15 January 2009

The Chairperson
Finance and Expenditure Select Committee
Parliament Buildings
WELLINGTON

Dear Sir

Submission on the New Zealand Screen Production Incentive Fund Tax Amendments in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill ("the Bill")

This submission is from the Screen Production and Development Association of New Zealand ("SPADA").

SPADA represents the interests of producers and production companies on all issues affecting the commercial and creative aspects of independent screen production in New Zealand.

We are willing to appear before the committee to present our submission if so required.

Submission recommendation

We recommend that the Screen Production Incentive Fund proposal included in Clause 69 of the Bill be amended to maintain the current treatment afforded to qualifying New Zealand productions. That is, to continue to permit a deduction for the film expenditure for such productions in the year of completion with no change to the current law. The current proposal would spread that deduction over 24 months.

We would note that our submission does not affect the deductibility of any expenditure met through a government screen production payment which will remain not deductible for tax purposes.

If our submission is not accepted, we recommend the implementation of that clause be deferred until the commencement of the 2010/11 tax year to avoid a backdated legislative change given producers have been operating under existing tax rules from 1 July 2008 when SPIF was introduced.

Background

The main purposes of the Income Tax Act are to:

- define and impose tax on, net income;
- to impose obligations concerning tax; and
- set out rules for calculating tax and for satisfying the obligations imposed.

Behind these purposes are key concepts that determine how income is recognised and how expenditure is treated.

Treatment of both income and expenditure has been determined by the courts and legislation.

A further key concept provided by the Income Tax Act is the capital/ revenue distinction. The criteria for this distinction has evolved over time through the courts and, with the concepts of income and expenditure, form the backbone of the Income Tax Act.

It is under these concepts that filmmakers are to determine their tax treatment (note in this submission our use of the term film and film makers related to films of all natures including television, but not including broadcasters, which mirrors the taxation provisions).

Under general principles, it would be considered that the making of a film involved expenditure of a capital nature on the basis that it resulted in the creation of a capital asset (from which licensing revenue would be derived). Expenditure under normal principles would not be deductible, unless the film was made with the intention of the outright sale of the underlying film rights (as opposed to the licensing of the film for viewing or sale).

However as the New Zealand film industry:

- has developed and evolved,
- as more films have been made, and
- given the fact that the vast majority of the income that will be received from a film will be received shortly after the film is completed (with very few being profitable beyond recoupment),

the application of standard principles to the film industry is not appropriate.

On the basis that the NZ film industry could not survive, or let alone prosper under such a classification, special film industry based rules for the deductibility of expenditure have been in place for some time (subject to minor modifications). The purpose of these rules was to allow filmmakers to immediately deduct the cost of producing films, in the same way as general business expenditure, but more beneficial than traditional capital expenditure (which is either depreciated over its useful life or not deducted at all). We outline a background of the New Zealand film provisions below.

On the other hand, the rules have also required that all revenue arising from films in whatever form is also taxable, such that outright sales of film rights which under normal rules would be capital in nature (and not taxable on disposal) are deemed taxable.

New Zealand treatment of film expenditure

The focus of our comments is in respect of qualifying New Zealand productions, given the income tax treatment of other productions are currently subject to either a two year or 24 month deduction rule (which can be accelerated to the extent of income derived). Thus the focus of the immediate deduction incentive is on New Zealand productions (which is the intended target of the SPIF grants).

Film production expenditure may be deducted in the income year the film is completed provided that the New Zealand Film Commission (NZFC) issues a final certificate that certifies the film is a New Zealand film.

Where Government grants are made in respect of the production of films the normal requirement is to reduce the amount of expenditure able to be claimed for tax purposes of an equal amount. Thus, the SPIF grant itself will not be assessable income nor will any expenditure on which the grant is spent be deductible income. For completeness, as is noted in the Commentary to the Bill this did not apply to Large Budget Screen Production Grants ("LBSPG"), which is being corrected in the Bill.

