



**Department of Communications,
Information Technology and the Arts**

**Submission on Australian
Government Film Funding
Support**

KPMG Tax
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Submission on Australian Government Film Funding Support (3)

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1 Introduction

We refer to the Department of Communications, Information Technology and the Arts (“DCITA”) Issues Paper dated July 2006 in relation to the review of the Australian Government’s film funding support (“the Issues Paper”).

As requested, this submission seeks to respond to the Terms of Reference outlined in the Issues Paper. The comments in this submission are based on KPMG’s extensive experience and involvement in advising on the raising of private investment for Australian films. Our primary focus has been the accessing of indirect Government assistance through available tax incentives (primarily Division 10BA), however in recent times such structures have also utilised direct financing by the Film Finance Corporation Australia (“FFC”).

In light of the above experience, it should be noted that the comments in this submission are restricted to the use of investor incentives for the financing of ‘commercial’ films intended for distribution in both Australia and overseas, rather than niche films with limited appeal in the broader market place. Commercial films are required to create employment and a sustainable and long-term production and post production industry in Australia. Niche, national interest type films are better placed to receive direct Government funding through agencies such as Film Australia Limited rather than seeking funding through private investment. We have also not sought to comment on the efficacy of direct funding methods.

We have also enclosed with this submission, for your interest, a copy of the KPMG Film Financing and Television Programming: A Taxation Guide 2005. This guide provides a useful summary of film and TV financing in 28 countries.

2 Background

2.1 The Australian film industry

The Issues Paper states in its first Term of Reference that this review will consider and make recommendations on the efficiency, effectiveness and appropriateness of Government support measures for funding films in Australia.

Prior to considering the way forward for film funding assistance in Australia, it is worthwhile considering the wider context to this review by touching on the historical performance of the Australian film industry and the success of current Government support measures for funding films in Australia.

2.1.1 Funding the production of a film

The making of a film is a long, complicated and expensive process¹. There is not only the creative works involved during the production of a film, but also the arrangement for funding prior to the production and the subsequent distribution of the film. Hence, in general, the making of a feature film will involve 3 principal activities:

- 1 Financing
- 2 Production
- 3 Distribution

Historically, investors will finance both commercial and independent films on a picture-by-picture basis. Funds are usually raised from sources such as:

- bank loans;
- pre-selling of distribution rights;
- private investors; and
- assistance from public motion picture support programs.

2.1.2 The role and effect of pre-sales and minimum guarantees

Most independent producers will sell (through a sales agent) their motion picture rights to a distributor in order to raise the required amount of funds for productions. The distributor will offer a guaranteed minimum revenue amount which allows them to raise funds by using this guarantee amount as collateral.

¹ KPMG Film Financing and Television Programming: A Taxation Guide preface pg iv

The amounts received in the form of pre-sales and minimum guarantees have been a critical source of finance for Australian films. However, not unlike a property developer “selling off the plan”, by pre-selling distribution rights the producer gives away much of a film’s upside potential.

In recent times, changes in the international film market have made pre-sale finance harder to obtain and the amounts being paid (for comparable rights in a film) have been significantly reduced. Taking advantage of a weak market, the sales agents and territorial distributors use their bargaining power to dictate the terms and price of their minimum guarantees as they know the independent producer’s options are limited. Consequently, investors have been required to contribute more towards a film’s budget without any expectation of greater revenue from the film.

The effect of all this is that typically by the time investors make their investment decision there is very little in the way of upside remaining – most of it having been taken by the sales agents and territorial distributors in return for advancing the funds necessary to make the film. Therefore the chances of a return on investment are low.

2.1.3 Revenue and cost trends internationally

Globally, the film industry is a multi-billion dollar industry. On 21 July 2006, the website “The Hollywood Reporter” forecasted that by 2008 the global film business will be worth US \$104.1 billion, compared with US \$75 billion in 2004². This means the film industry will be one of the fastest moving sectors.

As mentioned in page 4 of the Issues Paper, although the industry is large, it is a very competitive industry and major US studios have dominated motion picture production, finance and distribution globally in recent years. However, the major US studios have to date focussed on high budget, high profile films that have blockbuster box office potential, and so smaller, independent film production is now beginning to emerge.

Due to the dominance of the US studios, it is very difficult for independent producers to pre-sell their films. One of the main reasons is that most distributors prefer to purchase an independent film when it is completed, rather than based on the script alone. This illustrates how the risk in the industry is progressively increasing. Even if independent producers are able to pre-sell, the minimum guarantees offered are rarely sufficient or ideal. Hence, the trend for film financing for non-studio films is away from pre-selling.

Due to the difficulties associated with obtaining finance for a film in today’s market, it was observed at the 2004 Cannes international film market that independent financiers and filmmakers had downsized their production budgets and were setting up strategic partnerships with other independents.

² Van Tassel J, “Shows to grow”, in The Hollywood Reporter, 21 July 2006, viewed on 8 August 2006, < http://www.hollywoodreporter.com/thr/pwc/talking_display.jsp?vnu_content_id=1002803432 >

