South African Institute of Tax Professionals

11 March 2015

Group Executive: Interpretation & Rulings
SARS Legal & Policy Division
Khanyisa Building
Brooklyn
PRETORIA
0001

BY E-MAIL: POLICYCOMMENTS@SARS.GOV.ZA

Dear Sir/Madam

RE: DRAFT GUIDE – EXEMPTION FROM NORMAL TAX OF INCOME FROM FILMS

We thank you for the opportunity to engage with you on the Draft Guide to the exemption from normal tax of income from films ("Guide") as we strongly support the need for an interpretative guide in respect of section 12O of the Income Tax Act (No. 58 of 1962). Practitioners are having a surprising number of interpretative issues that are complicating an incentive that should be simple.

Set out below, is the consolidated commentary on the guide, developed from both an internal review as well as from consultations with members, stakeholders and industry. The commentary reflects the collective view of members, stakeholders and industry role players consulted.

1 FACTUAL SETTING

As an initial matter, the examples within the Guide should be tailored more closely to the factual settings in which this incentive is utilised. Almost all film schemes utilise a special purpose corporate vehicle (i.e. a private company) to hold the title to the film. This form of nominal ownership is necessary in order for the film to be eligible for the Department of Trade and Industry's ("DTI") film grant. These vehicles are typically formed solely to produce a single film with the company usually liquidating after the peak years in which film earnings arise.

Profits of a film are typically not distributed via dividends. Film profits are instead paid-out via an exploitation rights contract, meaning that the ordinary shares of most film companies have only nominal value. Exploitation rights can be fashioned any number of ways, such as:

- Investors can proportionately divide the aggregate profit based on relative investment contributions;
- Investors can receive a time-value of money compensation in addition to a profit share;
- Investors can receive a profit share as part or additional compensation; and
- Profit shares can be divided into tranches with some investors receiving a high yield only after a certain level of profits are generated.

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg Roads
Pretoria, South Africa
0081

PO Box 712
Menlyn Retail Park
0063

In these arrangements, income in respect of a film almost exclusively arises directly in the hands of the investors (i.e. the holders of the exploitation rights). These payments can be made via the special purpose corporate vehicle in a capacity where the vehicle is effectively equivalent to an agent or sums can be paid via a collection account management ("CAM") agreement. Payments are often made pursuant to a CAM agreement because the CAM agreement can continue after the special purpose vehicle is terminated.

However, there are a minority of scenarios where the company itself earns film revenue and passes these earnings to investor shareholders by way of ordinary or preference share dividends. This type of funding is most readily found in financing arrangements involving the Industrial Development Corporation ("IDC").

Recommendation: The Guide should explain the factual arrangements in which film investments arise, and these factual relationships should be contained within all of the examples (see below):

> Facts: A is a film producer that forms Special Purpose Company to satisfy the DTI grant criteria for producing a film. The film will be produced locally in 2015. Even though title in the film will be held by Special Purpose Company, the profit in the film will be split pursuant to an exploitation rights agreement between A and Investor. A has exploitation rights that provide A with a right of recovery equal to 10 per cent of the film sales proceeds and a R100 000 minimum. Investor will be entitled to the remaining film sales proceeds.

2 NATIONAL FILM VIDEO FOUNDATION

The Guide should also provide a more detailed explanation of the involvement of the National Film Video Foundation ("NFVF") and how relevant information can be obtained from the NFVF's website. In particular, the NFVF classifies films as "local productions" or as "co-productions" (the latter of which are joint arrangements between local South African and foreign parties).