In addition to the immediate deduction incentive for tax purposes, the government introduced a LBSPG as another form of industry incentive targeting large value productions. The value of the grant is a refund of 15% of qualifying New Zealand expenditure, where such expenditure is at least $15m (subject to some additional bundling rules) in respect of films, television movie (drama) and television drama series or mini-series. Where a person is entitled to a LBSPG they are not entitled to the immediate deduction incentive.

In our experience the majority of organisations which are entitled to a LBSPG are not impacted by the removal of the immediate deduction rule. That is because they are non-resident film owners, who are either subject to the 2 year rule anyway, or they set up a special purpose New Zealand entity that is 100% funded from offshore. The deduction is therefore accelerated to being immediately deductible given it has matching income from the offshore film owner.

Screen Production Incentive Fund

As announced as part of the 2008 Budget the new Screen Production Incentive Fund ("SPIF") was introduced to support the production of "strong New Zealand-driven creative screen projects with significant levels of private and international finance" as was noted in the media release by Helen Clark, Minister of Arts, Culture and Heritage of 22 May 2008.

The Minister also noted "Internationally, competition for production finance is intense. Many major screen producing nations, including Australia, now operate a domestic incentive scheme similar to the new Fund. If New Zealand is to maintain and develop a strong domestic screen industry and keep our filmmaking and television talent here, we have to compete effectively."

The scheme will operate by providing a grant of 40% of the Qualifying New Zealand Production Expenditure (QNZPE) that an applicant has spent on an eligible feature film or a grant of 20% of the QNZPE that an applicant has spent on an eligible television or other format screen production. QNZPE will be a minimum of $4m for feature films and a maximum of $15m, with smaller thresholds for television.

While we consider the payment of these grants will achieve many of the aims noted by the Minister of the incentive scheme we consider that the proposed taxation amendment can create potential disadvantages to the filmmakers it is meant to support.

Tax Implications of SPIF Grant

The amendments contained in the Bill will mean that film owners will not be able to gain tax deductions for film production costs in the year of completion. Rather the proposal is that those deductions be spread over a 24 month period (which could be 3 tax years).

There are essentially two group of investors who are affected by these changes in approach, both of whom the SPIF grant is intended to encourage more investment in the industry, to match that put in by the Government.

The first are private investors who are investing their funds in the movie as an investment alone, and are not actively involved in its production. This group is extremely rare and in fact the New Zealand Film Commission advise only twelve New Zealand films have been made over the last eight years with private investment (jointly with NZFC funding) ranging from $50,000 to $1 million. Such investors commonly offset the film deduction against other

taxable deduction, both as a timing advantage and as a means of minimising the downside risk of the investment. This approach by investors is exactly the same as the tax treatment afforded to most other investments which produce a loss in the initial period i.e. expenditure is incurred in advance of revenue being derived.

The second are producers (of both film and television) who commonly will use income from other activities (such as the income being earned from prior productions) to fund their investment in the current production. They will offset the deduction available from the newly completed production against the income being earned from other sources. This is the same as any business where the income from one source (or product) is offset against expenditure from another source (or product).

We consider that, in general, those producers who will be applying for a SPIF grant will be involved in the production of a New Zealand film and therefore prior to this proposed amendment either they or their investors would be able to claim a deduction for the expenditure in "year one", for any expenditure which is not covered by government grants.

As such the current practise of film production expenditure offset against other taxable income is standard practise permitted by taxation legislation, and is not a special incentive.

Negative Cash Flow Implications/Extra Funding Costs

The SPIF has been provided out of the 2008 budget as an allocation of $68.5m over 5 years, of which $36m is new funding and $32.5m is a reallocation of funding from existing funding to the New Zealand Film Commission.

The reallocation of funds is important to consider. Currently these funds provided to a film will enable an immediate deduction for non-government grant expenditure. If these same funds are now recategorised as SPIF, the deferred deduction rule will apply (we acknowledge there are new funds in the pool to be allocated but a substantial portion have simply been recharacterised).

