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KPMG LLP’s (KPMG) Film Financing and Television Programming: A Taxation Guide, now in its sixth edition, is a fundamental resource for film and television producers, attorneys, tax, and finance executives involved with the commercial side of film and television production. The guide is recognized as a valued reference tool for motion picture and television industry professionals. Its primary focus is on the tax and business needs of the film and television industry with information drawn from the knowledge of KPMG International’s global network of media and entertainment Tax professionals.

KPMG published the first guide more than 15 years ago as a resource for global coverage of incentives and tax updates as they apply to the film and television industry. Subsequent editions expanded into coverage of financing techniques, credits/incentives, and a thorough appendix of withholding tax rates—a valuable reference tool for all finance and tax professionals.

Each chapter of the sixth edition focuses on a single country and provides a description of commonly used financing structures in film and television, as well as their potential commercial and tax implications for the parties involved. Additionally, the United States chapter focuses on both federal and state incentives, highlighting the states that offer the more popular and generous tax and financial incentives. Key sections in each chapter include:

**Introduction**
A thumbnail description of the country’s film and television industry contacts, regulatory bodies, and financing developments and trends.

**Key Tax Facts**
At-a-glance tables of corporate, personal, and VAT tax rates; normal non-treaty withholding tax rates; and tax year-end information for companies and individuals.

**Financing Structures**
Descriptions of commonly used financing structures in film and television in the country and the potential commercial tax implications for the parties involved. The section covers rules surrounding co-productions, partnerships, equity tracking shares, sales and leaseback, subsidiaries, and other tax-effective structures.

**Tax and Financial Incentives**
Details regarding the tax and financial incentives available from central and local governments as they apply to investors, producers, distributors, and actors, as well as other types of incentives offered.

**Corporate Tax**
Explanations of the corporate tax in the country, including definitions, rates, and how they are applied.
Personal Tax
Personal tax rules from the perspective of investors, producers, distributors, artists, and employees.

Appendices
Additionally, withholding tax tables setting forth the non-treaty and treaty-based dividend, interest, and film royalty withholding tax rates for the countries surveyed are included as an appendix and can be used as a preliminary source for locating the applicable withholding rates between countries.

KPMG and Member Firm Contacts
References to KPMG and KPMG International member firm contacts at the end of each chapter are provided as a resource for additional detailed information.

The sixth edition of KPMG’s Film and Television Tax Guide is available in an online PDF format at www.kpmg.com/filmtax and on CD. The guide is searchable by country.

Please note: While every effort has been made to provide up-to-date information, tax laws around the world are constantly changing. Accordingly, the material contained in this book should be viewed as a general guide only and should not be relied upon without consulting your KPMG or KPMG International member firm Tax advisor.

Finally, we would sincerely like to thank all of the KPMG International member firm Tax professionals from around the world who contributed their time and effort in compiling the information contained in this book and assisting with its publication. Production opportunities are not limited to the 35 countries contained in this guide. KPMG and the other KPMG International member firms are in the business of identifying early-stage emerging trends to assist clients in navigating new business opportunities. We encourage you to consult a KPMG or KPMG International member firm Tax professional to continue the conversation about potential approaches to critical tax and business issues facing the media and entertainment industry.

Thank you and we look forward to helping you with any questions you may have.

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January 2012
Chapter 06
China and Hong Kong SAR

Introduction – China
In China, the government traditionally monopolizes the film industry so that only state-owned film studios may engage in the production and distribution of films. However, with China’s accession to the World Trade Organization (WTO), the restrictions over film production and distribution are being slowly relaxed.

China became a member of the WTO at the end of 2001, but it did not make any commitments to open up the film production sector to foreign investors. However, China has undertaken to import 20 films a year for release on a revenue-sharing basis immediately after its accession to the WTO. This may expose state-owned film studios to greater competition.

The film industry is regulated by the State Administration of Radio, Film, and Television (SARFT). To promote the film industry, SARFT issued the Provisional Rules on Operation Qualifications for Entry into Film Production, Distribution, and Exhibition (“Film Market Entry Rules”) on October 29, 2003, which was later superseded by a revised version on November 10, 2004. According to this set of rules, effective December 1, 2003, foreign investors may incorporate a film production company in the form of an equity joint venture or cooperative joint venture with China film production companies. However, the investors are required to have controlling interests in the equity joint venture or cooperative joint venture.

