

**NSW Film and Television Office (FTO)**

**Submission to 2006 review  
of the  
Refundable Film Tax offset Scheme  
(Division 376 of the  
*Income Tax Assessment Act, 1997*)**

**July 2006**

The New South Wales Film & Television Office (FTO) is a statutory authority established under the *NSW Film and Television Office Act 1988 (amended 1996)*. Its mission is 'to foster and facilitate creative excellence and commercial growth in the film and television industry in New South Wales'. The FTO through its Production Liaison Unit works to attract footloose production by representing Australia and NSW at international trade fairs and by pitching to inbound producers.

The FTO welcomes the opportunity to make a submission to the current review of the Refundable Film Tax Offset Scheme.

## **1. SUCCESS OF THE OFFSET AS AN INCENTIVE AND ITS IMPACT ON THE INDUSTRY**

When the federal government introduced the Offset measure in 2001 it was primarily concerned with encouraging large budget films to locate in Australia. AFC production statistics show the following trends:

- The average number of foreign productions in the past five years has risen to fourteen a year compared to eleven a year in the previous five years, representing an additional fifteen productions over the life of the Offset.
- The Australian spend on foreign productions has more than doubled, rising from an average of \$107m in the five years to 99/00 to an average of \$230m in the five years to 04/05m, with a peak of \$279m in 2002/03.
- The overwhelming majority of this spend has been in features, with nine titles spending \$243 million in Australia in 04/05, well above the ten year average of \$129m. The previous year saw a peak of foreign feature production with seven features - including the high budget *Star Wars – Episode III, Son of the Mask* and *Stealth* - spending \$249 million here.
- The picture for foreign and co-produced TV dramas is much less encouraging with spending in this area falling from a high of \$166 million in 1998/99 to \$40 million in 03/04 and just \$17 m in 2004/05 (of which only \$4m represented foreign production). The extension of the Offset to the area of television series has clearly yet to have an impact.

We can therefore surmise that the offset was successful in the first few years in attracting larger budget production to Australia. High-budget features such as *Superman, Stealth, Star Wars-III, Matrix, Charlotte's Web* and mini-series such as *Farscape* have built the capacity and skills of the Australian industry and provided an opportunity to showcase the industry internationally.

We do note however that the *Explanatory Memorandum* cited the expected cost of the Offset \$168 over five years. The cost of revenue has been considerably more modest at \$112m, just two-thirds of the figure envisaged.

## **2. A CHANGED ENVIRONMENT**

The environment has changed as a result of increased international competition from other jurisdictions offering superior or similar incentives, changes in the Post-production, Digital and Visual Effects (PDV) sector, and a 34% rise in the Australian dollar against the US dollar (56 US cents in 1/01 to 75 US cents in 6/06) which has reduced our competitiveness as a location.

Current indications are that there is a significant fall off nationally in offshore production in the 05/06 financial year. The review needs to take account of the changed environment which has placed the Australian production industry in a weaker relative position than it was five years ago.

While the FTO endorses the objectives of the Offset Scheme – namely, to encourage high budget productions - it is important to recognise that high budget production is essentially volatile. The industry is currently suffering from lack of throughput. There is hence a real risk that the skilled crews who have been developed as a result of the offset will be forced to move offshore to find work in 06/07. Indeed, a number are already working in NZ. So while the Offset Scheme has built the skills of the local industry our local crew need continuity of production to keep them here.

To ensure more regular throughput it is necessary to encourage more production in the mid-budget (\$25-40m) range so as to reduce volatility for the industry. Below we propose the introduction of a large expenditure credit whereby once a project has incurred \$50m of Qualifying Australian Production Expenditure other projects from the same studio/producer could automatically qualify for the Offset without having to meet either the \$15m threshold or the requirement for Australian to be 70% of budget, in the event that the latter rule is retained.

In addition, the FTO proposes the abolition of the requirement for Australian spend to represent 70% of overall film budget. This measure was intended to encourage Post Digital and Visual Effects (PDV) work to be done in Australia. It has not met this objective and, as explained below, the global environment for PDV work has changed significantly as PDV is now an increasingly discrete area. Most importantly, the 70% requirement has had a negative impact insofar as projects which could have brought an Australian spend of over \$15m have been disqualified due to not meeting this ratio. Globally, the large 'tentpole' productions in the \$50m plus range have been declining while the number of projects in the \$25-50m range has increased. Australia has been missing out on projects in this range and abolishing the 70% rule would help to turn this around.

