977, independent producers accounted for more than 65 percent of all films. Harmetz, *Studios Are Picking Up More Films From Independents*, N.Y. TIMES, June 26, 1978, at C18, col. 1.

³ Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified at I.R.C. §§ 280, 465 (1976)).

⁴ See note 25 and accompanying text *infra*.

⁵ See Grover, *supra* note 2. For a discussion of the advantages of foreign film production, see note 22 *infra*.

⁶ 15 U.S.C. §§ 661-696 (1976 & Supp. II 1978); 13 C.F.R. §§ 101-131 (1980).

⁷ For a discussion of SBICs and the Small Business Investment Act of 1958, see generally Comment, *The Small Business Investment Act of 1958*, 47 CALIF. L. REV. 144 (1959); Comment, *The Small Business Investment Company: An Attempt to Fill the Equity Gap*, 9 VILL. L. REV. 109 (1963); Annot., 7 A.L.R. FED. 224 (1971). See also Read, *Small Business Administration Activities Under the Small Business Investment Act*, 14 BUS. LAW. 582 (1959); Siels & Hodes, *New Horizons in the Regulation of Small Business Investment Companies*, 20 BUS. LAW. 921 (1965).

A minority enterprise small business investment company (MESBIC) is an SBIC which invests in small businesses owned by socially or economically disadvantaged persons. 15 U.S.C. § 681(d) (1976); 13 C.F.R. § 107.3 (1980). A MESBIC (referred to by the SBA as being a "301(d) licensee") and an SBIC are generally subject to the same SBA rules and regulations. 13 C.F.R. § 107.1 (1980). However, a MESBIC is subject to different SBA capital requirements and expenditure restrictions. See notes 45-55 and accompanying text *infra*.

small businesses which produce and distribute motion pictures.⁸ This comment analyzes the advantages and disadvantages of using an SBIC to invest in motion picture production and distribution.

I. INDEPENDENT MOTION PICTURE FINANCING BEFORE THE TAX REFORM ACT OF 1976

Prior to the 1976 Tax Reform Act, motion pictures were excellent tax sheltered investments.⁹ Even a film which lost money at the box office could be a good investment because it yielded generous tax deductions. Typically, movie investors sheltered income through production service partnerships and negative pick-up transactions.¹⁰

In a production service arrangement, investors formed a limited partnership to produce a film for a distributor. The partners contributed only part of the production costs and paid the bal-

⁸ 43 Fed. Reg. 21,439 (1978). The SBA undertook the motion picture pilot program to explore "policy issues" surrounding SBIC specialization in motion picture financing. These issues include: the impact of SBIC financing on the independents; the use of federal funds in such a high risk industry; the effectiveness of different risk-reducing techniques available to SBICs; the impact of such a program on the SBA's budget; and the degree of control SBICs should exercise over the independents' operations. 42 Fed. Reg. 60,729, 60,729 (1977). The pilot program is scheduled to continue at least until June 1981, at which time the SBA will decide whether SBIC specialization in motion picture financing should continue. 43 Fed. Reg. 21,439, 21,440 (1978).

The SBA has selected six applicants to participate in the pilot program. The SBA will not accept any other applications until the pilot program ends. *Id.* To date, only two of the original six applicants have been officially licensed as movie specialists. If the pilot program proves successful, the SBA will permit other investors to form movie specialist SBICs.

⁹ A tax sheltered investment postpones or reduces one's tax liability. See generally Calkins & Updegraff, *Tax Shelters*, 26 TAX LAW. 493 (1973); Krane, *Economic Analysis of Tax Sheltered Investments*, 54 TAXES 806 (1976).

¹⁰ See generally Fass, *Motion Pictures as a Tax Shelter: A Current Analysis of the Technique and the Problems*, 40 J. TAX. 154 (1974); Dyke & Horeb, *What Do Airplanes, Railroad Cars, Beef Cattle, Motion Pictures, Real Estate and Oil Wells All Have In Common?*, 48 WIS. B. BULL. 63 (1975); Fass & Howard, *How to Use the Service Partnership to Enhance Motion Picture Tax Shelters*, 43 J. TAX. 15 (1975); Kanter & Eisenberg, *supra* note 2; Wienser, *Tax Shelters—A Survey of the Impact of the Tax Reform Act of 1976*, 33 TAX L. REV. 5 (1977); Comment, *Motion Picture Tax Shelters: Are the Funds at Risk?*, 28 AM. UNIV. L. REV. 177, 180-84 (1979).

ance of the partnership's expenses with a nonrecourse loan.¹¹ The partnership used both the partners' asset contributions and the face value of the nonrecourse note to compute its costs of production. These costs, in turn, became tax deductions¹² which passed through to the partners and reduced the partners' taxable income.¹³ The partnership received payments from the distributor over a long period of time, realizing income for tax purposes years after the film's production.¹⁴ Thus, a production service partnership provided investors with large tax deductions for the taxable year in which the partnership produced a film. In addition, investors could defer tax payments on income earned from film production.

In a negative pick-up transaction, investors formed a limited

¹¹ A nonrecourse loan is a debt for which the borrower is not personally liable in the event of default. Thus, a nonrecourse loan protected the general partners of a production service partnership from liability. In addition, a nonrecourse loan increased each limited partner's tax basis. See note 13 *infra*. When a production service partnership received a nonrecourse loan from a bank, institution or private lender, the distributor guaranteed repayment. See Wiesner, *supra* note 10, at 78-79.

¹² The production service partnership's costs of production were business expenses which became tax deductions when paid or incurred. See I.R.C. § 162(a).

¹³ The Internal Revenue Service does not treat a partnership as a taxable entity. I.R.C. § 701. Income passes directly through to the partners and the partnership itself is not taxed. *Id.* Similarly, a partnership's tax deductions and investment tax credits pass through to the partners. I.R.C. § 702 (1976 & Supp. II 1978). However, a partner may deduct partnership losses only to the extent of that partner's adjusted basis in the partnership. I.R.C. § 704(d) (1976). "Basis" represents the amount of capital investment the partner has in the partnership. See Lyon, Bartlett, Holmes & Donald, *Depreciation: Basis, Useful Life, Salvage*, 62-5th TAX MANAGEMENT (BNA) A-24 (1980).