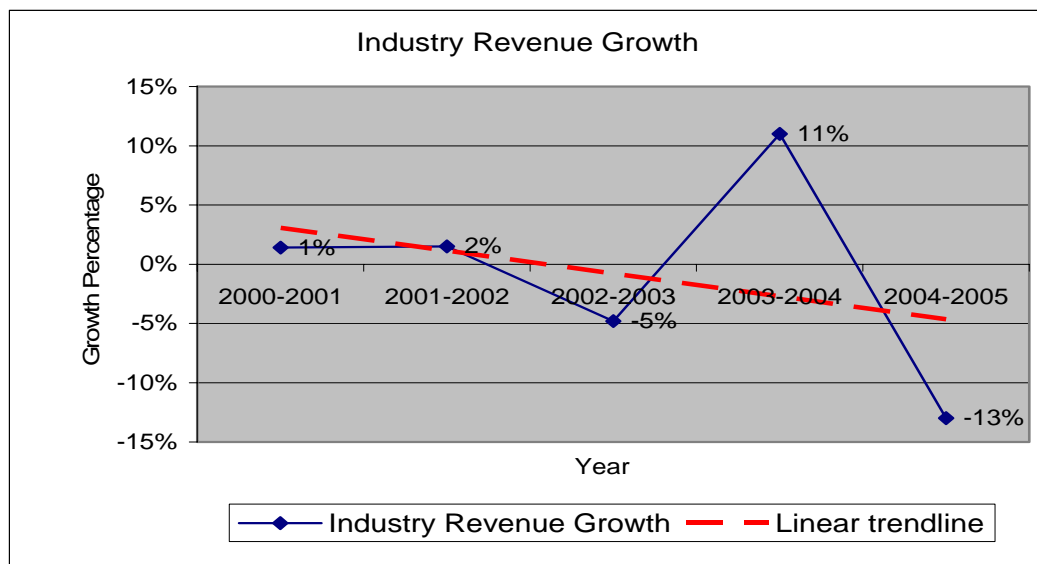
2.2 Revenue and growth of the film industry

The Australian film industry is a cottage industry, dominated by a few major US studios co-existing with many independent producers.

The industry has until recently been in a strong growth cycle³. The estimated revenue of the Australian film industry for the 2004-2005 year is A\$1.6 billion⁴. On the production side for the year, total feature film production expenditure in Australia on 31 projects was A\$588M. Of this total expenditure, A\$331M, or 58 per cent was actually spent in Australia⁵.

As shown in the table below⁶, revenue growth of the industry during the past 5 years has fluctuated but is generally showing a decreasing trend. This trend is echoed in the global film industry.

Year	00/01	01/02	02/03	03/04	04/05
Industry Revenue @ constant price (Mil)	1,779	1,806	1,719	1,908	1,660
Industry Revenue @ current price (Mil)	1,570	1,637	1,605	1,834	1,660
Real growth (%)	1.4	1.5	-4.8	11.0	-13.0



³ "IBISWorld Industry Report – Film and Video Production in Australia: P9111" in IBISWorld, 31 July 2006, viewed on 8 August 2006, < <http://www.ibisworld.com.au/reports/reportdownload.aspx?rtid=1&e=634&ft=pdf> > , p. 9

⁴ Ibid at p. 6

⁵ Ibid

⁶ Ibid

The top 5 grossing Australian films in 2004 and 2005 are shown in the table below⁷.

	2004	Amount (\$m)	2005	Amount (\$m)
No. 1	Strange Bedfellows	4.8	Wolf Creek	5.8
No. 2	Somersault	2.0	Little Fish	3.7
No. 3	One Perfect Day	1.2	Look Both Ways	2.8
No. 4	Love's Brother	0.9	Oyster Farmer	2.4
No. 5	Thunderstruck	0.9	The Proposition	2.2

In the competitive Australian film industry, it is becoming increasingly difficult for Australian film producers to establish themselves in the international and domestic market. This is demonstrated by the statistics quoted in the Issues Paper as released by the Australian Film Commission ("AFC") for the 2005 year, showing that although 8.2% of films released in Australia are local films, the box office share of these films was only 5.2%. This is also observed in the figures for the average Australian box office, with US films averaging A\$2.8M, UK film averaging A\$2.3M and Australian film averaging a mere A\$0.7M in 2005⁸.

In terms of the performance of films against budget, only 1 out of 15 Australian films break even, whereas 1 in 7 US films will cover costs and pay real returns to investors⁹. It is therefore not surprising that US films dominated the industry, having 80% of the global market and 81.2% of the Australian market. A table illustrating the share of each country in the Australian box office is shown below¹⁰.

Box office share in Aus – 2005¹¹

Country	Box office – total (\$m)	Box office – share (%)
US	663.8	81.2
UK	87	10.6
Australia	23.1	2.8
France	8.1	1.0

⁷ "2005 Box Office Backgrounder", in Australian Film Commission, January 2006, viewed on 8 August 2006, <<http://www.afc.gov.au/downloads/pubs/boxoffice%20backgrounder.pdf>>

⁸ Ibid.

⁹ Note 4 at p. 24.

¹⁰ Note 8.

¹¹ Ibid.

Canada	2.8	0.3
India	2.3	0.3
Other	30.4	3.7
<i>All films</i>	817.5	100

In terms of trading with other countries, although there were some famous Australian films such as *Babe* and *Moulin Rouge* that were successful internationally during the past decade, the export level of the industry is generally only at a medium level¹². A positive sign is that the export level of Australian film is increasing. However, the import level for the industry will continue to be high and at an increasing rate¹³. Hence, it is unlikely that Australian film will be able to compete with the US films in the short to medium term.

2.3 Government support for the film industry

As noted in the Issues Paper, support from the Government for the film industry can be divided into 2 main categories:

1. Direct support through the funding of Government agencies and other organisations such as the FFC and AFC; and
2. Indirect support through investor based incentives, such as Divisions 10BA/10B, the Film Licensed Investment Company (“FLIC”) scheme and the Refundable Film Tax Offset (“the Offset”).

2.3.1 Australia – primary measures of support

Our analysis of the various types of support from the Government for the film industry should be read together with page 7 to 9 of the Issues Paper.