Regular workflow is also essential for the PDV sector, which is not being adequately assisted by the Offset. We propose a discrete PDV scheme to address this.

The Offset program has only attracted three television mini-series and the extension of the incentive to TV drama series in 2005 has not succeeded in attracting new projects. The changed environment is such that unless the attractiveness of the incentive is enhanced we will not be able to draw this much needed television production to Australia.

## **2.1 Increased international competition**

Australia faces increased competition from a number of overseas jurisdictions including New Zealand, Canada, South Africa, and several American states which have introduced new incentives.

The major competitor is currently NZ which has enjoyed the patronage of high profile producer/director Peter Jackson and the infrastructure he has built, a range of good accessible locations which are relatively close together, and the recent investment in a large watertank. More studios are likely to be built. Although the NZ Offset incentive is largely the same as Australia's it offers the additional advantage of allowing producers to make an interim claim, which offers productions an advantage in relation to cash flow.

### **Canada**

The Film and Video Production Services Tax Credit is equal to 16 per cent of Canadian labour costs. A number of provinces offer additional incentives. For example, Nova Scotia offers the lesser of 35% of labour costs or 17.5% of total production costs, with additional incentives for regional productions.

### **United Kingdom**

The tax benefit is based on 20% of qualifying budget costs, of up to 80% of the film's budget

### **United States**

Many American states offer local sales tax exemptions as well as refundable tax credits:

- The **Louisiana** Motion Picture Incentive Scheme offers a tax credit of twenty percent of payroll for productions over \$1m. Film productions also enjoy a sales tax exemption.
- **Florida** offers a reimbursement of 15% of qualifying expenditures in the state with a threshold of \$850,000
- The **State of New York**, which advertises itself as film-friendly, offers a tax credit equal to 10% of qualifying expenditures and under the Made in

New York program an additional 5% credit applies for qualified production expenditures occurring in New York City. \$37.5m per year is available for these two programs alone. Further, NY State offers sales tax exemptions for most production and post production costs.

- **Rhode Island** offers an incentive worth 25% of qualifying expenditure.

## **Ireland**

Under 'Section 481' projects receive an incentive of up 20% of eligible Irish expenditure.

### **2.2 Exchange rate movements**

Since 2001 the Australian dollar has risen by 34% in relation to the US dollar, decreasing Australia's competitiveness.

Although the Canadian-Australian exchange rate has recently returned to its 2001 level of .8366 it has risen (and never dropped) against the Canadian dollar at various times over the life of the offset, peaking at 1.0496 in February 04. At that point Australia's competitiveness had deteriorated by 25%.

The Australian dollar rose in comparison with the NZ dollar in the three and a half years to May 06, (NZD1.0752 to NZD1.2367) with a 15% reduction in Australian competitiveness during that period.

### **2.3 Changes in the Post-production, digital and visual effects (PDV) Sector.**

The production process is changing with PDV representing a larger proportion of film budgets and, with technological advances, the location of PDV work is no longer significant. As a result the level of footloose PDV work has risen significantly and PDV is now a discrete area which was not the case five years ago. To date the offset policy has been more focussed on encouraging Australia as a shooting location. It has not been effective in supporting PDV because of the \$15m threshold for qualifying expenditure and the requirement that Australian spend represent 70% of the budget for projects under \$50m. Footloose PDV work by definition is not going to represent such a high proportion of the budget.

There has been at least one reported instance of a PDV production valued at over \$20m going to Canada because it did not meet the 70% Australian spend threshold. Canada does not have such a threshold. Australia has a highly developed PDV sector which is internationally recognised as a result of films such as the *Matrix*, *Moulin Rouge* and *Superman*. However the Australian sector is competing against other territories such as Canada and Britain which have attractive incentives available to PDV projects.

Throughput is particularly important to the PDV sector to encourage investment in training and facilities. The FTO therefore recommends a discrete arrangement for PDV be introduced with a threshold of \$5m and that the requirement for Australian spend to represent at least 70% of the budget not apply for PDV projects, regardless of whether the recommendation to abolish the 70% requirement for the Offset Scheme as a whole is accepted. This would encourage greater throughput of projects and regular workflow. Companies need to retain staff. If they are constantly forced to put people on and off they will lose trained and talented staff to overseas jurisdictions.

### **3. OPERATION AND ADMINISTRATION OF THE OFFSET**

One serious difficulty in the area of administration has been the treatment of insurances by the ATO. The industry disagrees with the treatment of insurances set out in Tax Determination 2006/2.