The key difference between historic NZFC funding and SPIF funding is the timing of the payments. Under current NZFC allocations, funding is provided during the course of the film's production. However, the SPIF grant will only be paid once the production is completed, and the Inland Revenue have verified the qualifying New Zealand expenditure. It is generally expected that payment will be made approximately 6 months after production has finished. As such, producers need to obtain funding to cover the cash flow deficit between when the money is spent during production and when the SPIF grant is eventually received. This funding cost is an additional burden on the total production costs, but is accepted by producers as a necessary cost to gain the SPIF grant.

If the Bill is passed in its present form, then in addition to the issue of a production being required to fund the SPIF (as the cash flow will not be received until approximately 6 months after production is completed), but it also creates the additional issues of

- Failure to attract private investors who were attracted by the tax offset of film production expenditure against other sources of income; or
- The need for the producer to fund the taxation cost as they will not be able to offset the film production expenditure against their other income (as other businesses would do) i.e. a deduction for expenditure will not arise until after the expenditure has been incurred creating a cash flow deficit.

As such a filmmaker needs to divert cash away from other projects in order to fund both the SPIF grant and the tax liability that arises from the delayed tax deduction. Current base rates for a business loan (unsecured) is 11.95% (even taking into account recent interest reductions, although this rate would generally not be available to a film production given its risk and would be significantly higher). Specifically for filmmakers the interest rate from film financiers is approximately 17%.

It is important to note again, that expenditure which is funded by the SPIF and other government grants will not be deductible anyway. The issue we are concerned with is the deductibility of other expenditure not covered by government grants in whatever form.

Illustrative example

We attach as an appendix to this letter an example of the cash flow implication that a combination of the SPIF and tax deferrals has on the cost of production. We highlight a range of scenarios of private funding, which show the greater the extent of private funding the more significant the funding cost.

The example is conservative given the tax deferral could stretch to 3 tax years with a 24 month deduction period.

We acknowledge that there is no practical way of eliminating the "delay" in the payment of the grants and accept that it is only a by-product of the scheme. However the cost of the delays is exacerbated by the delay in the tax deductions for the non-grantable expenditure and we can see no reason why this amendment is necessary. It is certainly not desirable.

We agree that there is a need to counter the "artificial tax losses" referred to in the Commentary to the Bill by denying a deduction for expenditure for which a grant will be received but to alter the timing of the deduction as well is not necessary, runs counter to the objectives of the scheme and will create significant disadvantages to producers and investors alike.

Tax Position of Non-SPIF Films

A further inconsistency in the tax treatment of SPIF related films is the comparison to films that receive other Government funding (such as NZFC, NZ on Air, Te Mangai Paho). Thus, a film that receives **any** SPIF funding will have the deferred deduction rule apply, whereas a film that receives no SPIF funding but receives other Government funding will be entitled to the immediate deduction. Importantly, the amount of SPIF funding received is irrelevant, so that a heavily funded SPIF/ NZFC production will have the same deferral as one with significant private investment but minor SPIF funding.

This inconsistency highlights the problem with the approach to the deferred deduction, and reflects the conceptual approach of not obtaining a dual incentive is flawed.

Alternative Deferral of Proposal

If the Government confirms a policy intent of a deferred deduction for films, we recommend a prospective implementation date rather than that proposed in the Bill, being 1 July 2008 which was the date of the start of the SPIF scheme.

With the backdated effect of legislation, and the delay caused by the Bill being held over post election, there was a significant period of uncertainty in respect of the tax rules that would apply to the SPIF. This meant a range of potential productions were being delayed (and thus the benefit of the SPIF negated) due to current rules being taxpayer acceptable, whereas the Bill proposed a backdated effect were not.

We understand policy officials have supported a prospective date to 1 January 2010 to permit productions in progress to continue. We consider the commencement of the 2010/11 tax year as being more appropriate being the commencement of the tax year, rather than part way through a tax year, given the spread of provisional tax dates during the year provides the real impact on tax payments and the 6 – 12 month time frame for most productions.