Although the measures of support listed are non-exhaustive, and exclude such measures as the funding of the ABC and SBS, we have considered in more detail below the measures which are most critical to the production of ‘commercial’ Australian films.

¹² Note 4 at p. 19

¹³ Ibid.

2.3.1.1 Direct support

Direct subsidy from Australian Film Commission

As stated in page 8 of the Issues Paper, the AFC has provided the main source of funding for the development of Australian film, especially in assisting the career development of writers, directors and producers through its Film Development Funding Programs.

During the 2004-2005 year, approximately AU \$9.7 million was provided by the AFC in supporting the development and production of films¹⁴.

FFC support

The role of the FFC is to provide financial support for production of Australian feature films, telemovies, mini-series and documentaries. Through grants from the Government, it is able to fund approximately 50 – 60% of a production budget if the film is an eligible film that has a provisional certificate under Division 10BA of the tax legislation¹⁵.

The level of financial assistance provided by the FFC in recent years and budgeted for the future is shown in the below table:

Year	02/03	03/04	04/05	05/06	06/07
Grant – film only	\$28.4M ¹⁶	\$22.3M ¹⁷	\$44.6M ¹⁸	Not available.	\$36.75M ¹⁹
Investment return – film only (\$Mil)	\$10.6M ²⁰	\$7.8M ²¹	\$5.9M ²²	Not available.	Not available.

¹⁴ “AFC Annual Report 04/05”, in Australian Film Commission, September 2005, viewed on 8 August 2006, < http://www.afc.gov.au/archive/annrep/ar04_05/arep0405-111.html >, pp. 111 &

¹⁵ Note 1 at p. 17

¹⁶ “FFC Annual report 02/03”, in Film Finance Corporation Australia, September 2003, viewed on 8 August 2006, < <http://www.ffc.gov.au/annual/FFCaRep03.pdf> >, p.22

¹⁷ “FFC Annual report 03/04”, in Film Finance Corporation Australia, September 2004, viewed on 8 August 2006, < <http://www.ffc.gov.au/annual/FFCaRep04.pdf> >, p.38

¹⁸ “FFC Annual report 04/05”, in Film Finance Corporation Australia, September 2005, viewed on 8 August 2006, < <http://www.ffc.gov.au/annual/FFCaRep05.pdf> >, p.44

¹⁹ “Investment guidelines 2006/2007”, in Australian Film Commission, July 2006, viewed on 8 August 2006, < http://www.ffc.gov.au/investment/0607_investment_guidelines.pdf >, p.4

²⁰ Note 17 at p.25

²¹ Note 18 at p.18

²² Note 19 at p.18

2.3.1.2 Indirect support

Division 10BA

Under Division 10BA, if the film qualifies as an Australian film, the investors will be entitled to a deduction of 100% of the capital subscribed. The deduction is available in the income year in which the subscription is made.

The table below summarises the Division 10BA funding during the past 5 years²³:

Year	00/01	01/02	02/03	03/04	04/05
Number of projects	8	10	7	8	17
Total budgets (\$m)	23.5	28.5	14.7	26.6	40.9
10BA funding (\$m)	7.31	13.65	5.71	9.6	21.2

It can be seen that, generally, the number of projects that have utilised Division 10BA funding and the total amount of funding provided is increasing.

FLIC Scheme

The FLIC scheme operates parallel to Division 10BA. As mentioned in page 9 of the Issues Paper, it facilitates greater private investment by being able to raise concessional capital of up to \$10M in each of the 2005-06 and 2006-07 years for investment in qualifying Australian films. The scheme was also offered in 1999. Shareholders investing in a FLIC are entitled to an immediate 100% deduction for the cost of their shares.

Both the capital raising in 1999 and the recent capital raising in 2005-06 failed to reach their investment targets.

Refundable Tax Offset

This scheme is available to large-budget productions having qualifying Australian production expenditure (“QAPE”) of at least \$15M on the production of the film. If qualified for this offset, tax liabilities equivalent to 12.5 percent of the QAPE can be offset.

As shown in the table below, since its inception in 2001, over A\$110M of benefits have been utilised²⁴.

²³ “Levels of financing of 10BA projects and effects on government revenue, 1980/81–2004/05”, in Australian Film Commission, July 2006, viewed on 8 August 2006, < <http://www.afc.gov.au/gtp/mptax10bastats.html> >

	No. of applications	No. certified	No. under assessment	QAPE of certified films	Aggregate benefits
Sept 01- June 06	17	17	0	\$885,255,244	\$110,656,906

One of the main disincentives for a producer in choosing to access the tax offset is that it cannot utilise any other support from the government, including funding from AFC or FFC, deductions under Division 10BA or 10B, and concessional capital raised from FLIC²⁵.

2.3.2 Government film support – international comparison

Government support for the funding of films in other jurisdictions takes many forms. We have briefly considered below the measures adopted in other jurisdictions where English is the main language and therefore the conditions for locally produced films is similar to that of Australia.

2.3.2.1 UK

The UK Government has mainly supported the local film industry by offering indirect support through investor incentives.

Until March 2006, UK had a 100% accelerated tax write off for expenditure incurred in creating qualifying British films for films having production expenditure of less than £15M (s48 relief). If production expenditure was higher than £15M, expenditure could be written off over 3 years (s42 relief).

The following table summarises the support provided to British films during the past 5 years:

Year	01	02	03	04	05
Cinema admissions in UK²⁶	10.6%	17%	-1.7%	3.7%	-3.8%
UK box office - local share²⁷	Not available	24.4%	15.7%	23.4%	34%
S42 relief (£M)²⁸	35	60	95	170	220
S48 relief (£M)²⁹	120	145	190	350	340

²⁴ "Operation of the refundable tax offset for large-budget productions", in Australian Film Commission, July 2006, viewed on 8 August 2006, < <http://www.afc.gov.au/gtp/mptaxrtokey.html> >

From March 2006, a new form of incentive will be available for films with production expenditure of less than £20M. Under the new scheme, 20% of the film’s production cost will be financed by the Government, together with a deduction equal to 150% of the production cost of the film available to offset future profits.