A production service partnership paid its production costs with a nonrecourse loan in order to increase the tax basis of each limited partner. The Internal Revenue Service permitted both limited and general partners to deduct their proportionate share of a partnership's expenses which had been paid with a nonrecourse note. See Treas. Reg. § 1.752-1(e) (1979). If the partnership used a recourse note, however, the loan increased the tax basis of only the general partners. *Id.* See Kanter & Eisenberg, *supra* note 2, at 100; Wiesner, *supra* note 10, at 6-7.

¹⁴ A partnership operating a production service company used the cash method of accounting. This permitted the partners to: (1) deduct production costs in the taxable year in which the partnership incurred the costs; and (2) not realize income until the year in which the income was received. Treas. Reg. § 1.446-1(c)(1)(i) (1979).

partnership to purchase a completed film. The partners provided a cash down payment when buying the motion picture and covered the balance of the film's purchase price with a nonrecourse loan.¹⁵ The partners then contracted with a distributor to have the film exhibited. The primary tax sheltering benefit of a negative pick-up transaction was that partners deducted the film's depreciation from their taxable income. Since the partners included the nonrecourse indebtedness in computing the film's basis, the partners enjoyed tax deductions which greatly exceeded their cash down payment.¹⁶

The Tax Reform Act of 1976 substantially reduced the tax sheltering advantages of production service partnerships and negative pick-up transactions. The Act limits deductions to the amount for which a noncorporate taxpayer is "at risk."¹⁷ Since

¹⁵ The partnership pledged the film copyright and negative as collateral for the nonrecourse loan. Fass, *supra* note 11, at 154.

¹⁶ The cost or other basis of an asset represents the limit to which a taxpayer may take depreciation deductions on that asset. Treas. Reg. § 1.167(a)-1 (1979). Thus, increasing the basis of a film increases the total amount of depreciation deductions which the owners of the film may claim.

If a partnership were to pay the fair market value for a film, the taxable income received from the film's rental would greatly offset the film's depreciation deductions. Thus, in order to maximize depreciation deductions and thereby make a negative pick-up transaction an effective tax sheltered investment, partnerships purchased films at prices substantially above the films' real market value. S. REP. No. 938 (pt. 1), 94th Cong., 2d Sess. 72, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3508.

¹⁷ I.R.C. § 465 (1976 & Supp. II 1978). The "at risk" rule applies to: (1) individuals, (2) electing small business corporations and (3) corporations in which five or fewer individuals control more than fifty percent of the outstanding stock. I.R.C. § 465(a) (Supp. II 1978). The "at risk" rule does not prohibit a corporation (or a corporate partner) which is neither a Subchapter S corporation nor a corporation with five shareholders who control fifty percent of the stock from using nonrecourse debt to create loss deductions. See H.R. No. 1515, 94th Cong., 2d Sess. 412 X.1, *reprinted in* [1976] U.S. CODE & AD. NEWS 4118, 4124; Fass & Howard, *Motion Picture Investments Adversely Affected by TRA but Opportunities Remain*, 46 J. TAX. 140, 140 (1977). Since a corporation's tax deductions usually do not pass through to shareholder, the corporation's shareholders may not use the deductions to offset their own personal income. However, deductions can be used to offset a corporation's (or a corporate partner's) taxable income.

Recent revenue rulings suggest that the Internal Revenue Service will restrict corporate and noncorporate investors from using nonrecourse debt to compute loss deductions if the investors finance a picture through a production service partnership or a negative pick-up transaction. The IRS has held that a

nonrecourse debt does not put a taxpayer "at risk," noncorporate taxpayers may no longer deduct partnership expenses paid with nonrecourse financing.¹⁸ If a partnership finances motion pictures with nonrecourse loans, film production costs and film depreciation will not provide inflated tax deductions to noncorporate partners. Investors may deduct partnership losses to the extent of actual investment.¹⁹ They may also claim an investment tax credit.²⁰ Nevertheless, despite these tax

production service partnership has "none of the incidents of ownership" in the films that it produces. The distributor owns the films and is the true borrower of the nonrecourse loans for income tax purposes. The partners of the production service partnership, therefore, may not use the nonrecourse debt to compute deductions. Rev. Rul. 77-125, 1977-1 C.B. 130. The IRS has also held that partners in a negative pick-up transaction may not use a nonrecourse note to compute film depreciation if the partners fail to show that the film's market value approximates the amount of the nonrecourse loan. Rev. Rul. 77-110, 1977-1 C.B. 58. Unless partners can purchase a film at a price substantially above the film's real market value, a negative pick-up transaction is not effective as a tax shelter. See note 16 *supra*. Thus, the IRS may prohibit even a widely-held corporation from using either a production service partnership or a negative pick-up transaction as a tax sheltered investment.

¹⁸ Taxpayers are not considered "at risk" if they are protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. I.R.C. § 465(b)(4).

¹⁹ The Tax Reform Act requires investors to amortize film production costs. I.R.C. § 280 (1976 & Supp. II 1978). One of the tax benefits of the service partnership was that production costs became tax deductions in the taxable year in which the costs were incurred. Thus, a partnership which paid all of its production costs as soon as it produced a film created large tax deductions for the partners. See notes 11-14 and accompanying text *supra*. The Tax Reform Act's amortization rule permits investors to deduct film production costs only in proportion to income received. I.R.C. § 280(b). The amortization rule applies to individuals, Subchapter S corporations, personal holding companies, and foreign holding companies. I.R.C. § 280(a) (Supp. II 1978). However, investors may have to amortize film production costs whether or not the investors are subject to the Tax Reform Act's amortization rule. See H. R. REP. NO. 658, 94th Cong., 2d Sess. 64, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 2897, 2958.

²⁰ An investor may claim an investment tax credit: (1) if the film is new and is intended for public entertainment or for educational purposes; and (2) only to the extent that the investor has an "ownership interest" in the film. I.R.C. § 48(k)(1)(A). An investment tax credit permits film investors to reduce the income tax they owe by an amount equal to as much as ten percent of the motion picture investments they made during the year. For a more detailed discussion of motion picture investment tax credits, see Fass & Howard, *supra* note 17, at 142-44; Wiesner, *supra* note 10, at 80.

benefits and recent attempts to circumvent the "at risk" rule,²¹ noncorporate investors no longer find motion pictures attractive tax shelters.²²

After the 1976 Tax Reform Act, noncorporate motion picture investors can only afford to finance films which turn a profit. In a field as speculative as the motion picture industry, however, it is difficult to predict whether a film will be successful.²³ A diverse portfolio of film investments increases the likelihood that one film will do well enough to cover the losses from the others. Investors must finance several pictures in the hope of realizing a net profit.²⁴

Even though the film industry is experiencing a healthy boom,²⁵ the major film companies have not substantially increased film production.²⁶ Thus, opportunities exist for independent motion picture producers and distributors. Investors who wish to finance independent film producers and distributors should not overlook the potential advantages of forming and operating as an SBIC.