Warner China Film HG Corporation, incorporated in December 2004, was the first China-foreign equity joint venture established in China for film production. However, the attempt to allow foreign investment in film production was suspended very shortly. In July of 2005, the PRC Ministry of Culture, SARFT and several other government agencies jointly issued a circular, Opinions on Foreign Investment in Culture Related Areas (“Opinions”), which prohibits foreign investors from establishing or investing in film production companies in China. The prohibition of foreign investment in the film production industry is re-emphasized under the prevailing National Foreign Investment Catalogue Guide which provides guidance on the industries that encourage, restrict, or prohibit foreign investments under the current Chinese regulatory framework. As a result, foreign investors may only participate in the co-operation of films with Chinese film production companies on a project basis, and the majority of the co-operations are in the form of Joint Production, Assisted Production or Contracted Production.
Foreign investments are also prohibited in the China film distribution industry, with the exception of Hong Kong and Macau investors which are permitted to establish wholly owned subsidiaries in China for the distribution of China-made films, owing to the Supplementary Provisions to the Film Market Entry Rules issued by the SARFT on March 7, 2005 and effective from January 1, 2005.

Currently, the production, distribution, releasing/showing, importation and exportation of films in China are subject to approval by the relevant authorities, mainly the SARFT.

### Key Tax Facts

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest effective corporate income tax rate</td>
<td>25%</td>
</tr>
<tr>
<td>Highest personal income tax rate</td>
<td>45%</td>
</tr>
<tr>
<td>Business Tax</td>
<td>Generally 5%</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>Generally 17%</td>
</tr>
<tr>
<td>Normal non-treaty withholding tax rates: Dividends</td>
<td>10%</td>
</tr>
<tr>
<td>Interest</td>
<td>10%</td>
</tr>
<tr>
<td>Royalties</td>
<td>10%</td>
</tr>
<tr>
<td>Tax year-end</td>
<td>December 31</td>
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</table>

### Film Financing

**Financing Structures**

Foreign investors may participate in co-operation of films with Chinese film production companies. The main cooperation models include Joint Production, Assisted Production, and Contracted Production.

**Co-production**

Currently, film co-production projects may only be undertaken in China in one of the following manners:

- **Joint production**: The Chinese investor and foreign investor jointly participate in the funding and production of a film in China, and in the sharing of rewards and risks associated with the exploitation of the rights over the film. The production project does not constitute a separate legal person in China. Instead, it is treated as an unincorporated co-operative joint venture with the Chinese investor and the foreign investor retaining their individual identities.
• **Assisted production**: The foreign investor is solely responsible for providing the capital and carrying out the production of a film in China. The Chinese participant provides assistance by way of equipment, instruments, and labor services. The foreign investor solely enjoys the rewards and bears the risks associated with the exploitation of the rights over the film while the Chinese participant is compensated by the foreign investor for the assistance provided.

• **Contracted production**: The foreign investor is solely responsible for providing the capital. It engages a Chinese party to carry out certain production or filming in China. The foreign investor solely enjoys the rewards and bears the risks associated with the exploitation of the rights over the film while the Chinese contractor is compensated by the foreign investor for undertaking the production of the film.

Approvals from the SARFT and the relevant permit/license should be obtained for co-production of films with Chinese partners. The Chinese partner is required to apply to the SARFT on behalf of both parties for such permit/license, which is known as the “China-Foreign Film Co-production Permit”. The permit is only valid for a period of two years.

The films produced under “joint production” may be released to the public in and outside of China upon obtaining the relevant releasing permit/license issued by the SARFT. The films produced under “assisted production” and “contracted production” may be brought out of China upon approval from the SARFT.

**Partnerships**

Effective March 1, 2011, foreign companies and individuals are allowed to establish foreign invested partnerships (“FIPs”) in China in industries which do not have restrictions on foreign investments. Accordingly, such a partnership is not a feasible form for foreign investors to produce films in China.

**Limited Liabilities Companies**

There are in general three types of foreign invested limited liability companies in China, namely Wholly Foreign Owned Enterprise (“WFOE”), China-Foreign Equity Joint Venture (“EJV”), and China-Foreign Cooperative Joint Venture (“CJV”).

For production of films in China, foreign investors are not allowed to set up a wholly owned subsidiary, i.e., WFOE, for such activities. The Film Market Entry Rules issued in the year 2004 by the SARFT allow foreign investors to establish EJV or CJV with China film production companies which are required to have the controlling interests of at least 51% of the registered
capital of the EJV or CJV. However, the Opinions subsequently issued by the SARFT and several other government authorities in 2005 and the prevailing Foreign Investment Guide Catalogue prohibit the establishment of any foreign invested film production companies in China, including EJV and CJV. With regard to film distribution, foreign investors are prohibited from setting up or investing in film distribution companies in China, with the exception of Hong Kong and Macau investors who are allowed to establish wholly owned subsidiaries in China for distribution of China-made films.

