



The Producer Offset: the Financier's Perspective

The new tax relief system brought in by the Australian Screen Production Incentive introduced a new range of tax measures for the motion picture industry in Australia, consisting of the following refundable tax offsets:

- the **Producer Offset**, for producers of films with Significant Australian Content or Official Co-Productions;
- the **Location Offset**, for producers of higher budget films shot in Australia; and
- the **PDV Offset**, for producers of films which have significant post-production, digital and visual effects work carried out in Australia.

These reliefs find their expression in the revised Division 376 of the Income Tax Assessment Act 1997 (Cth) (the **Act**). The previous film tax regimes contained in Divisions 10B and 10BA of the Income Tax Assessment Act 1936 (Cth) will be repealed in 2010, and applications under these arrangements are no longer being accepted.

Only one of the three tax offsets listed above may be claimed for any one film, and with the Producer Offset yielding an available rebate of up to 40% of qualifying expenditure for feature films (compared to 15% for the Location Offset and the PDV Offset), it has understandably received the majority of attention in Australia and internationally, and is likely to be used the most.

This briefing outlines:

- the workings of the Producer Offset and the criteria for eligibility; and
- specific issues for financiers proposing to cashflow the Producer Offset,

as independent film producers will rely on lenders to advance the anticipated amount of the Producer Offset as part of their financing arrangements. The participation of the finance community will therefore be key to providing the stimulus that the Producer Offset is intended to create.

We do not deal with the Location Offset or the PDV Offset in this briefing, however these draw on many of the concepts utilised in the Producer Offset, and we can provide specific information on these reliefs on request.

Although highly specialised and potentially subject to relatively small returns in the deployment of capital, the sovereign credit makes the Producer Offset an attractive proposition for lenders, particularly in the current financial climate.

The Producer Offset

The Producer Offset enables producers of films containing Significant Australian Content, or Official Co-Productions, to receive a refundable tax offset of 40% (for feature films) or 20% (for television and other film projects) of the production company's Qualifying Australian Production Expenditure (**QAPE**), provided certain minimum expenditure thresholds and other criteria are satisfied. Significant Australian Content and QAPE are the principal determinants of eligibility for the Producer Offset.

Executive Summary

The basic workings of the Producer Offset are as follows:

- The film must contain Significant Australian Content or be an Official Co-Production.
- Minimum QAPE thresholds must be met (and the Producer Offset is only available on QAPE).
- The Offset is only available to Eligible Production Companies (**EPCs**).
- The EPC must carry out all of the activities which are necessary for the making of the film, or arrange for those activities to be carried out.
- The film must be produced for exhibition to the public in cinemas (in the case of feature films wishing to qualify for the 40% offset) or for television broadcast or distribution to the public as a video recording.
- The film must be in an eligible format.
- The film must be completed in the income year in which the Producer Offset is claimed.
- The Offset is only available if the Film Authority has issued a Final Certificate to the EPC.
- The Film Authority is responsible for the general administration of the Producer Offset, and must be satisfied that the requirements set out above have been complied with before it will issue a Final Certificate. The Film Authority is the Film Finance Corporation (**FFC**) until

1 July 2008, at which time a new body, Screen Australia (which will be a merger of the FFC, Film Australia and the Australian Film Commission) will take over.

- The Film Authority must issue a Final Certificate if it is satisfied that the requirements of Division 376 have been complied with.
- The EPC will be required to submit the Final Certificate to the Australian Taxation Office (ATO) along with its income tax return at the end of the financial year in which the film is completed, and the ATO will calculate the applicable level of the Offset (ie 40% or 20% of the QAPE certified by the Film Authority) and apply that first against the EPC's tax liabilities before paying over the balance.

The detailed workings of the Producer Offset are set out in the Schedule.

Issues for Financiers

Financiers lending against the Producer Offset will clearly be concerned to ensure that (1) the film and the EPC qualify to receive the Producer Offset at the required level, (2) the EPC will apply to the Film Authority for the Final Certificate and submit its income tax return to the ATO as soon as possible after completion of the film and (3) the EPC will not have any tax liabilities against which the ATO could apply the Producer Offset (as opposed to paying it out in full where the EPC has no tax liabilities).

