Taxation (Annual Rates and Remedial Matters) Bill

Officials' Supplementary Report to the Finance and Expenditure Committee on Submissions on the Bill

3 August 1999

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FILM AMENDMENTS

General comment

On 7 July 1999 the Minister of Finance and Minister of Revenue announced a proposed amendment to close down, with effect from that date, certain tax planning arrangements involving films. The Minister asked the Finance and Expenditure Committee to include the amendment in the Taxation (Annual Rates and Remedial Matters) Bill, which had already been referred to the select committee for its consideration. The Minister also requested the committee to ensure that taxpayers had the opportunity to make submissions on the proposed change.

The amendment proposes to include in the definition of "film expenditure" expenditure related to the film but not currently included in the definition. They also treat loss attributing qualifying companies and their shareholders as associated persons.

Issue: Ambit of the amendments

Submission 13 and 13B
(Rudd Watts & Stone, and Simpson Grierson)

The proposed amendments affect both commercially successful and unsuccessful film projects as the legislation makes no distinction between tax driven film projects and legitimate film projects.

Moreover, the proposed amendments would mean that film investors and film companies will be treated prejudicially relative to investors and companies in all other industries.

The features of tax driven schemes that should be stopped are where expenditure on a film is artificially inflated and income expectations are unreasonable. The submission proposes that the amendment apply only to such schemes while preserving the possibility of "downside protection" for other film ventures.

The submitters have provided the Committee with alternative draft legislation which amends section EO 4A by inserting a number of additional criteria, any one of which will trigger the application of the section. These are:

- that the total payments for film rights for which a deduction is sought exceed 120% of the cost of producing the film (the submitters have asked that this figure be revised to 125%);
- that payments for which deductions are sought are exempt income in the hands of the recipient or the recipient is a person not resident in a "grey list" country (i.e. a country with similar tax rules to New Zealand);

- that there is not a reasonable expectation at the outset that the gross income to be earned by the investor as a result of the expenditure would be at least equal to the total expenditure;
- the expenditure is not on a New Zealand film or a film in relation to which at least 50% of the expenditure is in New Zealand.

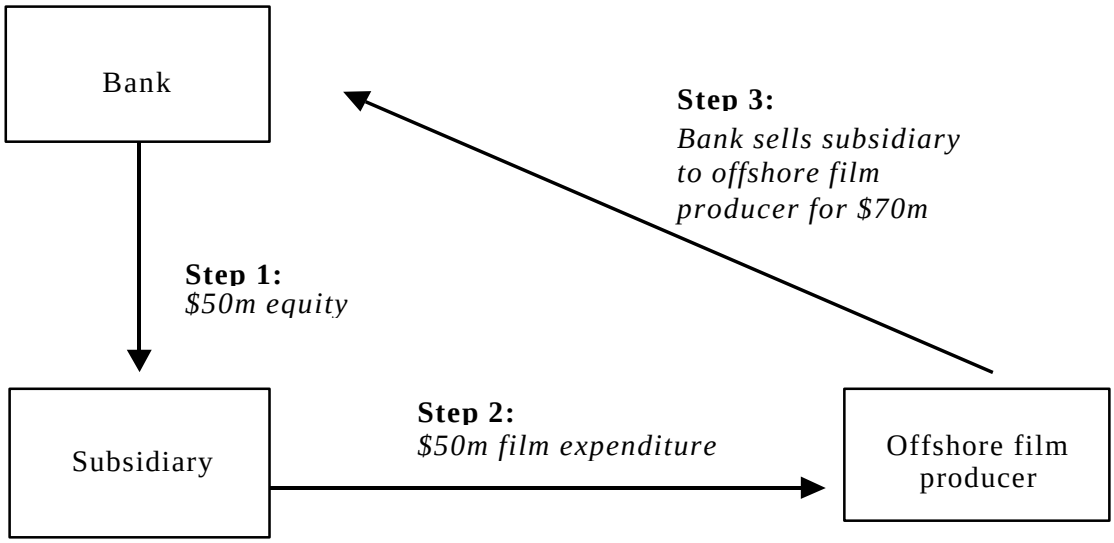
Comment

November bill amendments

The "November bill", now the Taxation (Accrual Rules and other Remedial Matters) Act 1999, stopped economic reimbursement tax schemes involving expenditure on films and petroleum mining schemes entered into by large corporate investors, primarily banks. The amendments claw back film deductions for expenditure within the tax definition of "film expenditure" where there is an arrangement that effectively reimburses the expenditure (usually by the exercise of a put option that a parent company has over shares in the deduction-taking subsidiary).