Other Financing Considerations

Exchange Controls and Regulatory Rules
China is a foreign exchange controlled country, and any funds coming into and going out of China are subject to approval by the China State Administration of Foreign Exchange (“SAFE”) and their designated banks. Companies or individuals in China are generally required to submit certain documents to the SAFE or banks to obtain such approval.

Subject to approval from the SAFE or the banks, foreign investors may be allowed to remit funds to and open bank accounts in China for co-production of films with Chinese partners. In addition, foreign investors should also be able to receive distribution or box office income from China provided the relevant China taxes have been duly settled.

Corporate Taxation

Chinese Resident Enterprises

General
A China resident enterprise is liable for Corporate Income Tax (CIT) on its worldwide income. A China resident company for CIT purposes is defined as one which is incorporated in mainland China or has its effective management in mainland China if it is incorporated outside of mainland China.

Taxable income is calculated as the excess of revenue over deductible expenses. Tax losses may be carried forward for up to five years. Taxable income/losses are generally calculated on an accrual basis.

The standard CIT rate is 25 percent. A reduced income tax rate of 15 percent is available for companies that are engaged in developing technologies that support cultural industry and are recognized as high-tech companies by the relevant government authorities.

Certain enterprises in cultural industries are allowed to claim additional deduction on the research and development expenses for developing new technology, new products and new processes.
Filing
Resident enterprises should file provisional CIT returns on a quarterly basis or in rare cases, on a monthly basis. In addition, enterprises are also required to file an annual reconciliation based on the audited financial statements.

Taxpayers with branches should calculate their taxable income and CIT liabilities on a consolidated basis, however, the head office and the branches should in general each file a separate monthly or quarterly provisional return and settle provisional CIT liabilities on a pro rata basis to their respective tax authority.

The monthly or quarterly provisional CIT returns should be filed and tax funds paid within 15 days after the end of a calendar month or quarter. Annual CIT reconciliation/return should be filed and the remaining tax funds for the year settled within five months after the end of a calendar year.

Non-Chinese Resident Enterprises
Non-resident enterprises should in principle only be liable for China CIT on China sourced income, for example royalties and dividends paid by Chinese resident enterprises. Where a foreign company carries out co-production of films in China, the foreign company may be liable for the China CIT on the relevant business profit if it is regarded as having a permanent establishment (PE) in China by virtue of the production activities carried out in China.

Amortization of Expenditure

Deduction and Amortization of Expenses
Taxpayers should be able to claim deductions on expenses provided that the expenses are incurred in the ordinary course of business of the taxpayers and the amounts are reasonable. In addition, the expenses shall be substantiated by valid official tax invoices which for the expenses incurred in China are called “Fa Piao”. There are limits on the deduction of certain expenses such as, entertainment expenses, advertising, and promotion expenses, and staff welfare expenses. Provisions for expenses such as bad debts and inventory impairments are generally not deductible for CIT purposes.

Depreciation charges on fixed assets are generally based on the minimum useful life provided under the CIT regulations, which generally range from 3 to 20 years depending on the nature of the assets. Taxpayer may determine reasonable residual value of an asset. The straight-line depreciation method is generally adopted. Accelerated depreciation is allowed for certain types of fixed assets.
Intangible assets such as patent rights, proprietary technology, trademark rights, copyright, and land use rights should be amortized using a straight-line method over their useful lives or period of use. The amortization period for an intangible asset regarded as an investment is the period of use specified in the relevant contract or agreement. Other intangible assets for which there is no set period of use or which are developed by the enterprise itself must be amortized over a period of at least 10 years. Film rights are the same as a copyright. Accordingly, costs incurred in connection with the production of a film should be capitalized as intangible assets and then be amortized when the film is exploited.

From 1 September 2009 to 31 December 2013, a publishing or distribution company may claim deductions for CIT purposes on the costs of the audio-visual products, electronic publications and transparencies (including microfilm products) which have an turnover of more than two years.

Related party transactions have to be carried out at arm’s-length. Cost sharing arrangement concerning the development or transfer of intangible assets as well as shared services are permitted under the arm’s length principle. It is possible to obtain an Advance Pricing Agreement from the tax bureau. The tax bureau is entitled to make any necessary transfer pricing adjustments. Taxpayers must prepare and maintain transfer pricing documentation, some portions of which must be contemporaneous, with the annual tax filing.

