1-1-1991

Legal Aspects of Cinematographic Production and Coproduction in Italy

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I. INTRODUCTION

This Article is intended to cover in a very general manner the legal aspects of film production in Italy. Much will be of a surprise to an American reader with a passing knowledge of the US film industry. For example, Italy (as in the majority of Continental European countries) views its national cinema as a cultural asset to be protected against foreign cultural imperialism, particularly American. To this end, a complex system of State subsidies supports the production of *Italian* films. In addition, Continental Europe tends

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to view a film as being the child of the director (and, to a lesser extent, of the other creative participants) rather than of the producer - hence, there exists the concept of moral rights, unknown in the US.

As will be seen, the protectionism of Continental European governments is on the increase in relation to the film industry. The new Cinema Bill in Italy is typical of the legal quagmire in which the European producer must manoeuvre.[1] Before looking at these problems, it might first be useful to examine the basic company law aspects of a producer's activities.

II. COMPANY LAW

A. General Discussion

As with most other business activities, a film production may be carried out by either an individual or a company. The choice is dependent upon several factors, including the extent to which the producer wishes to limit his liability, and the extent to which the tax laws favor one structure over the other. In practice, since producers seek to limit their personal liability as much as possible, films are produced by companies, rather than by individuals. The two corporate forms available in Italy which provide for limited liability are the Società per Azioni (S.p.A.) and the Società a Responsabilità limitata (S.r.l.).

Either an S.p.A. or an S.r.l. may be used to carry out most business activities, including film production, but the rules governing the creation and use of each are significantly different. These differences arise from the intended roles which the authors of the Civil Code foresaw for these structures. The S.p.A. was originally intended to be used for larger enterprises with a large number of shareholders. The S.r.l., on the other hand, was designed to be utilized by smaller entrepreneurs wishing to create a business enterprise and to limit their liability, but without losing their individuality within the structure.

These differences are reflected in various provisions of the Civil Code.[2] An S.p.A. has a minimum capitalization requirement of 200 million Lire, and may issue bonds to raise money on the public market. Furthermore, the shares of an S.p.A are intended to circulate freely and their transferability cannot be substantially impeded. Given the theoretical gap between the shareholders and the management of an S.p.A., the management is mandatorily subject to the close supervision of independent auditors ("sindaci").

On the other hand, an S.r.l. may be created with a minimum capitalization of 20 million Lire. The financing of the company is the sole responsibility of the participants and it may not issue bonds. The controls over the management

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[1] Draft Law No. 4325.

[2] Art. 2325 (S.p.A.) and Art. 2472 (S.r.l.).

are normally carried out by the S.r.l. participants themselves. Pursuant to Article 19 of the Decreto Legislativo of April 9, 1991 n° 127, an S.r.l is not obliged to appoint independent auditors unless it has either (i) a share capital of at least 200 million ITL (around $ 200,000); or (ii) a share capital of less than 200 million ITL, but at least two of the following limits are exceeded in two successive financial years:

(a) Asset value of at least 2 billion ITL after amortization and depreciation;
(b) Profits of at least 4 billion ITL deriving from sales and services rendered (net of any discount or VAT or other taxes);
(c) An average of at least 50 people employed during the financial year. Such independent auditors may be dismissed if the S.r.l does not exceed two of the above limits during two subsequent financial years.

Other differences concern the rules for the appointment of the Board of Directors, the holding of Board and shareholder meetings, the voting quorum, etc. Furthermore, these rules are more frequently mandatory for an S.p.A., while their application to an S.r.l. is more flexible.

Thus the choice between the two types of company for film production depends upon various factors. It should be borne in mind that what is often important to a producer is the image which he wishes to project: an S.p.A. indicates stability and financial weight. However, given its simpler structure and lower capitalization requirements, it is not unusual for Italian producers to operate through an S.r.l..