As such the following issues will be important:

- The EPC should be a newly established special purpose vehicle which is tax neutral and does not form part of a consolidated group of companies for tax purposes.
- The EPC should procure a Provisional Certificate from the Film Authority as a condition precedent to funding, as well as an auditor's opinion signing-off on the level of QAPE contained in the film's budget. Official Co-Productions should also be provisionally approved.
- Financiers will require first ranking security over the EPC's right to receive the Producer Offset and the bank account into which it will be paid, and will also require security over the EPC's rights in the film and substantially all of its other assets (the priority of which will be determined by the nature and sources of the remaining finance).
- The EPC will be required to grant a power of attorney in favour of the financier to enable it to deal with the Film Authority and the ATO in the event that the EPC does not apply for the Final Certificate and/or submit its income tax return. It may also be prudent to require a performance guarantee from the EPC's parent company (or another company of substance), to provide comfort that these and other contractual obligations assumed by the EPC in regard to claiming the Producer Offset will be complied with.

- Financiers will need to review and be comfortable with the distribution agreement providing for the release of the film in Australia prior to funding.
- Financiers will require an absolute right of approval to any replacements to the main cast and crew which could impact on the film containing Significant Australian Content.
- Financiers may wish to apply a discount to the amount advanced against the Producer Offset to provide a buffer, in case the level of QAPE determined by the Film Authority is lower than anticipated, and for the same reason they should also take a fall-back position in the recoupment waterfall for the film.
- The Completion Guarantor will be required (as a minimum) to agree not to complete and deliver the film in a manner which would make it ineligible to receive the Producer Offset, and (preferably) to do so in a manner which is consistent with its provisional certification. The Completion Guarantor should also bond the level of QAPE.
- The Collection Agent and beneficiaries under the Collection Agreement will need to agree that the proceeds of the Producer Offset will be repaid outside of the usual Collection Account arrangements.
- Appropriate representations, warranties and undertakings will be required from the production company, including:
 - that the film contains Significant Australian Content (or is an Official Co-Production);
 - as to the projected level of QAPE;
 - that it is an Eligible Production Company;
 - that it will not conduct any other business;
 - that it has secured a guaranteed release of the film in Australia;
 - that it has not applied for or received any other form of film tax relief or grant in Australia which would make it ineligible to receive the Producer Offset;
 - that the film will be produced in accordance with the budget, production schedule, cashflow schedule, synopsis and other materials provided to the financier as conditions precedent, as well as in accordance with the Provisional Certificate application submitted by the EPC to the Film Authority; and
 - as to the prompt application for a Final Certificate to the Film Authority and submission of its income tax return to the ATO for the year in which the film is completed.

These matters are additional to the usual documentary and other protections required by film financiers, such as sign-off on chain of title and reporting requirements.

Schedule

The specific workings and eligibility requirements of the Producer Offset are set out below.

Significant Australian Content

The Film Authority must be satisfied that:

- (a) the film has Significant Australian Content; or
- (b) has been produced as an Official Co-Production.

In determining whether a film has Significant Australian Content the Film Authority must have regard to:

- (a) the subject matter of the film;
- (b) the place where the film was made;
- (c) the nationalities and places of residence of the persons who took part in the making of the film;
- (d) details of the production expenditure for the film; and
- (e) any other matters it considers relevant.

The Explanatory Memorandum to Division 376 of the Act makes it clear that in circumstances where the matters under paragraphs (a) to (d) do not result in a strong case for or against certification, the Film Authority may consider sources of finance and the nationalities and places of residence of the owners of the copyright in the film.

Guidelines issued by the Film Finance Corporation in April 2008 acknowledge that many of these factors are qualitative rather than quantitative, and require an informed judgment. These guidelines state that the FFC will not regard any single factor as determinative, and that it will "consider all relevant factors as part of an holistic test, applied on a case by case basis, to determine whether a film has significant Australian content".

More helpfully, these guidelines go on to outline the following five part test which the FFC (and presumably Screen Australia thereafter) will use to evaluate whether a film has Significant Australian Content, and provide a commentary on each aspect, as set out below:

1 Subject Matter: to what extent is the story recognizably about Australia or Australians?

The guidelines imply that a film will need to either have an Australian setting or be made about Australians (in Australia or abroad), and state that fantasy type films are unlikely to qualify on content and will need strong Australian elements elsewhere. Documentaries which have no on-screen Australian content or setting will be considered from the Australian perspective within the international arena.