The November bill structure is illustrated by the following diagram:

FIGURE 1



(The numbers used in this example are close to those used in a real structure.)

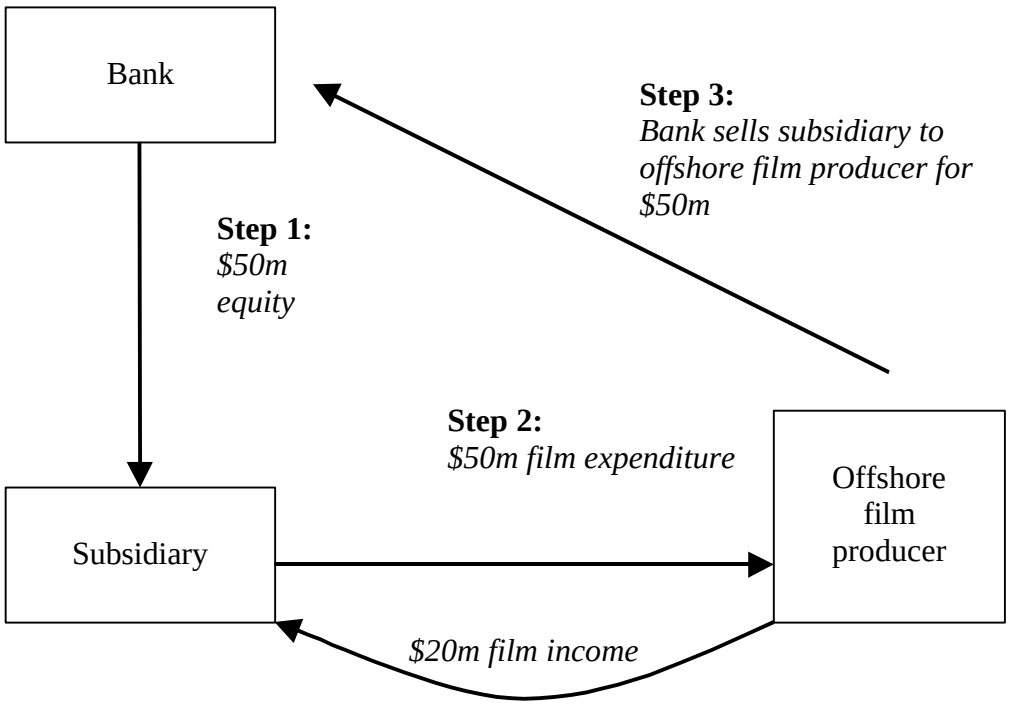
Thus:

New Zealand company group position	*Economic/Accounting income*	*Taxable income*
Deduction for film expenditure	-50	-50
Income from sale of subsidiary	+70	+70
Deduction for cost of subsidiary		-50
Total	+20	-30

Therefore while the economic/accounting position is that the bank has a $20m gain (being a rate of return for the time value of money of 5.77% pa assuming a 6 year term for the arrangement), its taxable position is a $30m tax loss. These figures assume that the proceeds from the sale of the shares are taxable and a deduction is allowed for the cost of the shares. If the proceeds are not taxable then the tax loss is even greater at $50 million.

A variant of the November bill structure is as follows:

FIGURE 2



This structure involves returning $20m as film income rather than by way of profit on the sale of shares. Although this may make the arrangement appear more

commercial, the mismatch between economic and taxable income is the same as in the previous example. Section EO 4A would also apply in this case to claw back the full film expenditure deduction to recognise that there has been economic reimbursement.

It is important to note that the film being produced may be "genuine" or "commercial", and not "tax driven" in the sense of there being an artificial inflation of costs. What the November bill structures allow is for a New Zealand financial institution to finance a film over which it has no substantive equity interest, with a financial return heavily subsidised by our tax base. Presumably this lowers the financing costs of the offshore film producer.

May bill amendments

The May bill's proposed amendments include in the definition of "film expenditure" expenditure on rights that are related to the film but are not currently included in the definition. They also treat loss attributing qualifying companies (LAQCs) and their shareholders as associated persons.