2.3.2.2 *New Zealand*

Conversely, New Zealand does not offer specific tax incentives for investors in the film industry.

However, Government funding support for the film industry includes the following:

- Total funding of NZ\$8M from the New Zealand Film Commission (“NZFC”) for films with production budgets of NZ\$1M to \$5M;
- A Large Budget Screen Production Grant which offers a 12.5% grant to assist large budget production.
- The NZ Film Fund which operates to assist films with budgets of over \$5M.

Year	01	02	03
NZFC funding (NZ\$ M)³⁰	4.2	7.6	4.7
Budget for films funded by NZFC³¹	13.7	16.4	10.0

2.3.2.3 *Canada*

The Canadian Government offers its support for its film industry through various tax-credit incentives and direct funding contributions to producers.

The Canadian Federal Government and the Provincial Governments both provide tax credits to their film producers. The 2 main support programs are the Canadian Film or Video Production Tax Credit (“CFVPTC”) and the Federal Film or Video Production Services Tax Credit (“FVPSTC”) offered by the Federal Government.

²⁵ Note 1 at p. 11

²⁶ “RSU Statistical Yearbook 2005/06”, in UK Film Council, July 2006, viewed on 8 August 2006, <<http://www.ukfilmcouncil.org.uk/information/statistics/yearbook/?y=2005>>, pp. 9 & 11

²⁷ Ibid at p. 13

²⁸ “British Film Industry”, in The United Kingdom Parliament, 27 February 2006, viewed on 8 August 2006. <<http://www.publications.parliament.uk/pa/cm200506/cmhansrd/cm060227/text/60227w87.htm>>

²⁹ Ibid.

³⁰ “New Zealand Film Commission: Feature Film Production 1990:2003”, in New Zealand Film Commission, July 2006, viewed on 8 August 2006, <<http://www.nzfilm.co.nz/downloads/ff%20productions1990to2003.pdf>>

³¹ Ibid

The CFVPTC is a federal based tax credit scheme administered by the Canada Revenue Agency (“CRA”), offering tax credits equal to 25% of the qualified labour expenditure to Canadian production companies that own the copyright in the film. However, as qualified labour expenditure is limited to 60% of the certified production costs, this means a maximum tax credit equivalent to 15% of the total film production cost can be claimed as a tax credit. Further, the CRA will not provide any tax credits to producers if the film is financed as a tax shelter investment.

Similar to the CFVPTC, the FVPSTC also offers tax credits administered by the CRA, but only offering an 11% tax credit with respect to the qualified labour expenditure incurred in Canada. However, this scheme is wider in that it is not merely offered to Canadian producers, but also to foreign producers operating through a permanent establishment in Canada. The main requirement for this funding is that the production cost of the film must be in excess of Canadian \$1 million.

Finally, the Canadian Government also provides direct funding support to the Canadian producers through a government-industry partnership called the Canadian Television Fund (“CTF”). This partnership has 2 programs which offer support to the industry. The first type of funding is through the License Fee Program (“LFP”) in which funds are provided to Canadian independent producers or broadcaster-affiliated production companies. The amount provided is generally 15% of the production budget if various requirements are satisfied, and up to 45% depending on the locality and type of programming. Support for film from the LFP is capped at Canadian \$750,000 per film. The second type of support is through the Equity Investment Program (“EIP”) administered by Telefilm Canada. Under this program, direct investment of up to 49% of the production budget is provided if certain requirements are satisfied. Two very similar schemes, called the Feature Film Fund (“FFF”) and Feature Film Distribution Fund (“FFDF”), are also available through Telefilm Canada. The FFF provides funding of up to Canadian \$1.5 million for film producers, while the FFDF allows qualified distributors to acquire rights to Canadian films, market Canadian films, or as security for corporate loans.

3 Barriers to raising private investment in Australian films

The reasons behind the low levels of private investment in Australian films are many and varied. Detailed and extensive research would be required to attempt to pinpoint one or two decisive factors which need to be addressed to boost the level of private investment. Such research is beyond the scope of the present submission given the available timeframe.

However, all of the below factors could be considered to have contributed to some degree to the decline in private investment in Australian films. A number of these factors were identified and considered in the Issues Paper, and therefore the below is intended as a high-level summary only.

3.1 Commercial risk

Returns on films investments are inherently unpredictable when compared with other investment options. This is unavoidable and the same risk is faced by private investors in film in all jurisdictions.

However, this risk is compounded when dealing with Australian films, given the historical poor performance of Australian films (as outlined at 2.2 above), the ever-decreasing share of the box office achieved by Australian films and the lack of established promoters in Australia.

3.1.1 Historical poor performance of Australian films

Again, the reasons behind the poor performance of Australian films are many and varied. However, some of the relevant factors include:

- *Lack of vertical integration* – In order to reduce the exposure to risk, Hollywood producers have vertically integrated the production, distribution and exhibition of films so that risks can be diversified. However, in the Australian industry the production process is still separated from distribution and exhibition of the film. This can lead to an over reliance on pre-sales.
- *Over reliance on pre-sales* – Material presales reduce the chance of investors making a profit as outlined in section 2.1.2. Further, as the trend for pre-sales is decreasing (refer to 2.1.2), this exacerbates the problem.
- *Failure to attract significant private investment* – The poor historical performance of Australian films creates a vicious circle whereby private investors are reluctant to invest in films when compared with other investment options, which in turn leads to over reliance on pre-sales to fund the film (above).
- *Lack of development* – Development is critical to the success of a film and is currently a very poorly funded process in Australia. The FFC does not currently provide funding for development and development funds offered by other agencies, such as the AFC, are mostly limited.