²¹ For a discussion of some of the tax sheltering strategies designed to circumvent the "at risk" rule, see Comment, *supra* note 10.

²² *Id.* at 204. In response to the Tax Reform Act, many independent film producers have begun making films abroad in order to attract foreign production capital. Many countries offer producers subsidies and prize money. See Hoffman, *supra* note 1; Grover, *supra* note 2; Kanter & Eisenberg, *supra* note 2, at 109-12. However, it is often difficult for American producers to qualify for receipt of foreign capital. In Canada, for example, a picture must include a Canadian costar, a Canadian director or producer, and a Canadian crew while 75 percent of the film's processing and post-production costs must be paid in Canada. Grover, *supra* note 2. In addition, the declining value of the dollar makes foreign film production less attractive, foreign backgrounds are not suitable for films requiring authentic U.S. scenery and there are complaints that many of the studios and technical personnel abroad are not on par with Hollywood's. *Id.*

²³ Prior to the 1976 Tax Reform Act, as many as seven out of ten motion pictures lost money at the box office. See Grover, *supra* note 2.

²⁴ See ECONOMIST, *supra* note 2, at 86.

²⁵ *Id.* at 85-86. This increase in demand appears to result from several factors: people are attending movie theatres more often and are paying higher prices; there is a growing television market for films; and the licensing of ancillary rights to tee shirts, soundtrack albums and posters is becoming more popular. *Id.*

²⁶ The "majors" presently produce and distribute only a few expensive films calculated to bring huge grosses. ECONOMIST, *supra* note 2, at 88; Lindsey, *Hollywood's Gamble on Big Hits—Fewer Movies and Empty Theaters*, N.Y. TIMES, Jan. 27, 1977, at 37.

II. INDEPENDENT MOTION PICTURE FINANCING THROUGH A SMALL BUSINESS INVESTMENT COMPANY

An SBIC is a privately owned and operated, money-making enterprise which is licensed, regulated and financed by the Small Business Administration.²⁷ To become an SBIC, investors must apply for an SBIC license either as a corporation or as a limited partnership with a sole corporate general partner.²⁸ The corporation or limited partnership must be "organized and chartered or otherwise existing under state law."²⁹ In addition, the articles of incorporation or of partnership must contain certain provisions³⁰

²⁷ Individuals, partnerships, corporations, insurance companies, and other entities may purchase the shares or limited partnership interests of an SBIC. See Comment, *The Small Business Investment Act of 1958*, *supra* note 8, at 148. However, if the sale of an SBIC's shares or partnership interests may result in a transfer of control over the SBIC, the SBA must first approve the sale. 13 C.F.R. § 107.701(a) (1980).

The purchase of a limited partnership interest in an SBIC must not entail any purchase or option to purchase a security of the SBIC's corporate general partner. Otherwise, the IRS will refuse to rule that the limited partnership SBIC will be taxed as a partnership. Without this IRS letter ruling, the SBA will not fund a limited partnership SBIC. See note 50 *infra*.

National banks, other member banks of the federal reserve system and non-member insured banks to the extent permitted under state law may purchase shares in a corporate SBIC. See 15 U.S.C. § 682(b) (Supp. II 1978). The market for a corporate SBIC's stock is improved by the fact that SBIC shareholders are entitled to take an ordinary loss on their shares. See notes 79-83 and accompanying text *infra*.

For a detailed discussion of an SBIC's obligations under the securities laws, see generally Lese & Rotberg, *Small Business Investment Companies and the Federal Securities Laws*, 20 FED. B.J. 343 (1960); Note, *The Regulation by the Investment Company Act of 1940 of Small Business Investment Companies Established Under the Small Business Investment Act*, 46 MINN. L. REV. 143 (1961); Conwill, *Protection or Oppression? The Investment Company Act Impact on the Publicly Held SBIC*, 19 BUS. LAW. 345 (1964); Turner, *SBICs, MESBICs and Conflicts of Interest*, 36 FED. B. J. 185 (1977).

²⁸ 15 U.S.C. § 681(a) (1976); 13 C.F.R. § 107.3, 107.4 (1980). After being licensed as an SBIC, a corporation may reorganize as a limited partnership SBIC if the SBA approves the reorganization. 13 C.F.R. § 107.4(f) (1980). Similarly, a limited partnership SBIC may reorganize as a corporate SBIC with SBA approval. *Id.*

²⁹ 15 U.S.C. § 681(a) (1976). The Small Business Investment Act does not specify the minimum number of shareholders or limited partners needed to form an SBIC. Nevertheless, the enterprise must conform to state law, and some states mandate that an enterprise have a minimum number of investors.

³⁰ The articles must specify in general terms that the enterprise is to carry out the purposes of the Small Business Investment Act for at least thirty years

and must be approved by the SBA.³¹ Finally, investors must satisfy certain capital requirements.³²

Once licensed as an SBIC, the enterprise selects and finances a portfolio of small businesses.³³ The SBIC may purchase shares or limited partnership interests in the concerns,³⁴ issue long-term loans to the concerns,³⁵ or guarantee loans that the concerns receive from third parties.³⁶

An SBIC may also provide management and technical assistance to a small business even when the concern is financed by the SBIC.³⁷ An SBIC may assess a fee for such services.³⁸ Thus, an SBIC may become involved in the day-to-day operations of

unless sooner dissolved by its shareholders or partners. 15 U.S.C. § 681(a), (b) (1976). In addition, the articles must specify the enterprise's name, areas of operation, principal place of business, and amount and classes of capital stock. 15 U.S.C. § 681(b) (1976).

Investors forming a limited partnership must further stipulate that the corporate general partner is organized under state law for the single purpose of serving as the sole general partner of the SBIC. 13 C.F.R. § 107.4(b) (1980). The articles of partnership must also state that the sole corporate general partner may not be removed or replaced by the limited partners without written SBA approval. *Id.*

³¹ 15 U.S.C. § 681(b), (c) (1976).