B. Structuring a Coproduction

With respect to coproductions, the participants, whether individuals or companies, may structure the coproduction as a jointly controlled company, or they may simply govern their relationship by contract. The latter course is invariably preferred.

1. The Contractual Relationship

The use of a contractual relationship certainly provides each coproducer with the greatest flexibility as to the contents and management of their joint venture. In a contractually-created coproduction, each participant retains its own identity and will only be responsible to third parties for liabilities arising out of agreements directly entered into by it.

Additionally, Italian law is flexible with respect to the choice of law and competent courts. Thus, Article 25 of the *Disposizioni sulla legge in generale*,[3] permits coproducers of different nationalities to choose the law which will

[3] The *Disposizioni* is a section of the Civil Code.

govern their contractual relationship. With respect to choice of competent courts, Article 2 of the Italian Code of Civil Procedure permits the parties to avoid the jurisdiction of Italian Courts and submit disputes to a court of the jurisdiction of their choice, if within the E.E.C. It is, of course, always possible to use arbitration to settle disputes if the parties so agree.

2. The Corporate Alternative

Given the small contribution of capital required by the Civil Code to create an S.r.l.,[4] and the limited formalities which must be complied with during the company's life time, the creation of a jointly controlled S.r.l. is a viable alternative for a coproduction structure with limited liability.

However, the use of an S.r.l. does have certain drawbacks. These result from the rather inflexible nature of corporate law with respect to the regulation of the relationship between the participants. In addition, producers are reluctant to go to the expense of setting up a separate production vehicle when the same end can be achieved by a simple contract. Only if the producers were keen to work together on several projects would this corporate alternative make sense.

III. TAXATION

A. Taxation of a Production Company

If a coproduction is effectuated through a jointly controlled company, there will only exist a single production company which will be taxed as a single corporate entity. If, on the other hand, a coproduction is carried out through a contractual arrangement, each participant will be taxed separately on the income attributable to it.

The fiscal regime which is applicable to a producer or coproducer will depend on its status as a taxpayer. A corporate coproducer with a permanent establishment in Italy would pay corporate income tax (IRPEG) at a flat rate of 36%. The corporate coproducer will also be subject to the so-called *imposta locale sui redditi* (ILOR) which is assessed at the flat rate of 16.2%. Since 75% of ILOR is deductible from taxable profits before the IRPEG is calculated, the combined rate of corporate income tax equals 47.8%. If the coproducer is an individual, he will be subject to a progressive income tax (IRPEF) with a maximum tax rate of 50%. The individual coproducer is also subject to ILOR, which is deductible from the income prior to the application of the IRPEF rates. Losses of both individuals and corporations may be carried forward for 5 years. There is no provision for loss carry-back.

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[4] Only three-tenths of the minimum capitalization requirement of 20 million Lira need be deposited in cash at the time of incorporation. *See* Civil Code, Art. 2329.

B. Criteria for Determining Taxable Income

The criteria for determining income and the rules governing the deduction or amortization of costs are set out in the *Testo Unico* (tax code) which became effective on January 1, 1988. These rules are generally the same for both individual and corporate taxpayers. The taxable income to the producer would consist of all amounts earned on the distribution and sale of film rights, including government subsidies and awards, less the costs incurred in the film's production. As a means of assisting and encouraging the film industry, the Italian tax law permitted a producer to exclude from its income up to 70% of earnings realized on a film, if such earnings were reinvested in the production of a new Italian film, or in coproductions in which the majority participation was Italian. If certain of the profits from a film were distributed, the 70% maximum was applicable only to the undistributed profits. To obtain this tax benefit, the producer had to submit an investment plan for the new film together with his tax return. The producer was also obliged to set forth an estimate of the dates of initiation and completion of the film and a financing program. The film had then be to commenced within a year after the submission of the relevant tax return and completed within 2 years of its commencement.[5] This tax break, however, was given a limited 5 year duration and is no longer in force. Several bills to reintroduce it are pending before Parliament, but the backlog is such that this tax shelter is yet to be re-introduced.