Conclusion

It would appear counter productive that upon the introduction of these SPIF grants that (New Zealand) film producers should be at a tax disadvantage, when compared with the situation should they not apply for such a grant, irrespective of the size of any SPIF grant.

In addition, the ability to obtain a tax deduction against the taxable income of producers and investors is not an incentive as such to the film industry, but which is something which is generally available to other taxpayers in respect of profits and losses from other sources.

We understand the reason why this amendment has been proposed is to not permit such productions to have two incentives. This rationale is flawed as the theoretical dual incentive is already in place and will continue for other Government funded productions but not SPIF ones.

If proceeded with in its current form the benefit the SPIF will have created will be seriously eroded by the cash flow costs to the production, which will have the effect of reducing productions through the removal of private investors from productions, and de-incentivising producers from investing in their own productions.

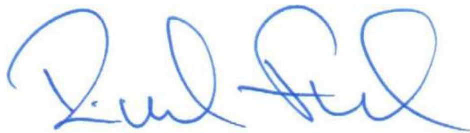
We are already aware of private investors who have stated they will not invest in productions as a result of the removal of the timing incentive, which will have the effect of reducing the number of films being made, against the principle for which the SPIF was introduced in the first place.

Recommendation

That the proposed amendments to section DS 2(4) of the Income Tax Act 2007 as contained in clause 69 of the Bill be deleted.

Alternatively, and only as a last resort, that the implementation date of the clause be from the commencement of the 2010/11 income tax year.

Yours sincerely



Richard Fletcher
SPADA President

SCREEN PRODUCERS INCENTIVE FUND
"SPIF"

Cash flow example films

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6	Scenario 7
Production budget (and QNZPE)	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Comprising:							
NZFC Funding (and other government agencies)	6,000,000	5,000,000	4,000,000	3,000,000	2,000,000	1,000,000	-
Private Investor/ Producer Funding	-	1,000,000	2,000,000	3,000,000	4,000,000	5,000,000	6,000,000
SPIF (40%)	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000
	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Taxation							
Expenditure	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Less grants	- 10,000,000	- 9,000,000	- 8,000,000	- 7,000,000	- 6,000,000	- 5,000,000	- 4,000,000
Tax deductible expenditure	-	1,000,000	2,000,000	3,000,000	4,000,000	5,000,000	6,000,000
Cash flow implications (17% cost of funds):							
Funding of SPIF for 12 months (some during production, balance after)	680,000	680,000	680,000	680,000	680,000	680,000	680,000
Funding of taxation (50% for 12 months - best case scenario)	-	25,500	51,000	76,500	102,000	127,500	153,000
Total additional cost	680,000	705,500	731,000	756,500	782,000	807,500	833,000

Cash flow example television

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6	Scenario 7
Production budget (and QNZPE)	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Comprising:							
NZFC Funding (and other government agencies)	6,000,000	5,000,000	4,000,000	3,000,000	2,000,000	1,000,000	-
Private Investor/ Producer Funding	2,000,000	3,000,000	4,000,000	5,000,000	6,000,000	7,000,000	8,000,000
SPIF (20%)	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Taxation							
Expenditure	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Less grants	- 8,000,000	- 7,000,000	- 6,000,000	- 5,000,000	- 4,000,000	- 3,000,000	- 2,000,000
Tax deductible expenditure	2,000,000	3,000,000	4,000,000	5,000,000	6,000,000	7,000,000	8,000,000
Cash flow implications (17% cost of funds):							
Funding of SPIF for 12 months (some production, balance after)	340,000	340,000	340,000	340,000	340,000	340,000	340,000
Funding of taxation (50% for 12 months - best case scenario)	51,000	76,500	102,000	127,500	153,000	178,500	204,000
Total additional cost	391,000	416,500	442,000	467,500	493,000	518,500	544,000