³² See notes 49-51 and accompanying text *infra*. Before the SBA issues a license, it considers "all relevant factors." These factors include: the need and availability of small business financing in the region where the SBIC will operate, the general business reputation and character of the proposed SBIC owners and management, and the SBIC's probability of success. 15 U.S.C. § 681(c) (1976).

³³ The SBA defines a "small business" as an enterprise which: (1) is independently owned and operated, (2) is not "dominant" in the motion picture industry, (3) does not have a net worth greater than \$6,000,000 and (4) does not have an average net income greater than \$2,000,000. See 15 U.S.C. §§ 632, 662(5) (1976 & Supp. II 1978); 13 C.F.R. §§ 107.3, 121.3-11 (1980). See generally Garrett, *Small Business Concerns and Small Business Investment Companies*, 20 FED. B.J. 318 (1960); Davidson, *What Is "A Small Business Concern" Under the Small Business Investment Act of 1958?*, 20 FED. B.J. 332 (1960).

³⁴ 15 U.S.C. § 684 (1976); 13 C.F.R. § 107.302 (1980). A corporate SBIC does not pay tax on the dividends it receives from the small businesses. See notes 84-85 and accompanying text *infra*. In addition, a corporate SBIC may treat a loss on the small business shares as an ordinary loss. See notes 79-83 and accompanying text *infra*.

³⁵ 15 U.S.C. § 685 (1976); 13 C.F.R. § 107.401 (1980).

³⁶ 13 C.F.R. § 107.501 (1980).

³⁷ See 15 U.S.C. § 687(b) (Supp. II 1978); 13 C.F.R. § 107.601 (1980).

³⁸ *Id.*

the enterprises in which it invests.³⁹

An SBIC may invest part of its funds in small businesses which produce and distribute films. However, an SBIC may not invest more than one-third of its portfolio in motion picture financing unless authorized to do so under the SBA's motion picture pilot program.⁴⁰ If authorized, the SBIC is classified as a "movie specialist."⁴¹

SBICs invest in film production and distribution in the same way as they invest in other types of small businesses. An SBIC selects, finances and manages a portfolio of motion picture enterprises. When an SBIC finances or manages a concern which produces a film, the small business hires actors and directs, photographs and edits the motion picture. Similarly, if a small business distributes a film, it oversees the production of prints, handles advertising and promotion, and arranges the exhibition of the picture.

To discourage a small business from producing or distributing a film which the SBIC does not consider commercially viable, the SBIC may insert certain conditions into its financing agreement with the small business.⁴² For example, the SBIC may require a producer or distributor to show that the expenditures and cast of future films will be comparable to a prior picture financed with the SBIC's funds.⁴³

Motion picture investors must decide whether the benefits of

³⁹ An SBIC, however, may not acquire permanent "control" over a small business. See 13 C.F.R. § 107.901 (1980). "Control" is defined as the power to direct the management and policies of an enterprise through management agreements, voting trusts, majority representation on the board of directors, etc. 13 C.F.R. § 107.901(a) (1980). An SBIC may acquire temporary "control" over a concern if necessary to protect the SBIC's investment. 13 C.F.R. § 107.901(c) (1980).

⁴⁰ 13 C.F.R. § 107.101(c)(1) (1980); 42 Fed. Reg. 60,729 (1977).

⁴¹ 42 Fed. Reg. 60,729, 60,729 (1977).

⁴² An SBIC may provide equity financing to a film producer or distributor "in such manner and under such terms as the [SBIC] may fix in accordance with the regulations of the [Small Business] Administration." 15 U.S.C. § 684(a) (1976). Similarly, an SBIC is free to negotiate the terms of a loan to a producer or distributor as long as the terms do not contradict SBA regulations. See 15 U.S.C. § 685(a) (1976). A movie specialist SBIC must submit its prototype financing documents to the SBA for approval. 43 Fed. Reg. 21,439, 21,441 (1978).

⁴³ A movie specialist may not force a small business to enter into tying, reciprocal or other restrictive arrangements with major film production or distribution companies. 43 Fed. Reg. 21,439, 21,441 (1978).

forming as SBIC outweigh Congressional and SBA restrictions. If investors wish to form an SBIC, they must also decide whether to organize as a corporation or as a limited partnership with a sole corporate general partner. In order to make these decisions, film investors should compare the characteristics of corporate and limited partnership SBICs with the characteristics of corporations and limited partnerships.⁴⁴ Specifically, motion picture investors should examine these factors: the funding available from the SBA, the degree to which investors are exposed to personal liability, the investors' managerial role and the income tax consequences.

A) Financing

Government financing is perhaps the biggest advantage of the SBIC program. The funding permits investors to finance more films which, in turn, increases the likelihood of producing or distributing a profitable picture.⁴⁵ The Small Business Administration finances an SBIC by purchasing or guaranteeing the SBIC's subordinated debentures.⁴⁶ Normally, the SBA may purchase or guarantee debentures worth up to either 300 percent of an SBIC's combined paid-in capital and paid-in surplus or \$35,000,000, whichever is less.⁴⁷ However, the SBA will purchase

⁴⁴ Motion picture investors normally consider the investment characteristics of five entities: the corporation, the limited partnership, the general partnership, the unincorporated association and the loan transaction. See Jacobson, *Independent Motion Picture Production—Choice of Production Entity*, 9 J. BEVERLY HILLS B. ASS'N 33 (March/April 1975).

⁴⁵ See notes 23-24 and accompanying text *supra*.

⁴⁶ 15 U.S.C. § 683(b) (1976). A subordinated debenture is a promissory note or bond for which the debtor is liable after paying other creditors. Debentures purchased or guaranteed by the SBA are subordinated to debenture bonds, promissory notes or other obligations which an SBIC issues to private creditors. See 15 U.S.C. § 683 (1976 & Supp. II 1978).

A limited partnership SBIC may issue nonrecourse debentures to the SBA. 13 C.F.R. § 107.4(e) (1980). For a discussion of the liability implications of the SBA nonrecourse financing, see notes 56-61 and accompanying text *infra*.

⁴⁷ 15 U.S.C. § 683(b)(1) (1976). "Paid-in capital and paid-in surplus" does not include capital provided by the SBA or borrowed funds. 13 C.F.R. § 107.3 (1980).