The amendments as proposed by the Government thus have two objectives:

1. To stop Kids World type structures involving investment in films by high income individuals through LAQCs. (This type of structure is illustrated in the annexed example.)

2. To ensure that large corporate investors cannot circumvent the November bill changes by incurring film-related expenditure that is not covered by the tax legislation specifically relating to films.

The amendments proposed by submitters would remove aspects of the economic reimbursement rules legislated in the November bill and those proposed in the May bill. The submitters' proposals, if accepted, would continue to expose the tax base to risk from film transactions.

Application of the suggested 125% threshold to the Kids World structure

The alternative amendments proposed by the submitters would seem to address the Government's first objective of stopping Kids World type structures. This is because those structures involve an artificial inflation of costs and would, therefore, fail to meet the submitters' suggested requirement that the expenditure on film rights must not exceed 125% of the cost of producing the film.

Applying the reasonable prospect of profit test to the November bill structures

The submitters are concerned that it is necessary to provide a capital guarantee (or "downside protection") if financial institutions are to invest in films. They consider that the combined effect of the November bill amendments and the proposed May bill amendments would prevent this in relation to any film whether or not "commercial". This is because in their view the amendments operate too harshly in a situation like that covered by the November bill, where a profit from the film is expected but not in fact realised.

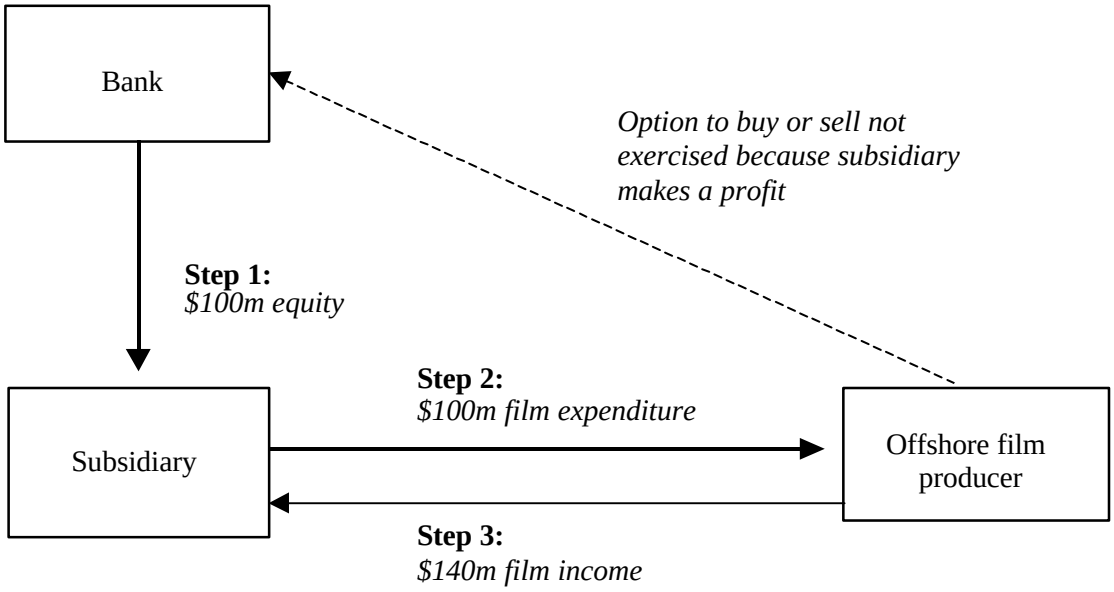
As an example of the effect of the amendments, if in figure 2 a net profit was expected from the capital guaranteed film investment but no profit was in fact produced, the gross income would be subject to tax, but no deduction would be allowed for the related expenditure. Thus, in figure 2, the $20m income would be taxed without any corresponding deduction.

The submitters have, therefore, suggested that the amendments (and the November bill legislation) should not apply where there is a reasonable expectation at the outset that the gross income from the film is at least equal to the cost of producing the film.

The submission means that the tax base would continue to subsidise the risk of a film being unsuccessful. However, officials agree that this should prevent the transactions that the November bill was specifically targeted at, those with a low expectation of income. In transactions actually entered into there was little real expectation of film income (figure 1) or the expectation was of a low level of film income (figure 2).