**Losses**

Tax losses may be carried forward for up to five years.

**Withholding Tax**

Non-resident enterprises are generally liable for the China WHT at 10 percent on certain China sourced passive income, such as dividends, loan interests, royalties, etc. Certain tax treaties provide for a reduced WHT rate on certain types of income.

Where a foreign investor transfers film exploitation rights developed in a co-production in China to a Chinese resident, the foreign investor is liable for China WHT on the proceeds received for the transfer. Where the rights are effectively connected with a PE of the foreign investor then such proceeds will have to be taken into account in computing the profits attributable to the PE.
Foreign Tax Relief

Chinese resident enterprises are generally entitled to a foreign tax credit on the foreign income tax paid related to foreign sourced income to the extent of the amount of Chinese tax that would have been paid had the income been earned in China. Any excess credit may be carried forward for up to five years.

Indirect Taxation

Business Tax

Companies and individuals, including foreign companies, that provide services (other than repair and processing services) and transfer intangible assets/immovable properties in China are liable for Business Tax (BT). BT rates range from 3 to 20 percent depending on the nature of the BT taxable activities, with 5 percent being the most applicable rate.

Transfer of rights for film distribution and television transmission in China falls within the category of transfer of intangible assets in China and will be subject to a 5 percent BT. From 1 January 2009 to 31 December 2013, qualified enterprises in film industries can enjoy BT exemption on revenue derived from the transfer of film copyrights, film distribution and box office income earned in rural areas.

BT returns are generally filed and tax funds settled either within 15 days after the end of a calendar month or 15 days after the end of a calendar quarter.

Value Added Tax (VAT)

Companies and individuals that sell goods in China, import goods into China or provide processing of services or repair services in China are liable to charge VAT. The standard VAT rate is 17 percent.

From 1 January 2009 to 31 December 2013, qualified enterprises in film industries are exempt from VAT on distribution of film copies.

Local Surcharges

Local surcharges are government charges imposed on BT and VAT taxpayers and calculated at a certain percentage of the BT or VAT liabilities. Effective from 1 December 2010, foreign invested companies and non-resident companies that are liable for BT and VAT are also liable for local surcharges.
The general local surcharges include Urban Maintenance and Construction Tax, Education Levy, and Local Education Levy which in total is generally 12 percent of the BT or VAT liabilities. In addition, some cities also charge other types of surcharges.

**Customs Duties**

The importation of audiovisual products should be subject to prior approval of relevant authorities.

The importer of audiovisual products is subject to VAT at 17 percent and import duty at the applicable rate. Import VAT and duty are collected by the Chinese customs authorities at the time of importation. Import duty is based on the c.i.f value of the imported goods, while VAT is based on the aggregate of the c.i.f value and import duty. The import duty rates depend on the international tariff codes and country/territory of origin of the imports. Import duty and VAT are payable within 15 days of import declaration.

From 1 January 2009 to 31 December 2013, imports of self-used equipment, accessories and spare parts that cannot be made in China for production of key cultural products are exempted from Customs Duty.

For 2011, the following customs duty rates apply to the relevant goods imported from Most Favored Nations:

<table>
<thead>
<tr>
<th>Product Description</th>
<th>Duty Rate</th>
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<tbody>
<tr>
<td>Exposed and developed cinematographic film</td>
<td>5% for 35 mm or wider or otherwise 4%</td>
</tr>
<tr>
<td>Exposed but not developed cinematographic film</td>
<td>6.5%</td>
</tr>
<tr>
<td>Undeveloped color cinematographic film</td>
<td>RMB9/m2 for 35mm or narrower or otherwise RMB13/m2</td>
</tr>
<tr>
<td>Blank videotapes</td>
<td>Zero-rated</td>
</tr>
<tr>
<td>Recorded videotapes</td>
<td>6% (2011 temporary rate) for reproducing sound or image, or otherwise zero-rated</td>
</tr>
<tr>
<td>Blank video discs</td>
<td>Zero-rated</td>
</tr>
<tr>
<td>Recorded video discs</td>
<td>Zero-rated</td>
</tr>
</tbody>
</table>
The c.i.f value basically covers all the payments incurred up to the point of landing on the customs territory of China, including royalties for intellectual properties which are contained in or connected with the imported goods. The c.i.f value should be based on the actual transaction price of the imports subject to verification of the PRC customs authorities. Where there is a “special relationship” between the overseas supplier and the importer, the customs authorities may seek to adjust the transaction price accordingly in arriving at the c.i.f value to help ensure that the correct value is used.

