



**SUBMISSION ON AUSTRALIAN GOVERNMENT REVIEW OF  
AUSTRALIAN FILM INDUSTRY  
9 AUGUST 2006**

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## Background

The Australian Government through the Department of Communications, Information Technology and the Arts called for submissions in response to its Issues Paper of July 2006, with respect to the Government providing support to the Australian Film Industry. The purpose of the review is stated, *“to ensure the current funding measures, and the structures which underpin them, are appropriate and effective”*. In addition the paper confirms the Australian Government’s commitment to maintaining a *“strong active and vibrant Australian film industry for both cultural and economic reasons”*. We commend this on-going support, absent which the industry would unlikely survive.

In addition a joint consultation paper on Research and Economic Modeling into varying the refundable Tax Offset for Film was also released in July 2006 by the Australian Film Commission and the Australian Government.

## Focus of this submission

The focus of this submission is to address the type of Government support we believe is necessary to enhance the likelihood of achieving success **by those producers who have a business model and focus on sustainability rather than single productions.**

## Our Industry Role

Film Headquarters is a commercial production company founded by me in 1996. In addition, and particularly relevant to this submission is my experience of over 25 years in relation to film production.

I, in association with my colleagues Gareth Calverley, a film and television producer, and Hugh Nalder a recently retired partner of the global advisory firm, PricewaterhouseCoopers, believe we have developed a sustainable business model for making feature films for distribution through multiple mediums. We are in the process of seeking investor support for the project and this is occurring independent of the outcome of the Australian Government review. Nevertheless we are of the strong opinion that certain structural changes in Government support are necessary and we deal with these in this submission.

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## Key Issues

We concur with the views expressed in the Issues Paper on pages 9 and 10. In particular:

- The project approach to film production has demonstrated a lack of sustainability, primarily as a consequence of consistent underperformance from a private investor perspective. This outcome has been magnified by the “propping up” from Government support both via tax incentives and AFC/FFC contributions. That is, there has been a **distinct lack of investor focus** at the production level.
- There has been a significant imbalance of focus on script development which is responsive to audience demand as opposed to cultural stories which lack box office appeal.
- It is true there are and will continue to be changes to customers’ options for viewing product. This is changing, and will continue to change the revenue mix that a film will achieve when it is distributed in the market place both in Australia and internationally.
- Given the above, the industry must respond if it is to remain viable. A key issue in this respect which not addressed in the paper is the **historical high costs of production budgets. Simply put most productions in Australia are doomed to financial failure at the outset because the production cost is too high relative to the market potential in Australia and internationally. The supply chain is such that a high budget film, (say a film with a budget in excess of \$5m) needs to be a “hit” at the box office for there to be any chance of an investor receiving a return. History demonstrates this to be the case.** There are a multitude of reasons for this situation including: the unsuitability of the script for international appeal, (high Australian appeal will not automatically translate to international appeal), high costs of actors, directors, support crew, and post production, and the “high take” that a small number of dominant distributors command to ensure release.

In our view all these factors translate to a very negative view from a private investor perspective.

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## **Investor focus is essential**

In our view investor focus is essential in any solution. This requires that the structure of the film production must be such that a risk/ reward equation is attractive for private investor participation.

In our view the key requirements to achieve this are:

- **A portfolio approach** - A move away from single film production and funding to multiple productions where the risks of success and failure inherent in any single production are spread to reduce investor risk;
- **A focus on lower cost productions** – there are many avenues to achieve this including innovative production techniques, performance oriented reward arrangements for actors, directors and other key suppliers;
- **A focus on script genre that has local and international appeal** – this can be achieved if there is an appropriate level of **investment** in development of suitable script; and
- **An income tax regime that rewards performance and is consistent with encouraging sustainability** – we believe this can be achieved by simplifying the current regime for write-off of capital expenditure for tax purposes, in conjunction with a tax offset incentive. This is expanded later in the submission.

Whilst we acknowledge the value of direct support to the industry via bodies such as the AFC, FFC and the various state bodies, we do not comment on this issue in this submission. Our focus centers on a sustainable business model which ideally does not rely on direct support for its success. In our view, if the success of a single production is dependent on direct support for its funding, it probably reflects it is not financially viable. The contributing reasons are likely to be the issues outlined above or a combination thereof. We also acknowledge there may be good reasons to provide direct support in many cases, (e.g. the production of an important cultural or historical story which might not otherwise eventuate).

The remainder of this submission deals with the indirect Government support referred to in the last bullet point above. The other factors are commercial and are not dependent on Government support.

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## **Indirect Government Support**

We cover this in two parts – the capital expenditure tax write-off regime and the tax offset incentive.