The type of transaction that would be unaffected by either the November or May bill measures if the submitters' proposal is accepted would be where the expectation of investors was as outlined in figure 3.

FIGURE 3



If this expectation were met, the economic reimbursement measures would not operate since there is no reimbursement of the expenses incurred in step 2.

However, if the film were unsuccessful, then the subsidiary would be sold to ensure the bank realised a profit (or return of investment) as in figure 2. Under the economic reimbursement measures, the deduction for film expenditure would be denied.

Essentially, therefore, the submitters' proposal is that where there is no expectation of profit, the economic reimbursement rule would apply and no double deductions would be allowed. Where there is an expectation of profit, however, the economic reimbursement rule would not apply and a double deduction would be allowed.

Officials have considered these points. The main arguments raised by the submitters for their proposed approach are:

(a) The New Zealand film industry needs the ability to attract investment from financial institutions. Such institutional investment will not be forthcoming if downside protection in the form of the transactions outlined are not available.

(b) Allowing double deductions might result in taxable income being less than accounting or economic income but this is not peculiar to the film industry. The bill would not prevent the described transactions operating outside the film industry. There is no good case for singling out the film industry.

The arguments against the submitters' proposal are:

(a) If the economic reimbursement rules apply in the transactions discussed with the submitters, taxable income of the banking group is the same as its accounting or economic income. Thus, it would still be open to the film industry to be financed along the lines outlined albeit without any tax advantage and under more stringent tax rules than apply outside the film industry.

(b) The proposal would draw a sharp distinction between the tax consequences that would apply to the same transaction depending upon the profit expectations of the parties.

Officials agree that the film industry is being treated less favourably relative to other sectors. However, balancing this are the concessionary provisions for the deductibility of film expenditure. The submitters consider that to some extent the concessions are counter-balanced by a number of existing anti-avoidance provisions in the films regime. Nevertheless, officials consider that the rules overall do operate more favourably than the rules for ordinary business deductions. These concessions provide special rules for film taxation and encourage investment in this high risk area. The transactions considered reduce investor risk and it therefore seems justified to prevent an even more favourable tax regime from resulting. On that basis, officials support applying the economic reimbursement rules to expenditure covered by the film tax regime. This means not altering the measures contained in the November bill.

The issue of applying economic reimbursement rules to film-related expenditure outside the film tax regime (as proposed in the May bill) has needed further consideration. Even where film-related expenditure is not subject to concessionary treatment, officials consider that the economic reimbursement rule should apply. There has been a substantial amount of investment in the film industry in recent times. The immediate deductibility of expenditure in relation to films both within and outside the films regime, combined with the difficulty in valuing films, means that

film investment poses a special risk to the tax base. The Government considers it important, therefore, to address this risk.

The Government acknowledges that longer term solutions across a wider range of industries are still necessary to close off the range of possibilities for putting the tax base at risk. The Government is currently working on such longer term solutions. However, this should not prevent the Government from implementing short-term solutions such as the present amendment when a clear risk to the tax base presents itself.

Therefore, although the proposed amendment is a short-term solution, the risk to the tax base posed by schemes using this film investment structure is too great for the Government to wait until comprehensive solutions are developed.

If the reasonable expectation aspect of the submitters' proposal were adopted more detailed rules for applying the test would need to be developed. This has been discussed with the submitters.

Other criteria for the application of section EO 4A as proposed by the submitters

As noted above, officials consider that the suggested 125% threshold test would be effective against Kids World type structures. This means that the requirement that the recipient of the payment for film rights be resident in a grey list country would be unnecessary. In addition, it would be likely to have little practical effect since an offshore producer may have deductions for actual film expenditure offsetting income it received from the sale of film rights. The requirement could also be circumvented by using a grey list entity as an intermediary or conduit for a tax exempt entity or an entity in a low tax jurisdiction.

Although the New Zealand film content requirement is desirable, it does not in itself address any of the tax issues since the structures that resulted in the November bill changes did in fact involve films with a significant New Zealand content.

Conclusion

In conclusion, the submitters' proposals do not achieve the Government's objective of maintaining the tax base.

Recommendation

That the submission be declined and the amendments proposed by the Government proceed.