- All relevant information can be found within the NFVF website (www.nfvf.co.za). The viewer hits the "filmmaking" tab at the top in order to go to "co-productions". This tab mostly contains information about the co-production treaties, but there is also a "Certificate of Nationality" form that needs to submitted regardless of whether the film is a co-production or not.
- The relevant parties need to submit a "certificate of nationality" to the NFVF stating the nationalities of all the parties involved so that some proof exists as to local South African participation in the film.
- In addition if a co-production is involved, the website contains the co-production agreements with all foreign countries. The agreements contain additional criteria.
- All required information is then submitted to the NFVF for approval. This approval is essential for obtaining the section 12O film incentive. While it is noted that the criteria for NFVF approval is not expressly listed on the website, approvals are being granted. Approval is generally dependent on the level of South African activity vis-à-vis foreign activity. While this criteria is outside the control of SARS, we would hope that SARS and National Treasury

impose some pressure on the NFVF to produce written criteria (i.e. to make the NFVF's informal criteria explicit).

Recommendation: The Guide should contain the basic outline of the NFVF approval process so taxpayers have a beginning point of engagement with the NFVF.

3 LEGISLATIVE INTERPRETATION ISSUES

"Income" derived from exploitation rights: Further clarification is required as to the meaning of "income derived from exploitation rights" of a film. We assume this form of income covers the direct revenue from the full life cycle of showing the film – movie sale rights, DVD, internet sale rights and television sale rights. However, we also assume that this phrase does not include sponsorship of toys, T-shirts, cups and other goods (as well as future book sales related to the film). The latter form of profit does not stem from the use of the film but only relates to the film brand.

Receipts and accruals "wholly dependent" on film profit and loss: While the guide describes the forms of receipts and accruals outside of the exemption, the guide does not fully describe certain types of receipts and accruals that should be within the exemption. Stated differently, if a service provider receives R500 000 in respect of exploitation rights regardless of film profits, this R500 000 falls outside the film incentive (i.e. is taxable). However, what happens if a service provider receives film exploitation rights in exchange for services, but this service income is wholly dependent on film profits. Our assumption is that these wholly dependent amounts are fully exempt. In other words, parties who take the full risk obtain the full exemption regardless of the nature of the contribution. The exemption essentially seeks to encourage risk capital/involvement as a form of funding. Set salaries, interest and other forms of set payments lack this risk element.

Excess deductions potentially allowed when "incurred to acquire" film exploitation rights: Section 12O(5)(a) allows film expenditures in excess of total film receipts and accruals to be deductible in certain instances. However, the terminology related to these deductions is ambiguous because these deductions relate to amounts "incurred to acquire" the rights. This allowance clearly covers the situations where one party acquires rights from another. However, what about the initial investors? If the initial investors agree to invest set amounts in exchange for their share of initial exploitation rights, this initial investment should again be viewed as the acquisition price for entry. On the other hand, subsequent contributions to subsidise unexpected losses would fall outside the relief.

Prohibition against funds expended if derived for the incurral of debts, credit or "similar financing": This prohibition appears to be a relic of the old section 24F in order to ensure that the sums qualified as borrowed money that was at-risk (i.e. a real and meaningful economic amount owing for the borrower). Prohibited "similar financing" should entail amounts equivalent to debt (financing that is repayable).

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg Roads
Pretoria, South Africa
0081

PO Box 712
Menlyn Retail Park
0063

Timing of the NFVF approval process: The film exemption applies if film rights are acquired before key filming start and end dates. What is the role of the NFVF approval process in terms of the film exemption? Does the exemption still apply if the NFVF application is submitted after film production? The actual date of NVFV approval presumably has no adverse impact on the incentive given the literal wording of section 12O. This aspect of the film exemption should be clarified.

4 Miscellaneous

Paragraph 2.4 of the Guide: Film receipts and accruals are largely exempt until and unless the net deduction is chosen. When read in isolation, paragraph 2.4 seems to suggest that previously exempt amounts are taxable if the net deduction election is subsequently taken. This implication should be removed. Film income only loses the exemption after the net deduction is taken.

Third party reporting: What kind of standard reporting is required of the Corporate Special Purpose Vehicle or CAM when making payments in respect of exploitation rights as proof of receipt? Is there an IT3 of some kind?

Please do not hesitate to contact us should you require any further information.

Yours sincerely,

Keith Engel
Deputy Chief Executive Officer

Erich Bell
Technical Team leader: Tax law & policy

Cc: nalberts@sars.gov.za