Effective from January 1, 2004, equipment, appliances, and materials imported for filming are eligible for VAT and customs duty exemption provided that they will be exported within six months after importation and the taxpayer makes a deposit equivalent to the VAT payable at Customs.

**Personal Taxation**

Effective from September 1, 2011, a new IIT Law provides various changes to the existing provisions and its main aim is to reduce the IIT burden for medium-low income earners and increase the IIT burden for high income earners. The main changes of the new IIT Law include the change of the income tax bracket for a certain tax rate, the increase of the standard monthly expense deductions for Chinese national employees, and the extension of IIT filing and payment due date.

**Resident Status**

An individual is a resident in China for Individual Income Tax (IIT) purposes if:

- He or she habitually resides in China because of household registration, family ties or economic reasons, or
- He or she resides in China for a full tax year

The term “habitually resides” is a legal criterion for determining whether an individual has residence or not, and it does not refer to “actually resides” or the place where he resides for a specified period of time. If an individual resides outside China for a reason such as studying, working, visiting of family, and traveling, and must return to China to reside at the conclusion of the period, China is the place where he or she habitually resides.
An individual is considered to have resided in China for a full tax year in the year concerned if his or her absence from China during the year does not exceed 30 days consecutively or 90 days in the aggregate.

IIT returns are generally filed and tax funds settled within seven days after the end of a calendar month. Under the new IIT Law, the due date is extended to fifteen days after month-end.

**Artists (Self-employed)**

**IIT Implications**

An artist’s income derived from his or her professional services will be considered as “personal service income” for IIT purposes. Accordingly, the individual will be taxed at progressive rates ranging from 20 to 40 percent. If the individual’s monthly income is less than RMB4,000 (US$621), RMB800 (US$124) may be deducted when calculating the taxable amount. If the individual’s monthly income is RMB4,000 (US$621) or more, 20 percent of the total remuneration may be deducted in determining the taxable amount.

A payer making a payment to an artist in respect of a performance in China is obligated to withhold and pay IIT to the Chinese tax authorities, regardless of whether the artist is a Chinese resident or not. Where the payer is not a Chinese entity or individual, the authorities may have to rely on voluntary disclosure by the artist.

**Non-Resident Artists**

Subject to the relevant double tax treaties between China and the resident country of the artists, China may have the taxing rights on the income derived by artists for their services/performances carried out in mainland China.

**Resident Artists**

A China resident artist is liable for IIT on the worldwide income. The individual may claim foreign tax credit on foreign sourced income to the extent of the amount of IIT that would have been paid had the income been earned in China.
Employees

**IIT Implications**

An individual’s income derived from employment services in China will be considered as “salaries and wages” for IIT purposes. The IIT rates operate on a progressive basis from 5 to 45 percent. Foreign nationals are entitled to a monthly deduction of RMB 4,800 (US$745) while the monthly deduction for Chinese nationals is RMB 2,000 (US$310). Under the new IIT Law, which is in effect as of September 1, 2011, the monthly expense deduction for Chinese nationals is increased to RMB 3,500 while that for foreign nationals remain unchanged. An employer in China is obliged to withhold IIT payable by individuals, whether they are Chinese or foreign nationals, to whom it makes payments, including salaries, rent, and commissions.

A foreign national may be exempt from IIT on “salaries and wages” earned in China if, among other conditions, he or she is present in China not more than 90 days or, if a tax treaty applies, 183 days in a calendar year or equivalent period. In addition, for a foreign national residing in China for a full tax year, whereby being a tax resident in China and taxed on worldwide income, the current IIT law and regulations provide tax relief on the individual’s overseas paid employment income to the extent relating to the number of days of services provided in China until he or she is considered to have resided in China for a consecutive five full tax years.

**Social Security Implications**

From July 1, 2011, the Social Insurance Law becomes effective. Based on this law, both Chinese and foreign national employees should participate in the China social insurance schemes. However, the law does not provide details on how foreign national individuals should participate.

In general, both employers and employees are required to make contributions to the social insurance schemes which principally include pension/retirement, unemployment, medical care, industrial injuries, and maternity. The bases and rates of contributions vary from city to city. Generally, the contributions for the above principal schemes are up to 49.5 percent of the base.
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**Introduction – Hong Kong SAR**

There are no specific provisions contained in the Inland Revenue Ordinance (IRO) that deal with the taxation of profits derived from the film industry. As such, the general taxing provisions apply. A brief discussion of these provisions is provided below, focusing on the provisions relevant to the film industry.