Typically production insurance and completion guarantees represent between 1.5% and 5% of the budget so the exclusion of these costs from Qualifying Australian Production Expenditure (QAPE) is a very significant disincentive to attracting international productions and creates an obstacle for productions qualifying for the offset.

The FTO believes that the insurances and completion service arrangements are production expenditures necessary to complete the film and are not costs of arranging or obtaining finances for the film. This approach proposed by the ATO is not consistent with the treatment of these costs under the NZ, English or South African incentives which can only reduce Australia's competitiveness further.

The FTO therefore suggests a legislative amendment to confirm that completion guarantee premiums and other insurances (film producers' indemnity insurance, negative film risk insurance, faulty stock camera and processing insurance, weather insurance and extra expense insurance) are identified as costs of production and not financing costs.

The Department of Communications, Information Technology and the Arts (DCITA) undertakes the certification as to satisfying the requirements of Division 376, including scrutinising the budgets to determine if the film's qualifying Australian production expenditure (QAPE) is at least \$15m, and if it is less than \$50m whether QAPE represents a minimum of 70 per cent of the budget. DCITA Film Branch is therefore better equipped to advise on this matter.

### **4. RECOMMENDATIONS**

The FTO believes that the Offset is the most appropriate means to encourage high budget production but that it needs to be amended to deal with changing circumstances. The FTO recommends the following:

#### **4.1 Introduction of a 'Large Expenditure Credit'**

The FTO suggests that a 'Large Expenditure Credit' be introduced where a project worth over \$50m has qualified for the Offset, other projects from the same studio/producer should automatically qualify for the Offset, without no requirement for minimum spend or for 70% of the budget to be spent in Australia, (if that requirement is retained). The suggested timeframe for additional projects to start principle photography (or production in the case of PDV work) is no more than two years from date of certification of initial film.

We envisage this would allow additional lower budget projects such as Movies-of-the-Week or PDV projects to qualify. At present a number of overseas jurisdictions, including Canada and Ireland, have no minimum threshold for expenditure. While this gives them an advantage we are not calling for abolition of the threshold. Instead we propose a 'Large Expenditure Credit' which will send a signal to the studios that if they demonstrate a significant commitment to local production they will be offered some additional flexibility. This proposal aims to increase the number of projects in the \$25-40m range.

#### **4.2 Abolition of the requirement for Qualifying Australian Production Expenditure (QAPE) to represent at least 70% of the film's total production expenditure if QAPE is between \$15m and \$50m.**

This measure was primarily introduced to encourage productions to do their PDV work in Australia. It has not been successful in supporting PDV and has had a negative impact by disqualifying projects in the much needed \$25-50m range which could not comply with this percentage ratio. This budget range is increasingly important globally due to the decrease in high budget 'tentpole' productions.

#### **4.3 Increase in the level of the offset from 12.5% to 15%.**

An increase in the level of the incentive is appropriate in view of the shift in the exchange rate – which has resulted in a 34% reduction in competitiveness - and the introduction of new incentives in other countries. The fall off in large budget foreign production in the past twelve months and the failure of the incentive to attract high budget television series after its extension to that area are evidence that the incentive is no longer sufficiently attractive at 12.5%.

#### **4.4 Separate entry threshold for Post-production, Digital and Visual Effects (PDV)**

The FTO proposes a separate PDV incentive, with a \$5m threshold and no 70% requirement, regardless of whether Recommendation 2 is accepted. This is needed to take account of the changes in the way PDV work is sourced.

#### **4.5 Interim claims**

The FTO suggests that producers be allowed to make interim claims under the Offset Scheme once \$50m has been spent in Australia, rather than having to wait for delivery. This would assist productions with cashflow and would put Australia on a level playing field with NZ, where such a system has been operating and has not to our knowledge been abused. At present there can be a two year lag between the end of Australian spend and delivery.

#### **4.6 Amend the legislation to allow to be counted as QAPE and shift responsibility to assessing QAPE to DCITA**

As outlined above, the FTO is concerned about the treatment of insurances by the ATO in TD 2006/2 which is at odds with the approach taken by competitor countries.

The FTO therefore proposes an amendment to the Division 376 of the *Income Tax Assessment Act, 1997*, to clarify that insurances which are for the provision of 'replacement resources' rather than enhancements are regarded as production expenditure in relation to making of the film, rather than as a financing cost. This would include completion guarantee insurance, film producers' indemnity insurance, negative film risk insurance, faulty stock camera and processing insurance, weather insurance and extra expense insurance. The administration of the scheme would be improved by shifting all responsibility for assessing QAPE to DCITA.