C. Amortization

Another interesting aspect of the fiscal regime with respect to the production of films concerns the amortization of the costs of production. A film is exploited economically over a period of time, and Italian fiscal legislation therefore provides that the costs of a production are not deductible in their entirety in the year in which they are incurred; instead, they may be treated as capital assets with a duration of 3 years. The Ministry of Finance has therefore established a 3 year period of amortization for theatrical films. In the case of films owned by television networks, either through in-house production or through purchase, the Ministry has provided that the 3-year amortization period is not applicable. Instead, the period of amortization is to be determined by the taxpayer using his prudent judgment to make the amortization period correspond to the longer period of economic exploitation, which is normal in the television market. When costs are incurred and the film is not completed, these costs can be amortized over a maximum period of 5 years in equal installments.

D. Tax Implications for International Productions

The regulations discussed above are applicable when the producer is Italian or has a permanent establishment in Italy. The tax issues become more

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[5] *See* Law of April 30, 1985, Art. 7, n. 163.

complicated when an international coproduction is involved and royalties generated by an Italian distributor are paid to a non-resident. Italy has concluded treaties for the avoidance of double taxation with most countries which have a certain economic influence in the world market. It is therefore necessary to examine the specific provisions of the applicable treaty to determine the treatment of royalties for any foreign resident. For example, the treaty executed with the United States,[6] which is of particular importance given the role of the U.S. in the film industry, provides that royalties are always taxable in the country of residence of the recipient. Royalties may also be taxed in the country where they are earned, but if the recipient is a resident of the other signatory country, the tax is not to exceed 8% of the gross amount of the royalties.

It should be noted that many production companies incorporate a Dutch B.V. as the vehicle for receiving royalty payments. Under the present Dutch-Italian Tax Treaty,[7] such royalties will not be taxed or any withholding made on their transfer. The Dutch B.V. would then normally transfer the royalties to a second company in a tax favourable jurisdiction (eg. the Dutch Antilles), which would be responsible for making the royalty payments to the producer. Under the new Dutch-Italian Tax Treaty, yet to come into force, a 5% withholding tax will be levied on royalties.

IV. COPYRIGHT LEGISLATION

A. Introduction

With regard to cinematographic works, Italian copyright law does not identify a single owner of the copyright, nor does the law simply identify a certain number of co-owners. Rather, the law distinguishes between *diritto morale* (moral rights), which belong to the film's creators, and the right to the economic exploitation of the film, which belongs to the producer.[8] The distinction between moral rights and economic rights is typical of the entire Italian copyright legislation and is not limited to film production. However, it is in the cinematographic field that this two level system creates the most problems.

The author who writes a book, the musician who composes a symphony, and the artist who completes a painting, possess both the economic and the

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[6] Treaty signed in Rome on April 17, 1984, and ratified by the Law of December 11, 1985, n.763.

[7] Treaty signed at The Hague on January 24, 1957, and ratified by the Law of June 18, 1960, n. 704.

[8] *See* the decision of the Court of Rome, November 23, 1983, *reported in* DIRITTO DELLE RADIODIFFUSIONI, 1984, at 571.

moral rights relating to the work produced. However, unlike the creators of a film, they usually control all the creative phases of the work. The situation is very different with respect to films. According to Art. 44 of the Copyright Act,[9] the art director, the music director, the writer of the screenplay, and the writer of the literary work on which the film is based are all considered "authors" of the film. However, they do not control the creation of the film in its entirety because the producer has certain rights to modify the contribution of the authors to meet his financial and marketing needs. On the other hand, the right of the author to protect his creative work from unauthorized modification is one of the most important components of the moral right. Consequently, it is not surprising to find that the most interesting problems of copyright law relating to film production concern the relationship between authors' and producers' rights.