Issue: Economic implications

Submission 12B and letter from Motion Picture Association (MPA)

Submission 12B
(Rudd Watts & Stone)

A report produced in the limited time available by Ernst & Young, approved by peer review by Dr Alex Sunderkov at NZIER, together with the MPA letter, suggest that the effect of a failure to target section EO 4A along the lines proposed by submission 13 is highly likely to have a significant adverse impact on future film production in New Zealand by US studios.

The results of the submitters' analysis, based on an assumed incremental expenditure of $100m indicate:

- total economic impact measured in terms of incremental output generated in the economy is approximately $210m;
- value-added impact (contribution to New Zealand Gross Domestic Product ('GDP')) is approximately $115m;
- total incremental increase in tax revenue is approximately $44m, made up of an initial incremental increase of $21m and a subsequent incremental increase from flow-on effects of $23m;
- owing to time constraints placed on the submission, the assumptions used to estimate economic benefit are conservative.

Based on this indicative analysis the submitters' conclusion is that incremental offshore film production expenditure in New Zealand has positive effects on the New Zealand economy and taxation revenue.

Extract from letter from Motion Picture Association

"The single most compelling factor in the decision to relocate production from Southern California to foreign jurisdiction is cost. If the existing New Zealand tax provisions now used for financing productions are eliminated, the cost of production in New Zealand may no longer be competitive when compared to other suitable locations around the world. Moreover, if changes in the law are effectuated so as to impact on ongoing productions including subsequent seasons of ongoing television series, the consequences will be even more dramatic in discouraging future production in New Zealand.

Film production is a moveable business. Our business is labour intensive, creating many desirable and high paying jobs. The worldwide marketplace for production is highly competitive. Foreign countries often seek assistance of the MPA in creating incentives likely to attract film production and, if so requested, we would assist you [the New Zealand Government]."

Comment

The Motion Picture Association (MPA) suggests that if the proposed amendment proceeds, production costs in New Zealand may no longer be competitive, and hence the industry may have to shift production offshore. However, the MPA has not indicated to what extent its investment decisions would be influenced by the proposed amendment. Nor has it specified particular investments that will not proceed if the proposed amendment is implemented.

The Ernst & Young report does not attempt to estimate the extent to which the proposed amendment would affect foreign investment decisions. Nor does it estimate the net cost or net benefit of the proposed amendment for New Zealand. Rather, all it does is to provide rough estimates of some of the potential benefits to New Zealand from an additional $100m of foreign investment in film production.

The report does not take into account the potential costs associated with failing to implement the proposed amendment. In particular, it ignores the cost to New Zealand associated with unintentionally attracting resources away from other investments that would be of greater net benefit to New Zealand. For example, the report notes that investment in tourism would yield even greater benefits to New Zealand. The report also ignores the considerable costs to New Zealand associated with the Government in effect underwriting at taxpayers' expense the risks associated with film production.

In any event tax policy should not be driven by any perceived need to provide incentives to investment in particular sectors.

Issue: Certainty of film tax treatment

Submission 14W
(New Zealand Film Commission)

The New Zealand Film Commission emphasises the desirability of having certainty and stability in the tax treatment of film investment. The Commission notes that film investment depends on as much certainty as possible in the fiscal and regulatory environment. The Commission would be concerned if the proposed tax changes were put together in such a way that they required further consequential change at a later date.

Comment

The New Zealand Film Commission does not oppose the proposed amendments. Instead, its primary concern is ensuring that there is certainty and stability in the tax treatment of the film industry, especially in order to encourage investment from overseas in the New Zealand film industry.

The Government recognises and endorses the desirability of having certainty and stability in the tax treatment of the film industry. The tax treatment of the film industry should be sustainable in the longer term and not be subject to significant

changes, as a constantly changing tax regime deters foreign investment. As the submission notes, there has recently been significant United States investment in the making of film and television programmes in New Zealand.

It is the Government's policy to encourage foreign investment into New Zealand because of the significant benefits to New Zealand that such investment brings, such as new jobs, skills and technology. Foreign investment in New Zealand also assists in lowering the cost of capital to New Zealand businesses.

However, the Government's tax policies are designed to ensure that investment decisions are generally based on commercial merit rather than taxation advantage, thereby minimising distortions to the pattern of investment. The most stable tax laws are those that minimise any tax base problems.

Recommendation

That the principle of the desirability of certainty and stability in the tax treatment of the film industry, as highlighted in the submission, be endorsed.