2 Place where the film was made: is the film to be fully produced in Australia (including concept and script development, pre-production, shoot, music and post production)?

The FFC expects a "significant proportion" of the work to be carried out in Australia.

3 The nationalities and places of residence of the persons who took part in the making of the film: to what extent is the film originated and creatively driven by Australians?

The guidelines state that the FFC expect key creative roles to be filled by Australians (i.e. writer, director, producers, lead actors and heads of departments), and that the inclusion of non-Australians will reduce the level of Significant Australian Content. There is also an expectation that the majority of the crew would be Australian, unless the subject matter of the film requires it to be shot offshore using offshore crew.

4 The details of the production expenditure incurred in respect of the film: what percentage of production expenditure will be incurred in Australia?

The FFC will require 67% of the film's budget to be spent in Australia.

5 Any other matters that the film authority considers relevant: the guidelines state that the FFC may also have special regard to:

- (a) the core origination of the project, in terms of the underlying rights and their ownership and development;
- (b) whether the lead producer is Australian;
- (c) ownership of copyright by Australians;
- (d) employment opportunities for Australians;
- (e) the amount of overseas crew; and
- (f) the body of work and the length of association with the project of the writer, director and producer (if the other elements are in doubt).

Films made in Australia which do not have sufficient Australian content and are not Official Co-Productions may nevertheless be eligible for the 15% Location Offset.

Qualifying Australian Production Expenditure (QAPE)

The amount of the Producer Offset will be calculated on the basis of a film's QAPE. QAPE has a dual role for the purposes of the Producer Offset, in that:

- it is the basis for determining whether the minimum expenditure thresholds have been met, and
- it determines the level of the Producer Offset, as the amount payable by the ATO is a fixed percentage of QAPE¹.

Before a film's QAPE can be established it is first necessary to determine its production expenditure, which the Act defines broadly as "the expenditure incurred in, or that is reasonably attributable to, the making of the production". Production expenditure for these purposes can include non-cash expenditure such as allowances for depreciating assets which are used in the production of a film.

QAPE is essentially a sub-set of production expenditure,

¹Save in the case of Official Co-Productions, as described below

and will be the total production expenditure for the film, to the extent such expenditure is incurred for, or is reasonably attributable to:

- goods and services provided in Australia;
- the use of land located in Australia; or
- the use of goods which are located in Australia at the time they are used in the making of the film.

Specific inclusions and exclusions apply when calculating production expenditure and QAPE and these are set out in the Appendix.

A maximum of 20% of the total “above the line” expenditure can be claimed as QAPE. Above the line expenditure in excess of 20% is not excluded from total film expenditure, nor does this preclude a film being eligible for the Producer Offset.

QAPE Thresholds

The Film Authority must be satisfied that the film meets the applicable minimum QAPE threshold, as set out below:

- Feature films: the QAPE threshold is \$1,000,000.
- Single episode programmes other than documentaries: the QAPE threshold is \$1,000,000 and the QAPE per hour must be at least \$800,000.
- Single episode documentary programmes: the QAPE per hour must be at least \$250,000.
- Series’ (or seasons) other than documentaries: the QAPE threshold is \$1,000,000 and the QAPE per hour must be at least \$500,000.
- Documentary series’ (or seasons): the QAPE per hour must be at least \$250,000.
- Short form animations: the QAPE threshold is \$250,000 and the QAPE per hour must be at least \$1,000,000.

Average QAPE per hour is calculated by dividing total QAPE by the actual total duration of the film in hours (including part hours).

For Official Co-Productions seeking to meet minimum QAPE thresholds, expenditure incurred by the EPC or another entity involved in the co-production (which would be QAPE if it was incurred in Australia as QAPE) is deemed to be QAPE for the purposes of determining whether the QAPE thresholds have been satisfied - however this will be excluded when quantifying the amount of the Producer Offset itself.

For television series, an average duration is taken across all episodes of a series, rather than each episode being required to meet the minimum QAPE threshold. An average duration will be taken across a season of a series (as each season will be assessed as a stand alone production), rather than across all seasons of a series.