B. Economic rights

Article 45 of the Copyright Act[10] states that "the exercise of the rights of economic utilization belong to the producer." These producer's rights are limited to the "cinematographic exploitation of the film produced."[11] The specific reference to "cinematographic exploitation" could be misleading as to the actual scope of the producer's rights. However, the current interpretation of the provision is that the producer's rights encompass television and probably video rights.[12]

The producer's economic rights only include exploitation of the film itself and do not extend to other ancillary means of economic exploitation of the work. For example, unless otherwise agreed between the parties, the producer does not have the right to independently exploit the screenplay or the soundtrack. These rights belong to the authors of the creative work, and may be exploited separately by them,[13] provided that the producer's rights are not thereby prejudiced. A producer is also prohibited from transforming the film into another medium of communication. This principle can be seen in a court decision which denied a producer the right to exploit a film in the form of a *fotoromanzo* (a published story recounted through pictures).[14]

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[9] Law of April 22, 1941, n. 633. [hereinafter Copyright Act].

[10] *Id.*

[11] *Id.* Art. 46.

[12] Although see the decision of Preture Rome, December 13, 1985, *reported in* 1986 IL DIRITTO DI AUTORE, at 208; 1985 TEMI ROMANA, at 984; and GIUR. ITAL. I, 2, 31.

[13] *See* Copyright Act, *supra* note 9, Art. 49.

[14] *See* App. Roma Oct. 10, 1957; 1958 IL DIRITO DI AUTORE, at 585.

The producer's rights to the economic benefit of the work extend for 50 years from the first projection of the film,[15] provided that the film is first shown within 5 years of the date of its completion. Otherwise the 50 year period begins to run from the year after the film's completion. This 50 year term was introduced in Italy in 1979 (previously the period of protection was limited to 30 years), in an attempt to adapt the Italian legislation to Article 7 (2) of the Bern Convention.[16] It has been noted, however, that the revised language of Article 32 of the Italian Copyright Act does not yet completely conform with the text of the Convention, which provides that the 50 year term will begin to run from the first public showing if the film is shown within 50 (and not 5) years from the date of its completion. However, since Italy has ratified the Convention, its provisions have become Italian law and would appear to be applicable, at least with respect to films produced in countries which have also ratified the Convention.

C. Diritto Morale

As mentioned above, Italian law considers a film to be the product of the joint efforts of at least four persons -- ie. the art director, music director, screenwriter, and author of the work on which the screenplay is based.[17] The author of the underlying work refers to the author of the original book, or, if the original material was adapted prior to the writing of the screenplay, it also refers to the author of the adaptation. This list is not exhaustive, and, in certain circumstances, may include other people. For example, in an animated film, it would include the designer of the characters.

These Authors have certain rights with respect to the film, including the right to recognition for their contribution and the protection of their interest in the integrity of the work.[18] The first right can be satisfied in a relatively simple manner by listing, in the film credits, the names of the authors and their role in the creation of the cinematographic work. The protection of each author's interest in the integrity of the work is somewhat more complex because it involves balancing the author's rights against the responsibility of the producer to ensure that the film will be completed for release on schedule. This balance is achieved by permitting the producer to modify the film only under certain circumstances, and providing the producer with greater flexibility to make changes during the production of the film as opposed to after its completion. According to articles 46 and 47 of the Copyright Act,[19] the producer may,

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[15] *See* Copyright Act, *supra* note 9, Art. 32.

[16] Paris Text, 1971.

[17] *See* Copyright Act, *supra* note 9, Art. 44.

[18] *See* Copyright Act, *supra* note 9, Art. 46.

[19] *See supra* note 9.

before the film is completed, modify the various contributions of the authors to the film, provided that such modifications are necessary for the economic exploitation of the film. An example of such a change would be the editing of a scene which might otherwise subject the film to a restrictive censorship.