The SBA may purchase preferred securities from a MESBIC as well as purchase or guarantee a MESBIC's subordinated debentures. See 15 U.S.C. § 683(c) (Supp. II 1978). If the MESBIC has a combined paid-in capital and surplus of less than \$500,000, the SBA may purchase or guarantee debentures

or guarantee debentures issued by a movie specialist SBIC only up to 300 percent of paid-in capital and surplus or \$5,000,000, whichever is less.⁴⁸

To protect itself as a creditor, the Small Business Administration places various restrictions upon the financing of an SBIC. For example, the SBA requires that an SBIC have a paid-in capital and paid-in surplus of at least \$500,000.⁴⁹ The corporate general partner of a limited partnership SBIC must also meet a separate net worth requirement.⁵⁰ Investors may find these capi-

worth up to 300 percent of the MESBIC'S capital value. If the MESBIC has more than \$500,000, the SBA may purchase or guarantee debentures worth up to 400 percent of the MESBIC'S paid-in capital and surplus. See 15 U.S.C. § 683(c)(2) (1976).

⁴⁸ 43 Fed. Reg. 21,439, 21,441 (1978). The SBA may purchase debentures worth up to 300 percent of a movie specialist MESBIC'S paid-in capital and paid-in surplus or \$35,000,000, whichever is less. *Id.*

⁴⁹ 15 U.S.C. § 682(a) (Supp. II 1978). A MESBIC is also subject to the \$500,000 paid-in capital and surplus requirement. However, an SBIC or MESBIC licensed before October 1, 1979 must have at least \$150,000 in paid-in capital and surplus. In all cases, nevertheless, the SBA may require an SBIC or MESBIC to have more paid-in capital and surplus if need to properly and profitably operate the SBIC or MESBIC. *Id.*

⁵⁰ The SBA will not finance a limited partnership SBIC or MESBIC until the enterprise receives an IRS ruling that the SBIC or MESBIC will not be treated as an association taxable as a corporation. 13 C.F.R. § 107.201(a)(1) (1980). Before a letter ruling will be issued, however, a limited partnership must meet several IRS requirements:

- 1) if the total contribution to the partnership is less than \$2,500,000, then the net worth of the corporate general partner must be at least fifteen percent of the contribution or \$250,000, whichever is less;
- 2) if the total contribution to the partnership is more than \$2,500,000, then the net worth of the corporate general partner must be at least ten percent of the contribution;
- 3) the limited partners may not own more than twenty percent of the stock of the corporate general partner or any affiliate;
- 4) the purchase of a limited partnership interest may not entail either a mandatory or discretionary purchase or option to purchase a security of the corporate general partner or its affiliate; and
- 5) the organization and operation of the limited partnership is in accordance with applicable state statutes.

Rev. Proc. 72-13, 1972-1 C.B. 735; Rev. Proc. 74-17, 1974-1 C.B. 438. Current fair market value is used in computing the net worth. *Id.* In addition, the corporate general partner's interest in the limited partnership is not included in the net worth evaluation. *Id.* Thus, a corporate general partner must maintain a substantial net worth in order to receive an IRS letter ruling and SBA fund-

tal requirements difficult to meet, particularly the capital requirements for a limited partnership SBIC.⁵¹

The SBA also restricts how an SBIC may use its federal funding. For example, an SBIC may not finance the production and distribution of films abroad.⁵² Further, a movie specialist may not finance the production and distribution of "X-rated" films⁵³ or films "having a predominant theme of a political or religious nature."⁵⁴ Finally, the SBA severely restricts the amount of

ing. For example, a corporate general partner would have to have a net worth of at least \$150,000 in order to manage a limited partnership SBIC with a total contribution of \$1,000,000. If delay in obtaining the IRS ruling causes hardship to an SBIC, the SBA may provide some interim financing pending receipt of the ruling. 13 C.F.R. § 107.201(a)(1) (1980).

For a discussion of the tax issues facing a corporation which is the sole general partner of a limited partnership, see generally Note, *The Corporation as Managing Partner in a Limited Partnership*, 55 N.D. L. REV. 271, 272-73 (1979); Stein, *Partnership Taxation for the Limited Partnership with a Corporate General Partner—It Can Be Done*, 25 U. MIAMI L. REV. 435, 436-40 (1971); Comment, *The Limited Partnership with a Corporate General Partner—Federal Taxation—Partnership or Association?*, 24 Sw. L.J. 285 (1970); Note, *Tax Classification of Limited Partnerships: The IRS Bombs the Tax Shelters*, 52 N.Y.U.L. REV. 408 (1977).

⁵¹ Financing a limited partnership SBIC or MESBIC is further complicated by the SBA requirement that the idle funds of a corporate general partner and of an SBIC enterprise be deposited in obligations guaranteed by the United States, deposited in a bank or invested in certificates of deposit. 13 C.F.R. §§ 107.4(d), 107.808 (1980). The assets which the corporate general partner maintains to satisfy IRS net worth requirements may be considered "idle funds." Thus, assets contributed to the corporate general partner may have to be converted into cash, thereby possibly subjecting the seller of the assets to a capital gains tax.

⁵² The SBA generally prohibits an SBIC or a MESBIC from financing a small business if the funds will be used outside the United States. However, SBA funds may be used in the foreign branch operations or in a foreign subsidiary of a domestic small business. See 13 C.F.R. § 107.1001(e) (1980).

⁵³ 43 Fed. Reg. 21,439, 21,441 (1978). A movie specialist SBIC or MESBIC must require a small business to: (1) not distribute X-rated films with SBA funds; and (2) edit all films produced with SBA funds in such a manner that the film will not be classified as X-rated.

Under the motion picture industry's voluntary classification program, a picture with an X-rating usually connotes a high degree of violence or sexual content. See generally Friedman, *The Motion Picture Rating System of 1968: A Constitutional Analysis of Self-Regulation by the Film Industry*, 73 COLUM. L. REV. 185 (1973); Harmetz, *Movie Ratings—Too Much of a Mystery?*, N.Y. TIMES, May 3, 1978, at C17.

⁵⁴ 43 Fed. Reg. 21,439, 21,441 (1978). Unfortunately, the SBA has not yet defined what constitutes a "political" or "religious" film.

money that an SBIC may invest in a single enterprise.⁵⁵

B) Liability

Limiting personal liability is an important consideration in speculative investments such as independent motion picture production and distribution. Like corporate shareholders and limited partners generally, the shareholders or limited partners of an SBIC are usually exempt from personal liability and risk only the amount of assets they contribute to the SBIC.⁵⁶ General partners, in contrast, are personally liable to partnership creditors.⁵⁷ Managing a heavily financed limited partnership SBIC may jeopardize all of a corporate general partner's assets.