- *Lack of universal subject matter* – Australian films often contain themes or subjects which are particular to Australia and are not universally attractive.
- *Lack of recognisable cast/director* – Due to budgetary constraints, Australian films are unlikely to include a ‘big name’ star or director. This excludes those in the market who will watch a film based on the previous work of an actor or director, irrespective of the subject matter of the film.
- *Poor or insufficient marketing* - Finally, the lack of marketing strategy is a major factor for the failure of Australian films. Compared to the US studios which always have a long term marketing strategy prior to commencement of film production and a substantial marketing budget compared to the size of the overall budget, marketing is generally not a significant proportion of the budget of Australian films and marketing is generally only undertaken in an ad hoc manner following completion of the film. In addition, marketing expenses do not form part of the production expenditure which is deductible to private investors under Division 10BA and therefore producers who seek funds from Division 10BA investors are incentivised to minimise the marketing expenditure forming part of the production budget.

3.1.2 Lack of established promoters

The Australian market has been characterised by numerous lesser known promoters. Although better known and trusted promoters have recently entered the market, there is still an element of distrust remaining which increases the commercial risk of film in the eyes of the investors. The creation of a film fund in Australia by Future Films, similar to the very successful UK Future Film fund, would have been a step in the right direction in this regard. However, the Future Film project has encountered significant difficulties in dealing with the Australian product ruling system which has hampered its success in Australia (refer to 3.2 below).

3.2 Insufficient or poorly administered incentives

There is little doubt that despite the poor performance of Australian films, if sufficient incentives were offered to private investors to balance or to some extent mitigate the commercial risks associated with such investments, the industry would be in a far better position to raise funds from private investors.

3.2.1 Division 10BA

The Treasurer is responsible for taxation policy in respect of Divisions 10B/10BA, the Commissioner of Taxation manages administration of claims and compliance issues under Divisions 10B/10BA and DCITA administers certification of films as ‘Australian Films’ under Division 10B and ‘qualifying Australian films’ under Division 10BA.

Film producers are currently in the unenviable position of trying to raise funds from private investors in an environment where although incentives are offered (in the form of tax deductions for investors), the availability of such incentives are viewed with great scepticism in the marketplace due to recent high profile challenges by the Australian Taxation Office (“ATO”)

over the *Moulin Rouge* and *Red Planet* films. Unfortunately, the structures utilised for these films were hardly 'typical', but they have resulted in the impression that the ATO is antagonistic towards all film investment.

Although product rulings can be obtained by the producer of a film to confirm the taxation consequences of the investment to the private investors, this system is less than ideal for the below reasons.

3.2.1.1 Perception that ATO "dislikes" film investment

The ATO has been 'burned' by a couple of high profile, aggressive tax structures and appears to approach 10BA investments with great suspicion. In particular, the ATO has adopted a very strict and legalistic interpretation of the "at risk" rule without due regard to the commercial aspects of attracting private investment. The ATO interpretation of the "at risk" rule also appears to have changed over time (see below). Unfortunately, the purpose of Division 10BA (to encourage private investment in Australian films to foster the Australian film industry) has become a secondary consideration (if it is a consideration at all) when evaluating potential projects.

The ATO also appears to place undue emphasis on the commercial decisions and motivations of other parties involved in the film investment e.g. the FFC, the distributor etc. Such an exercise does not impact in any way the deductibility of the investment under the terms of Division 10BA and can cause great frustration to the parties involved. For example, the product rulings published in respect of the *Jindabyne* film are in the public domain. These clearly show that the FFC has attempted to take on a more commercial role as head distributor in order to enjoy more advanced priority in respect of revenue recoupment than has previously been the case in other transactions the FFC has been involved in. As consideration for the grant of distribution rights to the FFC in respect of the film, the FFC agrees to pay a minimum distribution guarantee. Minimum guarantees are a common feature of film transactions and have been favourably ruled upon by the ATO in other published product rulings. It is therefore not considered appropriate for the ATO to question the method by which the FFC seeks to contribute to the production of Australian films.

3.2.1.2 Inconsistent application

The ATO has attempted to actively addressing industry education needs by establishing a Film Industry Partnership to enable the ATO to work with stakeholders in the film industry on issues concerning administration of the tax system.

In our recent experience, a particular concern of stakeholders in the film industry is the way in which the views of the ATO have varied between film projects in respect of the administration of particular requirements of Division 10BA. In particular, the way in which the 'at risk' test in section 124ZAM is currently being viewed by the ATO has caused some concern amongst industry stakeholders, as what was once accepted practice for the satisfaction of the 'at risk' rule is now being questioned by the ATO as not satisfying the test. In this regard, applications which were lodged in 2004/early 2005 were able to satisfy the 'at risk' test whereas applications which have been lodged more recently and which were based on the same criteria for satisfying

the 'at risk' test are now scrutinised by the ATO. For example, minimum guaranteed amounts from distributors are normal practice within the film industry. However, the ATO has recently questioned whether these payments offend the "at risk" rule, even though the payments do not in any way put funds in the hands of the investors to allow them to make their investment and payment of the minimum guaranteed amounts are subject to successful delivery of the film.