Provisional Certification: Provisional Certificates are designed to give an indication that a proposed film will be eligible to receive the Producer Offset if it complies with the details submitted to the Film Authority, although they do not provide a guarantee of receiving a Final Certificate. Financiers cashflowing the Producer Offset should always require the issue of a Provisional Certificate as a condition precedent to funding, although as the Certificate will not be addressed to them they should also seek an independent auditor’s opinion.

Only Available to an Eligible Production Company (EPC)

As the Producer Offset operates as a set-off against the production company’s Australian tax liabilities, an EPC must be an Australian resident or a foreign resident company which has a permanent establishment in Australia and an Australian Business Number (and is subject to Australian income tax). These criteria must be satisfied at the time the company lodges its income tax return and at the time the Producer Offset is due to be paid by the ATO.

A company is a resident in Australia for these purposes if:

- it is incorporated in Australia; or
- it carries on business in Australia and either has its central management and control in Australia, or its voting power is controlled by shareholders who are Australian residents.

Companies which are owned and controlled by foreign entities, and Australian commercial broadcasters which are related to those companies, may therefore be eligible for the Producer Offset.

The EPC Must Carry out the Activities for the Making of the Film

The Film Authority must be satisfied that the EPC carried out all of the activities which were necessary for the making of the film, or made arrangements for those activities to be carried out. The only exception to this is where a co-producer under an Official Co-Production can be treated as fulfilling the requirements for carrying out all the activities for the making of the film, in relation to that co-production partner’s activities.

“Making the film” means doing those things which are necessary for the production of the first copy of the film, including pre-production and post-production (which take their ordinary industry meanings). This does not include developing the proposal for the making of the film (even though Australian development expenditure counts as QAPE), arranging finance or distributing or promoting the film. An EPC may sub-contract certain activities in the making of the film to third parties.

The Film must be Produced for Exhibition to the Public in Australia

The Act alludes to intention (which is the test applied in the UK) in describing the requirement as the film being produced for exhibition to the public, however the Explanatory Memorandum indicates that the key requirement (for feature films) is that the Film Authority must be satisfied of the existence of a distribution guarantee, providing for the exhibition of the film in commercial cinemas on arms length terms. Guidelines issued by the FFC in November 2007 state that the Film Authority will require evidence of a commercial agreement for distribution via exhibition in commercial cinemas in Australia, where an admission fee is to be charged. This should be a bona fide release (six screens in aggregate in three capital cities has been cited as the requirement which would satisfy this), rather than a contrived arrangement for release on one or a very small number of screens. Test screenings, free or charitable screenings, and film festival screenings are excluded.

Recent conversations with the FFC have indicated that they do not intend to penalise producers if a prior Australian distribution deal satisfying this test falls away prior to final certification, although this is still to be confirmed as official policy.

This is a key issue for feature film financiers, as the amount of the Offset reduces from 40% of QAPE to 20% if the Australian release requirement is not satisfied.

Evidence of distribution on a commercial basis must also be provided for formats other than feature films. Such distribution may include Australian television broadcast or commercial delivery of a production via a new media platform (such as online or mobile content), where access to the content is available to Australians. This may be through bona fide self-distribution or arm's length distribution.

From a commercial perspective this requirement will inevitably give distributors the upper hand in negotiating distribution arrangements.

Eligible Format

The Film Authority must be satisfied that the film is:

- (a) a feature film;
- (b) a single episode programme;
- (c) a series or a season of a series; or
- (d) a short form animated drama, if not covered under paragraphs (a), (b) or (c).

A film will not qualify if it is, to a substantial extent, a film for exhibition as an advertising programme, a commercial, a discussion programme, quiz programme, panel programme, variety programme or other programme of a similar nature, a film of a public event (other than a documentary), a training film, a computer game, a news or current affairs programme or a reality programme.

The Film must be Completed in the Income Tax Year in which the Producer Offset is Claimed

A feature film will be treated as being complete when it is first in a state where it could reasonably be regarded as being ready to be distributed, broadcast or exhibited to the general public. A series or a season of a series will be complete when the 65th episode can first be reasonably regarded as being ready to be distributed, broadcast or exhibited to the general public, or when the series is first in such a state - whichever is earlier.