Issue: Not including service providers in film expenditure regime

Submission 13
(Rudd Watts & Stone, and Simpson Grierson)

The extension of the definition of a "right" in a film should be restricted to the application of section EO 4A. This would mean that the expenditure of service providers such as actors and directors would continue to be governed by the general deductibility provisions rather than the film expenditure regime in sections EO 3 and EO 4.

Comment

The expenditure of service providers such as actors and technicians who are not investors in a film, but whose remuneration is partly dependent on income from a film, would come within the film expenditure regime instead of the general deductibility provisions under the amendments as currently drafted. Officials agree that the expenditure of such service providers should continue to be governed by the general deductibility provisions rather than the film expenditure regime. It was not intended that the amendment apply to this expenditure.

Recommendation

That the submission be accepted.

Issue: Application date

Submission 12 and 13A
(Rudd Watts & Stone)

The proposed changes to section EO 4A of the Income Tax Act 1994 have retrospective effect and should be altered so the proposed clauses apply only to transactions entered into on or after 7 July 1999.

Comment

The proposed amendment to counter tax driven film deals applies to any expenditure incurred or depreciation recognised from 7 July 1999, the date the Government announced the amendment would be effective from, irrespective of whether investors have committed themselves to finance a project. The amendment may, therefore, affect a transaction that was entered into before 7 July 1999 if expenditure relating to the transaction is incurred or depreciation recognised on or after 7 July 1999. However, the proposed amendment would not affect a transaction for which all expenditure had been incurred or depreciation recognised before 7 July 1999.

The Government carefully considered the matter of the appropriate application date of the amendment before recommending that it apply to expenditure incurred or depreciation recognised from the date of announcement, 7 July 1999. The Government decided that it did not wish to "grandfather" aggressive tax driven deals, and that it wanted to send a message to potential investors that tax driven deals may be overturned part way through their lives. However, the amendment will not affect expenditure on a film incurred or depreciation recognised before 7 July 1999.

The expenditure incurred basis of the application date of the proposed amendment is consistent with that for section EO 4A, the related film economic reimbursement provision, which was recently enacted by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. This section, which reduces deductions for expenditure taken under the film expenditure regime if there is an effective reimbursement of the expenditure and the ambit of which will be widened by the proposed amendment, applies to expenditure incurred on or after 17 November 1998. This amendment also did not "grandfather" existing arrangements.

Another advantage of having an amendment apply to expenditure incurred or depreciation recognised rather than transactions entered into after the commencement date is that it provides more certainty where a transaction involves a number of contracts.

It should be noted that the "Kids World" prospectus itself put investors on notice that the tax results of the investment could be affected by future legislation.

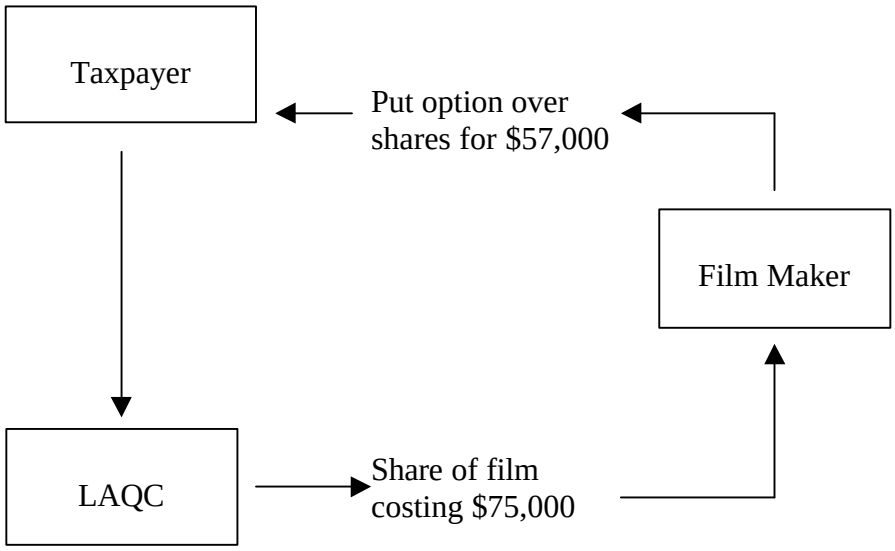
Recommendation

That the submission be declined.