3.2.1.3 Time and cost involved in ruling process

Due to the level of scrutiny adopted by the ATO of product ruling applications, the process has become extremely time consuming and expensive. The ATO must review the application and legal agreements submitted by the taxpayer, potentially request further information from the taxpayer, draft the ruling, seek comment from the taxpayer in relation to the draft ruling and then issue the final ruling for publication. Often this process will take anywhere from 3 to 10 months, depending on the complexity of the ruling to be issued.

In addition, there is no way of predicting how long a ruling application will take. In our experience, similar applications can take vastly different amounts of time to process depending on the case officer assigned to the ruling.

The timing of the fundraising process can be critical to the ability of the producer to make a film. Lengthy delays within the ATO often causes undue commercial hardship for producers as they may need to find other sources of investment, key stars may walk away from the project, circumstances may change which require a new provisional certificate to be applied for and subsequent amendments to the private/product ruling application may be necessary.

A producer is therefore lucky to complete the product ruling process for less than A\$200K. Such an additional cost can be quite prohibitive.

The time and cost associated with obtaining product rulings acts as a disincentive to producers to the raising of production funds from private investors through Division 10BA. Producers are well aware of the fact that private investors would require a product ruling in order to invest and therefore if the product ruling process does not meet the needs of the producer, no private investment will be sought.

3.2.1.4 Interaction with DCITA certification process

Our primary concern is with the administration and consistency of the certification process by DCITA and the way in which that process interacts with the management of applications for product/private rulings by the ATO.

One of the main concerns with producers seeking to raise funds from private sector investors for the production of a film is to instill confidence in the potential investors that the process of obtaining the private/product ruling from the ATO has begun. In our experience, investors will often not commit funds to the production of a film without first knowing that a product/private ruling has been applied for by the taxpayer.

In this regard, one of the requirements of the ATO when a private/product ruling is submitted for review is that the provisional certification from DCITA is included. However, often the application for a provisional certificate has been submitted with DCITA by the taxpayer, but the issue of the provisional certificate is delayed (for example, the allocated officer in DCITA goes on leave or is sick). The taxpayer then has to delay submitting the request for the private/product ruling until receipt of the certificate, which often has adverse affects when trying to attract private sector investment.

In particular, the process of obtaining a provisional certificate for a co-production film is often more involved than for a Division 10B/10BA film as the producer must obtain co-production certification from the Australian Film Commission (“AFC”) prior to applying to DCITA for a provisional certificate. In this regard, there are often delays in obtaining the relevant information required by the AFC from producers that reside in countries outside Australia, which in turn delays the certification process. In our experience, the ATO is not always clear on the process which producers must undertake in order to obtain certification from the AFC and then from DCITA, and is unaware of the balance between the difficulties that producers face in obtaining information from overseas producers compared with the need to lodge a ruling application with the ATO in order to attract private sector investment.

There also appears to be inconsistency within the ATO as to when to start reviewing an application for a private/product ruling. In our experience, some case officers will begin reviewing an application without receipt of the provisional certificate (provided they have a copy of the application made by the producer to DCITA and they receive a copy of the provisional certificate before publication of the ruling) as they understand that the review of an application can be quite time consuming and they want to get a head start on the review process. However, other case officers will not even begin looking at the application until receipt of the provisional certificate, which often delays the whole process by a number of weeks (or even months).

3.2.2 FLIC Scheme

Although the FLIC scheme has not suffered from the adverse publicity surrounding Division 10BA/10B over recent years, the scheme could still not be considered to be as successful as the Government may have hoped.

As mentioned above, the concessional capital raisings in 1999 and 2005-06 each failed to reach the allowed limit.

4 Submission on key issues – suggestions for improvement

4.1 What does the Aus film industry need to do to increase its chances of success and sustainability?

4.1.1 Key challenges facing Aus film and TV production sector

The key challenges of relevance are summarised at 3.1 and 3.2 above.

4.1.2 Methods of increasing competitiveness in marketplace and as a vehicle for investment

In order to increase the competitiveness of Australian films in the marketplace, the factors listed at 3.1 need to be addressed.

In the absence of commercially competitive Australian films, in order to increase the competitiveness of film as a vehicle for investment, the relevant incentives offered to private investors need to operate efficiently to ensure that investors have some prospect of at least breaking even as a result of their investment.

For example, under the current Division 10BA, if an investor on the top marginal tax rate of 46.5% obtains a 100% deduction for their investment of \$100 but is fully assessable on all income arising from the film, the investor needs to earn the equivalent of their investment amount as pre-tax income from the film in order to effectively recover the \$100 investment. Based on the historical performance of Australian films, this is unlikely to be the case.

4.1.3 Whether industry is suitably responsive to audience demand

As outlined above at 3.1.1, Australian film and TV often relies too heavily on Australian themes which may have limited appeal in the global marketplace. For example, although comedies are a popular choice in the global marketplace, Australian comedies often rely too heavily on the Australian sense of humour, which does not always translate overseas.

In addition, there is often an emphasis on character and relationship driven movies (referred to as arthouse movies). There seems to be a snobbery associated with producing films with broad commercial appeal (such as action films).

4.2 How can Government objectives best be met?

4.2.1 Whether current Government objectives for the film sector are appropriate

The Government objectives of creating additional activity which:

- Would not otherwise occur and is not a replacement for private investment;

- Should be transparent, accountable and cost effective; and
- Should be a catalyst to innovation, export and private investment

are considered appropriate in light of the comments made above in this submission.

4.2.2 Areas where Government support is most needed or appropriate

No comment.

4.2.3 The appropriateness of the current balance of support between genres and platforms

No comment.

4.2.4 The best way to maintain overall consistency in Government support programs with the general principles outlined

No comment.

4.3 What balance should be struck between direct and indirect funding?

4.3.1 Effectiveness of direct and indirect funding.

When comparing Government support through direct funding versus indirect funding through investor incentives, the indirect funding is considered most effective for creating a commercial film and TV industry. By comparison, direct funding is very effective in ensuring projects which are culturally significant to Australia are made.