The exercise by an author of his "moral rights" could lead to a dispute between the producer and one or more authors with respect to modifications to the film. If such a situation occurs, and the parties cannot resolve the dispute, the law provides for a government-appointed committee of technicians to determine whether the changes requested by the producer are necessary and therefore within his right to execute.[20] However, resort to this provision is rarely necessary. Once the film is completed, no changes may be made by the producer unless with the author's consent. To facilitate the ability of the producer to make changes, the law permits the authors to grant the producer, in advance, the right to modify the film even after its completion.[21] According to current legal opinion, however, even if such an agreement has been executed, an author always has the right to prevent modifications which would harm his honor or reputation.

The power of an author to protect his interest in the integrity of the work has even led several courts to find that excessive interruptions of a television film by advertisements may constitute harm to an author's moral rights. Such determinations are made on a case-by-case basis, taking into consideration various factors, including the type of film, its quality, and the frequency of the interruptions.[22] The new Television Law[23] introduces restrictions on the number of advertising breaks in films, drama and music programmes. These provisions become effective on 23 August 1991, except for such restrictions in relation to feature films which come into force on 1 January 1993. In conformity with EC Law,[24] the insertion of advertising is now permitted only in the normal breaks that would occur in a theatre or cinema. In addition, it will not be permitted to interrupt with advertising certain works of high artistic, religious or educational value, as selected by a commission.[25]

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[20] *Id.* Art. 47.

[21] *Id.* Art. 46.

[22] *See* the decision of Trib. Milano, Dec. 13, 1984; DIR. INFORMAZIONE ED INFORMATICA, 1985, at 231, with reference to Zeffirelli's Romeo and Juliet.

[23] Law of 6th August, 1990, n. 223.

[24] EC Directive 89/552/CEE.

[25] *See supra* note 23, Art. 8, para. 4.

D. Scope of the Italian legislation on Copyright.

In general the Copyright Law[26] applies to all works created by Italians anywhere in the world. However, with respect to cinematography, the law is restricted to the protection of works which are either created in Italy (Art. 189) or which are deemed "national," as defined with respect to eligibility for government benefits. The criteria for such eligibility are set out below. Furthermore, a person, whether or not Italian, will be entitled to seek the protection of the law for copyright violations in Italy, provided that the country where the film was produced offers reciprocal protection.[27]

V. SUBSIDIES AND OTHER BENEFITS FOR FILM PRODUCTION

To assist and promote the national entertainment industry, the Italian government has provided certain benefits to encourage film production. These benefits are limited to films designated as "national". The criteria for such designation are fairly restrictive.

A. Criteria for Receipt of State Benefits

The definition of a national film is set forth in Article 4 of Law No. 1213 of November 4, 1965 (as modified). This provision applies only to full-length films of more than 1600 meters and provides that national films must be filmed in the Italian language and filmed primarily in Italy. The producer must be of Italian nationality and carry out the majority of its business in Italy. If the producer is a company, its management must also be Italian. In addition to these requisites, the author of the underlying work, and/or screenplay, and the director, must be Italian. The law also requires that two thirds of the film's principal actors and three quarters of the film's secondary characters must be Italian; and that three quarters of the film's principal artistic, technical and executive personnel, and all of the remaining personnel, must be Italian.

A national film may be produced by an international coproduction provided that there exists a coproduction treaty with the country(ies) concerned and that an Italian national has at least a 30% participation (artistic, technical and financial) in the film being co-produced. This percentage participation may be exceptionally reduced (on a case-by-case basis) to 20%. Any State Aid granted will only be in relation to the Italian participation in the co-production. If the Italian participation is a minority participation, it must be real, not simply a facade to obtain Italian nationality.

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[26] *See supra* note 9.

[27] *See supra* note 9, Art. 185.

Apart from the nationality criterion, the only other requirement for qualification for certain State Aid is one of artistic quality/commercial potential.[28] In practice, the level of "artistic" quality required is very low. The commercial potential is more important. This is assessed through a review of the budget, contracts, quality of actors/director and the reputation and creditworthiness of the producer. This quality requirement is effectively imposed in order to protect the loan. To this end, certain other types of security are also sought: personal guarantees from the producer or his shareholders; an assignment of certain exploitation rights (often the Italian theatrical rights); and a completion bond. Nevertheless, the type of security required is often flexible according to the degree of trust in the producer.