**Key Tax Facts**

<table>
<thead>
<tr>
<th>Tax Fact</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate income tax rate – flat rate</td>
<td>Companies: 16.5%</td>
</tr>
<tr>
<td></td>
<td>Highest personal income tax rate: 17% */ 15% **</td>
</tr>
<tr>
<td>Normal non-treaty withholding tax rates:</td>
<td>Dividends: 0%</td>
</tr>
<tr>
<td></td>
<td>Interest: 0%</td>
</tr>
<tr>
<td></td>
<td>Royalties: See “Withholding Tax” section of this chapter</td>
</tr>
<tr>
<td></td>
<td>Tax year-end: Companies: Accounting year-end</td>
</tr>
<tr>
<td></td>
<td>Tax year-end: Individuals: March 31</td>
</tr>
</tbody>
</table>

* Highest progressive rate of tax  
** Standard rate of tax

Tax charged shall not exceed the standard rate of tax applied to the net income without personal allowances

**Film Financing**

**Financing Structures**

Various mechanisms for film financing are feasible. These include the provision of funds by way of share capital or loan finance (or a mixture of both) to a company, the creation of joint ventures involving companies and/or individuals, and the establishment of partnerships involving companies and/or individuals. The choice of structure in any particular case normally depends on the particular circumstances of that case, and it is usually possible to create a structure that meets both the commercial and tax objectives of the parties.
Co-production
Two or more parties may enter into a joint venture agreement to co-produce a film or, alternatively, to produce and/or finance a film whereby typically the rights to exploit the film are divided amongst the parties. The existence of a joint venture agreement does not necessarily mean that a partnership or profit sharing arrangement exists. The joint venture itself is not normally taxable. Rather, each party to the joint venture must consider its role in the venture to assess its particular tax position.

Partnership
Two or more parties may come together to produce and exploit a film in partnership. Partnerships in Hong Kong can have both limited and general partners. A partnership is taxable on its profits. Restrictions are, however, placed upon the use of losses in partnerships. Neither general nor limited partners can offset losses derived from their participation in one partnership against profits derived from their participation in another partnership. However, partnership losses can be offset against other income derived by the partners in their own right. In addition, a limited partner’s share of a loss in a partnership is broadly limited to the limited partner’s capital contribution.

Limited Liability Company in Hong Kong/Branch of a Foreign Company
A limited liability company or a branch of a foreign company could be established in Hong Kong to produce and exploit a film. If a branch of a foreign company establishes a “place of business” in Hong Kong, the branch must register with the Registrar of Companies under Part XI of the Hong Kong Companies Ordinance.

Equity Tracking Shares
These shares (typically known as preferred or preference shares) provide for dividend returns which are dependent on the profitability of a film production company’s business. The investor acquires such shares in the production company. These shares have the same rights as the production company’s ordinary shares except that the dividends are profit-linked and have preferential rights to the assets in the event of the liquidation of the company.

Regardless of the place of incorporation of the production company, dividends received on equity tracking shares are exempt from Hong Kong Profits Tax in the same way as dividends earned on ordinary shares.
Yield Adjusted Debt
A film production company may issue a “debt security” to investors. Its yield may be linked to the revenue from specific films. The principal would be repaid upon maturity and there may be a low (or even nil) rate of interest stated on the debt instrument. However, at each interest payment date, a supplemental (and perhaps increasing) interest payment may be paid where a predetermined target is reached or exceeded (such as revenues or net cash proceeds).

For Hong Kong Profits Tax purposes, this “debt security” would be classified as debt. The assessability and deductibility of the interest payments on the debt security would be determined based upon the rules for assessability and deductibility as outlined below.

Other Financing Considerations

Exchange Controls and Regulatory Rules
There are no specific exchange controls or regulatory rules restricting currency movements in Hong Kong. There is therefore nothing to prevent a foreign investor or artist from repatriating income arising in Hong Kong back to his or her home territory.

Corporate Taxation

Hong Kong Profits Tax

Assessable Profits
Hong Kong operates a “territorial” system of taxation. Generally, there is no distinction between resident and non-resident companies in terms of the liability to Hong Kong Profits Tax.