4.3.2 Relative strengths and weaknesses of direct and indirect support mechanisms.

As noted in the introduction, direct Government grants are appropriate for films or TV which are in the national interest but which may not have broad commercial appeal. Such films would be unlikely to be funded by private investment due to the fact that a commercial return from such investments is unlikely.

Investor incentives are preferred for commercial film and TV as they allow the marketplace to determine the most commercial projects, rather than allowing a single agency or Government funding body to be the sole judge of the project which should proceed.

4.3.3 Whether existing balance between these support mechanisms used by the Government is still appropriate and effective

For the reasons outlined above at 3.2, the existing indirect support offered to encourage private investment does not appear to be achieving its objective. In order to attract further private investment to the film industry, the Government needs to consider offering further incentives to investors to ensure films are able to compete with other investment products.

4.3.4 And if not, what is a more appropriate balance.

As outlined.

4.4 What options are there for stimulating growth in private investment?

4.4.1 Whether tax incentives are still effective and appropriate mechanism

Tax incentives are still the most effective and appropriate mechanism for encouraging private investment in Australian films. However, the type of incentive offered and the administration of such tax incentives requires amendment (refer below at 4.4.5).

4.4.2 Appropriateness of current 10BA/10B schemes

As outlined above at 2.3.1.2 and 3.2, Division 10BA/10B remain appropriate, however the issues in relation to the administration of the provisions need to be resolved and additional incentives which enhance the attractiveness of film as an investment need to be considered (refer 4.4.5 below).

In addition, thought should be given to expanding the eligible formats which qualify for Division 10BA/10B deductions. In our experience, the current eligible formats have been sufficient to cover the types of productions which our clients have been involved in, namely films and television mini-series.

However, short form animations are becoming more popular and more common within the industry and it would not be unusual for a producer or a private sector investor to want to be involved in this type of production. Therefore, we consider that widening the eligible formats to include short form animations would create more opportunities for the industry and widen private sector investment and production in Australia.

In addition to short form animations, we also consider that the opportunity is there to include the reality television format as part of the eligible formats. Reality television shows have experienced a huge growth in popularity over recent years and this is evidenced by the recent introduction of reality television shows as an eligible genre for a qualifying television series in relation to the refundable film tax offset. Therefore, it may be appropriate for DCITA to consider investment in reality television shows as being acceptable Division 10B/10BA expenditure.

4.4.3 Whether tax incentives for producers should be considered instead of for investors

Tax incentives for producers would, on the whole, be unlikely to have a significant effect on the basis that the majority of Australian producers are not significant taxpayers and, indeed, are often in tax losses.

4.4.4 Criteria which should apply for Australian participation in any incentive scheme

The current criteria for determining qualifying Australian films for Division 10BA purposes is considered appropriate in determining appropriate projects which stimulate the Australian film industry and create employment in Australia. Minimum or maximum production budget constraints are not considered necessary or appropriate.

4.4.5 Other models that might be effective in encouraging private investment

Due to the tight timeframe allowed for the preparation of submissions, the below represents a high-level summary of potential measures which may encourage private investment and highlights the advantages and disadvantages of each. If DCITA is of the view that any of the potential measures warrant further attention, we would be pleased to explore the options in more detail at a later date.

4.4.5.1 Retain Division 10BA with amendment and resolve the procedural/administrative issues

This option involves eliminating the current difficulties with the operation of Division 10BA and also expanding the type of expenditure in the production budget which qualifies for deduction under Division 10BA as follows.

Expand expenditure which qualifies

- Allow all genuine expenses in the production budget to qualify for Division 10BA purposes, including marketing expenses.

Improve administration of product ruling system to reduce time and cost

- Agree a set of pro forma legal agreements for standard Division 10BA investments.

These basic agreements can be modified to suit individual projects, however the expectation would be that if little amendment is made to the standard agreements, the ATO would require no more than 14 days to review the legal agreements.

- Agree a pro forma draft product ruling.

The ATO requires draft sections of the product ruling to be submitted with the application for a product ruling, however taxpayers are often not aware of the form that this should take. Therefore, the ATO could provide a standard form of the product ruling, which includes all the headings and the standard clauses completed (such as Terms of Use and so on), so that the taxpayer is only required to complete the areas in relation to the arrangement. If the ATO were to supply a standard form of the product ruling complete with the various headings that they require, this would simplify the process for the taxpayer and speed up the review process in the ATO.

- Simplify the product ruling checklist

The product ruling application checklist should also be reviewed and simplified. Often a lot of the questions asked in the checklist are not relevant and it takes a substantial amount of time to complete the checklist with reference to legal documents and paragraphs in the application. Perhaps the checklist should only refer to the main requirements of the ruling application, such as the general application details, information about the ruling sought and the documents required.

- Avoid inconsistent results arising from different case officers.

Where a producer requires multiple product rulings, each for a different film but with an identical transaction structure and identical legal agreements (e.g. when a film fund is created for investing in a number of films), the ATO should allocate the same case officer to the subsequent rulings and an identical product ruling (with the name of the film changed) should be issued within a very short timeframe e.g. 21 days.

The ATO should also develop timetable guidelines for each stage of this process so that taxpayers are not unfairly disadvantaged by the particular case officer they are allocated. For example, by a simple ruling taking 6 months to issue when a similar ruling has been issued in 3 months by another case officer.