B. Nature of State Benefits

Once the above hurdles are cleared, a producer is able to benefit from both:

> Reduced rate financing, eg. loans at an interest rate of 5.5%. Such loans are theoretically for up to 60% of the budget of the film, but such loans rarely exceed 40%.[29] Any loan must be repaid no earlier than 2 years and no later than 3 years from the date of the allocation of such funds;
>
> A premium amounting to 13% of the domestic gross box office receipts for 5 years from the date of the first public release of the film in Italy.[30]

In addition to these principal sources of financing, the State may also make specific grants for low budget/first films (so called Article 28 films). These awards are made every six months and consist of a lump sum (40 million lira) granted to no more than 10 Italian and 3 EEC films. Article 28 films may receive up to 80% of their budget on loan at the rate of interest of 4.5%. However, the contributors to the film must put up the remainder of the financing (ie. through deferred salaries).

Mention should also be made of the Obligatory Programme pursuant to which selected Italian and EEC films of artistic merit are placed on a list of films which must be shown in Italian cinemas for a specific period of time.[31] However, many exhibitors simply refuse to comply and the Programme is therefore of limited effect.

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[28] Titolo 2, Art. 8, of the Law of November 4, 1965, No. 1213.

[29] Law No. 819 of August 14, 1971.

[30] *See supra* note 28, Art. 7.

[31] *See supra* note 28, Art. 5.

C. New Proposals

The above system of State benefits and grants is due to be overhauled in the coming months once the proposed new Cinema Law[32] is enacted. At present the draft is the subject of intense lobbying, but the general outline is becoming clear. In particular, the 13% premium and Article 28 awards are to be abolished. The basic motives for this were that the 13% premium rewarded successful commercial rather than "quality" films, and that Article 28 projects were rarely released and, if released, rarely made a profit from which the State could recoup its investment. The new Law would make the award of State Aid more selective, providing for:

(i) reduced rate loans for up to 80% of a film's budget, repayment to be guaranteed by the State;

(ii) the annual selection of 25 projects to be funded for screenplay development.

(iii) the annual selection of 30 projects to receive a lump sum award in recognition of their particular artistic and cultural importance.

VI. QUOTAS

Article 26 of the Television Law[33] implements the EC Directive of 3 October 1989 (89/552/CEE). Article 26 provides that the following percentages of TV broadcast hours must be dedicated to *European* cinematographic works:

(a) not less than 40% during the first 3 years from the date of grant of the TV broadcast license (such grant to occur in the Autumn of 1991 - until now, the Italian TV industry has not been regulated);

(b) not less than 51% thereafter.

At least 50% of the time reserved to European works must be for *Italian* works, and at least one fifth of the latter must be films produced in the last 5 years.

The above is the clearest indication of the extent to which Europe is endeavouring to protect its film production industry by blocking the flood of American product which so many European broadcasters are keen to acquire.

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[32] *See supra* note 1.

[33] *See supra* note 23.

VII. CONCLUSION

The legislative context in which the Italian producer is required to work remains in a state of flux. The new draft legislation has been criticized for failing to take into account the relationship between TV and cinema.[34] It also fails to consider the implications of the growing home video market, satellite and cable. Above all, the possibility of 80% of a production budget coming from the State risks the development of a "welfare state" mentality amongst Italian producers. It also over-centralizes the industry and makes the possible abuse of the State's broad discretionary powers in granting such funds highly controversial. Only time will tell whether the Italian producer should celebrate or mourn in the face of the new legislation.

[34] For example, France requires that broadcasters pay a certain amount of their revenues toward the funding of the film industry, and UK broadcasters must commission a certain percentage of programming from independent producers.