In order to reduce the amount of assets which are vulnerable to creditors' claims, investors forming a limited partnership SBIC may want to choose a corporation which has few assets to serve as a managing general partner. Current federal tax guidelines, however, require that a sole corporate general partner in a limited partnership arrangement maintain a separate net worth of between ten and fifteen percent of partnership capital.⁵⁸ This

⁵⁵ An SBIC or MESBIC may not invest more than 20 percent of its combined private paid-in capital and paid-in surplus in a single producer or distributor. See 15 U.S.C. § 686(a) (1976).

The pilot program places special limitations on the amount of money a movie specialist may invest in a small business. A movie specialist SBIC may only finance up to 50 percent of a film's production costs, while a movie specialist MESBIC may finance up to 75 percent. In addition, movie specialist SBICs and MESBICs may not put more than 10 percent of their funds in preproduction financing. They also may not impair more than 25 percent of their private capital. 43 Fed. Reg. 21,439, 21,441 (1978). The funds a movie specialist uses to finance film production must be protected by insurance coverage standard in the film industry. *Id.*

⁵⁶ Shareholders are personally liable for a corporation's debts if creditors pierce the corporate veil. H. HEHN, *HANDBOOK OF THE LAW OF CORPORATIONS* 96-97 (1970). Similarly, limited partners are personally liable for partnership debts if they exercise impermissible "control" over the partnership. *UNIFORM LIMITED PARTNERSHIP ACT* § 7 reprinted in 6 *UNIFORM LAWS ANNOTATED* 561, 582 (1969) [hereinafter cited as U.L.P.A.].

⁵⁷ U.L.P.A. § 9. A general partner's liabilities include any wrongful acts or breaches of trust by the limited partnership towards third parties as well as all other partnership debts and obligations. *Id.*

⁵⁸ Rev. Proc. 72-13, 1972-1 C.B. 735, Rev. Proc. 74-17, 1974-1 C.B. 438. A limited partnership SBIC must meet these IRS net worth requirements in order to receive a ruling that the SBIC will be taxed as a partnership. Without such a ruling, the SBIC cannot receive SBA funding. See note 50 *supra*.

net worth requirement guarantees that a substantial amount of capital will be available to satisfy partnership debts.⁵⁹

The Small Business Administration offers some liability protection to the corporate general partner of a limited partnership SBIC. Normally, the SBA will turn only to the limited partnership's assets for repayment and will not seek repayment from the corporate general partner.⁶⁰ The SBA, in effect, provides limited partnership SBICs with nonrecourse financing.⁶¹ In terms of protecting the corporate general partner from personal liability, therefore, the SBA's funding is superior to recourse financing utilized by many other enterprises.

C) Control

The production and distribution of a motion picture demands constant managerial supervision. A motion picture investor may want to play an active role in managing the day-to-day activities of an enterprise. A shareholder can effectively manage a corporate SBIC if elected a corporate officer or director. Indeed, if an SBIC is organized as a close corporation, a shareholder may be permitted to exercise even more control over the enterprise.⁶²

In contrast, a limited partner normally forgoes the right to participate in a partnership's management in return for limited liability.⁶³ Nevertheless, the limited partners of an SBIC may be

⁵⁹ If an SBIC's corporate general partner did not have sufficient capital to meet reasonably anticipated business risks, creditors could pierce the general partner's corporate veil and hold its shareholders liable. *See* note 56 *supra*. Thus, the threat of creditors piercing the general partner's corporate veil as well as the IRS' net worth requirement will force investors to adequately finance an SBIC's corporate general partner.

⁶⁰ 13 C.F.R. § 107.4(e) (1980). The SBA may decide that a corporate general partner shall be liable for SBIC debts owed to the SBA. The SBA will make this decision before it purchases or guarantees the debentures of the limited partnership SBIC. *Id.*

The SBA may also require that the shareholders of the corporate general partner assume personal liability for the corporation's and the partnership's debts. However, such liability would become effective only if the shareholders violated SBA regulations. *See* 13 C.F.R. §§ 107.4(c), 107.701(e).

⁶¹ *See* note 11 *supra*.

⁶² In a close corporation, a shareholder may take a management role which resembles the role of a general partner in a partnership arrangement. However, the shareholders may become personally liable for managerial acts and omissions. *See, e.g.,* Cal. Corp. Code § 300(d) (West Supp. 1979).

⁶³ A limited partner who exercises "control" over the partnership business

able to exercise as much managerial supervision over the partnership as shareholders may exercise over a corporation. Acting as directors, officers and shareholders of the corporate general partner, limited partners can control the corporate general partner and influence partnership decisions. In some states, the limited partners may manage the partnership as officers and directors of the corporate general partner without forfeiting limited liability.⁶⁴ Federal tax guidelines, however, prevent one or two limited partners from dominating a sole corporate general partner since each limited partner may own no more than twenty percent of the corporate general partner's capital stock.⁶⁵

may be held liable as a general partner. U.L.P.A. § 7. The term "control" is ambiguous, and numerous commentators have attempted to define the term. See, e.g., Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969); Comment, *"Control" in the Limited Partnership*, 7 J. MAR. J. PRACT. & PROC. 416 (1974).

⁶⁴ In *Frigidaire Sales Corp. v. Union Properties, Inc.*, 88 Wash. 2d 400, 562 P.2d 244 (1977), limited partners were acting as corporate directors, officers and shareholders of a sole corporate general partner. The Washington Supreme Court held that the limited partners did not exercise "control" over the partnership as prohibited by section seven of the U.L.P.A. unless third parties mistakenly assumed that the limited partners were general partners and relied on the general liability of the limited partners. Similarly, in *Western Camps, Inc. v. Riverway Ranch Enterprises*, 70 Cal. App. 3d 714, 138 Cal. Rptr. 918 (1977), the court held that a limited partner who was also an officer, director and shareholder of the corporate general partner could not be held liable as a general partner unless the creditor relied on the limited partner's personal liability. See generally Note, *The Corporation as Managing Partner in a Limited Partnership*, *supra* note 50, at 283-87; Note, *Partnership: Liability of a Limited Partner Who Is an Officer, Director, and Shareholder of a Corporate Sole General Partner*, 31 OKLA. L. REV. 997 (1978); Note, *Corporations—Partnerships—Limited Partners Managing Partnership Affairs Through Control of a Corporate General Partner Are Personally Liable to Creditors Under Section 7 of the Uniform Limited Partnership Act Only When Their Actions Mislead the Creditors to Assume They Are Acting as General Partners*, 47 U. CIN. L. REV. 355 (1978).