- Ensure consistency of legal interpretation

The application of the legislation and what has been accepted practice by the ATO in the past needs to be maintained on a consistent basis or, if the ATO has changed its views on a particular issue they need to communicate those changes with stakeholders and why the previously held views of the ATO have changed. This should ideally happen before a taxpayer lodges an application for private/product ruling so that the taxpayer is aware of what the ATO requires in order to satisfy the requirements of Divisions 10B/10BA.

- Improve interaction between DCITA and ATO

There needs to be consistency and clarity of interpretation between DCITA, the ATO and the taxpayer as to the process of provisional certification and what is acceptable when lodging an application for a private/product ruling. For example, is a taxpayer entitled to lodge a ruling application with the ATO with the provisional certificate application, on the proviso that the provisional certificate will be provided to the ATO before the ruling is published, and expect that a case officer will start reviewing the ruling application?

- Restrict consideration of ATO to legal matters

As outlined above, product rulings can be significantly delayed when the ATO focuses on the commercial elements of the transaction which do not impact on the interpretation of the Division 10BA/10B. Where commercial matters, such as the manner in which the FFC contributes funds to a production, do not impact the interpretation of the tax legislation, the ATO should be prevented from questioning the actions of that party. Not only does such questioning delay the issuing of a ruling, such scrutiny should not be allowed to deter innovations which seek to improve the level of private sector investment. For example, if the FFC seeks to improve its return on funds contributed to a film by acting as head distributor, this ensures the FFC will have further funds to contribute to other projects in the future.

Advantages

- Allowing for other expenditure in the production budget to qualify for deduction under Division 10BA may result in producers being willing to allocate greater funds to marketing and improving the marketing strategy to improve the performance of Division 10BA films and thereby attract greater private investment through Division 10BA in the future.
- Improving the efficiency of the product ruling system may mean that producers will not avoid seeking private investment through Division 10BA due to the time and cost involved in obtaining a ruling. As a result, greater private investment in films could be encouraged.

Disadvantages

- Whilst the tax incentive is limited to a 100% deduction to investors, the film invested in must be a commercial success for the investors to break even. Given the poor historical performance of Australian films, these changes of themselves will not result in film becoming a less risky and more attractive investment option to private investors.

4.4.5.2 Retain Division 10BA with additional tax relief for film income

This option would involve retaining the 100% tax deduction for investors, whilst also allowing a certain percentage of film income to be exempt from tax.

By way of example, the following table illustrates the amount of pre-tax income required to be received by an investor in order to break even at different levels of income exemption:

Investment	Deductions	Exemption %	Film revenue	Exemption	Tax	Income after tax
100.00	46.50	0%	100.00	0.00	46.50	53.50
100.00	46.50	10%	92.00	9.20	38.50	53.50
100.00	46.50	15%	88.47	13.27	34.97	53.50
100.00	46.50	20%	85.19	17.04	31.69	53.50
100.00	46.50	25%	82.15	20.54	28.65	53.50

100.00	46.50	30%	79.32	23.80	25.82	53.50
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Therefore, if an exemption of 30% of income is offered, a film only needs to return 79% of budget before the investor breaks even.

Advantages

- It will allow film investment to compete more effectively against alternative investments available to private investors.
- There is precedent for this approach from previous measures (with any issues associated with the previous measures to be eliminated on drafting).

Disadvantages

- If the return to investors becomes too certain, it can result in poor quality films being made as private investment is overstimulated and the competition between films for the private investment funds is eliminated. Some competition is desirable to ensure that the marketplace assesses the commerciality of the films being produced. This can be mitigated by appropriate analysis to ensure that the exemption percentage chosen allows film as a product to compete with other investments, whilst still ensuring that the exemption is not excessive.

4.4.5.3 Expand the Offset to include films of any budget

Although not an option to increase private investment, this option would involve removing or lowering the minimum production budget requirement of \$15M to open up the Offset to non-studio Australian films.

Advantages

- The Offset is a relatively simple system to administer and involves none of the time or cost involved in accessing Division 10BA incentives through the product ruling system.

Disadvantages

- Does not stimulate private investment in films.
- May not be attractive to smaller Australian producers which are unlikely to derive significant assessable income.
- Excludes the producer from accessing all other types of funding support or incentives.

4.4.5.4 Expand or amend the FLIC scheme

Advantages

- There is no need to incur the cost or time involved in obtaining a product ruling to confirm the taxation consequences to investors.

Disadvantages

- The previous capital raisings have not been well subscribed.
- For the same reasons outlined in respect of Division 10BA, a 100% deduction alone is often insufficient to make film an attractive investment option when compared to other investment products.
- The scheme may require substantial amendment to make it attractive to investors.
- The marketplace does not decide which films are made using the concessional capital and therefore the scheme does not operate to ensure that the most commercial films are produced.

4.4.5.5 Replace tax incentives with a grant system

This option would involve abolishing all indirect funding through investor incentives and redirecting the support to direct funding through grants or similar methods.

Advantages

- Simplicity.

Disadvantages

- Whilst it is important for arts bodies to determine a minimum level of Australian content for films, it is inefficient to make a single agency or body the sole determiner of the films and TV which are produced in Australia. Indirect funding options have the benefit of ensuring the marketplace independently assesses the commerciality of the relevant project. A grant system alone will not assist the Australian film industry to grow beyond its current cottage industry status to become a thriving industry.
- The difficulty in jurisdictions with only a grant system has been in determining on what basis films are selected for grants. A direct funding system is always more subjective than indirect funding through investor incentives which let the marketplace decide which films are produced.

4.5 What is the most appropriate model for direct Government support to the film industry? Is current agency structure delivering best possible outcome?

As outlined in the Introduction, our submission is focussed on indirect funding via investor incentives and therefore no further comment is made on the direct funding measures, beyond the brief comments at 4.4.5.5 above.