### **Tax write-off regime**

The disadvantages of the current system, (Div 10BA and 10B) governing the write-off of capital expenditure on the production of Australian films are reasonably well addressed in the Consultation paper on Refundable Tax Offsets. In particular:

- The provisions are complex and costly in compliance, (e.g. obtaining provisional and final certificates);
- They are not currently effective in terms of attracting private investment in film production. This largely reflects the limit of 100% on qualifying expenditure deduction. It is worth noting that even when the deductions ranged upwards of 100%, whilst more capital was raised, the support was not efficient as sustainability for the industry was not achieved. In our view a significant contributing factor to this outcome was the imbalance “tax scheme” focus of high net worth investors and not the merit of the investment on ordinary commercial grounds.
- There is no incentive provision for the write-off of expenditure on script development other than Div 10B.

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We propose a simplified system for write-off of capital expenditure on the production of a film and/or on the development of script. In the latter case the costs of development might include: and initial payment to a writer to secure an option over a script, on-going development costs paid to either the writer or other editing or development resources be they internal or external to the production entity. Our recommendations are:

- Amend or abolish Div 10 BA and 10 B, (to the extent it relates to Australian films) and replace with a regime under the depreciating asset regime in Division 40;
- The structure of the write-off regime could be modeled on that for mining capital expenditure. In particular, the entitlement to deduction should require as a pre-requisite the features currently in Div 10 BA and 10B with respect to significant Australian content and eligibility. However the complexity associated with provisional and final certificates should be abolished. The fallback is a self assessment regime which is already a feature of Division 40.
- As an incentive, and to more effectively align expenditure with the receipt of income, the deductibility of capital expenditure on creating or acquiring film copyright and script copyright developed or under development, should be when the eligible expenditure is incurred. In this respect the provision would not be dissimilar to that applying for mining and petroleum exploration expenditure. In reality expenditure on script development is almost identical to exploration expenditure in that the commercial outcome is unknown at the time the expenditure is incurred, however the expenditure is an essential pre-requisite to successful future production. In the case of capital expenditure on film production, an outright deduction acts both as an indirect incentive, more closely reflects the matching of income receipt and expenditure being incurred, and eliminates the need and uncertainty of the owners of copyright having to estimate the copyright's effective life. The indirect incentive is inherent in the increased cash flow, and therefore future source of funding, resulting from the outright deductions sheltering income which would otherwise be subject to an income tax cash outflow.
- The entitlement to the deductions would rest with the entity, party or parties who carry on a business, or intend to carry on a business of film production for the purpose of producing assessable income. In almost all cases that would require the entity, party, or parties owning the copyright, or rights to exploit the copyright as a consequence of incurring the capital expenditure. In this respect the same deduction regime would apply irrespective of whether the party incurring the expenditure and owning the rights is a production company, or a group of individual investors owning part interests in copyright, (as has typically been the case with Division 10 BA productions).

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## Tax Offset regime

The disadvantages of the current offset regime are also well covered in the Consultation paper. In particular, the requirement for a minimum level of qualifying expenditure of \$15million has resulted in few Australian films being eligible.

We agree with the comment the offset is attractive to producers. It is easy to administer and the benefit of the offset can be applied towards funding of future productions, thereby reducing the reliance on private investors and or the Government Agencies such as the AFC or FFC.

Our recommendation is:

- The offset regime apply to films, or drama series with a production cost of \$1million or above, and documentaries costing \$500,000 or above;
- The level of offset be at least 30%;
- Excess offsets on any one film can be applied against other films within single production entities, and similarly within a wholly owned tax consolidated group of companies, but any net excess offset not be refunded but carried forward; and
- The regime applies in conjunction with the capital expenditure write-off regime outlined above, not as an alternative.

In our view the real benefit of an offset regime will apply to those producers who are striving to achieve a sustainable long term future and can utilize the offset to reduce reliance on alternative funding sources during the early stages of development of the business.

It is acknowledged that an offset regime may result in increasing levels of Government support over time. This would occur if:

- There was no cap mechanism;
- The industry attracted increased levels of investment and **most important**, achieved increased levels of profitability; and
- This success resulted in more and more production all benefiting from the offset regime.

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Whilst we have not fully investigated possible solutions in this submission, one option may be for the offset to reduce and ultimately cut out once an Australian film production business achieves a certain level of performance. The argument for Government support is less compelling for those businesses that have achieved sustainability and as a consequence are providing attractive returns to shareholders.

The above recommendation resembles closely the licensed franchise option outlined in the Consultation paper. It clearly favors those who have a vision and plan to establish a sustainable business, focused on providing appropriate risk weighted returns to its shareholders.

However we disagree with the example in the Consultation paper suggesting that there be a limit on the capital raising. In our view there should be a minimum and maximum limit on capital raising for each licensed producer – say, \$3 million minimum and \$20 million maximum over a five year period.

We agree with the suggestion that eligibility for a license be based on the quality of the business plan, which inherently should incorporate experienced producers and creative writers necessary to optimize outcomes.

However we believe equally it is essential that a bias not be automatically applied to the very small number of large established production entities already producing in Australia. The specific issue and question for these producers as regards eligibility is: have they already established a successful business incorporating Australian film production providing appropriate returns to shareholders and if not why not?

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