Nevertheless, some courts hold limited partners liable as general partners if the limited partners control a sole corporate general partner. See *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (1975); Note, *Limited Partnerships—Limited Partners Who Control Corporate General Partner Are Subject to Personal Liability as General Partners*, 7 TEX. TECH. L. REV. 745 (1976).

⁶⁵ Rev. Proc. 72-13, 1972-1 C.B. 735; Rev. Proc. 74-17, 1974-1 C.B. 438. If a limited partnership SBIC does not meet this capital stock limitation, then it will not receive SBA funding. See note 50 *supra*. Similarly, if five or fewer individuals control the corporate general partner, then the corporate general

D) Tax Implications

The 1976 Tax Reform Act's "at risk" requirement made partnerships less attractive to noncorporate motion picture investors by limiting the amount of tax deductions which pass through to partners.⁶⁶ Nevertheless, limited partnership SBICs still offer investors some tax benefits. The limited partners of an SBIC may claim an investment tax credit as well as deduct SBIC losses to the extent of their actual contribution.⁶⁷ In addition, if the corporate general partner is not subject to the "at risk" rule, the corporate general partner may include the face value of SBA nonrecourse loans when deducting business expenses.⁶⁸ However, since a corporate general partner's sole function is the management of its limited partnership SBIC,⁶⁹ the only taxable income which these deductions will offset is income earned through the SBIC.

Unlike a partnership, a corporation is a separate taxpaying entity.⁷⁰ When a corporation distributes its profits in the form of dividends, the shareholders pay taxes on the dividends they receive. In effect, the IRS subjects corporate earnings to double taxation.⁷¹ This double taxation on a corporate SBIC will be al-

partner will be subject to the "at risk" rule. See note 17 *supra*.

⁶⁶ See notes 9-22 and accompanying text *supra*.

⁶⁷ See notes 19-20 and accompanying text *supra*. Tax credits must be applied to the taxable income of the portfolio company before being passed through to a movie specialist. However, a movie specialist and a small business may negotiate the tax credits if they wish. 43 Fed. Reg. 21,439, 21,441 (1978).

⁶⁸ See note 17 *supra*. To avoid the "at risk" rule, the corporate general partner must not be a Subchapter S corporation and five or fewer individuals must not control over 50 percent of the corporate general partner's outstanding stock. *Id.*

⁶⁹ 13 C.F.R. § 107.4(b) (1980).

⁷⁰ The IRS may tax a limited partnership as a corporation if the enterprise has more corporate characteristics than noncorporate characteristics. Treas. Reg. § 301.7701-3 (1979). The list of corporate characteristics includes: continuity of life, centralization of management, limited liability, and free transferability of interests. Treas. Reg. § 301.7701-2 (1979). Although a limited partnership with a sole corporate general partner closely resembles a corporation, the IRS will nevertheless rule that an enterprise will be classified as a partnership rather than as a corporation if certain conditions are met. See note 50 *supra*.

⁷¹ If a corporation elects Subchapter S, the enterprise functions as a partnership in that it will not be taxed as an entity. All income and losses of the corporation will pass directly through to the shareholders. See I.R.C. §§ 1371-79 (1976 & Supp. II 1978). Nevertheless, there are several drawbacks to elect-

leviated somewhat if the IRS does not apply the "at risk" rule.⁷² If not subject to the "at risk" rule, a corporate SBIC may include debentures sold to the SBA when computing the SBIC's tax deductions.

Several tax provisions encourage investors to form SBICs.⁷³ These provisions reduce the effects of a double tax on a corporate SBIC's earnings. Specifically, the measures: (1) treat a taxpayer's loss on an SBIC's stock as an ordinary loss,⁷⁴ (2) treat an SBIC's loss on an investment in a small business enterprise as an ordinary loss,⁷⁵ (3) give an SBIC a 100 percent deduction on dividend income,⁷⁶ (4) exempt an SBIC from payment of the personal holding company surtax⁷⁷ and (5) exempt an SBIC from payment of the accumulated earnings surtax.⁷⁸ Each of these provisions makes a corporate SBIC more attractive to motion picture investors. Each is considered in detail below.

ing Subchapter S for a corporate SBIC involved in motion picture production and distribution. A Subchapter S corporation may not derive more than 20 percent of its income from "passive" investments. I.R.C. § 1372(e)(5) (Supp. II 1978). "Passive investment income" is defined as "gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities." *Id.* Thus, to a corporate SBIC deriving a substantial amount of income from film royalties and rentals, the "passive investment income" limitation is a severe restriction. See Jacobsen, *supra* note 44, at 35. Another problem related to the "passive" investment limitation is that an SBIC derives much of its income from the receipt of dividends and interest on loans as well as from the sales and exchanges of stock and securities. See notes 33-36 and accompanying text *supra*. Finally, if a corporate SBIC elects Subchapter S, it is then subject to the "at risk" and amortization rules of the 1976 Tax Reform Act. See notes 17 & 19 *supra*.

⁷² See note 17 *supra*. Unless five or fewer individuals own more than 50 percent of an SBIC's share, the corporate SBIC will not be subject to the "at risk" rule. *Id.*

⁷³ See generally Young, *Tax Aspects of SBICs*, 21 BUS. LAW. 958 (1966); Sell & Kalupa, *How Tax Advantages Are Obtained from a Small Business Investment Company*, 14 J. TAX. 66 (1961).

⁷⁴ I.R.C. § 1242.

⁷⁵ I.R.C. § 1243.

⁷⁶ I.R.C. § 243(a)(2).

⁷⁷ I.R.C. § 542(c)(8).

⁷⁸ Treas. Reg. § 1.533-1(d) (1979). The IRS does not expressly exclude SBICs from an accumulated earnings tax. However, an SBIC may overcome the presumption that it has accumulated earnings and profits beyond its reasonable needs. To overcome this presumption, the SBIC must: (1) comply with the provisions of the Small Business Investment Act; and (2) "actively" invest in small businesses. See Treas. Reg. § 1.533(d) (1979).

