South African Institute of Tax Professionals

29 June 2015

The National Treasury

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The South African Revenue Service

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RE: SUGGESTED REFINEMENTS TO THE FILM INCENTIVE: SECTION 12O (ANNEXURE C OF THE BUDGET REVIEW 2015)

This submission is in response to National Treasury's decision to address anomalies associated with the film exemption of section 12O. Our purpose is to provide some context to this unique but important sector.

We trust that this submission will assist you in the drafting process.

Should you have any further questions, please do not hesitate to contact me.

Yours sincerely,

Keith Engel

Deputy Chief Executive

On behalf of the Adhoc Film Tax Committee

South African Institute of Tax Professionals

FILM TAX EXEMPTION ISSUES: LEGISLATIVE ANNEXURE C AGENDA

1. Exempt Yield

a. Overview

Receipts and accruals derived from exploitation rights associated with qualifying films are exempt from normal tax by virtue of section 12O(2). This exemption currently contains three core requirements:

- Approval must be obtained from the National Film and Video Foundation.
- The amounts received or accrued must either be derived: (i) by a person who acquired the film rights before the principal photography date, or (ii) by a person after the principal photography date but before film completion as long as the funds are not applied for the benefit of the first group of persons (e.g. to buy-out the first group). Stated differently, the amounts received or accrued must be obtained from new investors for investment into the film (as opposed to buy-outs).
- The income must be received or accrued within 10 years of film commencement.

Income from exploitation rights must be wholly dependent on the profits and losses of the film (see section 12O(1)("exploitation rights" definition). In most cases, local films are legally housed under a special purpose corporate vehicle as a matter of historical practice and to facilitate film grants from the Department of Trade and Industry.

b. Dividends

Although the owners of most film schemes generate film-related income through the allocation of exploitation rights, some schemes extract profits by way of traditional dividends from the special purpose corporate vehicle. Company shareholders (such as the IDC) of the special purpose company can largely receive tax-free dividends (section 64F(1)(a)), but their corresponding non-company shareholders will be subject to a 15 per cent dividends tax. Yet, dividends derived from film profits are economically equivalent to film exploitation rights and are traditionally the more common method of passing on profits to owners (as opposed to the allocation of film exploitation rights). Dividends paid by a special purpose corporate vehicle (see the section 12(1) definition) should accordingly be exempt in all circumstances because these dividends merely represent a different form of exploitation right allocation.

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c. Pre-sale funding

Many films seek up-front funding to initiate the film process and to establish a viable starting point for future funding. This initial upfront funding often comes from film purchasers / distributors, and these up-front amounts are generally not dependent on film profits or other measured forms of success. As a practical matter,

- The largest funders of up-front fixed amounts are television owners (e.g. SABC, E-TV or DSTV) to purchase television rights to film for channel usage;

- Other fixed funds may be film distributors who pay up-front fixed amounts for geographical or movie-centre reach.

These forms of upfront funding should be exempt because these upfront amounts are not tied to salary.

If Government is not comfortable exempting these amounts, Government should fully allow for deductions offsets against these amounts. In other words, deductions should be fully allowed against pre-funding receipts /accruals to the extent the taxpayer can show that these amounts are fully applied for use as deductible film expenditures. The total deductions allowed under this approach can be limited so as not to exceed pre-funding receipts /accruals (thereby eliminating concerns about the creation of net losses usable against other forms of income). This rule would operate as an exception to section 12O(5).

2. Net deductions

a. Overview

Taxpayers may elect out of the exemption regime and obtain net deductions in limited circumstances. This election into the net deduction regime can only occur two years after the film completion date. These deductions rules come with several limitations to prevent the excess loss film schemes of former section 24O.

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b. The term “acquire”

The film deduction rules of section 12(5)(a) are limited solely for expenditures incurred “to acquire exploitation rights in respect of a film.” The word “acquire”, however, appears to be too limiting. Expenditures are not utilised merely to initially “acquire” the film rights but also to “create” or otherwise “fund” the films overall “enhancement and distribution”. To encompass these concepts, section 12(5)(a) should be extended to cover expenditures incurred “to acquire, devise or develop” the exploitation rights in respect of a film (see section 11(gA).

c. Loan, credit or financing limitation

Even though section 12O(5) generally allows for film expenditure deductions, no deduction is allowed for expenditures funded from loans, credit or similar financing. The purpose of this limitation is to prevent deductions arising from artificial financing design solely for tax avoidance (a common practice under former section 24O.

The difficulty imposed by this limitation is that many film participants obtain legitimate loan funding from third parties as follows:

- Lenders from the United States and the United Kingdom are willing to lend short-term funds for a fixed or variable interest rate with the lending collaterised against firm grants provided by the Department of Trade and Industry or delayed funding from the IDC. In essence, much of this short-term lending essentially mirrors bridge loans against guaranteed but delayed government and quasi-government funding.

- Short-term borrowings against homes, credit card debt and other micro-loans (or even family loans).

In view of the above, expenditures from loan funding should be allowed under several conditions. The loan funding must be short-term (e.g. a maximum of two years), and the loan must be repayable without regard to the profits associated with the film. Most importantly, the loan must leave the taxpayer at-risk – i.e. liable to repay regardless of film profitability.

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3. Process Issues

- *Collection Account Manager (CAM) designation (section 12O(4)(a)):* Film participants must provide reports to the National Film and Video Foundation either through the special purpose corporate vehicle or approved CAMs. Under current law, authorisation of CAMs occurs via Ministerial gazette. As far as we know, no Minister gazette of this nature has ever been issued. We think that this authorisation should instead come from SARS because SARS has the administrative expertise to determine viable administrative reporting entities (as opposed to the National Treasury, which is solely dedicated to policy). At this stage, we know Hollard is a local CAM and that there are two international CAMs ("Freeway" and "Fintage"). These CAMs should receive expedited approval.

- *Taxpayer reporting to the National Film and Video Foundation (NFVF) (section 12O(4)(a)):* Taxpayer reporting to NFVF must currently be performed within the time and manner prescribed by Ministerial prescription. Again, this process is too cumbersome and no such prescriptions have ever been issued. The NFVF should be in charge of the form of reporting. The Minister already controls the information flow from the NFVF to itself. The NFVF is capable of following National Treasury's lead in respect of the feed-through from the film industry.

- *National Film and Video Foundation (NFVF) approval (section 12O(2)(a)):* The role of the NFVF is somewhat controversial within the film industry due to the lack of published guidelines. Those in the "know" tend to obtain approval fairly quickly while others continue to struggle. The lack of published guidelines mean that investors cannot price the section 12O exemption into their pricing considerations. Given these concerns, we suggest that "approval" requirement be extended to allow for either NFVF approval or deem the DTI grant approval as sufficient approval for section 12O purposes.