The law governing the imposition of Profits Tax is contained in the Inland Revenue Ordinance (IRO) and its subsidiary legislation, the Inland Revenue Rules. A “person” will be chargeable to Profits Tax in respect of his or her “assessable profits” if:

- the profit arises from a trade, profession, or business carried on by the person in Hong Kong; and
- the profit arises in or is derived from Hong Kong, unless the profit arises from the sale of a capital asset.

“Person” is defined to include a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.
Carrying on Business in Hong Kong

The question of whether a company is carrying on business in Hong Kong is a question of fact. In practice, a company is considered to be carrying on a business in Hong Kong if it has an office, a place of business, or where part of its business activities are undertaken in Hong Kong. If a company is regarded as carrying on business in Hong Kong, the profits from that business will be subject to Profits Tax unless they are considered to be “offshore” sourced or specifically exempt from tax (e.g., dividends and capital gains).

Source of Profits

Whether profits are sourced in Hong Kong is a question of fact. Case law indicates that the broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. For example, this principle was considered in the case of CIR v HK-TVB International Limited (1992) (1 HKRC 90-064) in relation to the source of profits arising from the sublicensing of rights to films. This case concerned a Hong Kong based company that acquired non-Hong Kong rights to films from its parent company that produced the films. The rights were then sublicensed to unrelated television stations and film distributors outside Hong Kong. Although the sublicensees were located outside Hong Kong, the substance of the work performed to earn the profits was undertaken in Hong Kong, and it was held that the profits were Hong Kong sourced and taxable.

The Inland Revenue Department’s (IRD) current views on the source of various types of profits (e.g., trading profits, service fees and commission income) are published in a non-binding statement of practice, “Departmental Interpretation and Practice Notes No. 21 (Revised)” in December 2009.

Treatment of Dividends

Dividends received from a corporation whose profits are chargeable to Profits Tax are exempt from tax. Hong Kong does not have an imputation system.

Amortization of Expenditure

Deduction of Expenses

Subject to any specific provisions, expenses are only deductible to the extent they are incurred in the production of the taxpayer’s assessable profits for any period and they are not capital in nature. However, certain types of expenses are specifically deemed to be deductible, notwithstanding that
they may be of a capital nature (e.g., expenditure incurred to acquire patent rights). Deductions are allowed for the following items which are generally relevant to the film industry:

• Certain interest and related costs on money borrowed for the purpose of producing assessable profits (see further below)
• Rent paid for premises occupied for the purpose of producing assessable profits
• Bad and doubtful debts provided the debts were included in the taxpayer’s assessable profits and that they can be proven to have become bad; and debts in respect of money lent in the ordinary course of the business of lending of money within Hong Kong by a person who carries on a money lending business
• Depreciation allowances
• Expenditure on plant and machinery used for specified manufacturing activities and computer hardware and software are fully deductible in the year the expenditure was incurred
• Expenditure on the renovation or refurbishment of a commercial building is allowed as a deduction on a straight-line basis over a five-year period
• Cost of repairing premises, plant, machinery, implements, utensils or articles used in the production of the taxpayer’s assessable profits and the cost of the replacement of any implements, utensils or articles provided that no claims were previously made for depreciation allowances
• Subject to specific limitations, the cost of registering a patent, design, or trademark for use in Hong Kong in the production of the taxpayer’s assessable profits. This would not cover the cost of acquiring film rights
• Expenditure on environmentally friendly machinery and equipment is fully deductible in the year the expenditure is incurred
• Expenditure on environmentally friendly installations ancillary to buildings is allowed as a deduction on a straight-line basis over a five-year period

There are no specific provisions in the IRO that deal with the deductibility of costs incurred to produce or acquire a film. In addition, the IRD has not published any guidelines stating how they would treat such expenditures for Hong Kong Profit Tax purposes. Therefore, there is a technical risk that the IRD may consider such expenditures to be capital in nature and non-deductible.
**Deductions for Interest and Related Borrowing Costs**

A deduction for interest will be allowed where the interest is incurred on money borrowed for the purpose of producing the taxpayer’s assessable profits and at least one of the six specified conditions in the IRO is met. In particular, the interest was paid on money borrowed:

1. By a financial institution
2. By specified public utility companies, at rates of interest notified from time to time
3. From a person (other than a financial institution) who is subject to Hong Kong Profits Tax on that interest
4. From a financial institution either in Hong Kong or overseas
5. Wholly and exclusively to finance:
   i. A capital expenditure incurred on the provision of machinery or plant that qualifies for depreciation allowances for profits tax purposes
   ii. The purchase of trading stock which is used in the production of profits chargeable to Profits Tax provided the lender is not associated or connected with the borrower
6. Through the issue of certain publicly quoted debentures and certain commercial paper

In relation to conditions (3), (4), and (5) mentioned above, specific anti-avoidance provisions have been introduced with effect from June 25, 2004 which preclude a deduction from being claimed for interest on a loan which is secured by either a deposit or a loan made by the taxpayer (or an associate) and the interest on the loan or deposit is not subject to Hong Kong Profits Tax. Where the loan is partly secured by “tax-free deposits or loans;” the interest deduction will be apportioned on a “most reasonable and appropriate” basis, depending on the circumstances of the case.