Annex

FILM LEGISLATION PROPOSAL
SIMPLIFIED HIGH INCOME INDIVIDUAL EXAMPLE

The following example sets out how a film scheme targeted at high income individuals might work and details the effect of the proposed law change. Of necessity a number of the steps have either been considerably simplified or omitted. Any scheme targeted at high income individuals would typically consist of a number of taxpayers and a partnership of loss attributing qualifying companies, LAQCs.



1. Taxpayer sets up a special purpose LAQC with $75,000 of capital. $57,000 of the $75,000 is financed by Taxpayer via a loan. The balance of $18,000 is provided by the Taxpayer directly.

2. Taxpayer arranges for a put option to guarantee the shares in LAQC can be sold for $57,000 should the film be unsuccessful. (This sum is not taxable.) This ensures that Taxpayer's net cash outlay is only $18,000.

3. LAQC pays Film Maker $75,000 to acquire a share in a film and deducts this amount. This loss is transferred to Taxpayer. These losses provide Taxpayer with a tax refund of $25,000, or $1.39 for every dollar actually outlaid by Taxpayer.

4. $57,000 of the $75,000 Film Maker receives is set aside by Film Maker to fund the potential purchase of the shares in LAQC.

Economically Taxpayer has paid $75,000 for the LAQC shares, held them for some time and then sold them for $57,000, a net cost of $18,000. However, Taxpayer has also obtained a tax refund of $25,000 – in other words, Taxpayer has made $7,000 on the deal, but only at the expense of the tax base.

The proposed law change would reduce Taxpayer's losses by $57,000 because Taxpayer has been "reimbursed" that amount – in other words, Taxpayer has not borne a loss of $75,000, but only $18,000.

If the film is successful the put option is not exercised and the proposed amendment has no effect.

CROWN ENTITIES AND THE ASSOCIATED PERSON TEST

Issue: Special corporate entity rules

Clauses 27, 28, 42 and 45

Submission
(*1W - KPMG on behalf of Meridian Energy Limited*)

Further amendments are necessary to the special corporate entity (SCE) rules to:

1. clarify that the subsidiaries of SCEs cannot group loss offset with the subsidiaries of any other SCE, and

2. confirm that subsidiaries of a SCE can group losses with its parent SCE.

These are generic problems with the SCE rules.

Comment

SCEs either have no shareholders or are entities where changes in shareholding should have no tax consequence. The best example is that the shareholding in an SOE could change when the shareholding Minister changes – that should not affect the tax treatment of the SOE. Accordingly, the SCE rules deem that a SCE is held for tax purposes by a "same single person" at all times, regardless of who actually (if anyone) holds the shares.

The submission points out that there is some doubt as to who actually is deemed to own the shares in any subsidiary of a SCE. The Income Tax Act states that shares in a subsidiary are deemed to be owned by the shareholders of the parent company. However, this does not mesh well with the SCE provisions, where the "same single person" is deemed to have no other ownership rights other than those in the SCE. The submission correctly points out that this could cause confusion and unintended results.

Accordingly, the clarification of the rules governing SCEs and their subsidiaries as proposed is appropriate.

As with the associated person changes, the amendments should be backdated to 1992. However, tax returns that have already been filed that take up a different position should be "grandfathered".

Officials believe that the "notional single person" rule in section OD 5(5), which works in a similar way to the "same single person", is similarly affected and should be amended in like fashion. However, because this provision is more complicated it is recommended that this amendment be made in the next available taxation bill.

Recommendation

That the submission be accepted and that section OD 5(5) be clarified as soon as is possible.

Issue: Scope of the associated person amendments

Submission
(*Matters raised by officials*)

The amendments proposed in the bill are too wide in that they simply exclude the application of the associated person rules to SCEs, rather than limit their application. Further, the proposed amendments do not appropriately deal with companies in which SCEs directly or indirectly hold shares.

Comment

Each SCE is deemed to be held by a different "same single person" for the purposes of the voting and market value tests. To the extent these tests are used in the associated person tests for other companies, they should apply for SCEs as well. This will involve restricting the ambit of the proposed amendment.

The associated person rules should apply to ensure that SCEs and their subsidiaries are only associated vertically (that is, an SCE and its subsidiaries), but not horizontally (that is, SCE with SCE, or SCE subsidiary with another SCE or the subsidiary of another SCE).

Recommendation

That the submission be accepted.