The Producer Offset cannot be claimed part-way through the production of the film (unlike the UK's film tax credit), and EPCs with long production/post-production schedules will need to consider their cashflow needs carefully (or factor higher interest payments into their finance plans), particularly if completion of the film is scheduled to occur long before the end of the EPC's financial year. Financiers will similarly need to factor these timing issues into their interest reserve calculations.

The EPC must claim the Producer Offset in its income tax return for the year in which the film is completed. The EPC's claim for the Offset will be based on the existence of the Certificate from the Film Authority (see below) and the level of QAPE specified in the Certificate.

Issue of a Certificate and Payment of the Producer Offset

The issue of a Certificate by the Film Authority is the central requirement which unlocks the payment of the Producer Offset by the ATO. The Film Authority must issue a Final Certificate if it is satisfied that:

- the EPC carried out or made arrangements for the carrying out of the activities which were necessary to produce the film;
- the film has Significant Australian Content (or is an Official Co-Production);
- the film was produced for exhibition to the public in cinemas, or by way of television broadcasting or for distribution to the public as a video recording;
- the film is in an eligible format; and
- the relevant QAPE threshold has been met.

As stated above, the level of QAPE will determine the amount of the Producer Offset (save for Official Co-Productions). Once a Final Certificate has been issued the company must submit the Certificate to the ATO along with its income tax return for the year in which the film is completed. The ATO will not reconsider any matters considered by the Film Authority, and will calculate the Producer Offset based on the amount of QAPE specified in the Final Certificate and the 40% or 20% entitlement of the EPC, and will first apply the Producer Offset against any tax liabilities of the EPC before refunding the balance.

Under what Circumstances will the Producer Offset not be Available?

A company will not be entitled to the Producer Offset when:

- a deduction has been claimed in respect of the film under Division 10B;
- a final certificate for the film has been issued under Division 10BA;
- a certificate for the film has been issued for the Location Offset or the PDV Offset (as the tax offsets available under the Australian Screen Production Incentives are mutually exclusive);
- any person has deducted monies paid for shares in a film licensed investment company under Subdivision 375-H of the Act and that company has invested in the film; or
- production assistance (other than development assistance) for the film has been received before 1 July 2007 from the FFC, Film Australia, the Australian Film Commission or the Australian Film, Television and Radio School.

Appendix

Inclusions

The following expenditures are QAPE and should be included in the applicant company's audited expenditure statement:

- 1 Australian development expenditure;
- 2 Australian copyright acquisition;
- 3 insurance (other than forms of insurance which constitute financing);
- 4 Australian business overheads which are indirectly attributable to the production of the film;
- 5 publicity and promotion expenditure (provided they do not fall within the categories set out below);
- 6 residuals (provided they are paid out to cast members (or non-cast members who have worked on the film for more than 2 consecutive weeks) before completion of the production, and the payment relates to production activities in Australia);
- 7 depreciating assets;
- 8 additional audio-visual material;
- 9 legal costs (of Australian law firms);
- 10 travel to Australia;
- 11 freight costs for goods to be used in making the film;
- 12 expenditure incurred in other countries (subject to specific criteria);
- 13 fringe Benefits Tax and State payroll tax; and
- 14 remuneration other than by salary.

Exclusions

The following types of expenditure are specifically excluded from production expenditure and QAPE:

- 1 financing expenditure (including forms of insurance which constitute financing and specifically, completion bond fees);
- 2 foreign development expenditure;
- 3 foreign-held copyright acquisition;
- 4 publicity and promotion expenditures, where expenditure creates copyright which is held by a non-Australian resident or is incurred after the project is completed;
- 5 deferrals and profit participations;
- 6 residuals (unless paid out by the EPC before production is complete);
- 7 advances in respect of deferrals, profit participations or residuals (unless these are recoverable from the payee - if the payment is non-recoverable the advance can be included as QAPE as it is not related to the film's performance or earnings);
- 8 acquisitions of depreciating assets; and
- 9 distribution and promotion of the film.

In addition, the following expenditures are specifically excluded from QAPE:

- 1 expenditure while the applicant company is a foreign resident;
- 2 costs of services embodied in goods, where the service was performed outside Australia;
- 3 gratuities and entertainment expenses;
- 4 expenditure incurred in other countries; and
- 5 remuneration, travel expenses and per diems for non-cast members who are in Australia for less than two weeks.

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