In addition, the deduction for interest under conditions (3), (4), (5), and (6) mentioned above are also subject to what is commonly referred to as an “interest flow-back test.” Under this test, interest is not deductible where there is an arrangement in place between the borrower and lender whereby the interest is ultimately paid back to the borrower or a person connected
A connected person is defined as an associated corporation or a person who controls the borrower, or who is controlled by the borrower, or who is under the control of the same person as the borrower.

A partial deduction for interest is permitted where the interest only partially flows back to the borrower, but only in proportion to the number of days during the year in which the arrangement is in place. The test does not apply where the interest is payable to an “excepted person” which is defined to include: a person who is subject to tax in Hong Kong on the interest; a financial institution or an overseas financial institution; a retirement fund or collective investment fund in which the borrower or an associate has an interest; and a Government owned corporation.

Withholding Tax
Hong Kong does not currently impose any withholding tax. Accordingly, there is no withholding tax on interest payments or dividends paid by Hong Kong companies. While there is no withholding tax in Hong Kong per se, Hong Kong Profits Tax is imposed on amounts received by or accrued to non-resident persons:

1. From the exhibition or use in Hong Kong of any cinematography or television film, any tape or sound recording, or any advertising material connected with any of these things
2. For the use of or the right to use certain intellectual properties in Hong Kong including patents, designs, trademarks, copyright material, or secret processes or formula
3. For the imparting or undertaking to impart knowledge directly or indirectly connected with the use of any such intellectual properties in Hong Kong

Where the recipient of a royalty is not otherwise subject to Hong Kong Profits Tax, a deemed profit of 30 percent of the royalty is generally subject to Profits Tax. The normal tax rates for 2010/11 are 16.5 percent for corporations and 15 percent for other persons, which give rise to an effective withholding tax rate of 4.95 percent and 4.5 percent, respectively.

However, if the payment is made to an overseas associate and the intellectual property giving rise to the royalty payment has been wholly or partly owned by a person carrying on business in Hong Kong, 100 percent of the royalty is subject to Hong Kong Profits Tax at the rate of 16.5 percent.
Even if the subject intellectual properties are wholly used outside of Hong Kong, the royalty payments are deemed to be subject to Hong Kong Profits Tax where the payer claims a deduction in respect of the royalty payment for Hong Kong Profits Tax purposes.

**Personal Taxation**

**Artists**
Under the IRO, sums received or profits derived directly or indirectly from performance(s) in Hong Kong by an entertainer, who is not a Hong Kong resident, are generally chargeable to Hong Kong Profits Tax.

The IRO also provides that a non-resident entertainer is chargeable to Hong Kong Profits Tax in the name of the person in Hong Kong who pays or credits sums to that entertainer or his or her agent. The Hong Kong person who made the payment is responsible for (i) withholding an appropriate amount to pay the non-resident entertainer’s tax liability; (ii) completing the tax return to report the gross amount payable to the recipient; and (iii) settling the tax due with the IRD. For the above purposes, an entertainer is defined as a person who gives performances (whether alone or with other persons) in his or her character as an entertainer in any kind of entertainment including an activity in a live or recorded form which the public is or may be permitted to see or hear, whether for payment or not.

**Employees**
A separate tax, called Salaries Tax, is charged on an individual in respect of his or her income arising in or derived from Hong Kong from any office or employment sourced in Hong Kong and, in the case of employment sourced outside Hong Kong, on any income derived from services rendered in Hong Kong.

**Double tax treaty network**
Hong Kong has significantly expanded its tax treaty network with key trading partners worldwide in recent years. As of July 2011, Hong Kong has concluded 21 tax treaties and is in the process of negotiating treaties with more than 10 jurisdictions. The Hong Kong Government continues its efforts in maintaining Hong Kong as an attractive location for foreign investors. Residents of jurisdictions which have double tax treaties with Hong Kong should therefore check the relevant tax treaty agreement to assess the tax implications, if any, for their tax affairs.
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