



Film Financing and Television Programming: A Taxation Guide

Now in its seventh edition, KPMG LLP's ("KPMG") Film Financing and Television Programming: A Taxation Guide (the "Guide") is a fundamental resource for film and television producers, attorneys, tax executives, 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.

Doing business across borders can pose major challenges and may lead to potentially significant tax implications, and a detailed understanding of the full range of potential tax implications can be as essential as the actual financing of a project. The Guide helps producers and other industry executives assess the many issues surrounding cross-border business conditions, financing structures, and issues associated with them, including film and television development costs and rules around foreign investment. Recognizing the role that tax credits, subsidies, and other government incentives play in the financing of film and television productions, the Guide includes a robust discussion of relevant tax incentive programs in each country.

The primary focus of the Guide 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 member firm media and entertainment Tax professionals.

Each chapter 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. 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 production and distribution 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-efficient 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.

Digital Media

For the first time, we have included a discussion of digital media tax considerations recognizing its growing role in the distribution of film and television content.

KPMG and Member Firm Contacts

References to KPMG and other KPMG International member firms' contacts at the end of each chapter are provided as a resource for additional detailed information.

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 publication 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.

Production opportunities are not limited to the 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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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

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Introduction

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

Corporate income tax rate – flat rate	
Companies	16.5%
Highest personal income tax rate	17%*/15%**
Normal nontreaty withholding tax rates: Dividends	0%
Interest	0%
Royalties	See Withholding Tax section
Tax year-end: Companies	Accounting year-end
Tax year-end: Individuals	March 31

*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 among 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.

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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 revenue or net cash proceeds).

For Hong Kong profits tax purposes, this "debt security" would be classified as debt. The accessibility and deductibility of the interest payments on the debt security would be determined based upon the rules for accessibility 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.

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Corporate Taxation

Hong Kong profits tax

Assessable Profits

Hong Kong operates a “territorial” system of taxation. Generally, there is no distinction between resident and nonresident companies in terms of the liability to Hong Kong profits tax.

The law governing the imposition of profits tax is contained in the 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.

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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 periods 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 money-lending 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 that is fully deductible in the year the expenditure was incurred;
- Expenditure on the renovation or refurbishment of a commercial building 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 nondeductible.

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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, or
 - ii) The purchase of trading stock that is used in the production of profits chargeable to profits tax, provided the lender is not associated or connected with the borrower; or
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 that 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 with the borrower. 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

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there is no withholding tax in Hong Kong per se, Hong Kong profits tax is imposed on amounts received by or accrued to nonresident 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; or
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% of the royalty is generally subject to profits tax. The normal tax rates for 2010 – 2011 are 16.5% for corporations and 15% for other persons, which give rise to an effective withholding tax rate of 4.95% and 4.5%, 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% of the royalty is subject to Hong Kong profits tax at the rate of 16.5%.

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 nonresident 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 nonresident 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 that 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.

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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 an attractive location for foreign investors. Residents of jurisdictions that 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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