Normally, one who sells corporate stock at a loss treats the sale as a capital loss.⁷⁹ In contrast, a taxpayer investing in the stock of a corporate SBIC treats losses arising from the stock's resale or devaluation as an ordinary loss.⁸⁰ Similarly, an SBIC may treat its loss on the stock it owns in a small business as an ordinary loss rather than as a capital loss.⁸¹ If an SBIC shareholder or SBIC enterprise realizes a gain in the resale of stock, the gain is treated as a gain from the sale or exchange of a capital asset.⁸² Since capital gains are taxed at lower rates than ordinary income, an SBIC shareholder and an SBIC enterprise have the best of both worlds: they may treat profits from the sale of stock as a capital gain or, if sustaining a loss, use the sale to offset ordinary income.⁸³

In addition to treating a loss on stock as a capital loss, a corporation normally takes an eighty-five percent deduction on the amount of dividends it receives from domestic corporations.⁸⁴ In contrast, all of the dividends which a corporate SBIC receives

⁷⁹ I.R.C. § 1211 (1976 & Supp. II 1978). Like a noncorporate taxpayer, a corporate taxpayer may offset capital gains with capital losses. However, a corporate taxpayer may not offset ordinary income with capital losses. I.R.C. § 1211(a). In a partnership, the sale or exchange of an interest in the enterprise is generally treated as a capital gain or loss, so a loss from the sale of a partnership interest may be used to offset capital gains. I.R.C. §§ 741, 751 (1976 & Supp. II 1978).

⁸⁰ I.R.C. § 1242. A shareholder of a "small business corporation" may also treat stock losses as an ordinary rather than as a capital loss. I.R.C. § 1244 (1976 & Supp. II 1978). However, a "small business corporation" is defined as a corporation which derives more than half of its gross receipts from sources other than "royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities." I.R.C. § 1244(c)(1) (Supp. II 1978). Thus, like a Subchapter S corporation, a small business corporation may find it difficult to specialize in motion picture distribution since a distributor's earnings come from the royalties and rents paid by exhibitors. *See* note 71 *supra*. The I.R.C. income limitations would also prohibit a small business corporation from becoming an SBIC since an SBIC's income is principally derived from investing in small businesses. *Id.*

⁸¹ I.R.C. § 1243.

⁸² I.R.C. §§ 1201, 1202 (Supp. II 1978).

⁸³ Under I.R.C. § 1242, only SBIC shareholders may claim an ordinary loss on the sale of SBIC stock. The partners in a limited partnership SBIC apparently may not treat the sale of a partnership interest as an ordinary loss. Rather, the partners must treat the sale of an interest in a limited partnership SBIC as either a capital gain or loss. *See* note 79 *supra*.

⁸⁴ I.R.C. § 243(a)(1).

from its investments are tax free.⁸⁵ Thus, the 100 percent dividend deduction given to corporate SBICs is a distinct advantage over the tax imposed on fifteen percent of the dividends received by other corporations.

The tax laws attempt to force corporations to distribute their earnings. The IRS imposes a personal holding company surtax on close corporations which receive certain types of investment and personal service income.⁸⁶ Similarly, a corporation may be subject to an accumulated earnings tax if it fails to distribute unneeded corporate assets.⁸⁷ Qualifying corporate SBICs,⁸⁸ however, are exempt from both the personal holding company surtax⁸⁹ and the accumulated earnings tax.⁹⁰ Exemption from these taxes permits a corporate SBIC to avoid paying dividends to shareholders thereby reducing the shareholders' taxable income. Further, the exemptions permit a corporate SBIC to increase its available working capital thereby allowing the SBIC to diversify its film investments.

CONCLUSION

The Tax Reform Act of 1976 effectively eliminated films as tax sheltered investments for the majority of motion picture investors. In order to be a good investment today, a film must make a profit. Because of the speculative nature of motion picture production and distribution, however, prudent investors must invest in a number of films in order to hope to realize a net profit. If investors form an SBIC (or a MESBIC), the Small Business Administration will provide the investors with the funding they need to finance more films. In return for government financing, the film investors must comply with various SBA cap-

⁸⁵ I.R.C. § 243(a)(2).

⁸⁶ I.R.C. §§ 541-547 (1976 & Supp. 1978).

⁸⁷ I.R.C. §§ 531-537 (1976 & Supp. 1978).

⁸⁸ In order to be exempt from the personal holding company surtax, a shareholder of the SBIC must not own, directly or indirectly, a five percent or more stock interest in a small business funded by the SBIC. I.R.C. § 542(c)(8). In order for an SBIC to avoid an accumulated earnings tax, the SBIC's funds must be properly reinvested. See note 78 *supra*.

A special exemption from the personal holding company surtax and the accumulated earnings tax does not affect a limited partnership SBIC since only corporations are subject to these taxes. See I.R.C. §§ 542(a), 532(a).

⁸⁹ I.R.C. § 542(c)(8).

⁹⁰ Treas. Reg. § 1.533-1(d) (1979).

ital requirements, expenditure limitations and control restrictions.

Once motion picture investors decide to form or participate in an SBIC, the investors' personal business objectives will mandate which type of SBIC enterprise the investors will wish to elect. A limited partnership SBIC, for example, is not taxed as an entity and passes deductions through to its partners. The limited partners of the SBIC may claim an investment tax credit and receive a pass through of some loss deductions. They are also protected from debt liability. The corporate general partner, if not subject to the "at risk" rule, may enjoy substantial tax deductions. In addition, the corporate general partner is protected from liability by SBA nonrecourse funding.

A corporate SBIC, on the other hand, has less stringent start-up capital requirements than a limited partnership SBIC. Investors, as shareholders in the SBIC, may also have fewer problems exercising control over the SBIC and maintaining limited liability. While a corporate SBIC must contend with double taxation, generous tax incentives and possible exemption from the "at risk" rule substantially reduce the tax burden.

If organized as a limited partnership or corporate "movie specialist," an SBIC will be free to maintain its entire portfolio in motion picture investments. Under the SBA's motion picture pilot program, however, a movie specialist may not obtain as much SBA funding as other SBICs and is subject to more stringent expenditure limitations. In addition, the SBA will not license new movie specialist SBICs until at least the middle of 1981. Nevertheless, whether or not an SBIC is organized as a movie specialist, the Small Business Administration's funding should prove quite attractive to motion picture investors and warrants their consideration.

Jeffery D. Holmes